***Shaw Group*: Fifth Circuit Defines "Strong Inferences" for Pleading Scienter Under the PSLRA**

On July 29, 2008, the Fifth Circuit dismissed plaintiff's securities fraud class action suit filed against defendants, Shaw Group Inc., and four individuals, reversing on interlocutory appeal the District Court for the Eastern District of Louisiana.[1] Interpreting the heightened pleading standards required for securities fraud actions by the Private Securities Litigation Reform Act ("PSLRA") and for fraud claims in general by Rule 9(b) of the Federal Rules of Civil Procedure, the Court of Appeals found that plaintiffs did not plead scienter with sufficient particularity as to connect the individuals charged with the alleged fraud and thus did not fulfill the requirement that the inference of scienter be "cogent and compelling."

I. Background

Shaw Group Inc. ("Shaw") provides engineering, design and construction services to the energy, chemical and environmental industries as well as federal, state and local governments. On June 10, 2004, Shaw issued a press release announcing that the Securities and Exchange Commission ("SEC") was conducting a formal inquiry of the company relating to Shaw's use of the purchase method of accounting for acquisitions. When the stock price fell on this notice, several class action suits were filed. Union pension funds became the lead plaintiffs in this consolidated class action against Shaw and four key individuals, the Chief Executive Officer, Chief Financial Officer, Chief Operating Officer and former Chief Operating Officer.

The complaint alleged violations of Securities Exchange Act of 1934 Section 10(b) and Rule 10b-5 thereunder and Exchange Act Section 20(a) (control person liability) charging that the defendants:

- artificially inflated earnings by manipulating the purchase method of accounting in connection with two acquisitions;
- prematurely recognized revenue on long-term contracts by exploiting the percentage of completion method of accounting in violation of generally accepted accounting principles ("GAAP");
- failed to disclose material issues affecting the viability of a major construction project;
- overstated the Company's backlog of contracts, giving the false impression of high demand; and
- delayed or suspended paying vendors as a ploy to improve the Company's reported cash flow.

Plaintiffs alleged that the true nature of Shaw's financial condition leaked to the market in a series of disclosures beginning in August 2002 with an announcement that a customer had failed to make a significant milestone payment, followed by negative disclosures about the Company's earnings and operational performance.

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[1] *Indiana Elec. Workers' Pension Trust Fund IBEW, et al. v. Shaw Group Inc.*, et al. No. 06-30908, 2008 WL 2894793 (5th Cir. July 29, 2008) ("*Shaw*).

The district court, without opinion, denied Shaw's motion to dismiss for failure to satisfy Federal Rule of Civil Procedure 12(b)(6) in light of the PSLRA's heightened securities fraud pleading requirements. Shaw appealed, challenging the sufficiency of plaintiffs' pleading of falsity, scienter and loss causation and the Court of Appeals granted an interlocutory appeal.

In an opinion by Chief Judge Edith H. Jones, the Fifth Circuit explained that the PSLRA set higher standards of pleading to curb "'frivolous, lawyer-driven litigation . . . .'"[2] The court noted that the elements of a fraud claim have remained the same: a material misrepresentation or omission; scienter; reliance; damages and loss causation. However, the PSLRA enhanced the particularity requirements for pleading fraud under Federal Rule of Civil Procedure 9(b) in two ways. First, plaintiffs must "specify each statement alleged to have been misleading, [and] the reasons why the statement is misleading . . . ."[3] Further, for "each act or omission alleged" to be false or misleading, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[4]

The court did not examine the sufficiency of the allegations of falsity and loss causation because it found that the complaint insufficiently alleged that the defendants acted with scienter. The court stated it would analyze the five alleged acts of fraud pursuant to *Tellabs* three step approach to reviewing scienter allegations on a motion to dismiss a federal securities fraud case pursuant to the PLSRA.[5] The court noted that *Tellabs*:

- requires that the allegations must be taken as true;
- permits a court to consider documents incorporated in the complaint by reference and matters subject to judicial notice noting that a court must evaluate the facts collectively, not in isolation, to determine whether a strong inference of scienter has been pled;[6] and
- requires a court to take into account plausible inferences opposing a strong inference of scienter.

Ultimately, the inference of scienter must be "cogent and compelling," not merely "reasonable" or "permissible."

II. Scienter Is "Intent to Deceive" or "Severe Recklessness"

The court then reviewed the basis for scienter allegations, stating the required state of mind is an "intent to deceive, manipulate, or defraud" or "severe recklessness."[7] Severe recklessness is "not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care . . . that present[s] a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."[8] Furthermore, allegations of motive and opportunity alone will not suffice but may

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2 Citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2509 (2007).

3 15 U.S.C. § 78u-4(b)(1)(B).

4 15 U.S.C. § 78u-4(b)(2).

5 *Tellabs*, 127 S. Ct. at 2509-10.

6 The Court took judicial notice of the fact that the SEC terminated its inquiry against Shaw in December 2007 with no enforcement recommendation.

7 Citing *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 866 (5th Cir. 2003).

8 *Id.*

"(meaningfully enhance the strength of the inference of scienter)."[9] Finally, the court noted it had previously rejected the group pleading approach to scienter and instead looked to the state of mind of the individual corporate official(s) "who make or furnish the statement . . . rather than generally to the collective knowledge of all the corporation's officer and employees . . . ."[10] Consequently, "it is only necessary for us to address the allegations claimed to adequately show [scienter] on the part of the [named officer]" to determine whether the complaint sufficiently pleads scienter."[11] The court then proceeded to examine the scienter allegations.

III. Mere Failure to Follow GAAP Does Not Establish Scienter

The court first analyzed the two allegations of accounting irregularities, both relating to Shaw's alleged abuse of or failure to follow GAAP. The court noted it had previously held that "(mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter)."[12] Regarding the acquisition accounting, plaintiffs had alleged that Shaw had established artificially inflated reserves for pending contracts of the acquired companies that were used as "cookie jar" reserves to inflate its reported earnings and also alleged accounting irregularities and lack of required disclosures.

The court held that circumstantial allegations asserting that the officers must have known about the alleged fraud, because of their positions in the company and their highly involved management style, lacked sufficient specificity to support a strong inference of scienter. The court further stated that the fact that the allegations derived from confidential sources further detracted from their weight in the scienter analysis. The court rejected plaintiffs' assertion that the officers must have known of the accounting irregularities because they were so massive in light of the fact that there was never any acknowledged wrongdoing or restated financial reports by the company nor any SEC enforcement action. Finally, the court noted that plaintiffs had failed to even attempt to estimate how much earnings were inflated as a result of the "cookie jar" reserves and therefore held that plaintiffs could not "transform inherently nuanced conclusions into fraudulent misstatements or omissions simply by saying there were abuses or misuses of the GAAP rules".[13]

IV. Allegation Based on Anonymous Source That More Conservative Accounting Should be Used Discounted

Turning to the second allegation of premature revenue recognition, plaintiffs asserted that Shaw's management had pressured employees to inflate the percentage of completion of their projects, thus accelerating earnings recognition. Plaintiffs also asserted that Shaw lacked the internal controls necessary to estimate the percentage of completion accurately because its project tracking software did not work. As such, plaintiffs asserted that Shaw should have instead used the preferable, more conservative "completed-contract" method of accounting. The court again discounted use of anonymous sources and noted the fact that the company had never recalculated or repudiated its use of the percentage of completion method. Further, the fact that the company's internal accounting controls did not work did not necessarily lead to overstated revenues as it may just as well have lead to understated revenues. The court concluded that two comments made by the CEO, that the plaintiff

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9 *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 368 (5th Cir. 2004)

10 *Id.* at 366.

11 *Id.* at 367.

12 Citing *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 264 (5th Cir. 2005).

13 *Shaw*, 2008 WL 2894793, at *5.

asserted showed coercion, the first telling other officers "We have got to show more progress" and the second, telling a financial analyst that he "needed to do something to fix that" because Shaw's revenue numbers were too low, were insufficient to support an inference of scienter because the plaintiffs offered no source for the comment nor particularity as to when the comments were made. Additionally, other more likely, nonculpable inferences could be made regarding these comments. The court held that the allegations that the officers knew about the projects tracking software's malfunction were vague and did not supply sufficient sources, times or specific people involved to support an inference of scienter.

V. A Corporation Does Not Commit Securities Fraud by Failing to Disclose All Material Nonpublic Information When Nondisclosure Is Not Shown to be Misleading

The court then discussed plaintiffs' third allegation, that Shaw failed to timely or fully disclose material concerns regarding the viability of a major construction project. In fact, in 2002, Shaw had announced that NRG, the customer in question, would not make their next scheduled payment and Shaw had reached an agreement with NRG to acquire certain NRG assets in exchange for forgiveness of debt owed Shaw and a payment to NRG. The court discounted the plaintiffs' use of a confidential source and held the allegations failed to support a strong inference of scienter since the individual defendants were not specifically connected to the nondisclosures or the timing of the disclosures made. Plaintiffs cited no case law or SEC rules supporting their claim of untimely disclosure and generally "a corporation does not commit securities fraud merely by failing to disclose all nonpublic material information in its possession."[14] Similarly, a claim of incomplete disclosure is actionable only when such disclosure is misleading and here the court found that Shaw's announcement was in no way misleading. The court also found that the plaintiffs had not stated with particularity facts giving rise to a strong inference that any officer knew or was severely reckless in not knowing about the project difficulties long before NRG missed a payment and an officer's status alone does not support such an inference. The court pointed to contradictions between the complaint and the appellate brief with respect to alleged facts and implied that plaintiffs could not seem to get their story straight. The court rejected the final two allegations of inflated backlog and the slow or suspended payment of vendors because the complaint stated no facts with particularity that suggested that the officers knew about or sanctioned these alleged practices.

VI. Motive Is Not Sufficiently Alleged by Asserting That Senior Executives are Compensated Through Stock Plans

The court then turned to the motive and opportunity allegations that the plaintiffs had used to bolster their inferences of scienter. The court stated that senior officers always have the opportunity to commit fraud. However, to demonstrate motive, plaintiffs must show "concrete benefits that could be realized by . . . the false statements and wrongful disclosures . . ."[15] Thus, since officers are commonly partially compensated with stock and option grants, the court would not infer intent merely from trading in securities, noting however, that suspicious amounts of stock sales at suspicious times might be probative of scienter. The court rejected plaintiffs' allegations that two officers' large stock sales that took place in January 2001, near the market peak, were suspicious, noting that one officer had actually had two previous, larger sales of his stock. The court also noted there were other justifiable motives for the stock sales such as the fact that during "lock-up" periods applicable to

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14 *Gross v. Summa Four, Inc.*, 93 F.3d 987, 992 (1st Cir. 1996).

15 *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999).

two officers' stock, Shaw stock had split two-for-one. The lock-up periods had recently expired giving the officers the opportunity to take some profit. Lastly, the court refused to infer intent from the fact that the individual defendants' compensation packages were tied to company performance, finding such compensation commonplace and absent extraordinary circumstances, the mere fact of incentive compensation cannot sustain an allegation of fraud.

The Fifth Circuit's decision in *Shaw Group* follows other recent circuit decisions that require pleading with a high level of particularity and that give little weight to allegations based on confidential or anonymous sources.[16]

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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.

[16] Compare *Higginbotham v. Baxter International Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (interpreting *Tellabs* as instructing the courts to discount confidential sources when evaluating the allegations in their entirety) and *Cornelia I. Crowell GST Trust v. Possis Medical, Inc.*, 519 F.3d 778, 783 (8th Cir. 2008) (requiring a level of particularity before allegations based on confidential sources may be considered), with *Berson and Whiting v. Applied Signal Technology, Inc.*, No. 06-15454, 2008 WL 2278670 (9th Cir. June 5, 2008) (giving considerable weight to allegations based on confidential sources).