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2 Years After Tellabs: 'Core Operations' Pleading

Law360, New York (June 05, 2009) -- As the second anniversary of the Supreme Court decision in *Tellabs Inc. v. Makor Issues & Rights Ltd.*[1] approaches, a critical mass of circuit court decisions has begun to suggest some trends in how Tellabs has affected plaintiffs' use of "core operations" pleading, which claims that scienter has been alleged as to key executives because the purported fraud relates to the company's core operations or core products.

Tellabs mandates a "holistic" and "comparative" assessment of whether a complaint pleads scienter under the Private Securities Law Reform Act ("PSLRA").[2]

The high pleading bar set by Tellabs is reflected in the many circuit court decisions affirming dismissals of securities fraud claims for failure to plead scienter after Tellabs.[3]

At the same time, Tellabs may have resulted in increased reliance by plaintiffs on pleading based on core operations, which seeks to imply scienter by alleging that a matter was so critical to or well known within a company that its executives must have known about it.

Before Tellabs, some decisions deemed pleading based upon core operations fundamentally inconsistent with the PSLRA's specificity requirement, while others suggested that such pleading might substitute for actual knowledge.[4]

Plaintiffs now argue that Tellabs's mandate to consider "all" the factual allegations, even "vague and ambiguous" ones, requires courts to consider inferences based upon the company's core operations.

However, circuit court decisions after Tellabs indicate that pleading based upon core operations cannot create a strong inference of fraud unless specific allegations about executives' exposure to factual information "suggest that defendants had actual access to the disputed information." [5]

And, just as Tellabs requires that an inference of scienter be “cogent and at least as compelling” as an inference of “plausible nonculpable explanations for the defendant’s conduct,” core operations allegations will fail if there is an equally plausible reason to doubt that the executive actually knew the matter.[6]

“Rare” Cases in which Allegations Based Upon Core Operations Established a Strong Inference of Scienter

As the Ninth Circuit has noted, instances where the scienter inference based upon the core operations doctrine meets this strict standard after Tellabs are “rare.”[7]

Circuit court decisions that have relied on such pleading after Tellabs to find scienter involve specific allegations of facts that contradicted affirmative statements by defendants.

For example, the Seventh Circuit held that it was “exceedingly unlikely” that a CEO, who spoke about the “very strong” and growing demand for company products, was unaware of the lack of demand for the two “flagship” products that accounted for more than one-half of the company’s sales when allegedly the technological “bubble” for the products had “burst[],” sales “were dropping off a cliff,” the company’s largest customer had drastically reduced orders, and the company did not ship a single unit of one of the products during the class period.[8]

Similarly, the Ninth Circuit found that it would be “absurd to suggest” that a company’s key officers did not know of stop-work orders that would allegedly have a “devastating” effect on revenues (halting tens of millions of dollars of the company’s work, including work with one of the company’s most important customers), particularly where the orders purportedly had visible effects such as putting many employees out of work, demoting a project head, and turning a facility into a “ghost town.”[9]

The Third Circuit concluded that a complaint adequately alleged that a company chief financial officer should have known that competition was forcing large price discounts that were decimating its profit margins where the alleged discounts were substantial, widespread and pervasive; were given to some of the company’s largest clients; and “drastically” affected the company’s profit margins.[10]

Defendants also failed to offer any plausible explanation for the CFO’s “flat denials of unusual pricing”[11] made only weeks before the alleged “truth” was announced.

The Majority of Circuit Court Cases After Tellabs Have Found Pleading Based Upon Core Operations Doctrine Insufficient to Establish a Strong Inference of Scienter

In contrast, many other cases after Tellabs have found pleading based upon core operations insufficient where the complaint failed to allege specific facts that established

an executive's actual knowledge, or where there was a plausible basis to doubt such knowledge.

Allegations of Fraud and Misconduct by Lower Level Employees

Several cases refused to infer knowledge at the top levels of alleged fraud or misconduct committed by subordinates.

The Eleventh Circuit found that top executives could not be deemed to have known about improper vendor charge-back practices at stores across the country simply because the fraud was "widespread" where the fraud was less than 2 percent of the company's sales, was "simple," "did not require the participation of upper management," and would have been difficult for senior management to detect because it did not result in any "red flags." [12]

The Ninth Circuit held that the principals of a company that operated vocational colleges could not be deemed to have known of fraudulent enrollment practices merely because the company had a complex computer tracking system that monitored enrollment and other pertinent data across the company. [13]

The Ninth Circuit also ruled that a CEO could not be deemed to have known of the company's illegal payments to foreign officials even though the complaint alleged that the company was small and did a relatively small amount of business with a limited number of customers, and overseas sales were important. [14]

There was no basis to infer that the CEO was involved in these overseas sales, and the illegal payments "were not, by their nature, the type of transaction of which it would be 'hard to believe' senior officials were unaware," particularly because such payments are generally made surreptitiously. [15]

Business Problems

Two Eighth Circuit cases addressed situations where plaintiffs attempted to create an inference that top executives knew about problems with key products, concluding that plaintiffs had failed to allege a strong inference of scienter.

In one, plaintiff failed to show that executives would have known about problems with a clinical study that involved the company's principal product and was of "overarching importance" to the company and "vital" to its future, because the study was an independent one conducted at off-site locations, and the executives were not alleged to have been involved in the study's design or ongoing administration. [16]

In the other case, the court found that high-ranking executives could not be deemed to have known of problems in the development of technology that was allegedly "the single most important aspect of [the company's] business and was driving its stock price"

because the complaint did not “sufficiently allege” that the “problems were insurmountable or made specific time lines impossible or highly unlikely.”[17]

Accounting Issues

Numerous courts have rejected efforts by plaintiffs to impute knowledge of accounting errors to top executives using inferences based on the core operations doctrine.

The Third Circuit found that executives could not be deemed to have recklessly failed to detect a subsidiary’s understatement of a “core financial metric,” where the error was less than 6 percent and there was no indication that the company’s auditors had alerted the executives to the error or that the executives should have been aware of deficiencies in the subsidiary’s internal controls.[18]

The Fifth Circuit held that executives could not be deemed to have known of accounting irregularities of “hundreds of millions of dollars” by reason of their positions in the company, their “hands-on” management style, or the magnitude and extent of the company’s accounting violations because allegations that the accounting irregularities were “widely known throughout the company” were “too vague” to show knowledge, and the large number and varied nature of the irregularities also undercut any inference of knowledge.[19]

The Sixth Circuit ruled that a company’s top executives could not be deemed to have known of “egregious” accounting irregularities involving several of the company’s locations, where they were not “obvious” to management; a 5.68 percent change to total revenue “does not strike us as the type of “in your face facts” that “cry out” scienter.”[20]

The Eighth Circuit held that top executives could not be deemed to have known that the company had reported incorrect earnings simply because the company had a “sophisticated” computerized accounting system that allowed accurate estimates of costs that were at the “core” of the health company’s business where plaintiffs failed to show that the facts were actually known within the company or to identify “any contemporaneous reports, witness statements, or any information that had actually been provided to defendants.”[21]

In another case, the Eighth Circuit also decided that knowledge and scienter could not be inferred from “the sheer number of [accounting] violations” or the “magnitude” of their effects on the company’s financial disclosures, which overstated per-share earnings from 35 percent to more than 100 percent, given “a course of conduct involving dozens of employees committing hundreds of unrelated accounting errors of many different types over many different years — it seems almost inconceivable that there could have been any unifying intent behind the errors, much less an intent to defraud.” [22]

Lastly, the Ninth Circuit ruled that executives could not be deemed to have known about errors that were “largely definitional” and “would not be immediately obvious to corporate management.”[23]

Conclusion

While Tellabs’s mandate to consider “all” the allegations allows courts to consider pleadings that seek to base an inference of scienter on an executive’s purported knowledge of core operations, post-Tellabs appellate decisions show that such pleadings are not a substitute for actual knowledge.

Appellate courts have found that core operations allegations meet Tellabs’s stringent requirements only in “rare” instances, which have usually involved affirmative misstatements that are inconsistent with knowledge attributable to core operations.

More frequently, plaintiffs’ reliance on pleadings based upon core operations has failed, particularly where, as Tellabs requires courts to consider, there is an equally plausible basis to doubt that defendants actually had the claimed knowledge.

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[1] 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007).

[2] *Id.*, 127 S. Ct. at 2504-05, 2509-12.

[3] A number of circuit court decisions after Tellabs have affirmed dismissals of securities fraud complaints for failure to plead scienter. See, e.g., *ACA Fin. Guar. Corp. v. Advest Inc.*, 512 F.3d 46 (1st Cir. 2008); *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187 (2d Cir. 2009); *Winer Family Trust v. Queen*, 503 F.3d 319 (3d Cir. 2007); *Pub. Employees’ Ret. Ass’n of Colo. v. Deloitte & Touche LLP*, 551 F.3d 305 (4th Cir. 2009); *Indiana Elec. Workers’ Pension Trust Fund IBEW v. Shaw Group Inc.*, 537 F.3d 527 (5th Cir. 2008); *Ley v. Visteon Corp.*, 543 F.3d 801 (6th Cir. 2008); *Pugh v. Tribune Co.*, 521 F.3d 686 (7th Cir. 2008); *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240 (8th Cir. 2008); *Zucco Partners LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009); *Rosenberg v. Gould*, 554 F.3d 962 (11th Cir. 2009).

Other decisions have reversed such dismissals. See, e.g., *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. 2008); *Berson v. Applied Signal Tech. Inc.*, 527 F.3d 982 (9th Cir. 2008); see also *Lormand v. US Unwired Inc.*, No. 07-30106, ___ F.3d ___, 2009 WL 941505 (5th Cir. Apr. 5, 2009) (reversing in part and affirming in part district court decision); *Institutional Inv. Group v. Avaya Inc.*, 564 F.3d 242 (3d Cir. 2009) (same).

[4] Compare, e.g., *In re Bally Total Fitness Sec. Litig.*, No. 04C3530, 2006 WL 3714708, at *9 (N.D. Ill. July 12, 2006) (rejecting plaintiff’s theory that senior executives “must

have known” about accounting fraud because misstatements related to company’s “core business”; theory is an “attempt[] at an end-run” around the PSLRA’s requirement that fraud be pled with particularity); *In re Ancor Comm’ns Inc. Sec. Litig.*, 22 F. Supp. 2d 999, 1005 (D. Minn. 1998) (“[f]acts critical to a business’s core operations or an important transaction generally are so apparent that their knowledge may be attributed to the company and its key officers”), quoting *Epstein v. Itron Inc.*, 993 F. Supp. 1314 (E.D. Wash. 1998), abrogated by *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999).

[5] See, e.g., *South Ferry LP, #2 v. Killinger*, 542 F.3d 776, 785-86 (9th Cir. 2008) (pleadings based upon the core operations doctrine create inference of scienter only “where the nature of the relevant fact is of such prominence that it would be ‘absurd’ to suggest that management was without knowledge of the matter”).

[6] 127 S. Ct. at 2504-05, 1510; see also discussion *infra*.

[7] *South Ferry*, 542 F.3d at 786.

[8] *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702, 706-07, 709, 712 (7th Cir. 2008).

[9] *Berson v. Applied Signal Tech. Inc.*, 527 F.3d 982, 987 n.5, 988, 989 (9th Cir. 2008). Management had also allegedly met with a client to negotiate one of the threatened stop-work orders, and the stop-work orders were disclosed only two weeks after the allegedly misleading statement had been made. *Id.* at 985.

[10] *Institutional Inv. Group v. Avaya Inc.*, 564 F.3d 242, 2009 WL 1151943, at *19, *21 (3d Cir. 2009).

[11] *Id.* at *22.

[12] *Mizzaro v. Home Depot Inc.*, 544 F.3d 1230, 1241, 1249, 1251-52. (11th Cir. 2008). In contrast, the court noted that another case (decided pre-Tellabs) had inferred scienter where the fictitious transactions allegedly “constituted more than two-thirds of the company’s revenue.” *Id.* at 1251, quoting *In re Suprema Specialties Inc. Sec. Litig.*, 438 F.3d 256, 278-79 (3d Cir. 2006).

[13] *Metzler Investment GmbH v. Corinthian Colleges Inc.*, 540 F.3d 1049, 1067-68 (9th Cir. 2008). “[I]t is more ‘cogent and at least as compelling’ to conclude that [the company] maintained its information tracking systems for the necessary and legitimate purpose of running its business” rather than to keep management informed about enrollment and placement figures. *Id.* at 1068.

[14] *Glazer Capital Mgmt. LP v. Magistri*, 549 F.3d 736, 745-46 (9th Cir. 2008).

[15] *Id.* at 746-47.

[16] *Cornelia I. Crowell GST Trust v. Possis Medical Inc.*, 519 F.3d 778, 783 (8th Cir. 2008).

[17] *In re NVE Corp. Sec. Litig.*, 527 F.3d 749, 752 (8th Cir. 2008) (affirming district court's dismissal "for the reasons stated in the district court's thorough opinion," *In re NVE Corp. Sec. Litig.*, 551 F. Supp. 2d 871 (D. Minn. 2007)). See also *NVE*, 551 F. Supp. 2d at 886-87.

[18] *Globis Capital Partners LP v. Stonepath Group Inc.*, 241 Fed. Appx. 832, 836 (3d Cir. 2007).

[19] *Indiana Electrical Workers' Pension Trust Fund IBEW v. Shaw Group Inc.*, 537 F.3d 527, 534-36, 539-40 (5th Cir. 2008).

[20] *Ley v. Visteon Corp.*, 543 F.3d 801, 812 (6th Cir. 2008), citing *PR Diamonds Inc. v. Chandler*, 364 F.3d 671, 685 (6th Cir. 2004).

[21] *Elam v. Neidorff*, 544 F.3d 921, 926-27, 929-30 (8th Cir. 2008).

[22] *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240, 245-46, 249 (8th Cir. 2008), quoting *In re Ceridian Corp. Sec. Litig.*, 504 F. Supp. 2d 603, 608 (D. Minn. 2007).

[23] *Zucco Partners LLC v. Digimarc Corp.*, 552 F.3d 981, 1001 (9th Cir. 2008).