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THE PRIVATE SECURITIES LITIGATION REFORM ACT: ALLEGATIONS OF INSIDER TRADING AND THE PLEADING OF SCIENTER

By Jonathan A. Wexler and Geoffrey Mukae [1]

One of the ways in which the Private Securities Litigation Reform Act (the "Reform Act") sought to curtail abusive class action litigation was to raise the standard of pleading fraud so as to require allegations of "facts which give rise to a strong inference of scienter." Over the past 18 months, the courts have been grappling with what types of allegations will satisfy this new standard.

In an effort to get beyond this pleading hurdle (a barrier made even more formidable by the stay of discovery pending a motion to dismiss), the plaintiffs' bar has turned to allegations of "insider trading," a technique developed prior to the passage of the Reform Act. Such allegations, however, can be rebutted if insider trading during the class period does not differ materially from that during preceding periods. Accordingly, corporations that are potentially vulnerable to securities fraud claims should seriously consider adopting policies and procedures that would preclude the use of insider trading allegations as a means of overcoming the Reform Act's pleading requirements.

Heightened Pleading Requirements and the Legislative History

Section 21D(b)(2) of the Securities Exchange Act of 1934 (the "1934 Act"), added by the Reform Act, heightens the pleading requirements for allegations of "scienter" — a mental state embracing an intent to deceive, manipulate, or defraud. Accordingly, a plaintiff is required by this section to "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind" (emphasis added). On its face, this provision

seems to codify the pleading standard for scienter that has been articulated by the Court of Appeals for the Second Circuit, which developed and employed the "strong inference" standard prior to the adoption of the Reform Act. The Second Circuit's standard contrasts with that of other circuit courts, such as the Ninth Circuit, which have maintained much less demanding pleading requirements. This interpretation finds support in those sections of the Reform Act's legislative history in which the Conference Committee acknowledges that the new pleading requirement is "based in part on the pleading standard of the Second Circuit."

Other aspects of the legislative history also support the proposition that the Reform Act codified the Second Circuit standard. On December 5, 1995, Senator Alphonse D'Amato of New York submitted the report of the Conference Committee to the full Senate and said only the following about its new stricter pleading standards: "The legislation creates a uniform standard for complaints that allege securities fraud. This standard is already the law in New York. It requires that a plaintiff plead facts giving rise to a strong inference of the defendant's fraudulent intent."

However, relying on other excerpts of the Reform Act's legislative history, some legal commentators have argued and some courts have indicated that section 21D(b)(2) imposes pleading requirements that go well beyond those of the Second Circuit. During consideration of the Act, and in an effort to reflect the Second Circuit's standard in its entirety, Senator Arlen Specter added an amendment on the Senate floor, which would have instructed courts that a strong inference of fraud could be established by pleading of "motive, opportunity, or recklessness." This would have placed the new pleading standard squarely in line with that of the Second Circuit, allowing the plaintiff to satisfy the requirement of pleading "facts giving rise to a strong inference of fraud" by "alleging facts showing a motive for committing fraud and a clear opportunity for doing so." The Specter Amendment, however, was removed from the final Conference Report, indicating that Congress might not have wished the heightened standard to be fulfilled by a showing of "motive and opportunity," even though such a method has been a part of the Second Circuit standard to date.

In addition, the Statement of Managers, which constitutes

the legislative history to the Conference Report, provides that Congress desired an even stricter rule than the Second Circuit's standard and "did not intend to codify the Second Circuit's case law interpreting this pleading standard." In a footnote to the paragraph that contained this language, the Statement of Managers affirmatively declared that "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."

Thus, it seems that Congress, while heightening the standard for the pleading of scienter, did not delineate those allegations that would suffice to establish a "strong inference" of fraudulent intent, leaving it to the courts to interpret and define exactly what might fulfill this high standard. In addition, the legislative history is filled with contradictions, with the result that, as one legal scholar put it, "the more closely that one examines the legislative history on this point, the murkier the issue gets."

Differing Opinions From the Courts

Not surprisingly, courts that have interpreted the new pleading standard have divided on its requirements. The issue seems to have been narrowed to whether the Reform Act simply codified the Second Circuit standard and case law, allowing allegations of "motive and opportunity" or "recklessness" to satisfy the pleading requirement, or whether such methods were rejected by Congress, leaving the judiciary to decide what might fulfill the requisite "strong inference." Although varying interpretations existed within the Second Circuit over the past 23 years, in 1995, prior to the Reform Act, the Second Circuit articulated the standard for pleading scienter in *Acito v. IMCERA Group, Inc.*, as follows:

> The requisite 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

In interpreting the new requirements for a pleading of scienter, many district courts have adopted the Second Circuit standard in full, or with slight variation, including

district courts in California, Connecticut, New York, and Illinois. Only the Court of Appeals for the Third Circuit has touched upon the issue, handing down a decision in June 1997, entitled *In re Burlington Coat Factory Securities Litigation*. In that case, the Third Circuit suggested agreement with the Second Circuit's standard, citing *Acito* for authority on the subject. However, this should be considered only a glimpse of the Third Circuit's future direction since the parties in that action did not contend that the Reform Act applied, and the court did not discuss the new pleading standards.

Marksman Partners v. Chantal Pharmaceutical Corporation, a case that is often cited for the proposition that the Reform Act's heightened pleading requirements may be fulfilled through application of the Second Circuit standard in its entirety, comes from the Central District of California and was decided five months after passage of the Reform Act. The *Marksman Partners* court, acknowledging that the Reform Act does not contain "any express abrogation…of recklessness liability," concluded that nothing in the legislative history indicates "that Congress acted to eliminate recklessness as a basis for scienter" in securities fraud actions. The court also defined "recklessness" as an "extreme departure from the standards of ordinary care…which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

In addition, the court in *Marksman Partners* examined the legislative history of the Reform Act to determine whether a pleading of "motive and opportunity," with the requisite particularity, had been rejected as a means of fulfilling the heightened pleading requirements. After examining the legislative history and the narrow definitions accorded "motive" and "opportunity" by the Second Circuit, the court determined that Congress had not discarded the test in the process of enacting the Reform Act. The court adopted the Second Circuit standard in its entirety and, relying especially upon the plain language of the statute, concluded that "when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly and in the body of the statute."

In re Silicon Graphics, Inc. Securities Litigation, another California case decided four months after *Marksman Partners*, has come to stand for an alternative conclusion. In *Silicon Graphics*, the district court reviewed the

legislative history and found that Congress did not intend to codify the Second Circuit standard under the Reform Act because Congress chose not to include language from the Second Circuit standard relating to motive, opportunity, and recklessness. Thus, the court required that the plaintiff allege "specific facts that constitute circumstantial evidence of conscious behavior by defendants." In a footnote, the court responded directly to the *Marksman Partners* decision, stating that it "respectfully disagree[d]" with that court, finding that the "legislative history, the most definitive part of which is the Conference Committee Report, establishes the [Reform Act] standard as stricter than the Second Circuit."

Although both the *Marksman Partners* and the *Silicon Graphics* courts examined the same legislative history, they arrived at different conclusions. The explanation for this result may be found in the treatment by each court of the relevant legislative history. While both courts relied heavily upon the excerpt from the Conference Committee Report, which stated that the Committee explicitly chose not to codify language regarding "motive, opportunity, and recklessness," each court drew a different conclusion. In *Silicon Graphics*, the court found that, because Congress did not codify such language, such pleadings could not possibly fulfill the required "strong inference" of scienter. On the other hand, the court in *Marksman Partners* found no such implication and determined that, even if Congress chose not to codify such language, Congress did not expressly forbid the pleading of "motive, opportunity, and recklessness," maintaining the Second Circuit standard in its entirety as a viable means of fulfilling the heightened pleading requirement.

Recent Developments

Since *Silicon Graphics*, only a few courts have adopted the same line of reasoning. However, in both *Friedberg v. Discreet Logic, Inc.* (D. Mass. 1997) and *Norwood Venture Corp. v. Converse Incorporated* (S.D. N.Y. 1997), the courts adopted an aspect of the Second Circuit standard that was not included in the footnote to the Committee Report — specifically, the language referring to "conscious misbehavior" — but rejected the remainder of the Second Circuit pleading standard, going to "motive, opportunity, or recklessness."

On May 23, 1997, the *Silicon Graphics* decision was

reconsidered after the plaintiffs had been granted leave to amend their complaint ("*Silicon Graphics II*"). Surprisingly, in *Silicon Graphics II*, the court moved significantly towards the decision in *Marksman Partners*, finding that plaintiffs must create a strong inference of knowing or intentional misconduct, which might include "deliberate recklessness." While allowing a form of recklessness to suffice, the court also noted that "motive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud." Having acknowledged that pleadings of motive, opportunity and recklessness might be sufficient to fulfill the heightened pleading requirements of the Reform Act, it would seem that the case law is moving toward a unified standard. However, it is doubtful that this tentative judicial agreement will remain for long, as the case law has involved only district courts thus far.

Allegations of Insider Trading and the Pleading of Scienter

In order to satisfy the Reform Act's heightened pleading standard of "facts giving rise to a strong inference of scienter," many plaintiffs have resorted to allegations of insider trading as evidence of intentional misconduct. A study conducted by two Stanford Law School professors, Joseph A. Grundfest and Michael A. Perino, has found that since the passage of the Reform Act there has been a dramatic increase (from 20.7% to 56.5%) in the number of cases under Section 10(b) which include allegations of insider trading. These allegations commonly assert that one or more senior executives or directors of the issuer sold substantial blocks of the issuer's shares and/or options during the period that the price of those securities was alleged to have been fraudulently inflated.

Charges of insider trading have long been a part of class action cases. In 1989, the Court of Appeals for the Ninth Circuit, in a case entitled *In re Apple Computer Securities Litigation*, articulated a standard that has since been often cited, stating that "insider trading in suspicious amounts or at suspicious times is probative of bad faith and scienter." In 1995, the Second Circuit, in *Acito*, cited this standard for a similar proposition, instructing that "unusual insider trading activity during the class period may permit an inference of bad faith and scienter." The vast majority of

the other Circuits seems to have a similar standard regarding allegations of insider trading and the effectiveness of such allegations in satisfying the pleading requirement for scienter. In fact, most courts cite *In re Apple Computer Securities Litigation* for authority on the subject.

Courts generally examine four factors to determine whether insider trading is "unusual" enough to warrant the conclusion that scienter has been sufficiently alleged. The first three — timing, amount, and the number of insiders — may be mitigated by the fourth, past history of sales by the insiders. In most cases, the first three factors must be present in order for the court to find that scienter has been sufficiently pleaded. However, a long history of consistent trading by the insider may diffuse any inference created by the first three factors.

The first essential factor involves the timing of the sales. Sales by insiders must have taken place in one of two situations. The first situation involves trading while the insiders were allegedly perpetuating a fraud on the market by withholding some vital information that, if known, would drive the price of the issuer's security down. If the sale by the insider took place after the information was released and the price plummeted, the insider's sale has not been found to be probative of scienter. This is the logical conclusion since an insider would not perpetuate a fraud on the market by withholding information, only to watch as the information was released and the insider's total share value dropped. The second situation is one in which the insider trading took place after a misleading statement has been made to the market, but before the falsity of the statement has been revealed. If the insider trading took place during this period, courts are likely to find such activity probative of scienter. Thus, the timing of the alleged insider trading is important to the fulfillment of scienter pleading requirements. The trades must have taken place when the market was subject to some fraud, either perpetuated by the insiders through false statements or placed upon the market through a failure to reveal adverse information.

The second factor involves the amount of stock sold by the insiders during the relevant time period. Courts have varied on this requirement, depending on the circumstances of each case, but generally, if an insider sells a "large" percentage of the total shares held by that

insider, such sales will be held probative of scienter, regardless of the dollar amount received by the insider. For example, if an insider sold 100,000 shares amounting to a total sale price of $10 million, but the insider continues to hold 900,000 additional shares, such sales will likely not be held to raise an inference of scienter. However, if the insider made the same sale, but was left with only 100 shares, such insider trading would likely be probative of scienter.

Such calculations are not always so simple. For example, in a case decided this year by the First Circuit, *Friedberg v. Discreet Logic*, the court found sales of stock by five insiders to be probative of scienter even though the five defendants collectively sold only twelve percent of their holdings. The factual record was complex, involving an initial public offering (IPO) and a secondary public offering (SPO). As found by the court, the defendants made a successful IPO, became aware of adverse information soon after, but could not sell their holdings resulting from the IPO because of a "lock-out clause" under the terms of the IPO, precluding the insiders from selling their shares for six months. Because the adverse information was to be released before the six month "lock-out clause" ended, the insiders initiated the SPO through which they acquired collectively two million shares, over half of the shares issued through the SPO, and sold them for a profit of approximately $84 million. Thus, although the sale of two million shares represented only twelve percent of the five defendants' collective holdings, because the sale occurred when the insiders were aware of adverse material information and while they were perpetuating a fraud upon the market, the insider sales were found to be probative of bad faith and scienter.

The third crucial factor involves the number of insiders who traded during the relevant "fraud on the market" period. While no "magic number" seems to exist as far as what will fulfill the scienter pleading requirement, several courts have found that allegations of one insider having traded will not suffice. In *Acito v. IMCERA Group, Inc.*, the Second Circuit determined that sales by one insider of approximately 11% of his holdings would not raise a strong inference of scienter. The Second Circuit repeated this holding the following year in *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Companies, Inc.*, concluding that "the sale of stock by one company executive does not give rise to a strong inference

of the company's fraudulent intent; the fact that other defendants did not sell their shares during the relevant class period sufficiently undermines plaintiffs' claim regarding motive." In any case, if the plaintiff can allege that the insider trades (i) took place during the relevant time period, (ii) amounted to a large percentage of the insiders' total holdings, and (iii) involved a number of insiders making trades, it is highly probable that any court will find that an inference of scienter has been raised, allowing the plaintiff to escape a motion to dismiss or a motion for summary judgment.

However, there is a mitigating factor. This fourth factor involves a question of the insiders' past history of trading. If the insiders have not made a single trade since obtaining the stock, sitting on it for a number of years, the court will likely find a sudden "fire sale" during the relevant period by a number of insiders to be probative of scienter. But if the insiders can show that they have made trades in similar quantities prior to the period during which the market was allegedly subject to fraud, then regardless of whether the first three factors are present, courts will likely find that no inference of bad faith or scienter should follow. A good example of this fourth factor at work is found in the *Apple Computer Securities Litigation* case, decided by the Ninth Circuit in 1989. There, the plaintiffs pointed to evidence that the defendants collectively sold shares worth $84 million during the relevant period. However, the court found that "the defendants collectively sold a slightly greater number of shares during an equal period of time just before the [relevant] period than they did during the [relevant] period," defeating any inference of bad faith. Thus, the defendants' prior history of insider trading precluded any inference of scienter based on their sales during the relevant period.

An example of the interaction of the four factors is found in *Silicon Graphics II*, in which six insiders were alleged to have made sales during the relevant time period in an effort by the plaintiffs to plead a "strong inference" of scienter. The court began its analysis by noting that the Reform Act required that each defendant's sales be considered separately. First, all six insiders were identified by the court as having made sales of their stock holdings when the alleged fraud was upon the market. However, the second factor varied with each defendant. Four of the defendants, while having sold between 7,000 shares and 60,000 shares each, had marketed only between 2.6

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percent to 7.7 percent of their shares. The remaining two defendants, on the other hand, had sold 43.6 percent and 75.3 percent of their shares, a significant portion of their respective holdings. As far as their past histories of trading, the first four defendants were found to have consistently sold similar amounts in the previous quarters. The two defendants who had sold large percentages of their holdings, however, were found to have no history of sales activity at all. Based on these factors, the court dismissed certain claims with respect to the first four defendants, but allowed the plaintiffs' charges to continue against the two defendants who had traded heavily during the relevant period. In addition, based on the two insider traders and other allegations against the corporation, the action was not dismissed in its entirety with regard to the remaining defendants.

Case Exceptions to the Four-Factor Analysis

While the four factors are generally applied in the Second, Seventh, and Ninth Circuits, the use of the four factors has not been consistent across all federal jurisdictions. In two cases prior to the Reform Act, the courts found that claims of insider trading by only one corporate insider, although lacking the three factors described above, created a sufficient inference of scienter. For example, in 1996, a district court in Missouri found that insider trading by only one defendant in the amount of 3,230 shares (a return of $41,600) contributed to plaintiff's adequately pleading scienter (although it was unclear how much weight the allegation of insider trading was given). The sale amounted to only seven percent of the insider's holdings. In this case, entitled *Jakobe v. Rawlings Sporting Goods Company*, the district court for the Eastern District of Missouri stated that "alleged facts are sufficient to support…an inference [of scienter] if they either (1) show a defendant's motive to commit securities fraud, or (2) identify circumstances that indicate conscious behavior on the part of defendant." Based on this standard, it is clear that the case was initiated prior to passage of the Reform Act of 1995, allowing the court to apply a lower standard for the fulfillment of the scienter requirement.

Similarly, in December 1995, the Eastern District of Pennsylvania decided *McCarthy v. C-COR Electronics, Inc.* and applied the pre-Reform Act Ninth Circuit standard, which allowed general averments to satisfy a pleading of scienter. Here, the plaintiffs alleged only that

registered representatives based upon violations of the securities laws, NASD and stock exchange regulations;

- SEC and self-regulatory investigations and administrative and injunctive proceedings; and
- Defense of civil liability claims based upon allegations of insider and short-swing trading violations.

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one insider made trades comprising fifteen to twenty percent of his holdings during the relevant time period. Without inquiring into the insider's previous history of trading, the court found that the allegations raised an inference of scienter on the part of the corporation. However, because the Reform Act has heightened the requirements for a pleading of scienter in all federal jurisdictions, it is doubtful that the district court from Missouri would arrive at the same conclusion today. In fact, the *Jakobe* court would be required to decide specifically what aspects of the plaintiff's allegations contributed to the fulfillment of the requisite strong inference of scienter.

Corporate Policy Implications

The obvious implication of the increased emphasis on insider trading is that corporations should keep a tight rein on the trading activities of their senior officers and directors. Most corporations already have policies requiring persons subject to the reporting requirements of Section 16(a) of the 1934 Act to report their purchases and sales of the corporation's securities. They also call for the circulation of memoranda to all directors and employees not to trade during periods when material information has not been disclosed for a bona fide corporate purpose or during the course of sensitive acquisition negotiations. These policies, however, are probably not sufficient to prevent insider trading from being used as a means of overcoming allegations of securities fraud. This is because there is a normal tendency for insiders not to sell when the price of the company's shares are low and to sell when it is high.

What is needed is a policy designed to cause senior executives and directors to conduct their trades on a regular basis so as to deny the plaintiffs' bar this means of overcoming the pleading barrier created by the Reform Act. While a company could conceivably institute a requirement that each such person sell 15% of his or her holdings in the company's shares each year, such a requirement would undoubtedly be offensive to most of the affected individuals and would likely be ignored by controlling persons who would not wish to reduce their ownership interest in the company. Moreover, many stockholders might object to such a policy out of a preference that company officers and directors maintain a substantial ownership interest in the company.

The same result, however, can be largely achieved by a significantly less intrusive policy. With the exception of controlling shareholders, most senior executives and directors are likely to have obtained their share holdings through the exercise of stock options. Such persons tend to wait until the date of expiration approaches before exercising their options. In this way, they can achieve the maximum appreciation in their holdings without having actually to invest. Similarly, they are likely to sell at least a portion of the shares so acquired simply to recover the amount paid to exercise the options and to pay the resulting tax imposed upon the exercise. Thus, it is possible to effect a substantial change in the trading activities of senior executives and directors simply by changing the manner in which the company grants stock options to such individuals.

This can be done by eliminating large occasional grants of options to senior executives and directors and replacing them with annual grants of a smaller number of options. In addition, by heavily skewing the exercisability of the options to the final year before expiration, the company can assure itself that exercise and substantial sales will take place during that year. In this way, most sales that are likely to be used as a basis for satisfying the scienter requirements will be relatively evenly spread over all periods.

The effectiveness of this policy can be further enhanced by creating blackout periods following the end of each fiscal quarter until after the publication of the financial results for that quarter. This will further cause insider sales to be concentrated in non-blackout periods. Not only will this help to assure that all sale transactions by insiders take place when public disclosure is maximized, it will also help to destroy any correlation between trading activity within and without the relevant class period.

While these precautions will have a less significant impact on controlling shareholders who are likely to have obtained their share holdings through market purchases or acquisition transactions, the very size of their holdings should give them ample economic incentive not to sell during any period in which the company's disclosures might be challenged.

Conclusion

In furtherance of the Reform Act's objective of reducing the number of so-called "strike suits" based on no more than the plaintiffs' detection of a few errors in company documents or statements and an attendant drop in the company's stock price, a barrier was placed by Congress at the pleading phase of a case. As a result, the plaintiffs' bar has attempted to overcome this new, higher barrier with an increased focus on allegations of insider trading. Consequently, public companies should respond by adopting policies that will spread insider sales more evenly and thereby preclude the use of insider trading activity as a means of satisfying the heightened pleading requirement of the Reform Act.

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