DIRECTORS' AND OFFICERS' LIABILITY
STOCK SALES AND SCIENTER

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The Private Securities Litigation Reform Act 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.[1] The Second Circuit has adhered to its pre-Reform Act 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.[2] While the debate concerning the post-Reform Act viability of the motive and opportunity test appears to be ripening for Supreme Court resolution,[3] the Circuits agree that in certain circumstances sales of company stock by directors and officers may give rise to a strong inference of scienter. Recent decisions addressing allegations seeking to draw scienter inferences from director and officer stock sales during a period in which allegedly false or misleading public statements about the company were made provide useful guidance on how courts will assess trading information as circumstantial evidence of scienter.

Overview

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."[4] 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 (1) the timing of the sales; (2) the amount and percentage of overall holdings sold; (3) consistency of the sales with the insider's prior trading practices; and (4) whether other insiders sold stock in the same period.[5] Consistent with the objectives of the PSLRA, requiring plaintiffs to marshal factual support for a stock-sale based scienter theory forecloses, even at the pleading stage, resort to innuendo and capitalizing on coincidences. The

PSLRA requires plaintiffs to allege facts supporting a strong inference of scienter without first subjecting defendants to discovery.

Timing

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 are made do not support an inference of scienter.[6]

The context surrounding questioned sales is important in assessing the significance of the timing of sales. It bears emphasis that sales occurring pursuant to a periodic divestment plan or written trading plan consistent with SEC Rule 10b5-1 should not be considered suspicious regardless of their timing.[7] 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 never by itself gives 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.[8] 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.[9] Moreover, failure to sell stock at or near the highest price reached during the class period militates against an inference of scienter.

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.'"[10] 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.[11] The length of the purported class period should also be considered, as sales that might seem unusual in a relatively short period may be more commonplace when spread across a year or more.[12] 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.[13]

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.[14] 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 the Second and Ninth Circuits follow this approach.[15]

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 issued last week, the Ninth Circuit emphasized that the absence of prior sales should not support an inference of fraudulent intent, however, when the absence reflects compliance with securities rules restricting insider trading activity for a portion of the pre-class period.[16] A Texas district court recently held that even though plaintiffs alleged the number of shares sold, the sale price and the alleged illegal profit, the absence of any allegation addressing an officer's prior trading history precluded the sale of nearly 40% of the officer's company stock raising a strong inference of scienter.[17] This holding is sound, as a contrary rule would permit fraud allegations based on facts lacking essential contextual perspective. Courts deciding a motion to dismiss must of course accept well-pleaded allegations as true and construe them in the light most favorable to plaintiff. As another district court noted this year, however, "when determining whether a plaintiff has alleged circumstances that amount to a strong inference of scienter a court must also consider *all* the reasonable inferences to be drawn from the allegations . . . including inferences unfavorable to the plaintiff."[18]

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 trading advantage by certain directors or officers undermines allegations that the latters' sales support a strong inference of scienter. In *In re Silicon Graphics Inc. Sec. Litig.*,[19] plaintiff alleged that six SGI 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. 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.[20]

Courts have frequently declined to accept stock sales by a single director as the basis to infer scienter at the pleading stage.[21] 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," and 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.[22]

Lessons In Recent Decisions

Recent 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,*[23] the Ninth Circuit recently 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." 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 tell the court nothing and prove fatal to scienter allegations.

Last month, in *In re: Independent Energy Holdings plc Sec. Litig.*,[24] the Southern District of New York held that allegations of stock sales by a director who was also 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. The decision reminds directors and officers that sudden, large-scale stock sales occurring shortly before a negative public announcement may be viewed with suspicion.

ENDNOTES

1 15 U.S.C. § 78u-4(b)(2).

2 *In re Scholastic Corp. Sec. Litig.,* 252 F.3d 63, 74 (2d Cir. 2001); *Novak v. Kasaks,* 216 F.3d 300, 311 (2d Cir.) *cert. denied*, 121 S. Ct. 567 (2000).

3 *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,* 216 F.3d at 310; *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).

4 *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).

5 *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001); *In re Scholastic Corp.*, 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).

6 *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).

7 *Fishbaum*, 189 F.3d at 460.

8 *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).

9 *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).

10 *Rothman*, 220 F.3d at 95 (citation omitted).

[11] *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).

[12] *In re Splash Tech. Holdings, Inc. Sec. Litig.*, 2000 WL 1727377 (N.D. Cal. Sept. 29, 2000).

[13] *See Fishbaum v. Liz Claiborne, Inc.*, 189 F.3d 460 (2d Cir. 1999) (unpublished op.); *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).

[14] *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.").

[15] *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").

[16] *See Berger v. Ludwick*, 2001 WL 868355, *1 (9th Cir. Aug. 1, 2001).

[17] *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).

[18] *In re Visx, Inc. Sec. Litig.*, 2001 WL 210481, *3 (N.D. Cal. Feb. 27, 2001).

[19] 183 F.3d 970 (9th Cir. 1999).

[20] *In re Credit Acceptance Corp.*, 50 F. Supp.2d at 677.

[21] *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.").

[22] *In re Scholastic Corp. Sec. Litig.*, 252 F.3d at 75.

[23] 253 F.3d 423 (9th Cir. 2001).

[24] 2001 WL 840327 (S.D.N.Y. July 26, 2001).