Ninth Circuit Raises the Bar for Pleading Scienter

On November 26, 2008, the U.S. Court of Appeals for the Ninth Circuit issued its decision in *Glazer Capital Management v. Magistri*.[1] The decision addresses several important aspects of pleading scienter in securities fraud actions, including the so-called "collective scienter" doctrine.

I. Background and Procedural History

InVision Technologies Inc. ("InVision") was a publicly traded company that manufactured and sold explosives detection systems used to screen luggage at airports. In March 2004, it announced its anticipated merger with General Electric ("GE") and appended the corresponding merger agreement to its annual report filed with the U.S. Securities and Exchange Commission ("SEC"). That agreement, which was signed by InVision CEO Sergio Magistri ("Magistri"), included warranties and representations including, among others, that InVision was in compliance with all laws ("general warranty") and, specifically, in compliance with the books and records and anti-bribery provisions of Sections 13(b) and 30A of the Securities Exchange Act of 1934, respectively.[2]

Those statements turned out to be untrue. In July 2004, InVision issued a press release stating that an investigation conducted by GE in connection with the merger had revealed possible violations of the Foreign Corrupt Practices Act ("FCPA") in connection with the sale of InVision's products in Asia.[3] Though InVision resolved the claims with the government and ultimately consummated the merger with GE,[4] its share price declined after the July 2004 press release and shareholders filed a securities fraud class action, naming as defendants InVision, Magistri and its Chief Financial Officer, Ross Mulholland ("Mulholland"). The complaint alleged that the Defendants knew or were reckless in not knowing that the warranties and representations described above were false when made, in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

After InVision announced its government settlements, Plaintiffs amended their complaint to include facts disclosed in those settlements. The district court granted Defendants' motion to dismiss that complaint but granted Plaintiffs leave to replead. Plaintiffs then filed a Second Amended Complaint. Defendants moved to dismiss the Second Amended Complaint for failure to state a claim, and the district court granted that motion, holding that the complaint failed adequately to plead both the falsity of the alleged statements and that the Defendants acted with scienter. Plaintiffs appealed that decision and the Court of Appeals affirmed the dismissal.

II. The Court of Appeals' Decision

Before addressing the district court's decision, the Court of Appeals first rejected Defendants' threshold argument that the alleged misrepresentations were inactionable as a matter of law because, as Defendants argued, the statements "could not reasonably have been interpreted as factual communications *to investors*."[5] The Court

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1 *See* No. 04 Civ. 2181, 2008 WL 5003306 (9th Cir. Nov. 26, 2008).

2 *See Magistri*, 2008 WL 5003306 at *1, 3. Specifically, the merger agreement represented that "[n]either the Company . . . nor, to the Knowledge of the Company, any director, officer, agent, employee or other Person acting on behalf of the Company" has violated the anti-bribery provisions of the Exchange Act. *See id.* at *3.

3 *See id.* at *1. The press release noted that, while InVision had voluntarily reported the possible violations, further investigation could delay the anticipated merger. *See id.*

4 In December 2004, InVision entered into a non-prosecution agreement with the Department of Justice and agreed to pay an $800,000 fine. In February 2005, settled matters with the SEC. *See id.* at *2.

5 *See id.* at *3 (emphasis in original). According to Defendants, the warranty and representations alleged to be misleading unambiguously were addressed solely to GE because the merger agreement included language limiting the rights it conferred to the agreement's parties and was expressly conditioned upon a disclosure schedule that was never released

disagreed, holding that, given the gravity of the transaction, it was not unreasonable that investors would look to and rely upon statements in the merger agreement, notwithstanding the fact that it was a private document.

Turning to the decision below, the Court of Appeals largely declined to address the district court's falsity holding, given its ultimate agreement that Plaintiffs failed to plead scienter. Nevertheless, the Court reversed the district court in one particular respect. The district court had interpreted the general warranty narrowly, in light of other language in the merger agreement, to warrant only violations of law *known* to InVision at the time the warranty was made. The Court criticized that approach as "conflat[ing] the issue of scienter with the issue of falsity."[6] Instead, it opted for a broader, "plain language" interpretation and held that the Plaintiffs had adequately pleaded falsity by stating that Defendants were in violation of *some* law when the warranty was made.[7]

With regard to Plaintiffs' allegations of scienter, however, the Court of Appeals agreed with the district court that the facts plead in the SAC did not raise the requisite "strong inference" that the Defendants knew or were reckless in not knowing that their statements were false when made.[8]

Plaintiffs first argued that they could raise a "strong inference" of scienter as to InVision without pleading scienter as to any particular corporate official. As the Court noted, a securities fraud plaintiff generally will plead corporate scienter by alleging the scienter of an individual whose actions are attributable to the corporation.[9] Under the "collective scienter" doctrine, however, some courts have held that, under certain circumstances, a "strong inference" of corporate scienter may arise absent allegations specific to any particular corporate employee.[10] For instance, as Judge Richard Posner recently explained for the U.S. Court of Appeals for the Seventh Circuit, employee-specific allegations would be unnecessary if an alleged misstatement was "so dramatic" that the fact of the statement alone supported the inference that some corporate official knew it was false.[11] Noting this hypothetical, the Ninth Circuit concluded that the warranty and representations at issue in the merger agreement were not "so dramatic" as to justify application of the "corporate scienter" doctrine.[12]

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to the public. *See id.*

6 *See id.* at *4.

7 *See id.* For example, "Glazer has pleaded facts demonstrating that InVision was not in compliance with Section 13(b) of the Exchange Act at the time the warranties were made . . . ." *Id.*

8 *See* Private Securities Litigation Reform Act ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995) (codified in part at 15 U.S.C. § 78u-4) ("In any private action arising under this chapter . . . 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."); *see also Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007).

9 *See generally* Robert Malionek & Joseph Salama, *'Collective Scienter': Nixed by Second Circuit in 'Dynex'?*, N.Y.L.J., Aug. 22, 2008, at 4.

10 *See, e.g.*, *Teamsters Local 445 Freight Division Pension Fund* v. *Dynex Capital, Inc.*, 531 F.3d 190, 195 (2d Cir. 2008); *Makor Issues & Rights, Ltd.* v. *Tellabs Inc.* ("*Tellabs II*"), 513 F.3d 702, 710 (7th Cir. 2008) (Posner, J.); *see also City of Monroe Employees Retirement Sys.* v. *Bridgestone Corp.*, 387 F.3d 468, 690 (6th Cir. 2004).

11 *See Tellabs II*, 513 F.3d at 710. Under those circumstances, though the complaint identifies no particular corporate employee alleged to possess scienter, the complaint would nevertheless give rise to a strong inference that some corporate employee knew or was reckless in not knowing the statement's falsity. *See, e.g.*, *Dynex Capital, Inc.*, 531 F.3d at 195.

12 Indeed, the statements were so mundane that the Court of Appeals noted how,"[i]f the doctrine of collective scienter excuses Glazer from pleading individual scienter with respect to these legal warranties, then it is difficult to imagine what statements would *not* qualify for an exception to individualized scienter pleadings." *Magistri*, 2008 WL 5003306 at *6 (emphasis in original).

Nevertheless, it expressly declined to reach the question whether some future fact scenario could warrant application of the "corporate scienter" doctrine.[13]

Plaintiffs argued that five facts alleged in the SAC demonstrated that the individual Defendants knew or were reckless in not knowing that the warranty and representations were false when made. Assessing those factual allegations individually and in the aggregate, the Court of Appeals disagreed. First, Plaintiffs advanced a "core operations" theory, arguing that Magistri and Mulholland must have known about the Asian transactions because they were central to InVision's business. To the contrary, the Court of Appeals held that the underlying transactions were not so crucial to InVision's business that it would be "'hard to believe'" or "'absurd to suggest'" that Magistri and Mulholland were not aware of them.[14] Second, Plaintiffs argued that Sarbanes-Oxley certifications executed by Magistri and Mulholland demonstrated that they knew of the illegal Asian transactions.[15] Joining other Courts of Appeal, the Ninth Circuit held that a Sarbanes-Oxley certification could not show a defendant's scienter unless "'the person signing the certification was severely reckless in certifying the accuracy of the financial statements.'"[16] Because there were no such allegations regarding Magistri or Mulholland, their Sarbanes-Oxley certifications could not support an inference of scienter. The balance of Plaintiffs scienter arguments were similarly unavailing. The fact that GE discovered the potential FCPA violations early in its due diligence process "[a]t most . . . creates the inference that [Magistri and Mulholland] *should* have known of the violations," which was "not sufficient to meet the stringent scienter pleading requirements of the PSLRA."[17] Nor did the fact that Magistri stood to gain personally from the merger demonstrate his scienter because, as the Court of Appeals held for the first time, "evidence of personal profit motive on the part of officers and directors contemplating a merger is insufficient to raise a strong inference of scienter."[18] Finally, InVision's settlement agreements with the government, in which it admitted wrongdoing, could not satisfy Plaintiffs' pleading burden because the information in those settlement agreements was not sufficiently specific and illustrated scienter only as to some InVision employee, not Magistri in particular.[19]

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13 *See id.* ("[Prior Seventh Circuit decisions do] not foreclose the possibility that, in certain circumstances, some form of collective scienter pleading might be appropriate. For instance, as outlined in the hypothetical posed in [*Tellabs II*], there could be circumstances in which a company's public statements were so important and so dramatically false that they would create a strong inference that at least some corporate officials knew of the falsity upon publication.")

14 *Id.* at *8 (quoting *Berson* v. *Applied Signal Tech., Inc.*, 527 F.3d 982 (9th Cir. 2008)).

15 In relevant part, the certifications stated that: "The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures . . . and have: (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant . . . is made known to us . . .; (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures . . . . "

Id.

16 *Id.* at *9 (quoting *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006)).

17 *Id.* (emphasis in original).

18 *Id.* at *10.

19 *See id.*

III. Significance of the Decision

In the wake of *Magistri*, commentators have focused on the Court's discussion of the "collective scienter" doctrine.[20] The impact of that discussion and holding, however, are more limited than the attention may suggest. While it declined to apply the "collective scienter" pleading doctrine, the Court explicitly left open that possibility for the future. Nor did its decision indicate that it would require any more "highly unusual" facts than were already found permissible in other circuits.[21] Time will tell whether *Magistri* truly alters play in the Ninth Circuit in respect of the "collective scienter" doctrine.

Other aspects of the Court's decision, however, may be of significant benefit to defendants testing the sufficiency of a plaintiff's allegations of scienter in the Ninth Circuit. The decision greatly reduces the value of allegations of personal profit and Sarbanes-Oxley certifications as bases for inferring a defendant's scienter. Moreover, the decision adopts strong, albeit vague language regarding the circumstances under which a defendant will be charged with knowledge of a business' "core operations." These aspects of *Magistri* will yield practical benefits to defendants in the Ninth Circuit.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Philip Tisne at 212.701.3997 or ptisne@cahill.com.

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20 *See, e.g.*, Kevin LaCroix, *Ninth Circuit Rejects Securities Case Based on FCPA Disclosures*, The D&O Diary, Dec. 1, 2008, http://www.dandodiary.com; N. Peter Rasmussen, *9th Circuit Rejects Collective Scienter*, Jim Hamilton's World of Securities Regulation, Dec. 1, 2008, http://jimhamiltonblog.blogspot.com; *Pleading Scienter In The Ninth Circuit: The Collective Pleading Doctrine, SOX Certifications, and DOJ/SEC Settlement Documents*, SEC Actions, Dec. 1, 2008, http://www.secactions.com; *PSLRA Class Action Defense Cases -- Glazer Capital v. Magistri: Ninth Circuit Affirms Dismissal Of Class Action Holding Securities Class Action Complaint Failed To Plead Scienter Under PSLRA*, Class Action Defense Blog, Dec. 3, 2008, http://classactiondefense.jmbm.com.

21 *See* Rasmussen, *supra* note 22 ("The 9th Circuit did not quite rule out any situation in which there could be a finding of corporate scienter absent actionable individual intent, but it certainly indicated that this would require highly unusual circumstances . . .").