Loyola University Chicago Law Journal

Volume 44
Issue 5 *2013 Summer*

Article 10

2013

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Recommended Citation

Carol V. Gilden, , Michael B. Eisenkraft, & Josh Segal, *The Dangers of Missing the Forest: The Harm Caused by VeriFone Holdings in a Tellabs World*, 44 Loy. U. Chi. L. J. 1457 (2013).
Available at: http://lawecommons.luc.edu/luclj/vol44/iss5/10

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ESSAY

The Dangers of Missing the Forest: The Harm Caused By *VeriFone Holdings* in a *Tellabs* World

Carol V. Gilden, Michael B. Eisenkraft,** and Josh Segal****

INTRODUCTION

"A complaint [alleging securities fraud] adequately pleads scienter under the PSLRA [("Private Securities Litigation Reform Act")] only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[1] The Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* ("*Tellabs*")[2] definitively set the standard for evaluating allegations of scienter in securities fraud class action

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1. Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1324 (2011) (citations omitted). PSLRA refers to the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (2006)), which governs allegations of securities fraud. PSLRA's reforms "included, inter alia, new requirements for those who may serve as lead plaintiff and plaintiffs' counsel in securities fraud cases, reducing the availability of joint and several liability, and heightened pleading standards." Vaughn R. Walker, *Class Actions along the Path of Federal Rule Making*, 44 LOY. U. CHI. L.J. 445, 446 n.6 (2012) (citing Ann Morales Olazábal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud*, 2010 WIS. L. REV. 1415, 1416 n.1).

2. 551 U.S. 308 (2007).

complaints for purposes of a motion to dismiss. Under *Tellabs*, "[t]he inquiry . . . is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."[3] The Supreme Court reaffirmed this standard in *Matrixx Initiatives, Inc. v. Siracusano* ("*Matrixx*"),[4] holding that in making a determination about scienter on a motion to dismiss, "the court must review all the allegations holistically."[5]

Despite the Supreme Court's repeated and clear instructions, some lower courts, most notably the Ninth Circuit, have retained their prior practice of analyzing each allegation in isolation. They have justified this retention as a first level of analysis that precedes the Supreme Court-mandated "holistic" review of the plaintiffs' allegations. Specifically, in *Zucco Partners, LLC v. Digimarc Corp.* ("*Zucco*"),[6] a 2009 case decided after *Tellabs*, the Ninth Circuit endorsed a two-step analysis for scienter. First, the court must analyze whether the plaintiff's *individual* allegations of securities fraud create a strong inference of scienter.[7] Second, if no allegation, standing alone, adequately alleges scienter, the court will perform a "holistic" review of the plaintiff's allegations to establish whether the allegations *combine* to create a strong inference of intentional conduct or recklessness.[8] More recently, the Ninth Circuit in *In re VeriFone Holdings, Inc. Securities Litigation* ("*VeriFone Holdings*")[9] held that this two-step analysis is still proper in light of *Matrixx*.[10] *VeriFone Holdings* justified its continued endorsement of the two-step analysis by claiming that "a dual analysis remains permissible so long as it does not unduly focus on the weakness of individual allegations to the exclusion of the whole picture."[11]

This Essay argues that the Ninth Circuit's continued endorsement of a two-step analysis is misguided because it risks framing the question of scienter tendentiously. As recent findings in behavioral economics suggest, the psychological influence of analyzing each allegation in

3. *Tellabs*, 551 U.S. at 322–23.
4. 131 S. Ct. 1309 (2011).
5. *Matrixx*, 131 S. Ct. at 1324.
6. 552 F.3d 981 (9th Cir. 2009).
7. *Zucco Partners*, 552 F.3d at 992.
8. *Id.*
9. 704 F.3d 694 (9th Cir. 2012).
10. *See VeriFone Holdings*, 704 F.3d at 702 ("*Matrixx* on its face does not preclude this [two-step] approach and we have consistently characterized this two-step or dual inquiry as following from the Court's directive in *Tellabs*.").
11. *Id.* at 703.

isolation likely will cause judges to dismiss securities fraud lawsuits more frequently than under a purely holistic analysis of the allegations. Legally, the step of determining whether any allegation alone creates a strong inference of scienter constitutes a pollutant that interferes with the holistic analysis of scienter mandated by *Tellabs* and *Matrixx*.

The Essay proceeds as follows. Part I sets the stage by explaining the requirements for pleading scienter under the PSLRA as established by the Supreme Court. Next, Part II discusses the Ninth Circuit's and other courts' continued insistence on retaining a two-part analysis for evaluating allegations of scienter in securities fraud litigation, and provides a hypothesis as to why these courts have retained this test despite conflicting Supreme Court jurisprudence. Part III then analyzes the consequences of the two-part analysis using behavioral economics and Ninth Circuit case law.

I. Pleading Scienter Under the PSLRA

The PSLRA requires litigants to plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[12] Although Congress left the PSLRA's meaning of "strong inference" undefined,[13] the Supreme Court has supplied a definition: "To qualify as 'strong' . . . , an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[14] In failing to expressly define "the required state of mind," Congress also left scienter's meaning to the judiciary to decipher.[15] The Supreme Court has held that the term scienter encompasses "intent to deceive, manipulate, or defraud."[16] Every federal appellate court to subsequently consider the issue of scienter in securities fraud class actions has held that recklessness will also meet the standard,[17] though each has formulated the standard somewhat differently.[18]

12. 15 U.S.C. § 78u-4(b)(2)(A) (2006).

13. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007) ("Congress left the key term 'strong inference' undefined . . . ."); *id.* at 321–22 ("'Congress did not . . . throw much light on what facts . . . suffice to create [a strong] inference,' or on what 'degree of imagination courts can use in divining whether' the requisite inference exists." (citation omitted)).

14. *Id.* at 314. This heightened pleading standard only applies to scienter.

15. *See id.* at 329.

16. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

17. *Tellabs*, 551 U.S. at 319 n.3. As Geoffrey Rapp notes, the legal concept of recklessness emphasizes risk, which makes "[t]he manner in which we estimate probabilities . . . an essential component of any theory of recklessness." Geoffrey Christopher Rapp, *The Wreckage of Recklessness*, 86 WASH. U. L. REV. 111, 155 (2008). And as behavioral economics has demonstrated, people often estimate probabilities inaccurately. *See id.* at 153–61.

18. *See, e.g.*, Aldridge v. A.T. Cross Corp., 284 F.3d 72, 82 (1st Cir. 2002) ("high degree of

In *Tellabs* and *Matrixx*, the Supreme Court set out clear standards for analyzing whether a complaint adequately pleads scienter under the PSLRA for purposes of a motion to dismiss. In *Tellabs*, the Supreme Court specified a practical construction of the PSLRA's strong inference standard for scienter using three different "prescriptions."[19] First, as with any motion to dismiss, a court must accept all allegations in the complaint about scienter as true.[20] Second, courts "must consider the complaint in its entirety," specifically "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."[21] Third, in deciding whether the pleaded facts give rise to the required strong inference of scienter, a court must "take into account plausible opposing inferences" as the "strength of an inference" is "inherently comparative."[22] The Court in *Tellabs* emphasized the importance of the second prescription, reiterating elsewhere in its opinion that "the court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically."[23]

In *Matrixx*, the Court echoed the importance of its second "prescription," reminding lower courts that in "making this [scienter] determination, the court must review all the allegations holistically."[24] Scienter in *Matrixx* concerned knowledge about adverse reactions to a cold remedy drug, Zicam, including anosmia (loss of smell).[25] After the reminder about evaluating scienter "holistically," the Supreme Court listed a series of allegations that the plaintiffs in *Matrixx* made regarding scienter, including that Matrixx hired a consultant to review Zicam, prevented a scientist from using the name of the product at issue in a presentation, and issued a press release suggesting that "Zicam does not cause anosmia when, in fact, it had not conducted any studies

recklessness"); Novak v. Kasaks, 216 F.3d 300, 312 (2d Cir. 2000) ("conscious recklessness"); Ottmann v. Hanger Orthopedic Grp., Inc., 353 F.3d 338, 344 (4th Cir. 2003) ("severe recklessness"); Nathenson v. Zonagen Inc., 267 F.3d 400, 408 (5th Cir. 2001) ("severe recklessness"); Flaherty & Crumrine Preferred Income Fund, Inc. v. TXU Corp., 565 F.3d 200, 207 (5th Cir. 2009) ("severe recklessness"); *In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 550 (6th Cir. 1999) ("conscious disregard"); Howard v. SEC, 376 F.3d 1136, 1143 (D.C. Cir. 2004) ("extreme recklessness").

19. *Tellabs*, 551 U.S. at 322.

20. *Id.*

21. *Id.* at 322–23.

22. *Id.* at 323.

23. *Id.* at 326.

24. Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1324 (2011) (quotations omitted).

25. *See id.* at 1314 ("Respondents claim that Matrixx's statements were misleading in light of reports that Matrixx had received, but did not disclose, about consumers who had lost their sense of smell (a condition called anosmia) after using Zicam Cold Remedy.").

relating to anosmia and the scientific evidence at that time."[26] The Supreme Court concluded that the class plaintiffs' allegations, taken together, gave rise to a "cogent and compelling inference . . . that Matrixx acted with deliberate recklessness (or even intent) at least as compelling as any opposing inference," and thus found that the plaintiffs had adequately plead scienter.[27] In other words, *Matrixx* reaffirmed the already emphasized importance of the "holistic" analysis and demonstrated how courts should conduct it.

II. Staying the Course: Lower Courts' Retention of an Individualized Scienter Analysis after *Tellabs* and *Matrixx*

Even in the aftermath of *Tellabs* and *Matrixx*, many courts have ignored the Supreme Court's prescription that scienter should only be evaluated holistically and instead have followed a two-step process. Under this approach, the court first evaluates each allegation of scienter independently and, only after that individualized analysis is complete, does the court engage in, as a second step, a holistic analysis of the cumulative effects of the allegations. A complaint will survive a motion to dismiss on scienter grounds under the two-step approach if a court determines that scienter has been adequately pled under either the individualized or the holistic analysis.

The Ninth Circuit is the leading proponent of the two-step inquiry. In *Zucco*, Judge Bybee stated that "we recognize that *Tellabs* calls into question a methodology that relies exclusively on a segmented analysis of scienter" and that "our prior, segmented approach is not sufficient to dismiss an allegation of scienter."[28] In an unexpected turn, however, *Zucco* did not abandon the "prior, segmented approach" in favor of the holistic approach prescribed by the Supreme Court in *Tellabs*. Instead, the Ninth Circuit retained the old segmented approach, but grafted it onto the Supreme Court's holistic approach as the first of two steps. Specifically, *Zucco* stated:

> [F]ollowing Tellabs, we will conduct a dual inquiry: first, we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient, we will conduct a "holistic" review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness.[29]

26. *Id.* at 1324.
27. *Id.* at 1324–25 (internal citation and quotations omitted).
28. Zucco Partners, LLC v. Digimarc Corp., 552 F. 3d 981, 991 (9th Cir. 2009).
29. *Id.* at 992.

According to *Zucco*, the first of the two steps is derived from pre-*Tellabs* case law, which had "developed a set of rules to analyze different types of scienter allegations."[30] Specifically, the *Zucco* court admitted that "we have continued to employ the old standards in determining whether a plaintiff's allegations of scienter are as cogent or compelling as an opposing innocent inference."[31] *Zucco* justified the continued use of this first step by claiming that *Tellabs* did not "materially alter the particularity requirements for scienter claims" previously established in Ninth Circuit case law, but rather only added "an additional 'holistic' component to those requirements."[32] The *Zucco* court's interpretation of *Tellabs* thus incorrectly sought to preserve the elaborate framework that courts had previously applied to scienter allegations.

So far, the two-step inquiry has been an enduring feature of the Ninth Circuit's analysis, reappearing in both circuit-level and district-level decisions.[33] Most recently and significantly, in *VeriFone Holdings*, the Ninth Circuit provided a detailed analysis and justification of its decision to retain the two-step approach.[34] In *VeriFone Holdings*, the Ninth Circuit reversed a district court's determination on scienter, holding that while none of the individual allegations created the necessary "strong inference" of scienter, the plaintiffs' complaint adequately pled "intentional or reckless conduct on the basis of a *host* of allegations."[35] This conclusion—that "the sum is greater than its parts"[36]—led the Ninth Circuit into a philosophical review of its two-step process for analyzing scienter in securities fraud litigation.

First, the *VeriFone Holdings* court acknowledged that in *Matrixx*, the Supreme Court reiterated that courts must "review 'all the allegations holistically' when determining whether scienter has been sufficiently

30. *Id.* at 991.

31. *Id.*

32. *Id.* at 987.

33. *See, e.g.*, N.M. State Inv. Council v. Ernst & Young LLP, 641 F.3d 1089, 1095 (9th Cir. 2011) ("Under . . . Ninth Circuit law, we conduct a two-part inquiry for scienter . . . ."); WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1052 n.4 (9th Cir. 2011) (incorporating the *Tellabs* test through the express language of the *N.M. State* decision); *In re* NVIDIA Corp. Sec. Litig., No. C 08-04260 RS, 2011 U.S. Dist. LEXIS 117807, at *17–37 (N.D. Cal. Oct. 12, 2011) (undergoing a step-by-step application of the two-part test to six relevant factual circumstances); Curry v. Hansen Med., Inc., No. 5:09-cv-05094-JF (HRL), 2011 U.S. Dist. LEXIS 96697, at *12–22 (N.D. Cal. Aug. 25, 2011) (defining scienter generally and applying the two-part test).

34. *See In re* VeriFone Holdings, Inc. Sec. Litig., 704 F.3d 694, 702–03 (9th Cir. 2012).

35. *Id.* at 704. *See also id.* at 708–10 (analyzing the sufficiency of the plaintiffs' allegations).

36. *Id.* at 698.

pled."[37] After describing the two-step standard it adopted in *Zucco*, the Ninth Circuit declared that "*Matrixx* on its face does not preclude this [two-step] approach," and reiterated that it believed that the two-step inquiry followed "from the Court's directive in *Tellabs*."[38] The Ninth Circuit then stated that "[p]ost-*Matrixx*, our cases have employed varied approaches—some discuss first the sufficiency of specific allegations and then conduct a holistic review, while others conduct only a holistic analysis,"[39] before concluding that "[b]ecause the Court in *Matrixx* did not mandate a particular approach, a dual analysis remains permissible so long as it does not unduly focus on the weakness of individual allegations to the exclusion of the whole picture."[40]

In reaching this conclusion, the Ninth Circuit analyzed the potential effects of its two-step analysis. First, the Ninth Circuit claimed that "where an individual allegation meets the scienter pleading requirement, whether we employ a dual analysis is most likely surplusage because the individual and the holistic analyses yield the same conclusion."[41] The Ninth Circuit then acknowledged the potential danger inherent in its two-step process, noting the "risk, of course, is that a piecemeal analysis will obscure a holistic view,"[42] and citing to the Sixth Circuit's conclusion in *Frank v. Dana Corp.* that the "method of reviewing each allegation individually before reviewing them holistically 'risks losing the forest for the trees' and that such a method is unnecessarily inefficient."[43] This self-reflection by the Ninth Circuit brings into focus a puzzling question: Why, when a two-step analysis creates either surplusage or the danger of obscuring a holistic view, does the Ninth Circuit continue to support this approach, which adds danger of error and inefficiency without any obvious offsetting benefits?

This question becomes even more puzzling insofar as other circuits have criticized the Ninth Circuit's two-step approach as inconsistent with Supreme Court precedent.[44] The Third Circuit, for example, found that the first move in the two-step analysis merely "graft[ed] *Tellabs*'s

37. *Id*. at 702 (quoting Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1324 (2011)).

38. *Id.*

39. *Id.*

40. *Id.* at 703.

41. *Id.* at 702.

42. *Id.* at 703.

43. *Id.* (citing Frank v. Dana Corp., 646 F.3d 954, 961 (6th Cir. 2011)).

44. *See* Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 273 n.46 (3d Cir. 2009) (arguing that the Ninth Circuit "misinterpret[ed] the Supreme Court's [*Tellabs*] decision"); Frank v. Dana Corp., 646 F.3d 954, 961 (6th Cir. 2011) ("Our former method of reviewing each allegation individually risks losing the forest for the trees. Furthermore, after *Tellabs*, conducting an individual review of myriad allegations is an unnecessary inefficiency.").

holistic analysis onto the Ninth Circuit's earlier jurisprudence as an extra layer."[45] The Sixth Circuit asserted that an initial analysis of each separate allegation was out of step with *Matrixx*, arguing that aside from breaking with binding precedent, "conducting an individual review of myriad allegations is an unnecessary inefficiency."[46]

Yet, despite this criticism, the Ninth Circuit is hardly alone in employing a two-step analysis of scienter in securities fraud cases. Even where other circuits have not expressly endorsed the two-step framework, they regularly subscribe to it as a matter of practice.[47] And they tolerate piecemeal analysis in the lower courts, so long as such analysis is followed by holistic review. The Eight Circuit has put it most bluntly: "When a party asserts . . . that six factors collectively warrant a particular conclusion, we do not assume the district court failed to view the six collectively merely because it discussed them one at a time."[48] Even the Third Circuit—so critical of two-step analysis[49]—sustained a dismissal despite the fact that the district court discussed the entirety of the complaint very briefly, and only after "a lengthy discussion as to why *each* scienter-related allegation added little, if anything to plaintiffs side of the scienter scale."[50] Other federal courts have taken the same or similar approaches.[51]

So, why, given widespread criticism—and, at least for the Ninth Circuit and Third Circuit, substantial self-reflection—do some courts cling to the two-step framework for reviewing scienter allegations? The popularity of the method, which finds its way into judicial analysis even when uninvited, no doubt springs from its seeming reasonableness. And that seeming reasonableness, in turn, arises from the structure of legal thinking, its tendency toward incrementalism, and the logical

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45. *Avaya*, 564 F.3d at 273 n.46.

46. *Dana Corp.*, 646 F.3d at 961.

47. *See* 5A CHARLES ALAN WRIGHT & ARTHUR MILLER, FEDERAL PRACTICE AND PROCEDURE § 1301.1 (3d ed. 2004) (collecting cases in support of the proposition that "[v]irtually every court to consider the pleading standard in securities fraud cases after *Tellabs* has engaged in some form of an element by element analysis").

48. *In re* Ceridian Corp. Sec. Litig., 542 F.3d 240, 246 (8th Cir. 2008). The dissent, meanwhile, found the practice inconsistent with Supreme Court precedent. *Id.* at 678 (Ambro, J., dissenting).

49. *See supra* notes 44–45 and accompanying text.

50. City of Roseville Emps. Ret. Sys. v. Horizon Lines, Inc., 442 F. App'x 672, 675 (3d Cir. 2011).

51. *See, e.g.*, *In re* Bos. Scientific Corp. Sec. Litig., 686 F.3d 21, 31–32 (1st Cir. 2012) (asserting that the district court failed to consider scienter-related arguments "holistically"); Ashland, Inc. v. Oppenheimer & Co., 648 F.3d 461, 469 (6th Cir. 2011) (sustaining a district court's dismissal of the complaint, despite the lower court's use of "itemized analysis," because the "factual allegations, when considered together, [did] not give rise to a strong inference [of scienter]").

orientation to which it aspires.

To begin, the two-step method satisfies a lawyer's inherent desire for structure. In complicated securities fraud suits, itemized analysis of each individual allegation provides some structure to what might otherwise be an overwhelming task.[52] Structure is virtually synonymous with legal thinking. Law students learn to write and think according to rigidly structured formulae,[53] with the expectation that "lawyers and judges will 'both look for a tightly structured analysis that makes your conclusion seem inevitable.'"[54] Lawyers reserve some of their highest praise for those practitioners who reach that ideal[55] and regularly criticize "unstructured analysis."[56] Structure also promotes the sort of exactitude that facilitates appellate review.[57]

Second, by incorporating preexisting doctrine, the two-step approach seemingly preserves decades of securities fraud jurisprudence. In this sense, the two-step analysis allows the Ninth Circuit to retain some of the virtues of common law incrementalism and its minimalism.[58] By preserving existing doctrine, this sort of incrementalism theoretically enables the sequential aggregation of information, thereby "draw[ing] on the accumulated wisdom of past experience."[59]

More than anything else, however, the two-step analysis appears rational and is superficially quite appealing. In theory, holistic review can act as a failsafe measure, saving whatever meritorious complaints

52. *See* WRIGHT & MILLER, *supra* note 47, § 1301.1.

53. Jessica E. Price, *Imagining the Law-Trained Reader: The Faulty Description of the Audience in Legal Writing Textbooks*, 16 WIDENER L.J. 983, 995–1004 (2007) (describing and critiquing the dominant law school writing curriculum's emphasis on "IRAC," which teaches students to analyze legal problems by stating the legal *issue*, expressing the applicable *rule* of law(s), explaining and *applying* the legal rule to a particular fact pattern, and briefly stating the legal *conclusion*).

54. *Id.* at 998 (quoting RICHARD K. NEUMANN JR., LEGAL REASONING AND LEGAL WRITING: STRUCTURE, STRATEGY, AND STYLE 100 (5th ed. 2005)).

55. *See, e.g.*, Marsha S. Berzon, *David Feller—A Remembrance*, 24 BERKELEY J. EMP. & LAB. L. 227, 228 (2003) ("David [Feller] remained, twenty and thirty years after he had left the active practice of law, the gold standard, the person all his former colleagues would quote to younger lawyers like me. Thus, I was told, time and again: 'As Dave Feller says, a brief should be written so tightly that the first sentence of each paragraph can become the summary of argument.'").

56. *See, e.g.*, Illinois v. Somerville, 410 U.S. 458, 477 (1973) (Marshall, J., dissenting).

57. *Cf.* United States v. Perry, 228 F. App'x 557, 558–59 (6th Cir. 2007); United States v. Carillon Health Sys., 892 F.2d 1042 (4th Cir. 1989) (unpublished opinion).

58. Cass R. Sunstein, *Of Snakes and Butterflies: A Reply*, 106 COLUM. L. REV. 2234, 2242 (2006) ("Minimalism is grounded in an appreciation of the common law method and its appropriate place in constitutional law.").

59. Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422, 1475 (2011) (citing David A. Strauss, *Common Law Constitutional Interpretation*, 63 U. CHI. L. REV. 877, 891–92 (1996)).

that would otherwise succumb to the scrutiny of piecemeal analysis. As a matter of pure logic, there appear to be few objections to the adoption of a failsafe measure. As explained below, however, even judges are human and not creatures capable of pure logic. Therefore, this rationale for the two-step analysis falls short.

III. LOSING THE FOREST FOR THE TREES: A BEHAVIORAL ECONOMICS CRITIQUE OF THE TWO-STEP ANALYSIS

The two-step analysis appears relentlessly rational, but appearances can be deceiving. As courts often warn, "reviewing each allegation individually before reviewing them holistically risks losing the forest for the trees."[60] As the Ninth Circuit itself has recognized, sometimes "the sum is greater than the parts."[61]

Behavioral economics adds scientific heft to these timeworn adages. Experimental evidence demonstrates that the framing of a problem affects its resolution in irrational but predictable ways.[62] When faced with a logically identical choice between two outcomes, our preferences vary with the emotional context in which the problem is presented, or "framed."

For instance, Tversky and Kahneman asked 152 people to respond to the following problem (Problem 1):

> Imagine that the U.S. is preparing for the outbreak of an unusual Asian disease, which is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimate of the consequences of the programs are as follows:
>
> If Program A is adopted, 200 people will be saved.

60. Frank v. Dana Corp., 646 F.3d 954, 961 (6th Cir. 2011). *See also* Pub. Emps.' Ret. Ass'n of Colo. v. Deloitte & Touche LLP, 551 F.3d 305, 316 (4th Cir. 2009) ("Seeing the forest as well as the trees is essential."); WRIGHT & MILLER, *supra* note 47, § 1301.1 ("In employing any element by element analysis the danger that courts should recognize is that it is particularly easy *to lose the forest for the trees*. . . . [A] rigid quantitative method, such as counting the number of facts for and against scienter, will tend to underemphasize the interplay among the facts and is less appropriate than a more flexible approach that strives to keep the overall picture in mind." (emphasis added)).

61. *In re* VeriFone Holdings, Inc. Sec. Litig., 704 F.3d 694, 698 (9th Cir. 2012).

62. *See generally* Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453 (1981) [hereinafter Tversky & Kahneman, *Psychology of Choice*] (using experimental results to show that "[t]he psychological principles that govern the perception of decision problems and the evaluation of probabilities and outcomes produce predictable shifts of preference when the same problem is framed in different ways"); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251 (1986) (conducting various experiments to show that a preliminary analysis of a decision "frames the effective acts, contingencies, and outcomes").

> If Program B is adopted, there is 1/3 probability that 600 people will be saved, and 2/3 probability that no people will be saved.
>
> Which of the two programs would you favor?[63]

Tversky and Kahneman then presented a second group of 155 people with the same disease outbreak scenario, but with a different formulation of the program options (Problem 2):

> If Program C is adopted 400 people will die.
>
> If Program D is adopted there is 1/3 probability that nobody will die, and 2/3 probability that 600 people will die.
>
> Which of the two programs would you favor?[64]

Seventy-two percent (72%) of Problem 1 respondents chose Program A, while the remaining 28% of Problem 1 respondents chose Program B.[65] Thus, the majority choice in Problem 1 was "risk averse." In Problem 2, the results were reversed: 22% of respondents chose Program C, whereas 78% chose Program D.[66] Thus, the majority choice in Problem 2 was "risk taking." That is to say, though the outcomes were identical, the fact that in one set of questions the outcome is framed in terms of the number of lives *saved*, and in the other by the number of lives *lost*, resulted in a pronounced shift from risk aversion to risk taking. Psychology, not logic, determined preferences. This phenomenon equally affects experts deciding questions within their professional ken, whose deliberative processes ought to be disciplined by training and experience.[67] It also has been observed in judges' behavior.[68]

Establishing a default, or baseline, is a particularly powerful form of framing.[69] Scholars have observed a "default bias"—that is, people frequently prefer some sort of baseline option.[70] Confronted with "new

63. Tversky & Kahneman, *Psychology of Choice*, *supra* note 62, at 453.

64. *Id.*

65. *Id.*

66. *Id.*

67. *See* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 369 (2011) [hereinafter KAHNEMAN, THINKING, FAST AND SLOW] (public health professionals); Barbara J. McNeil, Stephen G. Pauker, Harold C. Sox, Jr. & Amos Tversky, *On the Elicitation of Preference for Alternative Therapies*, 306 NEW ENG. J. MED. 1259 (1982) (physicians); Tversky & Kahneman, *Psychology of Choice*, *supra* note 62, at 453 (university faculty and physicians).

68. Chris Guthrie, Jeffrey J. Rachlinksi & Andrew J. Wistrich, *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 797–98 (2001) ("The framing of the settlement decision affected judges in our study."); Jeffrey J. Rachlinksi, Chris Guthrie & Andrew J. Wistrich, *Inside the Bankruptcy Judge's Mind*, 86 B.U. L. REV. 1227, 1240 (2006) ("The decision frame affected the judges.").

69. *Cf.* Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1214 (2011) ("Once gatekeepers find markers of hard work, intensity, optimism, and enthusiasm by people inside the organization who seem dedicated and sincere, they relax their guard.").

70. *See, e.g.*, Eric J. Johnson & Daniel Goldstein, *Do Defaults Save Lives?*, 302 SCIENCE 1338

options, decision makers often stick with the status quo alternative—for example, to follow customary company policy, to elect an incumbent to still another term in office, to purchase the same product brands, or to stay in the same job."[71] A particular variant of the phenomenon, known as "anchoring,"[72] which describes when quantitative judgments are disproportionately influenced by an initial numerical reference point,[73] has been observed among judges.[74] And some scholars speculate that the status quo bias, in particular, may inflect judicial decision making.[75] In any case, the broader phenomenon of default biases is certainly familiar to jurists. In recognition of the influence of baselines on real-world decisions, the Supreme Court recently asked, "Shouldn't the default rule comport with the probable preferences of most [affected individuals]?"[76]

The two-step analysis explicitly adopted by the Ninth Circuit (and implicitly by other courts) risks framing the issue in an unbalanced manner by establishing an unnecessary baseline. Whatever answer a court generates on the first part of the two-step inquiry will affect its analysis of the subsequent holistic inquiry. That the procedure enlists the judge in establishing the baseline may exacerbate this default bias because the investment of time, energy, and resources in generating the baseline also creates some measure of investment in the outcome of the initial component of the analysis.[77] The first step of the evaluation is

(2003); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(K) Participation and Savings Behavior*, 116 Q. J. ECON. 1149 (2001).

71. William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8 (1988).

72. Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1504 (noting that the relevant "anchor" is "usually the status quo").

73. *See generally* KAHNEMAN, THINKING, FAST AND SLOW, *supra* note 67, at 119–28; Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1128–30 (1974).

74. Birte Englich, Thomas Mussweiler & Fritz Strack, *Playing Dice with Criminal Sentences: The Influence of Irrelevant Anchors on Experts' Judicial Decision Making*, 32 PERSONALITY & SOC. PSYCH. BULL. 188, 197–99 (2006) (German "legal professionals," mostly judges); Birte Englich, Thomas Mussweiler & Fritz Strack, *The Last Word in Court: A Hidden Disadvantage for the Defense*, 29 LAW & HUM. BEHAV. 705, 713–17 (2005) (German judges); Birte Englich & Thomas Mussweiler, *Sentencing Under Uncertainty: Anchoring Effects in the Courtroom*, 31 J. APPLIED SOC. PSYCHOL. 1535, 1547–49 (2001) (German judges).

75. *See, e.g.*, Marybeth Herald, *Deceptive Appearances: Judges, Cognitive Bias, and Dress Codes*, 41 U.S.F. L. REV. 299, 306 (2007) ("When courts interpret laws, the judges' status quo bias may undermine the implementation of laws dictating change."); Goutam U. Jois, *Stare Decisis Is Cognitive Error*, 75 BROOK. L. REV. 63, 98 (2009) ("When given a pre-existing set of legal rules, judges will be hesitant to move away from the status quo.").

76. Knox v. Serv. Emps. Int'l Union, 132 S. Ct. 2277, 2290 (2012).

77. Scholars have long observed that individuals who invest time, energy, and resources in a

sticky; it pulls the ultimate outcome toward it.

Indeed, evidence from within the Ninth Circuit suggests this stickiness affects outcomes in practice as well as theory. A Boolean search on LexisNexis for the citation for *Zucco*, with at least three mentions of scienter and the key word "dual inquiry," brought up twenty-two federal district court opinions. Each reviewed scienter allegations in detail and each explicitly recognized *Zucco*'s command to conduct a "dual inquiry"—first, an individualized analysis for each scienter allegation, and then a holistic analysis. As illustrated in Table 1, below, in only one of these twenty-two cases was there an explicit discussion of a conflict between the outcome of the individualized inquiries and the holistic analysis. (In a second case, there was a possible conflict between an individualized and a holistic analysis.) At the very least, the individual and holistic analyses pointed in the same direction in over 90% of the studied cases, thereby providing at least anecdotal evidence of "stickiness."

particular position display an irrational commitment to it. *See, e.g.*, Gillian Ku, Deepak Malhotra & J. Keith Murnighan, *Towards a Competitive Arousal Model of Decision-Making: A Study of Auction Fever in Live and Internet Auctions*, 96 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 89, 91–92 (2005) ("People who have freely chosen a course of action also tend to narrow their attention and focus on information that helps them justify further commitment."); Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 27, 41–42 (1976) (explaining that commitment frequently escalates when "additional time, effort, and resources" are invested). And some researchers have attempted to extend the theory of "endowment effects" to items that they wish to own. *See* James E. Heyman, Yesim Orhun & Dan Ariely, *Auction Fever: The Effect of Opponents and Quasi-Endowment on Product Valuations*, J. INTERACTIVE MARKETING 7, 10–11 (2004) ("[P]eople's valuation for an item changes based on whether they own the item." (citation omitted)). *Cf.* Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 477 (1897) ("A thing which you have enjoyed and used as your own for a long time, whether property *or an opinion*, takes root in your being and cannot be torn away without your resenting the act and trying to defend yourself, however you came by it." (emphasis added)).

TABLE 1
SCIENTER USING INDIVIDUALIZED VERSUS HOLISTIC ANALYSIS

Case Citation	Match or Conflict Between Individualized and Holistic Analyses
Kovtun v. Vivus, Inc., No. C 10-4957 PJH, 2012 U.S. Dist. LEXIS 139548 (N.D. Cal. Sept. 27, 2012)	Match (no scienter)
Kyung Cho v. UCBH Holdings, Inc., 890 F. Supp. 2d 1190 (N.D. Cal. 2012)	Match (scienter some defendants)
RS-ANB Fund, LP v. KMS SPE LLC, No. 4:11-CV-00175-BLW, 2012 U.S. Dist. LEXIS 53407 (D. Idaho Apr. 16, 2012)	Match (no scienter)
RS-ANB Fund, LP v. KMS SPE LLC, No. 4:11-CV-00175-BLW, 2011 U.S. Dist. LEXIS 129595 (D. Idaho Nov. 7, 2011)	Match (no scienter)
In re Nvidia Corp. Securities Litigation, No. C 08-04260RS, 2011 U.S. Dist. LEXIS 117807 (N.D. Cal. Oct. 12, 2011)	Match (no scienter)
Curry v. Hansen Medical, Inc., No. 5:09-CV-05094-JF(HRL), 2011 U.S. Dist. LEXIS 96697 (N.D. Cal. Aug. 25, 2011)	Match (no scienter)
Kyung Cho v. UCBH Holdings, Inc., No. C 09-4208 JSW, 2011 U.S. Dist. LEXIS 100580 (N.D. Cal. May 17, 2011)	Match (no scienter)
Louisiana Pacific Corp. v. Money Market 1 Institutional Investment Dealer, No. C 09-03529 JSW, 2011 U.S. Dist. LEXIS 32414 (N.D. Cal. Mar. 28, 2011)	Match (no scienter)
In re Bank of America Corp. Auction Rate Securities (ARS) Marketing Litigation, No. 09-md-02014 JSW, 2011 U.S. Dist. LEXIS 18208 (N.D. Cal. Feb. 24, 2011)	Match (scienter for portion of class period)
Allstate Life Insurance Co. v. Robert W. Baird & Co., 756 F. Supp. 2d 1113 (D. Ariz. 2010)	Match (scienter for some defendants)
In re Rigel Pharmaceuticals, Inc., No. C 09-00546 JSW, 2010 U.S. Dist. LEXIS 143948 (N.D. Cal. Aug. 24, 2010)	Match (no scienter)
In re Medicis Pharmaceutical Corp. Securities Litigation, No. CV-08-1821-PHX-GMS, 2010 U.S. Dist. LEXIS 81410 (D. Ariz. Aug. 9, 2010)	Conflict (scienter when holistic, potentially not when individual)[78]
Desserault v. Yakima Chief Property Holdings, LLC, No. CV-09-3055-RMP, 2010 U.S. Dist. LEXIS 56483 (E.D. Wash. June 3, 2010)	Match (no scienter)

78. *See Medicis Pharm. Corp.*, 2010 U.S. Dist. LEXIS 81410, at *33 ("Though Plaintiffs' allegations may not be sufficient to give rise to the requisite state of mind if considered in isolation, they do give rise to a cogent inference of scienter when considered collectively.").

Case Citation	Match or Conflict Between Individualized and Holistic Analyses
In re Century Aluminum Co. Securities Litigation, 749 F. Supp. 2d 964 (N.D. Cal. 2010)	Match (no scienter)
In re Taleo Corp. Securities Litigation, No. C 09-00151 JSW, 2010 U.S. Dist. LEXIS 13696 (N.D. Cal. Feb. 17, 2010)	Match (no scienter)
In re Medicis Pharmaceutical Corp. Securities Litigation, 689 F. Supp. 2d 1192 (D. Ariz. 2009)	Match (no scienter)
In re PMI Group, Inc., No. C 08-1405 SI, 2009 U.S. Dist. LEXIS 101582 (N.D. Cal. Nov. 2, 2009)	Match (scienter)
In re Cadence Design Systems, Inc. Securities Litigation, 654 F. Supp. 2d 1037 (N.D. Cal. 2009)	Match (no scienter)
In re PMI Group, Inc., No. C 08-1405 SI, 2009 U.S. Dist. LEXIS 56709 (N.D. Cal. July 1, 2009)	Match (no scienter)
Brant v. Kipp, No. CV 08-8320 AHM (RZx), 2009 U.S. Dist. LEXIS 48742 (C.D. Cal. May 21, 2009)	Match (no scienter)
City of Alameda v. Nuveen Municipal High Income Opportunity Fund, No. 08-4575 SI, 2009 U.S. Dist. LEXIS 42637 (N.D. Cal. May 20, 2009)	Match (scienter)
Teamsters Local 617 Pension & Funds v. Apollo Group, Inc., 633 F. Supp. 2d 763, 796 (D. Ariz. 2009)	Match with some Defendants, potential conflict with others (scienter as to some defendants)

Moreover, a review of these opinions confirms that the individualized analyses added little, if any benefit, to the holistic conclusion. Listing each individual factor and determining whether each one, on its own, sufficiently alleges scienter simply does not make the holistic analysis better and, as discussed above, potentially makes it worse. This potential to pollute a holistic analysis of securities fraud allegations is further confirmed by psychology. The narrow framing of problems often generates bad reasoning. Narrow frames simplify analysis,[79] which may encourage mental laziness by implying the availability of preexisting answers. Such frames certainly depart from the assumption that rational decision makers "make their choices in a comprehensively inclusive context, which incorporates all the relevant details of the present situation."[80] And, in many contexts, such narrow frames have been derided for generating systematic deviations from rational

79. Tversky & Kahneman, *Psychology of Choice*, *supra* note 62, at 456–57.

80. Daniel Kahneman, *Maps of Bounded Rationality: Psychology for Behavioral Economics*, 93 AM. ECON. REV. 1449, 1459 (2003).

behavior.[81]

By contrast, as Daniel Kahneman points out, "[b]roader frames and inclusive accounts generally lead to more rational decisions."[82] As Judge Posner has put it in a separate context, "[i]t is true that zero plus zero equals zero. But evidence can be susceptible of different interpretations, only one of which supports the party sponsoring it, without being wholly devoid of probative value for that party."[83] Piecemeal consideration of each allegation thus risks disregarding this probative quality—it risks losing the forest for the trees.

By ignoring the significance of contextual evidence, narrow framing also undermines the neutrality of the forum in a way that broader framing does not. Piecemeal parsing of the complaint hurts plaintiffs. They must make their case without the contextual cues that hold together traditional narratives.[84] Plaintiffs might use contextual cues to enhance the strength of their claims.[85] A holistic inquiry, by contrast, is neutral between plaintiffs and defendants. "Just as facts innocent in themselves may appear more suspicious in the company of other facts, so too can a fact that seems damning when presented alone sometimes be explained away by reference to other circumstances."[86]

81. *See, e.g.*, *id.* at 1459–60 (collecting numerous examples); Alok Kumar & Sonya Seongyeon Lim, *How Do Decision Frames Influence the Stock Investment Choices of Individual Investors?*, 54 MGMT. SCI. 1052, 1063–64 (2008) (providing empirical evidence suggesting that individual investors who narrowly framed their decisions were more likely to be under diversified, and to sell successful investments and hold onto losing investments).

82. KAHNEMAN, THINKING, FAST AND SLOW, *supra* note 67, at 372.

83. *In re* High Fructose Corn Syrup Antitrust Litig., 295 F.3d 651, 655 (7th Cir. 2002) (Posner, J.). *See also In re* Bos. Scientific Corp. Sec. Litig., 686 F.3d 21, 31–32 (1st Cir. 2012) (Boudin, J.) ("True, allegations that are individually insufficient can sometimes combine together to make the necessary showing. To take the simplest example, one known episode of an adverse drug reaction might be meaningless; an undisclosed collection of repeated and serious adverse reactions might permit an inference of conscious wrongdoing or recklessness because the adverse implication is so obvious.").

84. *Cf.* Muneer I. Ahmad, *Resisting Guantanamo: Rights at the Brink of Dehumanization*, 103 NW. U. L. REV. 1683, 1694 (2009) ("We can think of narrative as the architecture of context . . . . To understand a legal dispute, one must comprehend the narrative context it inhabits.").

85. *See* Ann Morales Olazábal, *Defining Recklessness: A Doctrinal Approach to Deterrence of Secondary Market Securities Fraud*, 2010 WIS. L. REV. 1415, 1430. *See also* Michael J. Kaufman & John M. Wunderlich, *Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation*, 73 OHIO ST. L.J. 507, 540 (2012) ("[T]he vagueness surrounding precisely how senior management knew about the facts pertaining to the misleading statements is simply one factor to consider in the scienter analysis.").

86. Institutional Investors Grp. v. Avaya, Inc., 564 F.3d 242, 273 n.46 (3d Cir. 2009); *accord* Meltzer Inv. GMBH v. Corinthian Colls., Inc., 540 F.3d 1049, 1069 (9th Cir. 2008) ("[*Tellabs*'s] directive that a complaint must be read in its entirety cuts both ways. Although a defendant cannot gain dismissal by de-contextualizing every statement in a complaint that goes to scienter, a plaintiff cannot *avoid* dismissal by reliance on an isolated statement that stands in contrast to a host of other insufficient allegations.").

CONCLUSION

Ultimately, *Tellabs*'s injunction that scienter allegations should not be evaluated individually is not just binding law; it is also *good* binding law as it discourages bias. As shown above, the Ninth Circuit's attempt to retain separate review of individual scienter allegations as part of a two-step process does not eliminate the problem of bias inherent in an individualized analysis of allegations. Instead, the two-step process allows the individualized analysis to pollute the holistic analysis and unnecessarily adds another level of review, building inefficiency and confusion into the process. For these reasons, the Ninth Circuit should let go of its piecemeal analysis of scienter allegations, follow the Supreme Court's dictates in *Tellabs*, and solely analyze scienter holistically.