WHITE PAPER

Recent Issues In The Pleading Of Scienter In Securities Fraud Claims

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Recent Issues In The Pleading Of Scienter In Securities Fraud Claims

By Lyle Roberts, Paul Chalmers, and Scott Lowry

An element of any securities fraud claim is the defendant's state of mind. In a claim brought under Rule 10b-5, the applicable question is whether the defendant acted with fraudulent intent (*i.e.*, scienter) when he made the alleged false or misleading statement. Prior to the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), the pleading of federal securities fraud claims was governed by Fed. R. Civ. P. 9(b), which specifically states that the "condition of mind of a person may be averred generally." A key part of the Reform Act (in the view of many commentators, the key part), was the imposition of a heightened pleading requirement for scienter. To survive a motion to dismiss, a plaintiff bringing a securities fraud claim must plead facts establishing a "strong inference" that the defendant acted with "the required state of mind." 15 U.S.C. § 78u-4(b)(2).

In an effort to ensure that securities litigators and the courts remained busy, however, Congress provided little guidance on how to apply its new scienter pleading requirement. There are two components to the scienter pleading analysts: (1) what is the substantive standard for scienter; and (2) what must a plaintiff allege to meet the "strong inference" pleading requirement. Did the Reform Act change the substantive scienter standard applied by various courts prior to the Reform Act? Not clear. While it had long been settled that knowingly making false statements can subject a defendant to securities fraud liability, Congress did not answer the open question of whether some lesser form of scienter, such as some form of recklessness as to falsity, was sufficient to support liability. What sorts of allegations are sufficient to meet the "strong inference" pleading standard? Also not clear. Congress did not specify the quantum or types of facts that would meet the standard — *e.g.*, Congress did not address whether allegations commonly held sufficient prior to the Reform Act, such as allegations of motive and opportunity to commit fraud on the part of the defendant, would still be sufficient.

Eight years after the passage of the Reform Act, courts continue to grapple with how to apply Congress' language and intent. This article addresses four areas related to pleading scienter in securities fraud claims that have received recent judicial attention; (1) components of the scienter analysis; (2) determining the scienter of corporations; (3) control person liability; and (4) the use of insider stock sales to establish motive and opportunity. Any, and all, of these issues can make the difference between the grant or denial of a motion to dismiss.

Components of Scienter Analysis

In the absence of express guidance from Congress, courts have developed contrasting approaches for both the substantive scienter standard and what a plaintiff must allege to meet the "strong inference" pleading requirement. While there has been a great deal of commentary over these contrasting approaches, there is also some question as to whether the differences have a significant practical effect on the dismissal of cases.

The Ninth Circuit's decision in *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999) redefined both components of the scienter analysis based on the Reform Act. In that case, the Ninth Circuit, after a close review of its securities litigation jurisprudence, and the Reform Act's language and legislative history, concluded that Congress intended to impose substantive and pleading standards more stringent than any followed by courts prior to the Reform Act. Thus, the Ninth Circuit found that while recklessness could constitute scienter, Congress intended to limit this to "deliberate recklessness," *i.e.*, recklessness so severe that it "strongly suggests actual intent." *Id.* at 979. The court also held that scienter could never be shown by motive and opportunity allegations alone. *Id.*

By contrast, in the wake of the Reform Act, the Second and Third Circuits adopted substantive and pleading standards thought to be more lenient. These courts concluded that Congress did not intend to alter their pre-Reform Act definition of recklessness, *i.e.*, conduct that is "'highly unreasonable' and 'an extreme departure from the standards of ordinary care . . . [such] that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001) (citation omitted); *In re Advanta Corp. Sec. Litig.*, 180 F.3d

525, 535 (3d Cir. 1999). The Second and Third Circuits also found that Congress intended to essentially adopt the Second Circuit's pre-Reform Act version of the "strong inference" test, which required the plaintiff to allege facts (a) to show that the defendants had the motive and opportunity to commit fraud, or (b) that constitute strong circumstantial evidence of conscious behavior or recklessness. *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000); *Advanta*, 180 F.3d at 534.

Other circuits have generally followed the Second and Third Circuits in adopting the pre- Reform Act "conscious behavior or recklessness" substantive standard, but have adopted pleading tests falling somewhere in between those of the Ninth and Second Circuits. These courts hold that, as a general matter, motive and opportunity allegations standing alone cannot give rise to a strong inference of scienter (but they may be enough in exceptional circumstances). Instead, these courts advocate examining all the allegations to decide if they support a strong inference. *See*, *e.g.*, *In re Comshare Inc., Sec, Litig.*, 183 F.3d 542, 550-51 (6th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283-84 (11th Cir. 1999); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999).

As a practical matter, the differences between the circuits may not be as dramatic as advertised. In particular, a consensus seems to be developing among most of the circuits that to determine whether a securities fraud plaintiff has created a strong inference of scienter, a court should evaluate the totality of the plaintiff's allegations. As the Ninth Circuit has stated, courts are "also [to] consider 'whether the total of plaintiffs' allegations, even though individually lacking, are sufficient to create a strong inference that defendants acted with deliberate or conscious recklessness.'" *No. 84 Employer-Teamster Joint Council Pension Trust Fund v, America West Holding Corp.*, 320 F.3d 920, 938 (9th Cir. 2003), *cert, denied*, 540 U.S. 966 (2003) (*quoting Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002)).[1] Indeed, during the past year, the Fourth and Eleventh Circuits explicitly adopted this approach. *See Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) ("[C]ourts 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.")[2]; *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1017 (11th Cir. 2004) ("We readily join the courts that have interpreted the PSLRA to permit the aggregation of facts to infer scienter."). Thus, with the possible exception of the Second and Third Circuits, the analytical approach utilized by courts examining scienter allegations is likely to be substantially the same.

Perhaps more telling is the fact that dismissal rates in the various circuits do not appear to correlate to the perceived toughness or laxity of the particular circuit's scienter standards. NERA released a study in February 2004 that examined, *inter alia*, the rate at which courts in each circuit dismissed securities fraud class action complaints from 1996 (the effective date of the Reform Act) through 2003. According to this study, the dismissal rate in the Second Circuit, considered to have the most lenient scienter standards, was slightly higher than in-.the Ninth Circuit, considered to have the toughest scienter standards (8% vs. 6%). Most of the other circuits had similar dismissal rates. Securities class action complaints, of course, can be dismissed for many reasons and it is impossible to account for every variable. That said, these statistics certainly suggest that the difference in scienter pleading standards between

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[1] *See also In re Cabletron Sys., Inc.*, 311 F.3d 11, 39 (1st Cir. 2002) ("'The plaintiff may combine various facts and circumstances indicating fraudulent intent'. . . to satisfy the scienter requirement.") (quoting *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 82 (1st Cir. 2002)); *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 431 (5th Cir. 2002) ("The appropriate analysis . . . is to consider whether all facts and circumstances 'taken together' are sufficient to support the necessary strong inference of scienter on the part of the plaintiffs."); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001) ("[U]nder the Reform Act, a securities fraud case cannot survive unless its allegations collectively add up to a strong inference of the required state of mind."); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1263 (10th Cir. 2001) (the court is to assess "whether the plaintiff's allegations, taken as a whole, give rise to a strong inference of scienter.")

[2] *Ottmann* represents the Fourth Circuit's first definitive ruling on scienter standards. Prior to that decision, the Fourth Circuit had simply applied — without actually adopting — the Second Circuit's approach. *See Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999).

the circuits is having relatively little effect on the disposition of cases. As most circuits apply a holistic, fact-intensive evaluation of all the scienter allegations in a complaint, the specific fact pattern before the court appears to be far more important than the legal standards adopted by the circuit.

Corporate Scienter

While the circuit split on the standards for alleging scienter as to individual defendants may be narrowing, a new (arguably inadvertent) split may be opening as to the standards for alleging scienter on the part of a corporation. Historically, whether a corporation has acted with scienter is determined by looking "to the state of mind of the individual corporate official or officials who make or issue the statement . . . rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment." *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366 (5th Cir. 2004). In other words, courts have recognized that corporations only act through their officers and directors, and, therefore, can only be held liable for fraud if one or more of those individuals can be held liable for fraud. Over the past year, however, a number of courts appear to have rejected this principle in favor of a "collective scienter" theory (although none of the decisions expressly address the question).

In *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.*, 387 F.3d 468 (6th Cir. 2004), the Sixth Circuit found that the plaintiffs had adequately alleged scienter as to Bridgestone and its wholly-owned subsidiary, Firestone, based primarily on internal Bridgestone/Firestone documents. At the same time, however, the court found that the plaintiffs had failed to allege scienter as to the sole individual defendant (Firestone's CEO) or, for that matter, any other officer or director. Similarly, in *In re NUI Sec. Litig.*, 314 F. Supp. 2d 388 (D.N.J. 2004), the court found that the plaintiffs had adequately alleged a strong inference of scienter for the corporation even though they did not adequately allege scienter as to the two individual defendants (the CEO and CFO of NUI). The court relied on the fact that NUI's associate general counsel, who was not a defendant in the case and made none of the alleged misstatements, allegedly knew of the company's fraudulent conduct. In *In re Motorola Sec. Litig.*, No. 03 C 287, 2004 WL 2032769, at *31 (N.D. Ill. Sept. 9, 2004), the court held that the plaintiffs had alleged a strong inference that Motorola "through its various officials, sought to mislead the investing public" about its vendor financing to a Turkish company. The claims against the individual defendants (the CEO, CFO, and COO of Motorola) were dismissed, however, because the plaintiffs' scienter allegations as to them were insufficient.

Whether these decisions are aberrations, or part of a larger trend, is yet to be determined. If an officer of the company makes the statement and a janitor knows the statement is false, has the corporation acted with fraudulent intent? Under the reasoning of these decisions, the answer may be yes, although it is arguable whether this is consistent with the common law of agency, which holds that a fraudulent state of mind cannot be imputed to the person making a misstatement. Nevertheless, corporate defendants in securities fraud cases will need to consider whether to argue affirmatively against the application of a "collective scienter" theory as part of any motion to dismiss or risk the type of result reached in *Bridgestone*, *NUI*, and *Motorola.*

Control Person Liability

Section 20(a) of the Exchange Act imposes secondary liability on "every person who, directly or indirectly, controls any person liable" under that Act, and requires that liability be imposed "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation . . . ." 15 U.S.C. § 78t(a). In other words, Section 20(a) imposes liability on a controlling person who culpably participated in the fraud. Once the primary violation has been established, however, Section 20(a) is not entirely clear as to who has the burden of showing culpable participation by the controlling person (or lack thereof). Some courts, especially those in the Second Circuit, have found that culpable participation is an element of the plaintiffs claim. Other courts have concluded that the lack of culpable participation is an affirmative defense. Not surprisingly, this dispute affects the plaintiff's pleading requirements.

In courts where culpable participation is an element of the plaintiffs claim, the plaintiff must allege particularized facts showing not just the primary violation, but also that the defendant controlled a person who committed the underlying violation, and that the defendant culpably participated in that underlying violation. *See*, *e.g.*, *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998); *In re Bayer AG Sec. Litig.*, No. 03 CIV.1546 WHP, 2004 WL 2190357, at *16 (S.D.N.Y. Sept. 30, 2004); *Vohs v. Miller*, 323 F. Supp. 2d 965, 972 (D. Minn. 2004); *In re Firstenergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 600 (N.D. Ohio 2004); *D.E. & J Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719, 750 (E.D. Mich. 2003). Accordingly, the plaintiff must "plead with particularity 'facts giving rise to a strong inference that the controlling person knew or should have known that the primary violator, over whom that person had control, was engaging in fraudulent conduct.'" *Burstyn v. Worldwide Xceed Group, Inc.*, No. 01 CIV.1125 (GEL), 2002 WL 31191741, at *8 (S.D.N.Y. Sept. 30, 2002) (citation omitted). In courts where lack of culpable participation is an affirmative defense, however, the plaintiff has no obligation to plead culpable participation in the complaint. *See*, *e.g.*, *In re Cable & Wireless, PLC*, 321 F. Supp. 2d 749, 760 (E.D. Va. 2004); *NUI*, 314 F. Supp. 2d at 400 n.3; *In re Vivendi Universal, S.A. Sec. Litig.*, No. 02 CIV.5571 (HB), 2003 WL 22489764, at *22 (S.D.N.Y. Nov. 3, 2003).

This issue has taken on added significance because of the recent collective scienter rulings discussed in Section II above. If a plaintiff need not plead or prove culpable participation under Section 20(a), the officers that manage a company may still be liable for securities fraud even if they did not act with scienter in making the alleged misstatements. In both *NUI* and *Motorola*, the courts found that the securities fraud claims were adequately pled against the companies, but not against the companies' officers. Because these officers controlled the companies, however, the Section 20(a) claims against them were allowed to proceed. *NUI*, 314 F. Supp.2d at 417-18; *Motorola*, 2004 WL 2032769, at *34-35. By applying Section 20(a) in this manner, the courts allowed the plaintiffs to bring their securities fraud claims against both the companies and their officers (in the form of Section 20(a) claims) without having to establish a "strong inference" of scienter as to any of the individual defendants. It is difficult to reconcile this result with the Reform Act's requirement that scienter be sufficiently plead as to "each defendant."

Insider Stock Sales

Insider stock sales are often used by plaintiffs to establish that the individual defendants had a motive to artificially inflate the company's stock price. As a general matter, however, courts have held that insider stock sales can only be used to support scienter allegations if the trading is suspicious in timing or amount. *See*, *e.g.*, *In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 550 (8th Cir. 2004); *In re Alpharma, Inc. See. Litig.*, 372 F.3d 137, 151 (3d Cir. 2004); *No. 84 Employer-Teamster*, 320 F.3d at 938. Whether stock sales are suspicious is usually a fact-intensive inquiry. Courts generally require that the plaintiff plead facts that put the defendants' stock sales into context. *AMDOCS*, 390 F.3d at 550; *Alpharma*, 372 F.3d at 151. Although the relevant factors may vary somewhat from case to case, courts typically examine such questions as:

- Did the defendant sell a significant percentage of his or her company stock holdings during the class period?
- Was the price at which the defendant sold at the top or bottom of the company's stock price during the class period?
- Can the timing of the sales be linked to some company pronouncement or action?
- Are the sales consistent with the defendant's prior trading pattern?
- Did the defendant acquire shares during the class period?

See, *e.g.*, *AMDOCS*, 390 F.3d .at 550; *Ronconi v. Larkin*, 253 F.3d 423, 434-35 (9th Cir. 2001); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 476 (M.D.N.C. 2004).

By far the most important factor, and one that arises in nearly every case involving stock sales, is whether the defendant sold a significant percentage of his or her company stock holdings during the class period. Regardless of the answers to the other contextual questions listed above, most courts refuse to find any inference of fraudulent intent if the defendants only sold a small percentage of their overall holdings while supposedly inflating the stock price. Although what constitutes a "small percentage" is debatable, courts have created a cutoff somewhere under 20%. *See*, *e.g.*, *In re Smith Gardner See. Litig.*, 214 F. Supp. 2d. 1291, 1304 (S.D. Fla. 2002) (collecting eases).

In its recent decision in *Nursing Home Pension Fund, Local 144 v, Oracle Corp.*, 380 F.3d 1226, 1232 (9th Cir. 2004), however, the Ninth Circuit recognized an exception to the rule. Larry Ellison, the CEO of Oracle, was alleged to have sold only 2.1% of his holdings during the class period, but that amounted to almost $900 million in proceeds. The court held that "where, as here, stock sales result in a truly astronomical figure, less weight should be given to the fact that they may represent a small portion of the defendant's holdings." But is that a sensible exception?

The Delaware Court of Chancery, which addressed the exact same stock sales in its recent summary judgment decision in *In re Oracle Corp. Derivative Litig.*, C.A. No. 18751, 2004 WL 2847876 (Del. Ch. Dec. 2, 2004), appeared to disagree, The court found that, "however wealthy Ellison is and however envious that may make some, the fact remains that Ellison sold only 2% of his Oracle holdings. Ellison remained the person with more equity at stake in Oracle than anyone anywhere. Plaintiffs continually emphasize the nearly $1 billion that he made on the sale, but ignore the roughly $18.9 billion in equity that he lost in the ensuing share price collapse." *Id.* at *42. In other words, a billion dollars does not hold the same significance for everyone in determining whether sales are "suspicious." It seems reasonable to conclude that the percentage of stock sold, rather than the amount of proceeds, will continue to be the key metric for courts. *See*, *e.g.*, *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 477 (M.D.N.C. 2004) ("Allegations of heavy trading or large profits, without further information, do not satisfy the scienter requirement.").

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