

Pleading Scienter in the Ninth Circuit: Did *Tellabs* Really Change Much?

Contributed by:

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In June 2007, the Supreme Court in *Tellabs*¹ addressed what plaintiffs must do to satisfy the Private Securities Litigation Reform Act's (PSLRA) requirement that they plead facts giving rise to a "strong inference" of scienter. In some circuits, the Supreme Court's decision substantially changed how courts go about evaluating scienter allegations. The Seventh Circuit, where *Tellabs* originated, for example, had held that the strong inference standard is met where the complaint pleads facts from which a reasonable person could infer that defendant acted with the required intent, without considering any competing inferences in favor of defendants. The Supreme Court rejected that formulation, holding that it did not capture "the stricter demand Congress sought to convey" in the PSLRA.²

In the Ninth Circuit, by contrast, *Tellabs* appeared not to depart substantially from the existing approach to the strong inference requirement. The Ninth Circuit had held that while district courts must consider the allegations in the complaint as a whole, they must also consider competing inferences in favor of defendant. The Supreme Court reached the same conclusion in *Tellabs*, except that it did not follow the Ninth Circuit's requirement that the inference of scienter must be the most plausible of competing inferences. Rather, *Tellabs* held that a complaint will survive if a reasonable person would deem the inference of scienter "at least as compelling" as any opposing inference one could draw from the facts alleged.³ In other words, a tie would now go to plaintiffs. Changing the tie breaker, however, did not signal a significant change in methodology or in most cases the likely results, as ties should be the exception rather than the rule.

It is now two years since the Supreme Court decided *Tellabs*, and thus an opportune time to consider whether and to what extent *Tellabs* has changed how the Ninth Circuit evaluates scienter allegations. Since *Tellabs*, the Ninth Circuit has published three significant decisions addressing the PSLRA's strong inference pleading requirement: *Metzler Investment GMBH v. Corinthian Colleges, Inc.*;⁴ *South Ferry LP No. 2 v. Killinger*;⁵ and, recently, *Zucco Partners, LLC v. Digimarc Corp.*⁶ In *Metzler*, the Court concluded that the Ninth Circuit's pre-*Tellabs* opinions remain viable, and reconciled rules articulated in those opinions with *Tellabs*. But in *South Ferry*, the Court expressed some angst about this question, conjecturing that in light of *Tellabs* certain of its earlier leading decisions may be "too demanding and focused too narrowly."⁷

In early 2009, however, the Ninth Circuit again returned to this question in *Zucco* and held that *Tellabs* did not change the Ninth Circuit's requirements for pleading scienter.⁸ Although the Ninth Circuit stated that *Tellabs* adds an additional "holistic" component to those requirements,⁹ such a holistic requirement was present in the Ninth Circuit's pre-*Tellabs* jurisprudence. Thus, after a brief expression of anxiety in *South Ferry*, the Court confirmed that, with the exception of the tie-breaker, the song remains largely the same with respect to evaluating scienter allegations in the Ninth Circuit after *Tellabs*.

Ninth Circuit's Pre-Tellabs Approach

Since 1999, the Ninth Circuit had held that the PSLRA—with its requirements of particularized pleading and a strong inference of scienter—imposed a high bar for securities-fraud complaints. The Circuit's *In re Silicon Graphics* opinion was the first to construe the PSLRA as requiring

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complaints to plead facts raising a strong inference of either intentionally fraudulent conduct or deliberate, conscious recklessness—as distinguished from simple recklessness, or merely a motive and opportunity to defraud.¹⁰ Notably, *Silicon Graphics* stressed that it would not evaluate allegations in isolation, and emphasized that it would consider the complaint "in its entirety."¹¹

Following *Silicon Graphics*, a line of cases in the Ninth Circuit demanded exacting scrutiny of different types of scienter allegations. For example, *In re The Vantive Corp. Securities Litigation* found that allegations of a "hands on" management style and access to financial reports did not indicate that defendants' financial statements were made with scienter, absent "corroborating details" describing the reports and their contents.¹² *Vantive* also stringently applied prior Ninth Circuit law that insider stock sales only become suspicious when the level of trading is "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information."¹³ The Court's application of this rule also included a holistic element, as it emphasized that the insufficient allegations of fraud elsewhere in the complaint had a "spillover effect" on the analysis of the stock transactions, making them less likely to persuasively indicate scienter.¹⁴

In *Gompper v. VISX, Inc.*,¹⁵ the Ninth Circuit again emphasized that a holistic approach should be taken. It held that all inferences—those favoring defendants as well as plaintiffs—must be considered in evaluating scienter allegations. It was in *Gompper*, moreover, that the Ninth Circuit announced its stringent tie breaker rule, holding that inferences of wrongful intent must be more plausible than competing non-culpable inferences.¹⁶ Of course, the Supreme Court in *Tellabs* departed from this aspect of the Ninth Circuit's scienter jurisprudence.

In re Read Rite Corp. Securities Litigation,¹⁷ is another example of the Ninth Circuit's strict approach to pleading scienter pre-*Tellabs*. There, the Ninth Circuit rejected allegations that defendants' post-class-period admissions indicated that statements during the period were knowingly false when made, finding that the statements did not indicate defendants had "contemporaneous knowledge" of facts contradicting their prior representations. Additionally, the Court held that plaintiffs could not plead scienter merely by contending that the alleged misstatements pertained to facts so critical to a business's "core operations" that defendants must have known the statements were false. According to the Court, such allegations created a reasonable inference of scienter, but not a strong one.¹⁸

Although these are by no means all the Ninth Circuit's scienter cases that preceded *Tellabs*, they illustrate the Circuit's holistic, yet stringent, approach.

Supreme Court's Decision in Tellabs

In *Tellabs*, the Supreme Court addressed the issue of what plaintiffs must do to satisfy the PSLRA's requirement that they plead facts that give rise to a "strong inference" of scienter. The PSLRA left the term "strong inference" undefined. The Circuit Courts subsequently split on what it required, which frustrated Congress's intent to have a uniform pleading standard. In its decision, the Supreme Court set forth a methodology for evaluating scienter allegations that is remarkably similar to the Ninth Circuit's prior approach of considering the complaint as a whole and weighing competing inferences.

Like the Ninth Circuit in *Silicon Graphics* and *Gompper*, the Supreme Court in *Tellabs* concluded that the complaint must be evaluated as a whole, and that in considering whether the inference of scienter was "strong," courts must also consider competing inferences that plausibly arise from the factual allegations. Unlike *Gompper*, however, which had required that the inference of scienter be the most plausible one, *Tellabs* concluded that plaintiffs satisfy the PSLRA when the inference of scienter is "cogent and at least as compelling as any opposing inference of nonfraudulent intent."¹⁹ In other words, under *Tellabs*, a tie goes to plaintiff.

No other aspect of *Tellabs* conflicted directly with Ninth Circuit caselaw. True, the Supreme Court emphasized—perhaps to a greater degree than the Ninth Circuit—that its review would be holistic: "The inquiry . . . is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard."²⁰ But although the Ninth Circuit might not have emphasized it to the same degree, such a holistic approach nevertheless was definitely part of the Court's pre-*Tellabs* scienter jurisprudence.

The Supreme Court in *Tellabs* went on to describe how to evaluate an allegation of scienter in light of opposing inferences, using language that sounded much like the Ninth Circuit's in *Silicon Graphics* and *Gompper*. The Supreme Court stated that the scienter allegations cannot be evaluated "in a vacuum," and that the inquiry is "inherently comparative." It therefore held that "a court must consider plausible nonculpable explanations for defendant's conduct, as well as inferences favoring the plaintiff." Additionally, *Tellabs* explained that "the inference of scienter must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations."²¹

Ninth Circuit's Decisions After Tellabs

The Ninth Circuit's three post-*Tellabs* scienter decisions feature two strong holdings that the Circuit's pre-*Tellabs* opinions remain viable, which bookend a moment of angst in the case decided between them.

Metzler v. Corinthian Colleges

Metzler Investment GMBH v. Corinthian Colleges, Inc., was the Ninth Circuit's initial reaction to *Tellabs*. The Court concluded in *Metzler* that the Ninth Circuit's pre-*Tellabs* opinions remained viable, and reconciled rules articulated in those opinions with *Tellabs*.²² The Court also explained that holistic review "cuts both ways," meaning that even if a single scienter allegation might suffice when viewed in isolation, it would nonetheless fall short in the context of an otherwise inadequate complaint.²³

As to allegations of insider trading, *Metzler* cited the Circuit's long-standing rule that stock sales by corporate insiders only give rise to an inference of scienter when the sales were inconsistent with the insider's trading history.²⁴ Phrasing the rule in terms of *Tellabs*, *Metzler* explained that where an insider's stock sales are not suspicious, an inference arises that "there was no insider information from which to benefit."²⁵

Metzler also confirmed that *Tellabs* did not alter the *Silicon Graphics* holding that scienter under the PSLRA requires a "strong inference of deliberate recklessness" with facts that "come closer to demonstrating intent, as opposed to mere motive and opportunity."²⁶ And the *Metzler* Court further suggested that the *Tellabs* holistic review requires a coherent theory of wrongdoing, not a shotgun pleading of unrelated improprieties, as it noted that plaintiffs did not "tie" a secondary theory of fraudulent conduct "to [their] more general theory."²⁷

Moreover, *Metzler* used the holistic approach to dispose of what it deemed plaintiffs' most persuasive allegation of scienter—an executive's purported statement that Corinthian's conduct was "in the gray area."²⁸ The Court explained that while "a defendant cannot gain dismissal by de-contextualizing every statement in a complaint that goes to scienter, a plaintiff cannot avoid dismissal by reliance on an isolated statement that stands in contrast to a host of other insufficient allegations." The Court concluded that this isolated statement was "not so indicative of fraudulent intent that it carries the weight of the entire 181-page complaint for purposes of establishing a 'strong inference' of scienter."²⁹ Thus, the Court suggested that *Tellabs*' requirement of holistic review prohibited "de-contextualizing," but was not likely to revive otherwise inadequate allegations.

South Ferry LP, No. 2 v. Killinger

In *South Ferry LP, No. 2 v. Killinger*, the Ninth Circuit appeared to second-guess *Metzler's* conclusion that *Tellabs* had little impact. The Court conjectured that in light of *Tellabs*, "perhaps" certain of its earlier leading decisions (*Silicon Graphics*, *Vantive*, and *Read-Rite*) were "too demanding and focused too narrowly in dismissing vague, ambiguous, or general allegations outright."³⁰ While it stopped short of concluding that *Tellabs* overruled those earlier decisions, it held that motions to dismiss under the PSLRA require courts "to consider the totality of circumstances, rather than to develop separately rules of thumb for each type of scienter allegation."³¹ Thus, the Court concluded that "[v]ague or ambiguous allegations are now properly considered as part of a holistic review when considering whether the complaint raises a strong inference of scienter."³²

On the specific question of whether pleading that alleged misstatements concerned "core operations" can give rise to a strong inference of scienter (a question answered in the negative before *Tellabs* in *Read-Rite*), the Court found that such allegations "may be relevant and help to satisfy the PSLRA scienter requirement in three circumstances."³³ First, they may be "used in any form along with other allegations" that combine to create a strong inference of scienter.³⁴ Second, "such allegations may independently satisfy the PSLRA where they are particular and suggest that defendants had actual access to the disputed information."³⁵ Third, in "rare circumstances," the "core operations" allegations alone may satisfy the PSLRA "where the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter."³⁶ Because the district court had ruled before *Tellabs* was decided, the Ninth Circuit remanded the case for further consideration in light of the new standard.³⁷

Zucco Partners, LLC v. Digimarc Corp.

In contrast to *South Ferry's* questioning of the Ninth Circuit's pre-*Tellabs* holdings, *Zucco* held that "*Tellabs* does not materially alter the particularity requirements for scienter claims established in [the Ninth Circuit's] previous decisions, but instead only adds an additional holistic component to those requirements."³⁸ In a tip of the hat to *South Ferry's* concerns, *Zucco* formalized a method for ensuring that holistic review would occur—even though, since long before *Tellabs*, the Circuit had held that "courts should consider the allegations in their entirety."³⁹

Zucco set forth a two-step inquiry that first considers scienter allegations categorically, and then considers them as a whole. Following *Tellabs*, the Court stated, it will first "determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter."⁴⁰ Second, "if no individual allegations are sufficient, we will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness."⁴¹

The Court also shed light on how evaluating individual scienter allegations—i.e., a "segmented" approach—still remains vital, and indicated the limited role of *Tellabs's* tiebreaker in favor of plaintiffs. Claiming Digimarc's financial statements had been falsified, the *Zucco* plaintiffs attempted to establish scienter with several familiar categories of allegations, including (1) confidential witness statements, (2) a subsequent earnings restatement, (3) resignations of several corporate officials, and (4) individual defendants' stock sales.⁴² The Court's analysis of these allegations was virtually indistinguishable from pre-*Tellabs* law.

As to the argument that the confidential witness statements showed that Digimarc's management knew it was violating GAAP, the Court found that "[s]ome of the confidential witnesses were simply not positioned to know the information alleged, [and] many report only unreliable hearsay."⁴³ In discounting the hearsay allegations, the Court acknowledged *Tellabs's* rejection of a standard that would "transpose to the pleading stage the test that is used at the summary

judgment and judgment-as-a-matter-of-law stages."⁴⁴ The Court reasoned, however, that while hearsay statements could not categorically be precluded from supporting scienter, hearsay might often indicate that a confidential witness's account is "not sufficiently reliable, plausible, or coherent to warrant further consideration."⁴⁵

The Court also rejected confidential witness statements that merely illustrated internal disagreement within Digimarc concerning accounting practices, reaffirming *Silicon Graphics'* holding that scienter under the PSLRA required deliberate recklessness.⁴⁶ Finally, the Court disposed of a witness's claim that a Digimarc executive ordered an accountant "not to write down obsolete inventory because . . . [doing so] would result in the Company's missing market expectations."⁴⁷ Although this statement in isolation might have been enough to demonstrate scienter, the Court echoed *Metzler's* conclusion that, under *Tellabs*, a plaintiff "cannot avoid dismissal by reliance on an isolated statement that stands in contrast to a host of other insufficient allegations."⁴⁸ Thus, a *Tellabs*-style holistic review actually cut against plaintiff.

Zucco also rejected plaintiffs' argument that scienter was supported by the resignation of several members of Digimarc's financial department. The Court ruled that "[a]lthough resignations, terminations, and other allegations of corporate reshuffling may in some circumstances be indicative of scienter," they only are in certain circumstances.⁴⁹ Again indicating that holistic review can hurt plaintiffs, the Court reasoned that "[w]here a resignation occurs slightly before or after the defendant corporation issues a restatement, a plaintiff must plead facts refuting the reasonable assumption that the resignation occurred as a result of a restatement's issuance itself in order for the resignation to be strongly indicative of scienter."⁵⁰ Put in *Tellabs'* parlance, the timing of a resignation may raise a competing, nonculpable inference that the resignation was due to poor performance, rather than fraud, and plaintiffs must plead facts to rebut that inference.

Moreover, while acknowledging *Tellabs'* observation that "personal financial gain may weigh heavily in favor of a scienter inference,"⁵¹ the Court in *Zucco* found "no indication that *Tellabs* has altered [the Circuit's] pleading standard,"⁵² which had long required allegations of inappropriate insider sales to be supported by facts concerning the amount and percentage of shares sold by insiders, the timing of the sales, and whether the sales were consistent with the insider's prior trading history.⁵³ Because the *Zucco* plaintiffs provided no allegation that insiders' sales were inconsistent with their usual trading patterns, "no inference of scienter [could] be gleaned" from the stock sale allegations.⁵⁴

After completing this review of the allegations by category, the Ninth Circuit considered them collectively. It acknowledged statements in *South Ferry* that (1) "*Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement"; and (2) even "[v]ague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter."⁵⁵ Nonetheless, the Court held in *Zucco* that "even if a set of allegations may create an inference of scienter greater than the sum of its parts, it must still be at least as compelling as an alternative innocent explanation."⁵⁶

With this rule in mind, the Court expended only a single paragraph on its holistic review of the scienter allegations. It found that even collectively, the allegations were "not as cogent or compelling as a plausible alternative inference—namely, that although Digimarc had difficulty controlling and updating its accounting and inventory tracking practices, there was no specific intent to fabricate the accounting misstatements at issue."⁵⁷ The brevity of this holistic review suggests that while it is important, the bulk of courts' analysis should remain on evaluating individual scienter allegations.

Looking Forward

Zucco demonstrates that *Tellabs* did not materially alter the Ninth Circuit's methodology for evaluating whether a complaint pleads facts that give rise to a strong inference of scienter. *Zucco* moved past *South Ferry*'s angst and reiterated *Metzler*'s holding that the Ninth Circuit's pre-*Tellabs* scienter decisions remain viable and controlling precedent. The Ninth Circuit's pre-*Tellabs* scrutiny of individual scienter allegations remains intact, and that authority already included the "holistic" or "collective" review mandated by *Tellabs*.⁵⁸ Moreover, both *Zucco* and *Metzler* demonstrate that, if anything, holistic review can in many instances be more helpful to defendants than plaintiffs, as it precludes plaintiffs from claiming that an otherwise inadequate complaint is saved by a single scienter allegation. True, *Zucco* acknowledged that *Tellabs* compelled the theoretical possibility that vague allegations could, strung together, become more than the sum of their parts. But *Zucco*'s brief discussion of this possibility suggests that it may be more hypothetical than real.

Finally, neither *Zucco* nor *Metzler* placed much weight on *Tellabs*' tie-breaker in favor of plaintiffs. And this makes sense. In the vast majority of cases, the detailed scrutiny of scienter allegations that the Ninth Circuit's decisions require both before and now after *Tellabs* should enable courts to reach a conclusion about whether culpable or non-culpable conduct occurred, thus avoiding the need to break ties. That was exactly what occurred in *Zucco*, as the Court reached such a firm conclusion about the inadequacy of the complaint that it did not even need to address the tie-breaker. Indeed, only in rare cases should a court be left so torn that the tie-breaker will decide the outcome.

Litigants within the Ninth Circuit can therefore expect that in the vast majority of cases, *Tellabs* should not alter the outcome.

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¹ *Tellabs, Inc. v. Makor Issues & Rights, Inc.*, 551 U.S. 308, 127 S. Ct. 2499 (2007).

² *Id.* at 2504.

³ *Id.* at 2510.

⁴ 540 F.3d 1049 (9th Cir. 2008).

⁵ 542 F.3d 776 (9th Cir. 2008).

⁶ 552 F.3d 981 (9th Cir. 2009).

⁷ *South Ferry*, 542 F.3d at 784.

⁸ *Zucco*, 552 F.3d at 987.

⁹ *Id.*

¹⁰ *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 977-79 (9th Cir. 1999).

¹¹ *Id.* at 985.

¹² 283 F.3d 1079, 1087-88 (9th Cir. 2002).

¹³ *Id.* at 1092-96 (quoting *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)).

¹⁴ *Id.* at 1093.

¹⁵ 298 F.3d 893, 897 (9th Cir. 2002).

¹⁶ *Id.*

¹⁷ 335 F.3d 843 (9th Cir. 2003).

¹⁸ *Id.* at 848-49.

¹⁹ *Tellabs*, 127 S. Ct. at 2504-05 (emphasis added).

²⁰ *Id.* at 2509 (citing *Gompper*, 298 F.3d at 897).

²¹ *Id.* at 2510.

²² *Metzler*, 540 F.3d at 1061 (citing *Gompper*, 298 F.3d at 897, and *Tellabs*, 127 S. Ct. at 2509).

- ²³ *Id.* at 1069.
- ²⁴ *Id.* at 1066-67 (citing *Silicon Graphics*, 183 F.3d at 986).
- ²⁵ *Id.* at 1067.
- ²⁶ *Id.* at 1069 (quoting *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 389 (9th Cir. 2002), in turn quoting *Silicon Graphics*, 183 F.3d at 974). *Tellabs* expressly declined to address whether plaintiffs could plead scienter merely by demonstrating recklessness. 127 S. Ct. at 2507 n.3.
- ²⁷ *Id.*
- ²⁸ *Id.* at 1069.
- ²⁹ *Id.*
- ³⁰ *South Ferry*, 542 F.3d at 784.
- ³¹ *Id.*
- ³² *Id.*
- ³³ *Id.* at 785.
- ³⁴ *Id.* at 785-86.
- ³⁵ *Id.* at 786.
- ³⁶ *Id.*
- ³⁷ *Id.*
- ³⁸ *Zucco*, 552 F.3d at 987.
- ³⁹ *Gompper*, 298 F.3d at 897; see also, e.g., *Vantive*, 283 F.3d at 1093 (insufficient allegations of fraud elsewhere in the complaint have a "spillover effect" on subsequent allegations); *Silicon Graphics*, 183 F.3d at 985 (emphasizing that it would consider the complaint "in its entirety").
- ⁴⁰ *Zucco*, 552 F.3d at 992.
- ⁴¹ *Id.*
- ⁴² *Id.*
- ⁴³ *Id.* at 996.
- ⁴⁴ *Id.* at 997-98 & n.4 (quoting *Tellabs*, 127 S. Ct. at 2510 n.5).
- ⁴⁵ *Zucco*, 552 F.3d at 997-98 & n.4.
- ⁴⁶ See *id.* at 998.
- ⁴⁷ *Id.* at 999.
- ⁴⁸ *Id.* (quoting *Metzler*, 540 F.3d at 1069).
- ⁴⁹ *Id.* at 1002.
- ⁵⁰ *Id.* (citation omitted).
- ⁵¹ *Id.* at 1004 (quoting *Tellabs*, 127 S. Ct. at 2511).
- ⁵² *Id.* at 1005-06 (citing *Metzler*, 540 F.3d at 1066-67).
- ⁵³ See *Silicon Graphics*, 183 F.3d at 986.
- ⁵⁴ *Zucco*, 552 F.3d at 1006.
- ⁵⁵ *Id.* at 1006 (quoting *South Ferry*, 542 F.3d at 784) (alteration in original).
- ⁵⁶ *Id.*
- ⁵⁷ *Id.* at 1007.
- ⁵⁸ See *Gompper*, 298 F.3d at 897; *Vantive*, 283 F.3d at 1093; *Silicon Graphics*, 183 F.3d at 985.