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THE PRIVATE SECURITIES LITIGATION REFORM ACT AND THE ENTREPRENEUR: PROTECTING NAÏVE ISSUERS FROM SOPHISTICATED INVESTORS

Robert Sprague and Karen L. Page***

INTRODUCTION

The purpose of U.S. securities laws is to protect investors by requiring full disclosure on the part of the issuers of securities. The intent is to increase the efficiency and integrity of the nation's capital markets by ensuring that all material information is publicly available. Thus, the laws were created and have been amended to provide legal redress for investors who were not provided with sufficient information to make a reasoned decision. In most respects, these laws presume relative naïveté on the part of the investors and relative knowledge and power on the part of the issuers.

There is evidence suggesting, however, that in the sphere of new ventures, the balance of power may be tipped in favor of the investors and away from the issuers. Indeed, it is often the case that entrepreneurs, though expert in their substantive field, tend to be naïve in financial and business matters. Investors, particularly venture capitalists, on the other hand, tend to be experienced and knowledgeable in financial matters. In these circumstances, there was a threat that securities laws could exacerbate the power imbalance in favor of the investors and leave the entrepreneurs vulnerable to unfair dealing. Specifically, because of the tenuous financial position of new ventures, any heavy-handedness on the part of

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investors could kill the venture, regardless of the merits of the investors' claims. Indeed, any threat of litigation, regardless of how spurious, could paralyze a new venture.

This article first examines the current research regarding control mechanisms used by investors in new ventures and conflicts that arise between investors and entrepreneurs. The legal environment associated with private securities litigation is then examined in detail. Specifically, this article examines court interpretations of the language within the Private Securities Litigation Reform Act regarding allegations of fraud; finding that the Act, though intended to address other perceived abuses, may actually benefit entrepreneurs accused of securities fraud in new venture financing. This article then briefly examines additional non-legal attributes that may also favor entrepreneurs when dealing with new venture financiers.

Business Start-Ups and Venture Capital

The iconic perspective of modern entrepreneurship is the handful of bright, young entrepreneurs developing their product with minimal resources, sometimes literally in a garage, to then be “discovered” by venture capitalists who fund and nurture the fledgling enterprise until it becomes a public corporation and leader in its industry, and, at the same time, turning the young entrepreneurs into wealthy captains of modern industry.¹

Since a start-up business does not have an established product in the market, there are generally little to no revenues in the business' nascent years. A small, start-up business has a variety of sources from which it may draw operating capital: the savings of the owners; bank loans, particularly those guaranteed by the Small Business Administration; friends and relatives; wealthy individuals—often referred to as “angels;” and venture capitalists.

Loans to the business are limited to the extent of the collateral of the owners and create a repayment burden while the business is still developing. Selling part of the business to an investor offers a viable alternative, as the amount of invested funds is structured on the expected future value of the enterprise, and there is no direct repayment burden.

Venture capitalists have become a significant source of new venture financing in recent years. “The venture capital market thus provides a unique link between finance and innovation, providing start-up and early stage firms—organizational forms particularly well-suited to innovation—with capital market access that is

¹ See, e.g., Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 38 (2006) (describing the \$25 million investment in the start-up company Google, which resulted four years later in a \$4 billion public stock offering).

tailored to the special task of financing these high-risk, high-return activities.”² By 2003, there were nearly 2,000 venture funds actively managing over \$250 billion in business investments.³ The typical venture capital process is for a venture capital firm to form a limited partnership, with itself as the general partner. Limited partners are then solicited to pledge funds to a particular venture fund. The limited partners are usually institutional investors and high-wealth individuals. The venture capital firm manages the fund, selecting in which ventures to invest. The venture capital firm collects a set management fee, as well as shares in positive returns earned by the fund.⁴

Angels, in contrast, are generally high-wealth individuals who invest directly in a business at a very early start-up phase. While there often is some form of personal relationship between the angel and the business owner, the availability of angels has progressed beyond just “friends and families.” Angels have become more prominent and accessible, even banding together into organizations to share leads and information.⁵

Whether the initial venture funding is provided by an angel or venture capitalists, it is expected that there will be subsequent rounds of financing as the business develops, often involving more than one venture capital fund.⁶ The investors’ goal is a liquidity event, usually in the form of an initial public offering (IPO) of the stock of the venture. The IPO creates a market for the stock of the venture, allowing the investors to sell their ownership interest in the venture—theoretically for a substantial profit.

Even where the investors and the entrepreneur are equally committed to maximizing shareholder wealth, they may have recurring disagreements regarding how to prioritize operating goals.⁷ The entrepreneur’s ultimate goal often is to build a viable business, while the investors’ goal is a positive return on investment

² Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons From the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003) (footnote omitted).

³ See Jeffrey M. Leavitt, *Burned Angels: The Coming Wave of Minority Shareholder Oppression Claims in Venture Capital Start-Up Companies*, 6 N.C. J.L. & TECH. 223, 223 (2005).

⁴ See Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was It Something Lawyers Helped Structure?*, 77 CHI.-KENT L. REV. 211, 216 (2001). See also Gilson, *supra* note 2.

⁵ See Leavitt, *supra* note 3. See also Pui-Wing Tam, *Fresh Crop of Investors Grows in Silicon Valley*, WALL ST. J., May 1, 2006, at C1 (discussing the rise of angel investors in Silicon Valley who were previously start-up executives, particularly at Google, Inc.); Jaclyne Badal, *Early Options*, WALL ST. J., Apr. 30, 2007, at R6 (discussing the various options entrepreneurs have for sources of start-up capital).

⁶ See generally Michael Gorman & William A. Sahlman, *What Do Venture Capitalists Do?*, 4 J. BUS. VENTURING 231 (1989).

⁷ See generally Harry J. Sapienza & Anil K. Gupta, *Impact of Agency Risks and Task Uncertainty on Venture Capitalist-CEO Interaction*, 37 ACAD. MGMT. J. 1618 (1994).

within a few years. Strategic goals may also differ because of differences in risk tolerance and portfolio balance. Whereas investors, for whom the company is but one of many investments, may be willing to commit to a single strategic target and cease participation if specific milestones are not met, entrepreneurs may be interested in pursuing multiple strategic targets because the company is the sole investment in the entrepreneur's portfolio. As a result, investors and the entrepreneur have different, and possibly conflicting, priorities.⁸

Investing in small, start-up ventures involves significant risk.⁹ Risk can have its rewards: venture funds collectively reported returns of 150% in 1999. But risk also sometimes means loss: venture funds collectively reported returns greater than negative 25% in 2002.¹⁰ One study has indicated that approximately 7% of investments account for more than 60% of venture capitalists' profits, while one-third of investments result in losses.¹¹

There are significant unknown variables associated with start-up ventures. By definition, the business model of a start-up has not been tested against an actual market. Most start-ups do not yet even have a product. It is unknown whether the idea can be converted to a marketable product, whether a competitive product is about to be introduced in the market, or whether the entrepreneur can manage an operational and growing business.¹² In addition, each party's self-interests may increase the risk of failure. Venture capitalists are only willing to provide the minimum funds necessary for the venture to meet discrete milestones, thereby minimizing the venture capitalists' risk if the venture appears unsuccessful in its early stages. At the same time, the entrepreneur is loath to give up too much ownership and control in the business. "Thus both venture capitalists and entrepreneurs willingly conspire to impose stringent limits on the resiliency of their enterprises."¹³ While venture capitalists and entrepreneurs may initially believe they are a partnership which has common goals, when things go badly, their divergent interests become painfully apparent.¹⁴

⁸ In particular, entrepreneurs and venture capitalists may have different interests regarding the timing and form of exit from the business venture. See generally D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA LAW REV. 315 (2005).

⁹ See *id.*; See generally Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45 (2002).

¹⁰ See Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867, 869 (2004). See also Rebecca Buckman, *Silicon Valley's Backers Grapple with Era of Diminished Returns*, WALL ST. J., Aug. 3, 2006, at A1 (noting that Silicon Valley-based venture capital firms had negative cumulative returns for six years into 2006).

¹¹ See Amar Bhide, *Bootstrap Finance: The Art of Start-Ups*, HARV. BUS. REV., Sept.-Oct. 1990, at 109.

¹² See Sapienza & Gupta, *supra* note 7.

¹³ Gorman & Sahlman, *supra* note 6, at 238.

¹⁴ See generally Gorman & Sahlman, *supra* note 6.

Venture capitalists attempt to control risk through governance procedures.¹⁵ Studies indicate that venture capitalists pursue less industry and geographic diversification when investment risk is high; therefore they manage risk through monitoring and involvement rather than through diversification.¹⁶ When deciding whether to fund a new venture, venture capitalists must consider more than the potential success of the venture, and hence the positive return on investment. Venture capitalists must also decide how best to structure the financing to protect their own interests while simultaneously enhancing the likelihood that the new venture will succeed.¹⁷ The foundation of this structure is governance and control.¹⁸

Although venture capitalists do not usually purchase a majority of the venture's stock, they do purchase enough to eventually control the company's board of directors, which has the ultimate responsibility of managing the company. The venture capitalists' equity investments in new ventures are typically in the form of convertible preferred stock.¹⁹ In addition, venture capitalists provide financing in stages, replenishing capital only if the venture remains a potentially viable investment.²⁰ As the venture capitalists invest more funds over time, they generally gain more control of the venture.²¹

With this level of control, venture capitalists can exert a number of powers. For example, the venture capitalists will require disincentives for the entrepreneur to exit from the venture, particularly by requiring that entrepreneurs sell their interest in the company (back to the company) should they leave²² or by placing the entrepreneurs on an equity vesting schedule.²³ However, at the same time, venture capitalists will obtain the ability to terminate the entrepreneur if they believe

¹⁵ See Bartlett, *supra* note 1, at 53-54 (discussing control and monitoring rights as one of the means venture capitalists use to manage risk).

¹⁶ See generally Sapienza & Gupta, *supra* note 7.

¹⁷ See Smith, *supra* note 8, at 316 ("Before venture capitalists invest, they plan for exit.").

¹⁸ See generally Jay B. Barney et al., *The Structure of Venture Capital Governance: An Organizational Economic Analysis of Relations Between Venture Capital Firms and New Ventures*, ACAD. MGMT. PROC. 64 (1989); Utset, *supra* note 9.

¹⁹ See Gilson, *supra* note 2, at 1072. See also Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 875 (2003) ("[O]verwhelmingly, venture capitalists make their investments through convertible preferred stock.") (footnote omitted).

²⁰ See Gilson, *supra* note 2. See generally Smith, *supra* note 8.

²¹ Smith, *supra* note 8, at 324 ("More often than not, venture capitalists do not acquire a majority of the votes in the initial round of financing. In subsequent rounds of financing, the venture capitalists build their voting power, and at some time within the first few rounds, venture capitalists acquire a majority of the votes.") (footnotes omitted).

²² See Utset, *supra* note 9, at 66-67.

²³ See generally Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998).

more competent senior management is needed and the entrepreneur is no longer necessary for the viability of the venture.²⁴ Research indicates the most significant reason new ventures fail is because of ineffective senior management, meaning that venture capitalists will “frequently” fire the original senior management.²⁵ Some anecdotal evidence suggests the entrepreneurs face a much harsher reality as they place confidence in venture capitalists whose business models are based on generating enormous returns on a small percentage of their many investments, rather than nurturing fledgling entrepreneurs. Indeed, some entrepreneurs have thought their dreams of a successful start-up were realized when venture capitalists agreed to invest, only to find that they were left with nothing.²⁶ Ultimately, if the venture capitalists believe the venture is no longer viable, they can liquidate it, which includes having the company buy back the venture capitalists’ stock (to the extent there are assets to pay for the redemption).²⁷

The entrepreneur, understandably, will more than likely fight any termination or liquidation decision by the venture capitalists. The entrepreneur is also not necessarily powerless, if the entrepreneur holds the knowledge necessary to make the venture viable. This may set up a conflict between the entrepreneur and the venture capitalists that ultimately may be destructive to the venture. In addition, one commentator has argued that since venture capitalists typically obtain control of the venture in the early stages of financing, they are essentially “locked in” during the early stages of the investment relationship.²⁸ If the venture capitalists are at odds with the entrepreneur, but the entrepreneur is too valuable to the venture to terminate or the relationship is in too early of a stage for the venture capitalists to have control, the result may be retaliation. Angels, too, may lack control mechanisms required for a graceful exit and feel it necessary to retaliate.

There are reputational costs associated with venture capital financing. The expertise of venture capitalists underlies and justifies their role.²⁹ Having to abandon an investment altogether would negatively impact a venture capitalist’s reputation. Abandonment because of conflicts with the entrepreneur would create a high exit cost for the venture capitalist. However, research indicates that individuals facing high exit costs may choose not to exit unfair transactions,

²⁴ See, e.g., Reynolds Holding, *Double-Crossed: Silicon Valley Entrepreneurs Say They Have Been Betrayed By Venture Capitalists and Lawyers, The Very People They Asked for Help*, S.F. CHRON., Nov. 17, 1999, at A1 (discussing an entrepreneur forced out of the company he founded two months after venture capitalists gained control of the company’s board of directors).

²⁵ See generally Gorman & Sahlman, *supra* note 6.

²⁶ See generally Holding, *supra* note 24.

²⁷ See Utset, *supra* note 9, at 110-11.

²⁸ Smith, *supra* note 8, at 317. Indeed, Gilson & Schizer, *supra* note 19, argue that the use by venture capitalists of convertible preferred stock is more for tax purposes rather than control.

²⁹ See Bankman & Cole, *supra* note 4, at 219.

choosing instead to remedy the unfairness by retaliating against the other party.³⁰ This retaliation may be in the form of litigation filed or threatened against the entrepreneur.

In situations where an investor files or threatens suit against the entrepreneur, some form of claim of misrepresentation, including outright fraud, will be pursued. Although the history surrounding the development of securities law in the United States since the 1930's has strongly favored investors over the issuer of securities (here, the entrepreneur), recent amendments to the U.S. securities laws may actually favor the entrepreneur.

SECURITIES REGULATION AND LITIGATION

The stock market crash of 1929 exposed significant shortcomings in the regulation of the sale of securities in the United States. Post-crash, it was discovered that billions of dollars had been invested in practically worthless securities.³¹ In formulating legislation to regulate the securities market, the U.S. Senate's sentiment was that "organizations and promoters . . . [had] sold 'fake' securities throughout this country to the tune of billions of dollars, and [had] sunk their fangs into the pocketbooks of the innocent investors with greater rapacity than a school of sharks ever sank teeth into human flesh."³² Congressional hearings "indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money."³³

In 1933, President Roosevelt recommended to Congress legislation for federal supervision of traffic in investment securities. While the federal government would not take any action that could be construed as approving or guaranteeing that newly issued securities are sound or will earn a profit, it did impose an obligation that every issue of new securities be accompanied by full disclosure. Further, President Roosevelt believed that in order to protect the public, the burden should be on the seller of securities to tell the whole truth—changing the ancient rule of *caveat emptor* (let the buyer beware) when dealing with securities to *caveat venditur* (let the seller beware).³⁴

The result of the post-crash investigations were two major pieces of federal legislation, both of which are integral to current securities markets. The Securities

³⁰ See Utset, *supra* note 9, at 119.

³¹ See generally S. REP. NO. 73-147 (1933).

³² 77 CONG. REC. 1018, 1019 (Mar. 30, 1933) (Change of Committee Reference of S. 875 to the Senate Committee on Banking and Currency).

³³ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

³⁴ See generally H.R. REP. NO. 73-85 (1933).

Act of 1933 regulates the initial offering of securities to the public by requiring full disclosure of all matters relevant to the securities, through the form of a registration statement filed with the Securities and Exchange Commission (SEC) and the distribution of a prospectus to all potential purchasers.³⁵ The Securities Exchange Act of 1934 regulates transactions in securities, particularly by regulating the activities of securities brokers and dealers and requiring companies that offer their securities to the public to regularly file reports with the SEC.³⁶

Since the aim of the Securities Act of 1933 is to protect the general public, securities that are not offered for sale to the general public can be exempt from the Act. Certain of these exempted offerings are considered “limited” because they qualify for exemption if they meet limits in the amount of funds raised and/or they are offered only to a limited number or class of investors. In 1982, the SEC promulgated Regulation D³⁷ to simplify and clarify existing limited offering exemptions from registration and to expand the availability of these exemptions.³⁸

In particular, sales of securities to “accredited” investors are generally exempt from the Securities Act. Accredited investors include institutional investors, “insiders” (i.e., officers and directors of the company issuing the stock), and high-wealth individuals.³⁹ A company (issuer) is under no statutory obligation to make disclosures as long as all of the securities it offers are purchased by accredited investors. The theory is that accredited investors are experienced, sophisticated, and can afford to assume the risks of their investments.⁴⁰

This does not mean that exempt securities are completely free of all securities regulation.⁴¹ Regardless of the disclosure requirements from which a security offering may be exempt, all sales of securities are subject to the anti-fraud provisions of the Securities Exchange Act of 1934.⁴² The SEC enforces this anti-fraud provision through Rule 10b-5, which makes unlawful the use of any scheme or artifice to defraud, as well as untrue statements of material facts, or the omission of material facts.⁴³ The Securities Exchange Act’s anti-fraud provision may also be enforced by private parties through a civil action.⁴⁴

³⁵ 15 U.S.C. §§ 77a–77aa (2007).

³⁶ 15 U.S.C. §§ 78a–78mm (2007).

³⁷ 17 C.F.R. § 230 (2007).

³⁸ See Manning G. Warren, III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under The Securities Act of 1933*, 33 AM. U. L. REV. 355, 358 (1984).

³⁹ 17 C.F.R. § 230.501 (2007).

⁴⁰ See Warren, *supra* note 38, at 376–78.

⁴¹ See generally *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

⁴² Section 10b; 15 U.S.C. § 78j (2007).

⁴³ 17 C.F.R. § 240.10b-5 (2007).

⁴⁴ See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2507 (2007).

When new venture investors have lost control so that they are either in disagreement with the manner in which the venture is operated and/or they are in fear of losing their investment, they may invoke section 10b of the Securities Exchange Act. To establish a claim for securities fraud under section 10b and Rule 10b-5, the investor must prove that the entrepreneur (1) made a misstatement or an omission of a material fact; (2) with scienter (i.e., with knowledge of its falsity and with an intent to deceive); (3) in connection with the purchase or the sale of a security; (4) upon which the investor reasonably relied; and (5) the investor's reliance was the proximate cause of his or her injury.⁴⁵ The fact that the investor purchased the securities under an exemption that did not require specific disclosures eliminates one possible defense to a securities fraud action—that the information forming the basis of the alleged misstatement or omission was fully disclosed to the investor and despite the disclosure, the investor chose to still invest in the venture.

In theory, sophisticated or professional investors who invest in new ventures via purchases in exempt offerings of securities, such as venture capital firms that are also sophisticated enough to negotiate control mechanisms, generally will insist on enough disclosures from the entrepreneur and undertake its own due diligence to make it highly unlikely that significant material facts can remain undisclosed without making the disclosures they do demand either false or misleading.⁴⁶ However, the current law regarding issuer disclosure obligations under the anti-fraud provisions of federal securities laws is both unclear and complex.⁴⁷ In addition, angels, including friends and family, may not be as sophisticated and thorough as a venture capital firm and may not ask for sufficient disclosures, creating a later opportunity to claim that material information was not disclosed. Regardless, the mere threat to file a securities fraud claim against the entrepreneur may be sufficient to allow the investor to regain control of the venture or to force an early buyout favorable to the investor.

Filing a lawsuit initiates a long, complex, and expensive process. A lawsuit can achieve a certain perceived strategic advantage for the plaintiff, even if there is no legitimate chance of culminating in a favorable verdict. From a new venture perspective, being accused of securities fraud has a number of consequences. First, it taints the venture. It raises the specter that the entrepreneur has misled—even swindled—the investor. Second, it freezes follow-on financing. It is a signal that the investor who has filed the lawsuit will not be providing future financing. In addition, the filing of the lawsuit raises the distinct possibility—regardless of the improbability—the venture is at risk of paying a large verdict (or settlement) in

⁴⁵ See Anish Vashista et al., *Securities Fraud*, 42 AM. CRIM. L. REV. 877, 880 (2005).

⁴⁶ See Harry S. Gerla, *Issuers Raising Capital Directly From Investors: What Disclosure Does Rule 10b-5 Require?*, 28 J. CORP. L. 111, 113 (2002).

⁴⁷ See *id.* at 114.

the near future. Investors will not invest in the venture if they believe they will be financing a judgment rather than actual business activities. Finally, the process of the litigation not only extracts costs in the form of funds that would otherwise be directed to actual business activities, but managers' time and energy are also diverted from the business to the litigation.

Disgruntled investors could theoretically use litigation or the threat thereof to obtain a strategic advantage—either to force a cash-out of their investment or a significant change in management or business strategy. Even if the litigation effectively ends the venture, it will at least provide a degree of liquidation from the remaining proceeds that still possibly preserves the investor's reputation by signaling that the investment decision was based on the entrepreneur's alleged fraud rather than the investor's poor decision-making.

The issue is how real the threat or commencement of litigation is for an entrepreneur and new venture even when the claims are designed to extract a strategic advantage not otherwise available through governance mechanisms. Because the standards for filing a claim for misrepresentation are so high under the Private Securities Litigation Reform Act of 1995, the very protections that were originally designed in the 1933 Act to protect naïve investors in fact serve to protect naïve entrepreneurs from sophisticated investors.

THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

While the U.S. Congress recognizes that private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action, it also is aware of substantial abuses in private securities litigation.⁴⁸ In 1995, Congress amended the Securities Act of 1933 and the Securities Exchange Act of 1934 by enacting the Private Securities Litigation Reform Act (PSLRA)⁴⁹ to address certain perceived private securities litigation abuses, including:

- (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action;
- (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability;
- (3) the abuse of the discovery process

⁴⁸ See generally H.R. CONF. REP. NO. 104-369 (Nov. 28, 1995).

⁴⁹ Pub.L. 104-67, 109 Stat. 737. See generally Ann M. Olazabal, *The Search for "Middle Ground": Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153 (2001) (analyzing the PSLRA).

to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.⁵⁰

The main concern of Congress was the phenomenon of “professional plaintiffs” who own a nominal number of shares in a wide range of publicly traded companies and who “race” to the courthouse, with the aid of class-action law firms, to file abusive lawsuits whenever stock prices drop.⁵¹ Despite Congress’ intent, the consequences of the PSLRA are more far-ranging. As the Supreme Court has noted, a clear objective of the PSLRA is a bit more broad: to serve as a check against abusive litigation by private parties.⁵² Therefore the standards and procedures promulgated under the PSLRA can apply as well to litigation (or the threat of litigation) arising from issues of disputed control between investors and entrepreneurs within new ventures.

Regardless of the motive of a securities lawsuit, the reality is that it is very expensive to defend. Most of the litigation cost—up to 80%—is incurred during pre-trial discovery.⁵³ The cost of discovery often forces innocent parties to settle frivolous securities class actions. In addition, the threat that the time of key employees will be spent responding to discovery requests, including providing deposition testimony, often forces coercive settlements.⁵⁴ Hence, the mere threat of litigation could lead to a forced outcome favorable to a disgruntled new venture investor.

Because a significant portion of the PSLRA attempts to minimize the potential for frivolous securities litigation, one important strategy of the PSLRA is to raise the requirements for alleging securities fraud by requiring pleading fraud with particularity. Specifically, where a plaintiff alleges that the defendant made an untrue statement of a material fact or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading, then the plaintiff’s complaint must specify each statement alleged to have been misleading, and the reason or reasons why the statement is misleading.⁵⁵ These heightened pleading requirements are so strict, it is reported that the dismissal rates for securities fraud actions have nearly doubled since passage of the PSLRA.⁵⁶

⁵⁰ H.R. CONF. REP. NO. 104-369, at 31 (1995).

⁵¹ *Id.* at 32-33.

⁵² See *Tellabs*, 127 S.Ct. at 2504.

⁵³ See H.R. CONF. REP. NO. 104-369, at 37.

⁵⁴ See *id.*

⁵⁵ 15 U.S.C. § 78u-4(b) (2007).

⁵⁶ See Amy J. St. Eve & Bryce C. Pilz, *The Fault Allocation Provisions of the Private Securities Litigation Reform Act of 1995—A Roadmap for Litigants and Courts*, 3 N.Y.U. J. L. & Bus. 187, 187 (2006).

The PSLRA reinforces the heightened pleading requirements by allowing a defendant to file a motion to dismiss the lawsuit if the plaintiff's complaint fails to meet the heightened pleading requirements.⁵⁷ To expedite the process and minimize costs, discovery can be stayed while the court considers the motion to dismiss.⁵⁸ The plaintiff is also required to prove that the acts or omissions complained of actually caused the plaintiff to suffer the loss for which the plaintiff seeks to recover damages.⁵⁹ The PSLRA also strengthens provisions for awarding a defendant attorneys fees and costs associated with a lawsuit the court determines was brought for an improper purpose, unwarranted by existing law, legally frivolous, or not supported by facts.⁶⁰

However, Congress' attempts to stem securities litigation abuse created some uncertainty. Prior to the passage of the PSLRA, securities fraud pleadings were governed by the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure.⁶¹ Although Rule 9(b) already required that fraud be pleaded with particularity, Congress believed that that rule alone had not prevented securities litigation abuse.⁶² In a securities fraud action in which the plaintiff alleges the defendant made an untrue statement of a material fact or omitted to state a material fact (necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading), the complaint must specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint must state with particularity all facts on which that belief is formed.⁶³ And if the success of the action is dependent upon proof that the defendant acted with a particular state of mind, the complaint must, with respect to each act or omission alleged, state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind.⁶⁴

Congress' concern with Rule 9(b) was based, in part, on the fact that the various federal courts have interpreted Rule 9(b) in different ways. Although Congress recognized that the Second Circuit Court of Appeals had adopted the most stringent interpretation of Rule 9(b) (and therefore the most stringent requirements for alleging securities fraud), Congress expressly chose not to codify the Second Circuit's interpretation in the PSLRA. This meant that Congress

⁵⁷ 15 U.S.C. § 78u-4(b)(3)(A) (2007).

⁵⁸ 15 U.S.C. § 78u-4(b)(3)(B) (2007).

⁵⁹ 15 U.S.C. § 78u-4(b)(4) (2007).

⁶⁰ 15 U.S.C. § 78u-4(c) (2007); *See also*, H.R. CONF. REP. NO. 104-369, at 37.

⁶¹ *See Tellabs*, 127 S.Ct. at 2507.

⁶² *See generally* H.R. CONF. REP. NO. 104-369.

⁶³ *See* 15 U.S.C. § 78u-4(b)(1) (2007).

⁶⁴ *See id.* at § 78u-4(b)(2).

specifically chose not to include in the pleading standard for securities fraud certain language relating to motive, opportunity, or recklessness.⁶⁵ This has resulted in confusion as to what is specifically required to successfully allege securities fraud.⁶⁶

The confusion is reflected in a split among various federal courts as to what must be stated in a complaint for securities fraud. The split revolves primarily around the standards required to establish scienter, which is a long-established requirement for a private lawsuit under section 10(b) and Rule 10b-5.⁶⁷ An investor who has purchased the stock of a new venture does not have to prove that the entrepreneur actually set out with the intent to defraud the investor. Intent can be established indirectly—it can be inferred through the entrepreneur’s conduct or through the surrounding circumstances. The PSLRA states that the plaintiff must state with particularity facts giving rise to a strong inference that the defendant acted with scienter. Further, this strong inference may be reflected by a defendant’s motive and opportunity to defraud, or through a defendant’s recklessness. This is where the complexity and legal uncertainties lie.

The First Circuit Court of Appeals, in determining what constitutes a “strong inference,” has suggested that a plaintiff’s allegations must show a “high likelihood” of scienter to satisfy the PSLRA standard.⁶⁸ The court has stated that although the inference need not be ironclad, it must be persuasive.⁶⁹ “Scienter allegations do not pass the ‘strong inference’ test when . . . there are legitimate explanations for the behavior that are equally convincing.”⁷⁰

In applying the “strong inference” language, the Second Circuit Court of Appeals has held that the

inference may arise where the complaint sufficiently alleges that the defendants: (1) benefited in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.⁷¹

⁶⁵ See H.R. CONF. REP. NO. 104-369, at 41 n.23.

⁶⁶ See generally Joseph T. Phillips, *A New Pleading Standard Under the Private Securities Litigation Reform Act?*, 69 U. CIN. L. REV. 969 (2001).

⁶⁷ See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976) (“[S]cienter’ refers to a mental state embracing intent to deceive, manipulate, or defraud.”); *Tellabs*, 127 S.Ct. at 2507 (“To establish liability under § 10(b) and Rule 10b-5, a private plaintiff must prove that the defendant acted with scienter. . . .”).

⁶⁸ *In re Credit Suisse First Boston Corp., Sec. Litig.*, 431 F.3d 36, 48-49 (1st Cir. 2005).

⁶⁹ See *id.* at 49.

⁷⁰ *Id.* (citation omitted).

⁷¹ *Novak v. Kasaks*, 216 F.3d 300, 311 (2nd Cir. 2000) (citations omitted).

The Third Circuit Court of Appeals has interpreted the requirements for establishing a strong inference of an intent to defraud as either an allegation of facts (a) to show that the “defendants had both motive and opportunity to commit fraud” or (b) that “constitute strong circumstantial evidence of conscious misbehavior or recklessness.”⁷² The Fourth Circuit Court of Appeals, on the other hand, has advocated a flexible, case-specific analysis when examining scienter pleadings.⁷³ The Fourth Circuit has taken the approach that “courts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter.”⁷⁴

The Sixth Circuit Court of Appeals has noted that, unlike traditional fraud pleadings, a PSLRA plaintiff is not given the benefit of all reasonable inferences, but is, under the “strong inference” requirement, “entitled only to the most plausible of competing inferences.”⁷⁵ The Sixth Circuit has also ruled that a plaintiff “may plead scienter in [section 10b] or Rule 10b-5 cases by alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud.”⁷⁶

The Second, Third, and Sixth Circuits’ approaches were summarized by the Ninth Circuit Court of Appeals when it noted that a court may: (1) apply the Second Circuit standard requiring plaintiffs to plead mere motive and opportunity or an inference of recklessness; (2) apply a heightened Second Circuit standard rejecting motive and opportunity, but accepting an inference of recklessness; or (3) reject the Second Circuit standard and accept only an inference of conscious conduct.⁷⁷ The Ninth Circuit chose to adopt a standard somewhere between the second and third approach: the evidence must create a strong inference of, at a minimum, deliberate recklessness. In other words, within the Ninth Circuit Court of Appeals, plaintiffs proceeding under the PSLRA cannot just allege intent in general terms of mere “motive and opportunity” or “recklessness,” but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent.⁷⁸ Further, the Ninth Circuit has held that “when determining whether plaintiffs have shown a strong inference of scienter, the

⁷² *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 538 (3rd Cir. 1999).

⁷³ *See Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003).

⁷⁴ *Id.*

⁷⁵ *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc) (citation omitted).

⁷⁶ *In re Comshare, Inc., Sec. Litig.*, 183 F.3d 542, 549 (6th Cir. 1999).

⁷⁷ *See In re Silicon Graphics, Inc., Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999).

⁷⁸ *Id.* at 979.

court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs.”⁷⁹

The Tenth Circuit Court of Appeals has stated that determining whether an inference is a strong one cannot be decided in a vacuum.⁸⁰ The Tenth Circuit did agree with the Ninth Circuit that evaluating a plaintiff’s suggested inference must be done in the context of other reasonable inferences that may be drawn.⁸¹ However, that is the extent of the Tenth Circuit’s agreement with the Ninth Circuit.⁸² The Tenth Circuit also rejected the Sixth Circuit’s holding that plaintiffs are entitled only to the most plausible of competing inferences.⁸³ The Tenth Circuit concluded that “[i]f a plaintiff pleads facts with particularity that, in the overall context of the pleadings, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the [PSLRA] is satisfied.”⁸⁴

In *Johnson v. Tellabs, Inc.*, the District Court for the Northern District of Illinois expressly rejected the Sixth Circuit’s approach and adopted the Fourth Circuit’s approach, holding that plaintiffs may use “motive and opportunity” or “circumstantial evidence” to establish scienter under the PSLRA, only if the plaintiffs’ allegations support a strong inference that each defendant acted recklessly or knowingly.⁸⁵

In *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, the Seventh Circuit Court of Appeals reviewed the Northern District’s conclusions.⁸⁶ First, the *Makor* court concluded that in passing the PSLRA, Congress had not changed the substantive scienter requirements.⁸⁷ “Prior to the passage of the PSLRA, every [C]ircuit to consider the substantive scienter standard . . . had held that a showing of recklessness was sufficient to allege scienter.”⁸⁸ Although the Ninth Circuit appears to have ruled that Congress did intend to change the substantive scienter standard (i.e., that a plaintiff must allege facts that create a strong inference of “deliberate

⁷⁹ *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (emphasis in original). “District courts should consider all the allegations in their entirety, together with any reasonable inferences that can be drawn therefrom, in concluding whether, on balance, the plaintiffs’ complaint gives rise to the requisite inference of scienter.” *Id.*

⁸⁰ See *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003).

⁸¹ See *id.* at 1188.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Johnson v. Tellabs, Inc.*, 303 F.Supp.2d 941, 961 (N.D.Ill. 2004), *aff’d in part, rev’d in part*, *Makor Issues & Rights, Ltd., v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), *vacated and remanded*, *Tellabs*, 127 S.Ct. 2499.

⁸⁶ *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006).

⁸⁷ *Id.* at 600.

⁸⁸ *Id.* (citations omitted).

or conscious recklessness” or a “degree of recklessness that strongly suggests actual intent”),⁸⁹ the Seventh Circuit decided to apply the same scienter standard as it did prior to the passage of the PSLRA: “an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”⁹⁰

The Seventh Circuit acknowledged that while the PSLRA did not change the substantive scienter standard, it did “unequivocally raise the bar for pleading scienter.”⁹¹ Here, the *Makor* court provided another overview of the various positions taken by the courts in determining whether a “strong inference” of scienter had been sufficiently pleaded. It noted that the Second and Third Circuits had taken the position that the PSLRA adopted the Second Circuit’s pre-PSLRA pleading standard for scienter (that plaintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior), while the Ninth and Eleventh Circuits adopted a higher burden, believing that Congress considered, but ultimately rejected the Second Circuit’s approach.⁹² The Seventh Circuit, following the remaining Circuits, decided to adopt a middle ground: “the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference.”⁹³

In its first substantive review of the PSLRA, the U.S. Supreme Court granted certiorari “to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a ‘strong inference’ of scienter.”⁹⁴ Its goal was to “prescribe a workable construction of the ‘strong inference’ standard, a reading geared to the PSLRA’s twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims.”⁹⁵

The procedural juxtaposition for the Circuit courts’ interpretations of “strong inference” had been in consideration of Rule 12(b)(6) of the Federal Rules of Civil Procedure motions to dismiss, which must accept all factual allegations in the complaint as true.⁹⁶ This does not change, but when ruling on a Rule 12(b)(6)

⁸⁹ *Id.* (citing *In re Silicon Graphics*, 183 F.3d at 979).

⁹⁰ *Makor Issues & Rights, Ltd.*, 437 F.3d at 600.

⁹¹ *Id.* at 601.

⁹² *See id.*

⁹³ *Id.* “Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient.” *Id.*

⁹⁴ *Tellabs*, 127 S. Ct. at 2506.

⁹⁵ *Id.* at 2509.

⁹⁶ *Id.*

motion, the 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.”⁹⁷ Finally, “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.”⁹⁸

“Strong inference” is contextual. “To determine whether the plaintiff has alleged facts that give rise to the requisite ‘strong inference’ of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”⁹⁹ And, “[t]he inference that the defendant acted with scienter need not be irrefutable, . . . or even the ‘most plausible of competing inferences[.]’”¹⁰⁰ However, “the inference of scienter must be more than merely ‘reasonable’ or ‘permissible’—it must be cogent and compelling, thus strong in light of other explanations.”¹⁰¹ The Court concluded that “[a] complaint will survive . . . 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.”¹⁰²

Addressing the issue of whether motive can give rise to a strong inference of scienter, the Court stated that motive can be relevant, and personal financial gain can weigh heavily in favor of a strong inference, but the absence of a motive is not fatal.¹⁰³ Ultimately, the Supreme Court concluded, “the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?”¹⁰⁴

⁹⁷ *Id.* (citations omitted; emphasis in original).

⁹⁸ *Id.*

⁹⁹ *Id.* at 2510.

¹⁰⁰ *Tellabs*, 127 S. Ct. at 2506 (citation omitted).

¹⁰¹ *Id.*

¹⁰² *Id.* (footnote omitted).

¹⁰³ *Id.* at 2511.

¹⁰⁴ *Id.* (footnote omitted). A number of federal courts have quickly applied *Tellabs*. In *Higginbotham v. Baxter International, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007), the first case interpreting *Tellabs*, the Seventh Circuit Court of Appeals ruled that a complaint that relied on confidential sources did not meet the strong inference of scienter requirement expressed in *Tellabs*. “[A]nonymity conceals information that is essential to the sort of comparative evaluation required by *Tellabs*. To determine whether a ‘strong’ inference of scienter has been established, the judiciary must evaluate what the complaint reveals and disregard what it conceals.” *Id.* at 757. *See also*, *Central Laborers’ Pension Fund v. Integrated Electrical Services, Inc.*, 497 F.3d 546, 551 (5th Cir. 2007) (holding that allegations of circumstantial evidence justifying a strong inference of scienter will suffice); *Key Equity Investors, Inc. v. Sel-Leb Marketing, Inc.*, 2007 WL 2510385, *5 (3rd Cir. 2007) (unpublished decision) (refusing to infer scienter from vague and unspecific allegations); *Winer Family Trust v. Queen*, --- F.3d ---, 2007 WL 2753734, *14 (3rd Cir. 2007) (holding that the group pleading doctrine, a judicial presumption that statements in group-published documents are

One issue the *Tellabs* Court expressly did not address is whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.¹⁰⁵ Every Circuit that has considered the issue has held that scienter may be established by a showing of recklessness.¹⁰⁶ Recklessness, in the context of securities fraud, is generally defined as “an act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.”¹⁰⁷ This “severe recklessness” is well beyond negligence, and, in essence, falls slightly below intentional conduct.¹⁰⁸

Plotkin v. IPaxess, Inc. exemplifies how these standards are applied when an investor sues a company for securities fraud.¹⁰⁹ In *Plotkin*, the investor (Plotkin) sued on the basis of three allegedly false and misleading press releases used to induce Plotkin (and others) to invest in the company. The Fifth Circuit Court of Appeals ruled that Plotkin had established a strong inference of fraudulent intent with respect to omissions in one of the press releases.¹¹⁰ The court concluded that Plotkin had alleged specific facts about agreements with strategic partners giving rise to a strong inference that the company knew or was severely reckless in not knowing at the time of the releases that the strategic partners were not able or were not likely to be able to make the payments they contracted to make.¹¹¹

Similarly, in *EP Medsystems, Inc. v. Echocath, Inc.*, the plaintiff-investor sued for securities fraud after four “imminent” contracts supposedly under negotiation with companies that would market the defendant-company’s products fell through after the plaintiff made its investment.¹¹² The court believed a strong inference of fraud could be established where multiple promised events fail to occur.¹¹³ The

attributable to officers and directors who have day-to-day control or involvement in regular company operations, is inconsistent with the PSLRA’s requirement that scienter be pleaded with respect to each act or omission by the defendant); *Oppenheim Pramerica Asset Management S.A.R.L. v. Encysive Pharmaceuticals, Inc.*, 2007 WL 2720074, *3 (S.D. Tex. 2007) (holding that conclusory assertions of knowledge and falsehoods are insufficient to withstand the defendants’ motion to dismiss); and *In re Ditech Communications Corp. Securities Litigation*, 2007 WL 2990532, *10 (N.D. Cal. 2007) (holding that defendants’ sale of personal stock while promoting financial soundness of corporation were not “suspicious enough” to raise a strong inference of scienter). *See also generally*, *Foster v. Wilson*, ---F.3d ---, 2007 WL 2893608, (9th Cir. 2007).

¹⁰⁵ *See Tellabs*, 127 S. Ct. at 2507 n.3.

¹⁰⁶ *See Ottmann*, 353 F.3d at 343.

¹⁰⁷ *Id.* (citation and internal quotations omitted).

¹⁰⁸ *Id.* at 344.

¹⁰⁹ *Plotkin v. IPaxess, Inc.*, 407 F.3d 690, 690 (5th Cir. 2005).

¹¹⁰ *Id.* at 693, 699.

¹¹¹ *Id.* at 699-700.

¹¹² *EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 869-70 (3d Cir. 2000).

¹¹³ *Id.* at 881.

court could not dismiss the possibility that the defendant-company, in an effort to coax a substantial investment, did not fairly represent to the plaintiff-investor the status of its negotiations with these companies.¹¹⁴

In contrast, the suing investor in *R2 Investments LDC v. Phillips* failed to meet the strong inference of scienter requirement.¹¹⁵ In *R2 Investments*, the investor sued the company after it failed (due to bankruptcy) to complete a tender offer to repurchase certain previously issued notes.¹¹⁶ The plaintiff-investor essentially argued that the company had not disclosed the liquidity crisis it was going through at the time of the investment.¹¹⁷ Even if the company had knowingly omitted material facts about its financial condition, the court held that “[k]nowledge of an omission does not itself necessarily raise a strong inference of scienter.”¹¹⁸ The court held that the plaintiff-investor had not alleged a clear motive for the alleged misstatements or omissions, therefore, “the strength of its circumstantial evidence of scienter must be correspondingly greater.”¹¹⁹ Essentially, the court concluded the plaintiff had not alleged that the company’s executives were aware of anything beyond worst case scenarios. Due to there being potential alternative funding sources, coupled with the plaintiff’s failure to allege any motive, the court concluded the plaintiff had failed to allege a strong inference the defendants “acted with an intent to deceive, manipulate, or defraud or that severe recklessness in which the danger of misleading buyers or sellers is either known to the defendant or is so obvious that the defendant must have been aware of it.”¹²⁰

As to motive, the court in *GSC Partners CDO Fund v. Washington* held that allegations that the defendant officers stood to benefit from the transaction in question is not sufficient.¹²¹ “[C]atch-all allegations that defendants stood to benefit from wrongdoing and had the opportunity to implement a fraudulent scheme are no longer sufficient, because they do not state facts with particularity or give rise to a strong inference of scienter.”¹²² A plaintiff must assert a concrete and personal benefit to the individual defendant resulting from the fraud.¹²³ “In every corporate transaction, the corporation and its officers have a desire to complete the transaction, and officers will usually reap financial benefits from a

¹¹⁴ *Id.*

¹¹⁵ *R2 Investments LDC v. Phillips*, 401 F.3d 638, 643 (5th Cir. 2005).

¹¹⁶ *Id.* at 639.

¹¹⁷ *Id.* at 643-44.

¹¹⁸ *Id.* at 644 (citation omitted).

¹¹⁹ *Id.* at 645 (quoting *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994)).

¹²⁰ *R2 Investments LDC*, 401 F.3d at 645 (citation and internal quotations omitted).

¹²¹ *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004).

¹²² *Id.* (citation and internal quotations omitted).

¹²³ *See id.*

successful transaction. Such allegations alone cannot give rise to a ‘strong inference’ of fraudulent intent.”¹²⁴

The heightened PSLRA pleading standards provide a significant hurdle for plaintiffs alleging securities fraud.¹²⁵ The authors’ research reveals a dearth of individual private plaintiff-investors suing a privately owned enterprise for securities fraud. As for large groups of investors alleging securities violations, the Stanford Law School Class Action Clearinghouse, in cooperation with Cornerstone Research, tracks class action securities filings.¹²⁶ In its 2007 Mid-Year Assessment, the Clearinghouse reported that 2007 marked the fourth consecutive six-month period with below average securities class action filing activity.¹²⁷ In addition, Rule 10b-5 claims in the first half of 2007 represented 81% of total filings, compared to 88% in all of 2006.¹²⁸ The Clearinghouse has suggested two hypotheses for the drop in securities class action filings: less fraud (resulting from increased SEC and Justice Department enforcement activities) and a strong stock market (essentially less volatility in the market leads to fewer disgruntled investors).¹²⁹

The Clearinghouse’s findings may reflect a recent trend. Professor Perino studied nearly 1,500 class action filings from 1996 through 2001, concluding the stated goals of the PSLRA (discouraging the filing of non-meritorious lawsuits and the “race to the courthouse”) were not accomplished.¹³⁰ Perino does, however, suggest that higher pleading standards relating to securities fraud improved overall case quality (driving out weaker cases).¹³¹ In addition, Professor Choi et al. found evidence that pre-PSLRA claims that would have settled for nuisance value would be less likely to be filed under the PSLRA.¹³² With the higher pleading standards

¹²⁴ *Id.* (citations omitted).

¹²⁵ See Olazabal, *supra* note 49, at 196 (concluding that “the PSLRA’s pleading requirements make it substantively more difficult for a plaintiff to clear the pleading hurdle and to proceed to discovery in a class action securities fraud case. . .”).

¹²⁶ See Stanford Law School Securities Class Action Clearinghouse in Cooperation with Cornerstone Research, *Securities Class Action Case Filings: 2007 Mid-Year Assessment*, available at http://securities.stanford.edu/clearinghouse_research/2007_YIR/20070710-01.pdf (tracking federal securities class action filings since the beginning of 1996 through June 22, 2007).

¹²⁷ See *id.* (no pagination).

¹²⁸ See *id.* (no pagination).

¹²⁹ See *id.* (no pagination).

¹³⁰ See Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, COLUM. L. SCH. WORKING PAPER SERIES, Working Paper No. 211, available at http://ssrn.com/abstract_id=346840.

¹³¹ See *id.* at 36-37.

¹³² See Stephen J. Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, JOHN M. OLIN CTR. FOR L. & ECON., Working Paper No. 07-008, available at <http://ssrn.com/abstract=975301> (finding evidence also that fewer suits resulting in non-nuisance settlements would be filed under the PSLRA, compared to pre-PSLRA, and that for the suits filed, fewer non-nuisance settlements would occur under the PSLRA).

for alleging securities fraud, the legal environment supports the argument that disgruntled new venture investors will be less likely to sue (or even threaten to sue) for securities fraud.

ADDITIONAL PROTECTIONS FOR ENTREPRENEURS

Regardless of the state of securities law, there are additional factors that can impact any potential disputes over control of an enterprise. It is presumed that when an entrepreneur is negotiating with potential investors, the relative power of the entrepreneur and investor largely determine who receives the greater benefit from the investment—and, hence, greater control. It is also presumed that where the entrepreneur has more power, there is less likelihood for litigation. An entrepreneur's personal and resource attributes can enhance his or her power relative to the investor.

While many entrepreneurs are new to the market for venture financing, other entrepreneurs have repeated experience. Entrepreneurs have been described as “novice” entrepreneurs, who have no prior business ownership experience; “serial” entrepreneurs, who have sold or closed a business in which they had an ownership stake and currently have an ownership stake in new, independent business; and “portfolio” entrepreneurs, who have concurrent ownership stakes in two or more independent businesses.¹³³ The latter two categories suggest that experience in entrepreneurship increases the entrepreneur's power for three reasons. First, experience provides the entrepreneur with a basis for comparison when negotiating with investors. Second, an experience curve effect may enable the entrepreneur to capitalize on his or her existing knowledge base and internal infrastructure, thereby reducing costs of capital. Third, experience is likely to generate credibility on the part of the entrepreneur.¹³⁴ The entrepreneur's experience is used by potential investors to screen applications for assistance.¹³⁵ Thus, not only will experience help the entrepreneur to see the relationship with the investor and the actual terms in a more sophisticated light, experience will also allow the entrepreneur to be seen by the investor as more capable and credible. Therefore it is arguable that entrepreneurs with more entrepreneurial experience will have more power relative to investors than entrepreneurs with less entrepreneurial experience.

¹³³ See generally Paul Westhead et al., *Decisions, Actions, and Performance: Do Novice, Serial, and Portfolio Entrepreneurs Differ?*, 43 J. SMALL BUS. 393 ¶ 2 (2005) available at 2005 WLNR 25307723.

¹³⁴ See *id.*

¹³⁵ See generally Paul Westhead & Mike Wright, *Contributions of Novice, Portfolio and Serial Founders Located in Rural and Urban Areas*, 33 REGIONAL STUD. 157 (1999); see also, Ian MacMillan et al., *Criteria Used by Venture Capitalists to Evaluate New Venture Proposals*, 1 J. BUS. VENTURING 119, 121 (1985).

Expert power is demonstrated when an individual has knowledge or expertise relevant to another.¹³⁶ One commentator has suggested that the hallmark of expertise is the ability to adjust one's skills to be adaptive and successful even in the face of changes in situational demands.¹³⁷ In venture finance situations, it can generally be assumed that the investor has more financial knowledge and expertise than most entrepreneurs. However, to the extent that the entrepreneur has his or her own financial expertise, the entrepreneur's power relative to the investor will be enhanced. It is therefore arguable that entrepreneurs with financial expertise will have more power relative to investors than entrepreneurs without financial expertise.

Rare substantive expertise in the entrepreneur's field may also enhance the entrepreneur's power, particularly when the field is a popular one for venture capital. Where the value of the enterprise lies within the entrepreneur, it is less likely that the investor will jeopardize the relationship with the entrepreneur than if the value lay within physical assets or intellectual property. It is therefore arguable that entrepreneurs with rare expertise in their fields will have more power relative to investors than entrepreneurs without rare expertise in their fields.

Specific experience or training in negotiations should also give entrepreneurs power in their negotiations with investors. One study has found that while both expert and amateur negotiators were able to reach integrative solutions over time, expert negotiators were more integrative early in the negotiations and tended to secure higher average outcomes than amateur negotiators.¹³⁸ Another commentator has found that experienced negotiators make more accurate judgments about the other party's priorities and are more likely to negotiate more favorable agreements.¹³⁹

It can be expected, then, that entrepreneurs who are experienced negotiators will be able to negotiate more favorable terms than will novice negotiators. It is therefore arguable that entrepreneurs with specific training or experience in negotiations will have more power relative to investors than entrepreneurs without training or experience in negotiations.

¹³⁶ See generally John R. P. French & Bertran Raven, *The Bases of Social Power*, in *STUD. IN SOC. POWER* 150 (Dorwin Cartwright ed., 1966).

¹³⁷ See generally Donald W. Fiske, *The Inherent Variability of Behavior*, in *FUNCTIONS OF VARIED EXPERIENCE* 326 (Donald W. Fiske & Salvatore R. Maddi eds., 1961).

¹³⁸ See generally Margaret A. Neale & Gregory B. Northcraft, *Experts, Amateurs, and Refrigerators: Comparing Expert and Amateur Negotiators in a Novel Task*, 38 *ORG. BEHAV. & HUM. DECISION PROCESSES* 305 (1986).

¹³⁹ See Leigh Thompson, *An Examination of Naïve and Experienced Negotiators*, *J. PERSONALITY & SOC. PSYCHOL.* 82 (1990).

Even where an entrepreneur has some personal attributes that may be advantageous in negotiations with investors, the entrepreneur is likely to strengthen his or her power through the accumulation of certain resources that are also likely to enhance power. These include strong intellectual property, loyal board members, high-status alliance partners, high-status legal counsel, and an advisory board.

Theft of intellectual property, euphemistically called “competitive intelligence,” is an important concern for every entrepreneur. Legitimate investors are acutely concerned with the protectability of entrepreneurs’ intellectual property; the stronger the protection, the more valuable is the property. Less legitimate investors will be concerned for other reasons; the weaker the protection, the easier it is to appropriate.¹⁴⁰ In either event, strong intellectual property protection should provide more power to entrepreneurs than weak intellectual property protection. It is therefore arguable that entrepreneurs who have strong intellectual property protection will have more power relative to investors than entrepreneurs with weaker intellectual property protection.

While it is often the case that investors will insist on board of directors seats, and even board control, loyal investors at least provide some buffer to this power.¹⁴¹ It is therefore arguable that entrepreneurs with loyal members on the board of directors will have more power relative to investors than entrepreneurs without loyal members on the board.

A number of scholars have argued that if an individual’s partners possess considerable legitimacy or status, then the individual may derive legitimacy or status through that affiliation. This “borrowed” legitimacy or status has been shown to have a number of positive economic benefits for the actor, ranging from survival to organizational growth to profitability.¹⁴²

In one of the more compelling demonstrations of the economic value of ties to high-status actors, one scholar examined the economic effects of interorganizational networks of privately held biotechnology firms and found that an affiliation with a prominent alliance partner increased the market value of the biotechnology

¹⁴⁰ See e.g., Holding, *supra* note 24 at A1 (discussing one incident in which an entrepreneur sought funding from a venture capital firm only to discover that the very next day a new company was formed to make the same product for the same market—funded by the same venture capital firm).

¹⁴¹ See, e.g., *id.* at A1 (also discussing an incident in which an entrepreneur allowed a venture capital firm to gain control of the board of directors, only to find himself fired from his own company two months later).

¹⁴² See Joel A. C. Baum & Christine Oliver, *Institutional Embeddedness and the Dynamics of Organizational Populations*, 57 AM. SOC. REV. 540, 540-41 (1992); see generally Joel M. Podolny & Damon J. Phillips, *The Dynamics of Organizational Status*, 5 INDUS. & CORP. CHANGE 453 (1996); Joel M. Podolny, *A Status-Based Model of Market Competition*, 98 AM. J. SOC. 829 (1993).

firm.¹⁴³ Consistent with an interpretation of these ties as carriers of legitimacy, the effect of affiliations varies inversely with the age of the start-up.¹⁴⁴ In other words, young start-ups benefit more from the status of their network partners than did older start-ups. It is therefore arguable that entrepreneurs with high-status alliance partners will have more power relative to investors than entrepreneurs without high-status alliance partners.

Just as high-status alliance partners may be a signal of quality and hence give an entrepreneur more bargaining power, so too may the status of the entrepreneur's general counsel. Some law firms are known in the venture finance industry as higher status and more connected, knowledgeable, and capable than other law firms. Thus, such law firms may provide the entrepreneur with power relative to the investors in at least two ways. First, such law firms may suggest a certain sophistication on the part of the entrepreneur that will translate into more respect. Second, the expertise of the law firms themselves in the domain of venture capital should inure to the benefit of the entrepreneurs through good legal advice. It is therefore arguable that entrepreneurs with high-status legal counsel will have more power relative to investors than entrepreneurs with low-status legal counsel.

One commentator has recommended that entrepreneurs create "quasi-boards of directors" or advisory boards to allow the entrepreneurs to gather expert advice without imposing on the advisors the legal or fiduciary burdens of being board members.¹⁴⁵ These advisors can offer advice without becoming embroiled in operations or politics. Such advice can benefit the entrepreneur in two ways when negotiating with investors. First, the existence of the board of advisors signals that the entrepreneur is willing to listen to independent, outside advice. Second, the advisors can provide invaluable advice with respect to the negotiations themselves. It is therefore arguable that entrepreneurs with an advisory board will have more power relative to investors than entrepreneurs with no advisory board.

CONCLUSION

Investors in new ventures who are unhappy with the state of their investment may wish to regain control of the venture or exit the venture through liquidation. When either of those strategies becomes extremely difficult, investors may resort to retaliation by threatening to file a securities fraud lawsuit against the entrepreneur. The securities legislation passed in 1933 and 1934 favored the naïve investor over the sophisticated issuer, a situation that could be detrimental to an entrepreneur—a relative naïve issuer selling to a sophisticated investor.

¹⁴³ See Toby E. Stuart et al., *Interorganizational Endorsements and the Performance of Entrepreneurial Ventures*, 44 ADMIN. SCI. Q. 315, 315 (1999).

¹⁴⁴ See *id.* at 320-21.

¹⁴⁵ See Harold W. Fox, *Quasi-Boards: Useful Small Business Confidants*, HARV. BUS. REV., Jan.-Feb. 1982, at 158.

Although Congress had other culprits in mind—“professional plaintiffs,” encouraged by corrupt class-action plaintiffs’ lawyers, “racing” to the courthouse whenever a publicly-traded company’s stock price dropped—when passing the Private Securities Litigation Reform Act, its consequences are apparently favorable for entrepreneurs who may face serious disagreements with investors. Although initially there was some disagreement among the courts as to the precise requirements to plead the strong inferences of scienter required by the PSLRA, the Supreme Court has stepped in to clarify the pleading requirements, reinforcing the fact that the PSLRA has created a significant hurdle to filing securities fraud actions. And some of the preliminary data indicate Congress has been successful in decreasing the number of securities fraud lawsuits filed in U.S. federal courts.

There are a number of personal and resource-based attributes of entrepreneurs that can enhance their power when negotiating the terms of investments in their companies. These power attributes, coupled with the heightened PSLRA pleading standards, should make entrepreneurs less vulnerable to claims of securities fraud when investors find they are not pleased with their investment.