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THIRD CIRCUIT APPLIES TELLABS TO REJECT MOTIVE AND OPPORTUNITY TEST IN FAVOR OF A "HOLISTIC APPROACH" TO PLEADING SCIENTER IN SECURITIES FRAUD ACTIONS

In *Institutional Investors Group v. Avaya, Inc.*, 2009 U.S. App. LEXIS 9110 (3d Cir. April 30, 2009), a panel of the United States Court of Appeals for the Third Circuit applied the United States Supreme Court's 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), for the first time to existing case law in the Third Circuit. In *Tellabs*, the Supreme Court held that a plaintiff who seeks to bring a claim for securities fraud under the Private Securities Litigation Reform Act (the "Reform Act") must plead an inference of scienter that is "cogent and at least as compelling as any opposing inference of non-fraudulent intent." [See [blog article](#) on *Tellabs*.] In *Avaya*, the Third Circuit held that the standard articulated in *Tellabs* requires courts to review scienter holistically, and not through analysis of any individual allegation of scienter, though the court did confirm that the Reform Act's particularity requirement for pleading scienter remains a determinative factor when conducting this analysis.

In *Avaya*, a putative class of shareholders alleged that Avaya, Inc. ("Avaya"), a seller of communications products and services, through its chief executive officer ("CEO") and chief financial officer ("CFO") (1) affirmatively denied that unusual price competition occurring in the market was hurting the company's profit margins (the "pricing pressure statements"), and (2) issued false or misleading financial projections despite knowing they were impossible to fulfill (the "forecasting statements"). The district court granted defendants' motions to dismiss, holding that plaintiffs had failed to plead scienter with adequate particularity as to both sets of statements. The Third Circuit reversed as to the pricing pressure statements but affirmed as to the forecasting statements.

The Third Circuit reversed dismissal of claims related to the pricing pressure statements, finding that under *Tellabs* plaintiffs had pled particularized facts that, when viewed holistically, supported strong inference of scienter. The pricing pressure allegations arose out of representations by Avaya's CFO that the company's pricing environment was "not significantly different" than it had been in past years. The CFO reiterated this assurance three times, during analyst calls, when responding to specific questions regarding the company's pricing strategy relative to others in the same industry who had made pricing cuts. Avaya subsequently missed its revenue projections for the quarter. While the company denied that the miss occurred because of its discounting policies, Lehman Brothers reported that the company had offered unusually aggressive discounts for its mid-range products and allegations from confidential witnesses confirmed these reports.

The Third Circuit held that plaintiffs had adequately pled knowledge or recklessness by the CFO. The court noted that *Tellabs* required it to make “a practical judgment about whether, accepting the whole factual picture painted by the Complaint, it is at least as likely as not that defendants acted with scienter.”

The court began this analysis by revisiting existing Third Circuit law governing allegations of motive and opportunity. Previously, the Third Circuit had permitted scienter to be pled based on such allegations even in the absence of other particularized allegations of knowledge or recklessness. This standard had been, and still is, applied by the Second Circuit even after *Tellabs*. See, e.g., *ECA & Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co.*, 553 F.3d 187, 198-99 (2d Cir. 2009). In *Avaya*, the Third Circuit parted ways with the Second Circuit and held that, under *Tellabs*, allegations of motive and opportunity, standing alone, were insufficient to support a strong inference of scienter. The court held, however, that when accompanied by other particularized facts, allegations of motive and opportunity could contribute to an inference of scienter.

The Third Circuit then considered the effect of *Tellabs* on allegations attributed to confidential witnesses. In an earlier decision, the Seventh Circuit had reasoned that, under *Tellabs*, such allegations had to be “discounted” because they were susceptible to more compelling non-culpable explanations. In *Avaya*, the Third Circuit disagreed with the Seventh Circuit and reaffirmed existing Third Circuit law holding that detailed allegations from witnesses alleged to have been in a position to know about the statements attributed to them, and which were corroborated by other allegations in the complaint, could contribute to a strong inference of scienter. The court further noted that this view was in accord with that followed by both the Sixth and Ninth Circuits when applying *Tellabs* to confidential witness allegations.

The *Avaya* court held that the confidential witness allegations further were strengthened by the fact that the operating margins reaffirmed by the CFO were “central” to Avaya’s business. The court explained that, based on the “content and context” of the statements, the CFO either must have known his statements were false when made or was reckless for making the statements without first verifying their accuracy. Taken as a whole, then, the court determined that the allegations related to the pricing pressure statements were subject to an inference of recklessness that was at least as strong as any competing non-culpable inference.

The Third Circuit, however, affirmed the district court’s dismissal of allegations relating to the Company’s forecasting statements. Plaintiffs argued that the statements – that Avaya was “on track to meet [its] goals for the year” – did not fall within the Reform Act’s safe harbor provision because they were not forward looking. The Third Circuit disagreed, explaining that the statements “do not justify the financial projections in terms of any particular aspect of the company’s current situation, they say only that, *whatever the situation is*, it makes the future projection attainable.” Because the statements were forward looking, the Third Circuit held, plaintiffs were required to plead particularized facts establishing that the statements

were made with actual knowledge of their falsity and not with mere recklessness. The court then found that plaintiffs had failed to meet this standard because, when viewed holistically, the allegations in the complaint gave rise to an inference of recklessness that was stronger than any competing inference of actual knowledge.

In addition to creating a split between the Second and Third Circuit on the use of motive and opportunity, the *Avaya* creates a split between the Ninth Circuit and Third Circuits when applying *Tellabs*. As the court in *Avaya* noted, the weight of post-*Tellabs* authority in the Ninth Circuit instructs courts to “undertake two separate inquiries,” first determining whether “any of plaintiff’s allegations, standing alone are sufficient to create a strong inference of scienter,” and then determining whether the complaint, as a whole, supports the requisite strong inference of scienter. See *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009) [[blog article](#) on *Zucco Partners*]; *Rubke v. Capitol Bancorp Ltd.*, 551 F.3d 1156 (9th Cir. 2009) [[blog article](#) on *Rubke*]. In *Avaya*, however, the Third Circuit appears to have elected to apply the “holistic” standard, only, without requiring that any particular category of allegations, viewed in isolation, be sufficiently particularized to survive review.

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