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## Sixth Circuit Affirms Dismissal Of Securities Fraud Complaint Where Inference Of Scienter Was Not Supported By Sufficiently Particularized Allegations Of Fact

In [\*Konkol v. Diebold, Inc.\*](#), No. 08-4572, 2009 WL 4909110 (6th Cir. Dec. 22, 2009), the [United States Court of Appeals for the Sixth Circuit](#) applied the [United States Supreme Court](#)'s decision in [\*Tellabs, Inc. v. Makor Issues & Rights, Ltd.\*](#), 551 U.S. 308 (2007) (see blog article [here](#)), to hold that securities fraud plaintiffs must plead an inference of scienter that is both “cogent and at least as compelling as any opposing competing inference.” The Sixth Circuit clarified that, under *Tellabs*, the inference of defendants’ scienter be “cogent” requires plaintiffs to plead “with particularity” facts supporting each individual allegation of scienter. Additionally, the Sixth Circuit held that *Tellabs* does not impose any burden on defendants to set forth a competing, non-fraudulent inference of scienter at the pleading stage. In reaching its decision, the Court attempted to harmonize *Tellabs* with the Sixth Circuit leading pre-*Tellabs* decision on the topic, [\*Helwig v. Vencor, Inc.\*](#), 251 F.3d 540 (6th Cir. 2001) (*en banc*).

*Konkol* arose out of allegations that the defendants, Diebold, Inc. (“Diebold”) and certain of its senior managers, manipulated revenue by improperly recognizing revenue on gaming machines that were not in compliance with federal and state certification requirements and that had not been fully delivered and accepted; by sending out phony invoices at quarter end to artificially inflate revenue in order to meet targets; and by prematurely recognizing revenue on bundled packages of product and training. The district court dismissed the complaint, with prejudice, based upon plaintiffs’ failure to state a claim for securities fraud in accordance with the heightened pleading requirements of the [Private Securities Litigation Reform Act of 1995](#) (“Reform Act”). The Sixth Circuit affirmed.

The Sixth Circuit began its analysis by considering each of plaintiffs’ scienter allegations individually to determine whether each allegation of scienter, standing alone, was sufficiently particularized to support a cogent inference of scienter. The Court noted that the complaint primarily sought to allege scienter on two grounds: (1) defendants’ access to financial information and (2) stock sales by insiders. The Court rejected plaintiffs’ attempts to plead scienter based upon defendants’ mere access to information – including financial reports, revenue and sales tracking software, and attendance at weekly and monthly financial meetings – because plaintiffs failed to describe with particularity the nature of the reports, what the software revealed, what was discussed at the meetings and how each individual defendant used the information to which he allegedly had access. The Court also rejected plaintiffs’ argument that “significant”

stock sales on a single day by five insiders supported a strong inference of scienter. The Court acknowledged that “insider trading at a suspicious time or in an unusual amount” is a relevant scienter factor, but held that, to raise an inference of scienter on this basis, plaintiffs must provide a “meaningful trading history,” including information about non-class period sales, the amount of stock retained by the insiders, and whether the defendants’ overall holdings increased during the class period. Because plaintiffs in *Konkol* failed to provide such detailed information, the Court found they had failed to plead a strong inference of scienter.

The *Konkol* plaintiffs also argued that seven additional facts, not initially highlighted in the complaint, also supported a strong inference of scienter. Again, the Court considered each allegation in turn and determined that none of the individual factors was sufficiently particularized to meet the *Tellabs* standard.

The Court rejected plaintiffs’ attempts to plead scienter based upon the “nature and pervasiveness of Defendants’ accounting violations,” noting that the complaint did not specify the total amount of revenue allegedly overstated. Further, the Court noted, because the alleged scheme involved revenue from three different sources, “even if the amount of revenue prematurely recognized was significant,” it likely would not have supported a strong inference of scienter because the “spread out” nature of the revenue would not have put defendants “on notice” of the misconduct.

The Court also rejected plaintiffs’ attempts to plead scienter based on the existence of confidential witness allegations. Plaintiffs argued that the confidential witnesses described the misconduct in detail and linked the defendants to it through allegations that the scheme “was perpetrated at a high level within the Company,” that “it was very obvious what they were doing,” and that the misconduct “was openly known within the Company.” The Court rejected these allegations, cautioning that such “generalized allegations” cannot substitute “for specific facts” when pleading scienter.

The Court similarly rejected scienter allegations based on the existence of an internal memoranda written Diebold’s outside law firm. In the memoranda, the law firm concluded that sales of uncertified voting machines to California counties would constitute a breach of contract and that California’s approval would be required before modifying the systems. The Court disregarded the allegations because “the complaint does not allege that the Defendants ever read, received, or were informed of the existence of these memos.”

The Sixth Circuit also rejected plaintiffs’ attempts to plead scienter based on the proximity in time (three days) between the allegedly false statements and the later corrections, the existence of concurrent investigations by the Department of Justice and Securities Exchange Commission, and defendants’ representations in Sarbanes-Oxley certifications that they were “knowledgeable” about the Company’s financial reports. While the Court found that these factors could support a strong inference of scienter, it

found that none was “sufficient to meet the heightened *Tellabs* standard on its own.”

Finally, the Court squarely rejected plaintiffs’ argument that a failure by defendants to provide an “alternative non-fraud explanation” favors a finding of scienter at the pleading stage. To the contrary, the Sixth Circuit found, both the Reform Act and *Tellabs* “make clear that the burden of proof, at this stage of the proceedings, rests with the investors.”

*Konkol* illustrates the circuit split that has developed regarding plaintiffs’ burden of pleading scienter after *Tellabs*. While the Third Circuit appears to have held that *Tellabs* allows plaintiffs to plead scienter based on a “holistic” analysis of all allegations in the complaint (some or all of which may be lacking in particularity), the Ninth Circuit, for the most part, has held that *Tellabs* does not replace the particularity requirement but imposes an *additional* requirement that, when taken as a whole, the particularized allegations must support an inference of scienter “at least” as strong as any competing inference. Compare [\*Institutional Investors Group v. Avaya, Inc.\*](#), 564 F.3d 242 (3d Cir. 2009) (see blog article [here](#)), with [\*Zucco Partners, LLC v. Digimarc Corp.\*](#), 552 F.3d 981 (9th Cir. 2009) (see blog article [here](#)). Although *Konkol* does not expressly acknowledge this split of authority, the Court’s citation to *Zucco* with approval when considering the insider trading allegations, as well as its repeated insistence on “particularity” and “specificity” to support a sufficiently “cogent” inference of scienter, suggests that the Sixth Circuit is aligned with the Ninth Circuit on this issue.

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