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FALSE CLAIMS ACT OPINION MAY BE RELEVANT TO SECURITIES LITIGATION

To Our Clients and Friends:

In *United States of America v. Science Applications International Corporation*, No. 09-5385, 2010 U.S. App. LEXIS 24808 (D.C. Cir. Dec. 3, 2010), a panel of the United States Court of Appeals for the D.C. Circuit reversed a $6.49 million jury verdict in favor of the government for a violation of the False Claims Act ("FCA"), 31 U.S.C. § 3729. (See Gibson Dunn's December 6, 2010 article: "D.C. Circuit Rejects the Government's Sweeping 'Collective Knowledge' and Damages Theories under the False Claims Act.") The court vacated the judgment and remanded the case for a new trial because the district court gave a "collective knowledge" instruction that the appellate court held conflicted with the strict FCA scienter standard. Plaintiffs in civil securities class action litigation likewise face a stringent scienter hurdle under the Private Securities Litigation Reform Act ("PSLRA"), and the D.C. Circuit's discussion of the "collective knowledge" theory should lend support to defendants seeking to dismiss securities class actions under the PSLRA's "strong inference" pleading standards.

The defendant government contractor was hired to provide technical assistance and expert analysis to support potential rulemaking for uniform national standards on the recycling and release of radioactive materials. The contracts contained provisions designed to identify and prevent potential conflicts of interest, and required the contractor to warrant that to the best of its knowledge and belief it did not have any organizational conflicts of interest. After a member of the public charged that the contractor was involved in other projects with companies in the area of nuclear recycling, the contractor disclosed contracts with two companies and the government determined that the contractor had placed itself in potentially conflicting roles.

The government brought suit against the contractor under the FCA for knowingly submitting false or fraudulent claims when it certified that it did not have any relationships constituting an organizational conflict of interest. After a four- week trial, and over the objection of the contractor, the jury was instructed that corporations can be held liable "for the collective knowledge of all employees and agents within the corporation so long as those individuals obtained their knowledge acting on behalf of the corporation." The jury was further instructed that it "must consider the knowledge possessed by those employees and agents as if it was added together and combined into one collective pool of information." If that collective pool of information gave a "reasonably complete picture" of false claims or statements, the jury was told that it could find that the contractor itself "possessed a reasonably complete picture of the false or fraudulent claims or false statements and acted knowingly." The jury was also instructed that the corporation "acted knowingly" if the jury determined that at least one corporate employee had actual knowledge of an organizational conflict and acted in "deliberate ignorance or in reckless disregard of such information," even if that particular employee had not submitted the certifications or claims to the government.

On appeal, the contractor argued that this "collective knowledge" instruction allowed the government to prove FCA liability without having to prove that any particular employees acted knowing the claims

were false or acted in deliberate ignorance or reckless disregard of their truth or falsity. The D.C. Circuit agreed, and held that the instruction was not consistent with the FCA's scienter requirement.

The court noted that in "non-FCA cases" it had "expressed a good deal of skepticism about corporate intent theories that rely on aggregating the states of mind of multiple defendants." The court noted that in enacting the FCA, Congress established a scienter requirement that required either actual knowledge of the falsity of their claims or reckless disregard of the truth or falsity, which would include when a defendant deliberately avoided learning the truth or engaged in aggravated gross negligence. The "collective knowledge" theory, however, would allow a plaintiff "to prove scienter by piecing together scraps of 'innocent' knowledge held by various corporate officials, even if those officials never had contact with each other or knew what others were doing in connection with a claim seeking government funds." (Quoting *United States ex rel. Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 918 n.9 (4th Cir. 2003)). Although Congress defined "knowingly" to include some forms of constructive knowledge, the definition only imposes liability "when the defendant deliberately avoided learning the truth or engaged in aggravated gross negligence."

Civil liability under Section 10(b) of the Securities Exchange Act of 1934 also requires plaintiffs to establish that the allegedly false or misleading statements were made with scienter, defined as a mental state equivalent to an intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Moreover, under the PSLRA, plaintiffs must plead with particularity a "strong inference" of scienter to defeat a motion to dismiss. Even the least rigorous showing of scienter, "deliberate recklessness," involves "not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Zucco Partners, LLC v. Digimarc Corp*, 552 F. 3d 981, 991 (9th Cir. 2009) (quoting *In re Silicon Graphics Sec. Litig.*, 183 F. 3d 970, 976 (9th Cir. 1999).

Courts in the securities litigation sphere have also wrestled with theories akin to the FCA's "collective knowledge" theory. See *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008) (scienter not plead against alleged mastermind of fraudulent scheme who signed false certifications but played no role in preparing or disseminating corporation's financial statements); (*Winer Family Trust v. Queen*, 503 F. 3d 319 (3rd Cir. 2007) (group pleading doctrine held inconsistent with the PSLRA); *Mizzaro v. Home Depot, Inc*., 544 F.3d 1230 (11th Cir. 2008) (rejecting collective scienter theory against a corporate defendant and requiring allegation that the actual speaker of the false statement acted with scienter). The Ninth Circuit has recognized a "core-operations inference" that would impute knowledge of "facts critical to a business's 'core operations'" to high-ranking officers, but only if there are detailed allegations about the defendants' actual exposure to information relevant to the claimed fraud. *South Ferry L.P. v. Killinger*, 542 F.3d 776 (9th Cir. 2008).

In a private securities class action, a "collective knowledge" theory, if adopted, would penalize the corporate enterprise for the alleged wrongdoing of wayward employees acting without the knowledge or approval of management, with the costs of the litigation ultimately being borne by the company's current shareholders. When combined with the PSLRA's heightened pleading standards, the Supreme Court's holding in *Stoneridge* that there is no implied liability against aiders and abettors, and the Court's concerns about expanding the jurisdiction of the federal courts by judicial interpretation

(*Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008)), the D.C. Circuit's rejection in a FCA case of the "collective knowledge" theory of scienter may prove instructive to courts evaluating similar theories in securities litigation.

Theodore B. Olson, Matthew D. McGill, Amir C. Tayrani, Ryan J. Watson, and Joshua B. Carpenter of Gibson Dunn briefed the case and Ted Olson argued the case in the D.C. Circuit in September 2010.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you work, the author of this alert, Timothy K. Roake (650-849-5382, troake@gibsondunn.com) or any of the following lawyers:

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