
IN THE COURTS

Third Circuit Court of Appeals Addresses Significant Issues in Securities Fraud Suit

by Karen Pieslak Pohlmann, Jill Baisinger, and Jason H. Wilson

On April 30, a unanimous panel of the Third Circuit Court of Appeals issued an opinion by Chief Judge Scirica, largely upholding the lower court's dismissal of a shareholder lawsuit against Avaya, Inc. and certain officers (collectively, Avaya) in which certain financial projections and statements concerning competition made by Avaya were challenged.¹ The Third Circuit held that the majority of the challenged statements were protected by the safe harbor rule, and that the plaintiffs had failed sufficiently to allege *scienter* as to others. However, it allowed claims to proceed as to certain statements.

Background

The plaintiffs in *Institutional Investors Group v. Avaya* alleged that Avaya misled the market from October 2004 until April 2005, during which time it claimed that there was no price competition occurring that would affect current profits (the Pricing-Pressure Statements), while in fact the opposite was true. In addition, the plaintiffs alleged that certain financial projections and portrayals of the company were misleading given the price competition and other problems presented by the newly instituted sales and marketing strategy (the Forecast-Related Statements). The plaintiffs claimed that the alleged fraud was revealed on April 19, 2005, when Avaya announced that it would be unable to meet its projected revenue goals, with the result that on the following day its stock dropped 25 percent.

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Forecast-Related Statements

The plaintiffs argued that Avaya's claim that the company was on track to meet its revenue growth and sales targets did not merit protection under the Private Securities Litigation Reform Act's (PSLRA) safe harbor provision, which protects a forward-looking statement if it is accompanied by "meaningful cautionary statements." The plaintiffs claimed that Avaya's statements were not forward-looking because they referred to existing sales. The Third Circuit rejected this argument, noting that the statements "say only that, whatever that situation is, it makes the future projection attainable."² The court also observed that Avaya warned investors in "extensive and specific language" that was tailored to the challenged future-looking statements. In particular, the company had warned against the adverse effects of "price and product competition," exactly what the plaintiffs asserted "was responsible for Avaya's missing its projections."³

The plaintiffs also argued that the safe harbor protection should not apply to the Forecast-Related Statements, because Avaya had had actual knowledge that those statements were false when they were made. The court did not reach this question, instead holding that the plaintiffs had failed to allege that Avaya's Forecast-Related Statements were made with actual knowledge and that certain early statements were not false because Avaya's forecasts had later turned out to be true. The court also recognized a distinction between actual knowledge and recklessness, allowing claims based on statements allegedly made with recklessness to proceed, and finding those claims based on statements as to which plaintiffs must plead actual knowledge, as failed.

Pricing-Pressure Statements

The plaintiffs argued that Avaya had publicly denied that it was offering unusual discounts to customers and facing pressure from rivals, but that analyst reports would later show that Avaya was not only giving steep discounts to users but also

laying off staff to cut costs. The plaintiffs bolstered these allegations with testimony from numerous confidential witnesses. In response, Avaya argued that the discounts provided during the class period were not materially different from those provided to customers in previous years. Avaya also challenged the plaintiffs' use of confidential witnesses, citing the Seventh Circuit's strong skepticism of such sources.

The Third Circuit held that its earlier case law addressing the sufficiency of allegations from confidential sources remained good law, namely, that confidential witness allegations must be evaluated by examining

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.⁴

The Third Circuit held that the plaintiffs had sufficiently pled "unusual price discounting" that was directly in conflict with public statements made by Avaya. The court noted that confidential witness allegations may be accepted but may still "fail to establish the falsity of a statement, or give rise to a strong inference of *scienter*."⁵

The Third Circuit next addressed whether the Pricing-Pressure Statements were made with the requisite level of *scienter*. On this point, the court held that allegations that Avaya's statements in March 2005 that there were no problems with its pricing structure were close enough to the release of an earnings report in April 2005 to allege recklessness. The court rejected Avaya's efforts to downplay the "inferential significance of any single allegation" and noted that "[e]ach case will present a different configuration of factual allegations, and it is the composite picture, not the isolated components, that judges must evaluate."⁶ However, the court limited its holding to Pricing-Pressure Statements made in March 2005 and thereby substantially limited the plaintiffs' class period to March 2005 through April 19, 2005. The court held that the statements made prior to March 2005 lacked the "inculcating

circumstances surrounding the March discounting statements."

The plaintiffs also argued that Avaya had a motive and opportunity to commit fraud. The Third Circuit rejected this approach. In a departure from its earlier jurisprudence and the Second Circuit, the court held that plaintiffs can no longer establish *scienter* merely by alleging facts establishing motive and opportunity. The court held:

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 non-culpable 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.⁷

Examining the plaintiffs' allegations, the court concluded that the allegations of motive and opportunity regarding pre-March 2005 statements, when viewed collectively, did not significantly enhance the strong inference of *scienter* that the PSLRA requires.

In sum, the Third Circuit's opinion is a significant examination of those allegations that the court deems sufficient to establish *scienter*. In this regard, the court held that solely alleging motive and opportunity is no longer sufficient. Instead, a holistic examination of the totality of allegations is necessary. In addition, the decision expands on and clarifies existing Third Circuit jurisprudence on important issues such as consideration of confidential witness allegations and application of the safe harbor rule.

NOTES

1. *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, (3d Cir. 2009).
2. *Id.* at 255.
3. *Id.* at 257.
4. *Id.* at 261.
5. *Id.* at 263, n.33.
6. *Id.* at 272.
7. *Id.* at 277.