
Securities Law Developments

Circuit Courts Begin To Coalesce on Private Securities Litigation Reform Act Standards

In the last few months appellate court battles have been raging between class action plaintiffs' lawyers and issuers' defense counsel to determine the future rules of the game for securities litigation. The issue is the application of provisions of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") that address the threshold requirements for asserting federal securities law claims. In a relatively short span, six of the twelve federal courts of appeals have addressed this issue.^{1/} The results have varied significantly, and a Supreme Court decision may be necessary to resolve the issue. But the most recent cases are beginning to suggest a developing consensus that, while not as helpful to potential defendants as they may have hoped when the statute first passed, make it clear that Congress and the courts have substantially "raised the bar" for private actions under the federal securities laws.

But there may be even greater practical significance revealed by the treatment given by each of these courts to the particular factual circumstances they faced. Regardless of the theory used, each of these appellate decisions was decided in favor of the defendants in securities fraud actions. The various approaches taken suggest that on the whole the courts are receptive to dismissing securities fraud claims unless specific and well-founded facts strongly suggest a prospect for success on the merits.

^{1/} The First, Second, Third, Sixth, Ninth and Eleventh Circuits have addressed the issue, all but the Second Circuit with in-depth analyses. The Fifth Circuit's conclusory language on the point in dicta in *Williams v. WMX Technologies, Inc.*, 112 F.3d 175, 177-78 (5th Cir. 1997), in which pre-PSLRA law applied, is not generally viewed as that Circuit's considered position on the issue. The Fourth Circuit, in *Phillips v. LCI International, Inc.*, 190 F.3d 609 (4th Cir. 1999), declined to decide what pleading standard the PSLRA requires, finding that the complaint failed under any standard, but took note that the PSLRA "requires us to 'curtail the filing of meritless lawsuits' . . . by allowing only those suits which demonstrate 'a strong inference of scienter' to survive a motion to dismiss." The Fourth Circuit did the same in *Krim v. Coastal Physician Group, Inc.*, 1999 WL 1008975 (4th Cir. Nov. 8, 1999).

The legal controversy arises out of language in the PSLRA that mandates dismissal of federal securities fraud claims unless the complaint states “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”^{2/} The courts have since struggled with two issues: (1) what did Congress mean by “the required state of mind,” and (2) what kinds of allegations can be sufficient to create a strong inference of that state of mind with the required particularity.

Before enactment of the PSLRA, the courts of appeals were in general agreement about “the required state of mind.” The required state of mind was “a mental state embracing intent to deceive, manipulate, or defraud,”^{3/} and the courts agreed that in addition to knowing conduct, proof of grossly reckless conduct could satisfy this requirement. The most often cited case describing what “recklessness” meant in this context was the Seventh Circuit’s decision in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), which spoke of “not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care” which presents a danger of misleading investors “that is either known to the defendant or is so obvious the actor must have been aware of it.”^{4/}

In contrast, before the PSLRA the federal courts of appeals applied widely differing pleading requirements for alleging the required state of mind to support federal securities fraud claims. For example, the Ninth Circuit was of the view that mere notice pleading was sufficient to satisfy this scienter requirement.^{5/} Other Circuits were more demanding. The Second Circuit was regarded by many as applying the most stringent pleading standard, mandating that a plaintiff plead facts establishing a “strong inference of fraudulent intent.”^{6/} This could be

^{2/} Securities Exchange Act of 1934 § 21D(b)(2):

Required State of Mind.

In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, 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).

^{3/} *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

^{4/} In *Hochfelder*, the Supreme Court left open the sufficiency of recklessness to show the required state of mind and has not since taken up the issue. *Id.*

^{5/} See *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547 (9th Cir. 1994) (*en banc*).

^{6/} *Chill v. General Electric Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

accomplished in one of two ways: “either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”^{7/}

During consideration of the PSLRA, members of the House and Senate frequently referred to the Second Circuit standard as a means of defining their own positions, or advocating a particular interpretation of the legislation. As a result, the PSLRA’s legislative history is littered with inconsistent declarations that the PSLRA either would codify or modify the existing Second Circuit standard. In the end, the statute included only the disarmingly simple provision that the complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”

In applying this language, the district courts first considering the issues tended to focus on the interplay between the PSLRA and the pre-PSLRA Second Circuit scienter pleading requirement, both because the language of the PSLRA tracked the “strong inference” aspect of the Second Circuit case law and because the legislative history involved substantial debate over the efficacy of the prior Second Circuit formulation focused upon “motive,” “opportunity,” and “recklessness.” The appellate courts, while certainly cognizant of the contentions regarding the pre-PSLRA Second Circuit standard, have tended to address the issue more in the vein of applying the language of the statute than a determination whether or not the Second Circuit standard has become the law of the land. Each appellate court to date has addressed two aspects of the PSLRA pleading requirement: (1) whether existing case law permitting claims based on allegations of severe recklessness was altered by the PSLRA, and (2) how the PSLRA’s scienter pleading requirement relates to pre-PSLRA pleading standards, including the sufficiency of pleading “motive and opportunity” to supply the required strong inference of scienter. Although different views have been expressed, there now appears to be a consensus developing on each of these issues.

Pleading Scienter Based on Recklessness

All but one of the six Circuits considering the issue have concluded that within the context of the PSLRA’s more stringent particularity requirement federal securities fraud claims may still be pleaded with allegations of scienter based on severely reckless conduct. Only the Ninth Circuit suggested otherwise, and did so in only a limited respect. In *In re Silicon Graphics Inc., Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999), the court majority held that under the PSLRA plaintiffs “must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct,” and that a showing of “mere recklessness” is no longer sufficient.^{8/} But amid much ado about this conclusion, and how it is mandated by the

^{7/} *Id.* (quoting *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)).

^{8/} There was a strong dissent, but a petition for rehearing *en banc* was denied, over a vociferous dissent by five of the Ninth Circuit judges, who argued that the decision “ignores the plain directives of Congress, casts aside the prior decisions of this court, and creates a striking conflict with our fellow circuits.” *In re Silicon Graphics, Inc. Sec. Litig.*, 1997 WL 997085, at *1 (9th Cir. Oct. 27, 1999).

PSLRA, the court never makes it clear whether this “deliberate recklessness” requirement differs in any material respect from the generally accepted *Sundstrand* recklessness scienter formulation. Indeed, at one point the court reaffirms the Ninth Circuit’s adherence to *Sundstrand*, as previously set forth in the *en banc* decision in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990).^{9/} Nevertheless, the court goes on to state that this means that recklessness satisfies scienter under § 10(b) only “to the extent it reflects some degree of intentional or conscious misconduct.”^{10/} “For this reason,” the court concludes, “we read the PSLRA language that the particular facts must give rise to a ‘strong inference . . . [of] the required state of mind’ to mean that the evidence must create a strong inference of, at a minimum, ‘deliberate recklessness.’”^{11/}

Much has been made of this conclusion. Class plaintiffs sought rehearing *en banc*, and garnered the support of the Securities Exchange Commission to do so, with the argument that this reading of the PSLRA improperly altered the substantive elements of the scienter requirement of § 10(b). As noted above, although *en banc* review was denied, five judges joined a dissent arguing that the opinion “casts aside” earlier panel decisions. But because the *Silicon Graphics* majority did not attempt to explain what it meant by “deliberate recklessness,” there is little in the opinion to conclude that the “sky is falling” on scienter in the Ninth Circuit. To the contrary, the *Silicon Graphics* majority not only restated the commitment to the Ninth Circuit’s ruling in *Hollinger* on the applicability of *Sundstrand*-type recklessness to show scienter, but it also explained that its “deliberate recklessness” standard was consistent with the Sixth Circuit’s recent treatment of recklessness under the PSLRA in *In re Comshare, Inc. Securities Litigation*, 183 F.3d 542, 550 (6th Cir. 1999).^{12/} The Sixth Circuit’s opinion in *Comshare*, along with recent decisions in the First,^{13/} Third,^{14/} and Eleventh Circuits,^{15/} all concluded, after studying the statute, that the PSLRA did not generally change existing substantive scienter requirements for securities fraud.^{16/} They found that where Congress sought to bar anything short of conscious misconduct as a basis for liability it did so in targeted provisions within the PSLRA, notably those addressing forward

^{9/} *Silicon Graphics*, 183 F.3d at 976.

^{10/} *Id.* at 977.

^{11/} *Id.*

^{12/} *See Silicon Graphics*, 183 F.3d at 977 n.7.

^{13/} *Greebel v. FTP Software, Inc.*, 1999 WL 902898, at *12-*15 (1st Cir. Oct. 8, 1999).

^{14/} *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

^{15/} *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1282-83 (11th Cir. 1999).

^{16/} *But see Greebel*, 1999 WL 902898, at *13 (characterizing *Silicon Graphics* and *Comshare* as “different results”).

looking statements and the applicability of joint and several liability.^{17/} The failure to do so more generally meant that Congress had not enacted any broad-based change to the existing substantive requirements for scienter.

In any event, whether or not *Silicon Graphics* represents a substantial departure from precedent on the recklessness issue, the consensus in the post-PSLRA appellate decisions is that factual pleadings giving rise to a “strong inference” of *Sundstrand*-type recklessness are sufficient to state securities fraud claims under the PSLRA. Unless and until the Supreme Court finally determines the adequacy of recklessness as a basis for § 10(b) liability, the prevailing view will almost certainly be that the current scienter standards in the various Circuits were not altered by the PSLRA.

Pleading Facts Showing the Required “Strong Inference” of Scienter

The appellate courts have been more varied in their approach towards the “procedural” aspect of the PSLRA’s mandates -- the details needed in a complaint to allow a securities fraud claim to proceed. But even with these differences there appears to be a developing consensus.

The first appellate court to address the question directly was the Second Circuit, in *Press v. Chemical Investment Services Corp.*, 166 F.3d 529 (2d Cir. 1999). Although the court affirmed dismissal of plaintiff’s claims without regard to the issue of scienter pleading, it stated in a paragraph of dicta that it regarded the PSLRA as having adopted the pre-PSLRA Second Circuit standard for pleading scienter. In other words, *Press* concluded that the PSLRA’s required strong inference of scienter could be satisfied by facts showing “motive and opportunity” in accordance with the earlier Second Circuit holdings.^{18/} But because it did so in dicta and without any attempt to analyze the statute’s language or legislative history, the opinion has carried little weight in later appellate considerations of the issue.

In contrast, five later appellate decisions have given ample consideration to the statute and legislative history. The Third Circuit, concluded in *In re Advanta Corp. Securities Litigation* that the pre-PSLRA Second Circuit “motive and opportunity” standard would suffice under the PSLRA. It found nothing in the statute or legislative history calling for a more demanding pleading requirement because both were contradictory or inconclusive. Although the *Advanta* court recognized that the Congressional Conference Committee expressly did “not intend to codify the Second Circuit’s case law” interpreting the “strong inference” standard because it

^{17/} The PSLRA precludes liability for forward looking statements unless they were made with actual knowledge that they were false or misleading. See 15 U.S.C. § 78u-5(c)(1)(B). Likewise, the PSLRA permits joint and several liability only for persons specifically found to have knowingly committed a violation of the securities laws, which requires “actual knowledge” a representation was false, and expressly excludes “reckless conduct” as a basis for finding a knowing violation. See 15 U.S.C. §§ 78u-4(f)(2)(A), 78u-4(f)(10)(A), 78u-4(f)(10)(B).

^{18/} *Id.* at 537-38.

intended “to strengthen existing pleading requirements,”^{19/} it ultimately held that “Congress’s use of the Second Circuit’s language compels the conclusion that the [PSLRA] establishes a pleading standard approximately equal in stringency to that of the Second Circuit.”^{20/} Perhaps not coincidentally, the Third Circuit had recently itself endorsed the Second Circuit approach for pre-PSLRA cases.^{21/}

Since the decisions in *Advanta* and *Press*, four other Circuits have found that the PSLRA imposes pleading requirements more demanding than the Second Circuit’s pre-PSLRA “motive and opportunity” standard. The Ninth Circuit majority in *Silicon Graphics* found it “clear from the legislative history that Congress sought more specifically to raise the pleading standard above that in the Second Circuit.”^{22/} It did so based on three factors: the Conference Committee language described above; the rejection of an express amendment designed to codify the Second Circuit standard; and the Congressional override of President Clinton’s veto of the statute, which was based in substantial part on the understanding that the “conferees make crystal clear . . . their intent to raise the standard even beyond [the Second Circuit] level.”^{23/}

The First, Sixth and Eleventh Circuits did not go as far as the Ninth Circuit because they did not find the legislative history determinative. Each instead found it unnecessary to go beyond the “strong inference” language of the statute. In *Comshare*, the Sixth Circuit declined to resort to the legislative history, finding that a strong inference of scienter cannot be shown “merely by alleging facts demonstrating motive and opportunity where those facts do not simultaneously establish that the defendant acted recklessly or knowingly, or with the requisite state of mind.”^{24/} Facts regarding motive and opportunity may be relevant to pleading circumstances from which a strong inference of scienter may be inferred, and may “on occasion” rise to the level of creating such an inference, but “the bare pleading of motive and opportunity does not, standing alone” suffice.^{25/} In *Bryant v. Avado Brands, Inc.*, the Eleventh Circuit expressed “basic agreement with the Sixth Circuit” because “[m]otive and opportunity . . . do not constitute a substantive standard; rather, motive and opportunity are specific kinds of evidence, which along with other evidence might contribute to an inference of recklessness or willfulness.”^{26/} And in *Greebel v. FTP*

^{19/} *Advanta*, 180 F.3d at 532 (quoting H.R. Conf. Rep. No. 104-369, at 37 (1995)).

^{20/} *Id.* at 534.

^{21/} *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3d Cir. 1997).

^{22/} *Silicon Graphics*, 183 F.3d at 978.

^{23/} *Id.* at 978-80.

^{24/} *Comshare*, 183 F.3d at 551.

^{25/} *Id.*

^{26/} *Bryant*, 187 F.3d at 1283, 1286.

Software, Inc., the First Circuit also found its view “close to that articulated by the Sixth Circuit.”^{27/} It concluded that the PSLRA’s strong inference standard was similar to the First Circuit’s pre-PSLRA pleading requirements for fraud, and held specifically that “merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough,” but also rejecting the contention that “facts showing motive and opportunity can never be enough to permit the drawing of a strong inference of scienter.”^{28/}

These most recent appellate decisions all seem to coalesce around the approach articulated by the Sixth Circuit in *Comshare*. Because this approach charts a path between the more extreme positions of the Second and Ninth Circuits, and because it leaves flexibility for the district courts to deal with varying sets of factual circumstances, we expect this type of approach ultimately to prevail.

Evidence of Renewed Skepticism Over Securities Fraud Claims

But one should not take away from these decisions a sense that the appellate courts have shrugged off the concerns expressed by Congress in the PSLRA. Apart from the apparent trend on the scienter pleading issues raised by the PSLRA, the seven appellate decisions considering motions to dismiss in cases under the PSLRA are striking for their receptiveness to Rule 12(b)(6) dismissals. In six instances dismissal was affirmed, regardless of the position taken on the underlying PSLRA issues, and in the seventh, the Eleventh Circuit vacated and remanded a district court decision declining to dismiss the claims. The courts seem to have gotten the overall message underlying the PSLRA -- concern over potentially abusive uses of the securities laws in private civil actions.

In the course of their decisions, these appellate courts:

(1) Reiterated or clearly adopted the rule that courts will consider on a motion to dismiss the contents of publicly filed documents, or documents partially referred to in the complaint, even if those documents are not themselves incorporated into the complaint. This allows defendants to place before the courts in a motion to dismiss certain helpful facts undercutting plaintiffs’ theory in support of the required strong inference of scienter.^{29/}

(2) Reiterated and in some respects expanded upon a requirement of specificity in pleadings that would bar plaintiffs from making references to alleged documents or oral

^{27/} *Greebel*, 1999 WL 902898 at *11.

^{28/} *Id.*

^{29/} See *Bryant*, 187 F.3d at 1274-81 (district court improperly excluded from consideration on motion to dismiss various SEC filings of which it should have taken judicial notice); *Phillips*, 190 F.3d at 614 (considering news article and company proxy statement); *Silicon Graphics*, 183 F.3d at 986; *Advanta*, 180 F.3d at 540-41.

statements without identifying with precision the identity of those documents, or the timing, content and participants in alleged conversations.^{30/}

(3) Reiterated that an alleged disclosure of financial information inconsistent with generally accepted accounting principles cannot form the basis for a securities fraud claim without the pleading of additional facts creating a strong inference supporting contemporaneous knowledge or conscious disregard of the inconsistencies.^{31/}

(4) Strongly reiterated that allegations showing insider selling before the release of negative information will not be sufficient to support the required strong inference of scienter unless those allegations show such selling was unusual in comparison to past trading activity, represented a significant portion of the stock and options held by those persons, and involved participation by the persons responsible for the disclosure in question.^{32/}

(5) Reiterated that allegations of benefits to management or directors from a supposed fraud like salary, perquisites, continuation in office, and the like will not generally create the required inference that they acted knowingly or with gross recklessness.^{33/}

The consistently demanding positions taken by the appellate courts on these issues may be

^{30/} See *Silicon Graphics*, 183 F.3d at 984-85 (allegations that specified types of internal reports revealed revenue shortfalls are insufficient because plaintiff does not identify specific reports, sources of information about them, who drafted them or who received them; a plaintiff “must provide, in great detail, all the relevant facts forming the basis” for information and belief pleading of this type).

^{31/} See *Greebel*, 1999 WL 902898, at *17 (general allegations of violations of GAAP fail to provide even a reasonable inference of scienter if they do not include details regarding the dollar amounts, transactions, customers, or company employees involved; where details are provided, the facts must show strong grounds for concluding the conduct was knowing or reckless, rather than merely incorrect); *Comshare*, 183 F.3d at 553 (failure to follow GAAP is by itself insufficient and allegations contain no “specific facts that illustrate ‘red flags’ that should have put Defendants on notice of the revenue recognition errors”).

^{32/} See *Greebel*, 1999 WL 902898, at *20-21 (alleged insider sales do not create inference of scienter because timing was not very suspicious, many of the sales were by an officer immediately before and after leaving his position, and almost all of the sales were by that one officer); *Comshare*, 183 F.3d at 553 (allegations of insider selling “largely tend to illustrate . . . motive and opportunity,” which, without more, is insufficient); *Silicon Graphics*, 183 F.3d at 987 (\$13 million in stock sales by six officers insufficient because it “was not dramatically out of line with prior trading practices or otherwise suspicious enough to create a strong inference”; all but two officers sold a small portion of their holdings, which properly include not only stock but vested options); *Advanta*, 180 F.3d at 540-41 (strong inference of scienter is not created by alleged insider sales when three individual defendants sold no stock; two sold only 5 and 7 percent of their total holdings, respectively; and stock sales during the 8-month class period were only twice the number of shares sold by those persons in the previous 28 months; the court also made it clear that the burden was on plaintiffs to allege facts showing stock sales were unusual, not on defendants to rebut an allegation of scienter that fails to identify necessary facts to determine whether stock sales were sufficiently unusual to create an inference of scienter).

^{33/} See *Phillips*, 190 F.3d at 622 (allegations of motive to prolong benefits as an executive or to increase compensation are insufficient); *Comshare*, 183 F.3d at 553 (allegations that individuals stood to receive greater compensation if stock prices increased insufficient because it goes only to motive).

as telling as the views they stated on the issues of recklessness and “motive and opportunity.” They are strong evidence that the courts have heard and are responding to the underlying intentions of Congress in the PSLRA to separate the chaff from the wheat in securities fraud claims at the motion to dismiss stage.

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