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Katten Muchin Rosenman LLP

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Reform Act Under Attack?

Congress enacted the Private Securities Litigation Reform Act of 1995 (the "Reform Act") to reduce the volume of abusive securities litigation filed by private plaintiffs. In the years after its passage, courts throughout the country raised the standards necessary to allege a claim of securities fraud, ruling that plaintiffs needed to provide greater specificity with respect to their allegations of both falsity and scienter (intent to deceive) in their complaints in order to survive motions to dismiss. *See, e.g., In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999); *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001). Since 1995, the U.S. Supreme Court has also issued a number of decisions concerning the standards applicable to cases of securities fraud. In each decision the court has either reversed a decision in favor of plaintiffs or affirmed a decision in favor of defendants, thereby further bolstering Congress's intent to reduce the amount of meritless private securities litigation. *See, e.g., Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007); *Dura Pharmaceuticals v. Broudo*, 125 S. Ct. 1627 (2005). The pleading standard serves as a crucial safeguard in cases alleging securities fraud because discovery is stayed during the pendency of motions to dismiss, thereby limiting the expenditure of fees in defense of the litigation until plaintiffs have established that the case has some merit.[1]

Despite this general trend of imposing higher standards on private plaintiffs attempting to state claims for securities fraud, certain courts stepped back from strict application of the Reform Act and relaxed the standards for pleading securities fraud in the period immediately after the corporate scandals involving Enron and WorldCom. *See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Co.*, 320 F.3d 920, 946 (9th Cir. 2003) ("[i]n this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious not to raise the bar of the PSLRA any higher than that which is required under its mandates"). With the stock market in a tailspin again, certain courts have again seemingly made it easier for plaintiffs to assert claims of securities fraud by reviving once-rejected theories of liability. Significantly, these theories—known as "collective scienter" and "core operations"—have been revived in the courts of appeals in which most private securities cases are filed, the Second Circuit (which includes the federal district courts in Connecticut, New York and Vermont), the Seventh Circuit (which includes the federal district courts in Illinois, Indiana and Wisconsin), and the Ninth Circuit (which includes the federal district courts in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington).

1 *This does not mean that defendants have won every court decision since passage of the Reform Act, but the Reform Act clearly raised the standards necessary to state a claim of securities fraud.*

For Additional Information

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Collective Scienter

In the typical private securities action, a shareholder (purporting to represent a class of shareholders) will sue a company and certain of its senior officers who made allegedly false statements on behalf of the company. The shareholder will attempt to establish that the senior officers making the allegedly false statements acted with scienter (intent to deceive) and the scienter of the senior officers will be imputed to the company. In certain cases, however, the shareholder will not be able to establish that the senior officers acted with scienter, but will claim that the company can nonetheless be held liable. The shareholder will claim that because while the company's senior officers did not have knowledge of the fraud, other individuals at the company did. The shareholder will also claim that it does not matter whether the individuals with knowledge of the fraud communicated their knowledge to the senior officers or that the individuals with knowledge of the fraud made any statements to the public. Rather, the shareholders will claim that the company is charged with the collective knowledge of all of its employees (or at least all of its "management" level employees). This is collective scienter, and it makes it easier to bring a claim of securities fraud as—after the fact—there is frequently someone in the company who will claim that he or she knew that the company was facing problems all along.

Collective scienter had been rejected for the most part as inconsistent with the Reform Act and general agency principles. *See, e.g., Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995); *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004); *Teachers' Retirement System of Louisiana v. Hunter*, 477 F.3d 162 (4th Cir. 2007). Recently, however, the Seventh Circuit reinvigorated the theory in its *Tellabs* decision on remand from the U.S. Supreme Court. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008). The original panel and the parties had focused their arguments on whether plaintiffs had alleged scienter as to the company's CEO, who had made the allegedly false statements apparently assuming that, consistent with established law, the company's intent was derivative of the intent of the named individual defendants. Indeed, the Seventh Circuit on remand noted that "[t]he emphasis throughout the litigation has been on [the CEO's scienter]." *Tellabs*, 513 F.3d at 707.

Nonetheless, the Seventh Circuit decided not to focus on the CEO's scienter and instead began with the "company's scienter." *Id*. In so doing, the Seventh Circuit suggested that it was narrowing, rather than expanding, whose scienter might be imputed to the company, but, in application, the court adopted a rather lenient standard for alleging scienter on behalf of the company. This broad application resulted partly from the application of the "core operations" doctrine, discussed below, but also from the court's willingness to assume that a company can have a "collective" intent separate from the intent of the individual defendants who made the allegedly false statements. The Seventh Circuit's adoption of the collective scienter theory was followed closely by the Second Circuit, which held in *Teamsters Local 445 Freight Division Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190, 195 (2d Cir. 2008) that "it is possible to raise the required inference [of scienter] with regard to a corporate defendant without doing so with regard to a specific individual defendant."

The Seventh Circuit *Tellabs* decision (and the Second Circuit decision in *Dynex* to the extent it follows the Seventh Circuit decision) improperly divorces the act of fraud from the intent to commit it. The Reform Act makes it clear that both are required in order to state a claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and both should exist concurrently in order to state a claim. While the Seventh Circuit justified its decision by pointing to the collective intent that a panel of judges might have, it ignored that each member of a panel of judges subscribes to the particular opinion (or dissents therefrom) and therefore can have a collective intent, whereas, only certain individuals at a company can make statements on the company's behalf or sign off on statements by the company, and that the intent of any other person at the company should be irrelevant to whether the company acted with scienter. This is not to say that there are not difficult issues of corporate intent in situations where there is a corporate stock buyback program, a corporate merger and acquisition, or a statement by the company that is not attributed to a specific individual, but these potentially difficult situations do not justify adoption of a theory of scienter that exposes a company to liability based on the knowledge of persons with no power to make statements to the company's shareholders.

Core Operations

The core operations theory also serves to reduce a shareholders burden to state a claim of securities fraud. It rests on the assumption that a company's senior-most officers know all the facts concerning the company's core operations. The doctrine, however, is inconsistent with the Reform Act's mandate that plaintiffs "state with particularity facts giving rise to a strong inference" of scienter because it does not require plaintiffs to allege any "facts" beyond the defendant's position as a high-level executive at the company. Thus, in the years since passage of the Reform Act, most courts had rejected application of the theory as a means to allege scienter. *See, e.g., In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843 (9th Cir. 2003) (rejecting notion that "facts critical to a business's core operations or an important transaction are so apparent that their knowledge may be attributed to the company and its key officers"); *Abrams v. Baker Hughes Inc.*, 292 F.3d 424 (5th Cir. 2002); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001).

The core operations theory, however, has made a comeback in 2008. As mentioned above, the Seventh Circuit adopted it in the *Tellabs* decision on remand, holding that it was "exceedingly unlikely" that the allegedly false statements resulted from "careless mistakes at the management level" as opposed to "intent to deceive" given that the statements concerned the company's "most important products." *Tellabs*, 513 F.3d at 709. The court further noted that the products at issue were the company's "flagship" products and "[t]hat no member of company's senior management who was involved in authorizing or making public statements about the demand for the 5500 and 6500 knew that they were false is very hard to credit." *Id*.

Shortly after the Seventh Circuit issued its *Tellabs* decision, the Ninth Circuit also adopted a variation of the core operations theory in *Berson v. Applied Signal Technology*, 527 F.3d 982 (9th Cir. 2008). The *Berson* court held that the company's CEO and CFO "must have known about the [company's stop-work orders] because of their devastating effect on the corporation's revenue." *Berson*, 527 F.3d at 987. The *Berson* decision was especially interesting because it appeared that the Ninth Circuit had rejected the core operations theory in *Read-Rite* and judges of each court of appeals are bound by earlier decisions from the same court of appeals.

The Ninth Circuit's approach to the core operations theory has evolved further in the six months since *Berson* was decided in June. In July 2008, a different panel of the Ninth Circuit ruled that "corporate management's general awareness of the day-to-day workings of the company's business does not establish scienter" even as to schemes designed to contribute to a major source of the company's revenue. *See Metzler Investment GmbH v. Corninthian Colleges, Inc.*, 540 F.3d 1049, 1055, 1068 (9th Cir. 2008). Then in September 2008, yet another panel of the Ninth Circuit addressed the core operations theory. *See South Ferry LP v. Killinger*, __ F.3d __, 2008 WL 4138237 (9th Cir. 2008). The court in *Killinger* discussed the previous Ninth Circuit decisions in *Read-Rite, Metzler and Berson*, discussed the Supreme Court's recent decision in *Tellabs, Inc. v. Makor Issues and Rights, Ltd.*, 127 S. Ct. 2499 (2007), and then tried to synthesize the different approaches to the core operations theory reflected in *Read-Rite, Berson* and *Corinthian Colleges*. *Killinger*, 2008 WL 4138237 at *4-5. The court ultimately ruled that core operations theory can be used in conjunction with other particularized facts to allege scienter, that the core operations theory alone will usually fall short of the Reform Act standard, and that "in some unusual circumstances, the core operations inference, without more, may raise the strong inference required by the" Reform Act. *Killinger*, 2008 WL 4138237 at *5-6.

The first two parts of the *Killinger* decision are generally consistent with the Reform Act. The third part—that there are times when the core operations theory alone is enough—however seems inconsistent with the Reform Act's insistence on specificity. The *Killinger* court attempted to explain this aspect of its holding further by noting that it applies only where "it would be 'absurd' to suggest that management was without knowledge of the matter," *Killinger*, 2008 WL 4138237 at *6, but "absurdity" does not serve as a substitute for particularized facts.

Conclusion

There continues to be diversity in application of the Reform Act over the 13 years since its passage. This diversity is not just between various district courts throughout the United States but, as can be seen from the discussion above, between and among the different courts of appeals. Indeed, while many of the decisions discussed above seemingly undermine the Reform Act, there are plenty of others that further its purpose of reducing the volume of abusive private securities litigation. *See, e.g., Metzler,* 540 F.3d 1049; *Mizzaro v. Home Depot, Inc.*, __ F.3d __, 2008 WL 4498940 (11th Cir. 2008); *In re Ceridian Corp. Sec. Litig.*, __ F.3d __, 2008 WL 4163782 (8th Cir. 2008); *New Jersey Carpenters Pension & Annuity Funds v. Biogen Idec Inc.*, 537 F.3d 35 (1st Cir. 2008).

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