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# DANGEROUS LIAISONS: COLLECTIVE SCIENTER IN SEC ENFORCEMENT ACTIONS

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## INTRODUCTION

Scienter is an essential element of a securities-fraud action brought by the Securities and Exchange Commission ("SEC") or private plaintiffs.[1] Scienter generally refers to intent or knowledge of wrongdoing.[2] Establishing scienter in a case against an individual is accomplished by pleading and proving the requisite mental state of the individual at the time he or she committed the wrongful act, usually a material misstatement or omission. Establishing scienter for a corporation, however, is more complex. A corporation is a legal artifice that does not think and cannot act on its own, although it has a

1. *See, e.g.*, Securities Exchange Act of 1934 §10(b) ("Exchange Act"), 15 U.S.C. §78j(b) (2008); Rule 10b-5 under the Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008); Securities Act of 1933 §17(a) ("Securities Act"), 15 U.S.C. § 77q(a) (2008). 15 U.S.C. §77q(a) (prohibiting fraudulent conduct in the offer or sale of securities) and 15 U.S.C. §78j(b) and 17 C.F.R. §240.10b-5 thereunder (prohibiting fraudulent conduct in connection with the purchase or sale of securities) all essentially prohibit the same type of fraudulent sales practices. *See* United States v. Naftalin, 441 U.S. 768, 773 & n.4 (1979). The SEC must prove that a defendant acted with scienter in order to establish a violation of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Aaron v. SEC, 446 U.S. 680, 695 (1980). Proof that a defendant acted recklessly is sufficient to establish scienter. Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990).

2. Black's Law Dictionary defines scienter as "[a] degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, esp. as a ground for civil damages or criminal punishment." BLACK'S LAW DICTIONARY 1463 (9th ed. 2009).

legal status distinct from that of its shareholders and agents.[3] A corporation acts solely through its agents.[4] As a result, doctrines such as respondeat superior have evolved to impute the knowledge of an agent-wrongdoer to the corporation in order to hold a corporation liable for securities fraud.[5]

Courts agree that a corporate defendant acted with scienter if the authorized corporate agent making a false statement acted with scienter.[6] The more difficult question is whether a corporation can be held liable for securities fraud when the person responsible for the misstatement was not aware of the truth but some *other* corporate employee was aware, or when no single corporate employee knew the truth but the collective knowledge of several employees would have exposed the truth. For example, if a corporate officer makes a statement and only an entry-level employee knows the statement is false, has the corporation acted with fraudulent intent? Furthermore, if a corporate officer makes a statement and no individual knows the statement is false, but by piecing together the collective knowledge of employees it becomes apparent that the statement is false, has the corporation acted with fraudulent intent?

In recent years, some private plaintiffs have resorted to a theory known as "collective scienter" to attach corporate liability on the basis of the collective knowledge of the corporation's employees, regardless of whether those employees had any role in making the alleged false statements. While most courts have rejected the collective scienter theory, a handful of courts have permitted some derivation of collective scienter.

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3. Black's Law Dictionary defines a corporation as "[a]n entity . . . having authority under law to act as a single person distinct from the shareholders . . . ; a group or succession of persons established . . . [as a] legal personality distinct from the natural persons who make it up," and "exist[ing] indefinitely apart from them." BLACK'S LAW DICTIONARY 391 (9th ed. 2009).

4. *See* RESTATEMENT (SECOND) OF AGENCY § 219(1) (1958).

5. *See* William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647, 654 (1994) [hereinafter Laufer, *Corporate Bodies*] (observing the prominence of respondeat superior as a theory for corporate liability); Williams J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 13 (1983).

6. *See, e.g.*, Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366 (5th Cir. 2004) (explaining that corporate scienter is established by looking "to the state of mind of the individual corporate official or officials who make or issue the statement").

All of the judicial decisions in the area of collective scienter involve private securities litigation. Because it is extremely rare for a corporation to litigate with the SEC, the question of whether the SEC can and should utilize the theory of collective scienter in its enforcement actions against public companies remains unanswered.[7] Although the SEC has never explicitly asserted a collective scienter theory, some commentators have opined that the theory may have been contemplated, if not utilized, by the agency in one SEC enforcement action.[8]

This Article initially describes the development of the concept of corporate liability from the theory of respondeat superior to collective scienter, and explains the various views espoused by courts. The Article then examines SEC enforcement actions that implicitly may have used collective scienter in reaching a settlement with a company. Finally, the Article highlights some legal and policy considerations associated with utilizing the concept of collective scienter in SEC enforcement actions. As discussed below, the SEC should avoid resorting to collective scienter in its enforcement actions because collective scienter would impose a negligence standard in conflict with other laws, chill corporations from voluntarily disclosing information, create inefficient deterrence and misplaced incentives, and would not provide sufficient notice and predictability to corporations regarding charges or penalties.[9]

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7. Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 394 (2008) [hereinafter Atkins, *Evaluating the Mission*] ("In practice . . . public companies seldom choose to litigate with the SEC . . .").

8. *See, e.g.*, Brian A. Ochs, *Has the Securities and Exchange Commission Expanded Corporate Liability?*, 38 SEC. REG. & L. REP. 1549 (Sept. 18, 2006). In researching this Article, the Author reviewed every public settled action between the SEC and a corporation from 2000 to the present and selected enforcement actions before that time frame. None of the information contained in this Article is based on any non-public information or sources. Moreover, the Author takes no position on the merits of any of the SEC enforcement actions mentioned in this Article.

9. A complete analysis of the benefits and costs of collective scienter should be undertaken before the SEC utilizes the theory in enforcement actions. This Article only briefly describes some of the problems with collective scienter and does not purport to be a complete analysis.

## I.
## Corporate Liability Based upon Respondeat Superior

Respondeat superior is a strict liability theory based on the common law of agency.[10] An agency relationship exists where a principal exercises control over an agent for the purpose of fulfilling the goals of the principal.[11] While most agency law depends on the agent's actual or apparent authority to act on behalf of the principal, respondeat superior depends specifically on an employment relationship.[12] Respondeat superior holds an employer (the principal) vicariously and strictly liable for the wrongful acts of its employees (the agents) committed within the scope of the employment relationship.[13] In the early twentieth century, the famous jurist and judicial philosopher Learned Hand explained that corporate liability "based upon the element of intent or wrongful purpose. . . is merely an imputation to the corporation of the mental condition of its agents."[14]

There has been no uniform justification for holding corporations vicariously liable for the actions of its employees. Some of the reasons for holding a corporation vicariously liable have been risk allocative, while others have been retributive.[15] Judge Posner has explained that the goal of vicarious liability is to deter risky behavior over which the principal has control.[16] Other commentators have posited that vicarious liability is a "deliberate allocation of risk" to employers, which

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10. Bradley P. Humphreys, *Assessing the Viability and Virtues of Respondeat Superior for Nonfiduciary Responsibility in ERISA Actions*, 75 U. Chi. L. Rev. 1683, 1689 (2008) ("respondeat superior" means "look to the man higher up").

11. 2A C.J.S. *Agency* § 1, at 306 (2003).

12. Restatement (Third) of Agency Introduction at 4 (2006). The "scope of employment" is crucial to the application of respondeat superior. An employee is an agent whose principal controls or has the right to control the manner and means of the agent's performance of work. *Id.* § 7.07 & cmt. f (listing the "factual indicia" as to whether an agent is an employee).

13. Restatement (Second) of Agency § 219(1).

14. United States v. Nearing, 252 F. 223, 231 (S.D.N.Y. 1918).

15. W. Page Keeton, et al., Prosser and Keeton on Torts § 69 (5th ed. 1984).

16. *See* Richard A. Posner, Economic Analysis of Law 188 (7th ed. 2007) ("The employer . . . can induce [employees] to be careful, as by firing or otherwise penalizing them for their carelessness.").

can better absorb and distribute the costs of liability.[17] Perhaps the most well-known justification for holding corporations vicariously liable comes from Dr. Thomas Baty, the acclaimed international law scholar,[18] who famously said in 1916, "In hard fact, the reason for the employers' liability is. . . the damages are taken from a deep pocket."[19]

The most common justification by courts for respondeat superior is rooted in public policy and incentives.[20] Employees are often financially unable to compensate the victims of their wrongdoing.[21] Because the law generally seeks to compensate the wrongfully injured, responsibility is assigned to the employer, which has the ability to control the employee.[22] As a result, the employer has the incentive to exercise the appropriate level of care to prevent wrongdoing.[23]

In the context of securities law, plaintiffs have utilized respondeat superior for decades as a source of liability for a corporation based on the acts of officers and directors.[24] For securities fraud, the existence of a corporation's scienter under respondeat superior is established by looking "to the state of mind of the individual corporate official or officials who make or issue the statement."[25]

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17. *See, e.g.*, KEETON, ET AL., *supra* note 15.

18. Vaughan Lowe, *The Place of Dr. Thomas Baty in the International Law Studies of the 20th Century* (Oxford Legal Studies Research Paper No. 11/2008), *available at* http://ssrn.com/abstract=1104235.

19. Thomas Baty, VICARIOUS LIABILITY 154 (Oxford 1916).

20. *See* Lewis A. Kornhauser, *An Economic Analysis of the Choice between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1363 (1982).

21. *Id.* at 1362.

22. *Id.* at 1362-63.

23. *Id.*

24. *See* Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 758-64 (1992).

25. Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 366 (5th Cir. 2004). Section 10(b) and Rule 10b-5 prohibit any person from engaging in certain forms of fraud, and "person" is a statutorily defined term that includes corporations and other legal entities. *See* Exchange Act § 3(a)(9), 15 U.S.C. §78c(9) (2008). In other words, corporations themselves can violate Section 10(b) directly. *See In re* Centennial Techs. Litig., 52 F. Supp. 2d 178, 185 (D. Mass. 1999) ("[I]f agency principles were not meant to be a viable basis for liability under Section 10(b), the text of Section 10(b) would need to be modified to declare, in effect if not precisely in these words, that it is unlawful for natural persons to engage in the prohibited conduct."); *see also* Sharp v. Coopers & Lybrand, 649 F.2d 175, 182 n.8 (3d

## II.
## Judicial Approaches to Collective Scienter in Private Securities Litigation

Agency principles, such as respondeat superior, do not address all the possible circumstances of wrongdoing. Respondeat superior does not apply to situations where an act and the scienter do not reside in the same employee. In that situation, plaintiffs have resorted to the theory of collective scienter to combine the knowledge of one employee, or several employees, with the misstatement of another employee to find corporate scienter.[26]

Whether collective scienter is an acceptable theory to allege or prove corporate scienter under the federal securities laws remains uncertain. The majority of the courts to rule on the theory of collective scienter have squarely rejected it in favor of the traditional approach to scienter, which generally requires the speaker to possess knowledge of falsity. A few courts, however, have accepted collective scienter either in an expansive form called the "strong" or "pure" version or in a form known as the "weak" or "hybrid" version.

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Cir. 1981) (explaining that corporate liability is primary, not secondary, when senior officers are involved in the securities fraud). A corporation also may be held liable pursuant to the "controlling person" provisions of Section 15 of the Securities Act, Securities Act §15, 15 U.S.C. § 77o (2008), and Section 20 of the Exchange Act, 15 U.S.C. § 78t(a).

26. Courts have rejected a similar theory called "group pleading" to allege liability against individual defendants, whereby plaintiffs could presume "that statements in prospectuses, registration statements, annual reports, press releases, or other group-published information, are the collective work of those individuals with direct involvement in the everyday business of the company." Southland Sec. Corp. v. INSpire Ins. Solutions Inc., 365 F.3d 353, 363-64 (5th Cir. 2004) (internal quotation marks omitted). The Fifth Circuit in *Southland* held that the "group pleading doctrine conflicts with the scienter requirement of the [Private Securities Litigation Reform Act]" because "the PSLRA requires . . . plaintiffs to distinguish among those they sue and enlighten each defendant as to his or her particular part in the alleged fraud." *Id.* at 365 (internal quotation marks omitted). The Eleventh Circuit, for example, reached a similar holding in *Phillips v. Scientific-Atlanta, Inc.*, when it stated, in dictum, that "the most plausible reading [of the PSLRA] in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating each defendant's state of mind regarding his or her alleged violations." 374 F.3d 1015, 1018 (11th Cir. 2004) (footnote omitted).

### A. *The Traditional Approach to Scienter: Speaker Must Possess Knowledge of Falsity*

Seven circuits have rejected collective scienter in favor of the traditional approach to corporate scienter that requires proof that the person responsible for the misstatement had scienter.[27] Of these seven circuits, five have rejected collective scienter specifically in the context of federal securities litigation while the other two have rejected the theory in analogous contexts.[28] The Ninth Circuit's decision in *In re Apple Computer,*

27. Garfield v. NDC Health Corp., 466 F.3d 1255, 1263-67 (11th Cir. 2006) (holding that scienter was not pleaded where complaint did not allege specifically that officers who signed certifications to financial statements required by Sarbanes-Oxley were presented with reasons to doubt the financial statements, even though a "management level employee" allegedly notified outside auditors of revenue recognition problems); *see* Ezra Charitable Trust v. Tyco Int'l Ltd., 466 F.3d 1, 5-11 (1st Cir. 2006) (explaining the need to examine knowledge of corporate managers who make statements to determine whether corporation had scienter); *In re* Tyson Foods, Inc. Sec. Litig., 155 F. App'x 53, 57 (3d Cir. 2005) ("Having concluded that there is no primary liability on the part of any of the individual officers, the District Court properly held that Tyson Foods could not itself be primarily liable under the facts of this case."); *In re* Apple Computers, Inc., 127 F. App'x 296, 303 (9th Cir. 2005) (explaining that the Ninth Circuit in *Nordstrom* "squarely rejected the concept of 'collective scienter' "); Nolte v. Capital One Fin. Corp., 390 F.3d 311, 313-16 (4th Cir. 2004) (holding that plaintiffs did not sufficiently plead scienter by alleging widespread knowledge within the corporation of problems without also alleging that problems were known to managers that made public statements); *Southland*, 365 F.3d at 366-67 (rejecting collective scienter and holding that it is "appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement"); Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435-36 (9th Cir. 1995) (rejecting collective scienter and stating "corporate scienter relies heavily on the awareness of the directors and officers"); *see also* Woodmont, Inc. v. Daniels, 274 F.2d 132, 137 (10th Cir. 1959) (rejecting collective scienter for the tort of deceit, a precursor to securities fraud); Saba v. Compagnie Nationale Air France, 78 F.3d 664, 670 n.6 (D.C. Cir. 1996) (explaining in lawsuit for willful damage to air cargo that "the proscribed intent (willfulness) depend[s] on the wrongful intent of the specific employees").

28. The Tenth Circuit rejected collective scienter in the context of the tort of deceit, *Woodmont*, 274 F.2d at 136-37, which is considered the precursor to the modern securities-fraud claim. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("[P]rivate securities-fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions."). The D.C. Circuit rejected the concept of collective scienter in the context of a claim for *willful* damage to air cargo. *See Saba*, 78 F.3d at 671 n.6. The principles in those cases should apply in the context of a securities fraud claim.

*Inc.*, best exemplifies the holdings of the five circuits that have rejected collective scienter in private securities litigation.[29] In that case, the plaintiffs alleged that Apple had scienter because CEO Steve Jobs made favorable statements about one of Apple's products, while at the same time, others in the company knew of the problems with the design, marketing, and manufacturing of that product.[30] Rejecting the plaintiffs' attempt to match the scienter of some employees with the statement of the CEO, the Ninth Circuit wrote: "A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement."[31] In other words, the culpability of the corporation is dependent on the culpability of some individual employee or agent.[32]

The Fifth Circuit in *Southerland Securities Corp. v. INSpire Insurance Solutions Inc.* relied on *In re Apple Computer, Inc.* to hold that a "defendant corporation is deemed to have the requisite scienter for fraud *only* if the individual corporate officer making the statement has the requisite level of scienter."[33] The Fifth Circuit found that agency law constrained it from imputing knowledge from one agent to another, and explained that its approach:

> is consistent with the general common law rule that where, as in fraud, an essentially subjective state of mind is an element of a cause of action also involving some sort of conduct, such as a misrepresentation, the required state of mind must actually exist in the individual making (or being a cause of the making of) the misrepresentation, and may not simply be im-

29. *In re* Apple Computer, Inc., 127 F. App'x 296 (9th Cir. 2005).

30. *Id.* at 302-03.

31. *Id.* at 303 ("We have squarely rejected the concept of 'collective scienter' in attributing scienter to an officer and, through him, to the corporation."); *see also Nordstrom*, 54 F.3d at 1435-36 ("[T]here is no case law supporting an independent 'collective scienter' theory"; holding there was "no way that [the insurer] could show that the corporation, but not any individual defendants, had the requisite intent to defraud").

32. An exploration of what it means for an entity to be culpable in a moral or philosophical sense is beyond the scope of this brief Article.

33. Southland Sec. Corp., 365 F.3d at 366 (emphasis added) (quoting *In re* Apple Computer Sec. Litig., 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002)).

puted to that individual on general principles of agency.[34]

Combined with recent authority from the Supreme Court construing the pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"),[35] the traditional approach to corporate scienter has resulted in district courts dismissing a greater number of private class action lawsuits. Courts applying the traditional approach have required that plaintiffs allege that a specific speaker had scienter before allowing a securities fraud lawsuit to proceed against the corporate defendant.[36]

### B. *The Strong Version of Collective Scienter Theory: Collective Knowledge of Employees May Be Aggregated*

The strong (pure) version of collective scienter stands in stark contrast to the traditional approach to corporate scienter. The strong version posits that corporate scienter is a distinct state of mind that is entirely separate from that of the corporation's individual officers, directors, and employees. Corporate knowledge is an undifferentiated aggregation of its employees' knowledge. Under the strong version of collective scienter, plaintiffs may allege scienter on the part of a corporate defendant without pleading scienter as to any particular employee.

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34. *Id.* (citing RESTATEMENT (SECOND) OF AGENCY § 175 cmt. b; § 268 cmt. d).

35. Section 21D(b)(2) of the PSLRA, which governs scienter pleading in securities fraud lawsuits, establishes a stringent rule for inference involving scienter and requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2) (2008). In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court held that "[t]o qualify as strong . . . 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." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

36. The SEC is not subject to the pleading requirements of the PSLRA. *See* 15 U.S.C. §78u-4(a)(1) ("The provisions of this subsection shall apply in each private action arising under this chapter that is brought as a plaintiff class action pursuant to the Federal Rules of Civil Procedure."). This Article does not explore the efficacy and efficiency of the private securities litigation system.

Although no circuit court yet has approved the strong version of collective scienter to establish liability, three circuits seem to have permitted plaintiffs to use the strong version at the pleading stage to allege scienter.[37] In *City of Monroe Employees Retirement Systems v. Bridgestone Corp.*, the Sixth Circuit became the first circuit court to adopt the strong version of collective scienter as a pleading alternative in a securities fraud case.[38] In that case, the court applied collective scienter to permit a class action lawsuit against a corporation to proceed without alleging scienter of the part of any individual.[39] Plaintiffs alleged that Bridgestone and its subsidiary Firestone had the requisite scienter under Section 10(b) because internal data concerning safety problems contradicted public statements and that the data were known to certain non-speaking employees.[40] In affirming the denial of the motion to dismiss, the court looked to the allegations of collective knowledge involving senior officers and lower level employees to hold that the plaintiffs properly pleaded corporate scienter.[41]

More recently, the Second Circuit in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, Inc.* seemed to endorse the strong version of collective scienter in pleading securities fraud.[42] The plaintiffs in that case alleged that Dynex Capital misrepresented certain aspects of the bonds it sold to investors, although the plaintiffs were unable to identify any

37. Some district courts have suggested that the strong version of collective scienter could be used to prove liability. *See, e.g.*, *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 496-97 (S.D.N.Y. 2005) (acknowledging that "[i]t is a fundamental principle that a corporation can only act through its employees and agents," but holding that "[t]o carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient."); *In re* Motorola Sec. Litig., No. 03 C 287, 2004 WL 2032769 (N.D. Ill. Sept. 9, 2004) (dismissing individual defendants, but holding that plaintiffs adequately alleged Motorola's scienter because there were "numerous circumstances" raising an inference that "Motorola officials" should have been aware that the public statements were incorrect).

38. 387 F.3d 468 (6th Cir. 2004).

39. *Id.* at 504-06.

40. *Id.* at 504-05.

41. *Id.*

42. Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190 (2d Cir. 2008).

specific individual with scienter.[43] Drawing a distinction between "pleading rules and liability rules," the Second Circuit explained that in pleading scienter "it is possible to raise the required inference with regard to a corporate defendant without doing so with regard to a specific individual defendant."[44] The Second Circuit adopted the Seventh Circuit's approach to pleading scienter from the remanded *Tellabs* case:

> [I]t is possible to draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud. 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.[45]

The Second Circuit reiterated the traditional approach that, in order to establish liability (as opposed to merely pleading it), "a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation."[46]

### C. *The Weak Version of Collective Scienter Theory: A Member of Management Must Have Scienter But Need Not Be the Speaker*

The weak (hybrid) version of collective scienter theorizes that a plaintiff properly pleads corporate scienter if the plaintiff alleges that a member of management knew or should have known the statement was false, even if that member of management was not the person who made the alleged mis-

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43. *Id.* at 193.

44. *Id.* at 195.

45. *Id.* at 195-96 (quoting Makor Issues & Rights, Ltd. v. Tellabs, Inc., 513 F.3d 702, 710 (7th Cir. 2008)).

46. *Id.* at 195. This quote arguably suggests that the Second Circuit requires the traditional approach to scienter to *prove* corporate scienter, while permitting the pure version of collective scienter to *allege* corporate scienter. *See also id.* at 196 ("[A]n announcement would have been approved by corporate officials sufficiently knowledgeable . . .").

statement. In other words, provided that a member of management was aware of the falsity, *any* statement made by an agent or employee of the company could be combined with the knowledge of a senior officer to find corporate scienter. The weak version has been endorsed by several district courts[47] and possibly one circuit court in dicta.[48]

While the weak version of collective scienter does not personify the corporate defendant and instead looks to the knowledge of an individual, it has been difficult to discern where the line should be drawn for the officers with knowledge. How senior must the non-speaking corporate officers be to have their knowledge imputed to the corporation? Although the district court in *Marsh & McLennan* recognized the difficulty with determining which officers to include, it did not provide any meaningful guidance to solve the dilemma other than saying "management-level employees" would be included.[49] In *Marsh & McLennan*, a division head and senior vice president were sufficient to extract the necessary scienter for the corporation. By comparison, the district court in *NUI* found that the knowledge of an associate general counsel was sufficient for corpo-

47. *See, e.g.*, *In re* Marsh & McLennan Cos., Sec. Litig., 501 F. Supp. 2d 452, 481 (S.D.N.Y. 2006) (attributing the knowledge of non-speaking head of division and senior vice president to corporate defendant; explaining "corporate scienter may be properly alleged from the corporation's collective knowledge, without evidence of any particular employee's scienter"); *In re* NUI Secs. Litig., 314 F. Supp. 2d 388, 412-13 (D.N.J. 2004) (holding that scienter of corporation was adequately alleged where the associate general counsel was notified of certain bad debt practices; her knowledge was sufficient to put the corporation "on notice," and thus any statements made by others were made with scienter for purposes of the company's liability).

48. The Fourth Circuit, while citing with approval *Southland*, hinted that it might permit collective scienter in some instances. In *Teachers' Retirement System of LA v. Hunter*, the Fourth Circuit stated, in dicta, that to establish securities fraud against a corporation, the plaintiff "must allege facts that support a strong inference of scienter with respect to at least one authorized agent of the corporation, since corporate liability derives from the actions of its agents." 477 F.3d 162, 184 (4th Cir. 2007). The use of the phrase "authorized agent" as opposed to "speaker" arguably seems to suggest that the Fourth Circuit is open to the weak version of collective scienter. It remains unclear how the Fourth Circuit would rule.

49. *In re Marsh & McLennan*, 501 F. Supp. 2d at 481 ("While there is no simple formula for how senior an employee must be in order to serve as a proxy for corporate scienter, courts have readily attributed the scienter of management-level employees to corporate defendants.").

rate scienter.[50] To date, no clear standard has emerged for defining the employees who could be included.[51]

## III.
## Reliance on a Theory of Collective Scienter in SEC Enforcement Actions

The SEC traditionally has pursued fraud actions against corporations only where facts have shown that senior corporate officers or directors committed, orchestrated, or knew of the misconduct.[52] The SEC has not explicitly asserted a theory of collective scienter in a fraud action against an issuer. In fact, neither the term "collective scienter" nor the term "collective knowledge" has ever been used in any SEC complaint or litigation release.[53]

Some commentators have suggested, however, that the SEC may have relied implicitly on the theory of collective scienter in at least one instance.[54] These commentators point to

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50. *In re NUI*, 314 F. Supp. 2d at 412-13.

51. Large corporations might have dozens of senior vice presidents or associate general counsel. As a result, the potential circle of "management-level employees" could be so large that the weak version could resemble the strong version of collective scienter.

52. *See, e.g.*, SEC v. Brightpoint, Inc., Litigation Release No. 18,340, 81 SEC Docket 160 (Sept. 11, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18340.htm.

53. Search conducted on Westlaw and through the SEC public search engine, http://www.sec.gov/divisions/enforce/friactions.shtml.

54. *See, e.g.*, Ochs, *supra* note 8, at 1549. It is difficult to know for certain the reasons behind the allegations in a settled action. Settled complaints and administrative orders reflect the culmination of negotiations between the SEC staff and defense counsel. As a result of negotiations, some facts or allegations may have been omitted from the public document. In addition, settled actions are not challenged in court, so the SEC staff may have limited their claims to the central allegations. Finally, the SEC may have limited its charges due to other reasons. For instance, the SEC may not have charged an individual because that individual provided substantial cooperation in the SEC's investigation. At the time the SEC charged the company, the SEC may not have completed its investigation into the individual's conduct; a charge against an individual may be forthcoming. In some rare instances, the individual wrongdoer may be deceased or beyond the jurisdictional reach of the SEC. *See, e.g.*, SEC v. Pediatrix Medical Group, Inc., Litigation Release No. 20,927, 2009 WL 563801 (Mar. 5, 2009) ("Pediatrix, by the actions of a now-deceased former senior financial officer. . ."), *available at* http://www.sec.gov/litigation/litreleases/2009/lr20927.htm; Complaint, SEC v. Zurich Fin. Serv., Litigation Release No. 20,825, 94 SEC Docket 2772 (Dec. 11, 2008)

the 2006 settled enforcement action against Scientific-Atlanta for aiding and abetting reporting, books and records, and internal control violations by Adelphia Communication.[55] In a civil action for aiding and abetting, the SEC generally must prove that the defendant had scienter in the form of knowledge of the perpetrator's securities law violation and intent to assist the perpetrator of the underlying violation.[56] The SEC's complaint against Scientific-Atlanta did not allege scienter on the part of any individual.[57] Instead, the SEC alleged facts known to "various officers and employees" that "taken together" demonstrated the company's wrongdoing.[58] Although the SEC separately charged two executives of Scientific-Atlanta, those charges were insufficient to support the scienter of the company.[59]

Similarly, in 2007, the SEC brought and settled an action against Cardinal Health without, at that time, charging any individuals. In this case, the SEC charged Cardinal Health with violating Section 17(a) of the Securities Act for materially overstating its operating revenue, earnings, and growth trends in certain earnings releases and filings with the Commission.[60] Although the conduct alleged in the complaint was egregious, the SEC did not charge any individuals at that time, resorting instead to general allegations that Cardinal's "corporate man-

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(charging and obtaining penalty against Zurich, but not charging any foreign individuals), http://www.sec.gov/litigation/complaints/2008/comp20825.pdf.

55. Complaint, SEC v. Scientific-Atlanta, Inc., Litigation Release No. 19,735, 88 SEC Docket 831 (June 22, 2006), http://www.sec.gov/litigation/complaints/2006/comp19735.pdf.

56. Exchange Act §20(e), 15 U.S.C. § 78t (2008).

57. Complaint, Scientific-Atlanta, Inc., Litigation Release No. 19,735, 88 SEC Docket 831.

58. *Id.* ¶¶ 3, 28.

59. *In re* Haislip, Exchange Act Release No. 54,030, Administrative Proceeding File No. 3-12339 (June 22, 2006), http://www.sec.gov/litigation/admin/2006/34-54030.pdf; *In re* Eidson, Exchange Act Release No. 54,031, Administrative Proceeding File No. 3-12340 (June 22, 2006), http://www.sec.gov/litigation/admin/2006/34-54031.pdf.

60. Complaint, SEC v. Cardinal Health, Inc., Litigation Release No. 20,212, 91 SEC Docket 511 (July 26, 2007), http://www.sec.gov/litigation/complaints/2007/comp20212.pdf. The SEC did not specify which subsection of Section 17(a) Cardinal violated, but the complaint uses the term "fraud" throughout it, suggesting Section 17(a)(1).

agement" acted in certain ways or had knowledge.[61] It is unclear from the 2007 allegations whether any one employee of Cardinal Health had the requisite scienter for fraud.[62] Ultimately, however, the SEC did charge individuals for fraud in connection with the same events.[63]

Aside from *Scientific-Atlanta*, there have been no other SEC actions that commentators have opined were rooted in a theory of collective scienter. One of the reasons the SEC has not relied on collective scienter may be the fact that the majority of the circuits have rejected collective scienter in favor of the traditional view of corporate scienter. Some SEC Commissioners have been reluctant to press novel theories of the law in enforcement cases.[64] Another reason may be the Commission's recognition in its "2006 Statement of the Securities and Exchange Commission Concerning Financial Penalties" (hereinafter "2006 Penalty Statement") that penalties against corpo-

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61. *Id.* ¶¶ 2, 11-12, 17, 36, 44, 47, 58, 60.

62. *See, e.g.*, *id.* ¶ 88 ("In connection with the above described fraudulent acts and omissions, Cardinal acted knowingly or recklessly. Further, Cardinal knew, or was reckless in not knowing, that the Company's annual and periodic reports and other public disclosures were materially false and misleading."); *see also id.* ¶ 92 (making a similar allegation for registration statements); *id.* ¶ 34 ("This statement was materially false and misleading because Cardinal was causing billions of dollars of such fluctuations through its movement of non-operating bulk revenue into operating revenue."). The matter resulted in a $35 million penalty against the company. *See* SEC v. Cardinal Health, Inc., Litigation Release No. 20,212, 91 SEC Docket 511 (July 26, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20212.htm.

63. SEC v. Miller, Litigation Release No. 21,058, 2009 WL 1480832 (May 27, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21058.htm.

64. Perhaps the most outspoken opponent of new theories of liability for enforcement actions is former Commissioner Paul S. Atkins. During his tenure on the Commission, Commissioner Atkins warned against expanding liability through the use of novel theories for enforcement cases:

> [D]iscretion in other areas such as formulating a theory of liability can be dangerous. For instance, discretion must not serve as a license to the SEC to test novel theories of liability and "push the envelope" of the law. Can you imagine how the SEC would respond to a company that claims merely to "push the envelope" of the law or accounting principles? If we are to enforce the rule of law, we must follow the rule of law in our approach.

Paul S. Atkins, Comm'r, SEC, Remarks to the 'SEC Speaks in 2008' Program of the Practising Law Institute (Feb. 8, 2008), http://www.sec.gov/news/speech/2008/spch020808psa.htm.

rations can harm shareholders.[65] In the 2006 Penalty Statement, the Commission announced the factors that the SEC would evaluate in assessing a monetary penalty.[66] The nature of those factors indicates that the Commission sought to limit a penalty to the most egregious conduct, which could be inconsistent with an action based on collective scienter. Indeed, one of those factors in the 2006 Penalty Statement is "the level of intent on the part of the perpetrators."[67]

A willingness by some courts (most notably the Second Circuit in *Dynex Capital*) to permit the use of collective scienter in pleading may cause the SEC to consider the use of collective scienter. Before adopting the use of collective scienter, the Commission should consider both the legal and policy implications of the theory. As discussed below, the use of collective scienter may undermine the efficacy of the enforcement program and significantly alter the disclosure of information to investors.

## IV.
## Legal and Policy Considerations with Collective Scienter in SEC Enforcement Actions

Even if collective scienter is a permissible theory to allege or prove corporate scienter, the Commission may opt not to rely on the theory based on legal and policy considerations. The SEC is not an equivalent of the plaintiffs' bar. As an independent agency of the federal government, the SEC has unique duties and obligations rooted in the concept of inves-

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65. Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), http://www.sec.gov/news/press/2006-4.htm [hereinafter "2006 Penalty Statement"]; *see also* Atkins, *Evaluating the Mission*, *supra* note 7, at 402 ("It stated unequivocally that penalties against corporations can harm shareholders, a point that previously had been in dispute within the Commission.").

66. 2006 Penalty Statement, *supra* note 65.

67. 2006 Penalty Statement, *supra* note 65. Collective scienter seems to overlook the moral and philosophical aspects of culpability. The basic premise behind the traditional view of scienter is the identification of a culpable individual from which to hold culpable the entity. With collective scienter, however, there is no culpable individual from which to hold the entity liable. A complete discussion of the moral and philosophical aspects of organizational culpability is not undertaken in this Article.

tor protection.[68] The SEC operates under a tri-parte mission "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation"[69] and is charged with exclusive authority to enforce certain provisions of the federal securities laws.[70] The following legal and policy considerations weigh against the SEC's use of any version of collective scienter—both in pleading and proving corporate scienter.[71]

### A. *Collective Scienter Would Impose a Negligence Standard In Conflict with Other Laws Enforced by the SEC*

In actions against public companies for fraudulent misstatements or omissions, the SEC primarily relies upon Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 under the Exchange Act. Together these laws, which are similarly worded, provide the core of the Commission's so-called anti-fraud authority, and violation of those laws may result in a penalty.[72] Although the SEC shares the authority with the private bar to bring actions for violations of

68. Mary L. Schapiro, Chairman, SEC, Testimony Concerning Enhancing Investor Protection and Regulation of the Securities Markets: Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Mar. 26, 2009) ("[A]s Justice Douglas pointed out long ago, only the SEC has the mission, and the privilege, of serving as 'the investors' advocate.'"), http://www.sec.gov/news/testimony/2009/ts032609mls.htm.

69. SEC, 2007 Performance and Accountability Report 5 (2007), http://www.sec.gov/about/secpar/secpar2007.pdf. In 1996, Congress revised the SEC's statutory mandate to expressly require the SEC "to consider or determine [in a rulemaking] whether an action is necessary or appropriate in the public interest" and to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." Exchange Act of 1934 § 3(f), 15 U.S.C. § 78 c(f) (2008). This same mandate arguably should be applied to enforcement actions.

70. *See, e.g.*, 15 U.S.C. § 77q(a)(2) & (3).

71. Because virtually every action filed by the SEC against a corporation is settled either simultaneously with the filing of the complaint or soon thereafter, the use of collective scienter by the SEC in the pleading stage amounts to the same as proving collective scienter. Accordingly, from the standpoint of the public, there is little practical distinction between the SEC using collective scienter for pleading in a settled action versus proving liability at trial.

72. *See* 15 U.S.C. § 77t(d); 15 U.S.C. § 78ff; *see also* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, sec. 202, § 21(A), 104 Stat. 931, 937-39 (1990); Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What Is Its Relevance Today?*, 1 N.Y.U. J. L. & BUS. 587, 589-95 (2005).

Section 10(b) of the Exchange Act and Rule 10b-5, the SEC has exclusive authority to bring actions for violations of Section 17(a) of the Securities Act.[73]

Section 17(a)(1) of the Securities Act—a close analogue in the Securities Act to Section 10(b) of the Exchange Act—requires the SEC to prove scienter, but Section 17(a)(2) or (3) of the Securities Act only requires the SEC to prove that the defendant acted negligently.[74] In instances where a corporation has made a material misstatement or omission but lacked the requisite proof of scienter, the SEC may resort to Section 17(a)(2) and (3).[75] In many instances, the SEC asserts a violation of Section 17(a) without specifying the subsection.[76] Although the SEC may obtain a penalty against a corporation for violating Section 17(a)(2) or (3),[77] the SEC often does not seek penalties for violations of those negligence-based provisions.[78] Given the SEC's ability to seek a penalty for negligent

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73. MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 6.05[2], at 6-34 (Law Journal Press 2009) ("[T]he overwhelming view today is that Section 17(a) does not provide for an implied private right of action.").

74. Aaron v. SEC, 446 U.S. 680, 697 (1980) ("It is our view, in sum, that the language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3). Although the parties have urged the Court to adopt a uniform culpability requirement for the three subparagraphs of § 17(a), the language of the section is simply not amenable to such an interpretation."); *see also supra* note 1 (mentioning *Aaron's* relevance to scienter).

75. *See* 15 U.S.C. § 77q(a)(2); 15 U.S.C. § 77q(a)(3).

76. *See, e.g.*, SEC v. El Paso, Inc., Litigation Release No. 20,642, 93 SEC Docket 2225 (July 11, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20642.htm.

77. 15 U.S.C. § 77t(b).

78. *See, e.g.*, SEC v. Quest Software, Inc., Litigation Release No. 20,950, 2009 WL 649660, at *2 (Mar. 12, 2009); SEC v. El Paso, Inc., Litigation Release No. 20,642, 93 SEC Docket 2225 (July 11, 2008); SEC v. Interpublic Group of Cos., Litigation Release No. 20,547, 93 SEC Docket 418 (May 1, 2008); SEC v. Jorissen, Litigation Release No. 19,580, 87 SEC Docket 1365 (Feb. 27, 2006). Indeed, out of the approximately seven cases brought against issuers pursuant to Section 17(a)(2) or (3) within the past five years, the SEC has obtained penalties from issuers in only three known instances. *See* SEC v. Raytheon Co., Litigation Release No. 19,747, 88 SEC Docket 1010 (June 28, 2006) (settling for a penalty of $12 million); SEC v. Huntington Bancshares, Inc., Litigation Release No. 19,243, 85 SEC Docket 1598 (June 2, 2005) (settling for a penalty of $7.5 million); SEC v. Dean Foods Co., Litigation Release No. 18,884, 83 SEC Docket 2355 (Sept. 14, 2004) (settling for a penalty of $400,000).

conduct under Section 17(a)(2) or (3), the practical benefits to the SEC of using collective scienter are arguably minimal, as compared to private plaintiffs.

More importantly, the use of collective scienter by the SEC would run afoul of Supreme Court precedent distinguishing scienter from negligence. Collective scienter conflates the concept of negligent material misstatements (proscribed by Section 17(a)(2) and (3) of the Securities Act) with intentional or reckless material misstatements (proscribed by Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act). The Supreme Court has interpreted the language of Section 10(b) to render "unmistakable a congressional intent to proscribe a type of conduct *quite different from negligence*."[79] On various occasions, the Court has rejected liability based on a theory that sounded in negligence. In *Ernst & Ernst v. Hochfelder*, the Court rejected liability under Section 10(b) based on a theory that corporate officers have a "common-law and statutory duty of inquiry."[80] Similarly, the Court in *Santa Fe Industries v. Green*, refused to hold that corporate mismanagement constituted "manipulative" or "deceptive" conduct under the statute.[81]

In refusing to relax the scienter requirement of Section 10(b), the Supreme Court has been mindful of the effect on other sections of the federal securities laws. In *Ernst & Ernst*, the Court explained that the limits on remedies under Sections 11 and 12 of the Securities Act—neither of which requires a showing of scienter—would be rendered meaningless if Section 10(b) were extended by courts to encompass acts of negligence.[82] In other words, the Supreme Court recognized that Congress intended to delineate between actions based in negligence and actions based in scienter and the remedies available under each.

The same is true for the dichotomy between scienter-based misstatements proscribed by Section 17(a)(1) and Section 10(b) and negligent misstatements proscribed by Section

79. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (emphasis added).

80. *Id.* at 192, 194.

81. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

82. Ernst & Ernst, 425 U.S. at 198-201, 206-11; *see also* Rombach v. Chang, 355 F.3d 164, 169 n.4 (2d Cir. 2004) (explaining that Sections 11 and 12 do not require pleading and proof of scienter).

17(a)(2) and (3). Collective scienter would effectively eliminate any meaningful distinction between those provisions, as recognized by the Supreme Court.[83] In effect, the universe of corporate scienter actions could expand enormously, while SEC actions based on corporate negligence could become non-existent.

### B. *Collective Scienter Would Chill Corporations from Voluntarily Disclosing Information to Investors*

The federal securities laws hinge upon disclosure of information to investors. The preamble of the Securities Act explains that the purpose of the Act is to encourage "full and frank disclosure" of the character of securities sold in interstate and foreign commerce and through the mail.[84] Similarly, the Supreme Court "repeatedly has described the 'fundamental purpose' of the [Exchange] Act as implementing a 'philosophy of full disclosure.'"[85] Nevertheless, as courts have held, "there is no general duty on the part of a company to provide the public with all material information."[86] Instead, a corpora-

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83. *See* Aaron v. SEC, 446 U.S. 680, 697 (1980).

84. The "principal purpose [of the Securities Act], as set forth in its preamble, is to provide 'full and fair disclosure' of the character of securities sold in interstate and foreign commerce and through the mails." CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 6 (1997). As then-professor, later Justice, Felix Frankfurter wrote in 1933:

Unlike the theory on which state blue-sky laws are based, the Federal Securities Act does not place the government's imprimatur upon securities. It is designed merely to secure essential facts for the investor, not to substitute the government's judgment for his own.

Felix Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 53, 108.

85. Basic, Inc. v. Levinson, 485 U.S. 224, 230 (1988) (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-78 (1977)); *see also* Adato v. Kagan, 599 F.2d 1111, 1124 (2d Cir. 1979) (explaining that Section 10(b) is "an antifraud provision intended to encourage disclosure of information material to investors").

86. *In re* Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1432 (3d Cir. 1997); *see also In re* Time Warner, Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) ("[A] corporation is not required to disclose a fact merely because a reasonable investor would very much like to know that fact"). Although there is no general duty to disclose material information, various national exchanges have rules for their listed companies that may require disclosure not otherwise required by federal securities laws. *See, e.g.,* NYSE, Inc., Listed Company Manual § 202.05 (2009) (stating that a NYSE listed company is expected to release quickly to the public any information which might rea-

tion has a duty to disclose information generally only where required by law or regulation or when the failure to do so would render another statement misleading.[87]

Recognizing these constraints, Congress and the SEC have taken steps to encourage issuers to disclose voluntarily information by providing certain liability protections in civil litigation. For example, Section 27A of the Securities Act provides a safe harbor for certain forward-looking statements of issuers if the statements are identified as forward-looking and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[88] Section 27A also imposes a heightened pleading requirement to establish fraud in some circumstances, requiring plaintiffs to prove that the forward-looking statement was made with actual knowledge that the statement was false or misleading.[89] Likewise, Rule 175 under the Securities Act provides that certain projections and forecasts will not be deemed to be fraudulent statements in some instances unless a plaintiff can provide that the projection or forecast "was made or reaffirmed without a reasonable basis or disclosed other than in good faith."[90]

Congress took a broad approach to encourage disclosure in 1995 by enacting the PSLRA. Congress enacted the PSLRA, in part, because it wanted to encourage voluntary disclosure.[91] Congress found that frivolous lawsuits had "chilled corporate

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sonably be expected to affect the market for its securities, and further stating that a NYSE listed company should act promptly to dispel unfounded rumors which result in unusual market activity or price variations); Nasdaq, Inc., Rules § 4310(c)(16) (2007) (requiring, except in unusual circumstances, that a Nasdaq-listed issuer shall make prompt disclosure to the public of any material information that would reasonably be expected to affect the value of its securities or influence investor decision).

87. *In re Burlington Coat Factory*, 114 F.3d at 1432; *see also* Regulation FD, 17 C.F.R. § 243.100-03 (2005).

88. Securities Act §27A, 15 U.S.C. § 78u-5(c)(1)(A) (2008).

89. *Id.*; *see also, e.g.*, Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993) (explaining that companies cannot be held liable for predictions that ultimately are not met because it would "deter companies from discussing their prospects," which would be "contrary to the goal of full disclosure underlying the securities laws").

90. Securities Act Rule 175, 17 C.F.R. § 230.175 (2008).

91. *See* AUSA Life Ins. Co. v. Ernst & Young, 206 F.3d 202, 218 (2d Cir. 2000).

disclosure," so it wanted to implement heightened pleading standards to reduce such lawsuits and thus encourage corporations to provide more information to the public.[92]

If the SEC follows the path of the plaintiffs' bar and attempts to pursue fraud-based actions against corporations under the theory of collective scienter, there may be a chilling effect on the same corporate disclosures that Congress and the SEC have sought to encourage. Indeed, forty years ago, Judge Friendly warned that the "frightening" prospect of negligent liability for corporate communications would deter management from voluntarily disclosing information to shareholders.[93] In order to avoid liability under a collective scienter regime, corporations would be required to speak with each and every employee and former employee (for the pure version of collective scienter) or each and every member of management (for the weak version of collective scienter) to ensure that no one possesses any knowledge that, when coupled with an unknowing misstatement, would give rise to collective scienter. Clearing all public disclosures with every employee and former employee—or even simply every member of management—may not be a feasible option for most public companies. As a result, corporations might limit their public disclosures to information absolutely required by law—a result that runs contrary to years of rules and regulations designed to encourage voluntary disclosure of information as well as the intent of Congress in passing the Securities Act.[94]

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92. *Id.* (citing S. REP. NO. 104-98 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683).

93. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968) (Friendly, J., concurring).

94. Wallace P. Mullin & Christopher M. Snyder, *Corporate Crime*, at 20 (Dec. 13, 2007) [hereinafter "Corporate Crime"] (manuscript, *available at* http://www.dartmouth.edu/~csnyder/crimesurvey19.pdf) ("[D]etermining the appropriate standard for something as complicated as enterprise monitoring of agents is terribly difficult and may lead to considerable uncertainty if left to the courts to make ex post determinations. In the face of this uncertainty, enterprises may undertake inefficiently too little commercial activity.").

### C. *Collective Scienter Would Create Inefficient Deterrence and Misplaced Incentives*

One of the central tenets of the SEC's enforcement program is to protect investors by deterring individuals from violating the federal securities laws.[95] The crux of deterrence is changing the behavior of individuals by placing consequences on certain misconduct. The expectation is that the unattractiveness of the consequence of the behavior will deter individuals from committing that behavior. In an effective law enforcement regime, an individual will opt to avoid the misconduct in order to avoid the sanction.[96]

Economic research in the area of deterrence and corporate sanctions indicates that the effectiveness of a sanction against a corporation for the acts of an agent (employee) depends upon the extent to which the principal (corporation) can control the agent.[97] Indeed, the ability to control the agent has been identified as the "strongest and clearest [economic] principle" for an efficient sanction scheme.[98] Under

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95. An interesting question, beyond the scope of this article, is whether the ability of the SEC to seek and obtain a penalty against a corporation, which usually settles prior to litigation, makes it less likely the SEC will bring charges against individuals, who often litigate in court. *See, e.g.*, SEC v. R&G Fin. Corp., Litigation Release No. 20,455, 92 SEC Docket 1882 (Feb. 13, 2008) (company settlement, which included a penalty, alleging misconduct by individual officers who were not charged), http://edgar.sec.gov/litigation/complaints/2008/comp20455.pdf; SEC v. MBIA, Inc., Litigation Release No. 19,982, 89 SEC Docket 2847 (Jan. 29, 2007) (alleging misconduct by senior executives but not charging them after obtaining a $50 million penalty against the company), http://www.sec.gov/litigation/complaints/2007/comp19982.pdf.

96. *See generally* Troy A. Paredes, Comm'r, SEC, Remarks at the 2009 Southeastern Securities Conference (Mar. 19, 2009), http://www.sec.gov/news/speech/2009/spch031909tap.htm.

97. *Corporate Crime*, *supra* note 94. Moreover, there has been extensive research concerning the ineffectiveness of private securities litigation in deterring securities fraud. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1504 (1996); Donald C. Langevoort, *Capping Damages for Open Market Securities Fraud*, 38 ARIZ. L. REV. 639, 653-57 (1996); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 692-93 (1992). *See generally* Adam Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 947-59 (1999).

98. *Corporate Crime*, *supra* note 94.

this principle, the party that is better able to control the agent should shoulder the burden of controlling the agent.[99] In other words, the regulator should impose liability on the corporation for the act of an employee only if the corporation is better able to control the employee than the regulator is.[100]

Collective scienter presupposes the need for a corporation to control *both* the person responsible for the misstatement *and* the person or persons having knowledge of the misstatement, which could be any employee or agent (under the pure version of collective scienter) or any member of management (under the weak version of collective scienter). While it is true that the corporation can prohibit all voluntary disclosures of information to shareholders—an undesirable result as discussed above—a corporation is required to make certain disclosures under the federal securities laws. Therefore, the key participant to control is the person with knowledge that the forthcoming statement is false, not necessarily the speaker. In other words, because the corporation is under a legal obligation to speak in some instances, the only way to completely avoid liability for corporate scienter is to control those in the corporation who have knowledge.

If a corporation can be charged with securities fraud based on the knowledge of any of its employees or agents (pure version) or any members of management (weak version), the officer or director on the verge of making a statement must survey all the requisite employees having knowledge that could be imputed to the corporation. Identifying the person or persons with knowledge can be enormously costly and, in the case of the pure version of collective scienter, may be akin to finding a needle in a haystack. Indeed, the entire premise of the pure version of collective scienter is that knowledge, no matter how deeply imbedded in an organization, can be matched with a misstatement to find corporate scienter of the organization. In most instances, a corporation is not better

99. *Id.*

100. *Id.* An interesting question, which is beyond the scope of this Article, is whether the SEC's focus on enforcement cases against corporate defendants has resulted in less focus on investigations of, and enforcement cases against, individual wrongdoers. Indeed, in the resource-constrained SEC, any resources spent bringing a case against a corporation are resources that arguably could have been spent investigating and bringing cases against individual wrongdoers.

equipped to locate that knowledgeable person than the SEC would be. In fact, both the corporation and the SEC may be ill-suited to locate the knowledgeable person in a pure collective scienter world. Accordingly, the deterrence achieved by the pure version of collective scienter appears to be minimal.

If adequately defined with clear boundaries, a weak version of collective scienter might assist in deterring misstatements. Placing the burden on senior management to vet disclosures with a properly-defined group of senior-level management in the chain of information could assist in ensuring that corporations release accurate and complete information to investors, while not placing any significant burdens beyond those currently in place.[101] Indeed, most public companies have a thorough vetting process for any public statements, due in part to the requirements imposed by the Sarbanes-Oxley Act.[102] The additional benefit of imposing corporate liability with the weak version of collective scienter remains unclear

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101. Defining the persons with knowledge that could be imputed to the corporation is difficult. A somewhat analogous situation arose in the rulemaking concerning Regulation FD. The SEC originally proposed that Regulation FD not only apply to a selective disclosure formally made in the name of the issuer, but also to a selective disclosure made by a "person acting on behalf of an issuer." Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590 (proposed Dec. 20, 1999), *available at* http://www.sec.gov/rules/proposed/34-42259.htm. As a result of comments that the SEC received during the rulemaking process expressing confusion over the proposal, the SEC "narrowed the types of issuer personnel covered by the regulation to senior officials and those persons who regularly communicate with securities market professionals or with security holders." Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 15, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249), *available at* http://www.sec.gov/rules/final/33-7881.htm.

102. The Sarbanes-Oxley Act already requires companies to establish internal controls over public disclosure. The Sarbanes-Oxley Act requires a company's "principal executive officer or officers and the principal financial officer or officers" to certify in periodic reports that he is "responsible for establishing and maintaining internal controls," 15 U.S.C. § 7241(a)(4)(A) (2008), and that he has "evaluated the effectiveness of the issuer's internal controls" within the past ninety days and has "presented in the report [his] conclusions about the effectiveness of [the corporation's] internal controls based on [his] evaluation as of that date." 15 U.S.C. § 7241(a)(4)(B)-(D).

and must be weighed against the costs, only some of which are discussed in this Article.

To the extent corporations attempt to limit their exposure to liability under a collective scienter regime, there is a risk that collective scienter will cause corporations to focus more resources than appropriate on the area of corporate disclosures. Corporations might need to exhaust significant resources in vetting disclosures (particularly under the pure version of collective scienter) at the expense of other critical corporate functions such as managing business risk and maximizing profit.[103] For the SEC, the marginal costs of collective scienter—both in terms of actual costs to corporations and the opportunity costs caused by focusing attention away from other areas—may outweigh the marginal benefits of the extra layer of compliance. In other words, collective scienter may achieve the result of minimizing misstatements but at enormous costs to other areas.[104]

### D. *Collective Scienter Would Not Provide Sufficient Notice and Predictability to Corporations Regarding Charges or Penalties*

The SEC's enforcement of the federal securities laws rests on principles of transparency and predictability, which are embedded in the concept of due process.[105] Individuals and enti-

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103. Indeed, the requirements of the Sarbanes-Oxley Act did not prevent the current economic crisis, which some surmise was largely a function of insufficient risk management. *See Enhancing Investor Protection and the Regulation of the Securities Markets – Part II: Hearing Before the S. Comm. On Banking, Housing and Urban Affairs*, 111th Cong. 5 (2009) (statement Paul S. Atkins, Former Comm'r, S.E.C.), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=081fbcf6-953b-4701-ba03-e354ec6e8514&Witness_ID=467044f8-c886-4855-988a-782b188976de.

104. This Article only briefly discusses a few of the costs and benefits of collective scienter. Before embarking down the path of collective scienter, the Commission should consider all the possible costs and benefits and conduct a robust cost-benefit analysis.

105. Although the concept of due process is rooted in criminal law, *see, e.g.*, U.S. v. Williams, 128 S. Ct. 1830, 1835 (2008) ("A conviction fails to comport with due process if the statute under which it is obtained fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement."), due process is applicable as well to SEC proceedings where large civil penalties and bars can effectively amount to a criminal sanction, *see* Atkins, *Evaluating the Mission*, *supra* note 7, at 376 (explaining one of the

ties need to know—in advance of their conduct—what conduct is proscribed and what is permissible.[106] Therefore, an enforcement regime must be clear in what it seeks to hold accountable and consistent in its application of the laws.[107]

The use of collective scienter to establish the liability of a company for fraud would interject opaqueness and uncertainty to the SEC's enforcement program.[108] Under either the pure version or weak version of collective scienter, the SEC Enforcement Division would have few predetermined bounds in bringing a fraud case where there has been a misstatement. Collective scienter would make corporate counseling and compliance entirely unpredictable. There would be no way for corporate counsel to predict with certainty what types of cases would or would not be pursued by the SEC.

In addition, collective scienter would add to the existing uncertainty in the area of corporate penalties.[109] The use of collective scienter to obtain a penalty against a corporation is inconsistent with most of the factors set forth in the SEC's 2006 Penalty Statement.[110] The factor examining the need for

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mandates of the 1972 Wells Committee was to examine the enforcement program in light of due process concerns); *see also* Kevin J. Harnisch & Natasha Colton, *When the SEC Comes Knocking*, BUSINESS LAW Today, Sept. – Oct. 2005 (discussing due process issues).

106. *See Williams*, 128 S. Ct. at 1835 (explaining the importance of due process).

107. *See* Atkins, *Evaluating the Mission*, *supra* note 7, at 410 ("Predictability and transparency provide for a fair process that respects the rights of all parties involved and ensures adherence to the rule of law."). Former SEC Chairman Christopher Cox said during his tenure that "clarity and consistency in law enforcement" are the "hallmarks of good government" and a "cornerstone of . . . [the] work at the SEC." Christopher Cox, Chairman, S.E.C., Remarks at the American Securitization Forum (June 7, 2006), http://www.sec.gov/news/speech/2006/spch060706cc.htm.

108. *See also* Ochs, *supra* note 8.

109. Even without the theory of collective scienter, there is enormous uncertainty for a company under SEC investigation as to whether a penalty will be sought by the SEC and for how much. *See* Paul S. Atkins, Comm'r, S.E.C., *Remarks to the 'SEC Speaks in 2008' Program of the Practising Law Institute* (Feb. 8, 2008) ("In most cases, one of the greatest economic uncertainties for a company under investigation is the penalty that ultimately will be levied against it."), http://www.sec.gov/news/speech/2008/spch020808psa.htm.

110. 2006 Penalty Statement, *supra* note 65. The 2006 Penalty Statement explains that the two most significant factors are: (1) "the presence or absence of a direct benefit to the corporation as a result of the violation," and (2) the degree to which the penalty will further harm shareholders. *Id.* The

deterrence—"[t]he likelihood that a corporate penalty will serve as a strong deterrent to others similarly situated weighs in favor of the imposition of a corporate penalty"—would be rendered meaningless with the pure version of collective scienter because, as discussed above, deterring conduct in that environment may be nearly impossible.[111] However, as mentioned, there might be some deterrence value achieved through a properly-defined weak version of collective scienter.

The factor examining whether the violation is widespread throughout the organization would have a much different meaning in a collective scienter regime. The 2006 Penalty Statement explains: "The more pervasive the participation in the offense by *responsible persons* within the corporation, the more appropriate is the use of a corporate penalty."[112] Under the strong version of collective scienter, "responsible persons" could mean anyone in the organization—at any level—who had knowledge of facts indicating that a statement made by someone else was misleading. Moreover, for either the strong or the weak version of collective scienter, such a person does not need to have any "participation" in the actual misstatement to establish the collective scienter of the corporation.[113]

The factor in the 2006 Penalty Statement examining "the level of intent on the part of the perpetrators" is pointless in a case based on collective scienter. The 2006 Penalty Statement focuses on the culpability of the "perpetrators" and explains that "the imposition of a corporate penalty is most appropriate

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2006 Penalty Statement also sets forth secondary factors that will be considered: (1) "The need to deter the particular type of offense," (2) "The extent of the injury to innocent parties," (3) "Whether complicity in the violation is widespread throughout the corporation," (4) "The level of intent on the part of the perpetrators," (5) "The degree of difficulty in detecting the particular type of offense," (6) "Presence or lack of remedial steps by the corporation," and (7) "Extent of cooperation with Commission and other law enforcement." *Id.*

111. *See supra* Part IV.C. "The likelihood that a corporate penalty will serve as a strong deterrent to others similarly situated weighs in favor of the imposition of a corporate penalty. Conversely, the prevalence of unique circumstances that render the particular offense unlikely to be repeated in other contexts is a factor weighing against the need for a penalty on the corporation rather than on the responsible individuals." 2006 Penalty Statement, *supra* note 65.

112. 2006 Penalty Statement, *supra* note 65 (emphasis added).

113. *See supra* Part III.

in egregious circumstances, where the culpability and fraudulent intent of the perpetrators are manifest."[114] Moreover, according to the 2006 Penalty Statement, "A corporate penalty is less likely to be imposed if the violation is not the result of deliberate, intentionally fraudulent conduct."[115] Yet, with collective scienter, not a single "perpetrator" (i.e., speaker) needs to possess "fraudulent intent."

Finally, the "presence or lack of remedial steps by the corporation" is difficult to measure in a collective scienter case. Considering that the knowledge of any employee or agent (under the pure version) or any management-level employee (under the weak version) could be imputed to the speaker, what sort of remedial steps does a corporation need to take to ensure that it has vetted properly every statement? As discussed above, corporations, particularly larger ones, may need to spend an enormous amount on compliance to avoid liability in a collective scienter regime.[116] It would be difficult to determine what "remedial steps" the SEC would expect to see under a collective scienter theory.

## V.
## Conclusion

The theory of collective scienter is a radical departure from the principles of corporate liability and runs contrary to the objectives of the federal securities laws. The dangers of collective scienter are manifest in SEC enforcement actions. By basing liability on knowledge that is disconnected with the misstatement, collective scienter interjects enormous uncertainty into the SEC enforcement program and conflates negligence with intentional and reckless conduct. Collective scienter undermines the goal of encouraging disclosure by chilling corporations from voluntarily disclosing information to investors. Any minimal deterrence achieved in curbing misstatements likely is outweighed by the additional costs of compliance and the opportunity costs of focusing corporate resources away from other vital functions such as risk management. Overall, the normal uncertainty associated with an enforcement action would be magnified as corporations would be unable to dis-

114. 2006 Penalty Statement, *supra* note 65.
115. *Id.*
116. *See supra* Part IV.C.

cern the SEC's standards for charging and seeking a penalty using collective scienter.

If the SEC seeks to utilize collective scienter, the Commission should issue guidance on the circumstances in which the theory would be pursued. One approach could be to adopt the weak version of collective scienter but to provide a clear limit on the management-level employees from which knowledge could be imputed to the organization and to provide guidance for the level of diligence the SEC expects from a corporation when it issues a statement. Another option might be to use collective scienter only in the most egregious cases, where a corporation is deliberately structured to avoid knowledge reaching the speaker. A wholesale resort to collective scienter would harm the SEC's overall goals and should be avoided.