

## The Importance of the Prefiling Phase for Securities-Fraud Litigation

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*The pleading burden that governs securities-fraud litigation is significantly higher than those standards that govern traditional civil cases. The heightened pleading burden applicable to securities cases has transformed the motion to dismiss into something like summary judgment. In fact, to contend with this heightened pleading burden, plaintiffs typically must spend more time in the prefiling phase gathering sufficient, reliable evidence of securities fraud.*

*With almost two decades of litigation under the securities laws' heightened pleading burden, empirical studies are revealing that certain kinds of evidence are more likely to defeat a motion to dismiss than others. But dismissal statistics and cases are telling in another respect as well. They reveal that some forms of corroboration (SEC proceedings, accounting restatements, bankruptcies) seem more likely to help stave off dismissal than others (insider trading, inferences from shared experience, and accounts from confidential witnesses). This issue—the effective strategies for investigating and pleading securities-fraud claims—is the subject of this year's conference sponsored by Loyola University Chicago School of Law's Institute for Investor Protection.*

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## INTRODUCTION

One of the most important questions in a securities-fraud case—called by some the “main event”<sup>1</sup>—is how plausible is it that the

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1. Stephen J. Choi & Adam C. Pritchard, *The Supreme Court's Impact on Securities Class Actions: An Empirical Assessment of Tellabs 1–2* (Univ. of Mich. Law Sch. Law & Econ. Research Paper Series, Paper No. 09-016 and N.Y.U. Law Sch. Law & Econ. Research Paper Series, Paper No. 09-34, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1434561](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1434561) (“The PSLRA makes the motion to dismiss the main event in securities fraud class

plaintiffs' allegations suggest fraud at the outset and not something else? That main event is characterized by a heightened pleading burden, no access to formal discovery, and an increased probability of sanctions under Rule 11. That main event has made the prefiling phase—the time when plaintiffs seek evidence to corroborate their allegations—much more significant.

Whether the plaintiffs' allegations plausibly suggest fraud largely depends on whether they have found sufficient, reliable corroborative evidence of their allegations in the prefiling phase. This may sound intuitive as surely the more evidence to support a claim, the more reason it has to progress through the screening phases of litigation. Empirical studies and case law have begun to confirm that plaintiffs who have gathered sufficient, reliable evidence to corroborate allegations of fraud in the prefiling phase are more likely to survive dismissal. But, interestingly, dismissal statistics and case law also reveal that certain forms of corroboration—certain kinds of evidence—appear more likely to help stave off dismissal than others. That is, empirical studies and case law have begun to clarify what kinds of evidence plaintiffs should focus on in a prefiling investigation. This issue—the effective strategies for investigating and pleading securities-fraud claims—is the subject of this year's conference sponsored by Loyola University Chicago School of Law's Institute for Investor Protection.

This Article is divided into two parts that track the argument above. The first Part contends that the securities laws have moved the motion to dismiss toward summary judgment, making plaintiffs more likely to survive a motion to dismiss if they have first gathered sufficient, reliable evidence to corroborate allegations of fraud in the prefiling phase. The second Part shows that some forms of corroboration (strong forms) appear more likely to defeat a motion to dismiss than others (weak forms). These strong forms of corroboration include Securities and Exchange Commission ("SEC") proceedings, accounting restatements, and a parallel bankruptcy. The weaker forms include insider trading, inferences from shared experiences, and accounts from confidential witnesses.

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actions, effectively using the district courts as gatekeepers charged with screening out meritless class actions at an early stage, while allowing meritorious actions to proceed."); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act 4* (Univ. Mich. John M. Olin Center for Law & Econ., Working Paper No. 03-011, 2003), available at [http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1018&context=law\\_econ\\_archive](http://repository.law.umich.edu/cgi/viewcontent.cgi?article=1018&context=law_econ_archive) (characterizing the motion to dismiss as the "main event").

I. THE SECURITIES LAWS ARE GOVERNED BY A PLEADING STANDARD  
SIGNIFICANTLY HIGHER THAN THOSE STANDARDS GOVERNING  
TRADITIONAL CIVIL LITIGATION

The focus on the prefiling phase is the result of the pleading standards and procedural rules that govern securities-fraud complaints. These rules create access barriers that are significantly higher than those that govern traditional civil cases.

A. *Section 10(b) and Rule 10b-5 Represent the Predominant  
Mechanism for Investors to Seek Recovery for Fraud*

The predominant vehicle through which private investors seek relief for fraud on the market is section 10(b) of the Securities Exchange Act of 1934.<sup>2</sup> This law forbids securities fraud in violation of the rules set by the SEC.<sup>3</sup> The SEC's Rule 10b-5 prohibits fraud—by commission or omission—in connection with the purchase or sale of any security.<sup>4</sup> The predominance of this mechanism caused Chief Justice Rehnquist to famously dub the 10b-5 action as “a judicial oak which has grown from little more than a legislative acorn.”<sup>5</sup>

But the judiciary has been careful not to make a federal case out of every instance of corporate negligence<sup>6</sup> or breach of fiduciary duty where the conduct alleged is not manipulative or deceptive.<sup>7</sup> Rather, the Supreme Court has settled that section 10(b) and Rule 10b-5 are intent-based liability provisions.<sup>8</sup> The level of intent required is called “scienter” in securities lingo, and it signifies an intent to deceive, manipulate, or defraud.<sup>9</sup> According to every federal court of appeals,

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2. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2012 YEAR IN REVIEW 6 (2013), available at [http://www.cornerstone.com/files/Publication/dd449114-231a-43c5-af94-341bb14bc830/Presentation/PublicationAttachment/0f96fd68-e318-41d2-b324-30cabf8c4d9d/Cornerstone\\_Research\\_Securities\\_Class\\_Action\\_Filings\\_2012\\_YIR.pdf](http://www.cornerstone.com/files/Publication/dd449114-231a-43c5-af94-341bb14bc830/Presentation/PublicationAttachment/0f96fd68-e318-41d2-b324-30cabf8c4d9d/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf) (finding that in 2012, approximately 85% of securities-fraud complaints were Rule 10b-5 claims); ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2012 REVIEW AND ANALYSIS 11 (2013), available at [http://www.cornerstone.com/files/upload/Cornerstone\\_Research\\_2012\\_Settlements.pdf](http://www.cornerstone.com/files/upload/Cornerstone_Research_2012_Settlements.pdf) (finding that between 1996 and 2012, there were 1306 securities-fraud settlements, and 997 of which involved only Rule 10b-5 claims).

3. 15 U.S.C. § 78j (2012).

4. 17 C.F.R. § 240.10b-5 (2013); see also *Facebook, Inc. v. Pac. Nw. Software, Inc.*, 640 F.3d 1034, 1038 (9th Cir. 2011).

5. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

6. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976).

7. *Santa Fe Indus. v. Green*, 430 U.S. 462, 478–79 (1977).

8. See *Ernst & Ernst*, 425 U.S. at 193–94 (holding that allegations of scienter are necessary in a private cause of action for damages under section 10(b) and Rule 10b-5).

9. *Id.* at 193 n.12.

scienter encompasses some form of recklessness as well.<sup>10</sup> Recklessness is “a highly unreasonable omission, involving not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>11</sup>

*B. The Civil Rules Already Require Heightened Pleading for All Fraud Claims*

To craft an adequate securities-fraud complaint, plaintiffs must comply with Federal Rules of Civil Procedure 8 and 9, as well as the pleading requirements and other standards of the Private Securities Litigation Reform Act of 1995 (“PSLRA”).<sup>12</sup>

Rule 8 is the baseline. Its federal notice-pleading standard requires a complaint to contain “a short and plain statement of the claim showing that the pleader is entitled to relief.”<sup>13</sup> According to the Supreme Court, a complaint must plead sufficient facts to “raise a right to relief above the speculative level” and “state a claim to relief that is plausible on its face.”<sup>14</sup> Determining whether a complaint meets this standard requires that the court engage in a “context-specific” inquiry and “draw on its judicial experience and common sense.”<sup>15</sup> Generally, “[a] claim has facial plausibility when the pleaded factual content allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.”<sup>16</sup>

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10. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3 (2007).

11. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977) (internal quotations omitted). Although the federal appellate courts have couched their recklessness standards differently, the application among the circuit courts of appeals tends to converge on whether there is an extreme departure from the standards of ordinary care presenting a danger of misleading investors that is either known to the defendant or so obvious that the actor must have been aware of it. Ann Morales Olazábal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud*, 2010 WIS. L. REV. 1415, 1424–25; Ann Morales Olazábal, *The Search for “Middle Ground”: Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act’s New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153, 162–64 (2001).

12. *See, e.g., FindWhat Investor Grp. v. FindWhat.com*, 658 F.3d 1282, 1296 (11th Cir. 2011) (noting that “[t]o survive a motion to dismiss, a claim brought under Rule 10b-5 must satisfy (1) the federal notice pleading requirements; (2) the special fraud pleading requirements found in Federal Rule of Civil Procedure 9(b), . . . and (3) the additional pleading requirements imposed by the Private Securities Litigation Reform Act of 1995” (internal citation omitted)).

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

14. *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555, 570 (2007); *see also Ashcroft v. Iqbal*, 556 U.S. 662, 680 (2009).

15. *Iqbal*, 556 U.S. at 679.

16. *Id.* at 663.

But cases of fraud present unique concerns, concerns that the drafters of the Federal Rules accept as absent from other kinds of cases. First, tarnishing someone's reputation with an allegation of fraud is easy, so easy, in fact, that plaintiffs may be tempted to bring bogus claims of fraud and defendants may be pressured to settle these claims rather than have their reputations publicly sullied.<sup>17</sup> Second, "fraud" is such a general category of misconduct that without particularized claims, the defendant may not have adequate notice of the real claim at issue, and the plaintiff may be able to defeat a motion to dismiss by generally alleging fraud and then proceeding to discovery to attempt to uncover whether fraud actually occurred.<sup>18</sup>

So, to discourage plaintiffs from filing meritless claims and to expose to the public claims of fraud that have no basis, Rule 9(b) requires a securities-fraud plaintiff to "state with particularity the circumstances constituting [the fraud]."<sup>19</sup> That is, investors have to plead the facts surrounding the fraud in advance: "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent."<sup>20</sup> But Rule 9(b) recognizes that our mind-reading capabilities are non-existent, that actually describing a mental state with precision is a trying feat, and that to come close to actually doing so on paper would require a level of wordiness inconsistent with Rule 8's calling for short and plain statements.<sup>21</sup> Thus, as a pleading rule, plaintiffs may allege the defendant's state of mind generally.<sup>22</sup>

Even with Rule 9(b)'s exception for state of mind, Rule 9(b) is still a significant pleading burden, namely because there is no fraud by hindsight.<sup>23</sup> As explained by the Ninth Circuit in *In re GlenFed, Inc. Securities Litigation*, there is no reason to assume that what is true at the moment of the discovery of the alleged fraud was also true at the time

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17. 5A CHARLES W. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1296 (3d ed. 2013).

18. *Id.*

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

20. *See, e.g.*, Romach v. Chang, 355 F.3d 164, 170 (2d Cir. 2004) (internal quotation omitted).

21. WRIGHT & MILLER, *supra* note 17, § 1301.

22. *See* FED. R. CIV. P. 9(b) ("Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally."); *see also* Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1252 (10th Cir. 1997) (stating the rule does not require particularity in connection with the condition of mind), *superseded by statute*, Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

23. *See, e.g.*, Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993) ("A statement cannot be fraudulent if it did not affect an investment decision of the plaintiff."); Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978) (requiring falsity at the time reports are issued).

of the alleged misrepresentation.<sup>24</sup> Indeed, between the time when a firm announces something to public investors and the time some sobering truth is revealed and the company's stock price drops, any number of events could have occurred that explain the difference between an earlier, cheerier statement and a later, less-rosy picture. Between an alleged misstatement and a drop in stock price, there may be a general decline in the stock market, a specific decline in the market for the defendant-firm's industry, a shift in consumer demand, a new competitor, a major lawsuit, an internal reevaluation of assets or recalculation of loan-loss reserves, etc.<sup>25</sup>

The point is that the mere fact that an allegedly fraudulent statement and a later statement are different does not mean that the earlier statement was false. Thus, even though plaintiffs may allege the defendant's state of mind generally, to suggest any culpable state of mind at all, plaintiffs must explain why the public statements were false *when made*, which often (though not always) depends on a showing that internal company information was inconsistent with contemporaneous public statements.<sup>26</sup>

It is important to emphasize that this common-law rule for pleading under Rule 9 developed in the shadow of plaintiffs' access to such internal information through discovery.<sup>27</sup> Plaintiffs had access to internal company information through the discovery provisions of the Federal Rules, and if they did not have the requisite internal information when they filed their complaint, they could revise and replead their

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24. 42 F.3d 1541, 1548 (9th Cir. 1994) (en banc), *superseded by statute*, Private Securities Litigation Reform Act of 1995, 109 Stat. 737.

25. *Id.*; see also *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 342–43 (2005) (“When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. (The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been—a claim we do not consider here.) Other things being equal, the longer the time between purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the loss.”).

26. See, e.g., *In re GlenFed*, 42 F.3d at 1548; see also *Shields v. Citytrust Bancorp Inc.*, 25 F.3d 1124, 1129–30 (2d Cir. 1994) (affirming dismissal of complaint as insufficient to support an inference of fraud when complaint did not demonstrate that defendant's disclosures were inconsistent with current data when made); Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims*, 76 WASH. U. L.Q. 537, 547 (1998) (noting the Ninth Circuit's statement that “Rule 9(b) . . . require[s] plaintiffs to plead with particularity contemporaneous facts, conditions, or statements that tend[] to show the alleged misstatement when made” (internal quotation marks omitted)).

27. Sale, *supra* note 26, at 562.

allegations soon after.<sup>28</sup>

*C. Securities-Fraud Cases Require Heightened Pleading Above the Heightened Pleading Under Rule 9*

Despite the heightened pleading standard under Rule 9, Congress and the judiciary believed that the concerns that justify heightened pleading in the fraud context are amplified in the securities-fraud class-action context. Congress and the judiciary feared that securities-fraud class-action plaintiffs compared to traditional fraud plaintiffs are even more motivated to bring spurious claims and, in turn, defendants are even more motivated to settle because damages are exponentially greater.<sup>29</sup>

In hearings to reform the securities-fraud class action, Congress listened to testimony that securities cases had become lawyerly led frivolous affairs in which counsel would file a suit on the hopes of an easy pay off. And, in those cases, if the suit progressed to discovery, plaintiffs' attorneys would take up the company's time and the time of key management while they fished for viable fraud claims.<sup>30</sup> So in 1995, Congress set out to reform securities-fraud litigation by enacting a number of procedural barriers. These procedural barriers were designed to reduce the plaintiffs' lawyers' role in securities cases, ensure that plaintiffs diligently investigated claims before filing them, and provide courts with tools to screen those securities cases that were clearly meritless.

To achieve these ends, Congress demanded more specificity and particularity in pleading—more than what was required under Rule 9(b).<sup>31</sup> First, the PSLRA required that plaintiffs allege with particularity each statement alleged to have been misleading and why it was misleading.<sup>32</sup>

Second, the PSLRA modified the rules for pleading on information

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28. *Id.* at 562–63.

29. *See, e.g.*, S. REP. NO. 104-98, at 6 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 685; H.R. REP. NO. 104-369, at 37 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 736; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975) (stating that “litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general”).

30. *See, e.g.*, S. REP. NO. 104-98, at 4–5; H.R. REP. NO. 104-369, at 37.

31. *See, e.g.*, Makor Issues & Rights, Ltd. v. Tellabs, Inc. (*Tellabs I*), 437 F.3d 588, 594 (7th Cir. 2006) (“Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief, . . . the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading—one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b).” (internal citation and quotation omitted)), *vacated and remanded*, 551 U.S. 308 (2007).

32. 15 U.S.C. §§ 78u-4(b)(1)–(2) (2012).



and belief. Normally, factual allegations may be based on information and belief, and a complaint containing these allegations is appropriate when the information is within the knowledge of the defendant, not the plaintiff, or the belief is based on factual information that makes the inference of culpability possible.<sup>33</sup> The PSLRA required that if an allegation is made on information and belief, then the plaintiff must allege with particularity all facts on which that belief is formed.<sup>34</sup>

Third, the PSLRA required plaintiffs to allege with particularity the defendant's state of mind.<sup>35</sup> In the normal course, Rule 9(b) allows plaintiffs to allege the defendant's mental state generally.<sup>36</sup> Yet under the PSLRA, plaintiffs must allege the defendant's mental state with particularity.<sup>37</sup> The PSLRA requires plaintiffs to allege the "who, what, where, why, and when" surrounding the fraud *and* the defendant's mental state.<sup>38</sup>

Alleging facts from which a court must draw a strong inference of the defendant's mental state is a significant break from Rule 9(b). What does it even mean to allege a "strong inference" of what is in someone else's head? Well, an "inference" is a conclusion reached by considering other facts and deducing a logical conclusion from those facts. So the question then is what "other" facts are considered and when does an inference become "strong"? As framed by one court, the inquiry devolves into "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'"<sup>39</sup> And one securities litigator has written that "[j]udges have enough latitude under the pleading standards to dismiss or not, in most cases. The pivotal 'fact' is . . . whether the judge feels the case is really a fraud case, or not."<sup>40</sup>

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33. See, e.g., *Arista Records LLC v. Doe 3*, 604 F.3d 110, 120 (2d Cir. 2010) ("The *Twombly* plausibility standard, which applies to all civil actions, . . . does not prevent a plaintiff from pleading facts alleged upon information and belief where the facts are peculiarly within the possession and control of the defendant, . . . or where the belief is based on factual information that makes the inference of culpability plausible." (internal citations and quotations omitted)).

34. 15 U.S.C. §§ 78u-4(b)(1)–(2).

35. *Id.* § 78u-4(b)(2).

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

37. 15 U.S.C. § 78u-4(b)(2).

38. See, e.g., *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 253 (3d Cir. 2009) (explaining the PSLRA's particularity requirement); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (2d Cir. 1990) (similar).

39. See, e.g., *Tellabs I*, 437 F.3d 588, 601 (7th Cir. 2006), *vacated and remanded*, 551 U.S. 308 (2007).

40. Douglas W. Greene, *Falsity is Fundamental: The Case for Emphasizing Arguments Against Falsity*, D&O DISCOURSE (Oct. 7, 2013), <http://www.dandodiscourse.com/2013/10/07/falsity-is-fundamental-the-case-for-emphasizing-arguments-against-falsity/>.

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court provided guidance on both questions—what “facts” are considered and when is an inference “strong.” First, no longer would plaintiffs receive the benefit of the doubt on a motion to dismiss. Rather, on a motion to dismiss, while the court must accept all factual allegations in the complaint as true, the court also must consider nonculpable or innocent explanations one could draw from those facts.<sup>41</sup> Second, an inference is strong only when the culpable inference drawn from those facts is at least as likely as the non-culpable explanation.<sup>42</sup>

There can be no question that this is a major change from notice-pleading standards<sup>43</sup> and that it has puzzled some judges. Judge Posner raised this notion, remarking that for judges accustomed to notice pleading, the drawing of strong inferences from factual allegations is “mysterious”; even where Rule 9(b) requires plaintiffs to plead facts, courts must treat those facts as true, drawing all reasonable inferences in favor of the plaintiff.<sup>44</sup>

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41. *Tellabs*, 551 U.S. at 322–23; see also *In re Guidant Corp. Sec. Litig.*, 536 F. Supp. 2d 913, 932 (S.D. Ind. 2008) (stating that “the [*Tellabs*] line of cases makes clear [that] we *must* consider competing inferences arising from the facts as pled in order to determine whether [p]laintiffs have created the requisite ‘strong inference’ of scienter” (emphasis in original)).

42. *Tellabs*, 551 U.S. at 322–23.

43. Consider what Charles W. Wright and Arthur Miller have to say on the subject:

A proposition that is at the heart of the application of the Rule 12(b)(6) motion, and one that is of universal acceptance, as evidenced by the myriad of illustrative cases cited in the note below—drawn from throughout the federal court system, including the Supreme Court—is that for purposes of the motion to dismiss, (1) the complaint is construed in the light most favorable to the plaintiff, (2) its allegations are taken as true, and (3) all reasonable inferences that can be drawn from the pleading are drawn in favor of the pleader.

5B CHARLES W. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE & PROCEDURE § 1357 (13th ed. 2013).

44. *Makor Issues & Rights, Ltd. v. Tellabs Inc. (Tellabs II)*, 513 F.3d 702, 705 (7th Cir. 2008). According to some, *Bell Atlantic Corp v. Twombly* and *Ashcroft v. Iqbal* may have heightened the pleading standard in traditional civil litigation to require this sort of PSLRA-weighting process. See, e.g., Hon. Shira A. Scheindlin, *Twombly and Iqbal: The Introduction of a Heightened Pleading Standard*, 27 *TOURO L. REV.* 233, 240 (2011) (“Judges now must draw inferences in favor of both sides. This balancing test requires the court to draw inferences on the defense’s behalf, without the benefit of a defense pleading. The process, overall, has created a new phenomenon: the motion to dismiss has become akin to summary judgment, while summary judgment has become akin to a trial.” (internal citations omitted)); Marc I. Steinberg & Diego E. Gomez-Cornejo, *Blurring the Lines Between Pleading Doctrines: The Enhanced Rule 8(a)(2) Plausibility Standard Converges With the Heightened Pleading Standards Under Rule 9(b) and the PSLRA*, 30 *REV. LITIG.* 1, 3 (2010) (“By enhancing the basic pleading standard applicable in every federal civil case, the Supreme Court has elevated the previously liberal Rule 8(a)(2) pleading standard to approach the heightened pleading standards predicated on allegations of fraud—the Rule 9(b) fraud pleading standard and the pleading standard for scienter in securities fraud actions under the PSLRA. This evident convergence of pleading standards blurs the lines between pleading doctrines that were adopted to address different policy concerns, thus creating a

The effect of these pleading rules is that the motion to dismiss for securities-fraud cases is summary-judgment like. For instance, the balancing act required to determine a “strong inference” may have caused judges to take a more liberal view of material properly subject to judicial notice in a securities-fraud case. Professor Hilary Sale put it best: “Since the PSLRA . . . the practice of incorporating documents has expanded to include documents not signed or publicly filed by defendants.”<sup>45</sup> Additionally, some judges have described the PSLRA’s pleading standard and the weighing of inferences as more akin to the inquiry on summary judgment than the motion-to-dismiss standard.<sup>46</sup> And some courts have even said that the standard for *pleading* scienter is *higher* than the standard for *proving* scienter at summary judgment.<sup>47</sup>

And yet, the PSLRA’s heightened pleading requirements are not the only changes that differentiate securities litigation from traditional civil cases. Two other procedural changes amplify the importance of the pre-filing phase for securities cases. First, the plaintiffs must satisfy the PSLRA’s heightened pleading requirements while discovery is

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federal civil litigation system that is unfair and incongruous.”); Suja A. Thomas, *The New Summary Judgment Motion: The Motion to Dismiss Under Iqbal and Twombly*, 14 LEWIS & CLARK L. REV. 15, 30 (2010) (“The second similarity in the motion to dismiss and summary judgment standards is that under both, while it appears that courts should view the facts in the light most favorable to the nonmoving party, in assessing whether a claim is plausible, courts assess both the inferences favoring the moving party and the inferences favoring the nonmoving party.” (internal citations omitted)).

45. Hilary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 945 n.163 (2002) (collecting cases).

46. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1556 (9th Cir. 1994) (Norris, J., dissenting) (“It is also true, however, that there are social costs associated with a rule of pleading that causes a proliferation of complaints that are chock full of allegations of detailed evidentiary matter. Not only are such pleadings burdensome for defendants to deal with, they are burdensome for judges who are required to comb through the evidentiary matter pleaded and struggle with the inferences it does or does not support as though the evidence were presented in affidavit form as required by Rule 56 rather than merely alleged in a complaint. This is a difficult and time-consuming process that judges must necessarily engage in at the summary judgment stage, but it is a wasteful use of judicial resources to require judges to engage in the same process at the pleading stage.”).

47. *See In re Novatel Wireless Sec. Litig.*, 830 F. Supp. 2d 996, 1017–18 (S.D. Cal. 2011) (“[A] private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct. . . . But at summary judgment, the standard is less stringent—the PSLRA requirement of pleading a ‘strong’ inference of scienter ‘puts securities fraud claims in the interesting posture of requiring plaintiffs to plead more than they must prove at trial, where a simple inference of scienter is sufficient to support a jury’s verdict.’ . . . The Ninth Circuit has confirmed that the PSLRA did not alter the substantive requirements for scienter under § 10(b) and that the standard on summary judgment or JMOL remains unaltered. . . . As long as a reasonable jury could conclude that the danger of misleading investors was either ‘known’ or ‘so obvious’ that defendants ‘must have been aware of it,’ a triable issue of fact exists.” (internal citations omitted)).

automatically stayed. Under Federal Rule of Civil Procedure 26, discovery proceeds despite any motion to dismiss.<sup>48</sup> Although Rule 26 allows a party to ask the court to stay discovery pending a dispositive motion, the court will stay discovery only if the moving party shows “good cause” for doing so.<sup>49</sup> But Congress believed that discovery was employed abusively and that plaintiffs engaged in “fishing expeditions” to uncover evidence to sustain already-filed claims.<sup>50</sup> With the PSLRA, Congress made automatic a stay of discovery pending any motion to dismiss.<sup>51</sup> The discovery stay compounds the effect of the heightened-pleading standard. Recall that the heightened pleading standard under Rule 9(b) evolved to require pleadings based on internal information, but now plaintiffs are faced with Rule 9(b)’s internal-information standard *and* the heightened scienter standard *without* discovery.<sup>52</sup>

Second, Congress increased the probability that those who brought meritless securities-fraud claims would risk monetary sanctions. Under Rule 11, attorneys must, among other things, not present any filing for an improper purpose (“such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation”); they must ensure that their claims, defenses, and legal contentions are nonfrivolous; and they must ensure that their factual contentions have evidentiary support. But Rule 11 does not mandate a judicial inquiry on compliance at the conclusion of every case. Congress perceived that the current Rule-11 mechanism was insufficient to deter the filing of frivolous suits.<sup>53</sup> To strengthen Rule 11 in the private securities-litigation context, Congress, through the PSLRA, required courts at final adjudication of the suit to include in the record specific findings whether the parties and their attorneys complied with Rule 11’s requirements.<sup>54</sup> If the court determines that a party did not comply with Rule 11, then the court is directed to impose sanctions in accordance with the Rule.<sup>55</sup>

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48. FED. R. CIV. P. 26(b)(1) (“Parties may obtain discovery regarding any nonprivileged matter that is relevant to any party’s claim or defense . . .”).

49. FED. R. CIV. P. 26(c).

50. S. REP. NO. 104-98, at 14–15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693–94.

51. 15 U.S.C. § 78u-4(b)(3) (2012). The PSLRA does explicitly provide that during the stay a party with actual notice of the allegations must treat all discoverable evidence within that party’s control as if it were subject to a continuing request for production of documents under the Federal Rules. The PSLRA does provide limited exceptions to the stay if the court finds that particularized discovery is necessary to either (1) preserve evidence; or (2) prevent undue prejudice to that party. *Id.*

52. *See Sale, supra* note 26, at 563–64.

53. S. REP. NO. 104-98, at 13–14.

54. 15 U.S.C. § 78u-4(c).

55. *Id.*

Together, these rules—heightened pleading, the discovery stay, and the mandatory Rule-11 inquiry—have transformed the motion to dismiss into a significant barrier. Courts have called the 10b-5 motion to dismiss an “acid test,”<sup>56</sup> an “eye of a needle made smaller and smaller over the years by judicial decree and congressional action,”<sup>57</sup> and a return to “a ‘demurrer-like’ process that creates considerable hurdles that a plaintiff must overcome before any discovery is permitted.”<sup>58</sup>

*D. This Heightened Pleading Has Made the Motion to Dismiss the Main Event For Securities Cases*

What’s the upshot of the PSLRA and *Tellabs*? First, plainly, motions to dismiss are prominent in securities-fraud litigation. In virtually every case (96%), defendants move to dismiss.<sup>59</sup> Generally, the parties won’t even discuss the possibility of settlement until the plaintiffs survive a motion to dismiss.<sup>60</sup>

Second, now more than ten years out, we may safely conclude that the PSLRA has increased the rate at which securities-fraud cases are screened. NERA Economic Consulting has concluded that “[d]ismissal rates have nearly doubled since the PSLRA. Dismissals accounted for only 19.4% of dispositions for cases filed between 1991 and 1995. More recently, for cases filed between 2000 and 2004, dismissals have accounted for 38.2% of dispositions.”<sup>61</sup> Numerous other studies

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56. *Eminence Capital, LLC v. Aspeon, Inc.*, 316 F.3d 1048, 1052 (9th Cir. 2003) (internal quotations and citations omitted).

57. *Alaska Elec. Pension Fund v. Flowsolve Corp.*, 572 F.3d 221, 235 (5th Cir. 2009) (per curiam with O’Connor, J., sitting by special designation).

58. *City of Pontiac Gen. Emps.’ Ret. Sys. v. Lockheed Martin Corp.*, No. 11-civ-5026, 2013 WL 3389473, at \*1 (S.D.N.Y. July 9, 2013).

59. DR. RENZO COMOLLI ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2012 FULL-YEAR REVIEW: SETTLEMENTS UP; ATTORNEYS’ FEES DOWN 16 (2013) [hereinafter COMOLLI ET AL., RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION], available at [http://www.nera.com/nera-files/PUB\\_Year\\_End\\_Trends\\_01.2013.pdf](http://www.nera.com/nera-files/PUB_Year_End_Trends_01.2013.pdf). It’s worth noting that defense counsel at this Conference stressed that defendants do not move to dismiss arbitrarily. Rather, defendants are keenly aware that a weak motion to dismiss may damage the defendant’s credibility with the court.

60. According to a survey of in-depth interviews of securities litigators, “settlement discussions almost never take place until after the motion [to dismiss] is filed, and . . . settlement discussions typically do not take place until after the class action has survived the motion to dismiss.” Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 775 (2009).

61. TODD FOSTER ET AL., NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: FILINGS PLUMMET SETTLEMENTS SOAR 4 (2007) (internal citations omitted), available at [http://www.mmc.com/knowledgecenter/BRO\\_Recent\\_Trends\\_SEC1288-final.pdf](http://www.mmc.com/knowledgecenter/BRO_Recent_Trends_SEC1288-final.pdf). The report cautions, though, that the

post-PSLRA dismissal rate may be slightly overstated, as it may include some

conclude that the PSLRA resulted in district courts granting an increased percentage of motions to dismiss.<sup>62</sup>

One interesting recent trend is that in the past five years, the rate of dismissals appears to be increasing. NERA Economic Consulting concludes that “[d]ismissal rates appear to be rising. Almost all cases filed from 2000 to 2006 have been resolved. Dismissal rates in those years have progressively increased from 32% to 36% in 2000–2002 to 43% to 47% in 2004–2006.”<sup>63</sup> And “[o]n a preliminary basis, it appears that dismissal rates continued to increase in 2007 to 2009, as 44% to 49% of cases filed in those years have already been dismissed.”<sup>64</sup>

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dismissals without prejudice that will be reversed by amended and better-pled complaints or dismissals with prejudice that will be successfully appealed. There is no indication that dismissal rates have continued to rise after an initial adjustment to the tougher pleading provisions of PSLRA.

*Id.*

62. See FREDERICK DUNBAR ET AL., NERA ECON. CONSULTING, RECENT TRENDS VI: TRENDS IN SECURITIES LITIGATION AND THE IMPACT OF PSLRA 6 (1999) (observing that the dismissal rate after the PSLRA increased from about 12% to between 25 and 28%); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 39–40 (1998) (surveying 100 rulings on a motion to dismiss during 1996 and 1997 and finding that more than half (60%) of those motions were granted in some form: fifteen motions were granted with prejudice; thirty-four were granted with leave to amend; and eleven were granted in part and denied in part); Richard H. Walker, *Introduction to the Implications of the Private Securities Litigation Reform Act Symposium*, 76 WASH. U. L.Q. 447, 448–49 (1998) (observing that “it is not too soon to conclude that the Act is having at least some bite at the federal level, making it tougher for plaintiffs to proceed. While the Act has not chilled plaintiffs from filing suit, it apparently has made early dismissals more commonplace. In the 280 class actions filed during 1996 and 1997, we are aware of sixty-three in which there have been rulings on a motion to dismiss. In more than half of these cases, fifty-six percent of the motions to dismiss have been granted in some form. By contrast, Congress heard evidence that in 1992, only approximately forty percent of all federal securities class actions were dismissed on a motion prior to trial. Available data shows that in 1990 and 1991, thirty-eight percent of the cases filed by a leading plaintiff law firm were dismissed on motion.” (internal citations omitted)). I’ve been unable to locate any studies that attempt to measure “shadow dismissals”—cases where in a pre-motion conference, the court provides direction to plaintiff’s counsel to dismiss and re-file or dismisses from the bench entirely. See Jonathan K. Youngwood, *The Limits of Bright-Line Rules and the Challenges of Defending Clients in a Constantly Changing Legal Environment*, ASPATORE, Sept. 2012, available at 2012 WL 3279514, at \*6–\*7 (describing a shadow dismissal in a securities case).

63. COMOLLI ET AL., RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION, *supra* note 59, at 24 (internal citation omitted).

64. *Id.* Professor Steinberg notes that these dismissal rates are misleading in that they are *artificially low* because, as a result of the PSLRA and the Supreme Court’s restrictive interpretations on the scope of the securities laws, plaintiffs institute federal securities class actions against fewer defendants than before the PSLRA. Marc I. Steinberg, *Pleading Securities Fraud Claims—Only Part of the Story*, 45 LOY. U. CHI. L.J. 603, 607 (2014). Steinberg observes that, as contrasted with yesteryear, federal securities class-action complaints alleging fraud-based violations typically name only: (1) key executive officers (such as the chief executive officer, chief financial officer, and chief operating officer); (2) the chair of the board of directors; (3) outside directors who serve on key committees (such as the audit or compensation committee)

Cornerstone Research likewise concludes that “for filings in cohort years 2008 through 2010, a larger percentage of cases were dismissed than in prior years. For filings in the 2008 cohort, 50% have already been dismissed. For the 2009 and 2010 filing cohorts, dismissals increased to 53% and 56% respectively. These percentages are likely to increase in the future as ongoing cases are resolved.”<sup>65</sup>

Whether this increased dismissal rate is related to *Tellabs* or the Supreme Court’s other recent securities-fraud decisions<sup>66</sup> has not yet been the subject of empirical study. In an informal survey of district court decisions in the months after *Tellabs*, however, Harold S. Bloomenthal and Samuel Wolff found that for cases resolving motions to dismiss and citing *Tellabs*, 65% of those motions were granted.<sup>67</sup> The authors are careful not to read too much into their findings, however, as the sample was limited and they did not compare dismissals with a cross section of PSLRA cases decided pre-*Tellabs*.<sup>68</sup> So we too take these findings for anecdotal evidence, but not hard science.

Interestingly, a recent paper by Professors Stephen Choi and Adam Pritchard concludes that *Tellabs* is having some effect, namely unifying

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whose alleged misconduct while serving as a committee member caused the improprieties; (4) the auditors; and (5) perhaps the underwriters. Whereas collateral actors—including attorneys, accountants (who have not certified financial statements), commercial and investment bankers (and their representatives), and consultants—are named as defendants in these class actions on relatively rare occasions.

65. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2013 MID-YEAR ASSESSMENT 15 (2013), available at <http://www.cornerstone.com/getattachment/07ff7c1f-b775-417c-9d6c-59cba194cb75/Securities-Class-Action-Filings%e2%80%942013-Mid-YearAsse.aspx>.

66. Supreme Court decisions since 2005 that further narrowed the scope of 10b-5 liability might explain the uptick in dismissals. In 2005, in *Dura Pharmaceuticals, Inc. v. Broudo*, the Court said that 10b-5 does not “provide investors with broad insurance against market losses,” and held that plaintiffs could not plead or prove loss causation by alleging just artificial inflation. 544 U.S. 336, 345 (2005). One study found that *Dura* resulted in a decreased number of class actions being filed, but did not assess the decisions’ effect on dismissal rates. Scotland M. Duncan, Note, *Dura’s Effect on Securities Class Actions*, 27 J.L. & COM. 137 (2008). In 2008, in *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, the Court said that “[o]verseas firms with no exposure to our securities laws could be deterred from doing business here,” and then rejected the notion of scheme liability for private actions under Rule 10b-5. 552 U.S. 148, 164 (2008). Then, in 2010, in *Morrison v. National Australia Bank*, the Court said that “some fear that [the United States] has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets,” and then foreclosed any private 10b-5 remedy for securities transactions that occurred outside the United States. 130 S. Ct. 2869, 2886 (2010). In 2011 in *Janus Capital Group v. First Derivative Traders*, the Court said that the private remedy under Rule 10b-5 must be given a “narrow scope” and then limited the Rule 10b-5 remedy to only those who “ultimately ha[ve] authority over a false statement.” 131 S. Ct. 2296, 2303 (2011).

67. 2 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES LAW HANDBOOK § 29:62, at 454 (2013 ed.).

68. *Id.*

the pleading standard. They studied a sample of securities-fraud class actions filed between 2003 and 2007, and found that *Tellabs* correlates with a lower dismissal rate on scienter grounds in the Ninth Circuit (which had applied the most rigorous pleading standard before the decision), but left, largely unaffected, dismissal rates in the other circuits.<sup>69</sup> Additionally, the authors found a decrease in low-value settlements (which are generally associated with meritless or weak claims) in those circuits applying moderate dismissal standards.<sup>70</sup> The study did not measure, however, whether the total dismissal number increased or decreased after *Tellabs*.

What element of a securities-fraud case is the focal point of a motion to dismiss? Scienter. Professors Choi and Pritchard find that, in a sample of securities-fraud class actions filed between 2003 and 2007, scienter is the basis for dismissal (at least in part) more than 43% of the time and that same argument is rejected in nearly a quarter of cases.<sup>71</sup> Additionally, an analysis of thirty-six district court decisions from 2012 that dismissed securities-fraud claims found that in 72% of those rulings, the court found scienter inadequate for the entire case, and that in only marginally more cases (77%), the court found scienter inadequate with respect to at least some claims.<sup>72</sup>

Materiality is also a common dismissal ground. According to Professors Choi and Pritchard, district courts grant dismissal (at least in part) in more than 10% of the cases for lack of materiality.<sup>73</sup> Others find that materiality plays a more prominent role on motions to dismiss. For instance, Professor David Hoffman analyzed 472 securities-fraud decisions and found that 385 of them addressed materiality, and of those, 44% dismissed at least one claim as immaterial as a matter of law.<sup>74</sup> Professors Stephen Bainbridge and G. Mitu Gulati likewise surveyed motions to dismiss and found that more than 70% of their

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69. Stephen J. Choi & Adam C. Pritchard, *The Supreme Court's Impact on Securities Class Actions: An Empirical Assessment of Tellabs*, J.L. ECON. & ORG. 850, 852 (2012).

70. *Id.*

71. *Id.* at 862 tbl.3. One caveat is that there is no indication that this study accounted for “elemental bleed”—considerations that are supposed to drive a court in deciding a single, isolated element also cloud evaluation of other unrelated elements. Credit is owed to Professor Geoffrey C. Rapp for the term. See Geoffrey C. Rapp, *Rewiring the DNA of Securities Fraud Litigation: Amgen's Missed Opportunity*, 44 LOY. U. CHI. L.J. 1475, 1479 (2013).

72. Wendy Gerwick Couture, *The Falsity-Scienter Inference*, 40 SEC. REG. L.J. 303, 304 (2012).

73. Choi & Pritchard, *supra* note 69, at 862 tbl.3.

74. David A. Hoffman, *The “Duty” to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 563–64 (2006).



sample involved materiality determinations in favor of the defendants.<sup>75</sup>

The prominence of these two elements in dismissal rates is consistent with the idea that the motion to dismiss is more akin to summary judgment. The Supreme Court has described one of these elements—materiality—as a quintessential jury question because it requires “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him.”<sup>76</sup> Likewise, the other element—scienter—has been described by the Court as normally a “matter of inference from circumstantial evidence,” evidence that by definition lends itself to two reasonable conclusions from the same facts.<sup>77</sup>

## II. TO ACCOUNT FOR THE SECURITIES LAWS’ HEIGHTENED SCRUTINY OF COMPLAINTS, PLAINTIFFS MUST SPEND MORE TIME IN THE PREFILING PHASE FINDING SUFFICIENT, RELIABLE CORROBORATION OF THEIR ALLEGATIONS

The reforms by the PSLRA and the standard in *Tellabs* encourage plaintiffs to spend more time gathering facts in the prefiling phase to corroborate the allegations in their complaints.<sup>78</sup> Securities-fraud complaints that contain reliable corroboration of their allegations are more likely to survive dismissal.<sup>79</sup> This seems rather intuitive. After all, the more evidence of a claim, the more likely it should pass through procedural screens. What is notable, however, is that empirical studies and case law suggest that certain forms of corroboration appear stronger than others, and these forms may not necessarily suggest an actual fraud.

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75. 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, 116 n.94 (2002).

76. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976).

77. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 391 n.30 (1983).

78. *See City of Pontiac Gen. Emps.’ Ret. Sys. v. Lockheed Martin Corp.*, No. 11-Civ-5026, 2013 WL 3389473, at \*1 (S.D.N.Y. July 9, 2013) (“As a combined result of pleading requirements set forth in the [PSLRA] . . . and in recent Supreme Court decisions such as [*Tellabs*], a securities class action cannot survive a motion to dismiss unless it provides considerable factual detail supporting each of the essential elements of a securities fraud claim. . . . While designed to give district courts a ‘gatekeeper’ responsibility to derail dubious class action lawsuits at the outset, an unintended consequence has been to cause plaintiffs’ counsel to undertake surreptitious pre-pleading investigations designed to obtain ‘dirt’ from dissatisfied corporate employees.”).

79. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1498 (2004) (“Lawsuits relating to more obvious indicia of fraud, such as accounting restatements, are more prevalent in the post-PSLRA . . . time period.”).

*A. Potential Evidence of Corporate Fraud*

At the threshold, securities fraud *is* concealment of the truth, and so, by its nature, without discovery, these cases pose special challenges to uncovering evidence to corroborate allegations.<sup>80</sup> In securities-fraud cases, discovery is stayed pending any motion to dismiss.<sup>81</sup> So what kinds of corroboration are available?

A useful starting point is to consider who discloses corporate fraud. When we do so, we find that there is no shortage of potential evidence out there. A 2007 study by several academics examined which mechanisms detect corporate fraud.<sup>82</sup> They derived a sample of 216 cases of alleged corporate frauds and identified who was involved in the fraud detection.<sup>83</sup> They found that it takes “a village” to detect fraud, and no single fraud detector dominates.<sup>84</sup> They found that six different sources accounted for at least 10% of the detections, but no single source was responsible for more than 17% of detections.<sup>85</sup> What sources did the study identify? Employees—“the most important external governance group with 17% of the cases”; media (13%); and industry regulators (13%).<sup>86</sup> The remaining sources include stock

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80. *See, e.g.*, *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 377 (1991) (Kennedy, J., dissenting) (asserting that “[t]he real burden on most investors . . . is the initial matter of discovering whether a violation of the securities laws occurred at all. This is particularly the case for victims of the classic fraud-like case that often arises under § 10(b). . . . The most extensive and corrupt schemes may not be discovered within the time allowed for bringing an express cause of action under the 1934 Act.”); S. REP. NO. 107-146, at 9 (2002) (stating that “the best cons are designed so that even after victims are cheated, they will not know who cheated them, or how”).

81. 15 U.S.C. § 78u-4(b)(3)(B) (2012). When Congress wrote that a stay applied to “*all*” discovery upon “*any*” motion to dismiss, Congress meant “*all*” discovery upon “*any*” motion to dismiss. That is, any defendant’s motion to dismiss will stay discovery entirely, not just as to that defendant but even as to nonparties or potential defendants. *See, e.g., In re Carnegie Int’l Corp. Sec. Litig.*, 107 F. Supp. 2d 676, 679–80 (D. Md. 2000). Courts have held that even a defendant’s suggestion that a motion to dismiss is coming is enough to stay discovery. *See, e.g., In re Firstenergy Corp. Sec. Litig.*, 229 F.R.D. 541, 543–44 (N.D. Ohio 2004) (“Although FirstEnergy has not yet filed its motion to dismiss, it has advised the Court of its intent to do so. . . . In such an instance, . . . the PSLRA’s discovery stay provision applies.”).

82. I.J. Alexander Dyck et al., *Who Blows the Whistle On Corporate Fraud?*, 65 J. FIN. 2213, 2213 (2010).

83. To be more precise, the authors gathered data on a sample of alleged frauds that took place in U.S. companies with more than \$750 million in assets between 1996 and 2004. *Id.* In their sample, plaintiffs brought securities-fraud class actions against the companies under either the 1933 or 1934 Act between 1996 and 2004. *Id.* at 2217. The authors then screened the sample for “frivolous” suits (dismissed cases or settled cases for an amount less than \$3 million) to end up with a sample of 216 cases of alleged corporate frauds. *Id.* at 2213, 2217.

84. *Id.* at 2224.

85. *Id.* at 2224–26.

86. *Id.* at 2226.

analysts, auditors, the company's clients or competitors, equity holders, law firms, the SEC, and short sellers.<sup>87</sup> A survey of in-depth interviews with plaintiffs' and defense lawyers likewise found that plaintiffs learned of potential frauds from "former employees, disgruntled investors, or referring attorneys who represent the prospective plaintiff for other purposes, such as real estate transactions or estate planning."<sup>88</sup>

Another useful starting point for potential sources is to consider what events are considered consistent with fraud and to look for public reports about those events. It's been long accepted that parallel action by the SEC, restatements of earnings, corporate bankruptcies, and insider trading are considered consistent with allegations of fraud.<sup>89</sup>

*Parallel SEC Proceedings.* Parallel SEC investigations or enforcement actions may suggest that a securities class action has merit. The SEC is not motivated by large class-action fees, and as a government agency, it has an air of credibility. Likewise, budget constraints encourage the SEC to devote those limited resources to cases that it judges to be strong.<sup>90</sup> Courts have said that even a corroborated SEC complaint may be strong evidence of the merit of the plaintiffs' case.<sup>91</sup>

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87. *Id.* at 2225 tbl.2.

88. Baker & Griffith, *supra* note 60, at 770.

89. This list is not exclusive. For example, Professor Charles W. Murdock catalogues four ways investors can acquire internal company information and not all of which overlap with those described above: (1) a special study by the board of directors, (2) a bankruptcy report, (3) a restatement of financial results, and (4) an informant from the company. Charles W. Murdock, *Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown*, 41 LOY. U. CHI. L.J. 801, 831–32 (2010).

90. *See, e.g., In re Nat'l Presto Indus., Inc.*, 347 F.3d 662, 664 (7th Cir. 2003) ("Given the vast resources of the federal government, it might seem that the government would rarely if ever be seriously inconvenienced by being compelled to litigate in a district more convenient to the defendant. But such a suggestion would be unrealistic. Federal agencies have limited resources, and the SEC in particular is often outgunned by the affluent defendants that it sues. The SEC cannot afford a regional office in every state.").

91. *See, e.g., In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1080, 1083 (N.D. Cal. 2001) (holding that allegations of premature revenue recognition in violation of Generally Accepted Accounting Principles ("GAAP") "combined with the other transactions detailed in the SEC complaint, provide strong circumstantial evidence" that the defendant acted with scienter); *City of Painesville, Ohio v. First Montauk Fin. Corp.*, 178 F.R.D. 180, 185–90 (N.D. Ohio 1998) (finding complaint met heightened pleading standard and noting that company previously disclosed an SEC investigation and indictments); *see also Hill v. State St. Corp.*, No. 09-CV-12146, 2011 WL 3420439, at \*10 (D. Mass. Aug. 3, 2011) ("At this point—the pleading stage—I cannot ignore that Plaintiffs' complaint is buttressed by, among other things, allegations made by six confidential sources and the booty from an [eighteen-month] investigation by the California AG."); *cf. In re LaBranche Sec. Litig.*, 333 F. Supp. 2d 178, 183 (S.D.N.Y. 2004) (allowing plaintiffs to lift the automatic stay of discovery while a motion to dismiss was pending because "[i]n this case, the SEC and NYSE investigated and are continuing to investigate the precise schemes alleged by Lead Plaintiffs in the Complaint. As a result of those investigations,

*Earnings Restatements.* A restatement of earnings by the company may also corroborate the plaintiffs' allegations of fraud. A restatement is reliable in that the source of the restatement is the company itself, and some believe restatements of revenue or income are akin to public admissions that financial statements contained material misstatements when made.<sup>92</sup>

*Bankruptcy.* Studies have confirmed that fraud on securities markets is more likely to be committed by desperate agents who fear that they are in the last period of employment than by those secure in their jobs and with the financial position of the company.<sup>93</sup> Additionally, the materials generated from a corporate bankruptcy—such as pleadings, transcripts, examiner reports, etc.—may provide a wealth of internal information for plaintiffs.<sup>94</sup>

*Insider Trading.* Insider trading is a classic feature of securities-fraud complaints. “For a spokesperson to cash in his own stock can . . . be like a ship’s captain exiting into the safety of a lifeboat while assuring the passengers that all is well.”<sup>95</sup> By consulting publicly available information, plaintiffs can find instances of corporate insiders trading the company’s stock.<sup>96</sup>

But identifying corroborative evidence or events consistent with fraud allegations is only half of the task. That corroborative evidence and those events must provide *reliable* indicators of fraud in the eyes of the district judge. Over the past decade or so, case law and empirical studies have revealed that some of these forms of corroboration appear more reliable than others. That is, some receive more favorable treatment under the case law and appear more likely to survive dismissal than others (I hedge by saying “appear” because I’m not aware of any studies that compare the forms of corroboration head to

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LaBranche [(the defendant)] has agreed to pay more than \$63.5 million to settle the regulators’ claims.”).

92. Sherrie Raiken Savett, *Plaintiffs’ Vision of Securities Litigation: Current Trends and Strategies*, SN084 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 375, 433 (2008).

93. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 725–27; see also Mitu Gulati, *When Corporate Managers Fear a Good Thing is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694–95 (1999) (noting that when a manager perceives himself to be in a final-period situation, he will no longer be disciplined by the fear of reputational sanctions and may act entirely in his self-interest in order to obtain the maximum private payoff before permanently departing from the managerial scene).

94. John M. Wunderlich, *Bankruptcy’s Protection for Non-Debtors From Securities-Fraud Litigation*, 16 FORDHAM J. CORP. & FIN. L. 375, 409 (2011).

95. *In re Scholastic Corp.*, 252 F.3d 63, 67 (2d Cir. 2001).

96. See, e.g., *Malin v. XL Capital*, 499 F. Supp. 2d 117, 131–33 (D. Conn. 2007) (collecting cases).

head, and because I don't mean to advocate a universal rule that one form of corroboration will always be more reliable than another.). I've shorthanded the forms of corroboration as either strong or weak. Strong forms of corroboration include SEC actions, earnings restatements, and bankruptcies. Weak forms of corroborative evidence include evidence of insider trading, inferences we can draw from shared experience, and accounts from confidential witnesses.

### *B. Strong Forms of Corroboration*

Parallel SEC proceedings, accounting restatements, and a company's bankruptcy are strong forms of corroboration as empirical studies suggest that allegations corroborated by these events are more likely to survive dismissal.

#### 1. SEC Proceedings

Empirical studies have found that the absence of SEC proceedings exposes a complaint to an increased chance of dismissal. In a pre-*Tellabs* study of initial public offerings from 1990 to 1999 involving securities claims, Professor Choi found that claims lacking hard-evidence of fraud—defined as an earnings restatement or SEC investigation or enforcement action—faced a lower probability of suit and a greater likelihood of receiving a dismissal or low-value settlement in the post-PSLRA period.<sup>97</sup> Professor Sale also found that of post-PSLRA decisions on a motion to dismiss from 1996 to 2000, those decisions in which the plaintiffs pleaded that the SEC investigated or was investigating survived 71% of the time—a dismissal rate, she said, that was about 20% higher than for claims without a similar allegation.<sup>98</sup> Similarly, in a research paper from several law professors that studied securities settlements, the authors found that “[w]here the SEC has filed a parallel enforcement action—based on the same allegations made in a class action complaint—the class action was dismissed in only 12% of cases.”<sup>99</sup> A survey of in-depth litigator interviews likewise concluded that the “sizzle” of an SEC investigation—of “executives being led out of the office in handcuffs”—may make a plaintiff's case more appealing to a judge or

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97. Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598, 598 (2007).

98. Sale, *supra* note 45, at 950 n.178.

99. Michael Klausner et al., *When are Securities Class Actions Dismissed, When Do They Settle, and For How Much?—An Update 6* (Stanford Law Sch. Working Paper Series, Paper No. 445, 2013), available at <http://ssrn.com/abstract=2260831>.

jury.<sup>100</sup>

Even though parallel SEC action may increase the odds a case has of surviving dismissal, it is not always true that SEC complaints or investigations evidence fraud. SEC complaints or investigations are just collections of unproven and contested allegations. Thus, courts may reject plaintiffs' attempts to rely upon allegations drawn from SEC complaints.<sup>101</sup> Indeed, should a litigant rely solely on an SEC complaint, courts have held that such conduct would warrant sanctions for violating the Rule 11 duty to validate the truth and legal reasonableness of papers filed with the court.<sup>102</sup>

The converse is true as well. Although parallel SEC action may increase the likelihood a case has of surviving dismissal, it is not always true that the absence of parallel SEC action evidences aboveboard conduct. For instance, as a result of a 2003 study, some scholars have concluded that private litigation fills an enforcement void created by the SEC's inherent limitations (i.e., budget restraints, political jockeying, bureaucratic barriers, etc.).<sup>103</sup> Indeed, the SEC appears to target smaller firms while private suits focus on larger ones.<sup>104</sup>

## 2. Earnings Restatements

Other studies have similarly found that the absence of earnings restatements hurts a case's chances for surviving a motion to dismiss. In a sample of 150 motion to dismiss decisions from the Second and Ninth Circuits from 1996 to 2001, Professors Pritchard and Sale found that cases with misstatements about revenue recognition, a restatement of earnings, and other Generally Accepted Accounting Principles ("GAAP") violations made dismissal less likely at least in the Second

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100. Baker & Griffith, *supra* note 60, at 788–89 (citation omitted).

101. *See, e.g., In re Connetics Corp. Sec. Litig.*, 542 F. Supp. 2d 996, 1005–06 (N.D. Cal. 2008) (dismissing a complaint that relied solely on allegations found in SEC complaints); *Geinko v. Padda*, No. 00-CV-5070, 2002 WL 276236, at \*5–\*7 (N.D. Ill. Feb. 27, 2002) (rejecting a complaint grounded merely on SEC allegations and lacking independent investigation).

102. *In re Connetics Corp.*, 542 F. Supp. 2d at 1005–06; *Geinko*, 2002 WL 276236, at \*6; *see also In re Apollo Grp., Inc. Sec. Litig.*, No. 10-CV-1735, 2011 WL 5101787, at \*10 n.5 (D. Ariz. Oct. 27, 2011) (noting that allegations from other complaints, which are unproven and uncontested, do not amount to facts and therefore do not satisfy Rule 11's pleading requirement).

103. James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 777 (2003) (finding that only 15% of settled securities class actions have a parallel SEC action).

104. *Id.* at 777–78. A later 2005 study by those same authors found that the SEC was more likely to target larger firms after the Enron debacle in 2001. *See* James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 901–02 (2005).

Circuit.<sup>105</sup> Similarly, Cornerstone Research finds that accounting cases—those involving allegations that the company issued financial statements inconsistent with GAAP, the fact most likely to lead to an earnings restatement—are less likely to be dismissed” than non-accounting cases.<sup>106</sup> For instance, Cornerstone found that in 2005, 36% of accounting cases were dismissed, but 60% of non-accounting cases were dismissed. And in 2006, 37% of accounting cases were dismissed (with 7% still pending resolution), but 49% of non-accounting cases were dismissed.<sup>107</sup> And a 2002 study by Professors Marilyn Johnson, Karen Nelson, and Adam Pritchard compared suits that resulted in either dismissal or a low-value settlement (\$2 million or less) with higher-value settlements, and found that accounting restatements were positively correlated with higher-value settlements.<sup>108</sup> In addition, several Stanford law professors that studied securities settlements between 2006 and 2010 found that even “[l]eaving aside class actions with parallel SEC actions, cases that involved restatements were dismissed less frequently than cases that involve non-restatement accounting issues, which in turn were dismissed less frequently than are non-accounting cases.”<sup>109</sup> Perhaps recognizing the increased likelihood that these cases will survive, other studies have found that after the PSLRA, plaintiffs brought an increased number of accounting-related cases.<sup>110</sup>

Earnings restatements, too, are not necessarily indicative of fraud, although studies suggest this fact will help a case survive dismissal. Indeed, “[r]estatements of earnings are common.”<sup>111</sup> So, they alone are usually insufficient to suggest that the defendant acted with fraudulent intent.<sup>112</sup> Rather, the amount of a restatement must be large enough to

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105. A.C. Pritchard & Hilary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 146 (2005).

106. ELAINE HARWOOD ET AL., CORNERSTONE RESEARCH, WHAT MAKES SECURITIES CLASS ACTIONS WITH ACCOUNTING ALLEGATIONS DIFFERENT? 1–2 (2011), available at <http://www.cornerstone.com/getattachment/c6b4254e-5ea4-4f02-8949-beeb7d304ae2/What-Makes-Securities-Class-Actions-with-Accountin.aspx>.

107. *Id.* at 2.

108. Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627, 646–47 (2007).

109. Klausner, *supra* note 99, at 6.

110. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 930–33 [hereinafter Perino, *Did the PSLRA Work?*].

111. *Goldberg v. Household Bank*, F.S.B., 890 F.2d 965, 967 (7th Cir. 1989).

112. *See Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 1000 (9th Cir. 2009) (“In general, the mere publication of a restatement is not enough to create a strong inference of scienter.”).

suggest that fraud was the case or a restatement must be coupled with other evidence that suggests fraud.<sup>113</sup>

### 3. Corporate Bankruptcy

Likewise, the presence of a bankruptcy suggests that a 10b-5 case is more likely to survive dismissal. In a 2013 study, Professor James J. Park found that securities cases against bankrupt companies were associated with more successful securities class actions and he suggests that courts use the fact of a company's bankruptcy to corroborate the allegations of fraud.<sup>114</sup> There's also evidence that companies that settle securities-fraud class actions are more likely to have liquidity problems and file for bankruptcy.<sup>115</sup>

Nevertheless, Professor Park found no support for the hypothesis that securities-fraud class actions against bankrupt companies are more likely to have *merit* than securities class actions against non-bankruptcy companies. Rather, he said, securities class actions against bankrupt companies are *perceived* as having more merit than suits against non-bankrupt companies.<sup>116</sup>

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Before moving to the weak forms of corroboration, there are two aspects of this dynamic that should not escape notice. First, instances of "strong" corroboration appear to be those least in need of a private, supplemental cause of action. These sources are the SEC or the company itself in cases of earnings' restatements or a bankruptcy filing. That is, these are cases in which the SEC is already pursuing fraud,<sup>117</sup>

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113. See, e.g., *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 488–89 (S.D.N.Y. 2004) (collecting cases holding that "a large correction is some evidence of scienter" and concluding that the size and nature of the restatement suggested that the restatement was no mere error but the result of systemic accounting abuses); see also Baker & Griffith, *supra* note 60, at 788 ("A plaintiffs' lawyer explained, 'You need sex appeal, you know. We used to think that just a restatement case was great because it was [an] admission, but you need more than just a restatement. You need a restatement and you need some benefit[, you need to show] that somebody benefited by the wrong.'" (alteration in original) (citation omitted)).

114. James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 577, 579–82 (2013).

115. See Lynn Bai et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. PA. L. REV. 1877, 1912 & n.88 (2010) (acknowledging generally the liquidity problems that companies face after settlement).

116. Park, *supra* note 114, at 579–82.

117. Where there is already public enforcement of the securities laws, one may question the necessity of additional private enforcement of the securities laws. Other laws, like the False Claims Act, the Age Discrimination in Employment Act, and the Fair Labor Standards Act, allow public enforcement to supersede private enforcement. See, e.g., 29 U.S.C. § 216(b) (2012) (Fair Labor Standards Act); *id.* § 626(c)(1) (Age Discrimination in Employment Act); 31 U.S.C. §§ 3730(b)(1), (c)(1)–(2) (2012) (False Claims Act).



cases in which the defendants have already announced to investors a public mea culpa (an earnings restatement), and cases in which investors aren't likely to recover much anyway because of bankruptcy. Second, plaintiffs can uncover strong forms of corroborative evidence cheaply and quickly. SEC actions, announcements of earnings restatements, and bankruptcies are all captured in public filings. The ease with which plaintiffs can get a hold of these kinds of corroboration may explain why after the PSLRA, securities-fraud cases were filed just as quickly as before.<sup>118</sup>

### *C. Weak Forms of Corroboration*

The SEC doesn't sue in every case. Indeed, one of the premises of the 10b-5 private action is that it acts as a necessary supplement to the SEC's enforcement power.<sup>119</sup> Moreover, not every company goes bankrupt. And for a company to out-and-out admit securities fraud is rare as well. So, if plaintiffs have a fraud case apart from these sources, then they must rely upon other evidence available at the prefiling phase. These other forms, to name a few, include evidence of insider trading, inferences from shared experience and common sense, and finally internal company information obtained from private investigators or former employees (i.e., confidential witnesses). I refer to these forms as weak forms of corroboration because studies do not suggest that their presence does much to prevent the dismissal of a securities-fraud case or because case law is largely suspect of these sources as reliable proxies for fraud.

#### 1. Insider Trading

The increased prevalence of option-based compensation schemes makes it easy to allege insider trading in virtually every case, which means that incidents of insider trading are coincidental in about every securities-fraud case. Thus, the case law uniformly holds that to suggest fraud, insider trading must be "unusual and suspicious."<sup>120</sup> The bottom

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118. See Perino, *supra* note 110, at 913 (finding that after the PSLRA, securities actions were filed as quickly as they were before the Act's passage).

119. See, e.g., *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1201 (2013) ("Congress, the Executive Branch, and this Court, moreover, have recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission." (citation omitted) (internal quotation marks omitted)).

120. See, e.g., *Teachers' Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 184 (4th Cir. 2007) (quoting *In re PEC Solutions, Inc. Sec. Litig.*, 418 F.3d 379, 390 (4th Cir. 2005); *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001)).

line is that courts are becoming inoculated to these kinds of allegations as suggestive of fraud.

According to Professor Sale,

[a]lthough trades are included in complaints in the hope that their presence will decrease the likelihood of a successful motion to dismiss, approximately 62% of the complaints containing such allegations are dismissed. . . . [I]t is more difficult for the plaintiffs to use stock trades, no matter how questionable, to meet the scienter requirement, and, thereby, to survive a motion to dismiss.<sup>121</sup>

Other studies confirm Professor Sale's conclusion that insider-trading allegations don't do much to bolster an inference of fraud. For example, a 2002 study by Professors Johnson, Nelson, and Pritchard compared suits that resulted in either dismissal or a low-value settlement with higher-value settlements, and found that insider-trading allegations were positively related to a higher probability of higher-value settlements in the pre-PSLRA period, but not the post-PSLRA period.<sup>122</sup> Perhaps recognizing that insider-trading allegations are not as compelling as plaintiffs would hope, the incidence of plaintiffs alleging insider trading in securities-fraud complaints has trended downward since 2005.<sup>123</sup>

## 2. Inferences from Shared Experience and Common Sense

Another way to bolster allegations of fraud is to ask judges to draw on their experience and commonsense to infer fraud. Two of the ways we see this play out in securities-fraud litigation is when plaintiffs contend that a court may draw a strong inference of scienter based on the defendant's motive to commit fraud or because the subject of the alleged fraud concerned one of the company's core operations.

The likelihood that these kinds of allegations will or won't stave off dismissal has not been empirically studied. But the case law suggests that these sorts of corroboration are weak. For instance, we can assume that generally, everyone wants to stay employed,<sup>124</sup> make their

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121. Sale, *supra* note 45, at 925.

122. Johnson, *supra* note 108, at 646–47.

123. COMOLLI ET AL., RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION, *supra* note 59, at 15.

124. See, e.g., Pirraglia v. Novell, Inc., 339 F.3d 1182, 1191 (10th Cir. 2003) (recognizing that defendants had “ample motive” to mislead investors where, shortly before taking control, the company had “fired its previous executive for failing to improve the company’s revenue,” and so the defendants “had especial cause to think that they would lose their jobs if they failed to produce results”); Serabian v. Amoskeag Bank Shares, 24 F.3d 357, 368 (1st Cir. 1994) (recognizing that the defendants were motivated to commit fraud “to save their salaries or jobs”).

company profitable, increase financial compensation in some way,<sup>125</sup> or portray their company and their work in a positive light.<sup>126</sup> But, as courts have been quick to point out, all corporate executives share these general aspirations, so these motives make poor proxies for distinguishing between culpable and nonculpable persons.<sup>127</sup>

Similarly, plaintiffs ask courts to infer that management knew about fraud when that fraud concerns the company's "core operations."<sup>128</sup> The inference stems from "two common-sense principles" that have endured the PSLRA: first, it is reasonable to infer that when a situation occurs within the business' core operations, senior management is likely aware of its existence and, second, it is reasonable to infer that senior executives are aware of the scheme when the scheme is pervasive and widespread within the company.<sup>129</sup> Similar to asking a court to infer motive based on shared experience or common sense, courts are likewise reluctant to infer that management acted with fraudulent intent where the only indicator is that the subject of the fraud concerns the company's core operations.<sup>130</sup> Indeed, the case in which a court will infer scienter based on the "core operations" inference alone is

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125. See, e.g., *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999); *Stevens v. InPhonic, Inc.*, 662 F. Supp. 2d 105, 123 (D.D.C. 2009).

126. See, e.g., *San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801, 814 (2d Cir. 1996) (noting that all companies desire to maintain high bond and credit ratings).

127. See, e.g., *Kalnit v. Eichler*, 264 F.3d 131, 139–40 (2d Cir. 2001) (recognizing that motive to increase stock value or compensation, standing alone, does not prove fraudulent intent); *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 622 (4th Cir. 1999) (noting that "assertions that a corporate officer or director committed fraud in order to retain an executive position . . . simply do not, in themselves, adequately plead motive"); see also *In re Rigel Pharm., Inc. Sec. Litig.*, 697 F.3d 869, 884 (9th Cir. 2012) (holding that the plaintiffs did not adequately allege motive to commit fraud because "allegations of routine corporate objectives such as the desire to obtain good financing and expand are not, without more, sufficient to allege scienter; to hold otherwise would support a finding of scienter for any company that seeks to enhance its business prospects").

128. A variant of this is Professor Couture's "falsity-scienter" inference, which posits that a statement's well-pleaded falsity gives rise to a strong inference that the speaker acted with scienter. Her point is that there are some subjects (the speaker's marital status, the speaker's name, etc.) that the speaker must know or would be reckless in not knowing, and so a false statement about a subject of that kind must have been made with scienter. See Couture, *supra* note 72 (noting that "a false statement about one's marital status gives rise to a strong inference, at the very least, of recklessness").

129. *City of Austin Police Ret. Sys. v. ITT Educ. Servs., Inc.*, 388 F. Supp. 2d 932, 949 (S.D. Ind. 2005).

130. See generally Michael J. Kaufman & John M. Wunderlich, *Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation*, 73 OHIO ST. L.J. 507 (2012) (surveying cases and explaining that courts are reluctant to infer scienter based on the "core operations" inference alone).

“exceedingly rare.”<sup>131</sup>

### 3. Confidential Witnesses

One of the most common ways in which plaintiffs seek to shore up their allegations is by adding accounts from confidential witnesses. Their accounts may go a long way to establishing scienter. To explain, one way to show scienter is to allege that the defendant had access to contemporary reports or data that contradicted the public statements.<sup>132</sup> That is, plaintiffs may effectively demonstrate scienter by juxtaposing what the firm and management told the investing public and what they said internally—what was said internally did not match what was said to the investing public.<sup>133</sup> Employees account for a significant portion of external mechanisms that detect corporate fraud.<sup>134</sup> According to a study by several academics, employees account for 17% of fraud detection.<sup>135</sup> That is, a significant source of fraud detection is the company’s own current and former employees. And this makes sense: former and current employees are primed to uncover facts concealed from public investors because these employees enjoy inside status.<sup>136</sup>

Contrary to the other forms of pre-filing investigation, obtaining confidential-witness accounts is not cheap. Often, this kind of discovery requires hiring private investigators. It also takes time to find and make contact with these witnesses. And when an investigator or plaintiffs’ attorney makes contact, there’s no guarantee that the witness

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131. *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 786 (9th Cir. 2008); *accord In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1191 (C.D. Cal. 2008).

132. *See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1230 (9th Cir. 2004) (“The most direct way to show both that a statement was false when made and that the party making the statement knew that it was false is via contemporaneous reports or data, available to the party, which contradict the statement.”); *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000) (“[T]he inference may arise where the complaint sufficiently alleges that the defendants . . . knew facts or had access to information suggesting that their public statements were not accurate”).

133. *See, e.g., Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1129 (2d Cir. 1994) (rejecting allegations of fraud where plaintiffs failed to contrast public disclosure with contemporaneous internal documents or data).

134. Dyck, *supra* note 82, at 2214.

135. *Id.*

136. *See, e.g., Geoffrey C. Rapp, Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. REV. 73, 108–09 (2012) (“Even though outside interests—like market arbitrageurs, short sellers, and regulators—may have reputational or financial incentives to seek out fraud, for such actors ‘detecting fraud is like looking for a needle in a haystack.’ Insider-employee whistleblowers ‘clearly have the best access to information,’ since ‘[f]ew, if any frauds can be committed without the knowledge and often the support of several employees.’ Insiders often also have the technical skills to comprehend the sometimes complex financial transactions that are at the core of many modern instances of fraud.” (internal citations omitted)).

will even talk with them (there can be no pay for testimony<sup>137</sup>) or tell them the truth.<sup>138</sup> Moreover, even if the witness does talk, there's a risk that the witness may later recant<sup>139</sup> when confronted by a former employer threatening legal action for breach of fiduciary, violation of a confidentiality agreement, or computer fraud.

Even if investigators and attorneys obtain confidential witnesses' accounts, the reliability of these sources' accounts is hotly debated in securities-fraud litigation. Anonymous employees don't enjoy the imprimatur of being a government agency or akin to an admission by the defendant itself. They're usually ex-employees. Their termination or resignation (possibly under bad terms) may give these witnesses reason to gripe, so courts are naturally suspicious of them. "Snitch[es] . . . liars,"<sup>140</sup> and axe-grinders;<sup>141</sup> a "gimmick" for obtaining costly discovery;<sup>142</sup> gossip-regurgitators and innuendo-makers;<sup>143</sup> not "privy to the big picture;"<sup>144</sup> and ultimately "not far above a false witness,"<sup>145</sup> are just a few of the phrases used by courts to describe these sources.<sup>146</sup>

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137. MODEL RULES OF PROF'L CONDUCT R. 3.4 cmt.3 (1983) ("[I]t is not improper to pay a witness's expenses or to compensate an expert witness on terms permitted by law. The common law rule in most jurisdictions is that it is improper to pay an occurrence witness any fee for testifying and that it is improper to pay an expert witness a contingent fee.").

138. Cf. *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1240 (11th Cir. 2008) (stating that one of the reasons "why courts may be skeptical of confidential sources" is that "lying to the police or to law enforcement in general will likely lead to much harsher consequences than lying to a plaintiff's attorney, so statements by confidential police informants may be more reliable than conversations between plaintiffs' attorneys and whistleblowers").

139. See, e.g., *City of Livonia Emps.' Ret. Sys. v. Boeing Co.*, 711 F.3d 754, 760–61 (7th Cir. 2013) (instance of confidential witness recanting); *In re BankAtlantic Bancorp, Inc. Sec. Litig.*, 851 F. Supp. 2d 1299, 1310 (S.D. Fla. 2011) (same).

140. See Michael J. Kaufman & John M. Wunderlich, *Congress, the Supreme Court, and the Proper Role of Confidential Informants in Securities Fraud Litigation*, 36 SEC. REG. L.J. 345, 356 (2008) (quoting Judge Posner during the oral argument in *Higginbotham* where the panel stated "having a confidential witness doesn't strengthen the allegation . . . . Such a person can be any kind of snitch, any kind of liar . . . [making] anonymous accusations against a company").

141. See *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (noting that confidential sources may have "axes to grind").

142. *City of Livonia Emps.' Ret. Sys.*, 711 F.3d at 759.

143. See, e.g., *In re Metawave Commc'ns. Corp. Sec. Litig.*, 298 F. Supp. 2d 1056, 1068 (W.D. Wash. 2003) ("The Court must be able to tell whether a confidential witness is speaking from personal knowledge, or merely regurgitating gossip and innuendo." (internal quotation marks omitted)).

144. *Material Yard Workers Local 1175 Benefit Funds v. Men's Wearhouse Inc.*, No. H-09-3265, 2011 WL 3059229, at \*6 (S.D. Tex. July 22, 2011).

145. *Id.*

146. The distrust of confidential witnesses in securities litigation is a not a view that is uniformly held. See, e.g., *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000) ("Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose

Plaintiffs must then persuade courts that these witnesses' accounts are trustworthy and reliable. This inquiry depends on whether the witnesses' job suggests that they were in a position to know the facts they claim to know, whether they provided detailed information to suggest they have actual knowledge, whether they supported their allegations with other sources or documents, and whether multiple sources across the company are consistent with the account.<sup>147</sup> (It is important to note that these are just factors to guide analysis, not control it.<sup>148</sup>) Indeed, to ensure the reliability of these sources, there have been instances where, before a motion to dismiss, a court allowed defendants to depose these witnesses or the district judge reviewed plaintiffs' attorneys' investigator's notes summarizing the witness interviews.<sup>149</sup> Once confidential witnesses are shown to be reliable and if they corroborate the plaintiffs' story, then the case may have a better chance of success.<sup>150</sup> A 2011 informal survey of dismissal rulings in 10b-5 subprime securities litigation found that if confidential witnesses were considered reliable sources—that is, described with sufficient

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while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them.”); *In re Cigna Corp. Sec. Litig.*, No. Civ. A. 02-8088, 2006 WL 263631, at \*1 (E.D. Pa. Jan. 31, 2006) (stating in a securities-fraud case that “[c]onfidential informants play a decidedly important role in many areas of public life”).

147. See, e.g., *Tellabs II*, 513 F.3d 702, 712 (7th Cir. 2008) (noting that the degree of detail provided and corroboration by multiple sources supports drawing strong factual inferences from confidential assertions); *N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC, Inc.*, 537 F.3d 35, 51 (1st Cir. 2008) (providing an analytical framework for determining the reliability of confidential witnesses); see also *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir. 2002) (stating that “the number of different sources helps the complaint meet [the PSLRA’s pleading] standard. Their consistent accounts reinforce one another and undermine any argument that the complaint relies unduly on the stories of just one or two former employees, possibly disgruntled.”).

148. *Teachers’ Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 193 (4th Cir. 2007) (Shedd, J., dissenting) (stating that “a personal aide or administrative assistant to the CEO could plausibly overhear a pertinent piece of information that may later form the basis for a securities fraud action, notwithstanding his job title”); Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure*, 12 FORDHAM J. CORP. & FIN. L. 551, 561 (2007) (stating that “job titles may convey little about actual job duties, and formal job duties may say little about whether an employee would have been privy to senior-level communications evidencing actionable misconduct”).

149. See, e.g., *Local 703, I.B. of T. Grocery & Food Emps. Welfare Fund v. Regions Fin. Corp.*, No. cv-10-2847, 2011 WL 4431154, at \*1 n.1 (N.D. Ala. Sept. 7, 2011) (stating that the court reviewed plaintiffs’ investigator’s notes in camera before crediting confidential-witness allegations); *Campo v. Sears Holdings, Corp.*, 635 F. Supp. 2d 323, 320 (S.D.N.Y. 2009) (ordering that defendants depose confidential witnesses to determine if they made statements attributable to them in the complaint) *aff’d*, 371 F. App’x 212 (2d Cir. 2010).

150. See, e.g., *Horowitz v. Green Mountain Coffee Roasters, Inc.*, No. 2:10-CV-227, 2013 WL 1149670, at \*10 (D. Vt. Mar. 20, 2013) (recognizing that a “critical difference” between the plaintiff’s allegations and allegations in another case that were deemed sufficient to allege a strong inference of scienter was the “credibility of the confidential witnesses in the two cases”).

particularity and satisfying some combination of the factors above—then the complaint was likely to survive a motion to dismiss, but if those witnesses were not reliable, then the case was likely to be dismissed.<sup>151</sup>

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I do not mean to say that it is always true that securities-fraud complaints that are strongly corroborated will always survive dismissal, or that securities-fraud complaints that are only somewhat corroborated will always be dismissed. We need only consult a few examples to know that that is not the case. For example, consider two appellate court decisions after *Tellabs* where the allegations appeared strongly corroborated, but resulted in dismissal.

First, in *Konkol v. Diebold, Inc.*,<sup>152</sup> the plaintiffs alleged that a voting-machine manufacturer—together with its senior managers—schemed to inflate profits (and thereby its stock price) by booking revenue for the sale of machines that did not comply with applicable law. The plaintiffs put forth several ways in which its allegations of fraud were corroborated, including, among other things, that the SEC and Department of Justice investigated the company's practices; that an outside law firm warned that the machines' purchasers would reject the voting machines because they did not comply with the law; that some defendants sold large amounts of the company's stock only weeks after false financial reports inflated the company's shares to an all-time high; and that confidential witnesses described the fraudulent scheme in detail and claimed that high-level officers of the company were involved.<sup>153</sup> According to the Sixth Circuit, these allegations were insufficient to satisfy *Tellabs*.<sup>154</sup> According to the court, the government investigations could have resulted "from any number of causes" other than stock fraud,<sup>155</sup> the plaintiffs did not allege that the law-firm warning made its way to top management,<sup>156</sup> the plaintiffs did not provide a meaningful trading history that would have put the stock sales in context,<sup>157</sup> and the confidential witnesses were described with too

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151. Christopher J. Miller, Note, "Don't Blame Me, Blame the Financial Crisis": A Survey of Dismissal Rulings in 10b-5 Suits for Subprime Securities Losses, 80 *FORDHAM L. REV.* 273, 310 (2011).

152. 590 F.3d 390, 395 (6th Cir. 2009).

153. *Id.* at 395–404.

154. *Id.* at 405.

155. *Id.* at 402.

156. *Id.* at 403.

157. *Id.* at 399–400.

little detail for the court to consider them reliable sources.<sup>158</sup>

Second, in *Matrix Capital Management Fund, LP v. BearingPoint, Inc.*,<sup>159</sup> the plaintiffs alleged that the management fund made numerous fraudulent accounting disclosures over an extended period. The firm allegedly went on an acquisition spree, buying several firms, including several foreign firms with no obligation to adhere to the accounting standards that applied to publicly traded companies. To corroborate their claims, the plaintiffs observed that the company restated its earnings, filed for Chapter 11 bankruptcy, and was investigated and subpoenaed by the SEC.<sup>160</sup> The Ninth Circuit concluded that the inference of scienter simply was not as compelling as the nonculpable inferences that executives were overwhelmed or negligent.<sup>161</sup> The court said that the restatements were an honest attempt by management to get a handle on its newly acquired foreign businesses and that the government investigation was too speculative to add anything.<sup>162</sup> The court did not address the weight to be afforded the defendant's bankruptcy.

Similarly, cases where the plaintiff's allegations are not strongly corroborated may still survive dismissal as well. In *Matrixx Initiatives, Inc. v. Siracusano*, the plaintiffs sued a manufacturer of a cold remedy for allegedly misleading the public about the safety of the drug.<sup>163</sup> According to the plaintiffs, the company knew or should have known that consumer reports and other accounts stating that the drug caused a loss of smell would have been material to investors, and that the failure to disclose this to investors would be to withhold information pertinent to their investment decisions.<sup>164</sup> That drug accounted for about 70% of the company's sales.<sup>165</sup> The Supreme Court concluded that the plaintiffs alleged scienter—not because of a parallel government action, bankruptcy, restatement, insider trading, or confidential-witness statement—but because of the inferences we could draw from our shared experience based on the nature of the fraud alleged.<sup>166</sup> The plaintiffs alleged that the company received reports from doctors claiming that some of their patients lost their sense of smell after using

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158. *Id.* at 398–99, 400–01.

159. *Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc.*, 576 F.3d 172, 177 (4th Cir. 2009).

160. *Id.* at 176–85.

161. *Id.* at 188–92.

162. *Id.* at 185.

163. 131 S. Ct. 1309, 1313 (2011).

164. *Id.*

165. *Id.* at 1323.

166. *Id.* at 1324–25.



the drug. Once the company learned that those doctors planned to present their findings, the company prevented the doctors from referencing the company's drug in the presentation.<sup>167</sup> Eventually, the FDA and *Good Morning America* alerted the public to the drug's risk of loss of smell.<sup>168</sup> After these warnings, the company issued a press release that stated that the drug was safe and that two double-blind studies found no link between loss of smell and use of the drug.<sup>169</sup> According to the Supreme Court, two facts made the inference of recklessness of intentional stock fraud at least as compelling as a nonculpable inference because they suggested a cover-up: first, the company prevented the doctor from referencing its drug.<sup>170</sup> Second, the press release was misleading because, in fact, the company "had not conducted any studies relating to anosmia [(loss of smell)]," and the scientific evidence at the time was inconclusive.<sup>171</sup>

As another example, in *Berson v. Applied Signal Technology, Inc.*, the plaintiffs alleged that a telecommunications company lied to the public by counting government contracts as part of its backlog of scheduled work when, in reality, the government issued stop-work orders on those contracts.<sup>172</sup> The company did not file for bankruptcy, there was no SEC investigation, and the company did not announce a restatement of its earnings. The fact that justified a strong inference of scienter, according to the plaintiffs, was that the stop-work orders accounted for millions of dollars of work, the loss of which resulted in one of the company's facilities becoming a ghost town.<sup>173</sup> The Ninth Circuit concluded that it would have been absurd to suggest that the company's executives were unaware of these stop-work orders because these contracts represented significant revenue for the company.<sup>174</sup>

In *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, the plaintiffs alleged that a fiber-optic-cable manufacturer was touting demand for its product and the potential for a new product when, in fact, demand was slipping, the new product was still in development, and the new product wasn't being received well by the market.<sup>175</sup> Like *Berson*, the company did not file for bankruptcy, there was no SEC investigation, and the

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167. *Id.* at 1315.

168. *Id.* at 1316.

169. *Id.*

170. *Id.* at 1324.

171. *Id.*

172. 527 F.3d 982, 987–88 (9th Cir. 2008).

173. *Id.* at 988 n.5.

174. *Id.* at 989.

175. *Tellabs II*, 513 F.3d 702, 706 (7th Cir. 2008).

company did not announce a restatement of its earnings. The plaintiffs instead alleged that the product was the company's flagship product and twenty-six different confidential witnesses (each described with particularity) said that inside the company, they knew sales were dropping and the new product was not being received well. The Seventh Circuit concluded that it was "exceedingly unlikely" that the defendants did not act with scienter.<sup>176</sup> The court explained that the products at issue were the company's "flagship product" and its "heralded successor," like "Windows XP and Vista are to Microsoft."<sup>177</sup> The idea that no member of the company's senior management knew about the demand problems with these products, the court said, "is very hard to credit."<sup>178</sup>

#### CONCLUSION

My point is that the securities laws have transformed the motion to dismiss into something like summary judgment—the "put up or shut up" moment in a lawsuit. This in turn means that plaintiffs are better situated when faced with a motion to dismiss if they have gathered sufficient, reliable evidence to corroborate allegations of fraud in the prefiling phase. And dismissal statistics are bearing this fact out, finding that those complaints with corroborated allegations are more likely to survive dismissal. But dismissal statistics and cases are telling in another respect as well. They reveal that some forms of corroboration—SEC proceedings, accounting restatements, and bankruptcies—seem more likely to help stave off dismissal than others—insider trading, inferences from shared experience, and accounts from confidential witnesses.

To close, notice that as important as the prefiling phase now is, many issues are still unexplored. Namely, how can plaintiffs effectively and ethically gather evidence before filing a complaint? How much of that evidence can plaintiffs get? And then, how can plaintiffs present that evidence to the court in a manner that it generates a "cogent and compelling" inference that the facts alleged amount to a potential fraud and not mere negligence or indifference? This Conference marks the beginning of the exploration of this phase.

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176. *Id.* at 709. The confidential witnesses are described as "important sources for the allegations not only of falsity but also of scienter." *Id.* at 711.

177. *Id.* at 709.

178. *Id.*