

## OUTSIDE COUNSEL

By **Scott A. Edelman and Hung Ta**

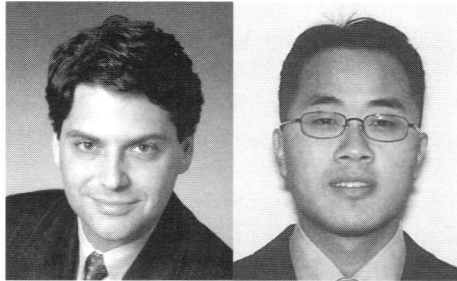
### *Pleading Scierter in the Second Circuit*

In enacting the Private Securities Litigation Reform Act (the "Reform Act"),<sup>1</sup> Congress set out to separate the wheat from the chaff in the area of securities law claims.

Congress sought to do so with statutory standards for pleading fraud in such cases that are by their nature inexact: requiring that a complaint specify "each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading,"<sup>2</sup> requiring that a complaint state with "particularity" all facts on which a belief of falsity is formed,<sup>3</sup> and requiring that a complaint "state with particularity facts giving rise to a strong inference" of scierter.<sup>4</sup> In so doing, Congress left considerable discretion to the courts to decide what constitutes "particularity" and whether factual allegations are sufficient to give rise to a strong inference. This article explores the way in which courts within the Second Circuit have applied the Reform Act's pleading standards for scierter.

Pre-Reform Act, the Second Circuit had enunciated a two-prong test for pleading facts giving rise to a strong inference of scierter such as would sustain an actionable securities fraud claim. A plaintiff could allege either (1) facts establishing a motive to commit fraud and an opportunity to do so, or (2) facts constituting circumstantial evidence of either reckless or conscious misbehavior.<sup>5</sup>

Under the first prong, the plaintiff must plead facts establishing that the defendants had both a motive ("concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged") and the opportunity ("the means and likely prospect of achieving concrete benefits by the means alleged") to commit fraud.<sup>6</sup>



Scott A. Edelman

Hung Ta

Under the second prong, the plaintiff pleads facts which allege that the defendants acted deliberately or recklessly in circumstances where they knew or ought to have known of the fraudulent facts.<sup>7</sup> Compared to the first prong, "the strength of the circumstantial allegations must be correspondingly greater."<sup>8</sup>

After considerable judicial and scholarly debate, the Second Circuit ultimately concluded that the Reform Act had done nothing to change the prior judicial standard. In *Novak v. Kasaks*,<sup>9</sup> the Second Circuit held that the Reform Act adopted the Second Circuit's "strong inference standard" and, more specifically, the two-prong test for pleading facts which give rise to such a strong inference.<sup>10</sup>

While affirming the vitality of the two-prong standard, however, the Second Circuit signaled a move away from a rigid application of the two-prong test, and towards a more careful and considered examination of the facts that inform, and are ultimately determinative, in individual cases:<sup>11</sup>

[L]itigants and lower courts need and should not employ or rely on magic words such as 'motive and opportunity' ... In applying [the Second Circuit] standard, district courts should look to the cases and [relevant] factors ... to determine whether plaintiffs have pleaded facts giving rise to the requisite 'strong inference.'

The remainder of this article will examine

the critical factors in individual cases and how they led the courts to their respective decisions.

### **Motive and Opportunity**

An often pleaded method of showing "motive and opportunity" is for a plaintiff to show a pattern of insider trading activity in advance of an announcement of bad news by the company. Not just any insider stock sale will suffice. To justify a securities fraud claim, courts require that the insider trading activity be "unusual." Plaintiffs have successfully established "unusual" insider activity by alleging "suspicious", sizable sales made a short time before a negative public announcement.<sup>12</sup> Sales are more likely to be considered unusual where there is an abnormal amount of profit from the sales; an abnormal portion of stockholdings being sold; a marked change in the volume of insider sales; and a significant number of insiders selling.<sup>13</sup>

Thus, insider sales activity was considered sufficiently unusual to establish motive in *In re Oxford Health Plans, Inc., Sec. Litig.*, where the defendants sold shares of Oxford Health Plans, Inc. in the relevant period, garnering a profit of \$78 million ("massive by any measure"); all the defendants except one made \$33 million of those total profits by selling two months before a negative public announcement; and the percentages of the defendants' holdings sold at one stage ranged from 11 percent to 100 percent ("not insignificant percentages").<sup>14</sup>

Similarly, in *In re Quintel Entm't Inc. Sec. Litig.*,<sup>15</sup> the court found sufficiently unusual insider sales of Quintel shares to establish motive by noting the number of corporate insiders who made sales; the volume of the sales ("[t]hese sales accounted for almost one-half of Quintel's trading activity during one week of the Class Period"); and the rapid escalation in sales (the sales "represented a

**Scott A. Edelman** is a partner and **Hung Ta** is an associate with Milbank, Tweed, Hadley & McCloy in New York.