

**THE SCIENCE OF SCIENTER:
THE PRIVATE SECURITIES LITIGATION REFORM
ACT'S EFFECT AND THE LONG-AWAITED
DECISION OF *MAKOR ISSUES & RIGHTS, LTD. V.
TELLABS, INC.***

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INTRODUCTION

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA)¹ and changed the way securities fraud cases are litigated. Among its most notable alterations, the PSLRA heightened the pleading requirements for a securities fraud action under Section 10(b) of the Securities Exchange Act of 1934,² and Securities Exchange Commission Rule 10b-5.³ Under the PSLRA's new standards, plaintiffs are required to show a "strong inference" of the

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¹ See Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in sections of 15 U.S.C. §§ 77, 78) (2000)).

² See 15 U.S.C. § 78u-4(b) (2000).

³ See 17 C.F.R. § 240.10b-5 (2005).

required state of mind, known in securities law as scienter.⁴ Prior to the enactment of the PSLRA, the Second Circuit Court of Appeals required plaintiffs to show a “strong inference” of scienter, while its sister circuits applied more lenient standards for pleading scienter.⁵ Under the Second Circuit’s pre-PSLRA standard, scienter could be satisfied by “intentional conduct *or* recklessness,” and a “strong inference” of scienter could be established by adequately pleading that the defendant had a motive and opportunity to defraud the plaintiff.⁶ Significantly, Congress incorporated the “strong inference” of scienter language into the PSLRA pleading requirements. It remains hotly debated, however, whether Congress intended to adopt the Second Circuit’s pre-PSLRA approach, including its motive and opportunity test, or if it merely borrowed the language of that standard.⁷ This note explores those two issues: (1) whether the substantive standard of scienter changed with the enactment of the PSLRA, and (2) whether pleading motive and opportunity to defraud is sufficient to adequately allege scienter for securities fraud actions.

Section I of this note provides background information on the laws governing securities regulation and the effect of the PSLRA on securities fraud actions. Section II analyzes the recent Seventh Circuit decision, *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*,⁸ which presented the first opportunity for the Seventh Circuit to address the heightened pleading requirements of the PSLRA. Section III provides an overview of the current circuit split on the two major scienter issues: (1) the whether the PSLRA altered the substantive standard of scienter, specifically, whether recklessness is still a sufficient state of mind; and (2) whether pleading motive and opportunity to defraud

⁴ 15 U.S.C. § 78u-4(b)(2).

⁵ Compare *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259 (2d Cir. 1993) *superseded by statute on other grounds as stated in* *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. 1996) (plaintiff must demonstrate “strong inference” of scienter); *with* *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994) (plaintiff need only allege that scienter existed).

⁶ See *In re Time Warner*, 9 F.3d at 269.

⁷ Compare *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000); *with* *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999).

⁸ 437 F.3d 588 (7th Cir. 2006).

constitutes the requisite “strong inference” under the PSLRA’s scienter requirement. Section IV analyzes how the Seventh Circuit’s decision affects the current state of the law, namely, how the Seventh Circuit fits into the current circuit split. This section also discusses how *Makor* overhauls the standards for securities fraud actions within the Seventh Circuit and its district courts. Section V discusses why the *Makor* decision is correct in holding that recklessness remains adequate under the substantive standard of scienter after the PSLRA, and why the “middle of the road” approach to the motive and opportunity test is likewise the wisest route to take. Section VI concludes that the Seventh Circuit adopted the proper substantive standard of scienter, as well as the proper interpretation of the requisite “strong inference.” Finally, this article concludes that achieving uniformity amongst the circuits is vital and will require a grant of *certiorari* or Congressional action for clarification.

I. BACKGROUND ON THE PSLRA

Reacting to the stock market crash of 1929 and the Great Depression, Congress designed modern securities laws to “substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”⁹ Congress sought to establish honest markets with honest publicity and to minimize mystery and secrecy in the marketplace.¹⁰ To this end, Congress passed the Securities Exchange Act of 1934,¹¹ including section 10(b) which prohibited securities fraud and created an investor cause of action when violated.¹²

⁹ *Id.* at 595 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

¹⁰ *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988) (citing H.R. REP. No. 73-1383, at 11 (1934)); *see also Makor*, 437 F.3d at 595.

¹¹ 15 U.S.C. §§ 78a-78mm. Section 10(b) of the Securities Exchange Act of 1934 codified in 15 U.S.C. § 78u-4(b), and Securities Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5; *see also Makor*, 437 F.3d at 594.

¹² *See* 15 U.S.C. § 78t. Subsequent to section 10(b), the Securities Exchange Commission (SEC) passed Rule 10b-5, which mirrored section 10(b) of the

A. Pre-PSLRA Pleading Requirements

Before Congress passed the PSLRA, the Circuit Courts of Appeals agreed that recklessness was a sufficient substantive standard of scienter for securities fraud actions.¹³ The courts understood recklessness to be the standard articulated by the Seventh Circuit in *Sundstrand Corp. v. Sun Chemical Corp.*,¹⁴ which defined recklessness as:

[H]ighly unreasonable omission, involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.¹⁵

At this stage, the substantive standard of scienter was undisputed.

Prior to the PSLRA's enactment, securities fraud lawsuits such as section 10(b) claims were governed by the pleading standards for fraud set forth in Rule 9(b) of the Federal Rules of Civil Procedure.¹⁶ Under Rule 9(b), the plaintiff is required to state "the circumstances constituting fraud or mistake . . . with particularity."¹⁷ Even under the Rule 9(b) pleading regime, the circuit courts applied varying

Securities Exchange Act. *See* 17 C.F.R. § 240.10b-5. Congress also passed the Securities Act of 1933 in attempts to reach its goals. *See* 15 U.S.C. §§ 77a-77aa.

¹³ *See, e.g.,* *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d. Cir. 1978); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc).

¹⁴ 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

¹⁵ *Sundstrand*, 553 F.2d at 1044-45; *see Hollinger*, 914 F.2d at 1569 (quoting *Sundstrand*); *Rolf*, 570 F.2d at 47 (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977), but adopting the language of *Sundstrand*).

¹⁶ Fed. R. Civ. P. 9(b); *see In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999).

¹⁷ Fed. R. Civ. P. 9(b); *In re Comshare*, 183 F.3d at 548.

standards.¹⁸ The spectrum widened as the Second and Ninth Circuits adopted significantly different pleading requirements: the Second Circuit required the plaintiff to present facts sufficient to create a “strong inference” of scienter,¹⁹ while the Ninth Circuit adopted a very relaxed standard that did not require a plaintiff to allege any specific facts to support scienter.²⁰

While Rule 9(b) already required a higher pleading standard for fraud claims than required for ordinary federal notice pleading, the Supreme Court noted that “litigation under [Securities Exchange Commission] Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general,”²¹ and members of both political parties in Congress agreed that meritless securities fraud actions and strike suits²² continued to plague the courts and financially bind market players.²³ Congress concluded that Rule 9(b) failed to prevent the abuse of the securities laws by private litigants and that a more stringent standard was still needed.²⁴ On December 22, 1995, overriding President Clinton’s veto, Congress amended the Securities Exchange Act with the PSLRA in

¹⁸ See S. Rep. No. 104-98, at 15 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 693.

¹⁹ See *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259 (2d Cir. 1993); see also Rick M. Simmons, Comment, *Reconciling Pleading Standards Under Pirraglia: The Private Securities Litigation Reform Act v. Federal Rule of Civil Procedure 12(b)(6)*, 81 DENV. U. L. REV. 665, 667 (2004).

²⁰ See generally *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994). If a plaintiff simply stated that “scienter existed,” this was sufficient under the Ninth Circuit’s pleading requirements. *Id.* at 1547.

²¹ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

²² A “strike suit” is defined as a suit often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement. BLACK’S LAW DICTIONARY 1448 (7th ed. 1999). Such a suit is often brought by small shareholders of a corporation with the intention to force a settlement instead of expending money on costly discovery and defense of the suit. See GILBERT’S LAW DICTIONARY 318 (pocket size ed. 1997).

²³ See H.R. REP. No. 104-369, at 41 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730, 739.

²⁴ *Id.*; see *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999).

hopes of eliminating meritless claims beyond the motion to dismiss phase.²⁵

B. The Passage of the PSLRA:

A New Pleading Standard or Codification of a Previous Standard?

The PSLRA was designed to curb “abusive class action securities fraud litigation” while still protecting investors and promoting confidence in the financial marketplace by heightening the pleading standards for securities fraud actions beyond the requirements of Federal Rule of Civil Procedure 9(b).²⁶ Specifically, Congress sought to eliminate the unnecessary increase in costs of raising capital caused by corporate fears of disclosing bad news since this news may be perceived as fraud.²⁷ Legislators acknowledged that strike suits were frequently being used to gain large settlement recoveries by misusing discovery and making it more economical for the victimized party to settle.²⁸

Pursuant to the PSLRA, a claim under Section 10(b) or Rule 10b-5 must state with particularity that (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied and (6) the false statement or omission

²⁵ *In re Comshare*, 183 F.3d at 548 (citing the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737); see 15 U.S.C. § 78u-4(b)(3)(A) (failure to meet pleading requirements will result in dismissal of the complaint).

²⁶ Jeffrey A. Berens, *Pleading Scienter Under the Private Securities Litigation Reform Act of 1995*, 31-FEB COLO. LAW. 39, 40 (2002).

²⁷ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 759-60 (1975) (discussing concerns of frivolous securities lawsuits’ negative effect on the marketplace); see also *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 (3d Cir. 1999).

²⁸ See H.R. REP. No. 104-369, at 31 (1995) (Conf. Rep.); *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000).

proximately caused the plaintiff's damages.²⁹ Specifically, the PSLRA's pleading standard for scienter required the following:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.³⁰

If the plaintiff fails to meet this requirement of a "strong inference" of scienter, a court should dismiss the complaint on motion.³¹ But did the substantive standard of scienter change? Is recklessness as defined by *Sundstrand* still enough? And what constitutes a "strong inference" of scienter? It appears from the legislative history of the PSLRA that even Congress was uncertain.³²

Because the PSLRA adopted the "strong inference" language from the Second Circuit's pre-PSLRA standard, it appeared that Congress adopted the Second Circuit case law on the issue. However, the Second Circuit's "strong inference" pre-PSLRA standard could be demonstrated in different ways: (1) by showing actual knowledge; (2) by demonstrating that the defendant had "the motive to commit fraud and an opportunity to do so" (referred to as the motive and opportunity test); or (3) by pleading facts of "circumstantial evidence of either

²⁹ *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 595 (7th Cir. 2006); *see also* 15 U.S.C. § 78u-4(b)(2); 17 C.F.R. § 240.10b-5.

³⁰ 15 U.S.C. § 78u-4(b)(2).

³¹ 15 U.S.C. § 78u-4(b)(3).

³² *See In re Advanta*, 180 F.3d at 531-33 (detailing the Congressional debate over what "strong inference" of scienter within the PSLRA means); *see also* Erin M. O'Gara, Note, *Comfort With the Majority: The Eighth Circuit Weighs in on the Proper Pleading Test for a Securities Fraud Claim in Florida State Board of Administration v. Green Tree Financial Corporation*, 270 F.3d 645 (8th Cir. 2001), 82 NEB. L. REV. 1276, 1282-83 (2004).

reckless or conscious behavior.”³³ So the question remained: Were all three of the Second Circuit’s pre-PSLRA approaches sufficient under the PSLRA? Although the Senate Committee stated that it did not intend to codify the Second Circuit’s pre-PSLRA standard for scienter, it did note that “courts might find this body of law instructive” and that the PSLRA’s pleading standard was not “a new and untested pleading standard that would generate additional litigation.”³⁴ Subsequently, the Senate did adopt an amendment that codified the Second Circuit’s standard almost verbatim, including its motive and opportunity test,³⁵ but the Joint Conference Committee³⁶ declined to adopt it.³⁷ Despite President Clinton’s endorsement of the Second Circuit’s pleading standard, the Joint Conference Committee stated that it intended “to strengthen existing pleading requirements,” and therefore opted to exclude “certain language relating to motive, opportunity, or recklessness.”³⁸

II. *MAKOR ISSUES & RIGHTS, LTD. V. TELLABS, INC.*: THE SEVENTH CIRCUIT WEIGHS IN

Investors, litigators, executives, and courts were all surprised to see the Seventh Circuit, one of the main securities litigation circuits in the country, avoid the PSLRA pleading requirements issue for nearly a decade. But in January of 2006, the Seventh Circuit issued its long-awaited decision addressing the PSLRA’s heightened pleading

³³ *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993).

³⁴ S. Rep. No. 104-98, at 15 (1995). Needless to say, and as this article demonstrates, Congress was wrong in its prediction that the PSLRA pleading standard would not create additional litigation.

³⁵ *See* 141 Cong. Rec. S9150-01, at S9170 (daily ed. June 27, 1995).

³⁶ The Joint Conference Committee was responsible for reconciling the differences between the House and Senate Bills. The Committee was made up of House and Senate managers; *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 978 (9th Cir. 1999).

³⁷ *See generally* 141 Cong. Rec. H13691-08, at H13702 (daily ed. Nov. 28, 1995) (Joint Explanatory Statement of the Committee of Conference).

³⁸ *Id.*

standards.³⁹ In *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, the plaintiffs accused Tellabs, a manufacturer of specialized equipment used in fiber optic cable networks, and Tellabs' executive officers, of engaging in a scheme to deceive the investing public about the true value of Tellabs' stock.⁴⁰ The plaintiffs' complaint alleged three statutory violations: (1) corporate securities fraud, in violation of section 10(b) of the Securities Exchange Act of 1934;⁴¹ (2) "control person" liability for the securities fraud against two Tellabs executives, pursuant to section 20(a) of the Securities Exchange Act;⁴² and (3) illegal insider trading in violation of section 20A of the Securities Exchange Act against one Tellabs executive.⁴³ After the district court granted Tellabs' motion to dismiss for failure to adequately plead, Makor appealed to the Seventh Circuit Court of Appeals.⁴⁴

A. Facts of the Case

The plaintiffs in *Makor*, a putative class of Tellabs stockholders, alleged fraudulent corporate conduct by Tellabs that spanned an eighteen-month period.⁴⁵ Beginning in December of 2000, Tellabs announced the release and immediate availability of its newest product, the TITAN 6500 system.⁴⁶ In addition to this announcement, Tellabs' Chief Executive Officer (CEO) predicted that the TITAN 6500's predecessor, the TITAN 5500, would continue growing as

³⁹ See generally *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 595 (7th Cir. 2006); see also Here At Last, <http://www.the10b-5daily.com/archives/00670.html> (Jan. 27, 2006, 16:45 EST).

⁴⁰ See generally *Makor*, 437 F.3d 588.

⁴¹ Section 10(b) of the Securities Exchange Act of 1934 is codified at 15 U.S.C. § 78u-4(b).

⁴² Section 20(a) of the Security Exchange Act is codified at 15 U.S.C. § 78t.

⁴³ Section 20A of the Act is codified at 15 U.S.C. § 78t-1; see *Makor*, 437 F.3d at 594.

⁴⁴ *Makor*, 437 F.3d at 594. The case was originally filed in the Northern District of Illinois. See also *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004) (the District Court appoint Makor Issues & Rights, Ltd. as Lead Plaintiff shortly after the filing of the Complaint).

⁴⁵ *Makor*, 437 F.3d at 588.

⁴⁶ *Id.* at 592.

well.⁴⁷ Over the next few months, Tellabs executives continued to release press statements claiming that “customers are buying more and more Tellabs equipment” and that “demand for [the TITAN 6500] is exceeding [Tellabs’] expectations.”⁴⁸ Around this time, Tellabs stock was valued at \$67 per share.⁴⁹ Until March of 2001, Tellabs publicly reported that business was thriving, and subsequently, stock prices were rising.⁵⁰

In March of 2001, in its first public suggestion that business was not quite as booming as it had portrayed, Tellabs reduced its first quarter sales projections from an \$890 million to \$865 million range to an \$830 million to \$865 million range.⁵¹ Despite this decrease, Tellabs executives continued to state that TITAN 5500 and 6500 sales thrived.⁵² Yet in April of 2001, Tellabs again reduced its first quarter sales projections to \$772 million.⁵³ When investors questioned this projection and asked if it was due to a lower than expected demand for the TITAN 6500, Tellabs’ CEO said that “the only reason for the downward projections was that Tellabs’s customers were pushing orders back from the first to the second quarter of 2001.”⁵⁴ Two weeks later, Tellabs announced that its first quarter sales were \$772 million.⁵⁵

Things continued to appear rosy for Tellabs through the second quarter until Tellabs again substantially reduced its quarterly sales projections.⁵⁶ On June 19, 2001, Tellabs announced that its second quarter revenues were only \$500 million, significantly less than the

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *See id.* at 593.

⁵⁰ *See id.* at 592-93.

⁵¹ *Id.* at 592. Tellabs attributed this decrease to “lower-than-expected growth in Tellabs’ CABLESPAN® business, a product unrelated to this action.” *Id.*

⁵² *Id.* at 592-93. For example, on a conference call with analysts, Tellabs’ CEO said that Tellabs’ core products, such as the TITAN 6100 and 6500 continue to grow. Similarly, Tellabs’ CEO reported that Tellabs was still seeing the TITAN 5500 maintain its growth rate after an investor questioned the TITAN 5500’s strength and demand. *Id.*

⁵³ *Id.* at 593.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *See id.* at 592-93.

projected estimate of \$800 million.⁵⁷ Tellabs' CEO told investors that the reduction was "almost entirely because of an enormous reduction in TITAN 5500 sales."⁵⁸ On June 20, 2001, Tellabs' stock price dropped to \$15.87 per share.⁵⁹

B. Issues Presented on Appeal

The Seventh Circuit faced multiple issues of first impression in *Makor*.⁶⁰ First, the court had to determine whether the substantive standard of scienter had changed under the PSLRA.⁶¹ On this issue, the court considered the two existing standards used by the other circuit courts of appeals: (1) that "recklessness" was sufficient; and (2) that "severe recklessness" or "deliberate recklessness" was required.⁶² Next, the court was asked what facts would suffice to create the requisite "strong inference" of scienter.⁶³ In this determination, the court reviewed the three-way split amongst its sister circuits regarding that standard.⁶⁴ The Seventh Circuit was finally ready to address the PSLRA head-on regarding these unsettled issues of law.⁶⁵

⁵⁷ *Id.* Tellabs had originally projected a range of \$780 million to \$820 million for its second quarter sales. *Id.*

⁵⁸ *Id.* at 593.

⁵⁹ *Id.*

⁶⁰ *See generally id.* For the purposes of this article, discussion is restricted to the two main issues of scienter: (1) the substantive standard of recklessness; and (2) the motive and opportunity test.

⁶¹ *See id.* at 600-01.

⁶² *Id.* at 600 (citing *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (Ninth Circuit)); *see also* *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 (11th Cir. 1999) (applying a "deliberate recklessness" scienter standard).

⁶³ *Makor*, 437 F.3d at 601.

⁶⁴ *Id.* at 601-02.

⁶⁵ The court also determined, as an issue of first impression, whether confidential sources must be identified. *Id.* at 596. Agreeing with all its sister circuits, the court held that confidential sources need not be explicitly identified, but that sufficient facts supporting the sources knowledge be pled. *Id.* While some of the circuits, including the *Makor* court, interpret the Ninth Circuit to hold that confidential sources must be explicitly named and identified, a close reading of *In re Silicon Graphics* seems to put the Ninth Circuit in the same category as the rest of the circuits in that *In re Silicon Graphics* does not require the identities to be

1. The Substantive Standard of Scierter

The court first evaluated the standard of recklessness under the PSLRA. Acknowledging the pre-PSLRA scierter standard and Congress' choice to use the same "required state of mind" language without redefining such, the Seventh Circuit concluded that Congress did not make the substantive scierter standard of recklessness more stringent through the PSLRA.⁶⁶ Instead, the Seventh Circuit adhered to the same definition of recklessness that it and the other circuits had for years: that recklessness is "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must be aware of it."⁶⁷ In short, the Seventh Circuit joined the First,⁶⁸ Second,⁶⁹ Third,⁷⁰ Fourth,⁷¹ Fifth,⁷² Sixth,⁷³ Eighth,⁷⁴ and Tenth⁷⁵ Circuits in holding that the substantive scierter requirement

disclosed, but does require specifics details regarding the sources' information and facts indicative of their reliability. *See In re Silicon*, 183 F.3d at 985 (9th Cir. 1999). As another issue of first impression, the court held that scierter allegations made against one defendant cannot be imputed to the other defendants in the action. *Makor*, 437 F.3d at 602-03 (rejecting the "group pleading presumption").

⁶⁶ *Makor*, 437 F.3d at 601. All of the other circuits except for the Ninth Circuit, and arguably the Eleventh Circuit, have likewise held that the recklessness standard did not change with the passage of the PSLRA. *See id.* at 600-01 (concluding that all circuit courts of appeals, except for the Ninth Circuit, have held that the substantive standard of recklessness remains unchanged after the PSLRA).

⁶⁷ *Id.* at 600 (citing *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.) (quotation removed) (applying the standard to omissions)); *see also* *SEC v. Jakubowski*, 150 F.3d 675, 681-82 (7th Cir. 1998) (applying the *Sundstrand* scierter standard in a case decided after the passage of the PSLRA).

⁶⁸ *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999).

⁶⁹ *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000).

⁷⁰ *See also* *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 536 (3d Cir. 1999).

⁷¹ *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 346 (4th Cir. 2003).

⁷² *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 408 (5th Cir. 2001).

⁷³ *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550 (6th Cir. 2001) (en banc).

⁷⁴ *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 659 (8th Cir. 2001).

⁷⁵ *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1260 (10th Cir. 2001).

remained the same after the PSLRA and required a showing of “reckless” conduct: nothing more, nothing less.

2. “Strong Inference” of Scierter

The court next addressed whether the Second Circuit’s motive and opportunity test survived the PSLRA.⁷⁶ In determining the issue, the Seventh Circuit carefully examined the opinions written by the other circuits.⁷⁷ Taking note of the broad range of disagreement amongst its fellow circuit courts, the Seventh Circuit adopted the “middle of the road” approach taken by the majority of the other circuits, which allows the courts to decide whether allegations of motive and opportunity to defraud are sufficient to create a strong inference of scierter on a case-by-case basis.⁷⁸ In doing so, the Seventh Circuit rejected the notion of a bright-line rule for adequate scierter pleadings involving allegations of motive and opportunity to defraud.

After briefly evaluating the legislative history of the PSLRA’s heightened pleading requirements, the court pointed out that the “scope [of legislation] is not limited by the cerebrations of those who voted for or signed it into law.”⁷⁹ Absent a detailed instruction of what pleadings are sufficient to create a “strong inference” of scierter, the court should consider all of the circumstances of the case collectively to determine if they create the requisite inference.⁸⁰ Under this standard, the Seventh Circuit held that motive and opportunity may be useful indicators, but because the PSLRA does not require or reject

⁷⁶ *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601-02 (7th Cir. 2006).

⁷⁷ *Id.*

⁷⁸ *Id.* at 601; *accord* *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-97 (1st Cir. 1999); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *Helwig*, 251 F.3d at 550-52 (Sixth Circuit); *Florida State Board of Administration v. Green Tree Financial Corporation*, 270 F.3d 645, 659-60 (8th Cir. 2001); *and Fleming Cos.*, 264 F.3d at 1261-63 (Tenth Circuit).

⁷⁹ *Makor*, 437 F.3d at 601 (quoting *United States v. Mitra*, 405 F.3d 492, 495 (7th Cir. 2005)).

⁸⁰ *Id.*

such for sufficiency, the decision is essentially left to the discretion of the court, but is limited by the traditional factfinder's role.⁸¹ In short, "[i]f a reasonable person could not draw a [strong inference of scienter] from the alleged facts, the defendants are entitled to dismissal [because] the complaint would fail as a matter of law to meet the requirements of § 78u-4(b)(2)."⁸² In short, the Seventh Circuit neither accepted nor rejected the notion that allegations of motive and opportunity to defraud will always be sufficient or insufficient to create a strong inference of scienter in securities fraud actions. Instead, the court held that allegations of motive and opportunity can be sufficient to plead a strong inference of scienter, but that it will be determined by the totality of circumstances contained in the complaint.⁸³

III. DISSENT THROUGHOUT THE CIRCUITS: THE SUBSTANTIVE STANDARD OF SCIENTER AND THE INTERPRETATION OF "STRONG INFERENCE"

Contrary to Congress' prediction that the PSLRA's pleading requirements would not generate additional litigation, the circuit courts of appeals disagree as to what the substantive standard of scienter is and what Congress meant by "strong inference that the defendant acted with the required state of mind."⁸⁴ As a result, two different substantive standards of scienter and three different standards

⁸¹ *See id.* at 601-02. While the Sixth Circuit's similar approach has been criticized as a violation of the plaintiff's Seventh Amendment right to a jury trial on factual issues, the Seventh Circuit stopped just short of the Sixth Circuit approach by limiting the court's discretion to the traditional standard of "a reasonable person could infer that the defendant acted with the required intent." *Id.* at 602; *see* *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004) (quoting *Helwig*, 251 F.3d at 553); *see also* *Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005).

⁸² *Makor*, 437 F.3d at 602 (citing *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003)).

⁸³ *Cf.* *Makor*, 437 F.3d at 601-02.

⁸⁴ *See* 15 U.S.C. § 78u-4(b)(2); *see also Makor*, 437 F.3d at 600-02 (describing the differing interpretations of the circuits courts of appeals).

of “strong inference” are being implemented across the country, defeating the PSLRA’s purpose of uniformity in securities fraud actions pleading requirements.⁸⁵

A. *The Second and Third Circuits’ Interpretation*

1. Substantive Standard of Scierter Remains “Recklessness”

The Second Circuit in *Novak v. Kasaks*⁸⁶ and the Third Circuit in *In re Advanta Corp. Securities Litigation*⁸⁷ maintain the view that Congress codified the standard set forth by the Second Circuit prior to the PSLRA, which required plaintiffs to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁸⁸ The Second Circuit’s substantive standard of scierter prior to the enactment of the PSLRA could be met by pleading “recklessness,” defined as conduct which is “highly unreasonable,” and which represents “an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.”⁸⁹ Because Congress explicitly used the Second Circuit’s language of “strong inference” and “required state of mind,” the Second and Third Circuits reasoned that Congress did not intend to change the substantive scierter standard.⁹⁰

⁸⁵ See generally 15 U.S.C. § 78u-4.

⁸⁶ 216 F.3d 300 (2d Cir. 2000). While *Novak* is not the first case within the Second Circuit to determine the scierter pleading standard, it is regarded as the Second Circuit’s leading authority because the court’s prior decisions failed to adequately explain its decision to adopt the pre-PSLRA motive and opportunity test. E.g., *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999).

⁸⁷ 180 F.3d 525 (3d Cir. 1999).

⁸⁸ See *Novak v. Kasaks*, 216 F.3d 300, 308-10 (2d Cir. 2000); see also *Press*, 166 F.3d at 537-38; *In re Advanta*, 180 F.3d at 534.

⁸⁹ *Novak*, 216 F.3d at 308 (quoting *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) (defining recklessness))).

⁹⁰ Cf. *Novak*, 216 F.3d at 308-310; see also *Press*, 166 F.3d at 537-38; *In re Advanta*, 180 F.3d at 534.

2. “Motive and Opportunity” Alone *Always* Suffices to Create a Strong Inference of Scienter under the PSLRA

After determining that the substantive standard of recklessness was adequate to allege scienter, the Second and Third Circuits went on to adopt the Second Circuit’s pre-PSLRA approach to the “strong inference” issue, which allowed a plaintiff to sufficiently plead a securities fraud action by alleging that the defendant had a motive and opportunity to defraud.⁹¹ The Second and Third Circuits reasoned that Congress’ use of the substantially same language of “strong inference” as the Second Circuit’s pre-PSLRA scienter standard “bespeaks an intention to import’ judicial interpretations of that language into the new statute.”⁹² Next, these courts reasoned that because the statutory text is unambiguous, resort to the legislative history or the purposes of the PSLRA is not required.⁹³ Even if the courts did consider the legislative history of the PSLRA, it contains conflicting expressions of intent and would not change their interpretation.⁹⁴ All the legislative history provides is that Congress intended to make securities fraud pleading standards more stringent, and it did just that by incorporating the Second Circuit’s “strong inference” standard.⁹⁵ Although Congress

⁹¹ See *Press*, 166 F.3d at 538 (to reject that the motive and opportunity test can sufficiently plead scienter takes this issue of fact away from the factfinder); *Novak*, 216 F.3d at 309-10 (reasoning that although the court need not wed itself to terms like motive and opportunity, allegations that adequately prove motive and opportunity are sufficient to plead a securities fraud claim); *In re Advanta*, 180 F.3d at 530-35 (same).

⁹² *Novak*, 216 F.3d at 310 (citing *United States v. Johnson*, 14 F.3d 766, 770 (2d Cir. 1994)); see *In re Advanta*, 180 F.3d at 533-34 (Congress’ use of the Second Circuit’s language compels the conclusion that it adopted an equally stringent pleading standard).

⁹³ *Novak*, 216 F.3d at 310; *In re Advanta*, 180 F.3d at 533-34.

⁹⁴ *Novak*, 216 F.3d at 310-11; see *In re Advanta*, 180 F.3d at 531 (“The Reform Act’s legislative history on this point is ambiguous and even contradictory”).

⁹⁵ See *Novak*, 216 F.3d at 310; *In re Advanta*, 180 F.3d at 533-34. The courts explained that the Second Circuit’s “strong inference” standard was the most stringent in the nation prior to the PSLRA’s enactment, so it is reasonable that the PSLRA sought to strengthen the pleading requirements by adopting the Second

opted not to use words such as “motive” or “opportunity,” its reference to the Second Circuit’s pre-PSLRA case law for guidance on what constitutes a strong inference supports the position that the Second Circuit’s motive and opportunity test is still a valid way of establishing a strong inference of scienter.⁹⁶

B. The Ninth and Eleventh Circuits’ Interpretation

1. Substantive Standard of Scienter is “Super-Recklessness”

In its scienter analysis, the Ninth Circuit adopted a “super-recklessness” standard, which requires a plaintiff to show a “strong inference of deliberate or conscious recklessness” to satisfy the PSLRA’s scienter requirement.⁹⁷ This is in contrast to the pre-PSLRA’s form of recklessness, adopted by all of the other circuits, which only require more than mere negligence.⁹⁸ Although the Eleventh Circuit in *Bryant v. Avado Brands, Inc.*,⁹⁹ categorized itself as adopting the majority of circuits’ “middle of the road” approach, it repeatedly stated

Circuit’s requirements. *Novak*, 216 F.3d at 307-11; *In re Advanta*, 180 F.3d at 533-34.

⁹⁶ *Novak*, 216 F.3d at 311; *In re Advanta*, 180 F.3d at 534-35. These courts did restrict the motive and opportunity test slightly by saying that motives commonly held by corporate insiders such as a desire for high corporate credit ratings or high stock prices that would yield higher compensation and benefits for the officers are insufficient. *Novak*, 216 F.3d at 307.

⁹⁷ *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975 (Ninth Cir.).

⁹⁸ *Compare Id.* (standard is “deliberate or conscious recklessness” or a “degree of recklessness that strongly suggests actual intent”); *with Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1284 n.21 (11th Cir. 1999) (rejecting Ninth Circuit’s “super-recklessness” standard and adhering to that of the Sixth Circuit in *In re Comshare*, 183 F.3d at 550). This difference in scienter analysis accounts for the varying categorization of the *Bryant* opinion through the case law and secondary materials. *Cf. Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (categorizing Eleventh Circuit with the majority of circuits adopting the “middle of the road” approach); *with Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (noting the Eleventh Circuit’s disagreement with the middle of the road approach).

⁹⁹ 187 F.3d 1271 (11th Cir. 1999).

that that the Eleventh Circuit's standard was "severe recklessness."¹⁰⁰ Both the Ninth and Eleventh Circuits cited the Congressional record to support their positions: that Congress sought to make the pleading requirements for securities fraud actions more stringent.¹⁰¹ These circuits also noted that the Supreme Court suggested "scienter" meant "intent to deceive, manipulate, or defraud."¹⁰² Based on these sources, the Ninth Circuit concluded that Congress could not have intended to keep the scienter standard at recklessness: instead, it intended to strengthen that standard by requiring allegations beyond basic recklessness.¹⁰³ Although the Eleventh Circuit continued to use the term "severe recklessness" to describe the substantive standard of scienter, it concluded that the plain language of PSLRA "makes it clear that recklessness was not eliminated as a basis for liability under" the PSLRA.¹⁰⁴ While the Eleventh Circuit considered itself in agreement with the majority of circuits that held that the substantive standard did not change, by consistently requiring a showing of "severe" recklessness, the Eleventh Circuit imposed a higher standard and raised the substantive standard of scienter for securities fraud actions.¹⁰⁵

¹⁰⁰ *Bryant*, 187 F.3d at 1285-87. Within these three pages of the opinion, the court reiterated six times that "severe recklessness" is the standard of scienter in the Eleventh Circuit.

¹⁰¹ See *In re Silicon Graphics*, 183 F.3d at 974-76 (providing basis for court's determination that new standard is "deliberate or conscious recklessness"); see, e.g., *Bryant*, 187 F.3d at 1281-84 (explaining "severe recklessness" standard).

¹⁰² *In re Silicon Graphics*, 183 F.3d at 975 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976)); *Bryant*, 187 F.3d at 1281-82.

¹⁰³ E.g., *In re Silicon Graphics*, 183 F.3d at 977 (recognizing departure from pre-PSLRA requirement of recklessness); *Bryant*, 187 F.3d at 1281-84 (acknowledging that the PSLRA did not change the substantive standard of scienter, but that "severe" recklessness is standard in Eleventh Circuit).

¹⁰⁴ *Bryant*, 187 F.3d at 1284 n.21 (rejecting *In re Silicon Graphics*' more stringent standard of recklessness).

¹⁰⁵ Compare *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) (categorizing Eleventh Circuit with the majority of circuits adopting the "middle of the road" approach); with *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (noting the Eleventh Circuit's disagreement with the middle of the road approach).

2. “Motive and Opportunity” Alone *Never* Suffices to Establish a Strong Inference of Scierter under the PSLRA

In considering the Second Circuits’ pre-PSLRA motive and opportunity test, both the Ninth and Eleventh Circuits found that the motive and opportunity test contradicts the goal of the PSLRA to curb abusive securities actions because it lowers the requisite state of mind from a substantive standard of “severe recklessness” to an evidentiary standard of inferences of recklessness or willfulness.¹⁰⁶ Similarly, the *Bryant* court believed that the motive and opportunity test was not well-rooted enough to assume that the PSLRA codified it *sub silentio* based on its use of the phrase “strong inference.”¹⁰⁷ The *In re Silicon Graphics Inc. Securities Litigation*¹⁰⁸ court also believed that Congress implicitly rejected the motive and opportunity test by rejecting the Senate’s amendment codifying the Second Circuit approach.¹⁰⁹ Under the Ninth and Eleventh Circuits, facts showing a motive and opportunity to defraud might provide evidence to support a finding of the required scierter, but a mere showing of motive and opportunity is insufficient to plead scierter, both under the Ninth Circuit’s “deliberate recklessness” and the Eleventh Circuit’s “severe recklessness” standards.¹¹⁰

¹⁰⁶ *Bryant*, 187 F.3d at 1286; see *In re Silicon Graphics*, 183 F.3d at 977-78 (this approach is the best conclusion considering Congress’ intent to adopt a more stringent pleading standard than that which existed, even in the Second Circuit, prior to the PSLRA’s passage).

¹⁰⁷ *Bryant*, 187 F.3d at 1286 (Eleventh Circuit).

¹⁰⁸ 183 F.3d at 970.

¹⁰⁹ *Id.* at 978 (citing *Gulf Oil Corp. v. Copp Paving Co.*, 419 U.S. 186, 200 (1974) (“holding that where the conference committee has expressly declined to adopt proposed statutory language, its action strongly militates against a judgment that Congress intended [the] result that it expressly declined to enact”) (internal quotations omitted)).

¹¹⁰ *Id.* at 974, 977 (deliberate recklessness); *Bryant*, 198 F.3d at 1286-87 (severe recklessness). Other authors have declared that the Ninth Circuit was unwilling to consider evidence of motive and opportunity to create an inference of “deliberate recklessness,” *e.g.*, Simmons, *supra* Note 19, at 668-69 (the majority of circuits took a middle of the road approach which allows motive and opportunity to

B. The First, Fourth, Fifth, Sixth, Eighth, and Tenth Circuits' Interpretation

1. Substantive Standard of Scierter Remains "Recklessness"

Except for the District of Columbia Circuit, the remaining circuits have concluded that the PSLRA did not alter the substantive standard of scierter.¹¹¹ This majority found that the standard of recklessness required by the pre-PSLRA standards remained sufficient after the enactment of the PSLRA.¹¹² Therefore, like the Second and Third Circuits, the First,¹¹³ Fourth,¹¹⁴ Fifth,¹¹⁵ Sixth,¹¹⁶ Eighth,¹¹⁷ and

provide some evidence of scierter, but the Ninth Circuit is in contrast to that), although this is inaccurate. The Ninth Circuit explicitly noted that "[t]he plain text of the PSLRA leaves it open for us to consider circumstantial evidence of recklessness and motive and opportunity as evidence of deliberate recklessness." *In re Silicon Graphics*, 183 F.3d at 977.

¹¹¹ See *Florida State Board of Administration v. Green Tree Financial Corporation*, 270 F.3d 645, 653-54 n.7 (8th Cir. 2001) (noting that there is "substantial agreement among the Circuits that have considered the question that 15 U.S.C. § 78u-4(b)(2) was not intended to alter the substantive standard for scierter") (citing *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 409 (5th Cir. 2001); *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1258-60 (10th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198-201 (1st Cir. 1999); *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283-844 (11th Cir. 1999); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548-49 (6th Cir. 1999); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999); *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529 537-38 (2d Cir. 1999)).

¹¹² *Greebel*, 194 F.3d at 200 (First Circuit); *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000); *In re Advanta*, 180 F.3d at 534 (Third Circuit); *Ottman*, 353 F.3d at 343, n.3 (Fourth Circuit); *Nathenson*, 267 F.3d at 408-09 (Fifth Circuit); *In re Comshare*, 183 F.3d at 548-49 (Sixth Circuit); *In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 550 (8th Cir. 2004); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003); see also *Bryant*, 187 F.3d at 1283-84 (Eleventh Circuit) (holding that the substantive standard is "recklessness," but applying a "severe recklessness" standard in its analysis).

¹¹³ See *Greebel*, 194 F.3d at 195-96.

¹¹⁴ See *Ottman*, 353 F.3d at 345.

¹¹⁵ See *Nathensen*, 267 F.3d at 411-12.

Tenth¹¹⁸ Circuits allow a showing of recklessness to suffice for scienter.

2. “Motive and Opportunity” Alone *Sometimes* Suffices to Establish a Strong Inference of Scienter under the PSLRA

These circuits, like the Seventh Circuit, hesitated in joining the extremes presented by the other circuits on the issue of “motive and opportunity” pleading, and instead, opted for the “middle of the road,” flexible standard.¹¹⁹ This “middle of the road” approach allows for case-specific analyses for scienter pleadings.¹²⁰ Instead of holding that the Second Circuit’s motive and opportunity test absolutely survived or ceased after the PSLRA’s passage, these “middle of the road-ers” held that while facts showing motive and opportunity to defraud may adequately allege scienter, whether those facts create a strong inference of scienter should be determined on a case-by-case basis determined by the facts alleged in the complaint.¹²¹ Under certain circumstances, facts providing evidence of a motive and opportunity to

¹¹⁶ See *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-52 (6th Cir. 2001) (en banc).

¹¹⁷ See *Florida State Board of Administration v. Green Tree Financial Corporation*, 270 F.3d 645, 659-60 (8th Cir. 2001).

¹¹⁸ See *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1258 (10th Cir. 2001).

¹¹⁹ See generally *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999); *Ottman*, 353 F.3d at 345 (Fourth Circuit); *Nathensen*, 267 F.3d at 411-12 (Fifth Circuit); *Helwig*, 251 F.3d at 550-52 (Sixth Circuit); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601-02 (7th Cir. 2006); *Green Tree*, 270 F.3d at 659-60 (Eighth Circuit); *Fleming Cos.*, 264 F.3d at 1261-63 (Tenth Circuit).

¹²⁰ See generally *Greebel*, 194 F.3d at 195-96 (First Circuit); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Nathensen*, 267 F.3d at 411-12 (Fifth Circuit); *Helwig*, 251 F.3d at 550-52 (Sixth Circuit); *Makor*, 437 F.3d at 601-02 (Seventh Circuit); *Green Tree*, 270 F.3d at 659-60 (Eighth Circuit); *Fleming Cos.*, 264 F.3d at 1261-63 (Tenth Circuit).

¹²¹ See *Greebel*, 194 F.3d at 197 (First Circuit); *Ottman*, 353 F.3d at 348 (Fourth Circuit); *Nathensen*, 267 F.3d at 411-12 (Fifth Circuit); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999); *Makor*, 437 F.3d at 601-02 (Seventh Circuit); *Green Tree*, 270 F.3d at 659-60 (Eighth Circuit); *Fleming Cos.*, 264 F.3d at 1261-63 (Tenth Circuit).

defraud could rise to the level sufficient to constitute a strong inference of scienter, although merely pleading that motive and opportunity exist fails to establish a strong inference of scienter.¹²² In these decisions, the First, Fourth, Fifth, Sixth, Eighth, and Tenth Circuits rejected the contention that facts showing motive and opportunity can never be enough to create a “strong inference” of scienter, but also did not adopt the position that facts showing motive and opportunity are always sufficient.¹²³ Instead of forming a steadfast rule as to the motive and opportunity test, these courts weigh the facts indicative of motive and opportunity based on the circumstances of the case.¹²⁴

IV. *MAKOR* DECISION’S EFFECT ON THE CURRENT STATE OF THE LAW: NEW STANDARD AT THE TRIAL LEVEL, BUT STAGNANCY AT THE APPELLATE LEVEL

At the national appellate level, the Seventh Circuit did not present any new substantive standard of scienter or any new formulaic approach to the “strong inference” requirement that might gain the issues additional attention. In *Makor*, the Seventh Circuit jumped on the “middle of the road” bandwagon with the majority of the circuits courts of appeals, finding that the substantive standard of scienter did not change after the PSLRA’s enactment.¹²⁵ The Seventh Circuit also

¹²² *Greebel*, 194 F.3d at 197 (First Circuit); *In re Comshare*, 183 F.3d at 551 (Sixth Circuit); *accord Bryant*, 187 F.3d at 1282-83 (Eleventh Circuit) (although holding that motive and opportunity without facts showing severe recklessness is never sufficient to plead scienter).

¹²³ See *Greebel*, 194 F.3d at 197 (First Circuit); *Ottman*, 353 F.3d at 348 (Fourth Circuit); *Nathensen*, 267 F.3d at 411-12 (Fifth Circuit); *In re Comshare*, 183 F.3d at 551 (Sixth Circuit); *Makor*, 437 F.3d at 601-02 (Seventh Circuit); *Green Tree*, 270 F.3d at 659-60 (Eighth Circuit); *Fleming Cos*, 264 F.3d at 1261-63 (Tenth Circuit).

¹²⁴ See, e.g., *Ottman*, 353 F.3d at 345-46.

¹²⁵ See *Makor*, 437 F.3d at 601-02; see also *Greebel*, 194 F.3d at 200 (First Circuit); *Novak*, 216 F.3d at 308-09 (Second Circuit); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999); *Ottman*, 353 F.3d at 343 n.3 (Fourth Circuit); *Nathenson*, 267 F.3d at 408-09 (Fifth Circuit); *In re Comshare*, 183 F.3d at 548-49 (Sixth Circuit); *In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 550 (8th Cir.

joined the majority in that it more or less admitted that it did not know if or when “motive and opportunity” would be sufficient to plead scienter under the PSLRA.¹²⁶ This admission by seven of the circuit courts of appeals ought to be enough for the Supreme Court to take the initiative and clarify the issue, or alternatively, for Congress to revisit the PSLRA and clarify the scienter requirements. Except for the District of Columbia Circuit, all circuit courts of appeals have now addressed the two issues presented in *Makor*: (1) whether the PSLRA changed the substantive standard of scienter; and (2) whether facts showing a motive and opportunity to defraud can sufficiently allege a strong inference of scienter. These issues could hardly get any riper for certiorari than they are right now.

The *Makor* decision had a far bigger impact within the Seventh Circuit’s district courts. Significantly, the Seventh Circuit Court of Appeals contradicted its district courts’ prior decisions on the issue of pleading scienter by alleging a motive and opportunity to defraud.¹²⁷

2004); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003); *see also Bryant*, 187 F.3d at 1283-84 (Eleventh Circuit) (holding that the substantive standard is “recklessness,” but applying a “severe recklessness” standard in its analysis).

¹²⁶ *See Makor*, 437 F.3d at 600-02; *Greebel*, 194 F.3d at 195-97 (First Circuit); *Ottman*, 353 F.3d at 348 (Fourth Circuit); *Nathenson*, 267 F.3d at 411-12 (Fifth Circuit); *Helwig*, 251 F.3d at 550-52 (Sixth Circuit); *Green Tree*, 270 F.3d at 659-60 (Eighth Circuit); *Fleming Cos.*, 264 F.3d at 1261-63 (Tenth Circuit).

¹²⁷ *E.g.*, *Selbst v. McDonald’s Corp.*, No. 04 C 2422, 04 C 3635, 04 C 3661, 2005 WL 2319936, at *22 (N.D. Ill. Sept. 21, 2005); *Ray v. Citigroup Global Markets, Inc.*, No. 03 C 3157, 2003 WL 22757761, at *4 (N.D. Ill. Nov. 20, 2003); *In re Sears, Roebuck and Co. Sec. Litig.*, No. 02 C 7527, 291 F. Supp. 2d 722, 726 (N.D. Ill. Oct. 24, 2003); *Schaps v. McCoy*, No. 00 C 5180, 2002 WL 126523, at *3 (N.D. Ill. Jan. 31, 2002); *In re Sys. Software Assocs.*, No. 97 C 177, 2000 WL 283099, at *13 (N.D. Ill. March 8, 2000); *Zoghlin v. Renaissance Worldwide, Inc.*, No. 99 C 1965, 1999 WL 1004624, at *5 n.3 (N.D. Ill. Nov. 4, 1999) (noting that Northern District of Illinois Courts have adopted the Second Circuit’s pre-PSLRA standard allowing motive and opportunity pleadings to be sufficient); *Rhem v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1251-53 (N.D. Ill. 1997); *but see In re Shopko Sec. Litig.*, No. 01-C-1034, 2002 WL 32003318, at *6 n.2 (E.D. Wisc. Nov. 5, 2002) (acknowledging but not deciding that the middle of the road approach allows a case-by-case analysis); *Great Neck Capital Appreciation Inv. P’ship v. Pricewaterhousecoopers, L.P.*, 137 F. Supp. 2d 1114, 1120 (E.D. Wisc. 2001)

Whereas most of the district courts within the Seventh Circuit had followed the Second Circuit's standard that pleadings of motive and opportunity sufficiently alleged a strong inference of scienter,¹²⁸ the Seventh Circuit in *Makor* adopted the approach less popular amongst its district courts: the "middle of the road" approach.¹²⁹ In doing so, the *Makor* court made no reference to its district courts' contrary decisions. Thus, within district courts of the Seventh Circuit, the law regarding pleading scienter has substantially changed by the Seventh Circuit's rejection of the Second Circuit's standard that adequate allegations of motive and opportunity create a strong inference of scienter. In this respect, *Makor* rewrote the pleading requirements of scienter for securities fraud actions brought in district courts within the Seventh Circuit Court of Appeals' jurisdiction.

V. DID THE SEVENTH CIRCUIT MAKE THE RIGHT DECISION IN *MAKOR*?

In a word, yes. The two important decisions made by the *Makor* court were that: (1) "recklessness" remained a sufficient the substantive standard of scienter after the enactment of the PSLRA; and (2) that pleadings showing a motive and opportunity to defraud may state a claim under § 10(b) and Rule 10b-5, but it may not always do so.¹³⁰

(following the Sixth Circuit's "middle of the road" approach, allowing pleadings of motive and opportunity to suffice in some cases, but not all); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 815, 823 (N.D. Ill. 2000) (*Chu I*) (same); *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 827, 841 (N.D. Ill. 2000) (*Chu II*) (same); *Danis v. USN Commc'ns, Inc.*, 73 F. Supp. 2d 923, 937-38 (N.D. Ill. 1999) (same).

¹²⁸ See, e.g., *Selbst*, No. 04 C 2422, 04 C 3635, 04 C 3661, 2005 WL 2319936 at *22; *Ray*, No. 03 C 3157, 2003 WL 22757761 at *4; *In re Sears, Roebuck and Co.*, No. 02 C 7527, 291 F. Supp. 2d at 726; *Schaps*, No. 00 C 5180, 2002 WL 126523 at *3; *In re Sys. Software Assocs.*, No. 97 C 177, 2000 WL 283099 at *13; *Zoghlin*, No. 99 C 1965, 1999 WL 1004624 at *5 n.3; *Rhem*, 954 F. Supp. at 1251-53.

¹²⁹ See *Makor*, 437 F.3d 588; see, e.g., *In re Shopko*, No. 01-C-1034, 2002 WL 32003318 at *6 n.2; *Great Neck Capital Appreciation Inv. P'ship*, 137 F. Supp. 2d at 1120; *Chu I*, 100 F. Supp. 2d at 823; *Chu II*, 100 F. Supp. 2d at 841; *Danis*, 73 F. Supp. 2d at 937-38.

¹³⁰ See generally *Makor*, 437 F.3d 588.

A. *The Substantive Standard of Scierter*

The Seventh Circuit's decision to maintain the same scierter standard is most compatible with the PSLRA's language and legislative history. First, the language of the PSLRA states that the plaintiff is required to allege "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."¹³¹ Congress did not alter the required state of mind. Instead, Congress altered the extent to which the plaintiff must prove the required state of mind to adequately plead a securities fraud claim.¹³² While the Ninth and Eleventh Circuits added stringency to the substantive scierter standard by requiring "deliberate"¹³³ or "severe"¹³⁴ recklessness, this anti-plaintiff exercise of judicial authority has no legitimate basis. Furthermore, the meaning of "state of mind" was undisputed prior to the PSLRA's enactment.¹³⁵ All of the circuits to address the issue, including the Ninth and Eleventh Circuits, had held that a "showing of recklessness was sufficient to allege scierter."¹³⁶ As the Seventh Circuit reasoned, "it seems more likely . . . that Congress did not object to the substance of the state of mind standard found in the law before the passage of the Act."¹³⁷ Just as Congress changed the extent to which scierter must be shown by adding the phrase "strong inference," it could just the same have modified the "required state of mind" had it so intended.¹³⁸ However, Congress did not address the state of mind required, which leaves only

¹³¹ 15 U.S.C. § 78u-4(b)(2).

¹³² *See id.*

¹³³ *See generally* *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (Ninth Circuit).

¹³⁴ *See generally* *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999).

¹³⁵ *See Makor*, 437 F.3d at 600.

¹³⁶ *Id.* (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc) (Ninth Circuit); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir. 1989)).

¹³⁷ *See Makor*, 437 F.3d at 600

¹³⁸ *Id.*

the reasonable interpretation that it had no intention of changing the previously-established standard of scienter.¹³⁹

While the Ninth Circuit claims to adopt the standard of recklessness articulated by the Seventh Circuit in *Sundstrand*, the standard previously noted and widely accepted through the circuits, it alters it by adding “deliberate” to its description of recklessness.¹⁴⁰ The Ninth Circuit tried to explain why it used the term “deliberate,” reasoning that it is suggested by the *Sundstrand* definition of “recklessness” by the terms “known” and “must have been aware.”¹⁴¹ However, this causes the Ninth Circuit’s standard to be redundant because those terms are implicitly a part of the meaning of “recklessness.” Assuming the Ninth Circuit would not design redundant standards of law, the only other interpretation is that the Ninth Circuit created a higher level of recklessness than the *Sundstrand* definition. Similarly, the words “deliberate” and “conscious” do not appear in the *Sundstrand* definition of reckless.¹⁴² The only descriptive terms provided by the *Sundstrand* definition that suggest what type of conduct is required to plead scienter are “highly unreasonable,” “not merely simple, or even inexcusable negligence,” and “extreme departure from the standards of ordinary care.”¹⁴³ The Ninth Circuit’s dependence on the terms “known” and “must have been aware” describe the latter part of the recklessness definition, which describes “the danger of misleading buyers or sellers.”¹⁴⁴

¹³⁹ *Id.*

¹⁴⁰ See *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (Ninth Circuit); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir.).

¹⁴¹ See *In re Silicon Graphics*, 183 F.3d at 976. *Sundstrand* states that:
[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 buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Sundstrand, 553 F.2d at 1045.

¹⁴² See *In re Silicon Graphics*, 183 F.3d at 976.

¹⁴³ See *Sundstrand*, 553 F.2d at 1045; *In re Silicon Graphics*, 183 F.3d at 976.

¹⁴⁴ See *Sundstrand*, 553 F.2d at 1044-45.

Accordingly, the defendant need not “know” or have “been aware” that his conduct was reckless: he must only have “known” or “been aware” that their reckless conduct could have misled buyers or sellers.¹⁴⁵ Thus, the Ninth Circuit’s heightening of the type of recklessness required to adequate plead scienter is misguided.

Although the Eleventh Circuit also claims to have adopted the *Sundstrand* definition of recklessness and to have joined the majority of the circuits holding that the substantive standard of scienter did not change with the enactment of the PSLRA,¹⁴⁶ it consistently reiterated that the standard for scienter in the Eleventh Circuit is “severe recklessness.”¹⁴⁷ Just as the Ninth Circuit has done, the Eleventh Circuit has changed the scienter requirement by adding this verbiage. The only difference is that the Eleventh Circuit tried to slip it under the rug by claiming “basic agreement” with the majority of circuits instead of acknowledging its use of a more stringent standard.¹⁴⁸

The legislative history also fails to suggest any Congressional intent to change the substantive standard for scienter. Significantly, neither the Ninth nor the Eleventh Circuit decisions analyzed the legislative history of the PSRLA in reaching their decisions to heighten the substantive standard of scienter.¹⁴⁹ In fact, the meaning of recklessness was hotly debated in the House of Representatives.¹⁵⁰ The definition finalized and passed by the House mirrored that of the *Sundstrand* definition.¹⁵¹ Although this definition was not explicitly

¹⁴⁵ *See id.*

¹⁴⁶ *See Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999).

¹⁴⁷ *See Bryant*, 187 F.3d at 1283-1287 (citing *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989) (consistently reiterating that the standard is “severe recklessness”)).

¹⁴⁸ *Cf. Bryant*, 187 F.3d at 1284 (agreeing with the Sixth Circuit’s decision of *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999), but applying a “severe recklessness” standard).

¹⁴⁹ *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 976-77 (Ninth Circuit); *Bryant*, 187 F.3d at 1283-84.

¹⁵⁰ *See H.R. REP. No. 104-369*, at 41 (Conf. Rep.); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531 n.6 (3d Cir. 1999).

¹⁵¹ *See 141 Cong. Rec. H2863-64* (daily ed. Mar. 8, 1995). This bill, known as House Bill 1058 defined recklessness as “highly unreasonable conduct that (A) involves not merely simple or even gross negligence, but an extreme departure from

incorporated into the final PSLRA, the circuit courts agree that this was the definitive scienter standard pre-PSLRA.¹⁵² The Joint Conference Committee explicitly said that “[it] does not adopt a new and untested pleading standard that would generate additional litigation.”¹⁵³ It is safe to assume that Congress was well-aware of the “contemporary legal context” surrounding the holdings by every circuit that recklessness was sufficient to allege scienter.¹⁵⁴ Accordingly, by not disturbing this well-settled legal principle of “recklessness” as defined in *Sundstrand*, courts should presume that Congress intended to codify that legal principle when it enacted the PSLRA.¹⁵⁵ Because Congress used the exact language, “required state of mind” from the pre-PSLRA law, it brought with it its well-settled legal meaning of recklessness as sufficient for scienter.¹⁵⁶

B. “Strong Inference” of Scienter

the standards of care, and (B) presents a danger of misleading buyers or sellers that was either known to the defendant or so obvious that the defendant must have been consciously aware of it.” *See also In re Advanta*, 180 F.3d at 531 n.6.

¹⁵² *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 600 (7th Cir. 2006) (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc)); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); *Van Dyke v. Coburn Enter., Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *McDonald*, 863 F.2d at 814-15 (Eleventh Circuit); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978) (assuming without deciding that recklessness was sufficient); *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 44-47 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 10454 (7th Cir.).

¹⁵³ S. Rep. No. 104-98, at 15; *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531-32 (3d Cir. 1999).

¹⁵⁴ *See Cottage Savings Ass’n v. Comm’r*, 499 U.S. 554, 561-62 (1991); *see also* cases cited *supra* note 152 (listing pre-PSLRA cases holding that recklessness was sufficient to allege scienter).

¹⁵⁵ *See Cottage Savings Ass’n*, 499 U.S. at 561-62 (when Congress enacts legislation directly on-point with well-settled case law, it should use exact language from the case law only where it intends to codify it).

¹⁵⁶ *E.g., id.*

Next, the Seventh Circuit's decision to adopt the "middle of the road" approach towards the motive and opportunity test also seems to be the most practical approach. Because the legislative history seems contradictory and ambiguous, the best route to take is an "I know it when I see it" approach to scienter. Although this allows for a drift in the jurisprudence of the various circuits, this flexibility is appropriate in the securities context. Rather than holding that pleading facts to support motive and opportunity to defraud is rigidly sufficient or insufficient, the Seventh Circuit's holding allows for a holistic approach.¹⁵⁷ This approach allows the court to determine whether the requisite strong inference of scienter has been demonstrated based on the totality of the circumstances.¹⁵⁸ Congress was very aware of the confusion that arose within its two chambers during the legislative processes of the PSLRA: the Senate's version of the PSLRA explicitly codified the Second Circuit's motive and opportunity test, but the Joint Conference Committee expressly denied codifying the motive and opportunity test.¹⁵⁹ Congress clearly knew that the inclusion of the motive and opportunity test in the PSLRA was debated, and yet, Congress opted not to choose a side. Instead, Congress used ambiguous language eluding to both the codification, and at the same time, the rejection, of the Second Circuit's motive and opportunity test.¹⁶⁰ Because Congress neither accepted nor rejected the Second

¹⁵⁷ See Here at Last, *supra* note 39.

¹⁵⁸ Cf. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601 (7th Cir. 2006); *accord* *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 409-11 (5th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir. 2001) (en banc); *Florida State Board of Administration v. Green Tree Financial Corporation*, 270 F.3d 645, 659 (8th Cir. 2001); *Philadelphia v. Fleming Cos., Inc.*, 264 F.3d 1245, 1261-63 (10th Cir. 2001).

¹⁵⁹ *Compare* 141 Cong. Rec. S9150-01, at S9170 (daily ed. June 27, 1995) (Senate's version codifies Second Circuit's pre-PSLRA approach); *with* 141 Cong. Rec. H13691-08, at H13702 (daily ed. Nov. 28, 1995) (Joint Committee does not intend to codify the Second Circuit's pre-PSLRA case law, which includes the motive and opportunity test).

¹⁶⁰ See S. Rep. No. 104-98, at 15 (1995) (Congress notes that although it does not intend to codify the Second Circuit's pre-PSLRA standard, courts might find this body of law instructive).

Circuit's motive and opportunity test in the PSLRA,¹⁶¹ it seems reasonable for the courts to adopt the same perspective. In other words, the most logical approach is to determine, based on the facts of the case before the court, whether the plaintiff has established a strong inference of scienter.

CONCLUSION

While the Seventh Circuit provided no new substance to the nationwide confusion regarding the substantive standard of scienter or the motive and opportunity test to establish a strong inference of scienter, it might at least refocus attention on the pleading requirements' inconsistencies. In sum, the Seventh Circuit's method keeps the pre-PSLRA substantive standard of scienter of recklessness and allows pleadings of a motive and opportunity to defraud to suffice in some cases, but not others. This approach presents the most practical approach and ought to be adopted. Now that all circuits except for the District of Columbia have decided the issues, it is time for the Supreme Court or Congress to address the incongruence and clarify the issues: in essence, to reveal the proper science of scienter.

Amongst all the confusion, "all that can be said with confidence on the issue[s] is that Congress agreed on the need to curb abuses."¹⁶² Simply put, this is not good enough. *Makor* could be the prime case to receive certiorari and curb the inconsistencies caused by Congress' lack of clarity, or alternatively, to initiate Congressional action to unify the circuit court's pleading requirements for securities fraud actions nationwide.

¹⁶¹ See H.R. REP. No. 104-369, at 41 (1995) (Conf. Rep).

¹⁶² *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 192 (1st Cir. 1999).