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# DIRECTORS' AND OFFICERS' LIABILITY

## A UNIFORM SCIENTER STANDARD IN SIGHT?

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For the better part of a decade, it has been a commonplace to say that Congress's goal in enacting the Private Securities Litigation Reform Act ("PSLRA") of establishing a uniform and more exacting standard for determining the sufficiency of scienter (i.e., intent to defraud) allegations in securities fraud cases proved elusive. The scienter standard, and whether the allegations of a securities fraud complaint satisfy it, are perhaps the most frequently litigated aspects of the PSLRA. Legal bookshelves groan under stacks of decisions and commentary categorizing the approaches adopted across the circuits. Last month, the U.S. Supreme Court granted certiorari and ordered expedited briefing in Tellabs, Inc. v. Makor Issues & Rights, Ltd.,[1] in which it will likely decide how to evaluate whether a complaint adequately alleges particularized facts that give rise to, as the PSLRA mandates, "a strong inference that the defendant acted with" scienter. The rigorous pleading standard contemplated by Congress will best be served by adoption of a standard which, as the majority of appellate courts have held, permits a court to weigh competing inferences of a defendant's innocent mental state alongside any culpable inferences that may arise from the allegations.

### Raising the Bar

Under the PSLRA, a securities fraud complaint alleging material misstatements or omissions 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 shall state with particularity all facts on which that belief is formed."[2] As to scienter, the complaint must, "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" scienter.[3] In other words, a plaintiff must allege particularized facts to demonstrate that each defendant knew, or recklessly disregarded, that alleged material misstatements or omissions made about the company were false when they were made. Every circuit to address the issue agrees that particularized allegations of severe recklessness satisfy the scienter requirement from a substantive standpoint, but the consensus

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fractures three ways on what facts are sufficient to create a strong inference of scienter.

A seven-circuit majority (the First, Fourth, Sixth, Seventh, Eighth, Tenth and Eleventh), has adopted a "totality of the allegations" approach, reasoning that "Congress chose neither to adopt nor reject particular methods of pleading scienter - such as alleging facts showing motive and opportunity - but instead only required plaintiffs to plead facts that together establish a strong inference of scienter."[4] The Second and Third Circuits take the position that the PSLRA adopted the Second Circuit's pre-PSLRA standard, under which plaintiffs may state a claim either by pleading motive and opportunity to commit fraud, or facts constituting strong circumstantial evidence of recklessness or conscious misbehavior.[5] The Ninth and Eleventh Circuits have embraced the most stringent standard, holding that the motive and opportunity approach did not survive the PSLRA. There, the complaint must plead facts showing at least "deliberate recklessness," so that "although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a strong inference of deliberate recklessness.[6]

Court disagreement about scienter is not limited to the method by which scienter may be established. A separate question inevitably arises: what does it mean for an inference to be "strong" in the context of the PSLRA? As the First Circuit has observed, "Congress plainly contemplated that scienter could be proven by inference, thus acknowledging the role of indirect and circumstantial evidence."[7] Courts on motions to dismiss in non-PSLRA cases must draw all reasonable inferences arising from well-pled allegations in plaintiff's favor. That is, when an allegation is capable of more than one inference, it must be construed in the plaintiff's favor. But the PSLRA plainly altered this traditional rule, to some extent, by requiring the plaintiff to show a strong inference of scienter. If the inference must be a strong one, surely competing inferences, including innocent inferences favorable to the defendant, must be considered in the mix. A contrary, blinkered approach might allow a plaintiff - despite congressional intent to heighten the pleading standard - to adequately allege scienter simply by considering cherry-picked culpable inferences that fail to reflect the universe of possible conclusions flowing from a set of facts.

Courts have employed varying approaches to resolve the tension between the traditional latitude granted the plaintiff on a motion to dismiss under Rule 12(b)(6), and the heightened pleading standard established by the PSLRA. Most circuits to address the issue have resolved this tension by giving primacy to the heightened pleading standard of the PSLRA. Rather than considering only inferences in favor of plaintiffs, the majority position considers all inferences on a motion to dismiss, including innocent inferences favorable to the defendant. Thus, to use a simple illustration, if unusual or suspicious stock sales by corporate insiders during the alleged class period may constitute circumstantial evidence of scienter, a court should be able to consider if the same individuals, or others who allegedly knew of the scheme, acquired or retained stock during the same period. Reasoning that an inference is "strong" under the PSLRA only where it is the "most plausible of competing inferences," the First, Fourth, Sixth and Ninth circuits have stated that such innocent inferences should be

incorporated into the analysis when evaluating scienter allegations. The culpable inference suggested by plaintiff must be the "most plausible" in order to be characterized as strong.[8] These courts will sift the allegations and dismiss the case when conduct alleged to support an inference of scienter has an equally plausible legitimate explanation.

The Eighth and Tenth Circuits have expressly rejected the "most plausible" standard, and prohibit any weighing of the strength of competing innocent and culpable inferences. In these courts, the strength of innocent inferences may be considered only to determine if plaintiff's suggested inference is "strong" in light of its overall context. The Tenth Circuit in Pirraglia v. Novell, Inc.,[9] reasoned that it is the province of the ultimate fact finder - not a court on a motion to dismiss - to weigh two equally strong inferences, one favoring the plaintiff and one favoring the defendant. Under this approach, "[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." The Second and Third Circuits have not ruled on whether innocent inferences may be considered when evaluating securities fraud scienter allegations, but both have acknowledged the issue.[10]

Tellabs Standard

If one is inclined to conclude that the scienter debate resembles a medieval debate about how many angels can dance on the point of a pin, the Seventh Circuit's Tellabs decision illustrates the often outcome determinative significance of the approach employed. In Tellabs, plaintiffs alleged Rule 10b-5 claims based on four categories of material misrepresentations allegedly made with scienter by the company and its CEO. These allegations, together with the Seventh Circuit's canvas of existing scienter approaches, neatly frame the issues before the Supreme Court.

A putative shareholder class alleged that Tellabs, a manufacturer of specialized optical networks equipment, and certain directors and officers engaged in a scheme to inflate the company's stock price between December 11, 2000 (when Tellabs issued projections for 2001 revenue) and June 19, 2001 (when Tellabs withdrew its previous guidance for 2001 revenue and revised its projection of revenue for the second quarter of 2001). The thrust of the complaint was that Tellabs improperly booked revenue for the fourth quarter of 2000 and that Tellabs' revenue projections for 2001 issued during the proposed class period were false. Plaintiffs' claims regarding the alleged falsity of the Company's fourth quarter 2000 results included allegations that the Company artificially inflated revenues through a variety of so-called "channel stuffing" activities designed to create the appearance of demand, including: (a) offering customers discounts and incentives; (b) providing excess product to customers with a pre-arranged understanding that the product could be returned; and (c) improperly booking revenue on consignment sales. After dismissing the original complaint, the district court granted defendants' motion to dismiss the second amended complaint, holding, among other things, that plaintiffs had failed to allege particularized facts sufficient to establish a strong

inference of scienter.

The Seventh Circuit reversed, enunciating a scienter standard more lenient than any other circuit, allowing a "complaint to survive if it alleges facts from which a reasonable person could infer that the defendant acted with the required intent." Expressing Seventh Amendment concerns about encroaching on a jury's province, the court allowed for no qualification of its "could infer" standard based on potential innocent inferences arising from the same or other facts alleged. The *Tellabs* approach thus permits dismissal only if a reasonable person could not conclude that the facts alleged create a strong inference of scienter. As Tellabs argued in it certiorari petition, however, merely requiring that an inference of scienter be possible simply restates the traditional pleading rule that all inferences from the facts alleged should be drawn in favor of the plaintiffs without regard for the PSLRA-mandated heightened pleading standards.

The consequence of the court's refusal to credit possible innocent inferences against possible culpable inferences is demonstrated in the court's disposition of one of the categories of allegations. The allegation of inflated fourth quarter financial results was premised primarily on channel stuffing activities. As to the CEO, the court found an inference of scienter based on allegations that (i) "a former senior business manager at Tellabs informed the plaintiffs that [the CEO] 'worked directly with Tellabs'[s] sales personnel' to effect the channel stuffing"; and (ii) "another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered, and said the CEO 'unquestionably knew'" about channel stuffing.

The complaint, however, broadly defined channel stuffing to include both illegitimate sales activities such as, the fabrication of purchase orders, and legitimate activities, such as simply offering major customers discounts and incentives, and extending credit terms from 30 to 90 days. Because "channel stuffing" can encompass both legitimate and potentially illegitimate conduct, courts have recognized that imprecise allegations regarding channel stuffing do not support a strong inference of scienter.[11] To allege that the CEO knew that channel stuffing was occurring, but not specify the kind of channel stuffing activity of which he was aware, "could" support an inference of scienter. But it is very hard to conclude, as a court in four other circuits would have to, that a culpable inference is the most plausible of the competing inferences.

## Conclusion

A key goal of the PSLRA was to bar securities fraud claims based on speculative scienter theories. In many cases, the difference between whether a reasonable person could, without regard to alternative innocent inferences, draw an inference of scienter from conduct (the Seventh Circuit's standard), and whether the same inference "would convince a reasonable person" (the Tenth Circuit's standard) or is the "most plausible of competing inferences" (the predominant standard) will determine whether the PSLRA's goal of heightening the pleading standard is enforced or not. There is general agreement that scienter may be inferred not only

from individual facts, but from the cumulative effect of particularized facts.[12] Similarly, a standard that requires a court to weigh all inferences, including innocent ones, is best calculated to promote the PSLRA's goal of preventing strategically ambiguous allegations of scienter from passing muster.

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[1] 127 S.Ct. 853 (Jan. 5, 2007).

[2] 15 U.S.C. § 78u-4(b)(1).

[3] 15 U.S.C. § 78u-4(b)(2).

[4] Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 601 (7th Cir. 2006), quoting Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 345 (4th Cir. 2003) (gathering cases).

[5] Novak v. Kasaks, 216 F.3d 300, 314 n.1 (2d Cir. 2000).

[6] In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999).

[7] Greebel v. FTP Software, Inc., 194 F.3d 185, 195 (1st Cir. 1999).

[8] In re Credit Suisse First Boston Corp., 431 F.3d 36, 49 (1st Cir. 2005); Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 350 (4th Cir. 2003), Gompper v. VISX,, Inc., 298 F.3d 893, 896-97 (9th Cir. 2002), Helwig v. Vencor, Inc., 251 F.3d 540, 553 (6th Cir. 2001).

[9] 339 F.3d 1182 (10th Cir. 2003).

[10] See, e.g., In re Digital Island Sec. Litig., 357 F.3d 322 (3d Cir. 2004); Press v. Quick & Reilly, Inc., 218 F.3d 121, 130 (2d Cir. 2000).

[11] See, e.g., Broudo v. Dura Pharm., Inc., 339 F.3d 933, 940 (9th Cir. 2003), rev'd on other grounds, 544 U.S. 336 (2005); Greebel v. FTP Software, Inc., 194 F.3d 185, 203 (1st Cir. 1999).

[12] Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015, 1017 (11th Cir. 2004).