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Lower Courts' Handling of 'Tellabs' 'Inference of Scienter

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007), the U.S. Supreme Court raised the bar for securities fraud complaints alleging violations of §10(b) of the 1934 Act. In an 8-1 decision, the Court held that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Id. at 2504-05.

The Court's holding resolved a split among federal appeals courts regarding the proper approach to pleading scienter under the Private Securities Litigation Reform Act of 1995 (the PSLRA) and strengthened the PSLRA's intended function as a "check against abusive litigation by private parties." Id. at 2504.

Lower courts appear to be applying *Tellabs* in a way that makes surviving dismissal harder than before. In particular, a number of courts have held that an insufficient basis for inferring scienter against an issuer is that the issuer has revisited its prior accounting through an investigation, revision, or restatement. Indeed, in post-*Tellabs* decisions, courts appear to want to encourage corporations to investigate, revise, and restate where appropriate.[1]

The lower courts generally agree that *Tellabs* provides a three-step process for evaluating motions to dismiss §10(b) claims for failure to adequately plead scienter. See, e.g., *Winer Family Trust v. Queen*, 503 F.3d 319, 327 (3d Cir. 2007). First, the court must accept all allegations in the complaint as true. Second, the court must consider "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter." *Tellabs*, 127 S.Ct. at 2509. Third, and finally, the court must "take into account plausible opposing inferences" of nonfraudulent intent. Id. Once these steps are taken, the court determines if the inference of scienter is cogent and at least as compelling as any plausible opposing inference. See, e.g., *Comm. Workers of Am. Plan for Employees' Pensions and Death Benefits v. CSK Auto Corp.*, Nos. CV06-1503-PHX-DGC, CV06-1580-PHX-JWS, 2007 WL 2808652, at *2 (D. Ariz. Sept. 27, 2007).

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Lower courts appear to be applying 'Tellabs' such that surviving dismissal is harder. Some courts say that an insufficient basis to infer scienter is when the issuer has revisited its prior accounting via investigation, revision, or restatement.

The lower courts seem to agree that *Tellabs* does indeed make it harder for plaintiffs to plead scienter. The U.S. Court of Appeals for the Third Circuit, for instance, noted that *Tellabs* "removes any doubt that the PSLRA's scienter pleading requirement is a significant bar to litigation." *Globis Capital Partners, L.P. v. Stonepath Group, Inc.*, No. 06-2560, 2007 WL 1977236, at *3 n.1 (3rd Cir. July 10, 2007). So far, most of the published decisions applying *Tellabs* in depth have resulted in dismissal of securities claims for failure to allege scienter sufficiently.

This memorandum focuses on post-*Tellabs* decisions addressing circumstances where an issuer revisits its prior accounting.

Circuit Court Decisions

The leading post-*Tellabs* case is *Higginbotham v. Baxter International Inc.*, 495 F.3d 753 (7th Cir. 2007), which has been cited by a number of other courts. In *Higginbotham*, the U.S. Court of Appeals for the Seventh Circuit, with Judge Frank H. Easterbrook writing for the court, affirmed dismissal of federal securities claims against an issuer that had restated earnings to correct errors created by fraud at a foreign subsidiary. In doing so, the court announced a number of principles emanating from *Tellabs*' new standard that are helpful to defendants.

First, restated financial statements, and the decision to hire an auditor to strengthen financial controls, do not establish a compelling inference of scienter. Id. at 760.

Second, the court rejected the notion that a compelling inference of scienter can be found from the initiation of an internal investigation into possible fraud. Id. at 758 ("Knowing enough to launch an investigation…is a very great distance from convincing proof of an intent to deceive.").

Third, failure to correct a misstatement immediately upon learning of it does not give rise to a compelling inference of scienter because in many cases business leaders may wish to investigate what happened before taking any corrective action. Id. at 761 (managers "are entitled to investigate for a reasonable time, until they have a full story to reveal").

Fourth, allegations of scienter based on confidential or anonymous sources (in *Higginbotham*, unidentified former employees and consultants) must be steeply discounted because they cannot be subjected to the requisite weighing of plaintiff's favored inference in comparison to other possible inferences. Id. at 757.

Finally, scienter cannot be based on public

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knowledge, specifically on public charges of problems at the company. Id. at 758-59.

In *Winer Family Trust*, the Third Circuit affirmed dismissal of §10(b) claims because the plaintiff failed to meet the third step of the *Tellabs* test. *Winer Family Trust*, 503 F.3d at 328-29. In *Winer*, shareholders of a meat supplier brought securities fraud claims against the supplier, its creditor and major shareholder, and individual officers and directors for alleged misstatements concerning the costs associated with the purchase and renovation of a new meat-processing facility and nondisclosure of the failure of a prior joint venture between the supplier and its creditor. The Third Circuit held that the plaintiff had not raised a strong inference of scienter because "[a] reasonable person would not deem the inference of scienter cogent and at least as compelling as any nonculpable inference." Id. at 329. Specifically, the court agreed with the district court's conclusion that the most plausible inference was that the defendant "revised its preliminary cost estimates as it learned more about the costs." Id.

Central Laborers' Pension Fund v. Integrated Electrical Services Inc., 497 F.3d 546 (5th Cir. 2007), where the U.S. Court of Appeals for the Fifth Circuit affirmed dismissal of class action securities fraud claims against an electrical contracting services company and several of its officers, contains a number of interesting holdings. First, "GAAP violations, without more, do not establish scienter." Id. at 552. Second, while confidential sources may provide a basis on which to infer scienter, they require "specific details, such as particular job descriptions, individual responsibilities, and specific employment dates for the witnesses" to be credited for *Tellabs* purposes. Id. Third, although insider trading may give rise to an inference of scienter, the circumstances of the trading will be examined for plausible nonculpable explanations (which the court found existed in this case). Id. at 552-54; cf. *In re Cyberonics Inc. Sec. Litig.*, No. H-05-2121, 2007 WL 2914995, at *6 (S.D. Tex. Oct. 4, 2007) (noting that "insider trading can only be a strong enhancement of an inference of scienter, not an inference by itself, if the trading occurs at suspicious times or in suspicious amounts"). Fourth, Sarbanes-Oxley certifications will not suffice to establish scienter unless there is a more particularized link between the person who signed them and knowledge of the alleged fraud. *Cent. Laborers*, 497 F.3d at 555; see also *Cyberonics*, 2007 WL 2914995, at *6 (noting that "any certifications under Sarbanes-Oxley made by defendants do not rise to a strong inference of scienter").

Claims Dismissal Not Affirmed

The U.S. Court of Appeals for the District of Columbia Circuit's decision in *Belizan v. Hershon*, 495 F.3d 686 (D.C. Cir. 2007), is the one significant instance so far of an appellate court not affirming dismissal of securities claims under *Tellabs*. Purchasers of debt securities brought suit against an investment bank that sold the securities on the theory that the defendants recklessly disregarded that the securities were part of a Ponzi scheme. The D.C. Circuit vacated and remanded to the district court for consideration of whether plaintiffs' amended allegations that defendants were specifically aware of both an SEC investigation and a document describing a high percentage of affiliated transactions established an inference of recklessness "at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, 127 S.Ct. at 2505. Nothing in *Belizan* suggests that the investment bank or auditor took any steps to investigate either suggestion of wrongdoing. When *Belizan* is compared to *Higginbotham*, *Winer*, and *Central Laborers*, it appears that when a corporation investigates allegations of wrongdoing, it decreases the chances that scienter may be inferred.

The Second Circuit

One final circuit court decision should be noted, although it is not a case involving an investigation or restatement. *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87 (2d Cir. 2007), is the first decision on *Tellabs* from the Second Circuit. *ATSI* affirmed dismissal of market manipulation claims for failure to plead scienter adequately. Plaintiff claimed the defendants fraudulently induced it to sell them plaintiff's convertible preferred stock, and the defendants in turn shorted plaintiff's common stock and covered their short position by converting the preferred stock, all of which caused a "death spiral" in the price of plaintiff's stock. The court was not persuaded that plaintiff had alleged a compelling inference of scienter. For one, general allegations of high-volume selling of plaintiff's stock coinciding with drops in the stock's price were insufficient without further allegations of what defendants owned and how much they sold. In addition, the trading patterns around conversion time were insufficient because there was no regular baseline pattern of trading and pricing in the markets. Third, the stock's negative reaction to positive news was not enough where plaintiff failed to plead a connection between the negative reaction and anything defendants did. Finally, and perhaps most importantly, the court rejected profit motive as a basis for inferring scienter:

> A strong inference of scienter is not raised by alleging that a legitimate investment vehicle, such as the convertible preferred stock at issue here, creates an opportunity for profit through manipulation. These circumstances are present for any investor in floorless convertibles. Accordingly, there is a "plausible nonculpable explanation[]" for the defendants' actions that is more likely than any inference that the defendants intended to manipulate the market: [plaintiff] and the defendants simply entered into mutually beneficial financing transactions. Id. at 104 (internal citations omitted).

Among other support, *ATSI* noted that *Chill v. General Electric Co.*, 101 F.3d 263, 267, 268 n.5 (2d Cir. 1996), held "'that a generalized motive that an issuer wishes to appear profitable, which could be imputed to any public for-profit enterprise, was insufficiently concrete to infer scienter.'" *ATSI*, 493 F.3d at 104.

District Court Decisions

The district courts generally have also relied on *Tellabs* in granting dismissal of securities fraud claims in cases of investigations or restatements. At least one district court has relied on restatements to infer scienter.

In re BearingPoint, Inc. Securities Litigation, No. 1:05-CV-454, 2007 WL 2713906 (E.D. Va. Sept. 12, 2007), is one of the most significant district court cases applying *Tellabs*. In *BearingPoint*, shareholders brought federal securities fraud claims against the company and its former top executives for allegedly making misstatements or omissions regarding its financial statements, internal controls, and a $397 million goodwill impairment charge. The shareholder suit arose in the wake of a series of disclosures by the company as to its discovery of errors in its financial statements and deficiencies in its internal controls, as well as an extensive independent investigation that resulted in a restatement. The district court dismissed plaintiffs' complaint as not adequately pleading scienter. In doing so, the court first recognized that "truthful disclosures of negative information 'militate[] against a finding that [defendants] acted with a culpable state of mind.'" Id. at *8. Second, the company's announcement of a goodwill impairment charge was not a basis to infer scienter. The court rejected as implausible plaintiff's theory that the company intentionally withheld information for one month about the timing and size of its goodwill impairment charge in order to consummate a private securities offering:

> It simply defies common sense to suppose that a public company withheld bad news

> to entice investment, *while knowing it soon would release even worse news* and thereby drive away all of the investment it had just garnered. Id. at *10 (emphasis added).

Indeed, the timing of the company's disclosures about the goodwill impairment charge better supported an inference of nonfraudulent intent, since the company would have had every reason to "quell the market's uncertainty" once it knew the precise amount. Id. at *10 n.10. Third, the company's efforts to fix its accounting and controls problems, even if imperfectly implemented, counseled against a strong inference of scienter. Id. at *14. Fourth, the existence and outcome of the audit committee's investigation, which was undertaken with the help of PricewaterhouseCoopers, was not a basis to infer scienter. Id. at *10, 14 (citing *Higginbotham*, 495 F.3d at 760).[2]

In *Caiafa v. Sea Containers Ltd.*, the U.S. District Court for the Southern District of New York dismissed claims substantially similar to those in *BearingPoint*. *Caiafa v. Sea Containers Ltd.*, Nos. 06 Civ. 2565, 06 Civ. 2670, 06 Civ. 2744, 06 Civ. 2776, 06 Civ. 2909, 06 Civ. 3099, 06 Civ. 3563, 06 Civ. 5655, 2007 WL 2815633 (S.D.N.Y. Sept. 25, 2007). The plaintiffs in *Caiafa* sought to establish an inference of scienter against officers of Sea Containers based on a restatement to correct accounting errors and the timing of a $500 million asset write-down. In granting dismissal, the court held that "the Complaint is replete with conclusory allegations of nothing more than purposed mismanagement, supposed GAAP violations by the Company, and other classic indicia of an impermissible attempt to plead 'fraud by hindsight.'" Id. at *9. The court went on to specifically reject the timing of the write-down as a basis for scienter: "'mere allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud.'" Id. at *11. Likewise, scienter could not be inferred from statements by the company's new CEO "that the Company's earlier financial statements might have to be restated…, or based upon the timing of SCL's write-downs soon after the original CEO's resignation." Id.

In *Roth v. OfficeMax, Inc.*, shareholders brought suit against the office supply giant based on a restatement of financial results prompted by an investigation into claims that some of its employees defrauded vendors. No. 05-C-236, 2007 WL 2892634 (N.D. Ill. Sept. 26, 2007). Citing *Tellabs* and its progeny, particularly *Higginbotham*, the court recognized:

> [I]t is now well-established that a securities complaint will not survive a motion to dismiss if plaintiffs simply point to statements that are later revealed to be misleading or untrue. Importantly, mere allegations of GAAP violations, the restatement of income, or statements regarding the internal controls of a company that are later proven to be false, are not sufficient to demonstrate that those who made the statements committed securities fraud…. [S]uch allegations amount to pleading fraud by hindsight. Id. at *3.

Turning to the specific facts of the case, the court first rejected the notion that it was reasonable to infer that senior executives of OfficeMax "must have known" of "red flags" that were known to lower-level employees. Id. at *4. Next, the court reaffirmed *Higginbotham's* holding that knowing enough to commence an internal investigation "is not enough to prove that defendants had intent to deceive." Id. at *6 & n.10. Third, "[t]he [issuer's later admission of the] existence of inadequate controls alone does not demonstrate that those who made statements regarding those controls necessarily acted with the intent to deceive." Id. at *7. Accordingly, the district court granted defendants' motion to dismiss.

Mizzaro v. Home Depot, Inc., No. 1:06-CV-11510, 2007 WL 2254693 (N.D. Ga. July 18, 2007), is similar to *OfficeMax*. In *Home Depot*, shareholders alleged that officers and directors of the home improvement chain artificially inflated the company's financial results by engaging in a "widespread and pervasive" scheme to process billions of dollars of fraudulent return-to-vendor (RTV) chargebacks. Without setting forth direct allegations that the defendants participated in the RTV charge-back scheme, plaintiffs attempted to create an inference of scienter by arguing that senior executives should have known about such large and fraudulent transactions and citing to newspaper articles and internal strategy documents as support. The court held that plaintiffs' allegations of scienter were insufficient under *Tellabs* because the complaint raised compelling nonfraudulent inferences to the contrary. Id. at *8. Specifically, upon learning of the alleged fraud, senior management commenced an internal investigation and "acted immediately to correct the fraud." Id.[3]

In re H&R Block Securities Litigation, No. 06-0236, 2007 WL 2908649 (W.D. Mo. Oct. 4, 2007), is similarly illuminating. Purchasers of H&R Block securities brought securities law claims alleging failure to disclose that certain financial products it sold might be unlawful and that it misstated its taxes. The court granted dismissal of the claims. Regarding possible inferences of scienter stemming from the company's restatement of financial statements after a lengthy investigation, the court held that "the fact of the investigation, especially because it was undertaken with the help of an independent auditor, negates an inference of an intent to deceive the investing public." Id. at *7.[4] It further held that instituting remedial measures taken with respect to the financial products "only creates an inference that the Company decided it needed to improve a bad product, not that the Company had been purposefully hiding the fact that its product was actually unlawful." Id. at *6. Finally, plaintiff could not show the company knew a product was illegal when its legal status is still unknown. Id.[5]

'In re Intelligroup Securities'

One of the most recent decisions dismissing claims pursuant to *Tellabs*, *In re Intelligroup Securities Litigation*, drew on numerous cases decided before and after *Tellabs* to also hold that allegations based on restatements or revisions, without more, do not establish a strong inference of scienter. *In re Intelligroup Sec. Litig.*, No. 04-4980, 2007 WL 3376743, at *15 (D.N.J. Nov. 13, 2007). The *Intelligroup* court—rejecting plaintiffs' reliance on alleged executive and auditor resignations, GAAP violations, Sarbanes-Oxley certifications, corrections in the restatement, and confidential witnesses—dismissed assertions that an issuer and its former officials acted intentionally or recklessly in timely failing to write off a promissory note that ultimately became uncollectible and triggered a restatement. Id. at *85. The court explained that it was just as plausible to infer that defendants had a lawful business purpose in writing down the note as they did. Id. at *59.

'Equal-Inference Approach'

In some contrast to these decisions, in *Communications Workers of America Plan for Employees' Pensions and Death Benefits v. CSK Auto Corp.*, the U.S. District Court for the District of Arizona found "the *Tellabs* equal-inference approach problematic." 2007 WL 2808652, at *3 n.2 (D. Ariz. Sept. 27, 2007). Characterizing the *Tellabs* decision as holding that "a tie goes to the Plaintiff," the court held that the allegations in the case before it—five years of financial restatements about inventory, vendor allowances, and store surplus fixtures and supplies brought about by an audit committee, and the unexplained resignations of the CEO, CFO, and COO—were sufficient to survive dismissal. Id. at *3.[6]

In re ProQuest Securities Litigation, No. 06-CV-10619, 2007 WL 3275109 (E.D. Mich. Nov. 6, 2007), also denied a motion to dismiss on similar alleged facts. ProQuest is a publisher of information concerning education, automotive products, and power equipment. The

alleged facts included seven years of restated earnings, a fired financial vice president who "intentionally manipulated" overstated revenues and understated expenses and regularly directed false journal entries (often near month-end and quarter-end closes), and a former chairman who sold all of his stock in 14 days, thus raising a "quite compelling" inference of scienter. Id. at *10-15.

In re Openwave Systems Securities Litigation, No. 07 Civ. 1309, 2007 WL 3224584 (S.D.N.Y. Oct. 31, 2007) is another example of a court denying motions to dismiss claims arising out of a large-scale restatement (six years of earnings), albeit in a slightly different context than the previous two cases, options backdating. While the court granted some defendants' motions to dismiss, it denied others'; the difference appears to turn on the extent to which plaintiffs pleaded specific allegations of an individual's direct personal benefit versus generalized allegations based on an individual's title or office. See id. at *10-12. For instance, the court denied motions to dismiss claims against those individuals specifically alleged to have received backdated options, but granted a motion to dismiss claims against the new CEO who assumed office at the tail end of the scheme and did not receive backdated options. Id. at *11 ("The only specific allegations of scienter ostensibly made against Peter Schmidt concern the office of the CEO, and not Peter Schmidt himself.").[7]

As *Commercial Workers*, *ProQuest*, and *Openwave* illustrate, the particular alleged facts matter. A multiyear restatement to correct false journal entries or intentionally backdated stock options is likely to be treated very differently from revisions or restatements based on variances in judgment, responses to developing information, or past mistakes.

Conclusion

The early returns suggest a significant change in how lower courts are addressing scienter issues in 12(b)(6) motions in §10(b) private civil cases. As one court aptly stated, the analysis required by *Tellabs* "is akin to holding a minitrial on the merits of the case based only on the complaint." *ProQuest*, 2007 WL 3275109, at *17. Before *Tellabs*, courts often used a traditional 12(b)(6) mindset and were reluctant to conclude that a reasonable person could not draw a strong inference of scienter when there were competing possible inferences. After *Tellabs*, in such circumstances, courts have been more willing to rule that an inference that scienter existed is not at least as compelling as an inference that fraudulent intent was missing.

The post-*Tellabs* trend that corporate investigations, revisions, and restatements do not necessarily support a sufficiently compelling inference of scienter is a sound one. Logic and experience teach that the more compelling inference is that a company that behaves honestly when a problem manifests itself also behaved honestly before then. As a matter of policy, "the 'fundamental purpose' of the [1934] Act [is] 'implementing a philosophy of full disclosure.'" *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-78 (1977) (citation omitted). Corporate investigations, revisions, and restatements implement the philosophy of full disclosure. Courts should not infer scienter from corporate conduct that should be encouraged.

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1. To be sure, there were some similar pre-*Tellabs* decisions. See, e.g., *In re Ceridian Corp. Sec. Litig.*, 504 F. Supp. 2d 603, 616-18 (D. Minn. 2007) (decided 16 days before *Tellabs*: in case involving five restatements, an SEC investigation, allegations of insider trading, and executive compensation tied to the company's financial performance, plaintiffs did not adequately allege scienter because "[a]t bottom, plaintiffs' allegations amount to little more than allegations that lots of accountants committed lots of GAAP violations"). Rather, the point is that *Tellabs* has strengthened the support for this approach, as reflected in the post-*Tellabs* cases.

2. Likewise, the SEC's investigation was not a basis to infer scienter. Id. at 15. To hold otherwise, the court noted, would create "an end-run around the stringent pleading requirements of the PSLRA, entitling every plaintiff who brought suit against a company under investigation access to discovery." Id.

3. The unspoken and unlitigated premise of *OfficeMax* and *Home Depot* is that the corporation's scienter is determined by the intent and knowledge of those senior officials responsible for the company's financial statements and not by the intent and knowledge of lower-level officials and employees. There is ample support for that premise. See, e.g., *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 366-67 (5th Cir. 2004) (it is "appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement") (collecting cases); *Nolte v. Capital One Fin. Corp*, 390 F.3d 311, 313-16 (4th Cir. 2004) (scienter was not pleaded by alleged knowledge within company of inadequacy of reserves without an allegation that this was known to the managers who made the public statements); *In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1085-86 (8th Cir. 2005) (corporation's sales forecasts were not made with scienter merely because one regional sales manager found them "unattainable"); *In re Alpharma, Inc. Sec. Litig.*, 372 F.3d 137, 149-53 (3d Cir. 2004) ("the mere fact that [allegations of accounting irregularities were] sent to Alpharma's headquarters" was "insufficient" to plead scienter).

4. See also *In re Astea Int'l Inc. Sec. Litig.*, No. 06-1467, 2007 WL 2306586, at *18 (E.D. Pa. Aug. 9, 2007) ("The plausible nonculpable explanation for the voluntary restatement is that Astea made an accounting mistake and promptly corrected it."); *Frank v. Dana Corp.*, No. 3:05CV7393, 2007 WL 2417372, at *6 (N.D. Ohio Aug. 21, 2007) ("The financial restatement details mistakes in Dana's accounting. The restatement does not, however, establish scienter….").

5. Disclosure: Willkie Farr & Gallagher represents the defendants in *H&R Block*. The views in this column represent those of the authors, not the views of any clients.

6. In contrast, other cases hold that executive resignations are not sufficient to infer scienter when they may be based on "new policies" or a "change in direction" rather than misconduct. *Cyberonics*, 2007 WL 2914995, at *5; see also *BearingPoint*, 2007 WL2713906, at *15-16 ("retirements and resignations of executives do not support a strong inference of scienter" unless "the executives departed under a cloud of illegality or accusations of fraud"); *Mizzaro*, 2007 WL 2254693, at *11 (rejecting arguments based on CEO's resignation as "mere speculation").

7. Another case, out of the U.S. District Court for the Central District of California, took a similar approach to a motion to dismiss options backdating claims. See *Middlesex Retirement Sys. v. Quest Software Inc.*, No. CV 06-6863, 2007 WL 3286784, at *16-25 (C.D. Cal. Oct. 22, 2007) (denying the motion as to those defendants who benefited from the backdating scheme, but granting the motion as to a defendant who joined the company after the backdating had occurred).