DEFINING RECKLESSNESS: A DOCTRINAL APPROACH TO DETERRENCE OF SECONDARY MARKET SECURITIES FRAUD

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Little has been written about recklessness as a level of intent sufficient to impose civil liability, even less in the context of the federally implied cause of action for securities fraud. This article engages the concept of recklessness in the setting of class action, fraud-on-the-market lawsuits against securities issuers and their executives. Extending prior work, the author demonstrates the utility of contextual factors in an assessment of an individual corporate actor's recklessness at the crucial pleading stage. The proposed rubric—based on magnitude, atypicality, and timing of the information misrepresented—is informed by recent Supreme Court pronouncements on scienter, by established 10(b) case law attempting to define recklessness as a level of intent producing fraud, and by the *Third Restatement*'s recent adoption of a fundamentally objective approach to recklessness in tort law more generally.

By providing an intellectually grounded prescription for the evaluation of inferences of recklessness in 10(b) cases, this work both harmonizes the federal common law of securities fraud and reinforces its normative power. At the same time, the author's conception of recklessness revives largely moribund legislative efforts to increase executive accountability and to improve the quality of corporate disclosure for the benefit of shareholders. Thus, it adds meaningfully to the literature seeking to establish and put into service an optimal level of securities fraud deterrence.

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INTRODUCTION

Over the last two decades much has been written about the efficacy of the class action as a means of deterring securities fraud. In 1995, the U.S. Congress enacted in the Private Securities Litigation Reform Act (PSLRA) a series of procedural reforms meant to reduce the incidence of strike suits.[1] Along the way commentators have offered a variety of proposals for more substantive reforms, among them limiting corporate liability by way of damage caps,[2] changing the system of regulatory fines,[3] empowering the SEC to vet securities fraud claims,[4] replacing the class action with other antifraud monitors,[5] eliminating criminal

1. 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. (2006)). The PSLRA's procedural reforms include, among others, new requirements for those who may serve as lead plaintiff and plaintiffs' counsel in open-market fraud cases, reducing the availability of joint and several liability, heightened pleading standards, and a broad discovery stay until after consideration of any motion to dismiss. §§ 101, 201.

2. *See generally* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 639–61 (1996) (advocating a reduction in the "draconian" liability threat posed by fraud-on-the-market class actions against corporations). The Securities and Exchange Commission has voiced its own concern about the punitive effect of the secondary market fraud class action suit against the issuer, vowing to carefully consider the effect large civil fines have on innocent shareholders. Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* http://www.sec.gov/news/press/2006-4.htm.

3. Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1515–17 (1996) (proposing a switch to civil fines enforced by bounties for private plaintiffs).

4. Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10B-5*, 108 COLUM. L. REV. 1301, 1306–07 (2008) (suggesting that broad private enforcement of Rule 10b-5 tempered by public oversight may achieve a more optimally deterrent effect).

5. A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Securities Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928–29 (1999) ("[T]he incentives of the exchanges' members should push exchanges to enforce vigorously prohibitions against fraud on the market.").

securities fraud liability for enterprises,[6] and even exempting non-trading corporations from civil liability for secondary market fraud.[7] Common to these reform suggestions is the premise that class action suits alleging fraud-on-the-market are both economically inefficient in their attempts to reduce agency costs and, importantly, ineffective at deterring fraudsters.[8]

Also common to them is a recognition that optimal deterrence is probably only achieved with a significant change in the incentives and penalties affecting the culpable *individuals* who conceive and implement securities fraud.[9] But individual deterrence is difficult, fraught with both legal and practical impediments. Instead, the private securities litigation landscape is largely dominated by enterprise liability arising from principles of respondeat superior, compounded by the practical realities of indemnity contracting and the settlement process, as well as the supervening influence of directors' and officers' insurance coverage.[10]

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6. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 833–36, 864–66 (1994) (demonstrating, inter alia, that under a vicarious criminal liability regime, increased corporate-enforcement expenditures have the effect of increasing corporate crimes such as securities and government procurement fraud and some environmental crimes). Many other more indirectly relevant reforms have been suggested, among them quasi-strict liability for auditors and other gatekeepers, Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 491–92 (2001), and an auction system for plaintiffs' claims, to more effectively align the interests of "entrepreneurial" plaintiffs' attorneys with that of their clients, Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3, 6 (1991).

7. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1566–72 (2006) (suggesting the total elimination of the secondary market fraud suit against a non-trading issuer as a radical means of reforming the current deterrence system); Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 240 (2009) (advocating exemption from fraud-on-the-market liability for issuer misstatements in mandatory disclosure filings only). Professor Coffee has well argued the point that enterprise liability results in a pocket shifting exercise, penalizing current shareholders for the benefit of former shareholders. Coffee, *supra*, at 1562.

8. Coffee, *supra* note 7, at 1535–37, 1566–67. This is true notwithstanding that executives who are complicit in corporate fraud sometimes lose their jobs and reputations, face criminal prosecution, and may also suffer with other shareholders the reduction in value of their company's stock and stock options.

9. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694, 720–27 (examining, inter alia, the economic arguments attending enterprise liability for securities fraud and demonstrating empirically that frauds are usually perpetrated by individuals in "last period" circumstances). Earlier scholarship had posited that "enterprise liability better serves the goal of optimal deterrence." *Id.* at 692.

10. *See* Coffee, *supra* note 7, at 1566–70. For a cogent discussion of these obstacles to more socially beneficial agency cost allocation between corporation and guilty agent, see Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate*

Professor John Coffee has attempted to deal with these daunting, intertwined hurdles to optimal deterrence by proposing that the buck stop, so to speak, with the trial judge or the board of directors—who should more substantively approve class action securities fraud settlements.[11] In short, he advocates an extension of the PSLRA's apportionment-of-liability provision to the settlement context.[12] Section 21(D)(f) of the Securities Exchange Act of 1934 requires the finder of fact to apportion liability among the defendants at trial.[13] But as most class action securities fraud suits settle,[14] no such allocation of blame is typically performed. He suggests that trial judges approving class action securities fraud settlements should do so, to further effectuate the purpose of Section 21(D)(f).[15] Perhaps more feasibly, Coffee argues, if a settling defendant's board is required to assess the settlement's apportionment of fault as between the corporation and the targeted individuals, and to publicly opine as to its fairness to the corporation, a real impact on individual deterrence could be achieved.[16]

Professor Donald Langevoort also has attempted to grapple with the individual liability problem, instead focusing on the question of whether we are "satisfied with the available tools for going after the executives who were complicit in the fraud."[17] Pointing to the possibility of some weapon other than the open market fraud suit, he explores the use of equitable remedies under Delaware law as well as within the context of SEC enforcement actions.[18] As a threshold matter he notes the difficulty of proving executive liability from the standpoint of the federal securities laws.[19] Consequently his essay makes several suggestions for reform, including the possibility of eliminating the fraud-on-the-market presumption in class actions, increased leverage applied by the SEC to obtain restitution from individual wrongdoers as part of a deferral of enforcement against the enterprise, and greater development of Delaware law on both "candor inside the corporation" and recoupment of executive pay.[20]

Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 650–51 (2007) [hereinafter Langevoort, *On Leaving Corporate Executives*] (discussing changes in plaintiffs' behavior if enterprise liability was abolished or significantly curtailed).

11. *See* Coffee, *supra* note 7, at 1567–68, 1571.

12. *Id*. at 1575.

13. 15 U.S.C. § 78u-4(f)(3)(2006); *see also* Coffee, *supra* note 7, at 1573.

14. Coffee, *supra* note 7, at 1585.

15. *Id*. at 1574–75.

16. *Id*. at 1575–81.

17. Langevoort, *On Leaving Corporate Executives*, *supra* note 10, at 630.

18. *Id.* at 640-48, 660.

19. *Id.* at 650.

20. *Id.* at 656–59 (quoting Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1199

I offer here an adjunct to these proposals, a doctrinal refinement valuable in its own right given the paucity of attention that recklessness has received in the scholarship, but which also has the added value of assisting a board of directors or judge in assessing the culpability of the individual officers who have been sued alongside the corporation. Soon after the passage of the PSLRA, a panel of the Second Circuit Court of Appeals observed the distinct difficulty for plaintiffs in pleading scienter without "specifically greedy comments from . . . authorized corporate individual[s]."[21] This is echoed in Langevoort's essay, in which he remarks on "the practical problems of assessing individual executive culpability in complex organizations with diffused lines of authority."[22] More globally, he laments the current system's propensity to "leave executives who either instigated, helped execute, acquiesced in, or closed their eyes to fraud with most or all the wealth that was generated by the deception."[23]

A rather direct means of holding executives accountable for their profitable complicity or willful ignorance can be generated out of a more reasoned jurisprudential definition of recklessness. The federal judiciary has, both before and after the enactment of the PSLRA, puzzled over what constitutes recklessness in the secondary market-fraud context, often collapsing it with a discussion of circumstantial proof of actual intent to defraud. In fact, no intellectually sound judicial approach has emerged for gauging the extent to which a plaintiff's allegations of reckless misstatements against a corporate officer adequately plead a strong inference of the necessary element of scienter in the typical 10(b) class action.[24]

In aid of enhancing individual deterrence, this Article refines the meaning of recklessness, providing a framework for its analysis at the pleading stage, separate and apart from allegations of actual intent. Providing some shape to what has heretofore been a conspicuously amorphous scienter standard, I demonstrate that in suits involving putative false statements by officers, upon a motion to dismiss three

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(2003)). In that vein, see also T. Leigh Anenson & Donald O. Mayer, *"Clean Hands" and the CEO: Equity as an Antidote for Excessive Compensation,* 12 U. PA. J. BUS. L. 947 (2010).

21. *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (warning against overly restrictive views of the PSLRA's heightened pleading standards).

22. Langevoort, *On Leaving Corporate Executives*, *supra* note 10, at 655.

23. *Id.* at 661.

24. 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2010). The U.S. Supreme Court has stated that "the scope of Rule 10b-5 is coextensive with the coverage of § 10(b)," and therefore, it adopts the use of "§ 10(b) to refer to both the statutory provision and the Rule." *SEC v. Zandford*, 535 U.S. 813, 816 n.1 (2002). This Article follows suit, referring to the claim as a 10(b) claim.

contextual factors can establish and limit inferences of an officer's recklessness available. These factors are the magnitude, atypicality, and timing of the misinformation or its disclosure.[25] Put otherwise, my thesis is that while no officer is expected to, nor can she, know every detail about a large publicly traded corporation, it is the epitome of recklessness for a highly paid corporate head to speak to the market about important corporate matters without knowing the truth. Hence, when pleading a circumstantial case of recklessness against a high-ranking corporate executive, a complaint that identifies the truth—placing it in the relevant corporate context—can establish a cogent and compelling inference that the true fact misrepresented was so important that the officer was either reckless in failing to know it or reckless in speaking about it without knowing.

Armed with this more distinct conception of recklessness, in the proper case top executives can be held more accountable for misstatements of major facts and events related to the companies they lead. Adoption of this proposal would have twin salutary results. First is increased individual liability for recklessness, which properly disincentivizes willful ignorance and eliminates plausible deniability, furthering the socially desirable goal of fraud deterrence by targeting its source. Second, this proposal harmonizes what has heretofore been incoherent case law, strengthening the prescriptive musculature of the common law of securities fraud.

The argument proceeds in three parts. First, in Part I, I establish the need for a cohesive analytical framework for consideration of recklessness allegations by studying the definition of recklessness presently employed in the courts, and how it has failed to create an individual deterrent effect or to produce consistent, logical results. Then in Part II I propose a contextual model for assessment of recklessness allegations and demonstrate its utility by uniting the scattered judicial decisions that have started in this direction. Part III weighs the theory and policy arguments supporting the adoption of this new approach for gauging recklessness. Then the Article concludes with some final thoughts.

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25. These contextual factors are currently utilized by courts when analyzing the suspiciousness of insider stock transactions, and also as a barometer of intent in 10b-5 cases. Prior work has also demonstrated that these contextual factors explain the best-reasoned decisions addressing motive and opportunity as indicia of scienter. *See generally* Ann Morales Olazábal & Patricia Sanchez Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scienter*, 60 FLA. L. REV. 401 (2008) (extending the stock sales model to create a rubric for consideration of adequacy of allegations of motive and opportunity in 10b-5 complaints). The model proposed here, then, is a constructive extension of these findings.

I. RUDDERLESS APPLICATION OF THE 10(B) RECKLESSNESS STANDARD

> *Many . . . have noted the fine line between recklessness and negligence. But there is an equally fine line between recklessness and knowledge.*[26]

In the archetypal open-market-fraud class action, a corporate officer is alleged to have made a materially false or misleading statement about an important product line or financial matter, quarterly earnings, for example. Usually the falsehood is in the corporation's favor, and it results in an alleged inflation of the stock price. Later the truth is discovered, and a class of plaintiffs sues under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.[27] Whether this falsehood constitutes a violation of the rule at the pleading stage will depend in great measure on the corporate officer's scienter. Without a rare damning admission of some sort, plaintiffs are hard-pressed to show at the critical motion-to-dismiss stage that the officer actually knew his statement was false.[28] Consequently, at the dismissal stage in these cases, most plaintiffs are instead attempting to establish in their complaints a strong circumstantial case that the misstatement was *recklessly* made. Commentators have noted that this is now a nearly insurmountable task, and as a consequence, that corporate defendants are too easily escaping liability.[29]

So what is recklessness? Black's Law Dictionary defines recklessness as "[c]onduct whereby the actor does not desire harmful consequence but nonetheless foresees the possibility and consciously takes the risk."[30] It is a tricky concept, hovering as it does between negligence and actual intent to injure. In tort, it has generally been referred to as conscious disregard of a substantial risk of serious harm.[31]

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26. Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights and Settlement Effects,* 51 BUS. LAW. 1157, 1165–66 (1996).

27. 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2010).

28. *See Novak v. Kasaks*, 216 F.3d 300, 304 (2d Cir. 2000) (addressing allegations of conscious misbehavior, where officers allegedly discussed dire need to misrepresent status for fear of Wall Street's reaction). *But see Press v. Chem. Inv. Servs., Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (noting that to require specifically greedy comments from an authorized corporate officer would tend to make "virtually impossible a plaintiff's ability to plead scienter in a financial transaction involving a corporation, institution, bank or the like").

29. *See, e.g.*, Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 413 (2008); *see also* Langevoort, *On Leaving Corporate Executives*, *supra* note 10, at 649–50 (calling the task "hard").

30. BLACK'S LAW DICTIONARY 1385 (9th ed. 2009).

31. RESTATEMENT (SECOND) OF TORTS § 500 (1965).

In the criminal law it has been said that it can take on "an objective meaning of gross negligence" as well as a "subjective meaning of advertent negligence."[32] Beyond traditional jurisprudence of torts and crimes, assessment of an actor's recklessness proliferates in such varied legal arenas as the availability of punitive damages in civil suits,[33] patent infringement law,[34] and violations of the Fair Credit Reporting Act in the

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> The actor's conduct is in reckless disregard of the safety of another if he does an act or intentionally fails to do an act which it is his duty to the other to do, knowing or having reason to know of facts which would lead a reasonable man to realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent.

Id. Professors Henderson and Twerski have suggested beneficial changes to the *Second Restatement*'s definition of recklessness, including the addition of a cost-burden approach to risk avoidance. James A. Henderson, Jr. & Aaron D. Twerski, *Intent and Recklessness in Tort: The Practical Craft of Restating Law*, 54 VAND. L. REV. 1133, 1155-56 (2001) (opining that the then-current discussion draft of the *Third Restatement*'s treatment of recklessness is an improvement over section 500 of the *Second Restatement*, quoted above).

32. Glanville Williams, *Recklessness in Criminal Law*, 16 MOD. L. REV. 234, 234 (1953); *see also* The Right Honourable the Lord Irvine of Lairg, Lord Chancellor, *Intention, Recklessness and Moral Blameworthiness: Reflections on the English and Australian Law of Criminal Culpability*, 23 SYDNEY L. REV. 5, 6–8 (2001) (discussing the English and Australian experiences with objective versus subjective conceptions of recklessness). By contrast, the Model Penal Code provides:

> A person acts recklessly with respect to a material element of an offense when s/he is aware of and consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his/her conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him/her, its disregard involves a gross deviation from the standard of conduct that a reasonable person would observe in the situation.

MODEL PENAL CODE § 2.02(2)(c) (Official Draft 1985). This formulation is a subjective one, requiring the individual's awareness of the risk.

33. For example, in California punitive damages are clearly available in actions where a defendant's conduct is in "wanton and reckless disregard" of the plaintiff's rights, *Franklin Supply Co. v. Tolman*, 454 F.2d 1059, 1075 (9th Cir. 1971); where acts were done with "reckless disregard of [their] possible results," *Trammell v. W. Union Tel. Co.*, 129 Cal. Rptr. 361, 372 (Ct. App. 1976) (quoting *Toole v. Richardson-Merrell Inc.*, 60 Cal. Rptr. 398, 415 (Ct. App. 1967)); or where the defendant's conduct evinces a "callous and conscious disregard of public safety," *Grimshaw v. Ford Motor Co.*, 174 Cal. Rptr. 348, 382 (Ct. App. 1981).

34. In 2007, the Federal Circuit created a standard of "objective recklessness" for purposes of establishing willful patent infringement. *In re Seagate Technology L.L.C.*, 497 F.3d 1360, 1371 (Fed. Cir. 2007) (en banc). For a discussion of the subject, see Robert Aloysius Hyde, *A Reckless Disregard of the Ordinary Infringer? Moving Toward a Balanced and Uniform Standard for Willful Copyright Infringement*, 35 U. TOL. L. REV. 377 (2003).

employment context.[35] Perhaps it is precisely because of the many and varied legal addresses at which recklessness resides that, as a concept, it has eluded precise judicial interpretation.[36] Indeed, the single common thread among the recklessness standards employed in this mixed bag of legal inquiries may be their opacity and lack of susceptibility to any kind of uniform application.

The federal securities laws are no different.[37] After 1976, when the Supreme Court in *Ernst & Ernst v. Hochfelder*[38] left open the possibility that recklessness would suffice to establish the necessary scienter in 10(b) cases,[39] the lower courts adopted recklessness as the minimum standard for a finding of scienter. PSLRA does not alter the scienter standard, but as a procedural matter requires the complaint to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[40] The Supreme Court continues to reserve the question of precisely what constitutes the necessary state of mind in a 10(b) suit.[41] However in its most recent opinion touching on scienter, *Tellabs v. Makor Issues & Rights, Ltd.*,[42] the Court noted that

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35. *Safeco Ins. Co. of America v. Burr*, 551 U.S. 47, 52 (2007) (adopting a recklessness standard for willful Fair Credit Reporting Act claims).

36. *See* Geoffrey Christopher Rapp, *The Wreckage of Recklessness,* 86 WASH. U. L. REV. 111, 115 (2008) ("In the courts, the definition of recklessness has remained elusive.").

37. In fact, the Second Circuit has acknowledged the "complexity and uncertainty" that surrounds application of the "strong circumstantial evidence of . . . recklessness," at the pleading stage in 10b-5 cases. *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000).

38. 425 U.S. 185 (1976).

39. The Court set out its reservation in a footnote:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10 (b) and Rule 10b-5.

Id. at 193 n.12. The Court has provided no additional guidance in defining the necessary state of mind, other than to allow that the 10(b) cause of action requires something more than negligence. *Id*. at 214–15.

40. 15 U.S.C. § 78u-4(b)(2) (2006). Section 21D of the PSLRA requires plaintiffs seeking recovery under section 10(b) to plead particular facts that give rise to a "strong inference" of scienter. Pub. L. No. 104–67, 109 Stat. 737, 747 (1995). For a detailed treatment of the PSLRA's provisions, see Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641 (1997).

41. *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (defining 10b-5's scienter element as "a wrongful state of mind").

42. 551 U.S. 308, 322 (2007) ("Our task is to prescribe a workable construction of the [PSLRA's heightened] 'strong inference' standard [for pleading scienter], a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims.").

the circuits are in agreement that recklessness may suffice to establish scienter in a 10(b) case.[43]

As in other legal arenas, recklessness in the 10(b) context has nowhere been defined serviceably or with any real consistency. Instead, it has sometimes been described as "a lesser form of intent[]"[44] rather than a "greater degree of ordinary negligence,"[45] or "as a mental state apart from negligence and akin to conscious disregard."[46] Compounding this murkiness and lack of uniformity in concept, the circuit courts of late have tended also to employ idiosyncratic terminology, referring to the recklessness standard variously as "deliberate" or "conscious recklessness,"[47] "severe recklessness,"[48] and "a high degree of recklessness."[49] As I have shown elsewhere, these more ominous sounding forms of recklessness that surfaced in post-PSLRA decisions

43. *Id.* at 319 n.3.

44. *E.g.*, *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 976 (9th Cir. 1999) ("[R]eckless behavior in the § 10(b) context is merely a lesser form of intentional conduct."); *see also Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (stating that recklessness is "relatively close to intentional conduct").

45. *Greebel v FTP Software Inc.*, 194 F.3d 185, 198–99 (1st Cir. 1999) (quoting *Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977)); *McDonald v. Alan Bush Brokerage Co.,* 863 F.2d 809, 814 n.10 (11th Cir. 1989) (quoting *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.,* 739 F.2d 1434, 1435 (9th Cir. 1984)); *accord Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir. 1978) ("[M]ore culpable than mere negligence, [but with an intent less culpable than] 'deliberately and cold-bloodedly . . . conceal[ing] information.'" (quoting the unpublished district court decision)); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir.1977) ("[A] conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception." (quoting *Coleco Indus., Inc. v. Berman*, 423 F. Supp. 275, 296 (E.D. Pa. 1976))); *see also In re Comshare Inc. Sec. Litig*., 183 F.3d 542, 550 (6th Cir. 1999); THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION §12.8[3], at 483–84 (5th ed. 2006) ("Recklessness is obviously a matter of degree and requires something considerably more than negligent conduct, but it still falls short of actual intentional action.").

46. *In re Comshare*, 183 F.3d at 550.

47. *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000) ("[T]he scienter requirement can be satisfied by pleading either 'conscious recklessness' . . . or 'actual intent.'") (quoting *Novak v. Kasaks*, 997 F. Supp. 425, 430 (S.D.N.Y. 1998)); *In re Silicon Graphics*, 183 F.3d at 974 (stating that plaintiffs must allege "facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct").

48. *See, e.g.*, *Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp.*, 565 F.3d 200, 207 (5th Cir. 2009) ("[S]evere[] reckless[ness] . . . demonstrates that the defendant must have been aware of the danger of misleading the investing public." (quoting *Plotkin v. IP Axess Inc.,* 407 F.3d 690, 697 (5th Cir. 2005))); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 344 (4th Cir. 2003) ("Such 'severe recklessness' is, in essence, 'a slightly lesser species of intentional misconduct.'" (quoting *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001))).

49. *See, e.g.*, *Aldridge v. A.T. Cross Corp.*, 284 F.2d 72, 82 (1st Cir. 2002) (citing *Greebel*, 194 F.3d at 198–201).

are no different from each other, and in fact are coexistent with prior formulations of recklessness.[50] Regardless of the precise label, in this setting recklessness is most often characterized as "an extreme departure from the standards of ordinary care . . . present[ing] 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."[51]

To be sure, a few of the federal appellate courts have attempted to create some structure for the concept of recklessness in 10(b) cases, but this effort has not gone much beyond pointing to fact-pattern types that may be indicative of scienter. And, apart from reference to the somewhat disobliging definition that is commonly quoted, the analysis in most of the other extant case law appears to be at best circular, tautological. Simply put, courts have not delved into the meaning of "obvious" here nor does any precedent stand out as having assessed the risk contemplated by the "danger" component of this definition.

The First and Sixth Circuits have overtly deferred any sort of meaningful intellectual inquiry into the substance of recklessness in favor of a mechanically applied "factors" approach.[52] In practice the factors these courts have enumerated[53] are specific factual scenarios, which often provide a poor fit for the ad hoc facts courts must consider in circumstantial cases alleging recklessness. Even the Second Circuit, the so called "Mother Court" of securities laws, has done little more to

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50. *See* 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).

51. *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285 n.21 (11th Cir. 1999) (emphasis added) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

52. *See e.g.*, *City of Monroe Emp. Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683–84 (6th Cir. 2005); *Geffon v. Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001).

53. The "factors usually relevant to scienter" are

> (1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery by a top company official; (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit; (6) disregard of the most current factual information before making statements; (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication; (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) the self-interested motivation of defendants in the form of saving their salaries or jobs.

Helwig v. Vencor, 251 F.3d 540, 552 (6th Cir. 2001) (citing *Greebel*, 194 F.3d at 196). Several of these factors are similar to the rubric proposed here. *See infra* Part II.A-II.C.

clearly flesh out the important concept of recklessness than also to articulate fact patterns that have or may in the future suffice to state a 10(b) claim on that basis, reasoning that "general standards offer little insight into precisely what actions and behaviors constitute recklessness sufficient for § 10(b) liability."[54]

Several general standards and interpretive practices have emerged nonetheless. First, many courts appear inclined to collapse their consideration of allegations that might properly support a finding of recklessness with a plaintiffs' alternative allegations of actual intent.[55] As a consequence, these courts regularly dismiss complaints that fail to provide an express evidentiary link between the falsity uttered by the officer and his contemporaneous actual knowledge of the truth, without further consideration.[56] Another standard reaction to allegations of

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54. *Novak v. Kasaks,* 216 F.3d 300, 308–09 (2d Cir. 2000). The *Novak* court further reasoned that "[i]t is the actual facts of our securities fraud cases that provide the most concrete guidance," pointing to several fact patterns as illustrative of the types of allegations that have been held to meet the recklessness standard in that circuit as well as some that have not, but which provided "important limitations on the scope of liability for securities fraud based on reckless conduct." *Id.*; *see also Kushner v. Beverly Enters. Inc*., 317 F.3d 820, 827 (8th Cir. 2003) (adopting the Second Circuit's fact-pattern approach).

55. *See*, *e.g*., *Ronconi v. Larkin*, 253 F.3d 423, 432 (9th Cir. 2001).

> [A complaint must] state a set of facts raising a strong inference that the statements were intentionally false, misleading or made with deliberate recklessness. To meet this pleading requirement, the complaint must contain allegations of specific 'contemporaneous statements or conditions' that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made.

Id. The judicial opinions in this area rarely make a clear distinction between actual knowledge and recklessness as separate bases for finding a strong inference of scienter; consequently it is those that do so that stand out. *See, e.g.*, *Middlesex Ret. Sys. v. Quest Software Inc*., 527 F. Supp. 2d 1164, 1182–84 (C.D. Cal. 2007) (assessing facts under each level of intent separately). This tendency to collapse the discussion of actual knowledge and recklessness appears to have been exacerbated by the Supreme Court's pronouncement in *Tellabs* requiring a holistic view of plaintiff's allegations and consideration of competing inferences. 551 U.S. 308, 326 (2007).

56. *See, e.g*., *In re Alpharma Inc. Sec. Litig*., 372 F.3d 137, 150 (3d Cir. 2004) (approving the district court's conclusion that the complaint failed to link the executives to the fraud); *Kushner v. Beverly Enters. Inc*., 317 F.3d 820, 827–28 (8th Cir. 2003) (holding that a strong inference of scienter could not be drawn in the absence of "allegations of particular facts demonstrating how the defendants knew of the scheme at the time they made their statements of compliance, that they knew the financial statements overrepresented the company's true earnings, or that they were aware of a GAAP violation and disregarded it"); *In re Navarre Corp. Sec. Litig*., 299 F.3d 735, 743 (8th Cir. 2002) (holding that plaintiffs' failure to plead "[w]hy . . . the defendants [would] have known of this" was fatal under the heightened pleading standard of the PSLRA); *Abrams v. Baker Hughes, Inc*., 292 F.3d 424, 432 (5th Cir. 2002) ("The plaintiffs point to no specific internal or external report available at the time of the alleged misstatements that would contradict them."). See also *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63,

recklessness is to seize on and discard without analysis what the court deems to be conclusory contentions that individual defendants knew or must have known[57] their statements were false, usually in light of their positions in the company, or of their "hands on" management style.[58] The other approach that circumstantial allegations of reckless misrepresentations take, and which is also routinely rejected out of hand by courts, is to argue that the information misstated was part of the company's core business operations, and therefore the true facts were or should have been known by high-ranking corporate officer-defendants.[59]

I posit that these general standards—often reflexively and somewhat emptily repeated by the courts—deserve reconsideration, particularly in light of the clear societal need to more effectively deter securities fraud by corporate agents. While there is no question that an officer's mere position in a company or active management style does not automatically render his misstatements reckless, the fact of his corporate office along with the type of information misrepresented *together* can and should in the appropriate case lead to a finding of recklessness at the pleading stage. And, equally important, it can be a reckless act in itself for a high-ranking corporate officer to disclose false material information without knowing the truth. Thus the primary or exclusive focus on a plaintiff class's failure to adequately plead the executive's contemporaneous knowledge of the truth is misplaced. In some cases is it even plausible

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76–77 (2d Cir. 2001), which found recklessness sufficiently pled where plaintiffs established executives' knowledge of truth while misrepresenting facts to public.

57. I surmise that many courts are uncomfortable with the "must have known" formulation in such complaints, which echoes negligence's "should have known" lexicon. *See, e.g.*, *Haw. Structural Iron Workers Pension Trust Fund* (*In re Apple Computer, Inc.*), 127 F. App'x 296, 300 (9th Cir. 2005) ("Claims that a speaker 'could have' or 'should have' known that the statements were false are insufficient to satisfy the standard . . . . 'Negligence, even gross negligence, does not rise to the level of the nefarious mental state necessary to constitute securities fraud under the PSLRA.'" (quoting *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 391 (9th Cir. 2002))).

58. *See, e.g.*, *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 535 (5th Cir. 2008); *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 239 (3d Cir. 2004); *Fischer v. Vantive Corp.* (*In re The Vantive Corp. Sec. Litig.*), 283 F.3d 1079, 1087 (9th Cir. 2002); *City of Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1263–64 (10th Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999); *Maldonado v. Dominguez*, 137 F.3d 1, 10 (1st Cir. 1998). *But see Sparling v. Daou* (*In re Daou Sys., Inc.*), 411 F.3d 1006, 1022–23 (9th Cir. 2005) (finding a sufficient inference of scienter where plaintiffs' allegations included "specific admissions from top executives that they are involved in every detail of the company and that they monitored portions of the company's databases").

59. *See, e.g.*, *Condra v. PXRE Grp. Ltd.*, 357 F. App'x 393 (2d Cir. 2009); *Cornelia I. Crowell GST Trust v. Possis Med., Inc.*, 519 F.3d 778, 783 (8th Cir. 2008); *Nevius v. Read-Rite Corp.* (*In re Read-Rite Corp. Sec. Litig.*), 335 F.3d 843, 848–49 (9th Cir. 2003).

(much less cogent and compelling[60]) that in fact the CEO or CFO did not know the truth? As a prescriptive matter, then, an alternate means of making a circumstantial case of recklessness against that executive is to establish that her failure to get the facts straight before speaking to the market *is itself recklessness*.[61]

The efficient capital markets hypothesis holds that material information about an efficiently traded public company is quickly absorbed into the stock's price.[62] Thus, when top corporate officers misspeak to the marketplace about material matters, harm to investors is not only possible, but likely.[63] What follows from these two rather intuitive propositions is that top corporate officers who are not adequately informed about important facts relating to their firms are reckless in making public statements that depend on the accuracy of that information.

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60. *Tellabs*, 551 U.S. at 324.

61. Some courts have alluded to this possibility, perhaps inadvertently, but this view has not spread beyond dicta in a few cases. *See, e.g.*, *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 264 (5th Cir. 2005) (noting that to establish scienter a "party must know that it is publishing materially false information, or the party must be severely reckless in publishing such information" (quoting *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990))). A different twist is presented by a complaint that alleges the defendants "knew, or were *reckless in failing to disclose*, adverse material." *See, e.g.*, *Financial Acquisition Partners LP v. Blackwell*, 440 F.3d 278, 289–90 (5th Cir. 2006) (emphasis added).

62. SEC Commissioner Paredes well captures the essence of the efficient capital markets hypothesis. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417, 480–81 (2003). For good or for bad, this hypothesis undergirds the fraud-on-the-market theory. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 241–47 (1988) (holding that the efficient capital markets theory provides adequate support for a presumption in 10(b) actions that shareholders in publicly traded companies rely on public material misstatements that affect the price of the company's stock); *cf.* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059 (1990) (setting forth several analytical flaws in the *Basic* decision). For a discussion of the history of the fraud on the market theory in common law and 10(b) cases, see Robert A. Prentice, Stoneridge*, Securities Fraud Litigation, and the Supreme Court*, 45 AMER. BUS. L.J. 611, 662–63 (2008).

63. *See, e.g.*, *Eckstein v. Balcor Film Investors*, 58 F.3d 1162, 1170 (7th Cir. 1995) ("Reliance is the confluence of materiality and causation. The fraud on the market doctrine is the best example; a material misstatement affects the security's price, which injures investors who did not know of the misstatement."). Of course, today defendants vigorously contest loss causation, as legal and evidentiary matters, in nearly every 10(b) lawsuit. But as an historical matter, class action open market fraud suits are legion in which plaintiffs allege that when the truth about a misrepresentation is revealed, it has a devastating effect on the company's equity stock price. *E.g.*, *In re Daou Sys., Inc.*, 411 F.3d 1006, 1027 (9th Cir. 2005) (holding, based on *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), that "the [complaint's] assertions of a steep drop in Daou's stock price following the revelation of Daou's true financial situation are sufficient to enable the complaint to survive a motion to dismiss").

This conception of recklessness falls squarely within the definition already accepted by the courts, and it therefore requires no radical reform to the legal system in order to achieve added executive accountability. What is needed instead, and critically so, is to define what type of information a high-ranking corporate officer cannot or should not be permitted to deny knowing when he is alleged to have made a misrepresentation to the investing public. This new framework will permit and encourage a more regularized and rational consideration of recklessness allegations in fraud-on-the-market complaints brought under 10(b). The next Part explores the parameters of recklessness when a top corporate officer is or purports to be ignorant of salient corporate information.

II. THE CONTEXTUAL MODEL: THREE INQUIRIES DEFINING AND DELIMITING RECKLESS MISREPRESENTATION

Every assessment of scienter in a 10(b) case is an ad hoc review of distinct facts. The *Tellabs* opinion teaches that when determining whether a complaint's particularized allegations permit the drawing of a strong inference of scienter as required by the PSLRA, the court must review the allegations of the complaint as a whole and consider possible competing inferences:

> [A] court . . . must engage in a comparative evaluation; it must consider, not only inferences urged by the plaintiff . . . but also competing inferences rationally drawn from the facts alleged. An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct. To qualify as "strong" within the intendment of [the PSLRA], we hold, an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.[64]

Therefore, the context of alleged misrepresentations is a critical component in the scienter inquiry. Context, by definition, provides the milieu within which competing inferences can be considered. But three

64. *Tellabs*, 551 U.S. at 314. Courts have incorporated the "cogent and compelling" mantra into their decisions, but its effect has been more subtle than dramatic. Basically, the courts that previously declined to consider competing inferences are now taking a "holistic" approach to review of a complaint at the dismissal stage. *See, e.g.*, *Pugh v. Tribune Co*., 521 F.3d 686, 693 (7th Cir. 2008) (altering, in light of the Supreme Court's decision in *Tellabs*, the circuit's prior approach to allegations of scienter in 10(b) cases).

contextual factors in particular stand out as relevant to the assessment of recklessness under the multivariate facts and circumstances that give rise to federal securities fraud suits. These are (1) magnitude, (2) atypicality, and (3) timing.

These three contextual factors serve, at least tacitly, as the primary rubric employed for considering whether an insider's stock transactions present enough of a motive for fraud to permit the drawing of a strong inference of scienter.[65] There seems to be no question in the circuits that, given the ubiquity of such allegations and their attendant review, insider stock sales can be indicative of scienter at least at the pleading stage. But since stock trades by insiders are also subject to other, innocent inferences,[66] the circuit courts are in agreement that complaints basing scienter on motive suggested by insider stock trades must allege more than that the defendant benefited from the alleged fraud by making profitable trades before the truth was revealed.[67] Accordingly, to satisfy the strong inference requirement, such insider trades must be "unusual" or "suspicious."[68] To evaluate the trades' unusualness or suspiciousness, courts consider their current and historical context: the total number of shares traded, the amount of the profit made, the percentage of an individual's stock holdings sold, the timing of the trades both as compared to the misrepresentations and market highs for the stock, whether the trades are out of line with the trader's past trading history, or even the number of insiders who traded at or near the same time.[69] Prior research demonstrates that these contextual considerations can be reduced to questions of magnitude, atypicality, and timing.[70]

This same contextual model provides useful parameters for strong inferences of reckless misstatement by a high-ranking corporate officer in a 10(b) case. In fact, a few courts have already found that it is "absurd" to suggest that officers are not aware of significant corporate

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65. *E.g.*, *Janas v. McCracken* (*In re Silicon Graphics*), 183 F.3d 970, 986 (9th Cir. 1999).

66. Defendants often are able to demonstrate legitimate non-price-related reasons for their sales. Indeed, an SEC rule provides a safe harbor for insiders to make trades that are presumptively unrelated to their knowledge of material non-public information where a trading plan or trust is set up in advance of that knowledge. *See* 17 C.F.R. § 240.10b5-1(c) (2010).

67. *Chen v. Navarre Corp. (In re Navarre Corp. Sec. Litig.)*, 299 F.3d 735, 747 (8th Cir. 2002).

68. *E.g.*, *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999) ("unusual"); *In re Silicon Graphics*, 183 F.3d at 986 ("suspicious").

69. *See Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000); *Rothman v. Gregor,* 220 F.3d 81, 94 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540–41 (3d Cir. 1999).

70. *See* Olazábal & Abril, *supra* note 25.

affairs.[71] These encompass matters of enormous magnitude or that in some other way are atypical within the company. Similarly, the timing of some purported misrepresentations can often provide strong circumstantial evidence of a corporate speaker's knowledge of the truth to the contrary. Despite an officer's tacit denial of actual knowledge, or rather the plaintiffs' inability at the pleading stage to point to direct evidence of such knowledge, the officer's failure to know about significant corporate matters constitutes recklessness. The only plausible opposing inference is that she is a highly compensated mouthpiece, serving primarily to insulate the company from claims of fraud.

A few courts have started to move in this direction. On remand from the Supreme Court's decision in *Tellabs*, the Seventh Circuit recently intimated that corporate officers' scienter can be inferred when announcements about important or "dramatic" matters are made, which prove to be utterly lacking in any factual basis.[72] And, a panel of the Ninth Circuit has gone even further in the direction advocated here, acknowledging the strength of context in establishing a sufficient inference of recklessness at the pleading stage in a 10(b) case. *Berson v. Applied Signal Technology, Inc.*,[73] involved claims that Applied Signal misrepresented as revenue-generating "backlog" certain work that was the subject of government stop-work orders.[74] Holding that the plaintiffs need not plead any particular facts indicating that Applied Signal's CEO and CFO knew of the stop-work orders, but instead could rely on an inference that they knew, the *Berson* court noted the devastating effect of the stop-work orders on the company's revenue and agreed that it was "hard to believe" that officers at that level would not be aware of stop-work orders that "halted tens of millions of dollars of the company's work."[75]

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71. *E.g.*, *Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 989 (9th Cir. 2008) (quoting *No. 84 Emp'r-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 943 n.21 (9th Cir. 2003)).

72. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 704, 710 (7th Cir. 2008) ("[K]nowledge is inferable from gravity . . . ."). In that regard, the court posited the following hypothetical:

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

Id. at 710.

73. 527 F.3d 982 (9th Cir. 2008).

74. *Id.* at 984–85.

75. *Id*. at 987–88 & n.5. Another panel of the Ninth Circuit, in a more recent case, appears to take this notion even further, suggesting that one "exception" to the rule against imputing knowledge of core operations to a company and its key officers exists

Further testing the contours of this inference, the court in *Berson* addressed, at least implicitly, the magnitude, atypicality, and timing factors related to the facts the defendants "must have known."[76] One of the four stop-work orders at issue halted between $10 and $15 million of work.[77] The contract involved one of the company's most important clients and resulted in the reallocation of between fifty and seventy-five workers, rendering one of their projects a "ghost town."[78] And finally, the court noted that the truth about that work stoppage was disclosed in an SEC filing a mere two weeks later.[79] While neither magnitude nor timing factors figured as prominently in the other stop-work orders, the court pointed out that plaintiffs had alleged in one of the four instances the client was a "difficult" one that had stopped large projects in the past and thus was "on defendants' radar screen"[80]—an atypical client and situation to be sure.

The use of these contextual factors has appeared sporadically in other decisions, but typically not as part and parcel of a methodical evaluation of recklessness based on the prominence or importance of the facts involved.[81] This intermittent look at contextual factors has instead often taken the form of extemporized discussion of "red flags" that may in the given case have alerted officers to the true facts, typically unconnected to a reasoned examination of the substance of

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where plaintiffs are able to make "detailed and specific allegations about management's exposure to factual information within the company" along with more general allegations about the "importance of the corporate information" and "management's role in a corporate structure." *Zucco Partners, L.L.C. v. Digimarc Corp.*, 552 F.3d 981, 1000 (9th Cir. 2009) (quoting *South Ferry LP, #2 v. Killinger*, 542 F.3d 776, 785 (9th Cir. 2008)). The analytical framework advanced here is somewhat different, eschewing the elusive inquiry into what information defendants actually knew and instead requiring particularized title and context allegations, so that the judge can upon a motion to dismiss assess the recklessness of an executive who speaks without an adequate factual foundation.

76. *Berson*, 527 F.3d at 987.

77. *Id.* at 988 n.5.

78. *Id.*

79. *Id*.

80. *Id.*

81. For an interesting pre-PSLRA, pre-*Tellabs* proposal that motive should be the determining factor in a finding of recklessness has also failed to gain any traction, see Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 676 (1991). Given the hostility courts have to motive pleading, motive cannot be the sine qua non of a strong inference of recklessness, but cobbled together with the magnitude-atypicality-timing of misrepresented facts, it can and should give rise to such an inference. *See* Olazábal & Abril, *supra* note 25, at 429–31.

recklessness.[82] The following sub-parts set out the highlights of this scattered case law, discussing each of the contextual factors and demonstrating its utility in the evaluation of plaintiffs' allegations of a high-ranking corporate officer's reckless misstatements.

A. Magnitude

Some courts faced with a complaint alleging the existence of red flags have focused on that information's magnitude.[83] Undoubtedly, the monetary value of a challenge facing the company or the widespread and financially devastating character of a fraudulent or illegal practice earmark it as the type of information for which a corporate head can and should be held accountable. On the other side of that coin, misrepresented numbers or facts that are trivial in proportion to the company's overall revenues, illegal practices that are small in scope, or matters that would otherwise be deemed immaterial,[84] are probably not within the realm of what we can or should expect a CEO or CFO to know with any certainty.

Magnitude can take the form of sheer size or it can be proportional. So where an alleged accounting fraud relates to inflated revenue figures at a single international division, the total sales of which amounted to only one half of one percent of the parent's revenue, the size of the irregularity should not give rise to an inference the officers knew about it.[85] Likewise, the Eleventh Circuit has held that de minimis effect on company revenues (0.5 percent and 0.17 percent in the two relevant years) of options misdating is not sufficient to constitute a red flag

82. *See, e.g.*, *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266–67 (11th Cir. 2006) (finding that there were "no allegations . . . that indicate[d] the presence of such 'red flags' in the company's financial statements").

83. *Id*. at 1266; *see* Olazábal & Abril, *supra* note 25.

84. Indubitably, the magnitude factor and immateriality are related, though clearly not coextensive. So for instance, without specifically relying on the magnitude of the falsity, the Second Circuit has noted that where facts misrepresented were immaterial, plaintiffs have not shown recklessness on the part of officers who failed to know about them. *ECA & Local 134 IBEW Joint Pension Trust v. JP Morgan Chase Co.*, 553 F.3d 187, 202–03 (2d Cir. 2009) (finding the misstatements immaterial under both accounting standard SFAS 57 and 10b-5, and quoting the district court as having determined the transaction at issue involved "a minute fraction of assets").

85. *In re Alpharma Sec. Litig.*, 372 F.3d 137, 151 (3d Cir. 2004) (concluding that no strong inference of scienter existed where the complaint, which relied on fraud occurring at the company's Brazilian subsidiary, was "devoid of any allegations which would establish that [the subsidiary] was so central to Alpharma's business that its increased revenue figures should have received particular attention from company executives").

putting an officer on notice of his misrepresentations.[86] And, correspondingly, where the total financial impact of a fraud is spread out over different functional business areas or different types of erroneous information, red flag arguments have generally been unavailing.[87]

On the other hand, the Third Circuit has held that where "fictitious transactions . . . constituted 'more than two-thirds of the company's revenue,'" a showing of a strong inference of the necessary scienter has been made.[88] In a related vein, the Fifth Circuit has held that a complaint raised a strong inference of scienter where a corporate officer's alleged misrepresentations related to the company's only patent, on what was essentially the company's only product, where patent protection was undeniably important, and where the company had repeatedly referred to the patent as "crucial" to the company's future.[89]

Another aspect of the magnitude inquiry might include relevant comparisons to other companies. So for instance when plaintiffs argued that Home Depot's officers knew of a purported fraud involving

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86. *Rosenberg v. Gould*, 554 F.3d 962, 966 (11th Cir. 2009) (quoting *Garfield*, 466 F.3d at 1266–67); *see also Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 791–92 (11th Cir. 2010) (stating that size of accounting error should be compared to total revenues and not to net income, the latter providing a deceptively large proportion); *Key Equity Investors, Inc. v. Sel-Leb Mktg., Inc.*, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,468 (3d Cir. 2007) (dissenting opinion frames the accounting error as a 400 percent overstatement of net income, while the majority found it to be a mere 10 percent error, as compared with gross income); *Globis Capital Partners, L.P. v. Stonepath Grp, Inc.*, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,370 (3d Cir. 2007) (holding that the cost understatements involved—5.7 percent in 2003 and less than 3.8 percent in 2002—were not "so startling" as to provoke a finding that they were red flags and therefore indicative of scienter). More indirect support for this approach is present in *Brody v. Stone & Webster, Inc.* (*In re Stone & Webster, Inc., Sec. Litig.*), 414 F.3d 187, 199–201 (1st Cir. 2005) (holding that alleged overstatement of financial results did not contribute to a finding of scienter at the pleading stage because the complaint gave "no indication whatsoever what the size of the alleged overstatement of current profits was").

87. *Konkol v. Diebold, Inc.*, 590 F.3d 390, 400 (6th Cir. 2009) (noting that the size of none of the three matters misrepresented—"uncertified voting-machine sales, software bundling, and false service invoices"—was individually large enough to draw suspicion); *see also W. Pa. Elec. Emps. Benefits Funds v. Ceridian Corp.* (*In re Ceridian Corp. Sec. Litig.*), 542 F.3d 240, 245–46, 249 (8th Cir. 2008) (quoting *In re Ceridian Corp. Sec. Litig.*, 504 F. Supp. 603, 606 (D. Minn. 2007) (holding that numerous unrelated GAAP violations committed by "many different employees" over a long period of time, no matter how large their cumulative effect, cannot suffice to establish a strong inference of intent on the part of high-ranking corporate executives to commit fraud).

88. *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 278–79 (3d Cir. 2006) (quoting Appellate Brief for the Plaintiffs at 133); *see also Rothman v. Gregor*, 220 F.3d 81, 92 (2d. Cir. 2000) (finding "remarkable" the proposition that a company which considered the need to expense royalties on a quarterly basis would be unable to recognize such expenses regularly, and instead to suddenly expense in a single quarter "*over 84 percent* of the total royalty advances it had capitalized" to that point).

89. *Nathenson v. Zonagen*, 267 F.3d 400, 425 (5th Cir. 2001).

manipulation of "return[s]-to-vendors," the Eleventh Circuit noted that no context had been provided to permit a finding that the so-called RTV rate was so high that officers would be aware of it, perhaps by showing that Home Depot's RTV rate was higher than that of other comparable companies.[90]

Thus, the magnitude factor provides necessary context for and insight into the salience of the matter alleged to have been misrepresented. Where a discrepancy is large, where a fraud is endemic, where a misstated fact relates to one of the company's biggest clients or products—these are the types of facts an officer is either deemed to know or is reckless in not informing himself about before speaking unequivocally to the market. Concomitantly, where magnitude cannot be shown relative to appropriate corporate metrics, the matter may not be obvious enough to give rise to a finding of recklessness, especially if neither the atypicality nor suspicious timing of the fact or its disclosure can be shown.

B. Atypicality

The atypicality of facts can also classify them as the type of information of which a top corporate officer is obviously aware or is reckless in failing to be aware. The Ninth Circuit has taken this proposition as far as to permit an inference that outside board members knew the underlying facts and that management had misrepresented it to investors. Faced with an argument that the facts "were 'purely[ ] management issue[s] that never rose to the level of Board discussions or communications with any shareholders,'" the Ninth Circuit in *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp*.[91] stated that it was "absurd to suggest" that the director defendants were unfamiliar with a serious ongoing FAA investigation into maintenance failings.[92] Presumably, the atypicality of such an event, along with its calamitous regulatory and public relations potential, made it prominent enough to impute knowledge to directors who presumably would deny knowing about it.[93] Accordingly, the court found, scienter was adequately alleged.[94] It is argued here that if such an inference is

90. *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1240, 1252 (11th Cir. 2008).

91. 320 F.3d 920 (9th Cir. 2003).

92. *Id.* at 943 n.21 (quoting Brief of Appellee-Respondent at 21).

93. The magnitude of threatened sanctions ($11 million) may also have played a part in the court's view that the information could not have escaped the Board's attention. *Id.*

94. *Id.* at 943.

possible with regard to non-executive directors, it is a priori available to plaintiffs alleging recklessness on the part of a CEO or CFO.[95]

In a similar fashion, a panel of the Tenth Circuit has refused to believe that a CEO was ignorant of an atypical accounting incident, and so held in *Adams v. Kinder-Morgan, Inc*.[96] that scienter was adequately pled.[97] There, the plaintiffs alleged that the company and its executives had improperly accelerated income from large contracts, falsely inflating revenues.[98] The fact that the company's outside auditor challenged the accounting treatment gave rise, in the court's mind, to a strong inference that the CEO was aware of the improper circumstances under which the acceleration had taken place.[99]

While atypical events can lead to cogent and compelling inferences that officers are aware of them, the reverse is also true. Matters which can be categorized as "run of the mill" or "par for the course" in a company or industry should not give rise to an inference of recklessness for failure to be aware of them. A good example of this appears in *Mizzaro v. Home Depot, Inc*.,[100] in which the Eleventh Circuit held that where only a single inventory out of the two per year conducted at Home Depot stores reflected an anomalous figure, this was not the type of information that would put officers "on notice of [an alleged] widespread and pervasive fraud."[101]

Thus like magnitude, the atypicality of an event within or a fact affecting the company, or of the type of fraud alleged, can add meaningfully to the discussion of scienter, providing appropriate parameters for a finding that a top corporate officer knew or was reckless in not knowing about it.

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95. *See* Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1601 (2005) ("[O]fficers . . . daily manage corporate operations, [unlike] directors, who more remotely monitor corporate affairs . . . .").

96. 340 F.3d 1083 (10th Cir. 2003).

97. *Id.* at 1106.

98. *Id.* at 1089.

99. *Id.* at 1106. The court also found it relevant that the CFO was actually aware of the improper treatment: "The fact that [the CFO] knew of the false statements is an important link in the inferential chain between [the president and CEO's] position as president and [CEO] and the conclusion that [the president and CEO] knew of the false statements." *Id*. *But see In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 150 (3d Cir. 2004) (stating that the fact that a division president's subordinate knew of fraud in subsidiary did not give rise to proper inference of scienter on the part of the division president).

100. 544 F.3d 1230 (11th Cir. 2008).

101. *Id.* at 1252.

C. Timing

Like the magnitude and atypicality factors, the timing of events, or the timing of important facts' truthful disclosure, can be helpful in providing the necessary context for a finding of recklessness. The timing factor is multivariate. It usually involves allegations of suspiciously fortuitous timing or of temporal proximity between false statements and subsequent revelations of the truth. In fact, in the usual case, the timing factor does not inform whether an officer was reckless in not knowing the truth. Instead, it more often contributes to a compelling inference that the officer actually knew the truth at the time he misstated it, which may more traditionally establish recklessness.

A pair of recent opinions illustrates some of the inculpatory effects timing can have on the recklessness inference at the pleading stage. The Fifth Circuit's *Plotkin v. IP Axess Inc.*[102] involved three announcements by a startup that it had obtained contracts exceeding $31 million, which did not materialize.[103] Noting the temporal connection between the company's announcement, its auditor's resignation, and its filing for bankruptcy protection, the court held that "later-emerging facts can, in some circumstances, provide warrant for inferences about an earlier situation."[104] Put differently, the incidence of those three facts in a short period of time permitted an inference that those responsible for the announcement knew the truth and had recklessly misstated the status of what turned out to be merely hoped-for lucrative deals.

An even further fetched timing coincidence supported a strong inference of recklessness in an options-backdating case. In *Middlesex Retirement System v. Quest Software Inc.*,[105] the court held that plaintiffs had established a circumstantial case of at least reckless misrepresentation.[106] This inference was compelled by the number and value of the options granted, the positions defendants held that gave them control over the grant dates, and—important to the instant discussion—

102. 407 F.3d 690 (5th Cir. 2005).

103. *Id*. at 693–95.

104. *Id.* at 697–98; *see also Rothman v. Gregor*, 220 F.3d 81 (2d Cir. 2000). There, the Second Circuit considered allegations that the company's financials were misstated because the responsible officers had failed to expense millions of dollars in royalty advances made with regard to an unsuccessful product, even long after it was clear they would not be recouped through future sales. *Id*. at 84–85. The court indulged a finding of recklessness at the pleading stage in that case, noting that more than a year had passed since the product's release and the officers had met quarterly to assess the likelihood of sales to offset the royalty advances. *Id*. at 91. Thus, the failure to expense the royalties recklessly misstated the company's financials until they were formally restated.

105. 527 F. Supp. 2d 1164 (C.D. Cal. 2007).

106. *Id.* at 1190.

the strong inference to be derived from the fact that the options "consistently had measurement dates on either the lowest prices of the year or immediately preceding rapid rises in the Company's stock."[107] The court did not find convincing the opposing inference, that such lucrative misdating occurred by happenstance.[108]

Courts have generally held that the temporal proximity of a false favorable statement and subsequent revelation that it was not true will not alone support an inference, at the pleading stage, of either actual knowledge or recklessness.[109] But some courts have found the temporal proximity of truthful disclosures and prior misrepresentations to be more suspicious. So, for instance, the First Circuit has held that a complaint does not plead fraud by hindsight, and therefore survives a dismissal motion, where it makes factual allegations demonstrating known developments in the company that "could have provided a basis for advance knowledge of the information disclosed."[110]

In *Mississippi Public Employees' Retirement System v. Boston Scientific Corp.*,[111] where the company voluntarily recalled an important product, the company's COO was deemed to have known about significant problems a mere week earlier when he stated they had been "fixed" without referring to the impending recall.[112] Three aspects of the inference drawn there stand out. First, that the truth was known in the company. Second, that the person misspeaking was a relevant high-

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107. *Id.* at 1183–84.

108. *Id.* at 1183. Admittedly, other courts have denied this relatively simple view of an options backdating fraud, focusing instead on the likelihood that a defendant beneficiary of propitiously misdated stock options knew that the accounting mistreatment of these options would eventually need to be corrected. *See, e.g.*, *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 791–92 (11th Cir. 2010).

109. *See, e.g.*, *Elam v. Neidorff*, 544 F.3d 921, 930 (8th Cir. 2008) (calling the proximity in time between June statements and mid-July revelations of their falsity "relevant to scienter" and "troubling," but holding that fact insufficient, on its own, to establish recklessness at the pleading stage); *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) (holding insufficient the scienter inference, where the only particularized allegation in the complaint was a "five week period between the optimistic statements and the below-expectation earnings report"). The rationale sometimes given is that simply proving the later falsity of a statement does not command an inference that the fact was intentionally misstated at an earlier time. In other words, that such pleading constitutes fraud by hindsight. *See, e.g.*, *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 85 (2d Cir. 1999) ("Management's optimism that is shown only after the fact to have been unwarranted does not, by itself, give rise to an inference of fraud."); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) (rejecting the contention that "the difference must be attributable to fraud" where plaintiff points only to two different statements of a firm's condition).

110. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1223–24 (1st Cir. 1996).

111. 523 F.3d 75 (1st Cir. 2008).

112. *Id.* at 91–92 (quoting Consolidated Amended Complaint at ¶ 101).

ranking officer, and third that the truth came out shortly after the officer misstated it.

Thus in the proper case, temporal proximity between disclosure of the truth and an officer's statement to the contrary may properly induce a strong inference about the officer's recklessness. And, certainly in combination with other factors such as the magnitude of the truth thereafter disclosed, suspect timing can give rise to a finding of recklessness sufficient to survive a motion to dismiss.[113] It is precisely this more contextual review of pleadings that the Supreme Court encouraged in *Tellabs*.[114]

Finally, the timing factor may play out in at least one exculpatory way, resulting in a finding that executives were not reckless with the truth of an important matter. For instance in the Second Circuit's *Rombach v. Chang*,[115] the company voluntarily revealed bad news earlier than it would have been required to under the SEC's periodic reporting regulations.[116] Finding no strong inference of scienter, the court noted that the news was revealed "well in advance" of the deadline for the filing of the company's Form 10-K.[117]

D. The Contextual Factors at Work

These factors should be considered in combination, as part of the courts' total, holistic assessment of allegations required by the Supreme Court in *Tellabs*. So where a single contextual factor does not give rise to an inference that an officer knew the truth, when it is viewed in tandem with the others, it can and may provide the necessary strong inference of recklessness.

A good illustration of the application of my proposed contextual model is *Goldstein v. MCI WorldCom*,[118] filed in the aftermath of the spectacular demise of WorldCom.[119] Plaintiffs alleged that CEO Bernie Ebbers and CFO Scott Sullivan made glowing statements about the company's revenue growth and profitability when $685 million in

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113. *See, e.g.*, *Hollin v. Scholastic Corp* (*In re Scholastic Corp. Sec. Litig.*), 252 F.3d 63, 77 (2d Cir. 2001) (noting that an eventual, large write-off "undermines . . . the argument that defendants were unaware of the sharp increase in . . . returns until shortly before Scholastic's . . . press release [revealing the truth]"); *Institutional Investors Grp. v. Avaya, Inc.*, 564 F.3d 242, 272 (3d Cir. 2009) (rejecting defendants' arguments that "temporal proximity *alone* is never enough to show scienter" (quoting Brief of Appellee-Respondent at 42 n.16)).

114. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 322–24 (2007).

115. 355 F.3d 164 (2d Cir. 2004).

116. *Id*. at 176–77.

117. *Id.*

118. 340 F.3d 238 (5th Cir. 2003).

119. *Id.* at 242.

worthless accounts receivable were being kept on the books.[120] Specifically, they pointed to a $405 million after-tax write-off that was taken soon after the company's failed merger with Sprint, alleging that Ebbers and Sullivan must have known or recklessly disregarded the fact that this bogus asset was propping up the company's balance sheet, but concealed it, inter alia, because they were motivated to close the critical pending merger deal.[121]

The Fifth Circuit rejected the argument that either Ebbers or Sullivan published their false statements with reckless disregard for the existence of the uncollectible receivables, describing the "critical issue in [the] case" as "whether the allegations of fraud contained in the plaintiffs' complaint are sufficiently connected to Ebbers and Sullivan such that this strong inference of scienter on their part is appropriate."[122] Finding no tie between Ebbers and/or Sullivan on the one hand, and knowledge of the receivables or any need or desire to write them off on the other, the court concluded that the plaintiffs had not adequately pled the necessary inference of scienter.[123] More particularly vis-à-vis the CEO, Ebbers, the court noted "[f]or example, the complaint fails to allege that Ebbers ever actually received a write-off request, delayed responding to a write-off request, or rejected a request to write-off a delinquent account."[124]

Requiring this kind of direct evidence of knowledge of falsity too closely approximates the actual intent standard and fails to give recklessness its due as a separate level of intent. A better assessment of the facts in *Goldstein* would have centered on the magnitude, atypicality, and timing aspects of the true facts and would have probed the inferences this type of context is capable of providing.

While not the focus of the court's opinion, other facts recited therein indicated that the plaintiffs alleged that the uncollectible assets amounted to 62 percent of the total reserves balance and 28 percent of net income for the quarter before it was written off.[125] In context, this is probably not as "monumental" as the plaintiffs alleged.[126] As for the atypicality factor (or lack thereof), the complaint apparently also alleged facts permitting the conclusion that WorldCom had written off an even larger amount of

120. *Id*. at 242–43.

121. *Id.* at 243–44, 249-51.

122. *Id.* at 249.

123. *Id.* at 251. Instead, the court commented that the failure to write off the accounts receivable was "perhaps . . . gross mismanagement" by those in charge of handling accounts, rather than recklessness on the part of WorldCom's top officers. *Id.* at 254.

124. *Id.* at 252.

125. *Id.* at 251.

126. *Id*. at 249.

uncollectible accounts receivable ($768 million) only the year before.[127] Timing did appear to be more suspicious, however, with the write-off coming within three months of the failed merger with Sprint, when the prospects for continuing to hide it had evaporated.[128]

Admittedly, applying the contextual-factors approach to the facts of *Goldstein* may not have changed the result in the case, given that the factors lead to contradictory inferences.[129] But it is my contention that the court's analysis in deciding the case was rudderless and somewhat misguided, and that the issue in *Goldstein* should have focused on these contextual factors rather than defaulting to a search for an elusive direct "link" between Ebbers and the company's true financial picture. It stands to reason we will only get the right results for the right reasons, and therefore more of the time, when we are asking the right questions in the first place.

III. SUPPORTING THEORY AND POLICY CONSIDERATIONS

There are two primary bases of support for this particular conception of recklessness, bounded as it is by magnitude, atypicality, and timing inquiries. The first of these requires a more detailed review of the etiology of the definition of recklessness presently in use in fraud-on-the-market cases and its context within the larger debate over the substance of recklessness in tort. It is to that we shall now turn. Then this Part addresses other current impetuses toward increased executive accountability for accurate disclosure of important corporate facts. These include both legislative efforts and case law contemplating a monitoring duty on the part of directors and (more relevantly) officers of publicly traded corporations. Finally, this part looks at the broader picture of the proposed recklessness standard, as it relates to the pleading and proof of 10(b) by a class of allegedly defrauded investors.

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127. *Id*. at 251.

128. *Id*. Notably the timing of the misrepresentation and acknowledgement of the truth here was almost inextricable from the defendants' palpable motives to commit the alleged fraud. These were (1) not to upset the pending merger with Sprint and ultimately minimize its dilutive effect on WorldCom shareholders, including defendants, and (2) to keep WorldCom's stock price artificially high so as not to trigger a material adverse change in Ebbers' incentive-based compensation, which would serve as an event of default with respect to massive loans Ebbers was carrying. The court acknowledged that these were compelling motives, but held that these alone could not establish scienter. *Id.* at 249-51.

129. This is especially true since temporal coincidences, without more, are unlikely to give rise to the necessary strong inference of scienter at the pleading stage. *See supra* note 102 and accompanying text.

A. The Underpinnings of the 10(b) Recklessness Standard

As stated before, the case law in this area is in a state of disarray. The trial courts are all over the board; even different panels within individual circuits vary in their approaches to allegations of recklessness. Über-specific fact-pattern based tests, hollow labels, and instinctual reactions have become the norm, having effectively displaced rational examination of the substance of recklessness as a level of scienter producing fraud.

A deeper look at the oft-quoted definition of recklessness in 10(b) cases, and the environment in which it was offered, provides a good foundation for an understanding of recklessness from a more normative perspective. Building on that, in the following subparts I also provide some relevant background drawn from the modern view of recklessness in the general tort arena. These two efforts together demonstrate the suitability of the contextual model I propose.

1. THE *SUNDSTRAND* DEFINITION

Diversity of approach and terminology notwithstanding, every circuit's definition of recklessness[130] can ultimately be traced back to the definition found in the Seventh Circuit's *Sundstrand Corp. v. Sun Chemical Corp*.[131] A closer look at the *Sundstrand* definition and at the background out of which it emanated reveals that what was intended was an objective standard. The commonly quoted but now attenuated full definition is:

> [R]eckless conduct may be defined as 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

130. *See, e.g.*, *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 600 (7th Cir. 2006); *Fla. St. Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 654 (8th Cir. 2001); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1258 (10th Cir. 2001); *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999); *Phillips v. LCI Int'l Inc.*, 190 F.3d 609, 621 (4th Cir. 1999); *Janas v. McCracken* (*In re Silicon Graphics Inc., Sec. Litig*.), 183 F.3d 970, 976 (9th Cir. 1999); *Hoffman v. Comshare, Inc.*, (*In re Comshare Inc., Sec. Litig*.), 183 F.3d 542, 550 (6th Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 535 (3d Cir. 1999).

131. 553 F.2d 1033 (7th Cir. 1977).

> buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[132]

The *Sundstrand* opinion resulted not from an open-market fraud claim, but from an appeal after trial of a 10(b) suit alleging actual reliance and seeking rescission or damages.[133] The court easily disposed of the corporation's appeal along with that of the CEO, ruling that the district court's finding of liability based on "intentional or reckless" misrepresentations was not precluded by the Supreme Court's then-recent decision in *Ernst & Ernst v. Hochfelder*.[134] In that regard, the *Sundstrand* court noted that the recklessness standard employed by the trial court was similar to precedent in the Seventh Circuit holding a defendant liable under 10(b) who was "blinded by conflict of interest" and who "wantonly ignored" readily available facts when formulating disclosures to shareholders.[135]

The so-called *Sundstrand* definition of recklessness, then, came as part of a later discussion about the liability of an outside director who also was a consultant to the plaintiff, and who was alleged to have omitted to state several material facts in connection with the plaintiff's stock purchase.[136] It was against this backdrop that the *Sundstrand* court adopted its definition of recklessness—from the memorandum opinion issued by the Western District of Oklahoma in 1976 in *Franke v. Midwestern Oklahoma Development Authority*.[137] The *Franke* opinion provides little apt reasoning.[138] The 10(b) claim there was against bond

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132. *Id.* at 1045 (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976), *vacated on other grounds*, *Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856 (10th Cir. 1980)); *accord Chill v. Gen. Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996) ("An egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of . . . recklessness" (quoting *Goldman v. McMahan, Brafman, Morgan & Co.*, 706 F. Supp. 256, 259 (S.D.N.Y. 1989))). For another in-depth discussion of the *Sundstrand* definition of recklessness in the context of securities fraud actions, see William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 179–88 (1997).

133. *Sundstrand*, 553 F.2d at 1036. As such, the suit was between a corporate seller (and one of its officers and directors) and a corporate buyer of securities—as opposed to a typical fraud-on-the-market suit, in which plaintiffs seek significant class action damages alleging no individual reliance but instead that the price they paid for the stock reflected the putative fraud in light of the efficient capital markets hypothesis.

134. *Id*. at 1039.

135. *Id.* at 1039–40 (quoting *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 993–94 (7th Cir. 1976)).

136. *Id*. at 1044.

137. 428 F. Supp. 719, 725 (W.D. Okla. 1976).

138. Apart from the definition later perpetuated by *Sundstrand*, the law articulated in the *Franke* opinion bearing on scienter (and indirectly therefore on recklessness) is no longer good law: "A plaintiff in a Section 10(b) case must plead and

counsel who allegedly failed to disclose, as part of their bond legality and tax-exempt-status opinion letter, adverse facts about a bond offering.[139] In granting summary judgment in the lawyers' favor, the trial court made short shrift of the plaintiff's argument "that 'recklessness' is a substitute for scienter." [140] After setting out its now oft-quoted definition of recklessness,[141] the *Franke* court simply held that the standard was not met in the case sub judice: "If indeed there is any validity to the proposition that obviousness of risk of harm can be a substitute for guilty knowledge, it is sufficient to note that there is no evidence here of such a state of facts."[142]

Returning to *Sundstrand*, the Seventh Circuit there was clearly more occupied with adopting recklessness as the relevant standard for scienter post-*Hochfelder* than it was in defining the contours of recklessness. Hence, in discussing the outside director/consultant's liability, the *Sundstrand* court imported the *Franke* definition as "the only post-*Hochfelder* reported definition of recklessness in the context of omissions . . . ."[143] After quoting the Supreme Court's footnote in *Hochfelder* to the effect that recklessness in other areas of the law had from time to time been equated with intentional conduct, the *Sundstrand* panel also noted that the *Franke* definition was "the kind of recklessness that is equivalent to willful fraud."[144] Thus, the *Sundstrand* court held, recklessness per *Franke* "should be viewed as the functional equivalent of intent."[145]

Importantly, the Seventh Circuit then explained in *Sundstrand* that the *Franke* definition served as a functional equivalent of intent "because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission."[146] This important adjunct to the *Sundstrand* definition of recklessness has escaped subsequent quotation. With it, *Sundstrand* moved beyond *Franke* by unequivocally ruling that obviousness of the risk of harm is indeed a proxy for guilty

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prove that the defendant was guilty of conscious fault, which would require that the defendant have actual knowledge of the matters complained of." *Id.* at 724–25.

139. *Id*. at 722, 724.

140. *Id*. at 725.

141. *Id.* (citing inter alia WILLIAM PROSSER, HANDBOOK OF THE LAW OF TORTS, 185–86 (4th ed. 1971)).

142. *Id.*

143. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977).

144. *Id.* (quoting *SEC v. Texas Gulf Sulphur Co*., 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (Friendly, J., concurring)).

145. *Id*.

146. *Id*. (citing inter alia OLIVER WENDELL HOLMES, THE COMMON LAW 130–63 (1909)).

knowledge, providing the external standard that permits ostensibly unintentional behavior to be deemed intentional for purposes of imposing liability.

Indeed, such an "external" or objective standard for recklessness is exactly what the *Sundstrand* court intended when it propelled the *Franke* definition into future case law.[147] This is consistent with what the Supreme Court has said about scienter in both *Hochfelder* and *Tellabs*, and with what is argued here.

2. TOWARD AN OBJECTIVE STANDARD OF RECKLESSNESS

The now superseded *Restatement (Second) of Torts* was published in 1965, and therefore was operative both in *Sundstrand*'s time and in that of most of the existing 10(b) case law. Its only general definition of recklessness is found in the context of "[r]eckless [d]isregard of [s]afety":

> The actor's conduct is in reckless disregard of the safety of another if he does an act or intentionally fails to do an act which it is his duty to the other to do, knowing or having reason to know of facts which would lead a reasonable man to realize, not only that his conduct creates an unreasonable risk of physical harm to another, but also that such risk is substantially greater than that which is necessary to make his conduct negligent.[148]

Though it sounds vaguely similar to the *Sundstrand* definition, it differs in some fairly material respects. First, as a matter of scope, it was intended to apply in the context of personal safety. More importantly, it is entirely subjective, focused as it is on what the actor knows or has reason to know about the risk of harm. As a more general matter, it also falls into the trap created by what knowledgeable commentators have referred to as a meaningless "culpability spectrum" between negligence and intent.[149]

Given the American Law Institute's recent revisions to the *Restatement of Torts*,[150] the general recklessness standard now is found

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147. *See id.*

148. Henderson & Twerski, *supra* note 29, at 1151 (quoting RESTATEMENT (SECOND) OF TORTS § 500 (1965)).

149. Professors Henderson and Twerski have noted that such a spectrum implying a progression from negligence to intentional conduct is "neither necessarily accurate nor particularly helpful" in understanding the nature of recklessness. *Id.* at 1137.

150. The ALI's website describes the status of the project. *Current Projects: Restatement Third, Torts: Liability for Physical and Emotional Harm,* THE AMERICAN

in *Restatement (Third) of Torts: Liability for Physical and Emotional Harm*, section 2:

> A person acts recklessly in engaging in conduct if:
>
> (a) the person knows of the risk of harm created by the conduct or knows facts that make the risk obvious to another in the person's situation, and
>
> (b) the precaution that would eliminate or reduce the risk involves burdens that are so slight relative to the magnitude of the risk as to render the person's failure to adopt the precaution a demonstration of the person's indifference to the risk.[151]

Like the *Second Restatement*, this definition has a subjective component, and it also is clearly not directly applicable to the instant question, falling as it does in a volume subtitled "Liability for Physical and Emotional Harm." But this definition does provide an interesting vantage point from which to think about the *Sundstrand* definition, and importantly, to gauge the fitness of the contextual model of recklessness I offer here. Unlike the *Second*, the *Third Restatement* incorporates a useful new dimension, an *objective* balancing test. Clause (b) requires an evaluation of the preventative measure or measures that would be needed to diminish or avoid the risk of harm as compared to the magnitude of risk. Thus, failure to avoid a known risk that can be mitigated relatively easily, according to section 2's comment a, constitutes "reckless and wanton" conduct—conduct that reveals "a reckless disregard" or "reckless indifference to risk."[152] Clauses (a) and (b) read together, then, permit much more of an external view of the actor's indifference, callousness, or lack of concern for the well-being of others—in short, her recklessness.

The contextual model I advocate imposes on top corporate officers—in particular the CEO and CFO—an obligation only to familiarize themselves with the most significant of corporate matters. This proposed recklessness standard for 10(b) cases thus incorporates the *Third Restatement*'s balancing test. Once a court has determined from the context pled that the matter misrepresented was based on prominent corporate information, it follows that this was information that was either already known to or readily available to the corporation's highest ranking

LAW INSTITUTE, http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=16 (last visited Nov. 8, 2010).

151. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 2 (2010).

152. *Id*. at § 2 cmt. a.

executives. Anywhere the misrepresented information is contextually shown to be prominent, the burden on the executive to inform herself is by definition slight. Therefore, prescriptively, when balanced against the inevitable harm to shareholders in the event of a misstatement, the executive's investigation or inquiry ought to be required, absent which the executive will have acted recklessly.

This approach to recklessness is consistent with the direction recklessness is taking in general tort law, by incorporating the new, more objective test approved in the *Third Restatement*. And it is noteworthy for purposes of this argument that my resorting to general tort law to support my proposal parallels the Supreme Court's rhetoric and past practice in 10(b) cases.[153] Finally, it is also worth mentioning here that the ends achieved by my proposal are entirely consistent with the original effort in *Sundstrand*, read in full, to inject objectivity into the recklessness standard used to measure securities fraud.

B. Sarbanes-Oxley and the Appetite for Corporate Accountability

Another way to test the validity of my contextual model of recklessness is to consider it in light of currently heightened but longstanding policy objectives. Two important provisions of the Sarbanes-Oxley Act of 2002 (SOX)—enacted in the wake of Enron and other high profile corporate scandals[154]—were specifically adopted to ameliorate what was perceived to be a lack of corporate accountability for fraud.[155] These are executive certifications of financial reports and SOX's now infamous "internal controls" provisions.[156] I argue that whether or not these statutory mandates have improved the accuracy or desirability of disclosure for the benefit of shareholders, at a minimum

153. A catalog of cases in which the Supreme Court has adverted to general tort law in its interpretations of the 10(b) implied cause of action is beyond the scope of this Article. But, for an example, see *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 344 (2005) (noting "the common-law roots of the securities fraud action" and citing the *Restatement of Torts*, in an opinion involving proof of loss causation). Though not directly on point here, it is noteworthy that the *Tellabs* Court referred to the then-tentative 2005 draft of the *Third Restatement* in passing. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 n.5 (2007). *See generally* Prentice, *supra* note 62 using the common law of fraud to assess the Court's decision in *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008)).

154. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.). The official name of the legislation is the Public Company Accounting Reform and Investor Protection Act. Nonetheless, I refer to it by its more colloquial name, SOX, throughout.

155. *See, e.g.*, Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843, 1844-55 (2007) (discussing as background the legislative process that produced SOX).

156. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

they reflect a strong public desire for corporate accountability, particularly that of top corporate officers. As such, they add support to the thesis advanced here—that corporate officers should be held personally accountable to shareholders for their misrepresentation of major corporate matters. Unfortunately, SOX has not exactly achieved that objective.

1. OFFICERS' "PLAUSIBLE DENIABILITY"[157] AND SOX'S EXECUTIVE CERTIFICATIONS

Professors Robert Prentice and David Spence have remarked on executives' tendency to defend themselves while their fraud-ridden "houses of cards [come] crashing down" by denying knowledge of inaccuracies.[158] This is exactly what Congress purported to foreclose by establishing executive certifications of corporate financial statements.[159]

Section 302 of SOX requires the CEO and CFO to certify that all "periodic report[s] containing financial statements filed by an issuer"[160] are free of material misstatements or omissions, and that they "fairly present" the firm's financial condition and results of operations.[161] In addition, it imposes duties on certifying officers to (1) establish, maintain, and evaluate internal controls, and (2) to disclose to the audit committee any deficiencies in the internal control design and any fraud involving an officer or employee who has a significant role related to the company's internal controls.[162] The officer's signature certifies compliance with these duties as well as the veracity of the financial information contained in the certified report.[163]

SOX also enacted criminal sanctions attendant to false certifications. Section 906 provides for imprisonment of up to ten years or a fine of $1 million for any person who "certifies any [periodic financial] statement . . . knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in [the statute]."[164] Individuals who "willfully" certify such a statement are subject to prison terms of twenty years and a fine of up to $5 million.[165]

157. Prentice & Spence, *supra* note 155, at 1899.
158. *Id*.
159. *Id*.
160. *See* Sarbanes-Oxley Act of 2002 § 906(a), 18 U.S.C. § 1350(a).
161. § 302, 15 U.S.C. § 7241.
162. *Id*.
163. *Id.*
164. § 906(a), 18 U.S.C. § 1350(c)(1).
165. § 906(a), 18 U.S.C. § 1350(c)(2).

Scholars have pointed out that these certifications were not especially new when enacted;[166] thus SOX sections 302 and 906 together clearly reflect a strong political will to increase accountability of the CEO and CFO, in particular regarding financial disclosures.[167] There is debate about whether SOX's certifications actually provide more accurate financial reporting or accountability.[168] As applied thus far anyway, they apparently have no real teeth with which to penalize errant executives.[169]

SOX nowhere mentions civil liability or pleading requirements for scienter in civil securities fraud suits.[170] This is because sections 302 and 906 were not intended to create a private cause of action, nor were they crafted to effect any change in scienter pleading in 10(b) cases against corporate executives.[171] The judicial consensus is that false SOX certifications do little to establish scienter in 10(b) cases.[172] Typical is the

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166. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1540–41 (2005) ("CEOs and CFOs had always been required to sign the annual report and were liable for knowingly filing fraudulent reports as well as for inadequate internal controls."). Professor Romano acknowledges, however, that the precise form of SOX sections 302 and 906 certifications is "of recent vintage." *Id.*

167. *Id*. at 1579 & n.168 (summarizing briefly the testimony in Congress on this provision). Professor Romano also notes that the SOX certification requirements had their antecedents in a Bush Administration "Ten-Point Plan" to make corporate executives more accountable to investors. *Id*. at 1541 & n.55 (citing Remarks at the Presentation of the Malcolm Baldridge National Quality Awards, 38 WEEKLY COMP. PRES. DOC. 370 (Mar, 7, 2002); Press Release, White House, President's Ten-Point Plan (Mar. 7, 2002), *available at* http://georgewbush-whitehouse.archives.gov/infocus/corporateresponsibility/index2.html).

168. *See generally*, *e.g*., Prentice & Spence, *supra* note 155; Romano, *supra* note 166; and works cited therein.

169. Some SEC enforcement activity has ensued. *See, e.g*., *In the Matter of Meridian Holdings, Inc., Anthony C. Dike and Michell V. Nguyen*, SEC NEWS DIGEST (Feb. 12, 2009), http://www.sec.gov/news/digest/2009/dig021209.htm (reporting that Meridian's CEO, Dike, was permanently enjoined from future violations of, inter alia, section 302, fined $25,000, and prohibited from acting as an officer or director of a public company for five years).

170. Sarbanes-Oxley Act of 2002 § 906(a), 18 U.S.C. § 1350(a).

171. Existing case law had already established that officers who signed SEC filings containing misrepresentations could be held liable therefore as primary violators of 10(b). *See, e.g*., *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061–63 (9th Cir. 2000).

172. *See Cozzarelli v. Inspire Pharms. Inc.*, 549 F.3d 618, 628 n.2 (4th Cir. 2008) (noting that a bare allegation of false SOX certification "does not provide independent support for an inference of scienter" at the pleading stage); *Glazer Capital Mgmt. v. Magistri*, 549 F.3d 736, 747 (9th Cir. 2008) (concluding that absent a showing of recklessness, the fact of an officer's SOX certification is "not sufficient, without more, to raise a strong inference of scienter on the part of [the certifying officer]"); *Ind. Elec. Workers' Pension Trust Fund v. Shaw Group, Inc.*, 537 F.3d 527, 544–45 (5th Cir. 2008) (same); *Cent. Laborers' Pension Fund v. Integrated Elec. Servs., Inc.*, 497 F.3d 546, 554-55 (5th Cir. 2007) (same).

Eleventh Circuit's analysis of the impact of certifications on scienter in *Garfield v. NDC Health Corp.*,[173] holding that "a Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements."[174] This brings us full circle to the question of what constitutes recklessness for purposes of pleading scienter.

At bottom, whether SOX's executive certifications actually provide more accurate and reliable financial accounting for the benefit of investors, added accountability for public company executives, an effective criminal penalty for corporate fraudsters, or any effect on scienter pleading is not the issue. In fact, if these provisions of SOX are or were mere political "optics," this proves my present point. In 2002, in the wake of the stunning millennial frauds of Enron, WorldCom, Tyco, and Adelphia among others, the capital markets were desperate for a boost in investor confidence. Citizens, policy wonks, and politicians alike viewed so-called executive accountability through formal financial-statement certifications, for better or for worse, as one way of achieving that.[175]

The financial markets today are even more severely bruised than they were following the turn of the millennium and just as desperate, if not more so, for investor confidence.[176] And regardless of any particular

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173. 466 F.3d 1255 (11th Cir. 2006).

174. *Id.* at 1266. According to the *Garfield* court, "[t]his requirement is satisfied if the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misrepresentations or omissions." *Id.*

175. Prior to the enactment of SOX, in June 2002, the SEC had proposed executive certifications of quarterly and annual reports. Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 41,877, 41,877 (June 20, 2002) (to be codified as 17 C.F.R. pts. 232, 240, 249). Apparently, the majority of the one hundred and two persons who commented on these supported the notion of executive certifications, as did those who commented in letters received by the SEC after SOX was enacted. Certification of Disclosure in Companies Quarterly and Annual Reports, Securities Act Release No. 8124, Exchange Act Release No. 46,427, Investment Company Act Release No. 25,722, 78 SEC Docket 875, 876 (Aug. 29, 2002).

176. *See* STATE STREET INVESTOR CONFIDENCE INDEX® HISTORICAL DATA (Oct. 26, 2010) (reflecting decade lows for investor confidence in late 2008, with a slow rebound in mid-2009 and generally falling numbers since). As a major policy objective, "Investor confidence" has become a watchword for both sides of most regulatory debates relating to the markets. *Compare* Amendments to Regulation SHO, 75 Fed. Reg. 11,232 (Mar. 10, 2010) (amending 17 C.F.R. 242.200(g) and 17 C.F.R. 242.201, purportedly to "help address erosion of investor confidence in our markets generally"), *with* Kathleen L. Casey, SEC Comm'r, Statement at Open Meeting Short-Sale Restrictions (Feb. 24, 2010), *available at* http://www.sec.gov/news/speech/2010/spch022410klc-shortsales.htm (arguing that the proposed amendments to Regulation SHO do not promote investor confidence).

For a more academic treatment of the phenomenon, see Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407 (2002). Professor Stout opines that

time frame or economic environment, few would deny that accountability for corporate fraud is a social good in itself.[177] As executives are publicly relieved of that accountability under SOX, another tack may be in order. Defining recklessness in the manner proposed here has the potential to achieve some of what SOX sections 302 and 906 have not.[178] And in turn, defining recklessness in the more structured manner proposed here has the potential to give SOX sections 302 and 906 the definitional gist and deterrent heft they presently lack.

2. INTERNAL CONTROLS, DISCLOSURE CONTROLS, AND MONITORING

The internal financial controls provisions of SOX, set out in section 404 of the statute,[179] have been widely condemned since their enactment. In general, its critics argue that the provision's costs outweigh its benefits to investors and the financial markets system as a whole.[180] The SEC rules promulgated as required by Congress in SOX section 404 require, inter alia, a statement of management's responsibility for establishing and maintaining control over the issuer's financial reporting, a statement

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"investors may not need to trust *people* before they are willing to give up their hard-earned dollars. But they must at least trust *the system*." *Id.* at 420.

177. Foreign securities regulation regimes have acknowledged in particular the need for executive accountability. *See, e.g.*, Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT'L L.J. 367, 401–02 (2005) (discussing Australia's fraud scandal experience and attendant regulation to increase executive accountability, including executive certifications). *But see* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 296 (2004) [hereinafter Langevoort, *Resetting the Corporate Thermostat*] (contending that differences in shareholder preferences for executive candor depend on investor profile).

178. Professors Vogel and Slavin have called for amendment of sections 302 and 906 to provide that a false certification establishes the necessary strong inference of scienter in a Section 10(b) case, thus augmenting civil liability for executives by way of a very broad and blunt instrument. Glen M. Vogel & Nathan S. Slavin, *Despite Initial Fears to the Contrary, It Appears that Sarbanes-Oxley Gave Private Litigants a "Dull Sword" When it Comes to Piercing the Corporate Veil*, 14 FORDHAM J. CORP. & FIN. L. 415, 442 (2009). The analytical model proposed here would more narrowly achieve much of the same effect regarding increased accountability, and without requiring legislative action.

179. Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006); *see also* 17 C.F.R. §§ 240.13a, 240.15d.

180. *See, e.g.*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE 38–42 (2006). *But see* Christopher H. N. Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons from the Sarbanes-Oxley Act*, 48 AM. BUS. L.J. (forthcoming 2011) (discussing motives of foreign issuers that delisted from U.S. exchanges and/or deregistered with the SEC and noting "at least some foreign private issuers see value in complying with the requirements of SOX [including Section 404] even after deregistration").

identifying the framework management uses to evaluate the effectiveness of the company's internal controls, management's annual assessment of the effectiveness of those internal controls and identification of any material weaknesses therein, and an auditor attestation report relative to management's assessment.[181]

These internal controls regulations relate exclusively to an issuer's financial reporting.[182] No doubt, financial or accounting fraud is a common scenario alleged in an open-market securities fraud case. And in the wide variety of cases so presenting, accounting errors can be indicative of a top-down culture of fraud, as it was in the instance of Enron,[183] in which case they may give rise to a strong inference of at least reckless misrepresentation. Alternatively, accounting problems can be attributed to simple mismanagement. Accordingly, case law both before and after SOX reflects a predisposition not to allow problems with an issuer's internal controls, standing alone, to constitute recklessness for purposes of section 10(b).[184] This echoes the now hoary rule that "GAAP [Generally Accepted Accounting Principles] violations . . . alone" do not suffice to provide a strong inference of scienter.[185]

A blanket rule that GAAP violations and false executive certifications of the accuracy of financial reporting do not automatically point to recklessness or fraudulent intent is a good one. Without it, fraud would be easily pleaded in any case involving an accounting error or discovery of a material weakness in internal controls. As the Eleventh

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181. Press Release, SEC, SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor (May 27, 2003), *available at* http://www.sec.gov/news/press/2003-66.htm.

182. At the time SOX was enacted, the notion of internal controls as a feature of corporate risk management was not a new one. In defining internal controls, however, the SEC refused to adopt the broader definition developed by the Treadway Commission in 1992 for evaluation of compliance with the Foreign Corrupt Practices Act. That definition includes assurances regarding not just financial reporting but also the "effectiveness and efficiency of operations" and "compliance with applicable laws and regulations." COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL – INTEGRATED FRAMEWORK (1992), http://www.coso.org/ICIntegrated Framework-summary.htm.

183. *See, e.g.*, Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 436–40 (2003); Nancy C. Rappoport, *Enron, Titanic, and The Perfect Storm*, 71 FORDHAM L. REV. 1373, 1378–80 (2003); Jonathan D. Glater, *Five Questions for Lynn Turner*, N.Y TIMES, Dec. 2, 2001, at C5.

184. *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000) ("[F]ailure . . . to identify problems with the defendant-company's internal controls and accounting practices does not constitute reckless conduct sufficient for § 10(b) liability."); *see also supra* notes 138–39 and accompanying text.

185. *See, e.g.*, *Chen v. Navarre Corp.* (*In re Navarre Corp. Sec. Litig.*), 295 F.3d 791, 802 (8th Cir. 2002); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261 (10th Cir. 2001); *Hoffman v. Comshare, Inc.* (*In re Comshare, Inc. Sec. Litig.*), 183 F.3d 542, 553 (6th Cir. 1999); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996).

Circuit aptly pointed out, this would have the effect of "eviscerating the pleading requirements for scienter set forth in the PSLRA."[186] But *in context*, GAAP violations and other financial mismanagement can give rise to a finding of, at a minimum, recklessness.

What perhaps is less well understood about SOX's now infamous "internal controls" is that they are part of the statute's broader mandate for issuers to establish and maintain *disclosure controls*. The regulations promulgated as a result of SOX define disclosure controls and procedures as follows:

> Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosures.[187]

The SEC's interpretation of disclosure controls makes it clear that these should embody processes and procedures addressing not only the timeliness but also the *quality* of disclosure in public reports.[188] These controls are what executives certify as part of their SOX section 302 obligations. And not only do issuers have disclosure control obligations, but officers have an obligation to certify that these controls are in place and operational.[189]

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186. *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006).

187. 17 C.F.R. §§ 240.13a-15(e), .15d-15(e) (2006).

188. Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 824, Exchange Act Release No. 46427, Investment Company Act Release No. 25722, 67 Fed. Reg. 57,276, 57,286 (Sept. 9, 2002) (codified in scattered sections of 17 C.F.R.) ("The new rules are intended to enhance investor confidence in the quality of the information available to them in quarterly and annual reports . . . ."). Professor Langevoort is more pointed about the need for reporting controls. *See* Langevoort, *Resetting the Corporate Thermostat*, *supra* note 177, at 315 (describing the desirability of reporting controls in light of managerial incentives to conceal or misrepresent).

189. An example of a publicly traded company's disclosure controls and procedures certification reads

> [The undersigned executives have] [d]esigned such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under [their] supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared.

Functionally, then, the federal securities laws have—through SOX—imposed an obligation of oversight and monitoring on top corporate officers.[190] This duty is intended, in part, to "prevent or detect material misstatements or omissions."[191] This idea is not especially controversial nor is it particularly new. The judiciary has also noted the

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In re MoneyGram Int'l, Inc. Sec. Litig., 626 F. Supp. 2d 947, 960 (D. Minn. 2009). Also see Item 4 of Part I-Financial Information of Form 10-Q, and the section entitled "Signatures" and "Certifications." Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276, 57,291 (Sept. 9, 2002) (codified in scattered sections of 17 C.F.R.).

190. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 876–77, 886 (2003). Professors Thompson and Sale describe officers as the "fulcrum" of governance, and advance the proposition that the federal disclosure laws—including executive certifications via SEC rules and later SOX—are imposing corporate-governance duties on officers, where state corporations law traditionally has focused on directors and shareholders. *Id.* at 861. They also maintain that federal securities laws work to "fill the hole in Delaware law" that is the lack of liability for officers for breach of the fiduciary duty of care. *Id.* at 905. State corporations law does impose a duty of monitoring and oversight on directors. A priori, corporate officers—who by definition have more hands-on, day-to-day duties associated with corporate affairs than do directors—should also have a duty to monitor, at least important corporate information. *See generally* Johnson & Millon, *supra* note 95, at 1600–01 (noting that as a matter of state corporations law, officers' duties as agents have been woefully overlooked, as they have been lumped together with directors as "generic 'fiduciaries'").

191. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, Exchange Act Release No. 47986, Investment Companies Act Release No. 26068, 68 Fed. Reg. 36,636, 36,643 (June 18, 2003) (codified in scattered sections of 17 C.F.R.). According to the SEC, the firm must maintain documentation evidencing, among other things, the propensity of the system to prevent or detect fraud:

> An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered.

Id.

In some ways, then, these new disclosure controls are reminiscent of the duty of oversight imposed by Delaware law on corporate directors. *See, e.g.*, *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996). For a detailed scholarly treatment see, e.g., H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 DEL. J. CORP. L. 1 (2001); Hillary A. Sale, *Monitoring* Caremark*'s Good Faith*, 32 DEL. J. CORP. L. 719 (2007). This assessment also involves a "red flags" analysis similar to that discussed earlier. *See, e.g.*, *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 373 (Del. 2006) ("In the absence of red flags, good faith in the context of oversight must be measured by the directors' actions 'to assure a reasonable information and reporting system exists' and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome." (quoting *In re Caremark Int'l Inc. Deriv. Litig.* 698 A.2d at 971)).

need for corporate officers to assure that there are adequate systems in place to permit them to inform themselves of material information before they make public statements, lest they be guilty of recklessness.[192] And this common law duty is broader than just SOX- or SEC-based disclosure controls and internal controls over financial reporting, it relates to the quality of corporate disclosure generally—including any kind of dissemination of corporate information to the market, whether financial or non-financial, and whether or not it relates to effectiveness and efficiency of operations or the corporation's compliance with laws and regulations. The SEC shares this much broader view of the purpose of internal controls, disclosure controls, and executive certifications as they relate to providing accurate and complete information to shareholders.[193]

C. The Larger 10(b) Class Action Landscape

Finally, critics may argue the doctrinal shift I have outlined is too dramatic, that it would cause a draconian increase in executive liability contrary to the spirit of the PSLRA, or that it represents too big a departure from the venerated recklessness definition in *Sundstrand*. But let us recall that the analysis I promote here applies at the pleading stage. It provides a more principled definition of recklessness for purposes of determining whether a "strong inference" of scienter can be drawn from the facts set forth in a class action fraud-on-the-market complaint. It is a jurisprudential refinement designed to inject into the dismissal stage a

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192. *See, e.g.*, *In re Warner Commc'ns Sec. Litig.*, 618 F. Supp. 735, 752 (S.D.N.Y. 1985), *aff'd* 798 F.2d 35 (2d. Cir. 1986).

> As to Warner, plaintiffs arguably need only show either that one or more members of top management knew of material information indicating an earnings decline, but failed to stop the issuance of misleading statements or to correct prior statements that had become misleading, or that Warner management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace.

Id.

193. Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8124, Exchange Act Release No. 46427, Investment Companies Act 25722, 67 Fed. Reg. 57,276, 57,280–81 (codified in scattered sections of 17 C.F.R.) (Sept. 9, 2002).

> We believe that, to assist principal executive and financial officers in the discharge of their responsibilities [inter alia] to discharge their responsibilities in providing accurate and complete information to security holders, it is necessary for companies to ensure that their internal communications and other procedures operate so that important information flows to the appropriate collection and disclosure points in a timely manner.

Id.

"practical and common-sense perspective"[194] on recklessness, one that perhaps has been lost in the years since *Sundstrand* was decided and in the years of uncertainty after the PSLRA heightened a well-understood and comfortable pleading standard.

The Supreme Court has on more than one occasion noted that pleading and proof of a securities fraud claim are two different things.[195] Most recently, in *Tellabs*, the court held that all that is required of a plaintiff's complaint alleging violation of section 10(b) is that it plead facts sufficient to permit "an inference of scienter at least as likely as any plausible opposing inference."[196] It is not, the Court reminds us in *Tellabs*, until an eventual trial that the plaintiff must "demonstrate that it is more likely than not that the defendant acted with scienter."[197]

Moreover, the Supreme Court cautions in *Tellabs* that the PSLRA's heightened pleading standard does not require "smoking gun" proof of the necessary element of scienter:

> The inference that the defendant acted with scienter need not be irrefutable, *i.e.*, of the "smoking-gun" genre, or even the "most plausible of competing inferences," . . . . Recall in this regard that [the PSLRA]'s pleading requirements are but one constraint among many the PSLRA installed to screen out frivolous suits, while allowing meritorious actions to move forward.[198]

It is important not to forget this broader view of the function of the recklessness standard in current 10(b) class action fraud-on-the-market suits. An executive who was merely negligent ultimately will prevail at trial. The law of recklessness as it has developed under 10(b) applies at the dismissal stage. The analytical rubric I propose here for consideration of recklessness allegations is designed for use in that setting. As such, it properly can depart slightly from the *Sundstrand* definition, which was articulated after a bench trial.[199]

There is one final point to be made about the current 10(b) class action environment. The current trend appears to be toward a reduction

194. *South Ferry LP, #2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008).

195. *See, e.g.*, *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 338 (2005) (referring to the loss causation element: "In our view, the Ninth Circuit is wrong, both in respect to what a plaintiff must prove and in respect to what the plaintiffs' complaint here must allege").

196. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 328 (2007) (emphasis omitted).

197. *Id.* at 329 (emphasis omitted).

198. *Id.* at 324 (quoting *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004)).

199. *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044–45 (7th Cir. 1977).

in liability under section 10(b). The Supreme Court's recent ruling in *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*[200] rejected the notion of scheme liability, eliminating 10(b) claims against aiders and abettors.[201] This has the effect of narrowing dramatically the field of parties potentially responsible for securities fraud. In addition to potentially exculpating lower-level internal corporate-fraud participants,[202] other parties like vendors and bankers, who are silently complicit in an issuer's fraud, now cannot be held accountable under 10(b).[203] Outside directors are rarely sued[204] and even fewer are held liable.[205] Further, the concern is often raised that any further increase in liability for outside directors will chill their willingness to serve, perhaps creating a leadership vacuum in Corporate America.[206] But what is the corresponding rationale for exculpating top corporate officers who misspeak to the public about material corporate matters?

Put otherwise, my final point is this: if corporate officers are not responsible for corporate fraud, then who is? Many have noted the now exceptional difficulty plaintiffs face in adequately pleading scienter.

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200. 552 U.S. 148 (2008).

201. *Id*.

202. For example, in *Pugh v. Tribune Co.*, the first appellate court to apply *Stoneridge* refused to find "scheme liability" in a situation where employees of Tribune and its subsidiaries had falsely inflated circulation figures for two Tribune publications so as to increase the amounts charged for advertising. 521 F.3d 686, 690, 696 (7th Cir. 2008). When the fraud was revealed, Tribune took a $90 million charge to earnings and several employees pled guilty to fraud charges. *Id.* at 690. The ensuing class action 10(b) fraud-on-the-market suit was dismissed by the district court.

The Seventh Circuit affirmed, applying *Stoneridge* to the plaintiff's claims against the Tribune employee who was allegedly behind the circulation scheme. *Id.* at 697. Plaintiffs argued that it was foreseeable that the circulation fraud would lead to an overstatement of the company's revenues. *Id*. Concluding that the Supreme Court's ruling in *Stoneridge* "indicates that an indirect chain to the contents of false public statements is too remote to establish primary liability," the court found that the Tribune employee had "participated in a fraudulent scheme but had no role in preparing or disseminating Tribune's financial statements or press releases," and therefore could not be found liable under section 10(b). *Id*.

203. *See, e.g.*, *In re Peregrine Sys., Inc. Sec. Litig.*, 310 Fed. Appx. 149 (9th Cir. 2009) (applying *Stoneridge* to affirm dismissal of a case alleging KPMG Consulting Firm "enabled" the issuer to improperly recognize millions in revenue through illusory agreements to purchase software).

204. Coffee, *supra* note 7, at 1549 (citing Thompson & Sale, *supra* note 190, at 896 & tbl.3).

205. Coffee, *supra* note 7, at 1551 (citing Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1068 (2006)); *see also* Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 568 (2003) ("As a practical matter, however, directors face limited meaningful exposure to liability.").

206. *See, e.g.*, Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 332–33.

From this perspective, the PSLRA's particularity and strong inference requirements appear to have gone far beyond protecting corporate securities issuers against strike suits. Instead this legislation appears to have created a shield for issuers and their leaders, one that is implausibly impenetrable and therefore socially undesirable. The pendulum should not swing so far to one side that no one is held accountable for corporate fraud.[207]

CONCLUSION

When top corporate officers speak to the marketplace, they have an obligation to familiarize themselves with significant corporate matters lest they harm shareholders by providing false information. Whether they have failed to fully inform themselves or have intentionally remained blind to the truth before speaking, the inference is both cogent and compelling that they have recklessly misstated such information in an effort to gloss over the truth.

In the post-Enron-WorldCom world, and especially since the most recent corporate scandals involving CDOs and options backdating, there is an increasingly urgent call for accountability to shareholders. Legislative measures have largely failed to make individual fraudsters more answerable for their frauds. Case law surrounding the scienter element of a 10(b) claim, especially as it relates to recklessness, has become muddled and wildly inconsistent. The terms "severe recklessness" and "deliberate recklessness," among others, are often brandished but rarely deployed by courts in any meaningful fashion. Perhaps understandably confused by plaintiffs' lengthy, rambling allegations, many courts have transformed recklessness from a separate level of intent supporting an inference of scienter into a largely meaningless adjunct to actual intent to defraud.

While the evaluation of recklessness in the 10(b) setting will always be a heavily fact-intensive task, this does not mean that a solid, intellectually grounded, and uniform standard for its application—especially at the dismissal stage—cannot be formulated. Here I have shown how a rational inquiry into the context of a misrepresentation provides useful structure to the concept of recklessness. Indeed, the magnitude, atypicality, and timing of information claimed to have been misstated (or its disclosure) provide valuable parameters for a court's

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207. An interesting subset of recent case law decided under Section 10(b) reflects a judicial willingness to infer that an unnamed corporate officer possessed the necessary scienter to surmount a motion to dismiss, at least for purposes of holding the corporation liable. *See, e.g.*, *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195–96 (2d Cir. 2008).

consideration of whether a strong inference of recklessness has been pled.

This contextual framework, an extension of the model employed for insider stock sales and for assessing allegations of motive in 10(b) cases, establishes a more objective or external view of recklessness. It properly balances the risk of harm to shareholders against the relatively slight burden imposed on a high-ranking corporate officer to know the most prominent corporate facts. It reemphasizes those executives' managerial-oversight role, without making them responsible for the minutiae of day-to-day operations. Suitably distinguished from the considerations that may be proper when assessing actual intent allegations, the magnitude-atypicality-timing conception of recklessness refocuses the courts and litigants at the pleading stage on what executives can properly be held accountable for truthfully disclosing in the face of their presumed ignorance.

Ultimately, the rubric set forth here accomplishes two important tasks. It harmonizes the fractured law of recklessness in 10(b) cases. And perhaps more importantly, it disincentivizes willful blindness, moving in the direction of both encouraging responsible corporate disclosure and eliminating plausible deniability. As such, it finds a proper place among other scholarly proposals that seek to more rigorously evaluate individual culpability as well as those that contribute to the larger concern over optimal deterrence of securities fraud.