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THIRD CIRCUIT INTERPRETS *TELLABS*; MOTIVE AND OPPORTUNITY IS NEITHER NECESSARY NOR SUFFICIENT TO ALLEGE SCIENTER

The Third Circuit Court of Appeals recently addressed the Supreme Court's *Tellabs*[1] decision and held that allegations of motive and opportunity are not sufficient to allege scienter under the Private Securities Litigation Reform Act (PSLRA).

In *Institutional Investors Group, et al.* v. *Avaya, Inc., et al.*,[2] the Third Circuit affirmed in part and reversed in part the decision of the United States District Court for the District of New Jersey granting defendants' motion to dismiss under the PSLRA.[3] In the 91-page opinion, Chief Judge Scirica and Circuit Judges Fisher and Roth provide an instructional analysis of the claims, and discuss why certain aspects of the approaches taken by other Circuit Courts of Appeal, including the Second and Ninth Circuits, may not comport with the *Tellabs* standard.

Background

Avaya Inc. sells communications products and services, including telephone systems. Plaintiffs alleged that during Avaya's 2005 fiscal year, Avaya's Chairman and Chief Executive Officer, defendant Donald Peterson, and its Chief Financial Officer and Senior Vice President of Corporate Development, defendant Garry McGuire, falsely denied that Avaya was facing any unusual price competition and issued groundless financial projections to the markets.

Plaintiffs included in their complaint statements made by Avaya, Peterson, and McGuire in October 2004 and January 2005 relating to financial projections, and statements in March 2005 relating to both financial projections and pricing pressure. With respect to "forecast-related projections," in October 2005 the company projected a fiscal year 2005 operating margin of 8.5% to 9% and revenue growth of 25% to 27%. In January 2005, when Avaya announced first quarter financial and operational results,

[1] *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).
[2] No. 06-4595, slip op. (3rd Cir. April 30, 2008).
[3] *See Charatz* v. *Avaya, Inc.*, No. 05-2319 (MLC), 2006 WL 2806229 (D.N.J. Sept. 28, 2006).

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it indicated that it was "on track to meet our goals for the year." Peterson reiterated the operating margin and revenue growth figures announced in October 2004. And in March 2005, McGuire adjusted upward the annual growth revenue projection to 28%.

According to plaintiffs, defendants revealed the truth to the market on April 19, 2005, when Avaya announced that it would not be able to meet the previously announced financial projections for fiscal year 2005.

Plaintiffs asserted claims under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "'34 Act"), as well as controlling person claims under Section 20(a) of the '34 Act. Under Third Circuit law, to state a claim for securities fraud under Rule 10b-5, plaintiffs must allege defendants made a misstatement or omission of material fact with scienter in connection with the purchase or the sale of a security upon which plaintiffs reasonably relied and plaintiffs' reliance was the proximate cause of their injury.

A plaintiff alleging fraud in connection with the sale of securities must also comply with the PSLRA, which Congress passed in 1995 in an effort to protect defendants from the expense of litigating meritless claims. The PSLRA created several hurdles for plaintiffs, including a heightened pleading standard requiring them to plead facts alleging a "strong inference" that the defendants acted with scienter, or intent to deceive. The PSLRA also provides a "safe harbor" for forward looking statements.[4] Forward-looking statements are immunized from liability so long as the statement is identified as such and accompanied by meaningful cautionary language, or is immaterial, or the plaintiff fails to show the statement was made with actual knowledge of its falsehood.

In 2007, the Supreme Court decided *Tellabs* and set a high bar with respect to the specificity required to allege scienter: factual allegations supporting a strong inference of fraudulent intent, standing alone, may not stave off dismissal—the court also must take into account plausible opposing inferences. Thus, a strong inference of scienter "must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent."

The Court's Decision

The PSLRA Safe Harbor

The district court held that the PSLRA safe harbor protected many of the statements plaintiffs alleged were misleading. Plaintiffs argued on appeal that the district court's conclusions were wrong in three respects. First, plaintiffs argued that statements that Avaya was "on track" and positioned to meet financial projections were not forward-looking. The Third Circuit disagreed, concluding that the "on track" and "position us" statements made in January 2005 contained both forward-looking and non-forward-looking aspects, but the two aspects could not meaningfully be distinguished, and any assertions of current fact were too vague to be actionable.

Plaintiffs next argued that it was inappropriate to apply the safe harbor to the pleadings because jurors could reasonably disagree over the meaningfulness of accompanying cautionary language. Again, the Third Circuit disagreed. The court found that the defendants' cautionary language—which included risks and uncertainties, including price and product competition, uncertainties with respect to its marketing strategy, and that actual financial outcomes and results could differ materially from projections—was "extensive and specific."

[4] *See* 15 U.S.C. § 78u-5(c) (Safe Harbor provision).

Finally, plaintiffs alleged that the defendants had actual knowledge of the false or misleading nature of the forecast-related statements. Plaintiffs conceded, however, that if the complaint's allegations did not give rise to a strong inference that defendants actually knew the forward-looking statements were false, then defendants' statements would come within the safe harbor provision. The court previewed its conclusion that plaintiffs had not, in fact, sufficiently pleaded a strong inference that defendants acted with actual knowledge that their forward-looking statements were false or misleading, and noted that "[t]his scienter conclusion provides a ground for dismissing [plaintiffs'] claims relating to the forward-looking statements, one that would apply even assuming defendants' cautionary language was inadequate."

Falsity

The court turned next to whether the complaint adequately alleged that defendants had made an untrue statement of material fact.

The court looked first at the so-called "pricing-pressure statements." Plaintiffs relied primarily on the statements of confidential witnesses and the issue for the court was the weight it should give to those witnesses. The court looked to *Tellabs* and the decisions of sister circuits in the wake of *Tellabs* and concluded that "in the case of confidential witness allegations, we apply [the PSLRA's particularity requirement] by evaluating the 'detail provided by the confidential sources, the sources' basis of knowledge, the reliability of the sources, the corroborative nature of other facts alleged, including from other sources, the coherence and plausibility of the allegations, and similar indicia.'" The court will look to these criteria—the "*Chubb* factors"—to determine whether allegations based on anonymous sources are adequately particularized and, thus, what weight the court should afford those allegations. Applying the *Chubb* factors, the court found that the allegations sufficiently identified the confidential witnesses and the basis of each source's personal knowledge.

The court then examined the forecast-related statements and found that plaintiffs had adequately alleged falsity with respect to statements made by McGuire in March 2005. On March 2, 2005, McGuire adjusted Avaya's projected revenue growth and expressed comfort with the forecast Avaya had communicated to the market in October 2004. The court held that "[i]f we assume the allegations of significant Q2 discounting are true, it is reasonable to infer that the reaffirmed projections of revenue and margins were, by March, no longer sound (and were thus misleading)."

Scienter

The court then turned to plaintiffs' allegations of scienter. Under the PSLRA, a plaintiff must "allege facts giving rise to a strong inference of either reckless or conscious behavior."[5] *Tellabs* held that the pertinent question 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."

[5] The court explained that the Supreme Court in *Tellabs* "continued to reserve judgment on 'whether reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5,' but it noted that '[e]very Court of Appeal that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly." *Id.* at 58-59 n.42 (quoting *Tellabs*, 127 S. Ct. at 2507 n.3).

Conscious or Reckless Behavior

With respect to the March 2005 pricing-pressure statements, the court found that (i) the content and context of McGuire's statements (wherein he repeatedly denied the existence of unusual discounting "in statements evincing certitude"); (ii) the state of Avaya's business at the time McGuire made the statements, including that Avaya's second quarter margins—an important indicator of the health of the company—were significantly contracting; and (iii) the temporal proximity of McGuire's denials in March to the end of Avaya's second quarter, "all diminish the plausibility of innocent explanations for McGuire's flat denials of unusual pricing" while "the cogency of the culpable explanation . . . correspondingly grows." "[T]he totality of the particularized facts . . . [t]aken together . . . give rise to a strong inference that McGuire either knew at the time that his statements were false or was reckless in disregarding the obvious risk of misleading the public. Accordingly, under *Tellabs*, [plaintiffs'] claims relating to the March discounting statements survive defendants' motion to dismiss."

In response to the allegations concerning conscious or reckless behavior, defendants had argued that each allegation by itself was insufficient and that "[t]he sum of several zeros is still zero." The Third Circuit rejected this approach. "[I]nference is not arithmetic. The inferential significance of any single allegation can be determined only by reference to all other allegations."[6]

Motive and Opportunity

Turning to plaintiffs' allegations of defendants' motive and opportunity to commit fraud—and perhaps the most instructive aspect of the decision—the court first examined whether pre-*Tellabs* cases permitting plaintiffs to plead scienter either "by alleging facts establishing a motive and opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior" are still good law. The court concluded that motive and opportunity may no longer serve as in independent route to scienter. Following the reasoning in *Tellabs* that "allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint," the Third Circuit concluded that "[i]f the significance of the presence, or absence, of motive allegations can be ascertained only by reference to the complete complaint, then a general rule that motive allegations are sufficient—or necessary—is unsound."

> It cannot be said that, in every conceivable situation in which an individual makes a false or misleading statement and has a strong motive and opportunity to do so, the nonculpable explanations will necessarily not be more compelling than the culpable ones. And if that is true, then allegations of motive and opportunity are not entitled to a special, independent status.

The court noted that the Second Circuit, by contrast, has continued to treat motive and opportunity allegations as a separate category, even post-*Tellabs*.[7]

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[6] The court declined to follow two recent Ninth Circuit decisions adopting a two-pronged scienter inquiry. *Id.* at 71-72 n.46 (discussing *Zucco Partners, LLC* v. *Digimarc Corp.*, 552 F. 3d 981 (9th Cir. 2009); *Rubke* v. *Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009)). Under the Ninth Circuit's approach, a court will first "determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; 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." *Zucco Partners*, 552 F.3d at 992. The Third Circuit viewed the Ninth Circuit's "new standard" as misinterpreting the Supreme Court's decision in *Tellabs*. *See Avaya*, slip op. at 71-72 n.46.

[7] Citing, e.g., *ECA & Local 134 IBEW Joint Pension Trust of Chi.* v. *JP Morgan Chase Co.*, 553 F.3d 187, 198-99 (2d Cir. 2009); *Teamsters Local 445 Freight Div. Pension Fund* v. *Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008)).

Having concluded that allegations of motive and opportunity are not sufficient to prove scienter, the court examined the allegations made by plaintiffs and framed the inquiry as "not whether defendants were likely to have a motive to commit fraud, but whether they were at least as likely as not to have acted on that motive and actually committed fraud." The court concluded that neither the defendants' desire to complete the two corporate transactions—general motives to aid and improve the company—nor defendants' trading practices—which remained consistent year-over-year and involved a small percentage of Peterson's and McGuire's Avaya common stock holdings—strengthened the inference of scienter.

Conclusion

In *Avaya*, the Third Circuit provides a framework for examining claims for securities fraud in the post-*Tellabs* environment, emphasizing that courts must look at the allegations as a whole, rather than focusing on the sufficiency of particular allegations. Importantly, the court clarified that allegations of motive and opportunity are neither necessary nor sufficient to alleging scienter under the PSLRA; rather, such allegations should likewise be looked at in the context of all of the allegations in a complaint. For all that *Tellabs* cleared up with respect to the requirements for alleging securities fraud, it is evident that the Circuit Courts continue to split on exactly how to apply those requirements in certain respects. It appears the Supreme Court's work is not done.

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