

Securities Litigation & Regulation

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COMMENTARY

South Ferry: Applying *Tellabs*, 9th Circuit Lowers The Bar for Pleading *Scienter* Under the PSLRA

By Blair A. Nicholas, Esq.

In its recent *South Ferry*¹ opinion the 9th U.S. Circuit Court of Appeals observed that the Supreme Court's decision in *Tellabs*² sets forth "the level of detail required under the [Private Securities Litigation Reform Act], and with its controlling and persuasive weight, it suggests that perhaps *Silicon Graphics*, *Vantive* and *Read-Rite* are too demanding and focused too narrowly in dismissing vague, ambiguous or general allegations outright."³

The *South Ferry* decision, issued by a three-judge panel, represents a seismic shift in the 9th Circuit's analysis of securities fraud complaints and significantly lowers the bar for pleading *scienter*, or intent to deceive, a key element of proof in litigation under the PSLRA.⁴

In *South Ferry* the 9th Circuit makes clear that the Supreme Court's reasoning in *Tellabs* "permits a series of less precise allegations to be read together to meet the PSLRA requirement, the prior holding of *Silicon Graphics*, *Vantive* and *Read-Rite* notwithstanding."⁵

The 9th Circuit also noted that even "[v]ague or ambiguous allegations are now properly considered as part of a holistic review when considering whether the complaint raises a strong inference of *scienter*."⁶

The *South Ferry* opinion emphasizes that *Tellabs* requires a court to "look to a complaint as a whole, not to each individual *scienter* allegation, as *Silicon Graphics* suggests."⁷

This repudiation of the pleading standards set forth in *Silicon Graphics*, *Vantive* and *Read-Rite* is particularly notable because these decisions have led to countless dismissals of securities fraud class actions within the

9th Circuit, which presides over the second highest number of class actions in the country.

Pre-*Tellabs*: 9th Circuit Sets High Bar For Pleading *Scienter* Under the PSLRA

Prior to *Tellabs*, the 9th Circuit's opinions in *Silicon Graphics*, *Vantive* and *Read-Rite* set an extremely high bar, if not the highest bar of any circuit court in the country, for securities plaintiffs to satisfy the PSLRA pleading standard for *scienter*.

In *Silicon Graphics* the 9th Circuit required securities plaintiffs, without any access to formal discovery, to plead "at a minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness."⁸

The court refused to consider allegations in general terms of mere "motive and opportunity" or "recklessness" but rather required plaintiffs to "state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent."⁹

Indeed, in *Silicon Graphics* the 9th Circuit went so far as to criticize the securities plaintiffs for not pleading requisite details of internal reports that exposed the securities fraud to corporate officers, such as the identity of the person who drafted the reports, how the plaintiffs learned of the internal reports and which officers actually received the internal reports.¹⁰

Three years later, in *Vantive*, the 9th Circuit relied on *Silicon Graphics* to reject the plaintiffs' claim that a court can make a strong inference of *scienter* from the existence of internal company reports that contradict management's public statements. The *Vantive* plaintiffs said management would have known of these internal reports because of their "'hands-on' managerial style."¹¹

The 9th Circuit held that it could not infer such knowledge from general allegations that management was informed about important issues in the company.

Finally, in *Read-Rite* the 9th Circuit again relied on *Silicon Graphics* to reject allegations that under the PSLRA "facts

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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."¹²

"Core operations" refers to the day-to-day workings of a company's business.

As the 9th Circuit observed in *South Ferry*, the *Silicon Graphics*, *Read-Rite* and *Vantive* decisions, issued without reference to *Tellabs*, effectively closed the door on plaintiffs' relying exclusively on the core-operations inference to plead *scienter* against key officers under the PSLRA.

The 9th Circuit had determined that core-operation allegations did not provide the exacting details of defendants' actual knowledge required under the PSLRA's heightened pleading standard for *scienter* as interpreted by *Silicon Graphics*, *Read-Rite* and *Vantive*.

9th Circuit's Application of *Tellabs*

The 9th Circuit's application of *Tellabs* significantly reduces the level of detail plaintiffs must plead to satisfy the *scienter* standard under the PSLRA.

Circuit Judge Ronald M. Gould, who previously sat on the *Vantive* panel, wrote the *South Ferry* opinion. Circuit Judges Raymond C. Fisher and Sanda S. Ikuta joined in the decision.

The panel observed that *Tellabs* suggests a high level of detail is required under the PSLRA.

Tellabs nevertheless instructs federal courts to "look to the complaint as a whole, not to each individual *scienter* allegation, as *Silicon Graphics* suggests," the panel said.¹³

Tellabs also counsels federal courts to "consider the totality of circumstances, rather than to develop separately rules of thumb for each type of *scienter* allegation," it said.¹⁴

In other words, "*Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement, the prior holdings of *Silicon Graphics*, *Vantive* and *Read-Rite* notwithstanding," the panel said¹⁵

Finally, *South Ferry* specifically instructs federal courts to assess the "allegations holistically as required by *Tellabs*," it said.¹⁶

Post-*Tellabs*: Key Officers' Knowledge of 'Core Operations' May Be Used to Impute *Scienter*

The 9th Circuit, after detailing the proper pleading standard and analysis under *Tellabs*, revisited its prior decisions holding that exclusive reliance on core-operation

allegations generally will not satisfy the level of detail required for pleading a strong inference of *scienter* under the PSLRA.

In *South Ferry* the 9th Circuit held that a district court may properly impute *scienter* based on the inference that key officers had knowledge of the "core operations" of the company under three circumstances.

First, citing *Tellabs*, the 9th Circuit held that core-operation allegations may be used "in any form along with other allegations that, when read together, raise an inference of *scienter* that is 'cogent and compelling, thus strong in light of other explanations.'"¹⁷

Second, core-operation allegations "may independently satisfy the PSLRA where they are particular and suggest that defendants had actual access to the disputed information."¹⁸

Notably, the 9th Circuit did not hold that defendants must have "knowledge" of the disputed information, but rather "actual access" to the disputed information.

Finally, the 9th Circuit said there are rare cases, where the nature of the relevant fact is of such prominence that it would be "absurd" to suggest that management had no knowledge of the matter, in which even bare core-operations allegations, without any accompanying particularized allegations, will be sufficient to meet the PSLRA standard.

In fact, the 9th Circuit recently addressed this precise circumstance and it permitted a securities plaintiff to rely exclusively on the core-operations inference "without particularized allegations about defendants' access to the relevant information" in *Berson v. Applied Signal Technology Inc.*¹⁹

In sum the 9th Circuit permits plaintiffs considerable latitude for imputing *scienter* based on core-operation allegations, and federal courts are instructed to "not close their eyes to circumstances that are probative of *scienter* viewed with a practical and commonsense perspective."²⁰

South Ferry: A Sea Change in the 9th Circuit's Analysis of *Scienter* Allegations

South Ferry significantly reduces the level of detail federal courts in the 9th Circuit will require for imputing *scienter* to corporate officers under the PSLRA.

In repudiating its prior decisions in *Silicon Graphics*, *Vantive* and *Read-Rite*, the 9th Circuit now has specifically recognized that *Tellabs* allows for a series of vague or imprecise allegations to be read together to meet the PSLRA requirement.

Simply put, *South Ferry* conclusively recognizes *Tellabs'* mandate that the focus of federal courts should be on the complaint as a whole, rather than the detail of each individual *scienter* allegation.

Further, in light of *Tellabs*, the 9th Circuit now has conceded that the *Silicon Graphics* standard was perhaps "too demanding" and set too high a bar for securities plaintiffs to adequately plead a strong inference of *scienter*.

The concession is not particularly surprising given the high level of detail that the 9th Circuit previously required of plaintiffs without any access to discovery at the pleading stage under the PSLRA.

This sea change in the *scienter* pleading standard by the 9th Circuit should allow for highly meritorious securities fraud suits that otherwise would have been dismissed under the overly rigorous *Silicon Graphics* pleading standards to survive motions to dismiss.

With a greater number of meritorious suits proceeding to a determination on the merits, securities fraud cases will provide a more effective vehicle for defrauded investors within the 9th Circuit to rightfully recoup their assets lost as a result of misconduct by corporate wrongdoers.

Notes

¹ *South Ferry L.P. #2 v. Killinger*, 2008 WL 4138237 (9th Cir. Sept. 9, 2008).

² *Tellabs Inc. v. Makor Issues & Rights*, 127 S. Ct. 2499 (June 21, 2007).

³ *South Ferry*, 2008 WL 4138237, at *5 (discussing *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970 [9th Cir. 1999]; *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079 [9th Cir. 2002]; *In re Read-Rite Corp.*, 335 F.3d 843 [9th Cir. 2003]).

⁴ 15 U.S.C. § 78u-4(b)(2).

⁵ *South Ferry*, 2008 WL 4138237, at *5.

⁶ *Id.*

⁷ *Id.*

⁸ *Silicon Graphics*, 183 F.3d at 979.

⁹ *Id.*

¹⁰ *Id.* at 985.

¹¹ *Vantive*, 283 F.3d at 1088.

¹² *Read-Rite*, 335 F.3d at 848 (quoting *Epstein v. Itron Inc.*, 993 F. Supp. 1314, 1326 [E.D. Wash. 1998]) (emphasis added).

¹³ *South Ferry*, 2008 WL 4138237, at *5.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at *6 (quoting *Tellabs*, 127 S. Ct. at 2510).

¹⁸ *Id.* at *6

¹⁹ *Id.* at *6 n.3 (citing *Berson v. Applied Signal Tech.*, 527 F.3d 982 [9th Cir. 2008]).

²⁰ *South Ferry*, 2008 WL 4138237, at *5.

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