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Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the Group Pleading Protocol in 10b-5 Cases

William O. Fisher
University of Richmond, bfisher@richmond.edu

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*By William O. Fisher**

Corporations often speak through documents. Some, like press releases, may not identify an author. Others, like 10-Ks, bear the signatures of many who did not write them but sign as required by law. In many cases, groups of individuals, working together, prepare these documents. When such documents contain misstatements, plaintiffs may not know initially who wrote them. To address this difficulty, the U.S. Courts of Appeals for the Ninth and Second Circuits created a judge-made pleading protocol. This protocol permits plaintiffs to name officers, and in some cases directors, as defendants in securities fraud cases without pleading specific facts to show what role each of them played in creating the statements that plaintiffs challenge.

The courts created this exception to particularity in fraud pleading before the Supreme Court decided *Central Bank* and before Congress passed the Private Securities Litigation Reform Act of 1995 (the PSLRA or Act). This Article traces the history of this "group pleading" and considers whether it survives today.

THE SCOPE OF THIS ARTICLE

The elements of a private 10(b) action for a misrepresentation in the purchase or sale of a security are:

A representation made by the defendant (or for which the defendant is responsible under 10(b) substantive law);
Of a material fact;
That was false;

* William O. Fisher is a partner in the San Francisco office of Pillsbury Winthrop LLP. He is a member of the California and District of Columbia bars and a member of Pillsbury's Securities Litigation Group. Bea Rickels proofread and checked citations and quotations. The views expressed in this Article are those of Mr. Fisher and should not be attributed to his firm or its clients.

Made when the defendant either knew the representation to be false or was reckless in not knowing that it was false (i.e., made with scienter);
Made in connection with the purchase or sale of a security;
On which the plaintiff relied; and
Which caused damage to the plaintiff.[1]

This Article focuses on a rule allowing plaintiffs to plead the first element—that a specific defendant "made" a representation or is otherwise responsible for it so as to be a proper 10(b) defendant. This is particularly a 10(b) issue because the other statutes that plaintiffs most frequently employ in private securities litigation—sections 11 and 12(a)(2) of the Securities Act of 1933—define the circle of defendants without requiring that each of them "make" a false statement.[2]

Private actions under section 10(b) are "fraud" actions for purposes of Rule 9(b) of the Federal Rules of Civil Procedure.[3] They are therefore subject to that Rule's requirement that, "[i]n all averments of fraud . . . , the circumstances constituting fraud . . . shall be stated with particularity."[4]

1. *See* 15 U.S.C. § 78j(b) (1994 & Supp. V 1999). When a plaintiff bases a 10(b) case on an omission, the elements become:

A failure by the defendant to disclose;
A material fact;
When the defendant was under a duty to disclose that fact;
At a time when the defendant either knew the undisclosed fact or was reckless in not knowing it;
In connection with the purchase or sale of a security;
When the plaintiff was relying on the defendant to disclose according to the defendant's duty; and
Which caused damage to the plaintiff.

See id.

2. *See* 15 U.S.C. §§ 77k(a), 77l(a)(2) (1994 & Supp. V 1999). Section 11 lists those who may be sued for a material misrepresentation or omission in a registration statement. They include all who sign the registration statement, all directors of the issuer on the date the registration statement is filed, all directors-elect whom the registration statement identifies, and all the underwriters for the issue. *See id.* § 77k(a). There is no requirement that each defendant must himself have written a misrepresentation.

Section 12(a)(2) creates liability for all who sell or offer to sell a security by means of a prospectus or oral communication that contains a material misrepresentation or omits to state a material fact necessary to avoid misleading by the words the prospectus or oral communication contain. *See id.* § 77l(a)(2). Under *Pinter v. Dahl*, 486 U.S. 622 (1988), the defendants include those who pass title to the securities so sold as well as those who "solicit" the sales. *See id.* at 643. As with section 11, section 12(a)(2) does not in terms require that each defendant himself author a misstatement.

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

4. *Id.* Cases in both the Ninth and Second Circuits acknowledge that Rule 9(b) applies to claims brought under section 10(b) of the Securities Exchange Act. *See* Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993) ("A Rule 10b-5 plaintiff must comply with Rule 9(b) . . . ."); Wool v. Tandem Computers Inc., 818 F.2d 1433, 1439 (9th Cir. 1987)

In cases in which plaintiffs sue multiple defendants for fraud, the complaint must set forth particular facts to show each defendant's role. A "claimant usually may not group all wrongdoers together in a single set of allegations. Rather, the claimant is required to make specific and separate allegations against each defendant."[5] In particular, "many courts . . . require the plaintiff to specify which defendant made each of the alleged misrepresentations."[6]

Where the misstatements appear in certain types of documents that plaintiffs believe were written by groups, some courts allow plaintiffs to link certain defendants to alleged misrepresentations simply by pleading that the defendants were part of the "group" that likely put the challenged documents together. Instead of pleading that defendant A actually authored an offending statement in, for example, a press release, plaintiffs can include A as a defendant on allegations that A occupied a certain position at the issuer. The court may then under "group pleading" presume that A, because of his or her position, participated in drafting the press release. Without any further facts, "group pleading" allows plaintiffs to allege that defendant A "made" the challenged statement and so plead the first element of a 10(b) case against this defendant. "Group pleading" is thus an exception to the normal rule that a plaintiff must plead particular facts to connect each defendant to an alleged fraud.

Judges created "group pleading." Congress did not include group pleading in any provision of the Securities Exchange Act. Federal circuits and district courts formulate the concept in different ways. Courts in the Ninth and Second Circuits provide the most elaborate formulations. Although other courts have articulated variations,[7] this Article focuses mainly on decisions in those two circuits.

This Article divides into five sections. First, it traces the development of "group pleading" in the Ninth and Second Circuits. Second, it discusses two abuses of the protocol—its use by some courts as a rule of substantive law rather than simply a pleading shortcut, and its misapplication in some decisions to the scienter element. Third, turning to the effect of *Central Bank,* this Article investigates the impact of the Ninth and Second Circuits'

("Rule 9(b), which applies to securities actions brought under Section 10(b) and Rule 10b-5, requires particularity in pleading the circumstances constituting fraud.").

5. 2 James Wm. Moore, Moore's Federal Practice § 9.03[1][f] (3d ed. 2000) (footnote omitted).

6. 5 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedure § 1297, at 97 (2d ed. Supp. 2000).

7. *See, e.g.,* Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1254 (10th Cir. 1997) (relying in part on the *Wool* decision discussed *infra* notes 8-12 and accompanying text, and in part on *In re* Storage Tech. Corp. Sec. Litig., 630 F. Supp. 1072, 1076-77 (D. Colo. 1986), which in turn references the *Somerville* decision discussed in the text accompanying note 70); *In re* Sahlen & Assocs., Inc. Sec. Litig., 773 F. Supp. 342, 361-62 (S.D. Fla. 1991) (citing to both Ninth and Second Circuit authorities but mixing up "group pleading" with "control person" liability).

definitions of primary liability on their respective "group pleading" rules. The fourth topic is a much debated issue—the effect of the PSLRA on "group pleading." The last section discusses whether the assumptions behind this pleading device reflect the real world of corporate disclosure.

WOOL v. TANDEM: *THE NINTH CIRCUIT VERSION*

Tandem Computers Inc. (Tandem) developed and produced multiple processor computer systems. On December 8, 1982, Tandem announced the restatement of its fiscal year 1982 revenue and earnings. Its stock dropped and shareholders filed a class action.[8]

Plaintiffs named as defendants not only the company but also three officers: the President/CEO, the Senior Vice President/COO, and the Vice President/Controller. The complaint did not, however, allege that any one of these officers was responsible for any particular false number in any identified financial statement.[9] The individual defendants moved to dismiss, arguing that plaintiffs' failure to link each defendant specifically to the alleged fraud violated Rule 9(b).[10]

The district court dismissed the claim against the individual defendants without prejudice and then granted summary judgment to the company

8. Wool v. Tandem Computers Inc., 818 F.2d 1433 (9th Cir. 1987). The court summarized the alleged improper revenue recognition in this way:

> Tandem's management, toward the end of each quarter, authorized shipments of equipment to carrier warehouses even though material conditions of sale remained unsatisfied. Tandem's employees prepared shipping documents which, on their face, indicated direct shipment to customers. In reality, the supposedly "sold" equipment was merely transferred to a warehouse and remained under Tandem's control. These and other practices permitted Tandem to book revenue from incomplete sales.

Id. at 1435.

9. The complaint attributed financial announcements to "Tandem," alleged that "Tandem's management" had employed certain procedures that generated revenue that the company should not have recognized, and then referred to "defendants" in the charging paragraphs. *See* Complaint for Violation of the Federal Securities Laws and Pendant State Law Claims, ¶¶ 16-18, 23, 30-32 (N.D. Cal. Oct. 23, 1984) (No. C 84 20656) (on file with the *The Business Lawyer,* University of Maryland School of Law). Nowhere did the complaint detail what role any individual defendant played in creating the financials.

10. Previous Ninth Circuit authority held that, in fraud cases involving multiple defendants, plaintiffs must specifically plead the role of each defendant in the fraud. *See, e.g.,* Semegen v. Weidner, 780 F.2d 727, 731 (9th Cir. 1986) (affirming dismissal of complaint against certain defendants in 10(b) case by holding, "the plaintiffs have failed to plead their claims against [these defendants] with the requisite particularity. Plaintiffs have done nothing more than set forth conclusory allegations of fraud . . . punctuated by a handful of neutral facts. The absence of particularity with respect to the alleged fraudulent participation of [these defendants] in the coal venture scheme and the absence of specification of any times, dates, places or other details of that alleged fraudulent involvement is contrary to the fundamental purposes of Rule 9(b).") (citations omitted).

on the ground that the named plaintiff could not establish the requisite injury.[11] The Ninth Circuit reversed. Addressing the argument that the complaint did not attribute particular fraudulent statements or acts to each individual defendant, the Ninth Circuit found the complaint sufficient and inaugurated its "group pleading" era with these words:

> In cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other "group-published information," it is reasonable to presume that these are the collective actions of the officers. Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and where possible the roles of the individual defendants in the misrepresentations.
>
> Wool clearly satisfied this requirement. The individual defendants are a narrowly defined group of officers who had direct involvement not only in the day-to-day affairs of Tandem in general but also in Tandem's financial statements in particular.[12]

ELABORATION OF WOOL*'S RULE*

The application of *Wool* raised two principal questions. The first was who the "group" included. The second was which corporate communications were "group published."

WHO IS WITHIN THE "GROUP"?

All individual *Wool* defendants were officers. The opinion did not address whether outside directors could ever be "group pleaded" into a 10(b) action. A little over one year after *Wool*, the Ninth Circuit decided *Blake v. Dierdorff*,[13] holding that the "presumption of collective action when there is misleading 'group published information' is equally applicable to members of a board of directors" as it is to officers.[14] Lower courts proceeded to struggle with this notion, particularly as it applied to outside directors. Neither the law nor practical experience suggested that outside directors were so deeply involved in a company's affairs as to formulate

11. *Wool*, 818 F.2d at 1436.

12. *Id.* at 1440 (citations omitted). Because this pleading protocol affects only one element—the connection between the defendant and allegedly misleading statements—and because it does so by a presumption that the defendant was part of a group that published the statement, it is more properly called the "group published information presumption." For convenience, this Article uses the shorter phrase "group pleading."

13. 856 F.2d 1365 (9th Cir. 1988).

14. *Id.* at 1369.

the text of corporate disclosures, or even approve the language of those disclosures.[15]

As district courts sorted out when "group pleading" applied to outside directors, the decisions ran the gamut. Some seemed almost randomly to apply "group pleading" to all directors.[16] Others focused on the directors' access to information;[17] membership on board committees;[18] involvement in day-to-day corporate management;[19] or some disjunctive test based upon the degree to which the directors participated in management or had some "special relationship" with the corporation, such as actual participation in the drafting of offending documents.[20]

15. The American Law Institute's *Principles of Corporate Governance* concluded that "the board can normally satisfy the requirements of present statutes without either actively managing or directing the management of the corporation, as long as it oversees management and retains the decisive voice on major corporate actions." 1 PRINCIPLES OF CORPORATE GOVERNANCE § 3.02 cmt. a (American Law Institute 1994).

16. *See, e.g.*, Robbins v. Hometown Buffet, Inc., No. 94-1655-J, 1995 WL 908194, at *5 (S.D. Cal. Mar. 16, 1995) ("[T]he group publishing doctrine may apply to defendant officers *and directors* merely by virtue of their status in the corporation, so long as the complaint also makes an effort to allege, where possible, how the defendants' status as officers *or directors* make them responsible for group published information.") (emphasis added).

17. *See, e.g.*, XOMA Corp. Sec. Litig., [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,491, at 92,160 (N.D. Cal. Dec. 27, 1991) ("Outside directors, although almost by definition excluded from the day-to-day management of a corporation, can fall within the group pleading presumption when, by virtue of their status or a special relationship with the corporation, they have access to information more akin to a corporate insider.") (citation omitted); *In re* Epitope, Inc. Sec. Litig., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,263, at 95,188 (D. Or. Nov. 30, 1992) (following *XOMA*).

18. *See, e.g.*, *In re* National Health Labs. Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,677, at 97,136 (S.D. Cal. July 2, 1993) ("[M]embership on the [audit or executive] committees could provide the link or special relationship necessary for application of the presumption."); Persky v. Turley, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,483, at 92,130 (D. Ariz. Dec. 19, 1991) (noting participation on Executive and Audit Review Committees, review of 10-Qs, and signing 10-Ks).

19. *See, e.g.*, *In re* Gupta Corp. Sec. Litig., [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,689, at 92,227 (N.D. Cal. Apr. 17, 1995) ("Where outside directors participate in the management of the part of the company allegedly involved in fraud . . . , the group pleading presumption may apply."); *In re* Ross Sys. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,363, at 90,496 (N.D. Cal. July 21, 1994) (dismissing claims against outside directors with leave to amend "to allege day-to-day management"); O'Sullivan v. Trident Microsystems, Inc., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,116, at 98,913 (N.D. Cal. Jan. 31, 1994) (dismissing outside directors because "plaintiffs provide[d] no factual basis to establish involvement of [these] directors in Trident's 'day-to-day management.' ").

20. *See, e.g.*, *In re* Syntex Corp. Sec. Litig., 855 F. Supp. 1086, 1100 (N.D. Cal. 1994) ("By definition, outside directors do not participate in the corporation's day-to-day affairs. Thus, the doctrine may be invoked as to outside directors only if they are 'involved in the day-to-day management of those parts of the corporation involved in the [alleged] fraud,' or if they otherwise have a special relationship or status with the corporation.") (alteration in original) (citation omitted), *aff'd*, 95 F.3d 922 (9th Cir. 1996); *In re* RasterOps Corp. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,467, at 91,194 (N.D. Cal. Oct. 31,

The Ninth Circuit settled this issue with its *In re GlenFed Inc. Securities Litigation*[21] decision in July 1995. *GlenFed* recognized the limited role that outside directors play and constrained the circumstances in which "group pleading" could bring them into a case:

> Plaintiffs contend that "the *Wool* 'group published information' presumption is applicable to outside directors where the plaintiffs plead that the outside directors hold positions on audit, executive and other committees that are responsible for overseeing the corporation's financial and disclosure activities." We disagree. . . . The "group published information" presumption is grounded in reasonableness—and it is not reasonable to presume in every case . . . that a "corporate scheme to defraud was collectively devised by the [outside] director defendants." To rely upon the "group published information" presumption, Plaintiffs' complaint must contain allegations that an outside director either participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times.[22]

A director's membership on board committees would not suffice.[23] Signing corporate documents would not suffice.[24] Using connections to help

1994) ("The group pleading rule may be used as to outside directors only if they participate in the daily affairs of those parts of the corporation involved in the alleged fraud, or otherwise have a special relationship with the corporation."). There are other decisions focusing on director involvement in drafting or disseminating documents or other "special relationships" with the corporation. *See In re* Medeva Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,323, at 90,241 (C.D. Cal. June 3, 1994) ("[I]n order to invoke the 'group published information' presumption against an outside director, the plaintiffs must allege that the director participated in the drafting of the fraudulent documents or 'otherwise enjoyed [a] special relationship' with the corporation."); Haltman v. Aura Sys., Inc., 844 F. Supp. 544, 548 (C.D. Cal. 1993) ("The rules with respect to pleading claims against an outside director require Plaintiffs to allege a special relationship or status with the corporation."); *In re* Digital Microwave Corp. Sec. Litig., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,044, at 94,594 (N.D. Cal. Oct. 19, 1992) (denying motions to dismiss and holding, "[e]ach of the defendants acted as a Director of [the issuer] . . . and is alleged to have directly participated in the management of the company, as well as the dissemination of false information regarding the financial condition and status of [the issuer].").

21. 60 F.3d 591 (9th Cir. 1995).

22. *Id.* at 593 (citations omitted).

23. *See id.* ("Merely because the complaint identifies a corporation's outside directors, various committee assignments, and generic responsibilities for every committee does not mean that the presumption of 'group published information' is applicable.").

24. Both pre- and post-*GlenFed* decisions so held. *See* Pre-*GlenFed*: *In re* Gupta Corp. Sec. Litig., 900 F. Supp. 1217, 1241 (N.D. Cal. 1994) (acknowledging decisions holding that "the mere fact that an outside director signed a group published document does not make the outside director liable for the contents of the document."); *In re* Ross Sys. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,363, at 90,496 (N.D. Cal. July 21, 1994) ("[C]laims that the director merely signed some of the group published documents are not

the issuer with an occasional business problem would not suffice.[25] Access to nonpublic information would not suffice.[26] Receiving copies of documents before release to the public and generally "reviewing and approving" the documents would not suffice.[27] Nor could plaintiffs apply "group

sufficient to meet group pleading requirements."); *In re* Medeva Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,323, at 90,241 (C.D. Cal. June 3, 1994) ("[T]he only specific allegation against Sinclair linking him to the fraud . . . is his signature on the 1992 Registration Statement and Prospectus. This allegation, by itself, does not satisfy the elements required to invoke the 'group published information' presumption . . . .") (citation omitted); XOMA Corp. Sec. Litig., [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,491, at 92,160-61 (N.D. Cal. Dec. 27, 1991) (granting directors' motion to dismiss, and noting "[plaintiffs'] only allegations against these defendants is that they signed some of the group published information. However, there is no allegation that these directors participated in the drafting of these documents, or otherwise enjoyed any 'special relationship' with XOMA. The allegations are insufficient to bring these outside directors within the group pleading presumption."). *See also* Post-*GlenFed*: Stack v. Lobo, 903 F. Supp. 1361, 1376 (N.D. Cal. 1995) ("[A]n outside director does not become liable for the contents of a group published document merely by signing it."); Strassman v. Fresh Choice, Inc., No. C-95-20017 RPA, 1995 WL 743728, at *14 (N. D. Cal. Dec. 7, 1995) ("[T]he fact that [the outside directors] signed several Fresh Choice documents filed with the SEC does not make them liable for the contents of the documents."); Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1127 (W.D. Mich. 1996) (same; relying on authority from Ninth Circuit); *In re* Valence Tech. Sec. Litig., No. C95-20459, 1996 WL 67326, at *6 (N.D. Cal. Feb. 13, 1996) (same). *But see In re* ValuJet, Inc., Sec. Litig., 984 F. Supp. 1472, 1478 (N.D. Ga. 1997) (relying on Blake v. Dierdorff, 856 F.2d 1365 (9th Cir. 1988), not citing to *GlenFed*, and holding "[u]nder the 'group publication doctrine,' the Plaintiffs may satisfy the pleading requirements by alleging that an individual defendant signed a publication containing misstatements").

It is unclear how *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000), will affect these authorities. *See infra* notes 139-43 and accompanying text.

25. *See Valence Tech.*, 1996 WL 67326, at *6 (dismissing director who was also CEO of his own company even though plaintiffs alleged that he arranged to have personnel of his own company assist the issuer in setting up foreign operations).

26. *See* Powers v. Eichen, 977 F. Supp. 1031, 1041 (S.D. Cal. 1997) (dismissing directors because the "allegations do not sufficiently describe the outside directors day-to-day involvement in the corporation, but rather attempt to include these directors by virtue of their titles and boilerplate 'access to information' language."); *In re* Interactive Network, Inc. Sec. Litig., 948 F. Supp. 917, 921 (N.D. Cal. 1996) ("Extending the doctrine to cover outside directors who, while not involved in the day-to-day workings of a corporation, are privy to inside information does not merely make it easier for plaintiffs without information about the inner workings of an organization to defeat a motion to dismiss. Instead, it extends the group of possible defendants liable in 10b-5 cases beyond those who might be responsible for making the decision."); *Strassman*, 1995 WL 743728, at *13-*14 (granting motion to dismiss even though plaintiffs alleged that the directors "had access to [the issuer's] internal operating plan, budget, forecasts and reports."). For a similar pre-*GlenFed* case, see *Gupta Corp.*, 900 F. Supp. at 1242 ("Conclusory allegations that an outside director had access to corporate documents likewise do not demonstrate the day-to-day involvement with corporate affairs necessary to establish liability under the group pleading presumption.").

27. *See In re* Oak Tech. Sec. Litig., No. 96-20552 SW, 1997 WL 448168, at *11 (N.D. Cal. July 1, 1997) ("Plaintiffs further allege that [the outside directors], as members of the Audit Committee . . . , 'reviewed and approved the issuance of [the] false financial statements . . . .' However, Plaintiffs fail to allege these Defendants' specific roles in the review and ap-

pleading" to outside directors with boilerplate allegations of day-to-day involvement in the company or its documents,[28] more specific assertions that they participated in bi-monthly lunches devoted to company strategy,[29] creative pleading that directors were "in solidarity" with a CEO,[30] or charges that the directors generally controlled the overall direction of the issuer.[31] About the only way to survive an outside director motion to dismiss in the Ninth Circuit after *GlenFed* has been to plead specifically the director's actual involvement in the preparation of the very documents that contain the misrepresentations or are misleading because of omissions.[32]

proval . . . . ") (citation omitted). *See also* Pre-*GlenFed* decisions: *In re* Syntex Corp. Sec. Litig., 855 F. Supp. 1086, 1100 (N.D. Cal. 1994) (dismissing claims against outside director even though plaintiffs pleaded that he "was privy to the contents of . . . quarterly and annual reports, press releases and presentations to securities analysts prior to their issuance, and had the ability to prevent their issuance or cause them to be corrected."); *In re* Ross Systems, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,496 (dismissing directors in face of plaintiffs' allegation that the directors "controlled the contents of [the issuer's] alleged misrepresentations through receiving copies of reports and press releases before distribution").

28. *See In re* Silicon Graphics, Inc. Sec. Litig., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325, at 95,963 (N.D. Cal. Sept. 25, 1996).

29. *See In re* RasterOps Corp. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,467, at 91,194 (N.D. Cal. Oct. 31, 1994) (denying a motion to dismiss, but noting, "[p]laintiff's allegation concerning attendance at bi-monthly lunch meetings [at which the company's financial condition was discussed] will not do the trick . . . twice a month does not mean day-to-day."). The court in *In re Splash Technology Holdings, Inc. Sec. Litig.*, No. C99-00109 SBA, 2000 U.S. Dist. LEXIS 15370 (N.D. Cal. Sept. 29, 2000), similarly rejected allegations that a director was uncommonly involved in day-to-day operations:

> [T]he complaint alleges that Berger was in"frequent contact" with . . . two of Splash's top executives, received copies of Splash's internal operating and budget reports circulated to executives, signed the Prospectus and Registration Statement, signed a . . . Merger Agreement between Splash and Radius that obligated Splash officers to present detailed budgets and projections to Splash directors . . . , received copies of the allegedly false reports and press releases prior to their issuance, and . . . was appraised by weekly and monthly reports of the status of orders for and sales of every Splash product. These allegations, however, still do not rise to the level of establishing the requisite participation in Splash's day-to-day activities.

Id. at *46-*47 (citation omitted).

30. *See Strassman*, 1995 WL 743728, at *13-*14 (granting outside directors' motion to dismiss, despite plaintiffs' claim that they "acted in 'total solidarity'" with CEO).

31. *See id.* at *14 ("The allegation that [the outside directors], along with [the CEO], controlled the company's financial and strategic operations and other management decisions does not address whether they were involved in the 'day-to-day' operations of [the issuer].").

32. Just how specific the allegations must be may depend on the judge. Compare the cases discussed in note 27 with *In re RasterOps Corp.*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,467, where the court denied a motion to dismiss and held that, "plaintiff's allegations that the outside directors participated in the preparation of documents containing the alleged misstatements indicate a 'special relationship' with the corporation sufficient to invoke the group pleading presumption." *Id.* at 91,194. Also, compare those cases to *In re Gupta Corp. Sec. Litig.*, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,689

The rules for outside directors provided a model for application of the "group pleading" presumption to outside advisors. In *Moore v. Kayport Package Express, Inc.*,[33] the Ninth Circuit held, in a limited partnership context, that outside professionals could not be swept into a case on a group publication presumption because "unlike the situation in *Wool*, the accountant, lawyer and stockbroker defendants in this case are not a narrowly defined group of corporate officers or directors who are alleged to have had day-to-day control over the fraudulent entities or their finances."[34]

Relying on this same rationale—that defendants who did not participate in day-to-day management could not be part of the "group"—courts held that underwriters and consultants were not properly named as defendants by "group pleading."[35] Venture capitalists and other large shareholders,

(N.D. Cal. Apr. 17, 1995), where the court denied a motion to dismiss and noted:

> plaintiffs allege that [the outside directors] (1) signed [the issuer's] 1993 Annual Report on Form 10-K; (2) were members of the audit and compensation committees . . . ; (3) were informed of [the] improper revenue recognition practices . . . ; (4) attended Board and audit committee meetings at which large transactions with revenue recognition issues were discussed and approved by Board members; (5) controlled the contents of [the issuer's] financial reports, press releases and presentations to securities analysts; (6) received copies of [the] financial reports and press releases prior to or shortly after their issuance; and (7) had the ability and opportunity to prevent the issuance of false statements. . . . By alleging that [the outside directors], as members of [the] audit committee, directly approved the allegedly fraudulent accounting practices that form the basis of the [complaint], plaintiffs have successfully asserted day-to-day management of the part of the Company involved in the alleged fraud.

Id. at 92,227-28. Lastly, in *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706 (D. Del. 2000), the court denied a motion to dismiss, citing *GlenFed* and other cases from outside the Ninth Circuit. *See id.* at 720. The court held:

> [a]lthough the complaint does not attribute any specific misstatement to these defendants, the wrong complained of—that the Company maintained declining loan loss reserves as its loan loss rates increased—is the kind of matter that these defendants *may have been* personally responsible for overseeing. . . . These defendants allegedly prepared, approved, *or* reviewed the Company's financial statements containing material overstatements to its net income.

Id. (emphasis added). Unless courts require a high degree of specificity, form allegations that directors participated in preparing documents will undermine the principle that outside directors should not be "group pleaded" into a case absent exceptional circumstances.

33. 885 F.2d 531 (9th Cir. 1989).

34. *Id.* at 540.

35. Underwriters have been held to be outside the scope of "group pleading." *See In re* Stac Elecs. Sec. Litig., 89 F.3d 1399, 1411 (9th Cir. 1996) (affirming dismissal of underwriters and quoting the outside director standard from *GlenFed* indicating the plaintiff "cannot rely on the group published information exception to Rule 9(b) because the [complaint] contains no allegations that [the] . . . underwriters 'either participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times.' ") (quoting *GlenFed*, 60 F.3d at 593). *See also* Krieger v. Gast, No. 4:99-CV-86, 2000 WL 288442, at *10 (W.D. Mich. Jan. 21, 2000) (stating that plaintiffs could not rely on the "group published information" presumption

even those with representatives on the board, were also generally outside the "group" absent specific charges that they participated in the issuer's daily corporate activities or that they had in fact drafted the challenged documents.[36]

to hold liable the investment banker for an insider group where plaintiffs alleged misrepresentations in connection with the insiders' acquisition of control by merging the issuer and shell corporation; citing primarily to Ninth Circuit authority in earlier "group pleading" discussion); O'Sullivan v. Trident Microsystems, Inc., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,116, at 98,914 (N.D. Cal. Jan. 31, 1994) ("[T]he group pleading presumption does not apply to the underwriters."); *In re* MDC Holdings Sec. Litig., 754 F. Supp. 785, 795 (S.D. Cal. 1990) (dismissing individuals at Drexel as to issuer statements because "Drexel was the underwriter for MDC. The position held by these parties in relation to MDC is not analogous to that held by the officers or directors of MDC. That is, they did not have direct involvement in MDC's day-to-day affairs or its publications. . . . Plaintiffs have not alleged a special relationship between MDC and Drexel.").

Courts have also held consultants outside "group pleading." In *In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935 (E.D. Pa. 1999), the court dismissed the former chairman and CEO of the acquired company who joined the board of the acquiring company, acted as a consultant to the acquiring company, and was a member of its Finance Committee. *See id.* at 949-50. Relying on *GlenFed,* the court found that the plaintiffs "failed to allege any facts to support their allegations that [this defendant] was involved in the day-to-day operations of Aetna after the . . . merger . . . ." *Id.* at 950. Similarly, in *Rubin v. Trimble*, No. C-95-4353 MMC, 1997 WL 227956 (N.D. Cal. Apr. 28, 1997), the court dismissed with prejudice claims against a director and consultant even though the complaint alleged generally that each defendant "'reviewed, edited, commented upon and participated in the preparation and dissemination of [the] August 1995 Prospectus.'" *Id.* at *20. The court noted, "[n]owhere does the complaint specifically allege that [this defendant] participated in [the issuer's] day-to-day activities . . . or had any other 'special relationship' with [the company] . . . ." *Id. See also In re* National Health Labs. Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,677, at 97,136 (S.D. Cal. July 2, 1993) (dismissing claim against firm providing public relations services to issuer).

36. In *In re Interactive Network, Inc. Sec. Litig.*, 948 F. Supp. 917 (N.D. Cal. 1996), the shareholder defendant owned between 25% and 37% of the issuer's stock and had a representative on the board. The court granted the motions to dismiss both the shareholder and the board representative, stating:

> plaintiffs have failed to plead circumstances sufficient to support a finding that [these] defendants were involved in the day-to-day running of [the issuer]. While they have detailed . . . the financial arrangements between [the shareholder and the issuer], and have stated that these arrangements led to [the shareholder] receiving a seat on [the issuer's] board, they have failed to show that [the shareholder] took an active role in [the issuer's] daily affairs. Plaintiffs may have alleged that [these] defendants had the capacity to participate in the day-to-day operations of [the issuer], but they have failed to allege that they actually did so.

Id. at 922. *See also In re* Splash Tech. Holdings, Inc. Sec. Litig., No. C99-00109 SBA, 2000 U.S. Dist. LEXIS 15370, at *48-*49 (N.D. Cal. Sept. 29, 2000) ("Plaintiffs allege that the group published information doctrine extends to Radius . . . since it shared a special relationship with Splash by virtue of (1) its ownership of 20% of Splash stock, (2) Splash being a Radius 'spin-off,' (3) the majority of Splash officers being former Radius officers, and (4) Radius' dependence upon its Splash stock for its survival. . . . Plaintiffs present no authority for the proposition that a shareholder who is not also either an officer or director may be

The day-to-day involvement test, however, does not serve well in determining which officers should be included within a "group" presumably preparing corporate communications. *Wool* held that plaintiffs properly named the President/CEO, the Senior Vice President/COO, and the Vice

liable under the group-published information doctrine. In addition, the example Glenfed II gave for evidence of a special relationship–participation in preparing or communicating group information at particular times–is absent here. Plaintiffs do not allege with particularity any statement in which Radius played a role."); *Stac Electronics*, 89 F.3d at 1411 (affirming dismissal of venture capital defendants among others and agreeing with the district court that "group pleading" was not available against those defendants); Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1128-29 (W.D. Mich. 1996) (Hillman defendants "exerted their influence or control over the Company because, as a group, they controlled 20.8% of [the issuer's] common stock, had determined a majority of directors through the October 1993 offering pursuant to a 1988 Hillman Subscription Agreement, controlled two outside directors . . . , and generally kept in continuous communication with [the issuer's] corporate officials during the class period," yet holding nonetheless that the "group pleading presumption does not apply to any of the main Hillman defendants."); Strassman v. Fresh Choice, Inc., No. C-95-20017 RPA, 1995 WL 743728, at *14 (N.D. Cal. Dec. 7, 1995) ("Plaintiffs allege that the group pleading doctrine applies to Rosewood, as the largest Fresh Choice shareholder, because Adams is both a principal of Rosewood and a member of the Fresh Choice Board of Directors. The group pleading doctrine may be applied to a venture capital firm if the plaintiff can show that the firm's agent participated in the preparation and dissemination of company documents containing misrepresentations. However, . . . Plaintiffs have failed to sufficiently allege that Adams prepared or disseminated any of the allegedly false or misleading Fresh Choice documents.") (citations omitted); *In re* Ross Sys. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,363, at 90,496 (N.D. Cal. July 21, 1994) (dismissing general partners of venture capital firms that sat on the issuer's board); *Gupta Corp.*, 900 F. Supp. at 1241 ("These claims against Novell [and] Rekhi [a Novell Executive Vice President and a director of the issuer] . . . are simply conclusory allegations unsupported by assertions of specific day-to-day involvement in the management of [the issuer]. As such, the allegations are insufficient to bring Rekhi . . . and Novell, a minority shareholder, within the gambit [sic] of the group pleading doctrine."); *In re* Proxima Corp. Sec. Litig., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,236, at 99,623 (S.D. Cal. May 3, 1994) (holding "group pleading" not applicable to venture capital defendants who collectively owned over 50% of issuer's stock prior to IPO); *In re* Quarterdeck Office Sys., Inc. Sec. Litig., 854 F. Supp. 1466, 1474-75 (C.D. Cal. 1994) (granting motion for judgment on the pleadings because plaintiffs failed to allege that the venture capitalists were involved in the day-to-day operations of the issuer, despite plaintiffs' allegations that defendants saw reports prior to publication); *O'Sullivan*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 98,913 (dismissing both 9.5% stockholder and its representative on the board on basis that the stockholder was "not the largest shareholder of [the issuer]. Moreover, plaintiffs have alleged no facts to establish that [the representative on the board] has participated in the preparation and dissemination of the registration statement or other documents that contained alleged misrepresentations."); *In re* Jenny Craig Sec. Litig., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,337, at 95,724 (S.D. Cal. Dec. 19, 1992) (dismissing claims against two institutional investors with representatives on the board; "because each of the [representatives] was only a director of [the issuer] and only one of seven, and each of [the institutional investors] owned no more than four percent of [the issuer's] stock, compared with the Craigs' ownership of 61 to 75 percent, the rules of group pleading do not apply"); *In re* Genentech, Inc. Sec. Litig., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,544, at 93,482 (N.D. Cal. July 7, 1989) (dismissing minority shareholder even

President/Controller on the theory that these officers were a "narrowly defined group . . . who had direct involvement not only in the day-to-day affairs of Tandem in general but also in Tandem's financial statements in particular."[37] That second qualification—presumptive participation in the preparation of the offending communications—was critical. Particularly as plaintiffs work out from the core of top officers[38] to name as defendants virtually any officer who sold what plaintiffs consider to be a significant amount of stock during the class period, it becomes less and less likely that a named officer actually had any role in drafting or disseminating the misrepresentations. The day-to-day involvement test does not discriminate

though it had a representative on the board, because "stock ownership, without more, is manifestly not enough to establish direct involvement in corporate 'day-to-day' affairs"), *deciding motions for reconsideration and clarification on other matters*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,813 (N.D. Cal. Sept. 15, 1989). *But see* Pre-*GlenFed* cases: *National Health Labs.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,136 (denying motion to dismiss by corporate defendants after plaintiffs argued that group published information presumption applied, where each "had a controlling stock interest in [the issuer] and shared directors. These entities allegedly profited from the fraud by obtaining over a billion dollars through sale of . . . stock."); Klein v. King, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,609-10 (N.D. Cal. Mar. 26, 1990) (holding CEO of a 20% shareholder who sat on issuer's board was a proper "group pleading" defendant, and denying motion to dismiss his shareholding company). A recent case reaches a similar result. *See In re* Imperial Credit Indus., Inc. Sec. Litig., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,965, at 94,233 (C.D. Cal. Feb. 23, 2000) ("Plaintiff has adequately alleged that Snavely and Shugerman had a special relationship with SPF. ICI[I] owned approximately 47% of SPF's stock. SPF stated in its. . . . Form 10-K . . . that 'altough [sic] the percentage ownership by ICII is less than 50%, ICII will continue to be able to control the election of at least a majority of the . . . Board . . . and to determine all corporate actions for the foreseeable future.' Through its control of SPF, ICI[I] was able to elect its chairman, Wayne Snavely, as chairman of SPF's Board . . . , [and to elect] Shugerman to SPF's board. . . . [T]he sum of these factors . . . is that Snavely and Shugerman had a special relationship with SPF exceeding that of a typical outside director. As a result, Snavely and Shugerman are subject to the group published information doctrine for statements made by SPF.") (citation omitted).

37. Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987).

38. In some cases, it seems odd to presume that even all senior officers participated in drafting the asserted misstatements. *In re Marion Merrell Dow Inc., Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,776 (W.D. Mo. Oct. 4, 1993), concerned allegedly false statements assuming FDA approval of a prescription drug for over-the-counter use despite knowledge of adverse reactions by patients. The decision denies motions to dismiss by, among others: the Executive Vice President for Research and Development, who was also a director; the Executive Vice President, who was also the President of Marion Merrell Dow Research Institute and a director; the CFO, who was also a director; and the Vice President/Controller. *See id.* at 97,765-67, 97,773. The court reasoned that the "group publication" doctrine roped in all officers and directors alleged to "be in day-to-day control of the company's management or finances." *Id.* at 97,766. Although those involved in research might have known of the adverse reactions to the drug, absent discovery it seems less likely that the CFO and Controller knew and even less likely that they actively participated in drafting the press releases or other statements about the prospects for FDA approval for non-prescription use.

between those officers who had such a role and those who did not. All officers, simply by going to work, participate in the daily affairs of their companies.

District courts in the Ninth Circuit have veered in differing directions as they have applied "group pleading" to officers. Some decisions rely on a "functional relationship" between the officer's position and the nature of the alleged fraud.[39] Although this test narrows the circle of defendants somewhat, it does not focus on the purpose of the "group publication" protocol—to permit plaintiffs to name as defendants those who presumably *drafted* the misrepresentations. A vice president in charge of European sales would presumably make periodic reports to his superiors in a corporation and thus would have some "functional relationship" with any

39. *E.g.,* Smith v. Network Equip. Tech., Inc., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,659 (N.D. Cal. Oct. 19, 1990). In dismissing certain officers, the court found the plaintiffs' use of "group" allegations overbroad:

> Plaintiffs have used group pleading indiscriminately to reach every officer of [the issuer]. In essence, Plaintiffs argue that *Wool* allows group pleading against anyone denominated an officer without regard to the nature of the fraud alleged by Plaintiffs, or the functional connection between the activities of an individual defendant and the activities involved in the fraud. . . . [I]n the present case, Plaintiffs allege a fraudulent scheme involving marketing, accounting practices, and fraudulent releases of information. Plaintiffs do not allege any improper conduct involving the design or manufacture of [the issuer's] products. . . . [T]here is insufficient evidence to bring the following individual defendants within the *Wool* group: . . . Vice President and Chief Technical Officer; . . . Vice President of Operations; and . . . Vice President of Corporate Development. Defendants argue, and Plaintiffs do not dispute, that these three individuals are involved in the design and manufacture of [the issuer's] products. Thus, they are not connected with the scheme alleged by the Plaintiffs, and cannot be properly included in the 'group' covered by group pleading under *Wool.*

Id. at 98,093-94. *See also* Molinari v. Symantec Corp., No. C-97-20021-JW, 1998 WL 78120, at *11 (N.D. Cal. Feb. 17, 1998) ("In a company as large as Symantec, the status of officer or director is not enough in itself to establish involvement in the group 'functionally related' to the alleged fraud."); *Strassman,* 1995 WL 743728, at *14-*15 ("Plaintiffs assert that the group pleading doctrine also applies to insiders Wells and Sherwin [respectively the corporate secretary and vice president of human resources] by virtue of the fact that both are Fresh Choice officers who had access to internal corporate documents. The fact that an individual defendant is an officer of the corporation, even if he or she is involved in the day-to-day management of the company, is not enough to invoke the group pleading doctrine. Instead, the officer must have some functional relationship with the alleged fraudulent activity. . . . Nothing in the [amended complaint] suggests that Wells had any functional relationship with any of the alleged misrepresentations. . . . As for Sherwin, he is alleged to be vice-president of human resources. As such, Plaintiffs assert that Sherwin was acutely aware of Fresh Choice's lack of management personnel to control and support the Company's growth which Plaintiffs claim forms the basis of several misstatements. However, . . . all allegations concerning misrepresentations centering on Fresh Choice's lack of management have been dismissed with prejudice. Therefore, since there are no alleged misrepresentations remaining involving Sherwin as vice-president of human resources, the group pleading doctrine may not be invoked against him.") (citing *Smith,* [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,659) (citations omitted).

fraud concerning sales in Europe. It is not "presumably" true, however, that that vice president would have any role in the characterization of European results included in an annual report or a press release with quarterly financials. The vice president might be consulted, and arguably should be consulted. On the other hand, it could just as easily be argued that sales executives, who tend to be optimistic as a breed, have no necessary role in preparing Securities and Exchange Commission (SEC) filings, annual reports, and press releases. Whatever the proper practice should be, the probability that the vice president will draft or even review the portion of the report or release describing European operations is not so high that the vice president should be presumed to have authored any mischaracterization of European sales and so automatically be included as a defendant in a securities lawsuit based on such a misstatement.

Aside from employing the "functional relationship" test, some Ninth Circuit district courts have expanded or contracted the officers included within the "group" based on the size of the issuer and the geographic dispersion of its operations.[40] These opinions, however, place too much faith in the ability of a district judge, at the outset of a case and without the benefit of any discovery, to determine how a corporation works. For example, when a corporation is small and geographically concentrated, it may well be that all officers participate in the preparation of all significant public announcements. It is also possible, however, that the different officers in a developing company have very different strengths and may not even possess the qualifications normally associated with the formal positions they hold. They may delegate public disclosures to one or more of their number whose talents appear suitable to that task, regardless of title.

40. The court in *Smith*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,959, emphasized that "[i]n large corporations, with far-flung offices and divisions, the status of officer or director is not enough in itself to insure involvement in the group functionally related to the fraud." *Id.* at 98,093-94. *See also In re* USA Talks.com, Inc. Sec. Litig., Master File No. 99-CV-0162-L(JA), 2000 U.S. Dist. LEXIS 14823, at *11 (S.D. Cal. Sept. 14, 2000) ("Because the individual defendants are inside, controlling persons of USAT, a small company with only four full-time employees, and allegedly acted together with regard to other disclosures, the [complaint] need not draw a specific connection between every alleged misrepresentation and a particular defendant."); *In re* Aldus Sec. Litig., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,376, at 95,988 (W.D. Wash. Mar. 1, 1993) (dismissing defendant "because during the Class Period he presided over an Aldus subsidiary in Scotland, and thus could not have been connected with the alleged misrepresentations"); *In re* Epitope, Inc. Sec. Litig., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,263, at 95,188 (D. Or. Nov. 30, 1992) (refusing to exclude three vice presidents in part by distinguishing the company from Network Equipment: "Epitope is not a 'large corporation with far-flung offices and divisions,' but rather a local company which bases a substantial portion of its operations and future income on a single product . . . ."); *In re* U.S. Bioscience Sec. Litig., 806 F. Supp. 1197, 1203-04 (E.D. Pa. 1992) (relying primarily on Ninth Circuit cases to deny dismissal "because Bioscience is a relatively small start-up company with only forty people in the entire enterprise, each officer and director can be expected to bear more responsibility and have greater knowledge of the venture than an officer . . . in a large, well-established corporation").

Small companies may also lack corporate routines to ensure the circulation of draft public disclosures to all appropriate officers before publication. Indeed, such companies may be dominated by a single strong individual who does not involve others in important announcements. An assumption that all officers in smaller, geographically concentrated companies are within some "group" preparing all corporate disclosures ignores all these circumstances.

The best-reasoned lower court decisions require plaintiffs to plead facts showing that all officers named in the "group" were "directly" involved in creating or communicating the allegedly misleading publication.[41] This is the very test suggested by *Wool*—that the "group" should be "narrowly defined" and should have "direct" involvement in the challenged document.[42] It is also the test that focuses on the purpose of the presumption.

That test yields an important corollary: an officer can only be a member of a "group" when he or she is at the company. The pleading exception should not apply to officers who left a company before a statement was "group published" or who joined the company after that publication.[43]

41. *E.g., In re* Oak Tech. Sec. Litig., No. 96-20552 SW, 1997 WL 448168, at *11 (N.D. Cal. Aug. 1, 1997) ("To establish the liability of the vice president Defendants under the group pleading exception, Plaintiffs must satisfy a necessarily stricter requirement. Since all of the inside officers in a corporation, by virtue of their positions, are involved in daily corporate activities, merely pleading as much is not sufficient to establish their liability under the group pleading exception. To establish the liability of these Defendants for Oak's allegedly misleading statements, Plaintiffs must plead that these vice presidents were directly involved 'not only in the day-to-day affairs of [Oak] in general but also in [the preparation of its] financial statements in particular.' The existing Complaint does not allege that these Defendants participated in the preparation or communication of allegedly misleading information. Thus, Plaintiffs have failed to establish the liability of the vice president Defendants under the group pleading exception.") (quoting *Wool*, 818 F.2d 1433, 1440 (9th Cir. 1987)). The court in *In re Splash Technology Holdings, Inc. Sec. Litig.*, No. C99-00109 SBA, 2000 U.S. Dist. LEXIS 15369, at *82 (N.D. Cal. Sept. 29, 2000), recently followed *Oak*. *See also* Copperstone v. TCSI Corp., No. C 97-3495 SBA, 1999 U.S. Dist. LEXIS 20978, at *54 (N.D. Cal. Jan. 19, 1999) (granting motion to dismiss because, "[f]or corporate insiders, a plaintiff must plead that the Defendants were involved in the preparation of the allegedly misleading statements" in order to invoke group pleading, and the complaint did not allege any facts showing that "the inside directors were directly involved in the preparation of" the challenged representations).

42. *See Wool*, 818 F.2d at 1440.

43. In *Berry v. Valence Technology, Inc.*, 175 F.3d 699 (9th Cir. 1999), *cert. denied* 528 U.S. 1019 (1999), the court affirmed dismissal of the former CEO:

> Dawson resigned as Valence's CEO on April 30, 1993. The district court held that since Plaintiffs failed to specify the nature of Dawson's operational involvement in Valence after that date, they were not entitled to the 'group published information' presumption. Plaintiffs did allege in their Third Amended Complaint that Dawson remained Chairman of the Board until October 30, 1993. They also alleged that Dawson retained significant holdings in Valence after his resignation as CEO, and that he sold more than $30 million in stock in the months following. Plaintiffs did not, however, allege that Dawson had any operational involvement in Valence's day-to-day corporate activities. In fact, the Third Amended Complaint contains no allegations of how Dawson controlled or otherwise significantly influenced the alleged misstatements made by Valence

WHAT CORPORATE COMMUNICATIONS ARE "GROUP PUBLISHED"?

If the first task in applying *Wool* was identifying the individuals within the "group" doing the publishing, the second was identifying what that "group" "published." *Wool* itself referred to "prospectuses, registration statements, annual reports [and] press releases" but also referenced unspecified "other 'group-published information.'"[44] One decision held that "*Wool*'s relaxed pleading rule applies . . . only to publicly-held companies."[45] Other opinions apply the pleading protocol to a Confidential Information Memorandum, Offering Memorandum, and Merger Agreement in what appears to be a private stock sale;[46] and even to offer sheets given to retiring employees as part of an effort to repurchase their stock.[47]

District courts in the Ninth Circuit have limited the protocol, however, by determining that many communications are not "group published." They have not extended *Wool* to oral statements.[48] They do not apply the presumption to analysts' reports,[49] articles in the financial

> after his resignation. Thus, the district court properly dismissed the claims against Dawson to the extent they are based on alleged misstatements made after his resignation.

Id. at 706-07 (footnote omitted). *See also In re* PETsMART, Inc. Sec. Litig., 61 F. Supp. 2d 982, 998 (D. Ariz. 1999) (asking rhetorically: "Do plaintiffs mean to suggest . . . that Hansen had the opportunity and was motivated to inflate the price of stock for a convertible note offering which occurred five months after his departure? Or that Schnabel should be held responsible for optimistic statements made during 1996 even though she didn't arrive until February of 1997? . . . [Plaintiffs] cannot combine the group pleading doctrine with an allegation of a fraudulent scheme to avoid pleading critical details."); *Aldus*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,988 ("[D]efendants argue that all post-termination 10b-5 claims against [three former officers] must be dismissed as group pleading cannot extend past the dates they left Aldus. Plaintiffs . . . do not respond to this contention, and on this basis, all post-termination claims against [those three] are hereby DISMISSED.").

44. 818 F.2d at 1440.

45. Wanetick v. Mel's of Modesto, Inc., 811 F. Supp. 1402, 1405-06 n.1 (N.D. Cal. 1992).

46. *See* J.F. Lehman & Co., Inc. v. Treinen, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,046, at 94,869 (C.D. Cal. June 9, 2000).

47. *See* Walsh v. Emerson, Nos. 88-952-DA, 88-1367-DA, 1989 U.S. Dist. LEXIS 18289, at *9 (D. Or. Oct. 2, 1989) (comment made in context of evaluating ERISA claim).

48. *See* XOMA Corp. Sec. Litig., [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,491, at 92,161 (N.D. Cal. Dec. 27, 1991) ("[B]y its very nature the group pleading presumption does not apply to oral statements by individual defendants–only to *group published* information."). *See also* Krieger v. Gast, No. 4:99-CV-86, 2000 WL 288442, at *9 (W.D. Mich. Jan. 21, 2000) ("[B]ecause the presumption applies only to written documents, it encompasses statements or omissions in the Notice [of a shareholders meeting] but does not apply to the oral statements which Krieger alleges Warren Gast made at the shareholders meeting."); Schlagel v. Learning Tree Int'l., [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,403, at 91,815 (C.D. Cal. Dec. 23, 1998) ("The Court agrees that even before the PSLRA, the group publication doctrine could not be applied to oral statements. The PSLRA has only strengthened the requirement that allegations of oral misrepresentations be attributed to specific individuals rather than lumping defendants together.") (citations omitted); *In re* Interactive Network, Inc. Sec. Litig., 948 F. Supp. 917, 923 (N.D. Cal. 1996) ("[T]he group

publication doctrine cannot apply to oral statements. This is clearly true."); *In re* Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1128 (W.D. Mich. 1996) ("[T]he group pleading presumption does not apply to oral statements made by individual defendants."); *In re* Gupta Corp. Sec. Litig., 900 F. Supp. 1217, 1240 (N.D. Cal. 1994) ("[O]ral statements attributable to individual defendants are actionable, if at all, against only those defendants."); Hi/fn, Inc. Sec. Litig., No. C-99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *36 (N.D. Cal. Aug. 9, 2000); Copperstone v. TCSI Corp., No. C97-3495 SBA, 1999 U.S. Dist. LEXIS 20978, at *53 (N.D. Cal. Jan. 19, 1999); Pleasant Overseas Corp. v. Hajjar, No. C93-20197 RMW (EAI), 1993 U.S. Dist. LEXIS 20981, at *20-*21 (N.D. Cal. Nov. 18, 1992).

Some decisions, however, have included oral statements within the "group pleading" presumption. For example, in *LB Partners, L.P. v. Neutrogena Corp.*, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,913 (C.D. Cal. Aug. 9, 1995), the plaintiffs alleged that the CFO's statement that the company knew of no reason for the rise in stock price was false because the company was in negotiation for purchase by a larger company at an above-market price. The plaintiffs also alleged that the Vice President/Treasurer/Secretary deliberately directed inquiries to the CFO and that he and the CEO/Chairman "arranged for and authorized" the CFO to make his statement. *Id.* at 93,404. The court held that although in this case the CFO "made an oral statement, the Complaint sufficiently alleges that this was 'other "group published information"' under Wool." *Id.* at 93,405. *See also* Rolex Employees Retirement Trust v. Mentor Graphics Corp., 749 F. Supp. 1042, 1044 (D. Or. 1990) (denying motions to dismiss 10(b) claim against five officers where some of the challenged statements were oral—e.g., "Some people have us at $1.50 (a share for 1990), and we think that's aggressive in terms of the economy. Some have us at $1.10, which is rather conservative. . . . The $1.25-to-$1.30 range, I think that's the range we would feel more comfortable with.") (omission in original). Others suggest that, with the right pleading, oral statements could fall within *Wool.* For example, in *In re RasterOps Corp. Sec. Litig.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,231 (N.D. Cal. Apr. 20, 1994), the court stated, "it is not reasonable to presume that oral statements by individual defendants are the product of . . . collective efforts." *Id.* at 99,603. Here, the plaintiffs provided no facts to indicate that statements made at a technology conference attended by securities analysts and the press, or statements that an identified defendant made in announcing the promotion of a Vice President, were "the collective actions of the officers rather than the statement of an individual defendant." *Id.* "Absent such facts," the court held, "plaintiffs may not invoke the group pleading doctrine with respect to these oral statements." *Id.*

49. *See In re* Network Equip. Tech., Inc. Litig., 762 F. Supp. 1359, 1367 (N.D. Cal. 1991) ("[I]ndependently published statements by financial analysts are not 'group published information.'"). *See also RasterOps Corp.*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,603 (same); *In re* Ross Sys. Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,363, at 90,499 (N.D. Cal. July 21, 1994) ("[P]laintiff may not use group pleading to attribute third party financial analyst reports to individual defendants because such reports are not 'group published information.'"); Fisher v. Acuson Corp., No. C93-20477RMW (EAI), 1995 WL 261439, at *8 (N.D. Cal. Apr. 26, 1995) (same); Leonard v. NetFRAME Sys., Inc., [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,982, at 93,781 (N.D. Cal. Aug. 8, 1995) (same); *Pleasant Overseas Corp.*, 1993 U.S. Dist. LEXIS 20981, at *20; *Copperstone,* 1999 U.S. Dist. LEXIS 20978, at *53. At least some cases, however, hold out the possibility that analyst reports might be attributed to the corporate "group" if the analyst reports themselves were based on corporate "group" publications. For example, in *Gupta Corp.*, 900 F. Supp. 1217 (N.D. Cal. 1994), the court denied a motion to dismiss "group pleading" claims founded on analysts reports which were allegedly based on the company's published third and fourth quarter results. *See id.* at 1241. The court stated:

> In cases where the analyst reports are actionable against the defendant corporation, the central inquiry for determining whether the reports are also actionable as group pub-

press,[50] or transaction documents, such as leases.[51] Documents specifically attributed to individuals are also outside the protocol.[52] This is appropriate because *Wool* creates a pleading "presumption." Although it is possible that a CEO/President would seek review and comment from others on his message to shareholders in an annual report, it is far from certain that he or she would do so. The top executive may see the message as a personal statement—his one chance to tell all shareholders his view of the company's performance and his plans and vision for the future. Courts should not presume that such messages are a joint product of the executive cadre.[53]

> lished information is whether the source of the reports' information is group published information. Thus, analysts' reports based on financial statements and press releases which are actionable against the defendant corporation are also actionable as group published information. By contrast, analyst reports which are based on oral statements by identified individuals are not actionable as group published information, because the underlying oral statements are not group published information.

Id. at 1240. Also, in *Flecker v. Hollywood Entertainment Corp.*, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,436 (D. Or. Feb. 12, 1997), the court denied a motion for summary judgment because plaintiffs came forward "with evidence tending to show that the analysts' statements could fall within the group published exception to the preclusion of liability for third party forecasts." *Id.* at 96,860.

50. *See* Steiner v. Hale, 868 F. Supp. 284, 288 (S.D. Cal. 1994) ("[T]he court also rejects the plaintiff's request to extend the group publishing doctrine to the publication of newspaper, journal, and magazine articles. . . . The court finds the doctrine does not apply to newspaper or journal articles prepared by individuals not associated with the corporation. The defendants have no control over the reporters or what is ultimately contained within the article. Thus, the reasoning behind the doctrine, as interpreted by the Ninth Circuit, is not applicable to this situation."). As with analysts' reports, however, there is some authority for applying the presumption if the article is itself based on corporate group information. *See In re* Keegan Management Co. Sec. Litig., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,275, at 91,483 (N.D. Cal. Sept. 10, 1991) ("The only allegations which do not refer to group published information are those which relate the comments of market analysts in a financial newsletter and a business magazine. However, since these comments are actionable only to the extent that they are based on group published information, the presumption also applies to them.") (citation omitted).

51. *See* Benedict v. Cooperstock, 23 F. Supp. 2d 754, 762-63 (E.D. Mich. 1998) (relying primarily on Ninth Circuit cases to find that the "group pleading" doctrine did not apply to promissory notes, equipment leases, and service agreements delivered to individual plaintiffs as part of an alleged Ponzi scheme).

52. *See* Pegasus Holdings v. Veterinary Ctrs. of Am., Inc., 38 F. Supp. 2d 1158, 1165 (C.D. Cal. 1998) ("[W]ritten or oral statements made by an identified defendant cannot be classified as 'group published' information."). *See also* Molinari v. Symantec Corp., No. C-97-20021-JW, 1998 WL 78120, at *10 (N.D. Cal. Feb. 17, 1998) (stating, without limitation to oral presentations, that "[s]tatements made by an identified individual are not group published materials.").

53. *But see In re* Silicon Graphics, Inc. Sec. Litig., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325, at 95,965 (N.D. Cal. Sept. 25, 1996) (applying "group pleading" to a report to shareholders including a letter signed by the Chairman of the Board/CEO which contained allegedly misleading statements about shipment of a product).

Because some forms of corporate communication are not subject to "group pleading," plaintiffs must identify the form of a statement before they can take advantage of that protocol.[54] Even if plaintiffs adequately allege the substance of a communication, *Wool* cannot apply unless plaintiffs specifically plead the form and that form is among those which are "group published."

THE SECOND CIRCUIT VERSION: A TRIO OF PARTNERSHIP CASES SETTING OUT PRINCIPLES ALSO APPLICABLE TO CORPORATIONS

The Second Circuit developed its "group pleading" protocol in the context of limited partnership transactions, where organizers and promoters frequently create a welter of partnerships and corporations to conduct a business. There are three principal cases.

Luce v. Edelstein[55] was the first. The twenty plaintiffs had invested in a limited partnership which was to renovate buildings in New York City and convert them into condominium units for artists and art-related businesses. The thirteen defendants included the limited partnership itself, as well as two corporate general partners, four other corporations and a partnership which were affiliates of and allegedly controlled the corporate general partners (who were the affiliates' alleged alter egos), and five individuals who

54. *See* Autodesk, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,260, at 95,429 (N.D. Cal. Nov. 14, 2000) ("Nor do plaintiffs specify *which* of the allegedly misleading statements provide the basis for the application of the 'group published information' doctrine. The . . . doctrine applies to written documents originating with the company, such as press releases, prospectuses, and SEC filings. By definition, it does not apply to third-party reports, such as reports issued by analysts, transcripts of interviews with company officers or directors, or reports of oral representations made by officers or directors."); In *re* Sunrise Tech. Sec. Litig., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,042, at 94,585 (N.D. Cal. Sept. 22, 1992) ("By its very nature the group pleading presumption does not apply to oral statements by individual defendants. Therefore, plaintiffs must allege facts that establish that the allegedly misleading statements were, in fact, 'group published'. . . . [P]laintiffs' allegations consist almost entirely of statements that 'Sunrise announced' . . . . Plaintiffs never allege *where* the alleged misrepresentations appeared—i.e., were these 'announcements' made in a press release or some other presumptively group-published forum, or were they made in private conversation? . . . Absent such allegations . . . plaintiffs cannot employ the group pleading presumption."). *See also* Smith v. Network Equip. Tech., Inc., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,659, at 98,093 (N.D. Cal. Oct. 19, 1990) ("Paragraphs 34, 40-42, and 46 of the Amended Complaint allege unattributed misrepresentations which were communicated in unidentified forms to financial analysts and the press. These allegations fail to allege specifically *either* particular misrepresentations by identified defendants, *or* particular misrepresentations published through identified forms of group published information. Thus, these allegations are inadequate and are stricken from the complaint with leave to amend.").

55. 802 F.2d 49 (2d Cir. 1986).

were "past or present directors and officers" of the two corporate general partners.[56]

The district court denied a motion for a preliminary injunction, dismissed portions of the complaint on the basis of a forum selection clause, and dismissed other allegations for failure to plead fraud with sufficient particularity.[57] The Second Circuit affirmed denial of the preliminary injunction and enforcement of the forum selection clause but reversed in part the Rule 9(b) dismissal and remanded to permit plaintiffs to amend.[58] The court found that some of the alleged misrepresentations in the Offering Memorandum passed 9(b) muster: allegations that the general partners represented they would make capital contributions of $385,000 when they actually contributed approximately $80,000, and allegations that the cost of renovating the buildings would be $4,500,000 when liabilities for the still incomplete project already exceeded $10,200,000.[59]

In the course of the opinion, the Second Circuit spoke directly to the specificity with which the complaint had to tie each defendant to the fraud, noting that, "no specific connection between fraudulent representations in the Offering Memorandum and particular defendants is necessary where, as here, defendants are insiders or affiliates participating in the offer of the securities in question."[60]

This formula was broad and threatened to sweep into limited partnership cases virtually any company or individual who had anything to do with the proposed business at the time the limited partners bought their interests. The Second Circuit's second case recognized this problem and circumscribed the pleading rule.

In *DiVittorio v. Equidyne Extractive Industries, Inc.*,[61] plaintiffs had purchased interests in a limited partnership formed to obtain and exploit coal properties and oil leases. They sued everyone in sight: (i) the limited partnership itself; (ii) the corporate general partner and its parent; (iii) two affiliated corporations that were, respectively, a contract driller and a contract miner; (iv) an affiliated corporation that sublet properties to the partnership; (v) a subsidiary of the corporate parent of the general partner that served as the manager and syndicator of the parent's real estate interests (the manager/syndicator); (vi) the current vice president of the corporate general partner; (vii) a former vice president of the corporate general partner; (viii) a director of the corporate parent of the general partner and director of the manager/syndicator who was a past or present officer of the general partner's parent and the manager/syndicator; (ix) a controlling shareholder and president of the general partner's parent who was also

56. *Id.* at 52.
57. *Id.* at 51.
58. *Id.*
59. *Id.* at 55.
60. *Id.*
61. 822 F.2d 1242 (2d Cir. 1987).

president of the general partner, and the secretary-treasurer and a director of the manager/syndicator; (x) a law firm; (xi) an accounting firm and one of its partners; and (xii) a contract driller that was not owned directly or indirectly by the corporate general partner or its parent. The district court dismissed for failure to comply with Rule 9(b).[62]

The Second Circuit reversed as to the limited partnership, the corporation that was the general partner, and the corporate parent of that general partner.[63] The court of appeals affirmed, however, as to all other defendants:

> The amended complaint identifies Eastern only as an "affiliate of the General Partner, and the Contract Miner for the Partnership's coal properties"; EDC as "an affiliate of the General Partner, and the co-contracting driller . . . for the development of the Partnership's oil properties"; Eastland as "an affiliate of the General Partner, which . . . sublet coal properties to the Partnership"; and Properties as "a subsidiary of Equidyne . . . [which] serves as a manager and syndicator of Equidyne real estate investments". These allegations are inadequate to charge these defendants with liability for misrepresentations in the Offering Memorandum.
>
> None of the individual Equidyne defendants, Ross, Beeler, Rock and Liebmann, is tied to the Offering Memorandum in any specific way, or even alleged to have been an officer or director of any non-individual Equidyne defendant when the Offering Memorandum was issued or the specified class of plaintiffs bought their limited partnership interests.[64]

As to the law firm defendant, the accountant defendants, and the drilling company that was not owned by the partnership's organizer, the court found no allegations "sufficient to describe any of them as insiders or affiliates," or "linking any of them in any specific way to any fraudulent misrepresentation or omission," and therefore affirmed their dismissal.[65]

Ouaknine v. MacFarlane[66] completes the trio of principal Second Circuit cases. In *Ouaknine*, plaintiff bought stock in a company that put the money into a partnership between that company and MacFarlane Perry Company. MacFarlane Development Company was a contractor for the underlying business project—renovation and sale of cooperative apartments in New York City. Plaintiff alleged misrepresentations in the offering memorandum for the stock and the limited partnership agreement, which plaintiff saw before buying the stock. Plaintiff sued the partnership, MacFarlane

62. *Id.* at 1244.
63. *Id.* at 1249.
64. *Id.* at 1248-49 (citations omitted).
65. *Id.* at 1249.
66. 897 F.2d 75 (2d Cir. 1990).

Perry, MacFarlane Development, and two individuals: Robert MacFarlane, who appeared to be the organizer of the venture, and an accountant who worked for MacFarlane and who allegedly induced plaintiff to agree to the sale of stock in yet another corporation. The district court dismissed.

The Second Circuit reversed in part, holding that all of the defendants were properly named on the securities claim, except MacFarlane Development.[67] The court characterized *DiVittorio* as holding that "allegations merely that [a] defendant is an affiliate and contracted to perform work are insufficient to link [the] affiliate with representations in [an] offering memorandum."[68]

Luce and *DiVittorio* were limited partnership cases. Although the plaintiff in *Ouaknine* had purchased stock, the proceeds of his investment were then transferred to a partnership. It was clear, nevertheless, that the Second Circuit would apply this trio of "group pleading" decisions to corporations. In making its "group pleading" holding, *Luce* cited to two district court cases,[69] both of which involved alleged corporate wrongdoing: *Somerville v. Major Exploration, Inc.*,[70] denying a motion to dismiss and holding that "for the most part, plaintiff's allegations with respect to these defendants involve misstatements or omissions in documents—annual reports, financial statements—that may be presumed to entail the collective actions of the directors, officers, and the accountant, in some cases";[71] and *Pellman v. Cinerama, Inc.*,[72] denying a motion to dismiss on facts involving an allegedly false proxy statement and observing that the "defendants here are all insiders . . . and numerous courts have held that the conduct of such individuals need not be specified if the complaint sufficiently describes the fraudulent acts and provides the individuals with sufficient information to answer."[73]

Moreover, although not part of the trio discussed above, *Cosmas v. Hassett*[74] confronted exclusively corporate facts and seemed to apply "group pleading" in that setting. *Cosmas* vacated dismissal of a lawsuit against eight directors brought by a securities purchaser alleging misleading statements by one officer/director in a magazine article and misleading statements in an annual report, a 10-K, and press releases. One defendant "signed the 1985 Annual Report and the 1985 10K, and, according to the amended complaint, the other defendants read these documents before they were issued."[75] The court found that the complaint "adequately identifies the

67. *Id.* at 84.
68. *Id.* at 80.
69. Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986).
70. 576 F. Supp. 902 (S.D.N.Y. 1983).
71. *Id.* at 911.
72. 503 F. Supp. 107 (S.D.N.Y. 1980).
73. *Id.* at 111.
74. 886 F.2d 8 (2d Cir. 1989).
75. *Id.* at 10.

defendants as those responsible for the statements."[76] Oddly, although decided after both *Luce* and *DiVittorio*, *Cosmas* cites to neither.[77]

ELABORATION OF THE SECOND CIRCUIT RULE

The Second Circuit "group pleading" protocol raised the same two questions as the Ninth Circuit protocol: (i) to which defendants did the "group pleading" exception apply (in this case, what entities and individuals were included within *Luce*'s "insiders and affiliates"); and (ii) to what communications did the exception apply. Because the Second Circuit's cases include so many cases decided in the limited partnership context, this Article will address these questions first there and then in the corporate setting.

TO WHAT DEFENDANTS DOES THE LUCE *EXCEPTION APPLY IN LIMITED PARTNERSHIP CASES?*

In the limited partnership context, the *Luce* exception to the general rule that a complaint must connect specific misstatements with particular defendants waives that pleading requirement for the "individuals who organized, promoted and/or managed the . . . partnerships and the affiliated corporations controlled by these individuals."[78] The "insider or affiliated" entity defendants typically include the general partners, managing companies, and corporations or partnerships actually involved in the sale of the limited partnership interests.[79]

76. *Id.* at 12 (citation omitted).

77. Only a few cases cite *Cosmas* as "group pleading" authority. *See, e.g.*, Benedict v. Amaducci, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,830, at 93,010 (S.D.N.Y. July 11, 1995).

78. Hayden v. Feldman, 753 F. Supp. 116, 117 (S.D.N.Y. 1990) (citation omitted). *See also* Parnes v. Mast Property Investors, Inc., 776 F. Supp. 792, 795 (S.D.N.Y. 1991) (finding that *Luce* applied to individual defendants who were officers of the corporate promoter of the limited partnerships in a case where plaintiff alleged that defendants participated in or directed the writing and distribution of the offering memoranda).

79. The definition is elastic. *See* ESI Montgomery County, Inc. v. Montenay Int'l Corp., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,345, at 96,100 (S.D.N.Y. Jan. 23, 1996). The court applied the *Luce* exception to MERMCI which was a wholly owned subsidiary of MIC, and a general partner in the limited partnership in which plaintiff ESI bought an interest. MIC retained a 28% interest in the partnership through its related entities. MMT was a common law trust created for the benefit of MIC and its affiliated companies, and was also a limited partner. The court found that the *Luce* exception applied to MERMCI, holding:

> MERMCI is an indirect subsidiary of defendant MIC and therefore is an affiliate of MIC. MIC agreed with defendant MMT that MMT would sell a portion of MMT's interest in the partnership to ESI. Thus, MERMCI is an affiliate in the sale offer for an interest in the Partnership. Moreover, while the *DiVittorio* court found that the *Luce* rule did not help the complaint overcome its defective particularity because the complaint *solely* identified the parties at issue as affiliates, ESI has described that:

Some limitations to the group of "insiders and affiliates" are well established. Lawyers and accountants who perform traditional, professional roles in preparing offering documents are not within the group.[80] Nor are

> (1) MERMCI contributed its assets to the Partnership; (2) MERMCI became and remained a general partner in the Partnership; and, (3) that plaintiff, MERMCI, MMIC and MMGP executed an agreement specifying their respective partnership interests. Thus, the complaint sufficiently alleges MERMCI to be an affiliate.

Id. at 96,100 (citations omitted). *See also* Boley v. Pineloch Assocs., Ltd., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,407, at 97,001 (S.D.N.Y. Aug. 2, 1990) (pleading exception applicable to CCL-Associates and CCL-Cornerstone, "[p]laintiffs allege that CCL-Associates, and by implication its general partner, CCL-Cornerstone, participated as insiders in the fraudulent preparation of the Memorandum. . . . Plaintiffs refer to the facts that CCL-Associates is the administrative general partner of Pineloch and received fees in connection with its organization, and that typically an administrative general partner is responsible for the preparation of placement memoranda and circulation to underwriters. They also refer to Moran's report [Moran was a general partner who had provided an affidavit to the Bankruptcy Court] of involvement by 'Cornerstone . . . ' in the preparation and review of the Memorandum.").

80. *See* DiVittorio v. Equidyne Extractive Indus., Inc., 822 F.2d 1242, 1249 (2d Cir. 1987) (finding attorney and accountant defendants outside the *Luce* group). Also, in *Morin v. Trupin*, 809 F. Supp. 1081 (S.D.N.Y. 1993), the court found that

> [a]lthough partners and principals in partnerships are insiders, and affiliates, controlling stockholders, officers and directors of partnerships are insiders . . . [o]utside attorneys and accountants will not be considered controlling persons unless they have influence over the day-to-day operations of the offering entity. Here, in contrast to earlier pleadings, the Plaintiffs allege that the professional defendants are insiders, who knowingly and consciously participated in the scheme to defraud. The Plaintiffs must therefore allege some form of immediate control over operations, or else plead sufficient connections between these defendants and the certain allegedly misleading statements which can be ascribed specifically to them to meet the particularity requirements of Rule 9(b).

Id. at 1087 (citation omitted). The court then granted leave to file an amended complaint against attorneys and accountants because plaintiffs had alleged their connection to specific misrepresentations. *Id.* at 1090. In *Morin v. Trupin*, 778 F. Supp. 711 (S.D.N.Y. 1991), the plaintiffs alleged that an attorney (Abrams), who was the in-house counsel for the entities involved in the syndication, "participated" in drafting certain sections of the Private Placement Memorandum and "supervis[ed] and direct[ed]" an outside law firm in connection with the offering materials, but did not allege that any false statements appeared in the sections that Abrams drafted himself. *Id.* at 718. The court held that the attorney was not an insider and that the complaint did "not adequately plead a connection between Abrams and [the allegedly misleading] statements." *Id.* In another case, *Stevens v. Equidyne Extractive Indus. 1980*, 694 F. Supp. 1057 (S.D.N.Y. 1988), the court found that, "[s]ince [counsel] in drafting the offering memorandum was acting not on its own behalf but on that of the Equidyne defendants, it is not a corporate insider and therefore the relaxed standards of pleading with respect to who said what do not apply." *Id.* at 1062. The court also held the accounting firm was "not an insider but in effect an independent contractor" and therefore "cannot be held for general statements in the Offering Memorandum not specifically attributed to it." *Id.* at 1063. Continuing, the court found accountants were answerable for representations of tax benefits in Pro Forma Financial Illustrations that they prepared, but the illustrations were accompanied with sufficient cautionary language that the accountants were independent brokerage firms that market partnership interests,[81] companies that provide contract service to a partnership's business,[82] or consultants to a partnership.[83] Some decisions also import the "day-to-day" in-

dismissed. *Id.* at 1064. *See also* Friedman v. Arizona World Nurseries Ltd. Partnership, 730 F. Supp. 521, 531 (S.D.N.Y. 1990), *aff'd*, 927 F.2d 594 (2d Cir. 1991) (unpublished table decision) (noting authority "for the proposition that where counsel drafted the offering memorandum and were acting on behalf of the general partner, they are not, without more, corporate insiders or affiliates to whom the relaxed pleadings standards are applicable. . . . [T]hey are not ordinarily liable for the general statements in the offering memorandum but rather plaintiffs must specifically attribute misstatements or omissions to them.") (citation omitted); Klein v. Churchill Coal Corp., Nos. 84CIV.6509 (WK), 1988 WL 92114, at *10 (S.D.N.Y. May 5, 1988) ("In a securities fraud suit arising out of the sale of limited partnerships, 'insider' status generally extends to the general partner and to affiliates involved in preparation of the offering memoranda, but not, in the absence of special circumstances, to the law and accounting firms who assist in such preparations.").

81. *See* Pahmer v. Greenberg, 926 F. Supp. 287, 308 ("Because [the broker/dealer defendant] was not an insider and because the complaint does not allege any specific facts indicating that [the defendant] attained insider status, the claims against it for securities fraud are not subject to relaxed Rule 9(b) pleading standards."), *aff'd sub nom*, Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997); Eickhorst v. American Completion and Dev. Corp., 706 F. Supp. 1087, 1092-93 (S.D.N.Y. 1989) (dismissing national brokerage firm acting as selling agent for limited partnership interests and holding, "[m]ere conclusory allegations of insider status . . . without accompanying facts which tie a defendant to the offering materials in a specific way, will not suffice to obviate the need to specify each defendant's connection with the alleged fraudulent acts. . . . There are no allegations that Hutton had any role in preparing the prospectus or the brochure describing [the limited partnership]. Moreover, no facts are presented to support the allegation that Hutton was closely involved with the activities of [the limited partnership] or the other defendants, or that Hutton actually stood in the position of an insider with relation to the sale of the interests . . . Plaintiffs . . . allege that a 'close association' existed among [two of the individual defendants] and certain unidentified members of Hutton's 'top management'. . . . Nowhere in the complaint, however, is the factual basis set forth for this conclusion. Likewise, plaintiffs offer no source of facts for their assertion that these unidentified members of the 'top management' at Hutton 'pushed' the sale of the [limited partnership] interests because [the two individual defendants] 'were friends and/or close associates of members of Hutton's top management'. . . . There are simply no facts presented to warrant an inference that a close relationship or friendship actually existed, or to ascertain what individuals might have been involved in such a relationship and if they pushed the sale of the [limited partnership] interests. Such conclusory allegations are insufficient to establish Hutton as an insider."). *See also* Boley v. Pineloch Assocs., Ltd., 700 F. Supp. 673, 678 (S.D.N.Y. 1988) ("PaineWebber is not an insider or an affiliate; thus, some basis for its alleged role must be stated.").

82. *See DiVittorio*, 822 F.2d at 1248-49 (finding an affiliated mining company (Eastern), an affiliated drilling company (EDC), and an unaffiliated drilling company (Inland) not insiders in case where limited partnership sought to exploit coal and oil leases); Chamarac Properties, Inc. v. Pike, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,802, at 97,950 n.2 (S.D.N.Y. Oct. 19, 1993) (holding that plaintiff could not use "group pleading" against a company that managed properties beneficially owned by certain partnerships in which plaintiff's limited partnership owned interests).

83. The court in *Morin*, 809 F. Supp. 1081 (S.D.N.Y. 1993), found that an outside adviser (Continental) and its president (Organek) were not insiders for purposes of a private placement memorandum. *Id.* at 1095. The court wrote:

volvement concept, or something similar, in order to limit the circle of individuals who can fall within the *Luce* exception.[84]

The line describing the circle of "insiders and affiliates," however, is ill-defined. The courts have provided no formal definition of these terms.[85] Moreover, *DiVittorio* left the status of "affiliates," however they might be defined, so unclear that one court wrote: "to be charged with lia-

> The Plaintiffs allege that the Offering Materials disclosed that Continental advised the Rothschild Group between 1983 and 1987 in connection with approximately 18 real estate syndications, including the Sacramento Associates Offering, involving 13 commercial real estate properties. They allege that Organek was more of an insider than either the [accountants] or [the attorneys], and that his sole employer was Trupin [the man who founded and controlled the Rothschild Group]. Organek's duties in the Trupin hierarchy, they allege, included locating real estate to be syndicated; acquiring these properties for the Rothschild Group; negotiating the acquisitions; structuring the transactions and financing the acquisition of the properties; obtaining loans for the acquisition of these properties; financial restructuring when syndication revenues did not generate sufficient funds; conducting the Rothschild Group's due diligence investigation preceding the acquisition of the properties; and obtaining and reviewing real estate information regarding the syndicated properties for inclusion in the relevant private placement memorandum.

Id. at 1094. The court then stated, "[t]hese allegations of [Continental's and its president's] activity to promote the interests of the syndication are still too insufficiently particular to link either to the preparation of the PPM or the sale of the partnership interests." *Id.* The court nevertheless permitted plaintiffs to file their amended complaint against Continental and Organek based on an alleged misrepresentation of a brokerage fee in the PPM. *Id.* at 1100.

On reconsideration, the court reversed and found that no claim could be made against Continental and Organek:

> The Plaintiffs have presented no evidence that Organek actually knew, or culpably refused to see, how the fees were being characterized in the Sacramento PPM. Without providing more to demonstrate Organek's "insider" status, his inaction will not make him liable. . . . [T]he Plaintiffs do allege that Organek participated in the day-to-day operations of Sacramento Associates. . . . [T]hese general allegations . . . are insufficient to survive Rule 9(b).

Morin v. Trupin, 823 F. Supp. 201, 206 (S.D.N.Y. 1993).

84. For example, in *Andrews v. Fitzgerald*, 823 F. Supp. 356 (M.D.N.C. 1993), the court found that the "[p]laintiffs have sufficiently pled facts of insider status and day-to-day involvement as to the Fitzgerald defendants so that Plaintiffs can take advantage of . . . *Wool* and *Luce*." *Id.* at 374. Securities claims against an officer and director and one-third owner of the other corporate general partner—KPWIC–were dismissed, however, because "[u]nlike other Defendants who allegedly worked with the *managing* general partner . . . and were involved in the Partnership's day-to-day affairs, or, like KPWIC, served as a general partner of the Partnership, there is no such 'tie-in' for [this individual defendant]." *Id.* at 374-75 (emphasis in original). *See also* Bruce v. Martin, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,964, at 94,118 (S.D.N.Y. Aug. 13, 1992) (granting motion to dismiss by director and member of two-man Finance Committee of corporate general partner because there were no allegations that he participated in the management of the corporate general partner or of the limited partnerships).

85. For example, research finds no decision tying the definition of an "affiliate" under *Luce* to the definition of "affiliate" in the securities regulations. *See* 17 C.F.R. § 230.144(a)(1) (2000).

bility for misrepresentations, an affiliate must . . . be tied to the offering memorandum in some, *albeit non-specific,* way . . . ."[86]

TO WHAT COMMUNICATIONS DOES THE LUCE *EXCEPTION APPLY IN LIMITED PARTNERSHIP CASES?*

The *Luce* court carved out its pleading exception for "representations in the Offering Memorandum."[87] As to other representations, however, *Luce* sustained the argument that the complaint failed to connect particular statements to specific defendants:

> [P]aragraph 68 of the complaint alleges: "During the course of the project, defendants continually misrepresented to the plaintiffs and the class the cost, status and expected completion date of the project." Paragraph 84 alleges: "Upon information and belief, defendants made oral and written representations to plaintiffs and the class regarding their returns on investment and cash and tax benefits apart from the Offering Memorandum. These further representations occurred, upon information and belief, both before the Closing and thereafter in connection with further solicitation of limited partners." Such allegations, which fail to specify the time, place, *speaker,* and sometimes even the content of the alleged misrepresentations, lack the "particulars" required by Rule 9(b).[88]

DiVittorio also dealt with an offering memorandum, although at one point it referred to "an offering memorandum or similar document . . . ."[89] The *Ouaknine* plaintiffs alleged misrepresentations in an offering memorandum and a related partnership agreement, and the decision appears to apply *Luce* to both.[90] In other limited partnership cases, lower courts in the Second Circuit have been somewhat reluctant to extend *Luce* beyond offering documents.[91]

86. Morin v. Trupin, 747 F. Supp. 1051, 1061 (S.D.N.Y. 1990) (emphasis added). The case of *Adler v. Berg Harmon Assocs.,* 816 F. Supp. 919 (S.D.N.Y. 1993), is an example of how elastic the "insiders and affiliates" concept can be. It ruled that two companies were "insiders" where one of them was the parent (and the other the parent of the parent) of a company which was, in turn, one of two joint venturers in a joint venture that promoted and syndicated the limited partnerships. *Id.* at 928. These companies were sufficiently connected with the private placement memoranda by the actions of an individual defendant who was an officer of each of the two companies and also president of the joint venture. *Id.*

87. Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986).

88. *Id.* at 54 (emphasis added) (footnote omitted).

89. DiVittorio v. Equidyne Extractive Indus., Inc., 922 F.2d 1242, 1248 (2d Cir. 1987).

90. Ouaknine v. MacFarlane, 897 F.2d 75, 80 (2d Cir. 1990).

91. For example, in *Morin,* the court found that "to the extent [plaintiffs] concededly rely upon nonparticularized oral representations or written statements extrinsic to the offering memoranda . . . [such as marketing literature and projections and oral sales pitches], plaintiffs are obligated under Rule 9(b) to give the specific defendants charged with such communicative acts more specific notice . . . [and observe] the obligation to specify the factual basis

TO WHAT DEFENDANTS DOES THE LUCE *EXCEPTION APPLY WHEN A CORPORATION IS THE ISSUER?*

Unlike the Ninth Circuit, the Second Circuit has not addressed in any studied way the reach of "group pleading" in cases where plaintiffs bought securities issued by corporations. With its principal cases authored in the comparatively free-form world of limited partnership deals, it is small wonder that district courts applying those precedents to corporations have reached differing conclusions, particularly as to which entities and individuals may be embraced within the "insiders and affiliates" that constitute the Second Circuit's "group."

The decisions addressing whether directors are within the "group" illustrate the point. *Somerville*, *Pellman*, and *Cosmas*—all early decisions—seem to treat directors the same as officers (as "insiders"), without any effort to identify outside directors and analyze separately the wisdom of applying the "group" exception to them.[92] Although some later opinions hold that

for holding a particular defendand responsible for a particular act . . . ." 747 F. Supp. at 1061-62. In another case, *Dymm v. Cahill*, 730 F. Supp. 1245 (S.D.N.Y. 1990), the court held that the plaintiff did "not allege that the misrepresentations were conveyed through an offering memorandum; in fact, he asserts that '[n]o offering memorandum . . . was provided . . . .' Therefore, he must provide each defendant with sufficient notice of that defendant's part in the fraud . . . ." *Id.* at 1250-51 (citation omitted). In *Tobias v. First City National Bank and Trust Co.*, 709 F. Supp. 1266 (S.D.N.Y. 1989), the court determined that the plaintiff could not take advantage of the *Luce* rule where misrepresentations were "ascribed to either the private placement memorandum or oral statements, or both." *Id.* at 1277. But, see *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,345 (S.D.N.Y. Jan. 22, 1996), where the court held, "[plaintiff] does not have to allege that [defendant deemed to be an 'affiliate' within the meaning of *Luce*] prepared or caused the preparation of the Confidential Investment Memoranda or the Representations [outside the Memoranda] provided to [plaintiff] prior to purchase." *Id.* at 96,101. The representations outside the Memoranda were included in schedules of sources and uses and in other statements repeated both orally and in writing. The court noted that "the Second Circuit in *DiVittorio* expressly included 'similar documents' as within the exception applicable to an offering memorandum with the caveat that both categories of documents must then satisfy certain criteria in order for the exception to be applicable." *Id.* at 96,100 n.5.

92. *See, e.g.*, Cosmas v. Hassett, 886 F.2d 8, 10 (2d Cir. 1989) (reporting that "the eight named defendants were directors of [the issuer]" and later further identifying one of them as the CEO); Somerville v. Major Exploration, Inc., 576 F. Supp. 902, 911 (S.D.N.Y. 1983) (holding that documents such as "annual reports, financial statements . . . may be presumed to entail the collective actions of the *directors*, officers and the accountant, in some cases.") (emphasis added) (citation omitted); Pellman v. Cinerama, Inc., 503 F. Supp. 107, 108, 111 (S.D.N.Y. 1980) (identifying defendants as "various officers, *directors*, and controlling shareholders of Cinerama," and stating that "[t]he defendants here are all insiders . . . .") (emphasis added). *See also* Friedman v. Treasure Island N.V., No. 99Civ.2882 (PKL), 1992 WL 111371, at *6 (S.D.N.Y. May 4, 1992) (holding nine directors in without any discussion of which were inside and which were outside); Quantum Overseas, N.V. v. Touche Ross & Co., 663 F. Supp. 658, 667-68 (S.D.N.Y. 1987) (finding plaintiff qualified for *Luce* exception by pleading that the individual defendants were "officers and/or directors [of the issuer and] were able to and did control the content of [the issuer's] public statements [and] SEC filings during the class period and of a Prospectus dated September 14, 1984 . . . .").

outside directors are not within the *Luce* circle,[93] a number of district courts have found circumstances such as serving on a committee or signing a document to forfeit "outsider" status even for directors who do not hold an office in the corporation.[94] There is no clear distinction like the "day-

93. For instance, in *Fisk v. Superannuities, Inc.*, 927 F. Supp. 718 (S.D.N.Y. 1996), the court distinguished in dicta "outside directors," among others, from the "insiders" who need not be particularly connected to misstatements. *Id.* at 727-28. In *Bank of Vermont v. Lyndonville Savings Bank & Trust Co.*, 906 F. Supp. 221 (D. Vt. 1995), the court held that where a complaint identified four defendants as "directors and employees" but gave "no indication whether these defendants held additional management positions or owned large shares of corporate stock," they would be treated "as outside directors. As a result, [the] complaint must connect the allegations of fraud to these particular defendants." *Id.* at 226. In *Klein v. Goetzmann*, 770 F. Supp. 78 (N.D.N.Y. 1991), the court found that outside directors, including those on an Audit Committee and who signed the 10-K and allegedly signed an Annual Report were not "insiders" for "group pleading." *See id.* at 81-82. In *Thornock v. Kinderhill Corp.*, 712 F. Supp. 1123 (S.D.N.Y. 1989), the plaintiffs bought limited partnership interests, and Kinderhill Corporation was a general partner. The court found:

> The Complaint does not allege that the outside directors [of Kinderhill] made any misrepresentations or omissions. The alleged misrepresentations were contained solely in the private placement memoranda and other documents "distributed by the Kinderhill defendants" generally without differentiation among defendants. There are no allegations that the outside directors participated in the management of Kinderhill or of partnerships named as defendants in this action.

Id. at 1128-29 (footnote omitted). Continuing, the court noted:

> Although it is true that where defendants are insiders or affiliates participating in an offer of securities, "no specific connection between fraudulent representations in [an] Offering Memorandum and particular defendants is necessary," plaintiffs have cited no such rule where the defendants were outside directors who are not alleged to have participated in the offer of securities in question, and where no facts allege the contrary.

Id. at 1129 (citation omitted).

94. More specifically, in *In re Livent, Inc. Sec. Litig.*, 78 F. Supp. 2d 194 (S.D.N.Y. 1999), the outside directors moved to dismiss because the complaint did not make specific allegations of wrongdoing by the defendants. As the court explained,

> [p]laintiffs contend, however, that the Complaint meets the particularity requirement by alleging that the Outside Directors, as members of the Audit Committee, were responsible for reviewing Livent's reporting procedures, internal controls, and management information systems, and the performance of [the auditor], and primarily responsible for reviewing the unaudited quarterly financials. The Complaint also alleges that the Outside Directors failed to investigate, or ignored, the "red flags" signaling the fraud.

Id. at 219. The court found that "[t]he Outside Directors are alleged to have been reckless in not discovering such schemes and in participating in the approval and dissemination of the misstatements in the documents filed with the SEC. The particularity with which the 'red flags' are alleged, combined with the group pleading doctrine, meets the 9(b) standard." *Id.* In *Greenfield v. Professional Care*, 677 F. Supp. 110 (E.D.N.Y. 1987), the plaintiffs alleged that three individual defendants "served as members of [the issuer's] audit committee, in which capacity they were responsible for monitoring [the issuer's] internal and external audit functions, control systems, financial accounting and reporting, and adherence to applicable legal, ethical and regulatory requirements." *Id.* at 114-15 (citation omitted). "[T]he complaint to-day involvement" test in the Ninth Circuit, and non-officer directors are at considerably more risk of being "group pleaded" into a case in New York than in California.

Lawyers, accountants, and independent broker/dealers, on the other hand, are generally not "insiders or affiliates" for *Luce* purposes in a corporate setting any more than they are in the limited partnership context.[95]

charges that each of these defendants signed an amended registration statement on May 30, 1995, and a Form 10K on January 9, 1986, after the corporation was informed of New York State's investigation and after the Albany office director informed [the issuer's] corporate counsel of the ongoing fraud." *Id.* at 115. The court held that "[w]hile there is some dispute as to whether these defendants should be treated as insiders or outsiders, on the facts pleaded these defendants appear to be much closer to the position of an inside director than they are to that of a typical outside director." *Id. See, e.g.*, Hallet v. Li & Fung, Ltd., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,318, at 95,909-10 (S.D.N.Y. Aug. 23, 1996) (denying motion to dismiss by defendant Hsieh and stating, "[a]lthough Hsieh was an outside director, he sat on the board to represent Cyrk's largest shareholder, Li & Fung BVI. The complaint alleges that, in addition to being Cyrk's largest shareholder, Li & Fung receives more than $2 million in fees for locating manufacturers in Asia for Cyrk's promotional products. The complaint also alleges that Hsieh sat on Cyrk board committees and had access to Cyrk's internal forecasts, budgets and plans. Plaintiff claims that Hsieh regularly reported to Li & Fung about Cyrk's business, plans, and future prospects. Each of the defendants is alleged to have signed [the] Registration Statement, to have had power and influence over Cyrk, and to have caused it to engage in illegal practices. Furthermore, Li & Fung BVI sold all of its shares of Cyrk during the class period. Li & Fung BVI is specifically charged in the complaint with having orchestrated, with Cyrk's 'top officers,' a publicity campaign in order to keep stock prices high until they sold their shares. The complaint also specifically alleges that 'Cyrk's insiders and largest shareholder worked closely with Montgomery Securities,' Cyrk's underwriter, to accomplish the fraudulent scheme. The facts as pleaded support the reasonable inference that Hsieh participated in the allegedly fraudulent representations and was aware of the adverse information . . . alleged to contradict those optimistic representations. In short, the allegations support the inference that Hsieh is more akin to a corporate insider than an outside director.") (footnotes and citations omitted); MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 979-80 (E.D.N.Y. 1995) (denying motion to dismiss by two members of audit committee by noting, "[defendants] argue that they are 'outsiders,' . . . I find these arguments unconvincing . . . . [These defendants] are alleged to have signed prospectuses containing materially false and misleading information. Moreover, [they] together constituted the Audit Committee--a committee charged with the responsibility of overseeing the work of [the auditor] . . . [P]laintiffs' allegations . . . reveal fraud, theft of securities and the fabrication of financial information by senior management at [the issuer]. In short, the complaint alleges massive accounting fraud during the class period. Considering that [the two defendants] were charged with overseeing the conduct of [the issuer's] accountants[,] I would conclude that the complaint satisfies . . . Rule 9(b), even if the allegations against them were limited to their status at [the issuer] and their signing of fraudulent prospectuses.") (footnote omitted); Kimmel v. Labenski, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,651, at 97,990 (S.D.N.Y. Feb. 9, 1988) (finding that *Luce* insiders or affiliates "arguably" included three outside directors who signed 10K).

95. *See Fisk*, 927 F. Supp. at 727-28 (distinguishing "lawyers [and] accountants," among others, from *Luce* "insiders"). There is no reason that attorneys and accountants should be "insiders" in the corporate context if they are not in the limited partnership setting, and the cases in note 80 *supra*, should apply to attorneys and accountants engaged to represent corporations.

Nor is a commercial bank providing some of the financing for a project.[96] Large shareholders of an allegedly offending issuer generally should not be "group pleaded" into a case under Second Circuit law. One decision finds that two companies that held stock in the issuer and shared directors with the issuer could not be "grouped" into a case because there was "no allegation of interaction among or between these corporate entities sufficient to justify the treatment of [the two stockholders] as insiders,"[97] and another suggests that shareholders become insiders only if they play "active daily roles in the relevant companies or transactions."[98] The "insider or affiliate" test, however, is so loose that some decisions are bizarre.[99]

96. In *Burke v. Dowling*, 944 F. Supp. 1036 (E.D.N.Y. 1995), the court held the bank which allegedly "assisted the preparation of the acquisition, financing, and historical sections" of one Private Placement Memorandum in an alleged Ponzi scheme to convert Irish castles into luxury hotels, and "assisted in the preparation of the acquisition financing sections" of a second Private Placement Memorandum was not an insider, even though the bank was the primary lender for both projects. *Id.* at 1063. It noted that "[m]ere preparation of sections of an offering memorand[um], however, does not make a drafter an 'insider or affiliate.' Without a more specific indication as to what statements in the offering memorandum [the bank] drafted, plaintiffs cannot allege fraud in the sale of securities under § 10(b) on [the bank's] part." *Id.* at 1063-64.

97. Brickman v. Tyco Toys, Inc., 722 F. Supp. 1054, 1061 (S.D.N.Y. 1989).

98. Polar Int'l Brokerage Corp. v. Reeve, 108 F. Supp. 2d 225, 237 (S.D.N.Y. 2000). In this case, the court held that "group pleading" was available against a company formed for acquisition, the private equities firm organizing that company, independent directors of the seller who served on the board committee evaluating the offer, other individuals at the seller who agreed to invest in the acquiring company, and investment banking defendants who invested in the acquiring company. *Id.* at 238. The court found it was not available, however, against insurance companies who invested in the acquiring company as institutional investors, holding:

> it is impossible to characterize the Insurance Company Defendants as corporate insiders with direct involvement in the daily activities of the relevant companies or intimate knowledge of the challenged transaction. . . . The Insurance Company Defendants' status as institutional investors in [the acquiring company] is insufficient to render them corporate insiders such that the group pleading doctrine applies.

Id. See also *Isanaka v. Spectrum Technologies. USA Inc.*, No. 99-CV-1358 (LEK/DRH), 2001 WL 197911, at *5-*6 (N.D.N.Y. Feb. 18, 2001), in which the court interpreted prior district court decisions to apply group pleading to individuals with direct involvement in the everyday business of the company who are in a narrow group of high ranking officers or directors participating in the preparation and dissemination of a document.

99. Friedman v. Treasure Island N.V., No. 90Civ.2882 (PKL), 1992 WL 111371 (S.D.N.Y. May 4, 1992), is one of the worst, though it dismisses the case on bases other than plaintiffs' failure to connect defendants with misrepresentations or omissions. *Id.* at *11. Plaintiffs had purchased debentures. The issuer's parent and sole shareholder was a joint venture. The Plaintiffs named 27 defendants and the court found that all but one (a corporate defendant) were insiders or affiliates for purposes of the Second Circuit "group pleading" rule. *Id.* at *1, *6. These included: the joint venture/parent, the nine companies that were the joint venturers, the "principals" of the joint venture (nine individuals, seven of whom were also directors of the issuer, and one trust), and the subsidiaries through which the issuer did business. One individual defendant was simply a member of the board of the joint venture, but

Although it is hard to find a clean decision addressing whether underwriters in a firm commitment underwriting are within the *Luce* pleading exception, *Gabriel Capital, L.P. v. NatWest Finance, Inc.*[100] suggests that such underwriters risk being swept into the group. *Gabriel* denied a motion to dismiss by two firms that were initial purchasers of notes that they then sold to institutional investors, including the plaintiffs. The firms moved to dismiss on the ground that the complaint did not identify which statements they supposedly authored in the Offering Memorandum. The court found that activities underwriters typically perform placed these defendants within the *Luce* "group:" "Plaintiffs allege that NatWest and McDonald arranged the financing of these Notes, drafted the Offering Memorandum, went on road shows, and sold the Notes to plaintiffs and others. Those allegations are sufficient to cast NatWest and McDonald as 'insiders or affiliates.' "[101]

Similar to the Ninth Circuit's "day-to-day" involvement test, the Second Circuit's "insider" test does not distinguish well between officers. All officers are "insiders" in the sense that they work inside the issuer. The cases reveal no limiting principle, such as the "functional relationship" concept that some district courts in the Ninth Circuit have employed, and the Second Circuit itself has not emphasized, as did the Ninth Circuit in *Wool*, that the circle of officers should be restricted to those directly involved in preparing the violating documents. The Second Circuit "group" can accordingly reach into a corporation below the top officer level to embrace, for example, a manager of marketing,[102] the president of a subunit within

was not a director or officer of the issuer. He was nevertheless "alleged to have been [an] . . . insider by virtue of his beneficial ownership of $2^1/_2$% of the common stock of [the issuer]." *Id.* at *6.

100. 94 F. Supp. 2d 491 (S.D.N.Y. 2000).

101. *Id.* at 502-03 (citation omitted). The court was unmoved by the argument that NatWest and McDonald were "initial purchasers, not underwriters" under Rule 144A. *Id.* at 503. "Although NatWest and McDonald were not underwriters for purposes of the 1933 Act, their participation in the financing and sale of the Notes, especially with respect to drafting the Offering Memorandum, make them 'insiders or affiliates' under *Luce.*" *Id.* See also *Waltree Ltd. v. ING Furman Selz LLC*, 97 F. Supp. 2d 464 (S.D.N.Y. 2000), where the plaintiff sued both ING Bank (Bank) and ING Barings (Barings). Bank had loaned money to Tatarstan and issued notes, which Barings "placed" and plaintiff bought. The complaint did not address the corporate relationship between Bank and Barings and lumped both defendants together. The court found that "group pleading" was appropriate because the facts of that relationship were exclusively within the defendants' knowledge. *Id.* at 469 n.6. The court noted, "there is little dispute that both ING entities were intimately involved in the Loan and the issuance of the Notes," and the court held the allegations put the defendants on sufficient notice of the charges against them. *Id.*

102. *See, e.g.*, MTC Elec. Tech. Shareholders Litig., 898 F. Supp. 974, 984 (E.D.N.Y. 1995) (finding one defendant to be an "insider" where that individual was the Manager of Marketing, was the son of one and the nephew of another of the two most powerful officers of corporation, marketed products in the United States, was listed in numerous press releases as the contact person at the corporation, was a defendant in a suit for fraudulent conversion of company stock, and "clearly had at least peripheral involvement in the Chinese joint venture agreements . . . " that were at the heart of the case).

the corporation,[103] corporate secretaries,[104] and vice presidents.[105] As in the Ninth Circuit, however, officers or directors in Second Circuit cases whose tenures fall outside a class period should not be within a "group."[106]

103. The court in *Nicholas v. Poughkeepsie Savings Bank/FSB*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606 (S.D.N.Y. Sept. 26, 1990), relied on *Ouaknine* to deny Michael Feeks' motion to dismiss in a case where plaintiffs alleged misrepresentations and omissions regarding the adequacy of loan loss reserves and quality of loan underwriting. *Id.* at 97,842. The court stated:

> Feeks was . . . the President of the Bank's Community Bank Group and as such oversaw and was actively supported by the Bank's commercial real estate division. As alleged in the complaint, the Bank's commercial real estate division and the loans within the commercial real estate lending portfolios were a primary source of the falsity of defendants' overstatements of the Bank's earnings, income and net assets by the understatement of its loan loss provisions and non-performing assets.

Id. The court went on to write:

> In the Bank's 1987 and 1988 Annual Reports, defendant Feeks is prominently listed as the second-ranking officer of the Bank. . . . As such, all statements of the Bank concerning, *inter alia*, the adequacy of its loan loss reserves, its 'high-quality' loan portfolio . . . are also properly attributed to Feeks as the second-ranking officer of the Bank.

Id.

104. *See* Neubauer v. Eva-Health USA, Inc., 158 F.R.D. 281, 283, 284 n.2 (S.D.N.Y. 1994) ("[P]osition as corporate secretary is sufficient to link [defendant] to the offering memorandum under Luce." Although this defendant had the same last name as the chairman/CEO and allegedly resided at the same address, the court appeared to give these facts small consideration, saying, in the context of analyzing "control person" allegations that "[g]iven the infinite variations in human relationships, her place of residence adds nothing of significance . . . ."). *See also* Klein v. Goetzmann, 770 F. Supp. 78, 82 (N.D.N.Y. 1991) (finding defendants not included within "group" by virtue of membership on board or Audit Committee, but "[t]he allegation that defendant Smith was secretary of the corporation is sufficient . . . to bring him within the Second Circuit's 'group pleading' rule . . . .").

105. *See In re* Health Management, Inc. Sec. Litig., 970 F. Supp. 192, 209 (E.D.N.Y. 1997) ("[T]he group pleading presumption applies to Hirsh and Myers. Hirsh and Myers are alleged to have been officers of Health Management or of its wholly owned subsidiary. Myers is alleged to have been Health Management's Vice President for Program Development. Hirsh is alleged to have been Vice President for Purchasing and Managed Care Contracts at HMI Pennsylvania. Although Hirsh and Myers may not have been top level officers of Health Management, the Court finds that the plaintiffs have alleged that they were 'insiders,' falling within the group pleading presumption."). But, note also that in this case plaintiffs alleged specific involvement by each of these two defendants in identified wrongdoing. One of them was allegedly present at the meeting during which an "in transit" inventory scheme was devised; the other allegedly prepared false paperwork to document an inventory transfer that had not occurred.

106. For instance in *Brickman v. Tyco Toys, Inc.*, 722 F. Supp. 1054 (S.D.N.Y. 1989), an individual defendant was not an insider where he did not join the board until after the class period, despite allegations that he controlled the issuer's directors. *See id.* at 1061. The court reasoned:

> although the amended complaint describes [this defendant] as "an insider," he did not become a . . . director until three months after the end of the proposed class period, and plaintiff concedes that, prior to attaining that position, this defendant had not had

TO WHAT COMMUNICATIONS DOES THE LUCE *EXCEPTION APPLY WHEN A CORPORATION IS THE ISSUER?*

Although the trio of limited partnership opinions authored by the Second Circuit dealt with offering documents, and although some lower court decisions in the corporate context so limited "group pleading" when a corporation was the issuer,[107] that limitation has not prevailed.[108] Indeed, such a limitation seemed likely to fail in a corporate setting given that *Luce* cited *Somerville* and *Pellman* with approval, and those decisions applied the pleading exception to annual reports, published financials, and proxy statements.[109] Subsequent opinions in the Second Circuit apply "group pleading" in a corporate setting to those documents as well as press releases and SEC filings.[110] At least one case extends the concept to tender offer documents,[111] another applies it to an acquisition agreement in a sale of

> "any previous official involvement in [the issuer's] affairs. . . ." Moreover, the term "insider" is conclusory and inexact. Plaintiff must define the type of conduct engaged in which renders each defendant liable for the misrepresentation at issue.

Id. (citation omitted).

107. *See* Pallickal v. Technology Intern., Ltd., No. 94CIV.5738 (DC), 1996 WL 153699, at *2 (S.D.N.Y. Apr. 3, 1996) (granting motion to dismiss by President/director of issuer and noting, "[t]he amended complaint does not allege that there was an offering memorandum. Thus, plaintiffs were required to allege facts specifically pertaining to [this defendant]."); *Klein*, 770 F. Supp. at 81 ("[T]his 'group pleading,' however, is limited to situations where the alleged misrepresentations are contained in an offering memorandum . . . .").

108. *See, e.g.*, Axel Johnson, Inc. v. Arthur Andersen & Co., 847 F. Supp. 317, 321 (S.D.N.Y. 1994) (applying *Luce* to annual financial statements of a corporation, whose stock was purchased by another company and finding defendant "has not suggested a rational basis for distinguishing an offering memorandum from other materials issued by the seller and foreseeably relied on by the buyer to put this case outside of the *Luce* rule").

109. *See* text accompanying *supra* notes 69-73.

110. *See generally* Cosmas v. Hassett, 886 F.2d 8 (2d Cir. 1989) (annual report, 10-Ks, and press releases); Furman v. Sherwood, 833 F. Supp. 408, 417 n.6 (S.D.N.Y. 1993) ("In cases like the one at bar, where the alleged false and misleading statements were made in [the issuer's] annual report and Company press releases, no such connection [between an individual defendant and the fraud] need be pled because such documents are presumed to entail the collective actions of the directors and officers."); Nicholas v. Poughkeepsie Sav. Bank/FSB, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606 (S.D.N.Y. Sept. 26, 1990) (proxy statements and annual reports); Runes v. Gridcomm, Inc., No. B-86-473-TFGD, 1990 WL 483735 (D. Conn. Jan. 3, 1990) (SEC filings and press releases); Quantum Overseas, N.V. v. Touche Ross & Co., 663 F. Supp. 658 (S.D.N.Y. 1987) (SEC filings).

111. *See* Polar Int'l Brokerage Corp. v. Reeve, 108 F. Supp. 2d 225, 238 (S.D.N.Y. 2000) ("With respect to Trinity, KKR, the Individual Defendants and the Investment Bank Defendants, . . . group pleading tactics are appropriate. As demonstrated by the Offer Documents themselves, all of these defendants were intimately involved both in negotiating the Offer and in drafting the allegedly fraudulent Solicitation and Tender Offer Statement. For example, the Solicitation—which was issued on behalf of Trinity, Willis Corroon and KKR—includes letters to Willis Corroon shareholders from five of the Individual Defendants and all of the Investment Bank Defendants.").

assets for stock,[112] and yet another appears to employ "group pleading" to deny a 9(b) motion where the misrepresentations allegedly occurred in letters relating to the purchase of stock from minority shareholders.[113]

The Second Circuit formula—sweeping in "insiders and affiliates"—focuses less on whether a defendant actually prepared the misstatement than on his or her relationship to the offending entity or the transaction in which the misstatement occurred. Perhaps for this reason, district court opinions are inconsistent in their application of group pleading to oral statements.[114] One decision even suggests that a letter to shareholders

112. In *Nationwide Cellular Service, Inc. v. American Mobile Communications,* [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,435 (S.D.N.Y. Oct. 29, 1991), AMC sold assets to Nationwide for stock. Nationwide sued for fraud, naming AMC shareholders in the suit. The court summarized the allegations as charging that

> the AMC shareholders were all parties to the [Asset Acquisition Agreement], and . . . that the AMC Shareholders collectively owned over 90% of the issued and outstanding common stock of AMC; each of the individual AMC Shareholders was an officer and/or director of AMC; and each . . . actively participated, either directly or through agents, in the negotiation and consummation of the transaction . . . .

Id. at 91,890 n.5 (citation omitted). The court then found that group pleading against these defendants was permissible and noted that "the majority of the misrepresentations Nationwide alleges are contained in either the June 1989 financial statements, upon which the Assets Acquisition Agreement was predicated, or in the Agreement itself." *Id.* at 91,890. *See also* Elliot Assocs., L.P. v. Hayes, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,283, at 95,593 (S.D.N.Y. Dec. 28, 2000) (finding "Operative Documents" to be "group-published" and defining Operative Documents to be a Certificate of Designations for preferred stock, a Preferred Stock Investment Agreement, and a Registration Rights Agreement (*id.* at 95,589)).

113. *See* Aquilio v. Manaker, Nos. 90-CV-45, 91-CV-93, 1991 WL 207473, at *12 (N.D.N.Y. Oct. 10, 1991) (discussing application of Rule 9(b) to common law fraud claim, and characterizing complaint as alleging that the "letters [were] condoned by all defendants in their capacities [as] members of the SAA board"; providing "cf" citation to "group pleading" case), *on reconsideration of other issues,* 1992 WL 144303 (N.D.N.Y. June 19, 1992).

114. Several courts have declined to apply "group pleading" to oral statements: Elliot Assocs., L.P. v. Covance, Inc. [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,269, at 95,489 (S.D.N.Y. Nov. 28, 2000) ("To allow group pleading in the context of oral statements would unduly expand its ambit beyond that contemplated by the Second Circuit when it adopted the theory."); Neubauer v. Eva-Health USA, Inc., 158 F.R.D. 281, 283-84 (S.D.N.Y. 1994) (applying *Luce* to alleged misrepresentations in offering memorandum, but separately analyzing oral misrepresentation claims and dismissing them in part because plaintiffs failed to allege "by whom" they were made); *In re* Time Warner, Inc. Sec. Litig., 794 F. Supp. 1252, 1261-62 (S.D.N.Y. 1992), *aff'd in part and rev'd in part (on other grounds),* 9 F.3d 259 (2d Cir. 1993) ("The specificity requirements for pleading actionable statements are relaxed in the case of offering memoranda because they are documents of vital importance to any issuing company, and accordingly can be presumed to result from collaborative effort by senior officers of a defendant corporation. The statements in question here, by contrast, were alleged to have been uttered by unnamed spokespersons or even more shadowy figures who are not shown to have been known to defendants, and who, from the pleadings, cannot be said to have been within the defendants' control when they made the alleged statements."); Ohman v. Kahn, 685 F. Supp. 1302, 1308 (S.D.N.Y. 1988) (holding alleged misrepresentations in telephone call and face-to-face meetings "do not involve the preparation of corporate doc-

specifically attributed to a single, indentified defendant might be subject to the pleading shortcut.[115]

ABUSE OF THE PLEADING PROTOCOL

As the development of "group pleading" in the Ninth and Second Circuit demonstrates, this protocol is a judicially created pleading presumption to permit plaintiffs to name defendants without honoring the otherwise applicable requirement that no defendant should be named in a fraud

uments by insiders which can obviate the need for particularizing among the defendants. As a result [these allegations] must be repleaded to specify the speaker, the approximate time of communication and the content of the communication."). Several decisions appear to have permitted "group pleading" where oral statements were involved, albeit without analyzing the difficulties of applying that concept when defendants speak rather than write: *Cosmas*, 886 F.2d at 10 (alleged misstatement made by CEO in magazine interview); Benedict v. Amaducci, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,830, at 93,010 (S.D.N.Y. July 11, 1995) (explaining the reach of *Luce* and citing *Cosmas*: "courts have sustained a finding of fraud against all the directors of a corporation for statements made by the corporation in public filings and by a sole director in a magazine article."); *In re* AnnTaylor Stores Sec. Litig., 807 F. Supp. 990, 996, 1005 (S.D.N.Y. 1992) (denying motions to dismiss where one of the aftermarket statements was made by "an AnnTaylor spokesperson" who said that the company was "comfortable" with an analyst earnings estimate, and writing that the individual defendants, "each of whom is alleged to have been aware of the dissemination and content of the allegedly fraudulent after-market statements through press releases and the media, need not be directly responsible for making each of the misstatements during the Class Period in order to satisfy the requirements of Rule 9(b)."). In *Mann v. Levy*, 776 F. Supp. 808 (S.D.N.Y. 1991), defendant Levy was identified as an officer and director of the issuer as well as a lawyer who represented the issuer and its president in connection with the private stock transaction in this case. He argued that the complaint failed to attribute any of the alleged false statements directly to him–the fraud was failure to reveal $2 million in returned merchandise. Levy had attended meetings where oral representations were made to plaintiff that the issuer had "great potential," had "turned the corner," was a "terrific company," had been in contact with additional investors prepared to infuse capital, and had initiated negotiations with a factor to provide cash flow. Levy participated in the telephone call to persuade plaintiffs to buy company notes that were in default, and he was also present at a meeting with the president, the factor, and plaintiff at which the factor stated that it was prepared to resume the factoring agreement. The court held:

> Where, as here, plaintiff alleges with particularity the content of the statements sued upon, the time and place at which they were made, and the fact that the speaker was one of at most five persons—all of whom are allegedly officers and directors of [the issuer] (or a single representative of its factor)—we find the requirements of Rule 9(b) have been met.

Id. at 813 (citing Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986)).

115. *See Nicholas*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606. The complaint included an allegation that a letter written by defendant Kinkade was misleading and, although the opinion is not entirely clear, the statements in it were among those apparently attributed to defendant Feeks. *Id.* at 97,838, 97,842. The decision does not address the conceptual difficulties of applying group pleading to statements expressly attributed to one defendant.

case without specifically alleging that defendant's role in the fraud.[116] By their terms, *Wool* and *Luce* addressed a pleading question.[117]

Some decisions, however, either misunderstand the "group pleading" concept or wrongly expand upon it, (i) by apparently transmuting it into a rule of substantive law applicable on summary judgment motions;[118] (ii) by converting this pleading presumption into a rebuttable evidentiary presumption;[119] or (iii) by allowing plaintiffs to continue to rely on "group

116. Decisions from both circuits recognize that "group pleading" is an exception to the otherwise applicable requirements of Rule 9(b). *See, e.g., In re* Oak Tech. Sec. Litig., No. 96-20552 SW, 1997 WL 448168, at *10 (N.D. Cal. Aug. 1, 1997) ("Rule 9(b) requires a plaintiff to attribute fraudulent acts or statements to a particular defendant. However, the Ninth Circuit has recognized an exception to this rule . . . .") (citing Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987)) (additional citation omitted); Rubin v. Trimble, No. C-95-4353 MMC, 1997 WL 227956, at *19 (N.D. Cal. Apr. 28, 1997) ("Under Rule 9(b), plaintiffs generally must attribute each fraudulent statement or act to a particular defendant. An exception to this rule is the 'group pleading' doctrine, under which plaintiffs need not identify each corporate officer or director who participated in drafting group-published information such a prospectuses, registration statements, annual reports and press releases.") (citing *In re* GlenFed Inc. Sec. Litig., 60 F.3d 591, 593 (9th Cir. 1995) and *Wool,* 818 F.2d at 1440) (additional citation omitted); ESI Montgomery County, Inc. v. Montenay Int'l Corp., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,345, at 96,100 (S.D.N.Y. Jan. 22, 1997) (referencing "the Luce exception to the general rule that fraud allegations against multiple defendants must identify each defendant with each act alleged against it"); Parnes v. Mast Property Investors, Inc., 776 F. Supp. 792, 796 (S.D.N.Y. 1991) ("As a general rule, plaintiffs claiming fraud must draw a specific connection between the allegedly fraudulent statements and each defendant . . . . However, an exception to that rule is made where, as here, plaintiff alleges that an offering memorandum was fraudulent and defendants are insiders or affiliates who participated in the offer of the securities.") (citing *Luce*, 802 F.2d at 55).

117. The *Wool* discussion that concludes with the "group publication" language is titled "Rule 9(b) Motion." At its outset, it identifies the issue as a pleading question:

> The individual defendants contended, and the district court concluded, that Wool's allegations against the individual defendants failed to satisfy the particularity requirement of Fed.R.Civ.P. 9(b). . . . [T]he individual defendants argued that the allegations in Wool's complaint were insufficient against them because: . . . the activities of each of the individual defendants were not separately and specifically identified.

818 F.2d at 1439.

Similarly, the "group pleading" language in *Luce* lies under the heading "Sufficiency of the Complaint," discusses Rule 9(b) explicitly and responds to the district court's dismissal of the complaint on the basis that it "fail[ed] to connect allegations of fraudulent representations to particular defendants." 802 F.2d at 54.

118. *See* Golden v. Terre Linda Corp., No. 95C0657, 1996 WL 426760, at *4 (N.D. Ill. July 26, 1996) (relying on Blake v. Dierdorff, 856 F.2d 1365, 1369 (9th Cir. 1988), and denying motion for summary judgment by Chairman of the Board/Secretary on 10(b) claim; using "group pleading" authority to attribute to the moving defendant an allegedly false and misleading representation that the corporation's stock would be registered, a representation made in a letter signed by a vice president).

119. *See In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746, 759-60 (N.D. Cal. 1997) (granting summary judgment as to some defendants and stating, "[u]nder the group pleading doctrine, in drafting a complaint, plaintiffs may rely on a presumption that statements in

pleading" after they have had discovery.[120] Better-reasoned cases are clear that "group published information is designed only to be a pleading device [rather than] . . . a hook on which to hang liability"[121] and that plaintiffs must identify "statements made by . . . individuals personally in order to survive summary judgment."[122]

A handful of opinions make a second mistake by extending "group pleading" to scienter.[123] This confuses two questions: (i) what allegations

'prospectuses, registration statements, annual reports, press releases, or other 'group published information," are the collective work of those individuals with direct involvement in the day-to-day affairs of the company. This presumption is rebuttable, however. On summary judgment, a defendant may rebut the group pleading presumption by producing evidence that he had no involvement in creating the challenged document. . . . All four defendants aver that they were not involved in preparing or disseminating any of the class period documents. All four defendants also aver that they did not make any of the alleged false and misleading statements of October 19, 1995 and November 2, 1995. Defendant Ramsay was on sabbatical and vacation on those dates, and defendant Sekimoto, who resides in Japan, was not present either. Defendants Baskett and Burgess did not participate in the October 19th conference call, and although they were present at the November 2nd meeting with analysts, their presentations did not involve financial forecasting, sales, or [the product involved in the case].") (citations omitted). *See also In re* 3Com Sec. Litig., 761 F. Supp. 1411, 1414-15 (N.D. Cal. 1990) (denying motion to dismiss where defendants argued that many challenged statements were "attributable only to Mr. Krause," on the basis that the group publication "presumption may be rebutted by a later showing that defendant Krause's statements did not reflect the collective actions of the other defendants.").

120. *See In re* Wall Data Sec. Litig., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,292, at 95,747-48 (W.D. Wash. June 25, 1996) (rejecting argument on motion to dismiss Second Amended Complaint that, in light of substantial discovery, court should revisit "group pleading" and hold plaintiffs to a higher standard for allegations against individual defendants).

121. *In re* Interactive Network, Inc. Sec. Litig., 948 F. Supp. 917, 922 (N.D. Cal. 1996).

122. Schlagel v. Learning Tree, Int'l, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,403, at 91,816 n.5 (C.D. Cal. Dec. 23, 1998).

123. *See, e.g., In re* BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976, 995 (E.D. Mo. 1999) (relying on "group pleading" to attribute knowledge to defendants to satisfy a negligence standard for section 14 claims and scienter requirement for 10(b) claims and stating, "The group pleading doctrine . . . attributes knowledge of this information to all officers and directors with inside information of or involvement in the day-to-day affairs of the corporation."); *In re* Newbridge Networks Sec. Litig., 767 F. Supp. 275, 282 (D.D.C. 1991) (referencing group published information authorities in scienter discussion). Other cases, which are more properly characterized as "group scienter" cases, hold on the basis of related but separate reasoning that scienter may be pleaded by group allegations. These cases reason that some information is so important to a corporation that it is presumably known by officers or directors. For example, in *Epstein v. Itron, Inc.*, 993 F. Supp. 1314 (E.D. Wash. 1998), the court found, "facts critical to a business's core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers." *Id.* at 1326. *Epstein* cites *Cosmas v. Hassett*, 886 F.2d 8 (2d Cir. 1989), for this proposition. But the *Cosmas* discussion of this matter, under the "Scienter" heading, *id.* at 12-13, is separate from the discussion of particularity in identifying which defendants were responsible for particular misstatements, *id.* at 11-12. This Article will not address these "group scienter" cases, except to note that they seem contrary to the direction that, in private actions for damages under 10(b), the plaintiff must plead "with particularity facts giving rise to a

are sufficient to hold defendants responsible for making a statement (which "group pleading" *does* address); and (ii) what allegations are sufficient to plead defendants' knowledge that the statement is false (which "group pleading" *does not* address). Most decisions considering this matter have correctly held that the two questions are separate.[124]

THE EFFECT OF CENTRAL BANK

Turning from the elaboration of "group pleading" and its proper use to whether it should be employed at all, there are three issues: (i) whether such pleading is consistent with the post-*Central Bank* focus on primary liability; (ii) whether "group pleading" survives the PSLRA; and (iii) whether the assumptions underlying the pleading protocol reflect the

strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (1994 & Supp. V 1999). It is hard to see how a general allegation that a matter was important to a company's overall business states particular facts providing a strong inference that a certain defendant knew a specific fact and considered it material.

124. In *Luce v. Edelstein*, 802 F.2d 49 (2d Cir. 1986), the complaint was based largely on allegations that the defendants made specific promises to induce the securities transactions while secretly intending not to carry them out or knowing that they could not be carried out. In remanding with the direction that plaintiffs should be permitted to amend, the court stated that amendments "relating to projections or expectations offered to induce investments must allege particular facts demonstrating the knowledge of defendants at the time that such statements were false." *Id.* at 57. *See also* Jacobs v. Coopers & Lybrand, L.L.P., [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,443, at 92,036-37 (S.D.N.Y. Feb. 26, 1999) ("Plaintiffs argue that Hirsch should be charged with knowledge of the material misstatements contained in Happiness's 1995 financial disclosure documents under the 'group pleading doctrine,' embraced by the Second Circuit . . . . However, even under the group pleading doctrine, a complaint must allege that the defendants are 'insiders or affiliates' and must allege 'particular facts demonstrating the knowledge of each of the defendants at the time that the statements were false.' . . . [T]he Second Amended Complaint alleges no facts other than that Hirsch was a director, a member of the audit committee, and a signatory of the 10-K form; it does not allege facts demonstrating that Hirsch knew at the time that the statements were false.") (citation omitted); ESI Montgomery County, Inc. v. Montenay Int'l Corp., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,345, at 96,100 (S.D.N.Y. Jan. 22, 1996) ("ESI's complaint must satisfy the two requirements of the *Luce* exception: (1) that the defendants are insiders or affiliates participating in the offer of the securities in question . . . ; and, (2) that the complaint alleges particular facts demonstrating the knowledge of defendants at the time that the statements were false . . . ."); Ackerman v. National Property Analysts, Inc., 887 F. Supp. 494, 505 (S.D.N.Y. 1992) ("[T]he *Luce* exception does not relieve a plaintiff from properly pleading allegations which demonstrate that each defendant knew or had reason to know of the false statements and material omissions in the offering material."). *See also In re* Cendant Corp. Sec. Litig., 190 F.R.D. 331, 336 (D.N.J. 1999) (granting outside director motion to dismiss common law fraud count, and stating, "[b]ecause of their 'group pleading' approach, the plaintiffs have failed to allege that even one of the CUC outside directors was actually aware of any accounting irregularities."); *In re* The First Union Corp. Sec. Litig., 128 F. Supp. 2d 871, 888 (W.D.N.C. 2001) (rejecting plaintiffs' effort to use group pleading to avoid specifically alleging scienter and finding "contrary even to pre-Reform Act law" the view that "because of their positions as corporate officers, defendants must have known of allegedly false and misleading nature of all the alleged misstatements").

reality of corporate life. This section addresses *Central Bank* and primary liability. The next two sections discuss the two remaining questions.

In *Central Bank of Denver v. First Interstate*,[125] the Supreme Court ruled that there is no aiding and abetting liability in private 10b-5 actions.[126] The Second and Ninth Circuits have held that *Central Bank's* rationale precludes conspiracy liability as well.[127] Because *Central Bank* seems to contract the circle of possible securities law defendants and because "group pleading" permits plaintiffs to place defendants within the circle at least for purposes of a complaint, it is important to consider whether *Central Bank* affects the "group pleading" authorities.

Few courts have directly considered this question. Several have held that *Central Bank* does not affect "group pleading."[128] They have done so in part on the basis that *Central Bank* announces a substantive rule while *Wool* and *Luce* address only pleading,[129] in part on the basis that "group pleading" is used against defendants sued as primary violators rather than as aiders or abettors or conspirators,[130] and in part because the Supreme Court acknowledged in *Central Bank* that:

125. 511 U.S. 164 (1994).

126. *Id.* at 191.

127. *See* Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin, 135 F.3d 837, 838 (2d Cir. 1998); *In re* GlenFed, Inc., 60 F.3d 591, 592 (9th Cir. 1995).

128. *See, e.g.*, *In re* American Bank Note Holographics, Inc. Sec. Litig., 93 F. Supp. 2d 424, 442 (S.D.N.Y. 2000) ("While it is true that there can be no aider and abettor liability under 10(b) . . . , grouping defendants together in the complaint does not in itself make the allegations defective. It is well settled that plaintiffs may engage in so-called group-pleading under 10(b) . . . ."); *In re* Sunbeam Sec. Litig., 89 F. Supp. 2d 1326, 1342 (S.D. Fla. 1999); *In re* Oxford Health Plans, Inc., 187 F.R.D. 133, 142 (S.D.N.Y. 1999) (relying on *In re* Health Management, Inc. Sec. Litig., 970 F. Supp. 192, 208-09 (E.D.N.Y. 1997)); *In re* Silicon Graphics, Inc. Sec. Litig., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325, at 95,963 n.5 (N.D. Cal. Sept. 25, 1996); McDaid v. Sanders, No. C-95-20750, 1996 WL 241605, at *2 (N.D. Cal. May 3, 1996). *See also* Copperstone v. TCSI Corp., No. C97-3495SBA, 1999 U.S. Dist. LEXIS 20978, at *52-*53 (N.D. Cal. Jan. 14, 1999) (noting argument by defendants, to whom no statements were attributed, that *Central Bank* required their dismissal and stating immediately that "the Ninth Circuit recognizes the 'group published information' doctrine").

129. *See Silicon Graphics, Inc.*, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,963 n.5 ("*Central Bank* does not prohibit group pleading, it merely prohibits a private right of action for aiding and abetting liability."); *McDaid*, 1996 WL 241605, at *2 (same); *In re* MTC Electronic Techns. Shareholders Litig., 898 F. Supp. 974, 980-81 (E.D.N.Y. 1995) ("Even assuming arguendo that [after *Central Bank*] a corporate insider must be personally responsible for a particular misstatement . . . in order to be primarily liable . . . there is no reason to conclude that such responsibility must be specifically alleged in the complaint. Indeed, the rationale for the relaxed pleading requirements under Rule 9(b) suggests otherwise.").

130. *See Oxford Health Plans, Inc.*, 187 F.R.D. at 142 ("Although the Supreme Court has eliminated secondary liability for aiders and abettors . . . primary liability under Rule 10b-5 may be imposed 'not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration.'") (quoting S.E.C. v. First Jersey Sec., Inc., 101 F.3d 1450, 1471 (2d Cir. 1996) (quoting Azrielli v. Cohen Law

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or a seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability . . . are met. In any complex securities fraud, moreover, there are likely to be multiple violators.[131]

The decisions dismissing *Central Bank*'s effect on "group pleading" are too hasty. True enough, *Central Bank* is substantive rather than procedural and eliminates aiding and abetting liability without defining primary liability. The Supreme Court's decision, however, makes the definition of primary liability important.[132] Before *Central Bank*, adding a defendant as an alleged primary violator—by "group pleading" or otherwise—was often of little significance. If the defendant was not a primary violator, he or she might well be an aider and abettor or a co-conspirator. If plaintiffs erroneously identified the defendant as a primary violator, it might be a case of "no harm, no foul." After *Central Bank*, this is no longer true, and a defendant wrongly added as a primary violator might well not be a proper defendant under any theory and therefore altogether wrongly sued.[133]

Precisely because the definition of a primary violation has assumed greater importance after *Central Bank*, courts have devoted more attention to the issue. Although not in agreement with each other, the circuits have sharpened their definitions. This has critical importance for "group pleading." Although only a procedural protocol, the purpose of "group pleading" is to permit plaintiffs to name at the outset of a case defendants whose precise roles plaintiffs will not know until discovery, but who, because of

Offices, 21 F.3d 512, 517 (2d Cir. 1994)); *Sunbeam*, 89 F. Supp. 2d at 1342 ("[I]n no way does [Central Bank] restrict the ability of a plaintiff to allege primary violations of Section10(b) against groups of defendants.").

131. *Central Bank*, 511 U.S. at 191, *quoted in part in Sunbeam*, 89 F. Supp. 2d at 1342.

132. *See* Shapiro v. Cantor, 123 F.3d 717, 721 n.2 (2d Cir. 1997) ("In pre-*Central Bank* cases, some courts did not distinguish precisely between primary liability and aiding and abetting liability."). *See also* Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1224 n.8 (10th Cir. 1996) ("Commentators have long recognized the vagaries in the borders between primary and secondary liability. . . . *Central Bank of Denver* requires courts to delineate primary liability much more clearly.") (citation omitted).

133. Aside from "control person" liability, it may be that plaintiffs cannot now name in a private 10(b) action any defendant who is not a primary violator. *See* Powers v. Eichen, 977 F. Supp 1031, 1040 (S.D. Cal. 1997) (stating that after *Central Bank*, "only primary participants in a section 10(b) violation may be held liable"); *Silicon Graphics, Inc.* [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,961 (same). *See also* Arduini/Messina Partnership v. National Med. Fin. Servs. Corp., 74 F. Supp. 2d 352, 362 (S.D.N.Y. 1999) ("[T]he only form of [section] 10(b) liability that remains viable [after *Central Bank*] is primary liability."); Rubinstein v. Skyteller, Inc., 48 F. Supp. 2d 315, 322 (S.D.N.Y. 1999) (same).

their positions, are so likely to be proper defendants that plaintiffs appropriately name them without pleading specific facts tying them to the fraud. Because, after *Central Bank*, defendants are named as primary violators, "group pleading" *presumes* that the facts will show each of these defendants to have played a primary violator's role. Accordingly, the criteria for including a defendant through "group pleading" should be good predictors of a primary violator role and must be evaluated by the criteria's predictive power for that purpose. Such an evaluation, in turn, begins with the definition of a primary violation.

In formulating that definition, some cases take an expansive view, and include as primary violators all those who participated in the preparation of a challenged statement. Others restrict primary liability to those who in fact wrote or spoke the offending words or numbers or to whom those words or numbers were specifically attributed.[134] If "group pleading" rules include within the "group" defendants who are unlikely to be primary violators under a particular circuit's definition of primary liability, then that circuit must either change the rules identifying the "group" or abandon "group pleading" altogether. With that in mind, this Article will now compare primary liability law to "group pleading" rules in the Ninth and Second Circuits.

THE NINTH CIRCUIT: CENTRAL BANK *LIKELY HAS A LIMITED EFFECT ON GROUP PLEADING*

In re Software Toolworks Inc. Securities Litigation[135] contains the most frequently quoted Ninth Circuit comment on primary liability. That decision reversed summary judgment granted to accountants.[136] Plaintiffs contended that the accounting firm violated section 10(b) by "participating in drafting . . . two letters that Toolworks sent to the SEC . . . [that] falsely stated that Toolworks did not have preliminary financial data available for the June quarter and misleadingly described the nature of Toolworks'

134. *See* McNamara v. Bre-X Minerals Ltd., 57 F. Supp. 2d 396, 429-30 (E.D. Tex. 1999) (noting that plaintiffs placed the decisions on primary liability in two categories, one promoting "a 'bright line' test, under which liability attache[s] only if the defendant itself made an allegedly false or misleading statement[,]" and the other advocating a test under which "a defendant [who] played a 'significant role' in preparing a false statement" would also be primarily liable), *motion for reconsideration on other matters denied*, 68 F. Supp. 2d 759 (E.D. Tex. 1999); *MTC Elec. Techs.*, 898 F. Supp. at 986 ("At first blush, these cases seem to suggest two distinct approaches. On the one hand, some courts have adopted a bright line rule: if the defendant did not actually make the alleged misleading statement, it cannot be primarily liable no matter how much assistance the defendant may have rendered to those who did. On the other hand, some courts have adopted a rule that focuses on the degree of help rendered, holding that a defendant may be found primarily liable for statements of others in which the defendant substantially participated. Upon close scrutiny, however, these different approaches start to blur.").

135. 50 F.3d 615 (9th Cir. 1995).

136. *Id.* at 629.

OEM contracts."[137] In granting judgment to the accountants, the district court had analyzed whether they had aided and abetted a 10(b) violation by Toolworks. By the time the Ninth Circuit decided the case, the Supreme Court had published *Central Bank.* The court of appeals therefore considered whether the accountants could be primarily liable:

> Despite *Central Bank,* we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that Deloitte is primarily liable under section 10(b) for the SEC letters. In fact, the July 1 SEC letter stated that it "was prepared after extensive review and discussions with . . . Deloitte" and actually referred the SEC to two Deloitte partners for further information. Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues.[138]

More recently, the Ninth Circuit reversed a judgment as a matter of law that a trial court entered in favor of a CEO/Board Chairman.[139] The trial court reasoned that "because [this defendant] did not participate in the drafting of the allegedly false financial statements, he did not make a statement within the meaning of [section] 10(b)."[140] The CEO/Chairman, however, had signed SEC filings containing the financials, and the Ninth Circuit held that "[b]ecause [this defendant] signed the statements alleged to be false, the district court erred in making the blanket holding that [he] could not be a primary violator . . . ."[141] The court of appeals concluded that "when a corporate officer signs a document on behalf of the corporation, that signature will be rendered meaningless unless the officer believes that the statements in the document are true."[142] In reaching its decision, the Ninth Circuit summarized *Software Toolworks* as holding

137. *Id.* at 628.

138. *Id.* at n.3 (citations omitted).

139. Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 (9th Cir. 2000).

140. *Id.*

141. *Id.* at 1063.

142. *Id.* at 1061. It is difficult to determine what the *Everex* decision means for outside directors. The opinion focuses on a CEO, repeatedly refers to "corporate officers" and distinguishes some of the cases cited by the defendant as ones in which "the defendant was an *outside* director." *Id.* at 1062. On the other hand, the Ninth Circuit cites to and quotes from *In re JWP Inc. Sec. Litig.,* 928 F. Supp. 1239 (S.D.N.Y. 1996), which held that audit committee members could be primarily liable for statements in SEC filings that they signed.

The Ninth Circuit also recognizes that any defendant may be primarily liable for misstatements or omissions in a document that it authors itself. *See* McGann v. Ernst & Young, 102 F.3d 390, 397 (9th Cir. 1996) (finding that an accounting firm might be liable for an allegedly false and misleading audit opinion that it knows will be included in a 10-K); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1441 (9th Cir. 1996) (accounting firm could be primarily liable for failure to include a going concern qualification in audit opinion).

"that substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements."[143]

In other decisions addressing primary liability, district courts in the Ninth Circuit have: (i) denied summary judgment to accountants for misrepresentations made in issuer press releases because of "a disputed issue of fact as to whether [the accountants] actively participated in the preparation, review or release" of those publications;[144] (ii) denied a motion to dismiss brought by "attorneys [who allegedly] drafted the prospectus which contained misrepresentations and omissions";[145] (iii) denied summary judgment to nonmanaging underwriters who "played little or no direct role in preparing the . . . prospectus, or completing the primary due diligence investigation" but whose "names appeared on the final prospectus";[146] (iv) denied a motion to dismiss by a financial advisor who allegedly prepared an Information Circular to solicit shareholder approval of a merger and a Term Sheet used to sell debentures;[147] (v) denied a motion by an underwriter for summary judgment on misleading statements in a prospectus because its "participation in both drafting and decision-making [was] sufficient to establish a triable primary liability claim under [section] 10(b)";[148] and (vi) denied motions to dismiss by three individuals who allegedly provided the false and misleading information about their company that was used in a press release by a merger partner and a solicitation to the merger partner's shareholders.[149] On the other hand, the courts have granted a motion by an outside director to dismiss a primary liability claim because there was no allegation that he was "a substantial participant in a fraud perpetrated by others"[150] and granted a motion for summary judgment to executives who submitted uncontested declarations that

143. *Howard*, 228 F.3d at 1061 n.5.

144. *In re* ZZZZ Best Sec. Litig., 864 F. Supp. 960, 968-72 (C.D. Cal. 1994).

145. Employer Ins. of Wausau v. Musick, Peeler, & Garrett, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994), *order on reconsideration of other matters*, 948 F. Supp. 942 (S.D. Cal. 1995).

146. *In re* ZZZZ Best Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,485, at 91,312-13 (C.D. Cal. Oct. 26, 1994) ("While it may be true they made no contribution to the preparation of the prospectus itself, the document as it was publicly disseminated had their name on it and gave no indication that it was not as much the product of the [nonmanaging underwriters] as it was of the managing underwriter.").

147. Trafton v. Deacon Barclays De Zoete Wedd Ltd., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,481, at 91,281 (N.D. Cal. Oct. 19, 1994).

148. Flecker v. Hollywood Entertainment Corp., [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,436, at 96,862-63 (D. Or. Feb. 12, 1997) (noting also the underwriters' "roles as analysts, investment bankers and business advisors with extensive contacts with [issuer] defendants [and] superior access to non-public information").

149. *Trafton*, [1994-1995 Transfer Binder] F. Sec. L. Rep. (CCH) at 91,295.

150. *In re* Medeva Sec. Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,323, at 90,241 (C.D. Cal. June 3, 1994).

they had nothing to do with the company statements that the plaintiffs challenged.[151]

Some of the Ninth Circuit district court opinions unquestionably go too far and include as primary violators defendants who do not qualify for primary liability even under the *Software Toolworks* "significant role in drafting and editing" formula. Moreover, the Ninth Circuit definition itself is too broad, and does not respect the Supreme Court's abolition of aiding and abetting liability. This Article, however, will not address that question. Whether misguided or not, the breadth of the Ninth Circuit test for primary liability combined with its relatively narrow "group pleading" rule suggests that the two concepts generally do not war with one another. If a defendant really was a part of what *Wool* described as a narrow group of individuals who had a direct involvement in preparing the offending document, then the defendant may well meet the test of playing the significant role in drafting and editing that apparently suffices under *Software Toolworks* for a primary violation.

One aspect of Ninth Circuit "group pleading" law, however, is at odds with that circuit's primary liability decisions. *GlenFed* introduced the "day-to-day" involvement test to determine whether outside directors would be within the publishing "group." The *Moore* decision and various district court opinions then employed that same test to determine whether certain other defendants were within the "group."[152] A defendant can be included within a "group" under this test, however, if that defendant, in *GlenFed's* words, "participated in the day-to-day corporate activities"[153] or, in *Moore's* words, "had day-to-day control over the fraudulent entit[y]."[154] By the terms of these tests, general involvement in "day-to-day" activities may suffice. Primary 10(b) liability under *Software Toolworks,* however, hinges on whether the defendant played a significant role in drafting or editing the particular statement that is misleading, not whether the defendant played some other role in the corporation—even if that other role was so regular as to be "daily."[155] The "day-to-day" involvement test for "group pleading" is out of sync with the Ninth Circuit's definition of primary liability.

151. *See In re* Silicon Graphics, Inc. Sec. Litig., [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,325, at 95,963 n.5 (N.D. Cal. Sept. 25, 1996). *See also* Binder v. Gillespie, 184 F.3d 1059, 1067 (9th Cir. 1999) (affirming summary judgment for an accounting firm on the basis that its participation in the preparation of unaudited quarterly reports was insufficient where deposition testimony showed that the accountants had "commented" on the quarterlies but had not been engaged to "review" them), *cert. denied sub nom.*, Binder v. Wilson, 528 U.S. 1154 (2000).

152. *See supra* notes 21-22, 33-36, and accompanying text.

153. *In re* GlenFed Inc. Sec. Litig., 60 F.3d 591, 593 (9th Cir. 1998). Oddly, *GlenFed* announces this standard in the context of a primary liability and "control person" discussion, but does not address how members of a "group" could, simply by participating in some day-to-day corporate activities, become primarily liable for a particular misleading document.

154. Moore v. Kayport Package Express, Inc., 885 F.2d 531, 540 (9th Cir. 1989).

155. *In re* Software Toolworks Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994).

THE SECOND CIRCUIT: CENTRAL BANK *SHOULD LEAD TO A MASSIVE OVERHAUL OF GROUP PLEADING LAW OR AN ABOLITION OF GROUP PLEADING ALTOGETHER*

Shapiro v. Cantor[156] and *Wright v. Ernst & Young LLP*[157] are arguably the two most important Second Circuit decisions addressing primary liability. *Shapiro* held that accountants whose only specifically alleged role was preparation of projections attached to offering memoranda could not be primarily liable for the memoranda's failure to disclose that one of the partnerships' principals was a convicted felon.[158] *Shapiro* quoted from an opinion in the *MTC Electronics* litigation in which the district court concluded:

> [I]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).[159]

Shapiro also quoted from the Tenth Circuit's decision in *Anixter v. Home-Stake Products Co.*, which reasoned that "in order for accountants to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[160] Speaking more generally, the Second Circuit wrote that a "claim under § 10(b) must allege a defendant has made a material misstatement or omission . . . ."[161]

Wright held that an auditor could not be primarily liable for an issuer's publication of financial results where the press release did not mention the auditor and expressly stated that the release contained "unaudited" figures.[162] The Second Circuit so decided even though plaintiffs alleged that the accountants had "signed off" on the numbers "with full knowledge of the fact that the market would and did interpret the release of these figures as having been approved by [the auditor]."[163] After again quoting from the lower court *MTC Electronics* decision, *Wright* held that:

> a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the

156. 123 F.3d 717 (2d Cir. 1997).

157. 152 F.3d 169 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

158. *Shapiro*, 123 F.3d at 721.

159. *Id.* at 720 (quoting *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995)).

160. *Shapiro*, 123 F.3d at 720 (quoting *Anixter*, 77 F.3d at 1226).

161. *Id.* at 720-21.

162. Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999).

163. *Id.* at 172.

> Act . . . . Thus, the misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision.[164]

If these two decisions were the universe, the Second Circuit rule would be clear. To be primarily liable under section 10(b), a defendant must actually make the challenged misstatement. Where the defendant is a "secondary actor" such as an accountant, and the misstatement is distributed by others, the misstatement must be specifically attributed to the secondary actor.

This clear picture, however, is clouded by two other Second Circuit opinions: *SEC v. First Jersey Securities, Inc.*[165] and *SEC v. U.S. Environmental, Inc.*[166] First Jersey Securities was a broker-dealer with branch offices throughout the United States. Its sales force frequently sold "units" combining shares of common stock with warrants. The sales force would recommend that purchasers of the "units" sell them back to First Jersey at a slight profit. First Jersey would then split the stock from the warrants and sell these components separately to different customers through different branches for significantly more than the price at which it had repurchased the units. The effect was to charge an excessive markup to the purchasers of the unbundled unit components.

The SEC sued not only First Jersey but also Robert Brennan. Brennan was a director and the one hundred percent owner of First Jersey. He was at one time its president and later became its chairman and Chief Executive Officer. He "was intimately involved in the operations of First Jersey, including all significant decisions regarding the firm's underwriting, retail sales and trading activities."[167] The evidence at trial sufficed to show that he "had knowledge of First Jersey's frauds and participated in the fraudulent scheme."[168] Pointing to findings that "Brennan was aware of and 'was intimately involved in' the decisions as to unit-splitting and pricing, and that he orchestrated First Jersey's balkanization of its branches in order to keep customers in the dark,"[169] the Second Circuit determined that:

> In light of the evidence presented at trial with regard to Brennan's hands-on involvement in the pertinent decisions, we conclude that the trial court did not err in finding that Brennan knowingly participated in First Jersey's illegal activity and that he should be held primarily liable for its violations of the securities laws.[170]

164. *Id.* at 175.
165. 101 F.3d 1450 (2d Cir. 1996).
166. 155 F.3d 107 (2d Cir. 1998), *cert. denied sub nom.*, Romano v. SEC, 526 U.S. 1111 (1999).
167. *First Jersey Sec., Inc.*, 101 F.3d at 1460.
168. *Id.* at 1471.
169. *Id.* at 1472 (citation omitted).
170. *Id.*

SEC v. U.S. Environmental, Inc. was a market manipulation case. The Second Circuit reversed a dismissal and held that a trader who executed buy and sell orders by which the stock price was manipulated might be a primary violator.[171] The fact that this defendant was not the mastermind of the fraud made no difference, for *Central Bank* "never intended to restrict § 10(b) liability to supervisors or directors of securities fraud schemes while excluding from liability subordinates who also violated the securities laws."[172]

First Jersey and *U.S. Environmental* suggest that the "bright line test" of *Shapiro* and *Wright* is not so bright after all. Although the manner in which the Second Circuit will ultimately resolve the apparent conflict between these decisions is yet unclear, two observations may improve prediction. First, *U.S. Environmental* was a straight manipulation case. Although *First Jersey* was not expressly so formulated, it, too, at bottom dealt with manipulation. First Jersey itself created the price difference between the units it repurchased and the unbundled parts it sold because First Jersey dominated both those markets. Indeed, the court found that First Jersey violated 17(a) and 10(b) in part by failing to disclose "the nature of the market for [the] securities [and] the Firm's control over that market . . . ."[173] In addition, at least by implication, First Jersey "represented that the prices paid for [the] securities reflected their value in a competitive market. In fact, the market was created almost entirely by First Jersey's own activity . . . ."[174]

By its very nature, manipulation usually requires many purchases and sales. Each person who knowingly solicits or executes a trade contributing to the manipulation, and each person who coordinates the trades for a manipulative purpose, could be a primary violator. On the other hand, a misstatement is a single event, and it may be quite possible to track the misleading words to one author or speaker. Accordingly, the primary violators in a misstatement case may number far fewer than those in a manipulation case.

Wright itself provides the second comment that may reconcile the Second Circuit's quartet of primary liability decisions. In the course of rejecting the view that a defendant who "substantially participates" in a misstatement could be a primary violator, *Wright* observed that "[i]n *First Jersey*, we affirmed the imposition of primary liability under § 10(b) on Robert Brennan, the president, chief executive and sole owner of First Jersey Securities, Inc. *Brennan had directed his employees to make false and misleading statements to customers.*"[175]

In short, *First Jersey* and *U.S. Environmental* may mean nothing more in a misstatement case than that the individual who knowingly directs a sub-

171. *See U.S. Envtl., Inc.*, 155 F.3d at 111.

172. *Id.* at 112.

173. *First Jersey Sec., Inc.*, 101 F.3d at 1467.

174. *Id.* at 1468.

175. Wright v. Ernst & Young LLP, 152 F.3d 169, 176 (2d Cir. 1998) (emphasis added).

ordinate to make a misstatement may be primarily liable along with the subordinate who actually and knowingly writes or speaks the defrauding words. If the defendant is a "secondary actor"—a term that the Second Circuit has not defined but which appears in a corporate misstatement case to mean those outside the corporation—then *Wright* imposes the additional requirement that the statement be specifically and publicly attributed to that defendant. That is the reconciliation of the four Second Circuit primary liability decisions that seems most consistent with *Central Bank.*

Underwriters are somewhat difficult to place in this analytical scheme. The court in *In re MTC Electronic Technologies Shareholders Litigation* originally granted an underwriter's motion to dismiss on the grounds that there was "no allegation that [the underwriter] made any of the allegedly fraudulent representations in [the] prospectus."[176] However, the court reversed itself on reconsideration, accepting the argument that the underwriters could be primarily liable because, "in light of the central role underwriters play in the issuance of securities and the special reliance placed on them by prospective investors, they are simply not secondary actors with respect to statements in a registration statement or prospectus."[177] The court found that "the underwriter's role in a public offering is such that the representations in a registration statement or prospectus are its own,"[178] and that "the statements in the . . . prospectus must be deemed to be those of [the underwriter] as much as they are those of [the issuer]."[179]

District court decisions in the Second Circuit, however, have frequently determined that outsiders other than underwriters are not primarily liable. A European bank's role in placing convertible notes did not subject it to primary liability, even though it distributed offering documents allegedly including misleading information, because the plaintiffs "did not allege that [the European bank] wrote any of the allegedly fraudulent material. Rather, they allege only that it disseminated the information to potential investors."[180] A technical advisor to an issuer could be sued as a primary violator only after the plaintiffs alleged that other defendants made misrepresentations that those other defendants specifically attributed to the advisor.[181] An operating subsidiary was not a primary violator where plain-

176. *In re* MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995).

177. *In re* MTC Elec. Techs. Shareholders Litig., 993 F. Supp. 160, 161 (E.D.N.Y. 1997).

178. *Id.* at 162.

179. *Id.* at 162-63.

180. *In re* College Bound Consol. Litig., Nos. 93Civ.2348 (MBM), 94Civ.3033 (MBM), 1995 WL 450486, at *3 (S.D.N.Y. July 31, 1995) (granting motion to dismiss on 9(b) grounds and distinguishing bank's role from that of accounting firm held in on primary liability theory in *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994)).

181. The court granted the advisor's motion to dismiss in part in *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 94 F. Supp. 2d 491, 508-10 (S.D.N.Y. 2000), commenting that: "At most, the Amended Complaint alleges that [the advisor] knew that [others] would make misrepresentations to plaintiffs about [the advisor's] role in the [issuer's business]." *Id.* at 510. In a later opinion, the court held that a further amended complaint did allege a primary violation

tiffs alleged misrepresentations in a holding company's annual reports but did not allege that the subsidiary knowingly provided false information to the holding company that it then included in those reports.[182] Accountants were not primarily liable for statements *made by management* that the accountants had recommended certain internal controls for a business and that the accountants would oversee those internal controls and conduct annual audits.[183] A bank that loaned money to a subsidiary of an issuer after the issuer signed an agreement to sell its stock but before the closing was not primarily liable for the issuer's false representation about the cash that it would have at closing, even though the loan created the falsity.[184]

As these decisions show, plaintiffs should have some difficulty alleging primary liability against "secondary actors." *Wright* should make those difficulties particularly acute. Moreover, it is unclear whether pre-*Wright* decisions holding that those outside an issuer could be liable still survive.[185]

to the extent plaintiffs pled that, during a road show, other defendants made specific statements that they attributed to the advisor. Gabriel Capital, L.P. v. NatWest Fin., Inc., 122 F. Supp. 2d 407, 418-21 (S.D.N.Y. 2000). In an unpublished decision, the Second Circuit recently affirmed a judgment in favor of a public relations firm. Although one press release was printed on that firm's letterhead, "there was no evidence suggesting that anyone believed the press release represented a communication" by this outside consultant. Winkler v. Wigley, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,278, at 95,573 (2d Cir. Dec. 6, 2000).

182. Sotheby's Holdings, Inc. Sec. Litig., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,059, at 94,942-43 (S.D.N.Y. Aug. 30, 2000) (granting a motion to dismiss and rejecting the argument that it was reasonable to infer the subsidiary endorsed the statements in the holding company's reports).

183. *See* Pahmer v. Greenberg, 926 F. Supp. 287, 304-05 (E.D.N.Y. 1996) (granting motion to dismiss).

184. *See* Interallianz Bank AG v. Nycal Corp., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,227, at 99,548, 99,552-53 (S.D.N.Y. May 4, 1994) (granting motion to dismiss). Also, see *Scone Investments, L.P. v. American Third Market Corp.*, [1998 Supp. Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,207, at 90,849 (S.D.N.Y. Apr. 28, 1998), which granted a motion to dismiss by a bank that allegedly loaned money to one defendant so that the defendant could buy securities, pressured that defendant to sell the securities in order to bring down debt and "released" the securities for sale to one of the plaintiffs, who accepted transfer of the shares on the basis of a false statement that he would only need to hold them for a week because they had already been resold at a profit.

> [T]he Bank is alleged to have directed that the MKTB securities be sold, not that the sale be effectuated by way of fraudulent misrepresentation.
>
> * * * *
>
> Primary liability does not attach when the alleged fraudulent conduct is no more than the performance of a routine market function. . . . Here, the Bank's financing of the Rosehouse defendants' purchase of the MKTB securities and the release of its shares for trading amounts to nothing more than the routine functioning of a lending institution.

Id. at 90,854 (citation omitted). *See also* V.H. Farey-Jones v. Buckingham, No. CV99-4205 ADS, 2001 WL 178933, at *10-*11 (E.D.N.Y. Mar. 4, 2001) (where one defendant allegedly made misrepresentations causing plaintiff to sell to a second defendant in a scheme to benefit the first and second defendants and a third besides, plaintiff stated no primary violation against defendants two and three).

185. *See, e.g.*, Werner v. Satterlee, Stephens, Burke & Burke, 797 F. Supp. 1196, 1207-09

Second Circuit trial courts are much more apt to find that those inside a corporation can be primarily liable. Audit committee members may be primary violators for misstatements in 10-Ks that they sign, as well as misrepresentations "that were directly authorized by the Board of Directors—for example, [representations] found in . . . proxy statements."[186] A COO may also be a primary violator for misrepresentations in an SEC filing that he signs.[187]

Although district court decisions remain divided, some send primary liability deep into the executive ranks. *In re MTC Electronics* rejected in dictum the proposition "that a corporate insider must be personally responsible for a particular misstatement . . . in order to be primarily liable . . . ."[188] Three cases illustrate this view.

In re Kidder Peabody Securities Litigation[189] is probably the best known of these three. General Electric owned GE Capital Services, which in turn owned Kidder. Kidder employed a government securities trader named Orlando Joseph Jett. Jett recorded transactions which, though they had no economic significance, generated paper profits for Kidder. Kidder pro-

(S.D.N.Y. 1992) (seeming to hold that a law firm could be primarily liable for statements made in a prospectus where the law firm acted as general corporate counsel to the issuer, assisted in sham transactions and then assisted the issuer in preparing the registration statement and prospectus that omitted key facts about the transactions); *In re* Union Carbide Corp. Consumer Prods. Bus. Sec. Litig., 676 F. Supp. 458, 466-70 (S.D.N.Y. 1987) (denying motion to dismiss by investment bankers who supplied projected sale price for business units that issuer included in public documents and holding, "[p]reparation of misleading projections or provision of the raw data for such projections can constitute direct participation in a misrepresentation, and lead to primary 10b-5 liability . . . ."). It is unclear from both opinions to what extent the misleading documents specifically attributed statements in them to the law firm or the investment bankers.

186. *In re* JWP Inc. Sec. Litig., 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996) (denying summary judgment on 10-Ks and proxy statements). On the other hand, the committee members were not primarily liable for "press releases issued by . . . management or other statements that were not expressly authorized by the Board of Directors." *Id.* (granting summary judgment on press releases because audit committee members were entitled to judgment "to the extent that [plaintiffs'] claims are based on alleged misrepresentations that the audit committee defendants did not make."). In an unpublished decision, the Second Circuit affirmed a judgment in favor of an outside director where plaintiff alleged that part of an annual report misled and where the director's signature was limited to other parts of the report. Winkler v. Wigley, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,278, at 95,573 (2d Cir. Dec. 6, 2000) ("[The director] did sign a financial statement contained in the report, but . . . this statement concerned 1979 and 1980, the years before [the transaction about which the report allegedly omitted material facts].").

187. *See* Thomson Kernaghan & Co. v. Global Intellicom, Inc., Nos. 99Civ.3005 (DLC), 99Civ.3015 (DLC), 2000 WL 640653, at *5 (S.D.N.Y. May 17, 2000) (finding the COO's "filing of allegedly false and misleading documents with the SEC which misrepresented Global's financial condition cannot be dismissed as 'merely preparatory to the fraud,' but rather represent misrepresentations upon which plaintiffs' securities fraud claim may be premised") (citation omitted).

188. *In re* MTC Elec. Tech. Shareholders Litig., 898 F. Supp. 974, 980 (E.D.N.Y. 1995).

189. 10 F. Supp. 2d 398 (S.D.N.Y 1998).

vided its financial data to GE Capital Services on a quarterly basis, and "that data was incorporated in [GE Capital Services'] financial statements and GE's quarterly and annual reports."[190] After GE disclosed the false profits and took a one-time charge to correct its books, its stock price fell. Shareholders sued not only General Electric, but also Kidder and four individuals: (i) Kidder's Board Chairman and CEO; (ii) Kidder's Chief Financial and Administrative Officer, whose responsibilities included overseeing Kidder's operations and its audit and credit functions; (iii) the head of the Fixed Income Division in which Jett worked; and (iv) Jett himself.

In holding that such defendants might be primarily liable for financial statements published by General Electric, the court wrote that *Central Bank's* requirement for a defendant to "make a misrepresentation does not mean that the defendant must communicate that misrepresentation directly to the plaintiff."[191] Instead,

> where the defendant has made a misstatement but used another actor to deliver the message, the defendant still may be liable as a primary violator. . . .
>
> [I]f plaintiffs can show that defendants were the original and knowing source of the misrepresentation and that defendants knew or should have known that misrepresentation would be communicated to investors, primary liability should attach.[192]

In denying summary judgment to the head of the Fixed Income Division, the court specifically held that he might be a primary violator even though he "was not the actual speaker for any of the alleged misstatements."[193] "[A] reasonable trier of fact could conclude that [he] was knowingly and inextricably involved in generating the false profits that led to the misstatements."[194]

In re The Leslie Fay Companies, Inc. Securities Litigation[195] is the second case addressing primary liability of officers who do not themselves "make"a statement. It held that division presidents might be primarily liable for submitting material financial misstatements from their divisions to be incorporated into Leslie Fay's consolidated financial results.[196] At least two of the division presidents argued that "they were not spokesmen for the Company and did not control corporate policy or communications to shareholders or the investing public[,]" and all argued that they "did not

190. *Id.* at 407.
191. *Id.*
192. *Id.* (citations omitted).
193. *Id.* at 419.
194. *Id.*
195. 918 F. Supp. 749 (S.D.N.Y. 1996). Note that this case pre-dates *Shapiro* and *Wright.*
196. *Id.* at 761-62.

draft, issue or sign any of the Company's public financial documents."[197] The court nevertheless denied their motion to dismiss and found "[t]he fact that the Division Presidents were not responsible for consolidating and gathering the financials, and did not sign any of the public documents does not absolve them of liability."[198]

In re Health Management, Inc.[199] is the third case suggesting that "non-speaking" officers may be primary violators under Second Circuit law. In *Health Management*, the court denied a motion for more definite statement filed by defendants Myers and Hirsh.[200] Myers and Hirsh had allegedly participated in a scheme to include fictitious "in transit" inventory in Health Management's balance sheet, which decreased its cost of goods sold and thereby inflated its earnings. At the time they took the actions asserted in the complaint, Myers and Hirsh were vice presidents of Health Management's Pennsylvania subsidiary. Plaintiffs alleged that Myers had attended a meeting at which executives devised the scheme, and that Hirsh had created one false inventory form and directed another employee to create a second phony form. The court held that "plaintiffs have alleged facts implicating Hirsh and Myers in the 'in-transit' inventory portion of the overall fraudulent scheme to impart to the investment community an artificial earnings statement."[201] Expressly relying on *First Jersey*, the court ruled that "plaintiffs need not allege that Hirsch and Myers made any fraudulent statements during the Class Period."[202]

Copland v. Grumet[203] stands opposed to *Kidder*, *Leslie Fay*, and *Health Management* and is much more in tune with *Central Bank's* instruction that those who only aid and abet a misstatement cannot be liable for it in a private 10b-5 action. The *Copland* plaintiffs alleged that two officers cooked the books of a subsidiary and that the subsidiary's financial figures were then incorporated into the issuer's public financials. The court found no claim stated against the subsidiary officers for primarily liability on the misstatements in the parent company's reports.[204] "[T]here were no 'statements' which were attributed to them in the public documents at issue."[205] This reasoning seems to treat executives like the accountants in *Wright* and to

197. *Id.* at 761.
198. *Id.* at 762.
199. 970 F. Supp. 192 (E.D.N.Y. 1997).
200. *Id.* at 209-10. This case also pre-dates *Shapiro* and *Wright.*
201. *Id.* at 209.
202. *Id.*
203. 88 F. Supp. 2d 326, 332 (D.N.J. 1999) (relying expressly on *Shapiro* and *Wright*, although sitting in the Third Circuit, and concluding that *Wright* "has added a new consideration, namely that in order to hold an individual liable for material misstatements, the misrepresentations must have been attributable to that specific actor at the time of public dissemination").
204. *Id.* at 332-33.
205. *Id.* at 332 n.9.

require attribution of statements to the executives individually for them to be primary violators.

However the Second Circuit resolves the ambiguity created by these decisions, it is certain that that circuit's "group pleading" cases are wildly out of tune with that court of appeals' definition of primary liability. At a semantic level, the phrase "insiders and affiliates" is not anywhere near a close description of defendants who actually make a misstatement or to whom a misstatement is publicly and specifically attributed. Even if primary liability reaches those who order a misstatement as well as those who make it (as *Wright* interprets *First Jersey*), even if primary liability bores down inside a corporation to the persons who (in *Kidder's* words) were the "original and knowing source of the misrepresentation," or even if primary liability reaches (as *Health Management* and *Leslie Fay* imply) those who take the actions in a corporation that ultimately cause it to make a material misrepresentation, the circle of primary violators is much smaller than those encompassed by the word "insiders." The word "affiliates" is similarly unfocused. In no way does it point to those who actually wrote or spoke misleading words or those outside a corporation to whom specific statements are publicly linked. Instead of being a good predictor of who will ultimately be found primarily liable after discovery, the Second Circuit's definition of who can be "group pleaded" into a case seems to invite naming defendants who are not primary violators.

Aside from the linguistic disconnection, the actual holdings under the two tests do not match. For example, "insiders and affiliates" can include a corporate secretary,[206] even though that position may be largely ministerial and the secretary so far removed from a statement that he or she could not be a primary violator under Second Circuit law. The sometime application of Second Circuit "group pleading" law to oral statements and to writings signed by an identified individual[207] is similarly out of sync with the primary liability opinions of that court of appeals. It certainly can be the case that a group creates the text of a speech or analyst presentation given by one executive, and documents signed by a single officer can be written by committee. An oral statement or a document signed by one individual, however, can also be created by the speaker or sole signatory alone. The probability that others were sufficiently involved to be primarily liable under Second Circuit holdings is not so high that a court should presume such involvement. Even if an oral statement or a writing attributed to a single author is a group production, the odds are small that a court can, at the outset of a case and without discovery, use the *Luce* "insiders or affiliates" formulation to correctly identify those—other than the speaker or author—who are likely responsible for the statement under

206. *See supra* note 104 and accompanying text.

207. *See supra* notes 114-115 and accompanying text.

Shapiro or *Wright* or even under *First Jersey*, *Kidder*, *Health Management*, and *Leslie Fay*.

Given the vast difference between its "group pleading" rules and its definition of primary liability, the Second Circuit would do well to discard the group rules altogether. If not, this circuit must undertake a major overhaul to conform the *Luce* exception to its post-*Central Bank* decisions.

THE EFFECT OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

As necessary as they would otherwise be, efforts to conform "group pleading" to definitions of primary liability may be moot. The PSLRA may ultimately end "group pleading" in all its forms.

In private actions under section 10(b) of the 1934 Act, the PSLRA requires that plaintiffs plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," which is scienter in a 10(b) case; demands that complaints "specify each statement alleged to have been misleading [and] . . . the reasons why the statement is misleading;" and imposes a stay of discovery until the trial court decides motions to dismiss.[208]

The PSLRA's command that plaintiffs plead scienter with particularity should end the erroneous reliance that some courts have placed on "group pleading" to satisfy that element of a 10(b) case.[209] The more important question, however, is whether the PSLRA ends "group pleading" altogether. The lower courts are split on this issue.[210]

208. 15 U.S.C. § 78u-4 (1994 & Supp. V 1999). The requirement for specific scienter pleading is codified at subsection (b)(2), the requirement that each misleading statement be specified at subsection (b)(1), and the discovery stay at subsection (b)(3)(B). Courts have interpreted the new scienter pleading rule differently, and this Article will not review those opinions. The PSLRA contained many other provisions besides the three mentioned in the text (e.g., replacing joint and several liability with proportionate liability for many defendants, defining a procedure for choosing and the substantive standard for selecting the lead plaintiff in 10(b) class actions, establishing a formula capping 10(b) damages and creating a "safe harbor" for "forward-looking statements").

209. *Chu v. Sabratek Corp.*, 100 F. Supp. 2d 827 (N.D. Ill. 2000), confuses "group pleading" with "how each individual defendant was supposed to know that the statements . . . were false," but correctly concludes that the PSLRA means that "[t]o the extent the plaintiffs plead scienter based exclusively on an individual defendant's position in [the company's] hierarchy, their claims must be dismissed." *Id.* at 836-37.

210. Cases holding that "group pleading" does not survive the PSLRA: *In re* Premier Techs. Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,293, at 95,654 (N.D. Ga. Dec. 8, 2000); *In re* Ciena Corp. Sec. Litig., 99 F. Supp. 2d 650, 663 n.11 (D. Md. 2000) (remarking, though not deciding the question, "that application of [group pleading] doctrine to nonspeaking defendants would seem to be inconsistent with the strict pleading requirements of the [PSLRA]"); Zishka v. American Pad & Paper Co., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,208, at 95,044 (N.D. Tex. Sept. 13, 2000); *In re* Ashworth, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,243, at 95,287 n.3 (S.D. Cal. July 18, 2000) (stating in the footnote that while the group pleading doctrine did not apply, "there

Opinions ruling that the PSLRA forecloses "group pleading" divide into three categories. The first set points to the Act's requirement that plaintiffs plead each defendant's scienter individually and reasons that it would make little sense to demand such particularized allegations of each defen-

may be circumstances where it would be appropriate to attribute statements to a group of defendants, such as where a corporation's officers and directors are few in number and make corporate decisions on a group basis."); *In re* Dura Pharms., Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,245, at 91,303 (S.D. Cal. July 11, 2000) (same); Calliott v. HFS, Inc., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,939, at 94,030-31 (N.D. Tex. Mar. 31, 2000); Branca v. Paymantech, Inc., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,911, at 93,850 (N.D. Tex. Feb. 8, 2000); Marra v. Tel-Save Holdings, Inc., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,480, at 92,288 (E.D. Pa. May 18, 1999); *In re* Home Health Corp. of Am., Inc. Sec. Litig., [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,414, at 91,877 (E.D. Pa. Jan. 29, 1999); Coates v. Heartland Wireless Communications, Inc., 26 F. Supp. 2d 910, 915-16 (N.D. Tex. 1998); Allison v. Brooktree Corp., 999 F. Supp. 1342, 1350 (S.D. Cal. 1998).

Cases holding that group pleading survives the PSLRA include: *In re* SmarTalk Teleservices, Inc. Sec. Litig., 124 F. Supp. 2d 527, 545 (S.D. Ohio 2000); *In re* Splash Tech. Holdings, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,249, at 95,351-52 n.13 (N.D. Cal. Sept. 29, 2000) (noting that although the "cases finding tension between the group-pleading doctrine and the [PSLRA] are more persuasively reasoned, the Court assumes for purposes of its analysis that the group published information doctrine survives the [Act]"); Stanley v. Safeskin Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,221, at 95,145 (S.D. Cal. Sept. 15, 2000); *In re* USA Talks.com, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,231, at 95,235 (S.D. Cal. Sept. 14, 2000) (seeming to employ group pleading after noting that Ninth Circuit has not addressed the effect of the PSLRA); *In re* Solv-Ex Corp. Sec. Litig., 96Civ.7575 (RMB), 2000 U.S. Dist. LEXIS 13113, at *15 (S.D.N.Y. Sept. 6, 2000); *In re* Hi/fn, Inc. Sec. Litig., No. C99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *36-37 (N.D. Cal. Aug. 9, 2000) (noting that the Ninth Circuit has not reached the PSLRA's effect on group pleading, but then finding that the doctrine would not save the relevant plaintiffs' allegations anyway); Cheney v. Cyberguard Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,258, at 95,410 n.5 (S.D. Fla. July 31, 2000) (stating, unclearly, that, "[a]lthough some of the defendants argue that after the [PSLRA], the 'group pleading doctrine' can no longer be used, the Eleventh Circuit has not specifically addressed the issue and at least one district court in the circuit has assumed the doctrine's continued viability. Plaintiffs have adequately alleged that each of the individual defendants, due to their high ranking positions at Cyberguard were involved in controlling the content of the information released by Cyberguard.") (citations omitted); *In re* System Software Assocs., Inc. Sec. Litig., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,910, at 93,847 (N.D. Ill. Mar. 8, 2000) ("Without deciding the issue, this court adopts the group publication theory—to the extent that any inferences mentioned above may seem to rely on that theory—for purposes of this opinion only."); *In re* AgriBioTech Sec. Litig., [1999-2000 Transfer Binder], Fed. Sec. L. Rep. ¶ 90,771, at 93,757 (D. Nev. Mar. 2, 2000); *In re* Theragenics Corp. Sec. Litig., 105 F. Supp. 2d 1342, 1358 (N.D. Ga. 2000); *In re* The Baan Co. Sec. Litig., 103 F. Supp. 2d 1, 17 (D.D.C. 2000); *In re* Secure Computing Corp. Sec. Litig., 120 F. Supp. 2d 810, 821 (N.D. Cal. 2000) (granting motion to dismiss but apparently in this part of the opinion giving guidance to plaintiffs for repleading); *In re* American Bank Note Holographics, Inc. Sec. Litig., 93 F. Supp. 2d 424, 442 (S.D.N.Y. 2000); *In re* BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976, 988 (E.D. Mo. 1999); *In re* Livent, Inc. Sec. Litig., 78 F. Supp. 2d 194, 219 (S.D.N.Y 1999); *In re* Sunbeam Sec. Litig., 89 F. Supp. 2d 1326, 1340-41 (S.D. Fla. 1999); Danis v. USN Communications, Inc., 73 F. Supp. 2d 923, 939 n.9 (N.D. Ill. 1999) (appearing to conclude that dant's state of mind while permitting some defendants' connection with the misstatements to be pled by "group" allegations. *Coates v. Heartland Wireless Communications, Inc.*[211] provides perhaps the best statement of this position:

> a plaintiff must state with particularity the facts that give rise to a strong inference that the defendant acted with the required state of mind. 15 U.S.C. § 78u-4(b)(2). This requirement is fairly interpreted to require that a plaintiff allege facts regarding scienter as to each defendant. So interpreted, [this section] is consistent with the [PSLRA's] policy of protecting defendants from unwarranted fraud claims and strike suits. It is nonsensical to require that a plaintiff specifically allege facts regarding scienter as to each defendant, but to allow him to rely on group pleading in asserting that the defendant made the statement or omission.[212]

Some courts respond that this view conflates two different 10b-5 elements. One element is that the defendant make the challenged statement. The defendant's state of mind is a separate element. As the court in *In re BankAmerica Corp. Securities Litigation*[213] stated "[c]ases holding that group

group pleading continues after the PSLRA until the Seventh Circuit holds otherwise); *In re* Oxford Health Plans, Inc., Sec. Litig., 187 F.R.D. 133, 142 (S.D.N.Y. 1999); *In re* PETsMART, Inc., Sec. Litig., 61 F. Supp. 2d 982, 997 (D. Ariz. 1999) (stating in a confused discussion that the court "do[es] not dispute plaintiffs contention that the doctrine survives the [PSLRA]" but doing so in the context of applying the "opportunity" prong of the "motive and opportunity" test for evaluating scienter allegations); *In re* Aetna Inc. Sec. Litig., 34 F. Supp. 2d 935, 949 n.7 (E.D. Pa. 1998) (failing to decide the question but remarking that "[a]lthough it is unclear whether the group pleading doctrine survives under the [PSLRA], the Court will assume for the purposes of this Motion that the . . . doctrine is still viable."); Copperstone v. TCSI Corp., No. C97-3495 SBA, 1999 U.S. Dist. LEXIS 20978, at *52-*54 (N.D. Cal. 1999) (noting the defense argument that the PSLRA abolishes group pleading, then proceeding to hold that plaintiffs had not pleaded sufficient facts to take advantage of the doctrine anyway); Schlagel v. Learning Tree Int'l, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,403, at 91,815 (C.D. Cal. Dec. 23, 1998); Schaffer v. Evolving Sys., Inc., 29 F. Supp. 2d 1213, 1225 (D. Colo. 1998); *In re* Stratosphere Corp. Sec. Litig., 1 F. Supp. 2d 1096, 1108 (D. Nev. 1998); Genna v. Digital Link Corp., 25 F. Supp. 2d 1032, 1044 (N.D. Cal. 1997) (commenting, apparently as dicta, "[d]efendants claim that only defendants who actually made statements can be held liable because the PSLRA abolishes group pleading . . . . [T]here is a potential for liability if the allegedly false or misleading statements are shown to be the collective actions of the defendant officers. However, because plaintiff has not met his burden of pleading false and misleading statements, the court does not determine at this time whether any individual defendant should be dismissed with prejudice."). This note does not include post-PSLRA cases that employ group pleading without discussing whether the PSLRA makes reliance on such pleading wrong.

211. 26 F. Supp. 2d 910 (N.D. Tex. 1998).

212. *Id.* at 916. *See* Branca v. Paymentech, Inc., [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,911, at 93,850 (N.D. Tex. Feb. 8, 2000) (following Coates v. Heartland Wireless Communications, Inc., 55 F. Supp. 2d 628, 634 (N.D. Tex. 1999)).

213. 78 F. Supp. 2d 976 (E.D. Mo. 1999).

pleading is no longer available . . . state that because the [PSLRA] requires that . . . scienter be pled with regard to each act or omission, the group pleading doctrine was overruled *sub silentio* by the Act. However, the [group pleading] doctrine has nothing to do with scienter."[214]

A second set of decisions holding that the PSLRA ends "group pleading" relies not only on the Act's requirement for specific scienter allegations but also on the Act's command that a plaintiff specifically identify misstatements or omissions. *Allison v. Brooktree Corp.*[215] reasons:

> [T]he continued vitality of the judicially created group-published doctrine is suspect since *the [PSLRA] specifically requires that the untrue statements or omissions be set forth with particularity as to 'the defendant'* and that scienter be plead in regards to 'each act or omission' sufficient to give 'rise to a strong inference that the defendant acted with the required state of mind.'[216]

More important, however, than the ambiguity as to which defendants are sued on which statements—a matter that plaintiffs might seek to address by conclusory pleading that defendants A, B, and C were all in a group responsible for statements 1 and 2—is the failure to allege particular facts to show that each of the defendants actually drafted or spoke the offending words. Ultimately, that is the fundamental failure of group pleading.

A third group of cases simply states that "group pleading" is inconsistent with the Act's overall emphasis on factually specific allegations.[217] This view has considerable force, as "group pleading" was created by judges

214. *Id.* at 988 (citations omitted).

215. 999 F. Supp. 1342 (S.D. Cal. 1998).

216. *Id.* at 1350 (emphasis added) (citation omitted). Other courts have questioned the doctrine's continuing vitality on this same reasoning. *See In re* Premier Techs. Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,243, at 95,654 (N.D. Ga. Dec. 8, 2000); *In re* Ashworth, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,243, at 95,287 (S.D. Cal. July 18, 2000); *In re* Dura Pharms., Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,245, at 95,303 (S.D. Cal. July 11, 2000); Calliott v. HFS, Inc., [2000 Transfer Binder] Fed. Sec. L. Rep. ¶ 90,939, at 94,032 n.3 (N.D. Tex. Mar. 31, 2000) (following *Marra*, [1999 Transfer Binder] Fed. Sec. L. Rep. ¶ 90,480); Marra v. Tel-Save Holdings, Inc., [1999 Transfer Binder] Fed. Sec. L. Rep. ¶ 90,480, at 92,288 (E.D. Pa. May 18, 1999).

217. *See In re* Ciena Corp. Sec. Litig., 99 F. Supp. 2d 650, 663 n.11 (D. Md. 2000) (stating that the "application of that doctrine to non-speaking defendants would seem to be inconsistent with the strict pleading requirements of the [PSLRA]."); Zishka v. American Pad & Paper Co., [Current Binder] Fed. Sec. L. Rep. ¶ 91,208, at 95,044 (N.D. Tex. Sept, 13, 2000) (rejecting "the notion of 'group pleading,' and 'group publication' and conclud[ing] that such concepts, if previously sustainable, did not survive the adoption of [PSLRA]. To comply with the [Act], Plaintiffs thus must plead with particularity their allegations against each individual Defendant.") (citation omitted); *In re* Home Health Corp. of Am., Inc. Sec. Litig., [1999 Transfer Binder] Fed. Sec. L. Rep. ¶ 90,414, at 91,877 (E.D. Pa. Jan. 29, 1999) (agreeing "that the group published information doctrine is inconsistent with the [PSLRA's] pleading requirements").

and favors plaintiffs by permitting them to name defendants without specifically alleging facts against them to support a required element of the case. This does seem contrary to the whole thrust of the PSLRA.

One rejoining argument is that the PSLRA was itself a specific piece of legislation, that Congress targeted the changes it chose to make and that courts should not infer that Congress intended to make others. Because Congress did not insert a requirement that plaintiffs plead particular facts to connect each defendant to misrepresentations or omissions, none should be judicially added simply because courts conclude that such a change logically compliments the pleading reforms that Congress introduced.

The rebuttal, however, is that Congress through the PSLRA deliberately drove the courts towards specific pleading. It expressly required specific scienter pleading and specific allegations to identify which statements plaintiffs contend to be misleading and why they were misleading. It is hubris for the courts to conclude that, just because Congress did not also single out group pleading for abolition, the bench should retain a judge-made generality which is so out of step with the legislature's unmistakable signal that only specificity will prevent abuse.

Although the cases finding that the PSLRA abolishes "group pleading" have weight, the opinions that seem to support group pleading's survival after the Act are far less persuasive. Some say nothing more than that the court assumes the continued existence of the protocol only for purposes of the one decision containing the comment.[218] Others say little more than that they continue to apply "group pleading" because the courts of appeals in their circuits have not yet held that they should stop.[219] Some, like *In re*

218. *See In re* Splash Tech. Holdings, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. ¶ 91,249, at 95,351-52 (N.D. Cal. Sept. 20, 2000) (see quotation in note 210 *supra*); *In re* Systems Software Assocs., Inc. Sec. Litig., [2000 Transfer Binder] Fed. Sec. L. Rep. ¶ 90,910, at 93,847 (N.D. Ill. Mar. 8, 2000) (noting also that the Seventh Circuit has not decided the question and that two cases in the district and one outside the district had employed group pleading after the PSLRA: Koehler v. NationsBank Corp., No. 96C2050, 1997 WL 80928 (N.D. Ill. Feb. 20, 1997) (but not addressing whether PSLRA ends "group pleading"); Powers v. Eichen, 977 F. Supp. 1031, 1040-41 (S.D. Cal. 1997) (same); *In re* Discovery Zone Sec. Litig., 943 F. Supp. 924, 937-38 (N.D. Ill. 1996) (same)); *In re* Aetna Inc. Sec. Litig., 34 F. Supp. 2d 935, 949 n.7 (E.D. Pa. 1999) (noting, "[a]lthough it is unclear whether the group pleading doctrine survives under the [PSLRA], the Court will assume for the purposes of this Motion that the . . . doctrine is still viable.").

219. *See* Stanley v. Safeskin Corp., [Current Binder] Fed. Sec. L. Rep. ¶ 91,221, 95,145 (S.D. Cal. Sept. 15, 1999) (noting that the *In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997), decision had employed group pleading in a PSLRA case and stating, "[t]he Court is unaware of any Ninth Circuit decision, to date, that has rejected the group pleading presumption"); *In re* USA Talks.com, Inc. Sec. Litig., [Current Binder] Fed. Sec. L. Rep. ¶ 91,231, at 95,235 (S.D. Cal. Sept. 14, 2000) (noting that the "Ninth Circuit has not specifically addressed whether the heightened pleading standard for securities fraud cases, imposed by the [PSLRA], has eliminated the 'group pleading' or 'group published' doctrine"); *In re* Hi/fn, Inc. Sec. Litig., No. C99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *36

BankAmerica Corp. in the passage set out above, argue that the PSLRA changed other pleading rules but did not specifically abrogate "group pleading" and that courts should not infer that Congress sought to end the group rule.[220] "Group pleading" itself, however, was never based on any statute. Accordingly, it may be quite appropriate for courts to reconsider this judicially created rule if it appears—as it does—to be contrary to the overall approach that Congress took.

A few opinions justify the use of the pleading protocol by pointing to post-PSLRA decisions that employ "group pleading" without discussing the Act's effect on such allegations.[221] The cases on which these opinions, however, rely cannot constitute authority on a point they do not even address.

One decision preserves "group pleading" on the basis that it creates only a "rebuttable presumption"[222] and another on the basis that it creates a "reasonable presumption."[223] This, however, avoids the question, which

(N.D. Cal. Aug. 9, 2000) (stating that "the Ninth Circuit has not addressed this issue" and citing to *In re* Secure Computing Corp. Sec. Litig., 120 F. Supp. 2d 810 (N.D. Cal. 2000), as a decision that "upheld the doctrine's continued application."); Cheney v. Cyberguard Corp., [Current Binder] Fed. Sec. L. Rep. ¶ 91,258, at 95,410 n.5 (S.D. Fla. July 31, 2000) (stating that "the Eleventh Circuit has not specifically addressed the issue and at least one district court in the circuit has assumed the doctrine's continued viability"); *In re* Sunbeam Sec. Litig., 89 F. Supp. 2d 1326, 1341 (S.D. Fla. 1999) ("Although the Court recognizes that some courts have questioned the continuing vitality of the group pleading doctrine, we find that the rationale behind the group pleading doctrine sound and will not disturb it absent direction from the Eleventh Circuit. The Court notes that this conclusion is consistent with both the language of the PSLRA, and the overwhelming majority of courts to consider the matter."); Danis v. USN Communications, Inc., 73 F. Supp. 2d 923, 939 n.9 (N.D. Ill. 1999) ("Until receiving clarification from the Seventh Circuit, this court is unwilling to read the [PSLRA] as abolishing all remnants of notice pleading and the liberal standards under which motions to dismiss are viewed."); Schlagel v. Learning Tree Int'l, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,403, at 91,815-16 (C.D. Cal. Dec. 23, 1998) ("Although the Court recognizes that some courts have questioned the continuing vitality of the group-pleading doctrine . . . , the questioning occurred in the context of attributing liability to seemingly unrelated executive employees. Until the Ninth Circuit speaks otherwise, the Court finds the rationale behind the group-pleading doctrine sound and will not disturb it.").

220. *See* quotation in text at note 214, *supra*. In *In re Strastosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096 (D. Nev. 1998), the court held, "[d]efendants offer no case authority for their proposition that group pleading has been sub silentio abolished by the [PSLRA], and this Court declines to adopt such a proposition." *Id.* at 1108. The court also noted and relied on a district court decision, *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 759 (N.D. Cal. 1997), which employed group pleading in a case governed by the PSLRA but did not discuss any argument that the Act abrogated such pleading. *Id. See also In re* American Bank Note Holographics, Inc. Sec. Litig., 93 F. Supp. 2d 424, 442 (S.D.N.Y. 2000) ("It is well settled that plaintiffs may engage in so-called group-pleading under 10(b) and Rule 10b-5; nothing in the [PSLRA] has altered that doctrine.").

221. *See supra* note 220 (citing *Strastosphere* references to the *Silicon Graphics* decision). *See also supra* note 218 (citing *In re System Software Assocs., Inc.* references to the *Discovery Zone* and *Koehler* cases).

222. *In re* Theragenics Corp. Sec. Litig., 105 F. Supp. 2d 1342, 1358 (N.D. Ga. 2000).

223. *In re* BankAmerica Corp. Sec. Litig., 78 F. Supp. 2d 976, 988 (E.D. Mo. 1999).

is whether such a pleading "presumption" should be tolerated at all, given the Act's several requirements for specific factual allegations. One case analyzes the Tenth Circuit's pre-PSLRA scienter pleading rules, reasons that those rules track PSLRA requirements, and then concludes that the Tenth Circuit's pre-PSLRA "group pleading" authority must also survive the Act.[224] But this is a non sequitur, as "group pleading" does not address scienter but instead each defendant's connection to misstatements or omissions.

A few opinions endorse post-PSLRA "group pleading" without any reasoning at all.[225] The remaining cases supporting such pleading rely on the other opinions summarized above.[226]

With the arguments that the pleading protocol survives the Act quite weak and those holding that the Act abolishes "group pleading" not yet universally accepted, the debate remains open. That debate, however, should consider one further point. The purpose of "group pleading" is to permit plaintiffs to name as defendants those who are likely to have had a sufficient hand in the offending statements so that they could be primary violators *but who cannot be tied to the statements by specific facts without discovery.*[227]

224. *See* Schaffer v. Evolving Sys., Inc., 29 F. Supp. 2d 1213, 1225 n.5 (D. Colo. 1998).

225. *See In re* PETsMART, Inc. Sec. Litig., 61 F. Supp. 2d 982, 997 (D. Ariz. 1999); Copperstone v. TCSI Corp. No. C973495 SBA, 1999 U.S. Dist LEXIS 20978, at *52-*54 (N.D. Cal. Jan. 19, 1999); Genna v. Digital Link Corp., 25 F. Supp. 2d 1032, 1044 (N.D. Cal. 1997).

226. *See In re* Solv-Ex Corp. Sec. Litig., 96Civ.7575 (RMB), 2000 U.S. Dist. LEXIS 13113, at *15 (S.D.N.Y. Sept. 6, 2000); *In re* The Baan Co. Sec. Litig., 103 F. Supp. 2d 1, 17 (D.D.C. 2000); *In re* SmarTalk Teleservices, Inc. Sec. Litig., 124 F. Supp. 2d 527, 545 (S.D. Ohio 2000); *In re* Secure Computing Corp. Sec. Litig. 120 F. Supp. 2d 810, 821 (N.D. Cal. 2000); *In re* AgriBioTech Sec. Litig., [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,771, at 93,757 (D. Nev. Mar. 2, 2000); *In re* Livent, Inc. Sec. Litig., 78 F. Supp. 2d 194, 219 (S.D.N.Y. 1999); *In re* Oxford Health Plans, Inc., 187 F.R.D. 133, 142 (S.D.N.Y. 1999).

227. See, for example, *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 706 (D. Del. 2000), where the court responded to defense argument "that the act of signing, or participating in the preparation of, group-published documents does not amount to a misstatement or omission." *Id.* at 720-21. The court reasoned:

> [p]laintiffs have not yet had the opportunity to take discovery to determine the role that these defendants played in the Company, and the extent to which they were knowledgeable of the alleged inadequacy of the Company's loan loss reserves. In light of these defendants' membership on the Company's Audit Committee, Financial Oversight Committee, or Executive Committee, the court will permit plaintiffs to conduct discovery to determine whether these defendants made actionable misstatements or omissions.

Id. See also Danis v. USN Communications, Inc., 73 F. Supp. 2d 923, 939 n.9 (N.D. Ill. 1999) (answering defense arguments about group pleading and outside directors: "The exact extent of each of the individual defendant's role and duties within USN, and their corresponding knowledge, cannot be ascertained until after discovery. Plaintiffs' recovery against any particular defendant will depend on actual proof tying that defendant to a material misrepresentation."); *In re* Alliance Pharm. Sec. Litig., Nos. 92-1380-IEG (AJB), 92-1445, 1995 U.S. Dist. LEXIS 11351, at *37 n.14 (noting the group publishing doctrine "is justified by the need to allow plaintiffs discovery before they can pin down which directors and officers were

That rationale for the protocol is completely at odds with the discovery stay that the PSLRA imposes at the outset of a case while defendants test the factual allegations of a complaint with motions to dismiss.[228] That stay is designed to stop "sue first and ask questions later" tactics. As the Ninth Circuit stated: "Congress clearly intended that complaints in these securities actions should stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed."[229] This reasoning for the stay is unreservedly hostile to the notion of "group pleading," which is precisely that plaintiffs should be able to name defendants without having "actual knowledge" that those defendants made the statements that plaintiffs claim are wrong.

WHETHER THE PLEADING PROTOCOL MAKES SENSE

Putting to one side the effect of such recent developments such as *Central Bank* and the PSLRA, there is a more fundamental question: Does "group pleading" make sense? Put another way: Is the title that a defendant holds a reliable indicator that he or she is presumptively likely to have written or contributed to a particular false statement in a corporate disclosure?

actually involved in certain corporate actions."); *In re* AnnTaylor Stores Sec. Litig., 807 F. Supp. 990, 1004-05 (S.D.N.Y. 1992) (stating, "[p]rior to discovery, plaintiffs are not expected to pinpoint precisely who uttered the statements . . . [, and endorsing that,] 'a plaintiff may not be able to plead the precise role of each defendant when a group of defendants has acted in concert . . . . Under those circumstances, it is appropriate to plead the actions of the group and leave development of individual liability questions until some discovery has been undertaken, rather than to dismiss the plaintiff because he does not have what may be concealed information.' ") (citing Jackson v. First Fed. Sav. F.A., 709 F. Supp. 863, 878 (E.D. Ark. 1988); Wegbreit v. Marley Orchards Corp., 793 F. Supp. 957, 962 (E.D. Wash. 1991) (discussing RICO claim and dismissing for other reasons, citing *Wool* and reasoning so: "[c]onsidering that no discovery has occurred, the plaintiffs' statement of the defendants' respective roles is adequate."), *case reinstated* under Exchange Act section 27A, 793 F. Supp. 965 (E.D. Wash. 1992); Nicholas v. Poughkeepsie Savings Bank/FSB, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606, at 97,842 (S.D.N.Y. Sept. 26, 1990) ("It would be virtually impossible before there had been any discovery for the plaintiffs to delineate which defendants were responsible for which acts. It is sufficient in the Court's view for the plaintiff to allege the positions held by the defendants and charge them collectively rather than specify their individual conduct.").

228. *See* 15 U.S.C. § 78u-4(b)(3)(B) (1994 & Supp. V 1999).

229. Medhekar v. U.S. District Court for the N. Dist. of Cal., 99 F.3d 325, 328 (9th Cir. 1996) (holding that the discovery stay in the PSLRA applies to initial disclosures under Rule 26(a) and related local rules); SG Cowen Sec. Corp. v. U.S. District Court for the N. Dist. of Cal., 189 F.3d 909, 912 (9th Cir. 1999) (quoting *Medhekar*, 99 F.3d at 328, while finding that a district court erred in permitting limited discovery to learn, among other things, the relationship between the issuer defendant and an investment banking/brokerage house defendant employing an analyst following the issuer). *But see* Vacold LLC v. Cerami, No. 00CIV.4024 (AGS), 2001 WL 167704, at *6-*7 (S.D.N.Y. Feb. 16, 2001) (granting plaintiff relief from stay in order to conduct limited merits discovery; recognizing that its holding is contrary to *SG Cowen*).

Both the Ninth and the Second Circuits adopted "group pleading" without empirical evidence before them. Plaintiffs' briefs in *Wool* and *Luce* were devoid of citations to studies showing such a strong pattern of participation in corporate disclosures by individuals or entities occupying certain positions that courts could properly presume involvement by such potential defendants in certain types of communications.[230] It is not clear that the world reflects such a pattern.

Consider the financial statements that an issuer publishes in a press release each quarter. The degree to which the CEO is involved in creating the release may vary. If the release purports to quote the CEO, it may be fair that he or she be held accountable for that quotation. It is unrealistic to *presume*, however, that the CEO created the numbers in the release. The CEO may have played a key role, even becoming involved in revenue recognition decisions on large transactions that could mean the difference between meeting analyst estimates or not. On the other hand, the CEO may have had virtually no involvement in revenue recognition decisions or other accounting matters, leaving all of that to the finance staff.[231] The probability that the CEO was so involved in the creation of a specific false number so that the CEO could be primarily liable for that number is not high enough to justify a presumption.

This problem with the presumption underlying "group pleading" grows larger when courts apply group analysis to long documents such as a 10-K. Although it may be safe to presume that such documents are the product of collective effort, it is also likely that different individuals write different sections. Thus, the COO or someone on the COO's staff may have principal or complete drafting responsibility for a paragraph in the MD&A on an operational issue. On the other hand, the COO may have nothing to do with drafting the section devoted to liquidity. It makes no common sense to include the COO as a "group" defendant in a case based on an alleged misrepresentation regarding liquidity simply because the COO or a member of the COO's staff was a part of a team that drafted the 10-K.

CONCLUSION

If the courts keep "group pleading" at all, then in light of *Central Bank* and each circuit's definition of primary liability (i) at least some of the

230. See the discussion of "group pleading" in: Opening Brief for Plaintiff-Appellant, Wool v. Tandem Computers, Inc., (9th Cir. July 7, 1986) (No. 85-2674), 33-34 (on file with *The Business Lawyer*, University of Maryland School of Law). Also see the discussions of "group pleading" in: Plaintiffs-Appellants' Brief, Luce v. Edelstein, (2d Cir. March 28, 1986) (No. 86-7120) (on file with *The Business Lawyer*, University of Maryland School of Law); Reply Brief for Plaintiffs-Appellants, Luce v. Edelstein, 2-4 (2d Cir. May 5, 1986) (No. 86-7120) (on file with *The Business Lawyer*, University of Maryland School of Law).

231. Whether the CEO should be liable on the basis of signing an SEC filing containing the financials, rather than a presumption that he participated in the preparation of the financials, is a different question. *See supra* notes 139-43 and accompanying text (discussing Howard v. Everex, 228 F.3d 1057 (9th Cir. 2000)).

Ninth Circuit "group pleading" rules should be revised; and (ii) the Second Circuit's "group pleading" rules should be completely overhauled. The more fundamental question is whether "group pleading" should survive at all. It is inconsistent with the PSLRA's overall emphasis on specific pleading and inconsistent with the discovery stay. It depends upon factual assumptions about the business world that judges have made without empirical evidence as a guide and that experience suggests are false. Courts would do best to put this pleading protocol to the sword.