

Which “state” is best for you:  
**The Many States of Scierter  
Under the Private Securities  
Litigation Reform Act**

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Securities class actions have evolved into one of the most persistent and substantial threats faced by public companies. In the 1980s and early 1990s, a significant drop in the market price of a corporation’s stock would be followed by a complaint which alleged securities fraud in connection with that decline. The value of these lawsuits, and whether the defendant corporation would believe it appropriate to pay some amount to settle the suit, turned on whether the complaint could withstand a motion to dismiss. For years it was generally accepted that the Second Circuit had the most stringent pleading requirements for scierter, and thus was the most defendant-friendly circuit to be in.

As evidence of the coercive effect of these lawsuits mounted, Congress began to consider how best to reform the practice of securities litigation. Congress ultimately enacted the Private Securities Litigation Reform Act of 1995 (the “Reform Act”) in order to combat various actual and/or perceived abuses in the practice of securities litigation, including:

- (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants’ culpability;
- (2) the targeting of “deep pocket” defendants;
- (3) the abuse of the discovery process to coerce settlement; and
- (4) manipulation of clients by class action attorneys.

The Reform Act contained numerous provisions which were designed to eliminate these abuses, including a safe-harbor for forward-looking statements and a stay of discovery.

In the wake of the enactment of the Reform Act, perhaps the single most controversial provision is the heightened pleading standard established by it for scierter or intent to defraud. In the past several months, various circuit courts have interpreted the Reform Act’s scierter pleading requirements in significantly different ways. The result of these divergent decisions is that the Second Circuit’s pleading requirements are now less stringent than those of other circuits. The circuit-by-circuit analysis which follows is designed to assist companies in determining where to bring, or where to attempt to move to transfer, their securities fraud lawsuits.

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### Pre-Reform Act Scierter Pleading Requirements

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**No Liability For Securities Fraud For Merger After Denial Of Sale:** The Fourth Circuit has held that a CEO’s public statement that his company “was not for sale,” made three weeks before the company announced that it was being acquired in a merger, was not a material misstatement of fact, in violation of the securities laws. Affirming the trial court on other grounds, the Fourth Circuit held that the statement, when evaluated in the context in which it was made, was not a material misstatement of fact and that the stockholders had failed to allege specific facts giving rise to a strong inference that LCI acted with a “reckless or conscious effort to defraud.” The court was careful to distinguish a statement that the company is “not for sale” from a denial that negotiations were ongoing, which may rise to a material misstatement of fact if true. *Phillips v. LCI International, Inc.*

The requisite state of mind which must be alleged by a plaintiff in a securities fraud action was first established in *Ernst & Ernst v. Hochfelder*. There, the United States Supreme Court held that, in order to assert a private cause of action for damages under Section 10(b) and Rule 10b-5, a plaintiff must allege scienter, defined as a “mental state embracing intent to deceive, manipulate, or defraud.”<sup>1</sup> The Supreme Court declined to address whether reckless conduct could form the basis for a private action for damages under these provisions. Since *Ernst & Ernst* was decided, every circuit has held that recklessness can serve as a basis for liability under Section 10(b) and Rule 10b-5.

Prior to the enactment of the Reform Act, the various circuits had different approaches to how to properly plead scienter, with the Second Circuit’s standard being the most rigorous. To survive a motion to dismiss in the Second Circuit, a plaintiff had to allege either: (1) facts constituting strong circumstantial evidence of conscious or reckless behavior by the defendant; or (2) facts showing the defendant’s motive for committing the fraud and the clear opportunity to do so.<sup>2</sup>

### The Reform Act’s Scienter Pleading Requirements

With respect to the required state of mind which must be pleaded in all securities fraud actions, the Reform Act states that:

In any private action arising under this chapter 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 chapter, state with particularity **facts giving rise to a strong inference that the defendant acted with the required state of mind.** [emphasis added]

This language in the Reform Act, as it relates to pleading scienter, is somewhat ambiguous. Although it states that a plaintiff must allege facts giving rise to a “strong inference” that a defendant acted with the “required state of mind,” it fails to make clear what the required state of mind is and what type of facts can properly demonstrate scienter. In particular, the Reform Act does not address the question of whether evidence of “motive and opportunity” can adequately demonstrate scienter. As discussed below, the circuits have answered this question in a number of different ways.

### “Motive and Opportunity” Pleading Survives the Reform Act in the Second and Third Circuit

The Second Circuit has interpreted the Reform Act as codifying the Second Circuit’s pre-Reform Act approach to pleading scienter in securities fraud actions. In *Press v. Chemical Investment Services*,<sup>3</sup> the Second Circuit affirmed the district court’s granting of summary judgment dismissing a complaint, and held without analysis that:

The Private Securities Litigation Reform Act of 1995 heightened the requirement for pleading to the level used by the Second Circuit... Plaintiffs must ‘state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind’...As a pleading requirement, a plaintiff must either (a) allege

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**Title VII Discrimination Claims May Be The Subject Of Mandatory Arbitration:** Joining the majority of circuits that have considered the issue, the Second Circuit has concluded that sex discrimination claims may be submitted to mandatory arbitration under a National Association of Securities Dealers registration agreement. Only the Ninth Circuit has struck down the arbitration provision. *Desiderio v. National Association of Securities Dealers*.

**Former Executives Protected By 5th Amendment Privilege:** The Second Circuit Court of Appeals has ruled that executives who have left a company cannot be compelled to produce company documents still in their possession if they assert their Fifth Amendment privilege against self-incrimination. The court reasoned that former executives no longer act as corporate representatives and are not the custodian of corporate records. However, the court cautioned that former executives who “abscond” with corporate documents may be prosecuted for theft or obstruction of justice. *U.S. v. John Doe I*.

facts to show that ‘defendants had both motive and opportunity to commit fraud’ or (b) allege facts that ‘constitute strong circumstantial misbehavior or recklessness.’

Thus, in the Second Circuit, allegations that a defendant had a motive and opportunity to commit securities fraud can continue to be used to demonstrate scienter.

Shortly after the Second Circuit’s decision in *Press*, the Third Circuit articulated its interpretation of the Reform Act’s pleading requirements in *In re Advanta Corp. Securities Litigation*.<sup>4</sup> There, after noting that the Reform Act’s legislative history is “ambiguous and even contradictory” with respect to whether Congress intended to adopt the Second Circuit standard for scienter, the Third Circuit analyzed the language of the Reform Act and concluded that:

We believe Congress’s use of the Second Circuit’s language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in stringency to that of the Second Circuit. Because the Second Circuit standard was regarded as the most restrictive prior to the Reform Act, this interpretation is consistent with Congress’s stated intent of strengthening pleading requirements and deterring frivolous securities litigation.

The Third Circuit also held that the Reform Act did not alter the “substantive contours of scienter,” and that recklessness remains a basis for liability.

### “Motive and Opportunity” Pleading Are Not Enough in the Sixth, Ninth and Eleventh Circuits

The Sixth Circuit rejected the Second Circuit’s approach in *In re Comshare, Inc. Securities*

*Litigation*.<sup>5</sup> There, the Court held that “plaintiffs may plead scienter in Section 10(b) or Rule 10b-5 cases by alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud.” Unlike the Second Circuit, the Sixth Circuit held that evidence of a defendant’s motive and opportunity alone cannot support liability under Section 10(b) or Rule 10b-5. Like the Third Circuit, the Sixth Circuit concluded that the Reform Act did not alter the substantive law of scienter, and thus a strong inference of recklessness would suffice to demonstrate scienter.

The Ninth Circuit also rejected the Second Circuit’s approach in *In re Silicon Graphics, Inc. Securities Litigation*.<sup>6</sup> There, the Ninth Circuit held that “particular facts giving rise to a strong inference of deliberate recklessness, at a minimum, are required to satisfy the heightened pleading standard” under the Reform Act. The Ninth Circuit reached its conclusion by first noting that the Reform Act requires that the facts alleged must create a strong inference of deliberate recklessness.

The Ninth Circuit also noted that the Reform Act was silent as to whether, as in the Second Circuit, motive and opportunity or circumstantial evidence of simple recklessness are sufficient to adequately demonstrate scienter. The Court concluded that, because the legislative history demonstrates that Congress intended to raise the pleading standards above the then-existing Second Circuit

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**Anti-Discrimination Policy Is Not Enough:** The Tenth Circuit Court of Appeals recently held that Wal-Mart’s written policy against discrimination did not protect it from a verdict for compensatory and punitive damages because the evidence showed that Wal-Mart did not make a good faith effort to educate its employees about the company’s compliance with anti-discrimination laws. The court indicated that companies need to make an effort to train managers as well as employees throughout the company in order to establish a good faith defense against punitive damages for vicarious liability under Supreme Court law. *EEOC v. Wal-Mart Stores, Inc.*

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standard, Congress did not intend to adopt the Second Circuit's approach. Therefore, the Ninth Circuit joined the Sixth Circuit in holding that motive and opportunity evidence is not adequate to demonstrate scienter.

The Eleventh Circuit set forth its approach in *Bryant v. Avado Brands, Inc.*<sup>7</sup> There, the Eleventh Circuit, noting that it was in “basic agreement” with the Sixth Circuit, held that “a securities fraud plaintiff must plead scienter with particular facts that give rise to a strong inference that the defendant acted in a severely reckless manner.” The Eleventh Circuit reached its decision by noting that facts which show a strong inference that a defendant acted with a severely reckless state of mind still form the basis for liability under Section 10(b) and Rule 10b-5. The Eleventh Circuit then expressly rejected the Second Circuit's “motive and opportunity” analysis, holding

that evidence of “motive and opportunity” may be relevant to a showing of severe recklessness, but that they do not, standing alone, demonstrate scienter.

### Conclusion

Both plaintiff's counsel and companies named as defendants in a securities fraud action should be aware of the differences in the law with respect to scienter from one circuit to another. Until the case law develops, it remains unclear how much more must be pleaded to meet the higher standards of recklessness in the Sixth, Ninth and Eleventh Circuits. What is clear is that a company would prefer to defend against a securities fraud action in these circuits at this time. Conversely, the Second and Third Circuits would appear to offer plaintiffs the greatest chance of surviving a motion to dismiss by allowing scienter to be pleaded by evidence of motive and opportunity. Ultimately, because differences in pleading standards undercut the Reform Act's goal of creating a uniform pleading standard, it is likely that the United States Supreme Court will eventually resolve the conflict. ■

## AKO corner

### notable decisions

**In *Marks v. New York University et al.*:** A judge in the Southern District of New York granted AKO's client's/defendant's motion for summary judgment and dismissed plaintiff's claims of age and sex discrimination. The judge also dismissed plaintiff's claims that the University breached the terms of a severance agreement. In dismissing all of plaintiff's claims, the court noted that as it was undisputed that NYU had actually withdrawn the settlement offer before plaintiff's purported acceptance, the only issue was whether the Older Workers Benefit Protection Act (OWBPA) made the offer irrevocable for the twenty-one day period. The court held that OWBPA's twenty-one day “consideration” period does not create an irrevocable power of acceptance in the employee. The Court's resolution of this issue, one of first impression within the Second Circuit and many others, confirms that employers have the ability to withdraw OWBPA offers prior to acceptance.

<sup>1</sup> 425 U.S. 185, 96 S. Ct. 1375 (1976).

<sup>2</sup> See, e.g., *Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994).

<sup>3</sup> 166 F.3d 529 (2d Cir. 1999).

<sup>4</sup> 180 F.3d 525 (3d Cir. 1999).

<sup>5</sup> 183 F.3d 542 (6th Cir. 1999).

<sup>6</sup> 183 F.3d 970 (9th Cir. 1999).

<sup>7</sup> 187 F.3d 1271 (11th Cir. 1999).

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