THE CONTINUING SCIENTER DEBATE: WHERE WE STAND IN 2001

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The Private Securities Litigation Reform Act ("PSLRA") requires plaintiffs seeking to allege securities fraud to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," *i.e.*, scienter. The Second Circuit has adhered to its pre-PSLRA scienter standard, sustaining allegations (a) demonstrating that defendants had both motive and opportunity to commit fraud or (b) showing strong circumstantial evidence of defendants' conscious misbehavior or recklessness. While the debate concerning the post-PSLRA Act viability of the motive and opportunity test appears to be ripening for Supreme Court resolution, the Circuits agree that certain allegations of motive for corporate insiders to commit securities fraud may give rise to a strong inference of scienter.[2] Recent decisions addressing allegations seeking to draw scienter inferences from director and officer stock sales and other conduct during a period in which the company and its executives made allegedly false or misleading public statements about the company provide useful guidance on how courts will assess various considerations as circumstantial evidence of scienter.

I. ALLEGING SECURITIES FRAUD UNDER SECTION 10(B) AND RULE 10B-5

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for any person "[t]o use or employ, in connection with the purchase or sale of any security … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78j(b). Similarly, SEC Rule 10b-5 makes it unlawful for any person to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made,

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[2] See In re Livent, Inc. Noteholders Sec. Litig., 2001 WL 740673, *38 (S.D.N.Y. June 29, 2001) ("The point of disagreement among the courts turns on the 'motive and opportunity' prong of the Second Circuit's test, a standard which, standing alone, has been viewed as less rigorous than that of intentional misconduct or recklessness."); see also Novak v. Kasaks, 216 F.3d 300, 310 (2d Cir.), cert. denied, 121 S. Ct. 567 (2000); In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 978-79 (9th Cir. 1999); In re Baker Hughes Sec. Litig., 136 F. Supp. 2d 630, 638-39 (S.D. Tex. 2001).

not misleading … in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

In order to state a claim for securities fraud under these provisions, the plaintiff must allege that in connection with the purchase or sale of securities, defendant, acting with scienter, either made a false material representation or failed to disclose material information so that plaintiff – acting in reliance on the material misrepresentation or omission – suffered injury. Rothman v. Gregor, 220 F.3d 81, 89 (2d Cir. 2000); In re Comshare Inc. Sec. Litig., 183 F.3d 542 (6th Cir. 1999); In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999); Williams v. WMX Techs., Inc., 112 F.3d 175 (5th Cir. 1997); Gasner v. Board of Supervisors of County of Dinwiddie, 103 F.3d 351 (4th Cir. 1996); Paracor Finance, Inc. v. General Electric Capital, 96 F.3d 1151 (9th Cir. 1996) (en banc).

II. THE SCIENTER REQUIREMENT PRIOR TO THE PASSAGE OF THE PSLRA

In Ernst & Ernst v. Hochefelder, 425 U.S. 185 (1976), the Supreme Court concluded that section 10(b) was enacted to prohibit "knowing" or "intentional," as opposed to negligent, conduct. Accordingly, it foreclosed liability unless the plaintiff could plead and prove that the defendant acted with a "mental state embracing intent to deceive, manipulate or defraud." Id. at 193-4 n.12. The Court noted, however, that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act," thereby leaving open the possibility that, in some circumstances, recklessness could be sufficient for civil liability under section 10(b) and Rule 10b-5. Subsequent to Hochefelder, virtually all of the circuit courts determined that "recklessness" in some form could satisfy the scienter requirement. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) ("Our circuit … along with ten other circuits, has held that recklessness may satisfy the element of scienter in a civil action for damages under § 10(b) and Rule 10b-5"); In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989) ("We have also recognized that recklessness on the part of a defendant meets the scienter requirement of Section 10(b) and Rule 10b-5"); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989) ("the rule of this Circuit is that a showing of 'severe recklessness' satisfies the scienter requirement").

Even before the PSLRA, courts had uniformly held that negligence – even gross negligence – is not sufficient to satisfy the scienter requirement in securities fraud actions. See, e.g., Meadows v. SEC, 119 F.3d 1219, 1226 (5th Cir. 1997) (in order to meet the scienter requirement, the recklessness must "include[] not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care."); In re Glenayre Tech. Inc. Sec. Litig., 982 F. Supp. 294, 298 (S.D.N.Y. 1997) ("recklessness in this context approximates actual intent and is not merely a heightened form of negligence"); Sundstrand Corp. v. Sun Chem. Corp, 553 F.2d 1033, 1044 (7th Cir. 1977) (recklessness involves "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care … present[ing] 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."); Greebel v. FTP

Software, Inc., 194 F.3d 185, 199 (1st Cir. 1999) ("the definition of 'reckless behavior' should not be a liberal one lest any discernible distinction between 'scienter' and 'negligence' be obliterated for these purposes").

Prior to the PSLRA, the Second Circuit and most other courts held that a plaintiff could satisfy the pleading requirement for scienter by alleging in the complaint "facts that give rise to a strong inference of fraudulent intent." Shields v. Citytrust Bancorp. Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). Second Circuit cases before the PSLRA held that this "strong inference" could be drawn where plaintiffs alleged: (a) facts demonstrating that the defendants had both the motive and the opportunity to commit fraud or; (b) strong circumstantial evidence of defendants' conscious misbehavior or recklessness. In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 74 (2d Cir. 2001) (noting Second Circuit has maintained pre-PSLRA standard); Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000) cert. denied, 121 S. Ct. 567 (2000).

The Ninth Circuit, however, expressly rejected this standard, opting for a less rigorous one. See In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541, 1545, 1547 (9th Cir. 1994) (holding that it was "very clear" from Rule 9(b) that "plaintiffs may aver scienter generally … simply by saying that scienter existed"). Thus, prior to the passage of the PSLRA, the Ninth Circuit permitted plaintiffs to allege scienter generally, without explicitly laying out the circumstances from which it could be inferred.

III. PLEADING SCIENTER POST-PSLRA

In December 1995, Congress passed the Private Securities Litigation Reform Act in an effort to curtail the filing of spurious securities fraud claims.[3] Under the PSLRA, the complaint must specify "each statement alleged to have been misleading" as well as the reason why the statement was false or misleading. 18 U.S.C. § 78u-4(b)(1). The PSLRA also requires that, "[i]n any private action arising under this chapter … the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). A complaint that does not satisfy these pleading requirements must be dismissed. 15 U.S.C. § 8u-4(b)(3)(A). "Although speculative and conclusory allegations will not suffice to plead scienter, the Second Circuit has made clear that 'great specificity' is not required, so long as plaintiffs allege enough facts to support a strong inference of fraudulent intent." In re Independent Energy Holdings PLC Securities Litigation, 2001 WL 840327, at *15 (S.D.N.Y. July 26, 2001) [citations omitted].

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[3] Congress enacted the PSLRA to curb abuse in private securities litigation, particularly the filing of "strike suits." As the Committee on Banking, Housing and Urban Affairs stated in a report: "The committee heard substantial testimony that …certain lawyers file frivolous 'strike' suits alleging violations of Federal securities laws in the hope that the defendants will quickly settle to avoid the expense of litigation. These suits…are often based on nothing more than a company's announcement of bad news, not evidence of fraud." S. Rep. No. 104-98 at 4 (1995).

The PSLRA sought to codify, among other things, the pleading standard for scienter in a private securities action. In attempting to establish a uniform and coherent pleading standard, however, Congress ignited a fierce debate over how demanding Congress intended the scienter requirement to be. "Despite the clarity of … language that a complaint must state particularized facts giving rise to a 'strong inference' that the defendant acted with scienter, the federal courts have laboriously debated the test for determining when a 'strong inference' has been established." In re Baker Hughes Securities Litigation, 136 F. Supp. 2d at 630, 638 (S.D. Tex. 2001). Three views have emerged on the pleading requirement for scienter in securities fraud actions.

A. THE NINTH CIRCUIT'S RIGOROUS STANDARD

The PSLRA has prompted the Ninth Circuit to exchange the most lenient pleading standard for the most rigorous standard. The Ninth Circuit has interpreted the PSLRA as elevating the pleading standard for scienter in a securities fraud case, requiring that a plaintiff plead, in significant detail, facts constituting strong circumstantial evidence of deliberately reckless or conscious misconduct. Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 979 (9th Cir. 1999) Silicon Graphics. Facts suggesting recklessness or a motive and opportunity to commit fraud provide a reasonable inference of intent, but are not by themselves sufficient to establish a strong inference of deliberate recklessness. In re Baker Hughes, 136 F. Supp.2d at 639. The Ninth Circuit's standard mandates recitation of "specific facts indicating no less than a degree of recklessness that strongly suggests actual intent," rather than mere motive and opportunity. Id.

In Silicon Graphics, the Ninth Circuit examined the legislative history of the PSLRA, and concluded that Congress intended a more exacting standard than the one previously enunciated by the Second Circuit ("Congress generally intended to raise the pleading standards to eliminate abusive securities litigation and … it specifically intended to raise the pleading standard above that in the Second Circuit."). Silicon Graphics, 183 F.3d at 977. The court noted that Congress expressly repudiated a proposed amendment by Senator Arlen Spector, which would have codified the Second Circuit's alternative test. Id. at 978. It also emphasized the Conference Report's express statement that: "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." Id. (citing H.R. CONF. REP. 104-369, at 41 n. 23).[4] Similarly, the congressional override of Clinton's presidential veto "provided powerful

[4] See also Senate Committee on Banking, Housing and Urban Affairs Report, S.Rep. No. 98, 104th Congress, 1st Sess., at 15 (1995) ("[t]he Committee does not intend to codify the Second Circuit's case law interpreting this pleading standard").

evidence of [Congress'] intent to elevate the pleading standard beyond that in the Second Circuit." Id. at 979.[5]

The Ninth Circuit's interpretation of the PSLRA scienter standard raises the scienter pleading requirement above both the Hochfelder standard and other courts' interpretations of Hochfelder. See In re Southern Pacific Funding Corp. Sec. Litig., 83 F. Supp. 2d 1172, 1177 (D. Or. 1999) (Silicon Graphics "raised the substantive standard applicable to section 10(b) claims to that of 'deliberate recklessness' and 'deliberate recklessness' constitutes a higher degree of recklessness than previously contemplated."); Bryant v. Avado Brands, Inc., 187 F.3d 1271 (11th Cir. 1999); Greebel v. FTP Software, Inc. 194 F.3d 185 (1st Cir. 1999); see also In re Splash Technology Holdings Inc. Securities Litigation, 2000 WL 1727377, at *5 (N.D. Cal. 2000) ("[a] complaint merely alleging that a defendant had the motive and opportunity to commit fraud is insufficient.").

B. THE SECOND CIRCUIT'S STANDARD: "MOTIVE AND OPPORTUNITY" MAY SUFFICE

The Second and the Third Circuits have held that the PSLRA did not elevate the pleading standard for establishing a strong inference of scienter any higher than that which previously prevailed in the Second Circuit. See In re Scholastic Corp. Securities Litigation, 252 F.3d 63, 74 (2d Cir. 2001) ("Second Circuit case law remains the standard after passage of the Act"); Novak, 216 F.3d at 310 (the PSLRA "raised the nationwide pleading standard to that previously existing in this circuit and no higher [] with the exception of the 'with particularity' requirement"); In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir.1999) (the PSLRA "establishe[d] a pleading standard approximately equal in stringency to … the Second Circuit'[s] pre-PSLRA pleading standard").

Thus, in the Second and Third Circuits, plaintiffs can plead scienter by either: (a) alleging facts demonstrating that defendants had both the motive and opportunity to commit fraud or; (b) otherwise alleging facts to show strong circumstantial evidence of defendant's conscious misbehavior. See Novak, 216 F.3d at 311; In re Advanta, 180 F.3d at 534 ("it remains sufficient for plaintiffs [sic] plead scienter by alleging facts establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior").

In In re Advanta, the court examined the legislative history of the PSLRA and concluded that it was "ambiguous and even contradictory," and consequently was "reluctant to accord it much weight." Id. at 531, 533. Instead, it focused on the plain language of the PSLRA, which closely paralleled that previously employed by the Second Circuit. It noted that with the

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[5] President Clinton expressed concern that "the pleading requirements of the Conference Report with regard to a defendant's state of mind imposes an unacceptable procedural hurdle to meritorious claims being heard in federal courts." 141 Cong. Rec. H15, 214 (daily ed. Dec. 10, 1995).

exception of the Act's 'particularity' requirement, the two standards are virtually identical. Id. at 533. The court in In re Advanta was convinced that Congress's nearly wholesale adoption of the Second Circuit's language "compel[led] the conclusion" that the PLSRA established a pleading standard substantially identical to that which previously existed in the Second Circuit. Id. at 534. Moreover, the court maintained that had Congress wished to eliminate the "motive and opportunity" test, it could have expressly done so in the statute. Id. The court further reasoned that this interpretation was compatible with Congress's intent to deter frivolous or vexatious lawsuits by heightening pleading standards. Id.

C. A MIDDLE GROUND

Some federal courts, notably the Sixth and Eleventh Circuits, have adopted an intermediate standard, concluding that a strong inference of scienter can be established by alleging specific facts that constitute strong circumstantial evidence of recklessness or conscious misbehavior. See In re Baker Hughes, 136 F. Supp.2d at 640. In In re Comshare Inc. Sec. Litig., 183 F.3d 542, 551 (6th Cir. 1999), the Sixth Circuit stated that while facts pertaining to motive and opportunity may "on occasion rise to the level of creating a strong inference of reckless or knowing conduct," the "bare pleading of motive and opportunity" are not sufficient to establish an inference of scienter. Adopting this conclusion, a Texas district court (noting that the Fifth Circuit has yet to address the issue) recently concluded that "the reasoned approach most in accord with the language of the PSLRA is that a strong inference of scienter is not raised where a plaintiff merely alleges facts of a defendants' motive and opportunity to commit fraud." In re Baker Hughes, 136 F.Supp.2d at 640. Rather, in order to raise a strong inference of scienter, a plaintiff must set forth specific facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. Id.

IV. THE SECOND CIRCUIT AND THE SURVIVAL OF "MOTIVE AND OPPORTUNITY"

While the circuits disagree about the post-PSLRA viability of the "motive and opportunity" test, they agree that facts suggesting a "motive" to commit securities fraud are relevant in assessing whether a defendant acted with scienter under any standard. Motive is commonly understood to "entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." Shields v. Citytrust Bancorp, Inc., 25 F.3d at 1124, 1130 (2d Cir. 1994). In the Second Circuit, allegations that the defendant benefited in a "concrete and personal way from the purported fraud" may generate the strong inference required bring a claim for securities fraud under 9(b). Novak, 216 F.3d at 307. Opportunity encompasses "the means and likely prospect of achieving concrete benefits by the means alleged." Shields, 25 F.3d at 1130. Bald assertions of motive and opportunity will not suffice. In re Advanta, 180 F.3d at 535 (conclusory allegations would "undermine the … rigorous pleading standard Congress has established [under the PSLRA]"). Moreover, "[m]otive must be pled with greater specificity than opportunity," as the latter is more easily demonstrated. In re Complete Management Inc. Securities Litigation, 2001 WL 314631, at *11 (S.D.N.Y. March 30, 2001). As a practical matter, corporate insiders rarely dispute "opportunity" allegations.

Plaintiffs seeking to plead facts giving rise to a strong inference of scienter have alleged several recurring "motives" for corporate insiders to commit fraud. The most frequently encountered allegation is that sales of company stock by company directors and officers during the alleged class period give rise to a strong inference of fraudulent intent. Courts recently have also addressed attempts to plead scienter by reference to: the company's purported need to raise capital, maintain a high credit/bond rating, project an image of corporate profitability and effect certain mergers or acquisitions, as well as incentives for management to secure increased compensation. The following section analyzes how the courts have received such allegations. It bears emphasis that when such allegations are combined, they will not be examined in isolation. Rather, courts will perform a comprehensive evaluation of all facts bearing on motive in each case.

V. FACTS ASSERTED AS SUGGESTING A STRONG INFERENCE OF SCIENTER

A. STOCK SALES

Lawyers preparing a securities fraud complaint typically review recent SEC Form 4 disclosures (Statement of Changes in Beneficial Ownership) by a company's directors and officers in order to determine these individuals' trades in the company's securities during the class period. The fruit of such investigations is the recurring allegation that specific stock sales by one or more corporate insiders are "strong circumstantial evidence" that the company and its directors and officers made alleged material misrepresentations or omissions with scienter. Recognizing that corporate insiders routinely sell company stock for legitimate reasons ranging from a wish to diversify a portfolio to a daunting tuition payment, courts have rejected efforts to allege insider stock sales as proof of scienter unless the sales are "unusual" or "suspicious." Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1224 (1st Cir. 1996) ("The mere fact that insider stock sales occurred does not suffice to establish scienter."); Baker Hughes, 136 F. Supp. 2d at 646; In re First Union Sec. Litig., 128 F. Supp. 2d 871, 897 (W.D.N.C. 2001). While such hazy terms inevitably yield decisions reflecting a court's overall perception of relevant trading conduct, courts have identified several factors to facilitate a reasonably well-informed evaluation of particular conduct.

In assessing whether a stock sale is unusual or suspicious, courts have considered: (a) the timing of the sales; (b) the amount and percentage of overall holdings sold; (c) consistency of the sales with the insider's prior trading practices; and (d) whether other insiders sold stock in the same period. Ronconi v. Larkin, 253 F.3d 423, 435 (9th Cir. 2001); In re Scholastic, 252 F.3d at 74-75; Stevelman v. Alias Research Inc., 174 F.3d 79, 85 (2d Cir. 1999); Acito v. Imcera Group, 47 F.3d 47, 54 (2d Cir. 1995).

1. *Timing of Stock Sales*

Plaintiffs often allege that a strong inference of fraudulent intent may be inferred when an insider sells stock shortly before the public disclosure of information that adversely affects the stock price. The contention is that the company made misrepresentations or delayed

disclosing negative information until one or more directors or officers had the opportunity to sell stock at an artificially inflated price. Director and officer stock sales occurring before alleged misrepresentations or omissions of material fact do not support an inference of scienter. Rothman v. Gregor, 220 F.3d 81, 95 (2d Cir. 2000); Acito, 47 F.3d at 54; In re Complete Mgt. Inc. Sec. Litig., 2001 WL 314631, *12 (S.D.N.Y. March 30, 2001).

The context surrounding questioned sales is important in assessing the significance of the timing of sales. Sales occurring pursuant to a periodic divestment plan or written trading plan consistent with SEC Rule 10b5-1, for instance, should not be considered suspicious regardless of their timing. Fishbaum v. Liz Claiborne, Inc., 189 F.3d 460 (2d Cir. 1999). Sales of stock by an insider in order to exercise options (and thereby increase holdings) suggest nothing untoward.

The temporal distance between sales and the public disclosure of negative information has proved critical. Close temporal proximity between sales and bad news does not, in itself, give rise to a strong inference of scienter. When additional factors support a strong inference of scienter, however, several courts have held that sales occurring approximately two months or less before disclosure of negative information may be suspiciously timed. In re Oxford Health Plans, Inc., 187 F.R.D. 133, 140 (S.D.N.Y. 1999); Simon v. American Power Conversion Corp., 945 F. Supp. 416, 435 (D.R.I. 1996). The balance tips toward the opposite conclusion as the interval widens, with courts regularly declining to draw an inference of fraudulent intent based on sales occurring six months or longer before negative announcements. In re Party City Sec. Litig., 147 F. Supp. 2d 282, 313 (D.N.J. May 29, 2001) (sales 3-12 months too remote); In re Credit Acceptance Corp. Sec. Litig., 50 F. Supp. 2d 662, 677 (E.D. Mich. 1999) (10 months too remote); Plevy v. Haggerty, 38 F. Supp. 2d 816, 835 (C.D. Cal. 1998) (7-10 months too remote).

2. ***Amount and Percentage of Holdings***

Considerable scrutiny will be given to the number of shares sold during the class period, the portion of overall company stock holdings the sales constitute and the amount of profit from the sales. These considerations should not be examined in isolation. As the Second Circuit has noted, "[l]arge volume trades may be suspicious but where a corporate insider sells only a small fraction of his or her shares in the corporation, the inference of scienter is weakened." Rothman v. Gregor, 220 F.3d 81, 95 (2d Cir. 2000).

While the dollar amount received in a sale is relevant, courts tend to place greater emphasis on the percentage of overall stock holdings involved in the sale. Meaningful retained holdings suggest that directors and officers have every incentive to keep the company profitable. Courts in the Second Circuit and elsewhere have generally held that sales of less than 10% of stock, even by multiple directors and officers, do not support a strong inference of scienter. See, e.g., Rothman, 220 F.3d at 94-95 (sales by three directors and officers of less than 10% of the shares of each); Acito, 47 F.3d at 54 (sale by one outside director of 30,000 shares comprising less than 11% of holdings); In re Glenayre Techs Sec. Litig., 982 F. Supp. 294, 299

(S.D.N.Y. 1997) (sales by seven insiders collectively of $36 million in stock comprising 5% of collective holdings), aff'd, 201 F.3d 431 (2d Cir. 1999).

The length of the purported class period should also be considered, as sales that might appear unusual in a relatively short period may be more commonplace when spread across a year or more. In re Splash Tech. Holdings, Inc. Sec. Litig., 2000 WL 1727377 (N.D. Cal. Sept. 29, 2000). Purchases of company stock during the alleged class period by insiders whose stock sales are questioned will weaken an asserted inference of fraudulent intent, unless sales overwhelm purchases. See Fishbaum, 189 F.3d at 460; In re Complete Mgt., 2001 WL 314631 at *12; In re Symbol Techs Class Action Litig., 950 F. Supp. 1237, 1240 (E.D.N.Y. 1997).

A recurring issue is whether vested options should be counted when calculating an insiders' overall holdings. Including an insider's vested but unexercised options in total stockholdings usually will reduce the proportion of stock actually sold to the stockholdings available to be sold. See, e.g., In re Silicon Graphics, 183 F.3d at 1001 (Browning, J., concurring and dissenting in part) (Two officers "sold significant percentages - 43.6% and 75.3% respectively - of the shares they could have sold, if vested options are included. If vested options are excluded, [these officers] sold 95% and 99.8% of their holdings respectively."). Typically, no reason exists to distinguish vested stock options from common stock because vested options are readily convertible into stock and may be sold immediately, and both the Second and Ninth Circuits follow this approach. See, e.g., In re Silicon Graphics, 183 F.3d at 987; Acito, 47 F.3d at 54; but see In re Oxford Health Plans, Inc., 187 F.R.D. at 140 ("vested options are not shares").

3. *Prior Trades*

Courts have regarded sales of a substantial amount of stock shortly before the release of adverse information as unusual when preceding the sale the holder had gone extended periods with minimal or no sales. In a decision rendered in August 2001, the Ninth Circuit emphasized that the absence of prior sales should not support an inference of fraudulent intent when the absence reflects compliance with securities rules restricting insider trading activity for a portion of the pre-class period. See Berger v. Ludwick, 2001 WL 868355, *1 (9th Cir. Aug. 1, 2001). A Texas district court recently held that even though plaintiffs alleged the number of shares sold, the sale price and the profit, the absence of any allegation addressing the relevant officer's trading history precluded the sale of nearly 40% of the officer's company stock raising an inference of scienter. In re Baker Hughes, 136 F. Supp. 2d at 647; see also In re Baan Co. Sec. Litig., 103 F. Supp. 2d 1, 19-20 (D.D.C. 2000) (rejecting scienter inference from allegation of insider stock sales lacking historical comparison); compare Marksman Partner, L.P. v. Chantal Phar. Corp., 927 F. Supp. 1297, 1312-13 (C.D. Cal. 1996) (sustaining scienter allegations based on insider's sale of 20% of holdings with no prior sale in three years). Information about prior trades thus enables the court to assess the stock sale in dispute in an appropriate contextual perspective.

4. ***Other Insiders' Trading Activity***

The absence of unusual company stock sales during the class period by other insiders with access to the same information allegedly used to the trading advantage of certain directors or officers undermines allegations that the latters' sales support a strong inference of scienter. In Silicon Graphics, plaintiff alleged that six company officers made false and misleading statements about the company's health while collectively selling 388,188 shares totaling nearly $14 million in proceeds. Four of the officers sold between two and eight percent of their respective holdings, and the remaining two officers sold 43.6 and 75.3 percent of their respective holdings. Although the Ninth Circuit acknowledged that the sale by an officer of more than three-quarters of his stock was noteworthy, it attached more weight to the fact that "[c]ollectively, the officers – even including the two who sold the greatest percentage of their holdings – retained 90 percent of their available holdings" at the end of the class period. Silicon Graphics, 183 F.3d at 987. The court concluded that the significance of the 75.3 percent sale was further attenuated by the officer's remoteness from daily corporate affairs and a prior legal restriction on stock sales, the termination of which coincided with the sales. The absence of suspicious stock sales by directors and officers who likely would have been "essential participants" in any alleged fraud is a particularly compelling factor against an inference of scienter. Id.; see also In re Credit Acceptance Corp., 50 F. Supp. 2d 662, 677 (E.D. Mich. 1999).

Courts have frequently declined to accept stock sales by a single director as the basis to infer scienter at the pleading stage. See, e.g., Stevelman, 174 F.3d at 85-86 (noting in dicta, "[W]e have suggested that scienter may not be inferred 'strongly' when the alleged fraud is alleged to have benefited only a single defendant in a corporate entity."); San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc., 75 F.3d 801, 814 (2d Cir. 1996) ("In the context of this case, we conclude that the sale of stock by one company executive does not give rise to a strong inference of fraudulent intent; the fact that other defendants did not sell their shares during the relevant class period sufficiently undermines plaintiffs' claim regarding motive.").

The Second Circuit, however, recently declined to recognize "a per se rule that the sale by one officer of corporate stock for a relatively small sum can never amount to unusual trading." In re Scholastic Corp., 252 F.3d at 75. It held that allegations that one officer "sold 80 percent of his holdings within a matter of days for a not insignificant profit, after having sold no [company] stock" for a year were sufficient to withstand a motion to dismiss. Id.

5. ***Lessons In Recent Decisions***

An appendix at the conclusion of this article sets forth recently decided cases addressing allegations that stock sales support an inference of scienter, and highlights the factors on which each decision turned.

Recently-issued decisions from the Ninth Circuit and Southern District of New York addressing motions to dismiss securities fraud claims illustrate that no single factor is determinative, and the weight attached to each will vary according to its perceived prominence in the mix. In Ronconi v. Larkin, 253 F.3d 423 (9th Cir. 2001), the Ninth Circuit reinforced its growing body of decisions declining to infer fraudulent intent from director and officer stock sales. Plaintiffs alleged securities fraud based on optimistic statements by directors and officers about synergies stemming from a merger with a competitor. When the anticipated synergies failed to materialize and the stock declined, plaintiffs alleged that stock sales by eleven directors and officers coinciding with the optimistic predictions created a strong inference of fraudulent intent.

The Ninth Circuit disagreed, refusing to draw an inference of scienter, even from one officer's sale of 98 percent of her stock at a handsome return during the class period. The Court found more persuasive that seven of the insiders "sold too soon to be taking advantage of their allegedly fraudulent statements, because the price increase allegedly caused by fraud occurred after they sold, and the price at which they sold is about where the stock ended up after the alleged false statements were corrected." Id. at 436. The sale by one officer of 98 percent of her stock could not support an inference of scienter, the court reasoned, because plaintiffs failed to provide sufficient trading history to sustain any conclusion about consistency with prior trading practices. Although the plaintiffs had provided substantial trading history information, the information was of minimal value because it addressed an historic period in which securities rules precluded the insiders from trading. The lesson is that rote recital of trading activity in the months immediately preceding the alleged class period may be useless to the court and prove fatal to scienter allegations.

In In re: Independent Energy Holdings PLC Sec. Litig., 2001 WL 840327 (S.D.N.Y. July 26, 2001), the Southern District of New York held that allegations of stock sales by a director who was one of the largest shareholders in the company supported a strong inference of scienter. The director had owned more than one million shares of company stock and sold nearly 43% of his holdings, receiving $24.62 million in proceeds about five weeks before the first of multiple public announcements leading to a precipitous decline in stock price. The court also attached significance to simultaneous stock sales by two other directors of 14 and 17 percent, and to analyst "buy" and "strong buy" recommendations with price targets of approximately $10 per share higher than the director's sale price. Id. at *21. The decision reminds directors and officers that sudden, large-scale stock sales occurring shortly before a negative public announcement may be viewed with suspicion.

B. NECESSITY OF RAISING CAPITAL

Numerous cases have addressed whether a company's need to raise working capital provides sufficient motive to sustain an inference of fraudulent intent. The majority of cases hold that a generalized desire to raise capital is insufficient to raise a strong inference of scienter. See, e.g., Salinger v. Projectavision, Inc., 972 F. Supp. 222, 223 (S.D.N.Y. 1997) ("It is not sufficient … to plead scienter by alleging an abstract desire to enable the company to continue to enjoy a high stock price and thereby ease the difficulties of raising additional capital."); see also In re 1993 Corning Sec. Litig., 1996 WL 257603, at *6 (S.D.N.Y. 1996) (noting the "Second Circuit's unequivocal rejection of the concept of motive predicated upon the desire to maximize the marketability of debt securities and to minimize interest rates"); Feasby v. Industri-Matematik Int'l Corp, 2000 WL 977673, at *4 n. 5 (S.D.N.Y. July 17, 2000) ("allegations that defendants were 'motivated by' a desire to raise capital or 'benefited by' raising capital are insufficient.") (citations omitted); Glickman v. Alexander & Alexander Services, Inc., 1996 WL 88570, at *7 (S.D.N.Y. 1996) ("generic" allegations of motive such as raising "desperately-needed" capital are too vague to satisfy the scienter requirement for securities fraud). Thus, blanket assertions that debt financing was "badly needed" or "critical" do not constitute particularized facts from which a strong inference of scienter may be drawn.

Certain courts have ruled, however, that "sufficiently particularized facts alleging the need to raise capital can be probative of scienter." In re Baker Hughes, 136 F. Supp. 2d at 643. In In re Kidder Peabody Sec. Litig., 1995 WL 590624, at *5 (S.D.N.Y. Oct. 4, 1995), the court concluded that scienter could be inferred where the company was required to demonstrate profitability in order to obtain desperately-needed bank financing. Similarly, In re Tel-Save Sec. Litig., the court ruled that plaintiff adequately pled motive by alleging that the company would have suffered a $25 million loss had the stock fallen below a certain price and that the stock's inflated price secured the defendant the collateral necessary to secure a $30 million loan. 1999 U.S. Dist. LEXIS 16800 at *16-17. Thus, where the claims are sufficiently specific, courts may accord weight to a particularly acute need for capital.

C. EXECUTIVE COMPENSATION

General allegations that senior executives of the company would secure increased compensation by inflating the company's financial results are inadequate to establish an inference of scienter, as a contrary rule "would effectively eliminate the state of mind requirement as to all corporate officers and defendants." Melder v. Morris, 27 F.3d at 1097, 1102 (5th Cir. 1994); see also Acito, 47 F.3d at 54 (2d Cir. 1995) ("[T]he existence, without more, of executive compensation dependent upon stock value does not give rise to a strong inference of scienter."); Shields, 25 F.3d at 1130 (incentive compensation "can hardly be the basis on which an allegation of fraud is predicated"); In re E.Spire Communications, Inc. Securities Litigation, 127 F. Supp. 2d 734, 742 (D. Md. 2001) (plaintiff's allegations that the defendants' false statements were motivated by a desire to enhance their executive compensation were "insufficient to create a strong inference of scienter because such allegations pertain to common motivations of corporate officers"); In re The First Union Corp. Securities Litigation, 128 F.

Supp. 2d 871 (W.D. North Carolina 2001) ("Even when a personal motive – to increase compensation – is alleged, it does not satisfy the scienter requirement."); In Party City Securities Litigation, 147 F. Supp.2d 282 (D.N.J. May 29, 2001) (court dismissing the plaintiffs' allegation that the defendants committed fraud in order to "protect and enhance their executive positions that the substantial compensation and prestige that they obtained thereby."); In re Criimi Mae, Inc. Securities Litigation, 94 F. Supp. 2d 652, 660 (D. Md. March 30, 2000) ("[A]ssertions that a corporate officer or director committed fraud in order to retain an executive position … simply do not, in themselves, adequately plead motive. Similarly insufficient are allegations that corporate officers were motivated to defraud the public because an inflated stock price would increase their compensation"); Ferber v. Travelers Corp., 785 F. Supp. 1101, 1107 (D. Conn. 1991) ("[i]t does not logically follow that because executives have components of their compensation keyed to performance, one can infer fraudulent intent.").

If the allegation is specific and combined with other facts suggesting fraudulent intent, however, allegations concerning executive compensation may support a strong inference of scienter. See, e.g., In re Digi Int'l, Inc. Sec. Litig., 6 F. Supp. 2d 1089 (D. Minn. 1998). The In re Digi court declined "to adopt a per se rule that executive compensation premised on performance c[ould] never form part of the basis supporting an inference of scienter." Id. at 1097. Rather, it noted that the existence of incentive-based compensation, coupled with other relevant factors, could give rise to an inference of scienter. In re Digi pointed to multiple factors – including executive compensation – which *collectively* provided a motive for securities fraud.

Thus, "[p]laintiffs must allege a combination of facts which may include performance-based compensation" to establish the motive necessary to sustain an inference of fraud. In re Green Tree, 61 F. Supp. 2d 860, 873 (D. Minn. 1999). See, e.g., Grandon v. Merrill Lynch and Co., Inc., 2001 WL 826092, at *6 (S.D.N.Y. July 20, 2001) (holding that the practice of charging excessive markups on bonds to increase compensation of Merrill Lynch's officers *"in the context of the [other] allegations"* is sufficient to meet the scienter requirements of Rule 9(b) and the PSLRA).

D. HIGH CREDIT OR BOND RATING

"[T]he desire to maintain a high credit rating is insufficient alone to support an inference of motive because virtually every company wants to maintain such a rating." In re Green Tree, 61 F. Supp. 2d at 860, 874 (D. Minn. 1999). In San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co., 75 F.3d 801, 814 (2d Cir. 1996), the court rejected the argument that motive could be demonstrated by alleging that an inflated stock price and an illusion of continued profitability maintained a high bond/credit rating for defendants, thereby maximizing the marketability of $700 million in debt securities. Similarly, the Second Circuit held in Acito that motive could not be inferred from a company's desire to maintain a high bond or credit rating, because "if scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions." Acito, 47 F.3d at 54. Most recently, in In re E.Spire

Communications, Inc. Securities Litigation, 127 F. Supp.2d 734 (D. Md. 2001), a Maryland district court held that "a company's desire to maintain a high bond or credit rating does not qualify as a sufficient motive for fraud." Courts have thus consistently dismissed plaintiff's arguments that motive can be inferred solely from a desire to maintain a strong credit or bond rating. Id. at 744.

E. CORPORATE PROFITABILITY

A generalized desire to project an image of corporate profitability is not an adequate motive to establish scienter in the securities fraud context. See In re Complete Management Inc. Securities Litigation, 2001 WL 314631, at *11 (S.D.N.Y. March 30, 2001) ("The motive simply to maintain the appearance of corporate profitability … will naturally involve benefit[s], but those benefits are insufficiently concrete to qualify as motive for fraud under the Second Circuit's securities fraud jurisprudence.") (citations omitted); Chill v. General Electric Company, 101 F.3d 263, 268 (2d Cir. 1996) ("The motive to maintain the appearance of corporate profitability, or of the success of an investment, will naturally involve benefit to a corporation, but does not entail [the] concrete benefits [necessary to establish motive for the purposes of scienter].").

In Chill, the Second Circuit declined to infer scienter from a company's interest in justifying to its shareholders a $1 billion investment in its subsidiary: "[i]n this case, GE obviously would want to justify its investment in [its subsidiary] and have that investment appear profitable, but such a generalized motive, one which could be imputed to any publicly-owned, for-profit endeavor, is not sufficiently concrete for purposes of inferring scienter." Id. at 268.

F. MERGERS/ACQUISITIONS

Courts have also routinely rejected allegations that motive can be established by demonstrating that an inflated stock price could facilitate a merger or acquisition. In In re Green Tree, the court dismissed the plaintiffs' contention that the defendants defrauded the public to make the company more attractive for sale, as the company "had to know that any potential purchaser … would perform due diligence before finalizing the deal." 61 F. Supp. 2d at 874. Similarly, in In re The First Union Corp. Securities Litigation, the court held that "… Plaintiffs' allegation[] that Defendants were motivated to enhance the ability of First Union to fund acquisitions … [was] … deficient." It noted that every public corporation and corporate executive has a legitimate interest in maintaining or increasing shareholder value through increased stock prices. 128 F. Supp. 2d 871, 896 (W.D.N.C. 2001). Similarly, another court rejected scienter allegations suggesting that the company effected various acquisitions by using the inflated value of the stock as merger consideration. In Re Health Management, Inc. Sec. Lit., 970 F. Supp. 192, 203-4 (S.D.N.Y. 1997). Courts are almost certain to dismiss claims relying on "unsubstantiated allegations" that a defendant inflated its stock price in an effort to "consummate unspecified acquisitions." In re Home Health Corp. of America, Inc. Sec. Litig., 1999 WL 79057, at *16 (E.D. Pa. 1999).

In Rothman, however, the Second Circuit noted that "… in some circumstances, the artificial inflation of stock price in the acquisition context may be sufficient for securities fraud scienter." 220 F.3d at 92 (citing Sirota v. Solitron Devices, Inc., 673 F.2d 566 (2d Cir. 1982) and In re Time Warner Inc. Securities Litig., 9 F.3d 259, 270 (2d Cir. 1993)). The Rothman court considered whether the defendants' motive could be inferred from their use of stock as consideration to acquire four companies. The court concluded it was "strongly inferable" in that case that the company "improperly refused to expense royalty advances in order to artificially inflate its stock price with an eye toward using its stock to acquire [another company]." Id. at 94. The court emphasized the complaint's allegation that the principal acquisition relied upon to support scienter involved merger consideration that was mostly stock. The court deemed the combination of other allegations in the complaint with specific allegations of inflating the stock price to facilitate acquisitions sufficient to establish the requisite strong inference of scienter. The court declined to decide whether scienter can be established "solely by an allegation of a high stock price artificially maintained in the context of one impending acquisition." Id.

G. AUDITING AND OTHER PROFESSIONAL FEES

In claims against auditors and other professional service firms, courts have held that "the desire for future auditing fees is … insufficient as a matter of law to state an inference of fraud under the motive-and-opportunity theory." In re Complete Management Inc. Securities Litigation, 2001 WL 314631, at *19 (S.D.N.Y. March 30, 2001); see also Four Fingers Art Factory v. Nicola, 2001 WL 21248, at *5 (S.D.N.Y. Jan. 9, 2001) ("a general allegation that [defendant] was motivated to commit fraud in the hope of obtaining a fee is insufficient to establish fraudulent intent under 9(b)"); ICD Holdings S.A. v. Frankel, 976 F. Supp. 234, 245 n. 51 (S.D.N.Y. 1997) ("the fact that professional service firms like [the defendant] receive fees for their services is insufficient to supply the motive essential to the motive-and-opportunity theory under Rule 9(b)"); In re Health Management, Inc. Securities Litigation, 970 F. Supp. 192, 202 (E.D.N.Y., 1997) ("It is unreasonable to believe that [the auditor] would willingly condone … fraud by risking its entire reputation … to preserve a fee."); Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994) ("… it seems extremely unlikely that [defendant] was willing to put its professional reputation on the line by conducting fraudulent auditing work.").

STOCK SALES AS SUPPORT FOR SCIENTER

Case	Decision	No. of Shares Sold	Value of Shares Sold	Percentage of Shares Sold	Timing	Prior Trading History	Other
In re Party City Securities Litigation (D. N.J. 2001)	No Scienter	All 125,000	$2 million $2.8 million	100% 5% (collectively 8%)	Defendant's sales of all of his shares took place well before the announcement of bad news. Many of defendant's sales took place after the stock reached its high.	Defendant's trading of 125,000 shares during class period was consistent with his stock sales in previous years.	
In re Baker Hughes (S.D. Tex. 2001)	No Scienter	21,000	$666,205	37% (alleged by the plaintiff; not accepted by the court)			No allegation that the former CEO and Chairman sold any personal stock during class period.
In re The First Union Corp. Securities Litigation (W.D. N.C. 2001)	No Scienter		$1.46 million $200,000	Less than 5% Less than 5%			Defendants actually increased their respective holdings of stock during class period.
In re VISX, Inc. (N.D. Cal. 2001)	No Scienter	730,000 160,336 224,547 135,414 172,000 50,674	$51.8 million $12.1 million $13.7 million $8.4 million $6.8 million $4.1 million			The defendants' sales were not dramatically out of line with the number of shares sold during the previous year.	

Case	Decision	No. of Shares Sold	Value of Shares Sold	Percentage of Shares Sold	Timing	Prior Trading History	Other
In re Independent Energy Holdings (S.D.N.Y. 2001)	Scienter		$24.62 million	43%	Timing was suspicious, as all analysts following the company had "Buy" or "Strong Buy" recommendations on the stock.		
In re E. Spire Communications (D. Md. 2001)	No Scienter	153,000 2,000	$1,108,000 $18,000	9.12% 0.66% (Note: figures include exercisable options)		Both defendants had previously sold large numbers of shares.	
In re Scholastic (2d Cir. 2001)	Scienter	19,400	$1.25 million	80%		Defendant had not sold a single share for approximately a year and a half prior to the sale in question.	
W.R. Carney v. Cambridge Technology (D. Mass. 2001)	No Scienter	125,000 85,004	$3.85 million $2.6 million		Court found nothing suspicious with respect to timing.	Court found nothing unusual with respect to trading patterns.	

Case	Decision	No. of Shares Sold	Value of Shares Sold	Percentage of Shares Sold	Timing	Prior Trading History	Other
In re Baan Company Securities (D.C. 2000)	No Scienter	40,000 40,000 559,000					Plaintiffs do not indicate what percentage of stock each defendant sold and whether this was consistent with previous trading patterns.
In re Splash Technology Holdings (N.D. Cal. 2000)	No Scienter	47,500 83,629 117,800 47,008 (collectively 295,937)	$1,338,500 $2,285,415 $3,202,040 $1,473,252 (collective value $8,299,257)	31.32% 25.17% 47.37% 28.46% (collectively 33%)	High volume of sales during one week in July coupled with the temporarily proximate subsequent decline in stock value and disclosure of negative news arouses some suspicion.		
Rothman v. Gregor (2d Cir. 2000)	No Scienter	1,494,720 70,000	$20 million $1.615 million	9.3% 9.9%	Defendant actually purchased shares during the class period.		

Case	Decision	No. of Shares Sold	Value of Shares Sold	Percentage of Shares Sold	Timing	Prior Trading History	Other
In re Advanta (3d Cir. 1999)	No Scienter	7% 5% (figures not available for other defendants, though three individual defendants sold no stock during class period)	1,023,766 (collectively)			The sales were not particularly large compared to previous trading practices.	
Silicon Graphics (9th Cir. 1999)	No Scienter	388,188 (collectively)	$13.8 million	2.6% 7.7% 4.1% 6.9% 43.6% 75.3%		Sales by three of the defendants did not deviate dramatically from their previous trading history.	While defendant's sales of 75.3% of his stock appears suspicious, a full contextual overview reveals otherwise.
In re Credit Acceptance Corp. (E.D. Mich. 1999)	No Scienter	2,425,000 30,000		9% n/a	Defendants made the sales early in the class period.		Defendant selling over 2 million shares lost more than any other individual when stock plummeted. No stock sales by CFO.