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OUTSIDE COUNSEL

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Pleading Scienter in the Second Circuit

In enacting the Private Securities Litigation Reform Act (the "Reform Act"),[1] Congress set out to separate the wheat from the chaff in the area of securities law claims.

Congress sought to do so with statutory standards for pleading fraud in such cases that are by their nature inexact: requiring that a complaint specify "each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading",[2] requiring that a complaint state with "particularity" all facts on which a belief of falsity is formed,[3] and requiring that a complaint "state with particularity facts giving rise to a strong inference" of scienter.[4] In so doing, Congress left considerable discretion to the courts to decide what constitutes "particularity" and whether factual allegations are sufficient to give rise to a strong inference. This article explores the way in which courts within the Second Circuit have applied the Reform Act's pleading standards for scienter.

Pre-Reform Act, the Second Circuit had enunciated a two-prong test for pleading facts giving rise to a strong inference of scienter such as would sustain an actionable securities fraud claim. A plaintiff could allege either (1) facts establishing a motive to commit fraud and an opportunity to do so, or (2) facts constituting circumstantial evidence of either reckless or conscious misbehavior.[5]

Under the first prong, the plaintiff must plead facts establishing that the defendants had both a motive ("concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged") and the opportunity ("the means and likely prospect of achieving concrete benefits by the means alleged") to commit fraud.[6]

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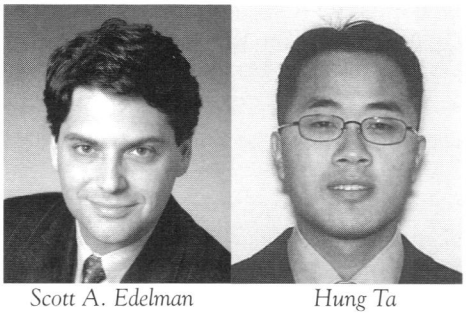

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Under the second prong, the plaintiff pleads facts which allege that the defendants acted deliberately or recklessly in circumstances where they knew or ought to have known of the fraudulent facts.[7] Compared to the first prong, "the strength of the circumstantial allegations must be correspondingly greater."[8]

After considerable judicial and scholarly debate, the Second Circuit ultimately concluded that the Reform Act had done nothing to change the prior judicial standard. In *Novak v. Kasaks*,[9] the Second Circuit held that the Reform Act adopted the Second Circuit's "strong inference standard" and, more specifically, the two-prong test for pleading facts which give rise to such a strong inference.[10]

While affirming the vitality of the two-prong standard, however, the Second Circuit signaled a move away from a rigid application of the two-prong test, and towards a more careful and considered examination of the facts that inform, and are ultimately determinative, in individual cases:[11]

> [L]itigants and lower courts need and should not employ or rely on magic words such as 'motive and opportunity' ... In applying [the Second Circuit] standard, district courts should look to the cases and [relevant] factors ... to determine whether plaintiffs have pleaded facts giving rise to the requisite 'strong inference.'

The remainder of this article will examine the critical factors in individual cases and how they led the courts to their respective decisions.

Motive and Opportunity

An often pleaded method of showing "motive and opportunity" is for a plaintiff to show a pattern of insider trading activity in advance of an announcement of bad news by the company. Not just any insider stock sale will suffice. To justify a securities fraud claim, courts require that the insider trading activity be "unusual." Plaintiffs have successfully established "unusual" insider activity by alleging "suspicious", sizable sales made a short time before a negative public announcement.[12] Sales are more likely to be considered unusual where there is an abnormal amount of profit from the sales; an abnormal portion of stockholdings being sold; a marked change in the volume of insider sales; and a significant number of insiders selling.[13]

Thus, insider sales activity was considered sufficiently unusual to establish motive in *In re Oxford Health Plans, Inc., Sec. Litig.*, where the defendants sold shares of Oxford Health Plans, Inc. in the relevant period, garnering a profit of $78 million ("massive by any measure"); all the defendants except one made $33 million of those total profits by selling two months before a negative public announcement; and the percentages of the defendants' holdings sold at one stage ranged from 11 percent to 100 percent ("not insignificant percentages").[14]

Similarly, in *In re Quintel Entm't Inc. Sec. Litig.*,[15] the court found sufficiently unusual insider sales of Quintel shares to establish motive by noting the number of corporate insiders who made sales; the volume of the sales ("[t]hese sales accounted for almost one-half of Quintel's trading activity during one week of the Class Period"); and the rapid escalation in sales (the sales "represented a

156 percent increase over total insider sales for fourteen months prior to the start of the Class Period.").[16]

By contrast, the Second Circuit held that the insider sales in question were not unusual in *Rothman*[17] (one of the company officers had sold only 9.9 per cent of his stock during the class period, garnering a profit of only $1.6 million; the other company officer, although making a $20 million return, had sold only about 9.3 per cent of his stock and, further, had sold before the fraud was allegedly committed);[18] and in *Acito v. IMCERA Group, Inc.*[19] (where a company officer sold one set of shares in accordance with a prior company announcement and before any act of fraud was committed; his second set of sales constituted only 11 percent of his holding in the stock; and no other defendants sold their shares during the relevant class period).[20]

Apart from "unusual" sales, there are few fact situations in which courts are prepared to find motive. The bare fact that executives may have desired to increase the stock price in order to increase their compensation linked to the stock price[21] or to maintain a company's bond or credit ratings[22] is generally insufficient to establish a relevant motive. To allow plaintiffs to plead scienter by alleging what are otherwise "motives possessed by virtually all corporate insiders" would be to subject nearly all companies to lawsuits as soon as stock prices decline for any reason.[23]

In *Rothman*, however, despite finding that the insider sales were not sufficiently unusual to establish motive,[24] the Second Circuit denied the defendants' motion to dismiss because plaintiffs alleged that the defendants were motivated to commit fraud in order to inflate the price of the company's stock and thereby facilitate the stock acquisition of another company.[25]

'Conscious Misbehavior'

The second method by which a plaintiff may plead an actionable securities fraud claim is with allegations of "conscious misbehavior" or "recklessness." In the Second Circuit, the courts have generally required plaintiffs to come forward with detailed allegations about the documentary or testimonial bases for a claim of fraud. Such documents or testimony can then show that the defendants knew of facts or had access to information contradicting their public statements.[26]

Examples of cases where the courts have upheld allegations of conscious misbehavior or recklessness include *Novak*[27] (defendant company, AnnTaylor, continued to issue positive public statements about the status of inventory when internal company documents indicated that certain of the inventory was several years old and unlikely to be sold at full price, and that levels of such inventory as proportion of total inventory had grown significantly);[28] Rothman[29] (company failed to expense royalty advances in compliance with announced accounting policies when company knew of poor sales and had filed lawsuits to recover those advances from software developers);[30] and *In re Scholastic Corp. Sec. Litig.*[31] (court found that publishing company had made representations about sales and net income contrary to external data received from distributors, internally generated data and warning of a specified employee).[32]

In contrast, the Second Circuit affirmed the dismissal of a securities fraud claim in *In re Carter-Wallace, Inc. Sec. Litig.*,[33] where the plaintiffs were unable to present any internal memoranda or other evidence to rebut the defendants' claim that they were not aware of any causal connection between a drug (Felbatol) manufactured by the defendant company and a frequently fatal medical condition called aplastic anemia. In the absence of any internal memoranda or other evidence, plaintiffs' allegations amounted to nothing more than "conclusory allegations" which did not constitute strong circumstantial evidence of conscious misbehavior or recklessness.[34]

Conclusion

The above cases show that plaintiffs cannot proceed with securities claims based on so-called "fraud by hindsight."[35] Instead, plaintiffs must allege facts such as unusual insider trading activity or some other extraordinary motive to deceive the public. In the absence of such facts, a plaintiff must come forward with some tangible evidence that the defendants' statements were contemporaneously known by them to be false. Unless such factors are identified and particularized in the complaint, courts in the Second Circuit should not permit a plaintiff to rummage through the defendants' files in search of a claim.

(1) Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §78u-4(b)(1)-(2) (1998)).

(2) Securities Exchange Act §21D(b)(1); 15 U.S.C. §78u-4(b)(1) (1998).

(3) Id.

(4) Securities Exchange Act §21D(b)(2); 15 U.S.C. §78u-4(b)(2) (1998).

(5) See, e.g., *In re Time Warner Inc. Sec. Litig.* 9 F.3d 259, 269 (2d Cir. 1993), cert. denied sub. nom. 511 U.S. 1017 (1994).

(6) *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994).

(7) See, e.g., *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir.), cert. denied, 531 U.S. 1012 (2000).

(8) *Kalnit v. Eichler*, 264 F.3d 131, 142 (2d Cir. 2001).

(9) 216 F.3d 300, 311 (2d Cir.), cert. denied, 531 U.S. 1012 (2000). See also *Kalnit*, 264 F.3d 131 at 138-39.

(10) *Novak*, 216 F.3d at 311.

(11) Id. See also *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000).

(12) *In re Oxford Health Plan, Inc., Sec. Litig.*, 187 F.R.D. 133, 139 (S.D.N.Y. 1999).

(13) *Rothman*, 220 F.3d 81 at 94.

(14) 187 F.R.D. 133 at 139-40.

(15) 72 F. Supp. 2d 283 (S.D.N.Y. 1999).

(16) Id. at 296.

(17) 220 F.3d 81.

(18) Id. at 94-95.

(19) 47 F.3d 47 (2d Cir. 1995).

(20) Id. at 54.

(21) Id.

(22) *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 813-14 (2d Cir. 1996).

(23) *Novak*, 216 F.3d 300 at 307.

(24) See supra.

(25) 220 F.3d 81 at 93-94. Note, however, that it was significant to the Second Circuit's decision to find scienter that the plaintiffs pleaded not only motive to inflate the stock price, but also facts establishing conscious misbehavior or recklessness. Id. at 94.

(26) See *Novak*, 216 F.3d 300, 308.

(27) 216 F.3d 300.

(28) Id. at 304.

(29) 220 F.3d 81.

(30) Id. at 90-92.

(31) 252 F.3d 63 (2d Cir. 2001), cert. denied, -- S. Ct. -- (2001).

(32) Id. at 71

(33) 220 F.3d 36 (2d Cir. 2000).

(34) Id. at 40-41.

(35) See, e.g., Novak, 216 F.3d 300 at 309.