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Tellabs and Pleading a Strong Inference of Scienter: Is a New Split Emerging over its Application in Private Securities Litigation?

Celesq® AttorneysEd Center
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6421 Congress Avenue, Suite 100, Boca Raton, FL 33487
Phone 561-241-1919 Fax 561-241-1969

Tellabs And Pleading A Strong Inference of Scienter: Is A New Split Emerging Among the Circuits?

By Thomas O. Gorman[1]

I. Introduction

A. With the passage of the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4 (1995) ("PSLRA"), in 1995, Congress sought to eliminate baseless securities class actions while permitting those with merit to proceed. As part of that effort, Congress sought to establish uniform pleading standards.

1. One of the key limitations and pleading standards is Section 21D(b)(2), 15 U.S.C. § 78u-4(b)(2), which requires that a securities law plaintiff plead a "strong inference" of the required state of mind. The section did not specify the required state of mind.

2. Prior to the passage of the PSLRA, the circuits had split regarding the pleading standards for the required state of mind. While all agreed that an Exchange Act Section 10(b), 15 U.S.C. § 78j (2000), claim required proof of scienter, the precise formulations differed from circuit to circuit. The pleading standards also differed. Generally, the Second Circuit was viewed as having the most stringent pleading standards while the Ninth Circuit had the most lax. *Compare In re Time Warner, Inc. Sec. Litig.*, 9 F. 3d 259, 268 (2nd Cir. 1993) with *In re GlenFed, Inc. Sec. Litig.*, 42 F. 3d 1541, 1545 (9th Cir. 1994) (en banc).

3. Following the passage of the PSLRA, the circuit courts split again. Over time, a split emerged over two key issues regarding the application of Section 21D(b)(2).

a. One issue focused on what actually constitutes a "strong inference" of the required state of mind with all circuits agreeing that the required state is scienter.

[1] Mr. Gorman is a partner resident in the Washington, D.C. office of Porter Wright Morris & Arthur. He chairs the firm's SEC and Securities Litigation Group and is co-chair of the ABA's White Collar Crime Securities Fraud Subcommittee. For current information on securities litigation, please visit his blog at www.secactions.com.

b. A second focused on how to deal with competing inferences.

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c. The Second Circuit took the view that its prior jurisprudence was essentially incorporated into Section 21D(b)(2). *See, e.g., Press v. Chem. Inv. Serv. Corp.,* 166 F. 3d 529, 538 (2nd Cir. 1999). The Ninth Circuit, however, adopted what became the highest standard. *In re Silicon Graphics, Inc. Sec. Litig.,* 183 F. 3d 970, 974 (9th Cir. 1999) (en banc). Other circuits took an intermediate view. *See, e.g. Ottmann v. Hanger Orthopedic Group,* 353 F. 3d 338 (4th Cir. 2003).

B. The Supreme Court resolved the split over what constitutes a strong inference and the use of competing inferences in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2540-2505 (2007) ("*Tellabs*"*)*. The Court did not address the question of what type of evidence is required to establish a strong inference. Rather, the Court stressed assessing all of the allegations in the complaint. Likewise, the High Court also declined to consider the question of what constitutes scienter, an issue it has avoided for decades. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, and n. 12 (1976).

1. Many commentators labeled *Tellabs* as another in a series of pro-business decisions such as *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770 (2008)(declining to adopt "scheme liability") and *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005) (requiring proof of loss causation). *But see* Thomas O. Gorman, *Tellabs Inc. v. Makor Issues & Rights, Ltd.: Pleading a Strong Inference of Scienter*, Practicing Law Institute, Securities Litigation & Enforcement Institute (Sep. 2007).

2. At the same time, the Court did not adopt the jurisprudence of any specific circuit although it did reject the standard of the Seventh Circuit as too low in reversing and remanding *Tellabs.*

C. Since *Tellabs* was decided, the First, Second, Third, Fourth, Seventh, Eighth and Ninth Circuits have considered the application of the Supreme Court's teachings on the meaning of "strong inference" of the required state of mind under the PSLRA.

1. The First and Sixth Circuits have concluded that *Tellabs* requires a lower pleading standard than their prior decisions.

2. In the Fourth, Fifth and Eighth Circuits, it appears that *Tellabs* has resulted in a higher pleading standard.

3. In Third and Seventh Circuits, there is no obvious impact.

4. The Second and Ninth Circuits have specifically combined their prior case law with *Tellabs*. In the Second Circuit, this appears to reduce the Supreme Court's test while in the Ninth, it appears to have increased the pleading standard potentially setting up another circuit split.

D. The varying interpretations of *Tellabs*, particularly in the Second and Ninth Circuits, appears to have revived the circuit split that Congress and later the Supreme Court sought to resolve.

E. To examine the impact of the Supreme Court's decision in *Tellabs* the following points will be considered:

1. The Supreme Court's decision;

2. The pre-*Tellabs* split among the circuits;

3. *Tellabs* on remand to the Seventh Circuit;

4. Decisions in each circuit which have considered and applied *Tellabs*; and

5. Analysis and conclusions.

II. The decision in *Tellabs*

A. *Background*: Under the PSLRA, the pleading standards for the required state of mind are incorporated in Section 21(D)(b)(2) of the Act. That Section specifies in part that in "any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

1. The "strong inference" standard evolved out of the pre-PSLRA case law.

2. Prior to the passage of the PSLRA, the pleading standards of the Second Circuit Court of Appeals were generally deemed to be the most stringent, regarding state of mind. Under that standard, a securities plaintiff was required to plead facts giving rise to a "strong inference" of fraudulent intent. That requirement could be met by: "alleg[ing] facts establishing a motive to commit fraud and an opportunity to do so" or by "alleg[ing] facts constituting circumstantial evidence of either reckless or conscious behavior." *In re Time Warner, Inc., Sec. Litig.,* 9 F.3d 259, 269 (2nd Cir. 1993); *see generally,* 5A Wright & Miller, Federal Practice and Procedure, Section 1301.1 at 300. *Cf. In re GlenFed, Inc. Sec. Litig.,* 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc) (holding that state of mind need not be pled with particularity in securities fraud cases). Other courts took an intermediate position. *See, e.g., In re HealthCare Compare Corp., Sec. Litig.,* 75 F.3d 276, 281 (7th Cir. 1996).

3. Congress adopted the Second Circuit's "strong inference test in an effort to create a national pleading standard and "more stringent pleading requirements to curtail the filing of meritless lawsuits." H.R. Conf. Rep. No. 104-369, at 37 (1995). While the legislative history is less than clear, the committee reports note that the Second Circuit case law was not adopted, but should be reviewed as "instructive." *Id*. at 15.

B. *The Supreme Court's Decision*: The Supreme Court resolved the question of what constitutes a strong inference of scienter under Section 21D(b)(2) and how to consider competing inferences in *Tellabs.* 127 S. Ct. 2499 (2007).

1. The Court held: "A plaintiff alleging fraud in a Section 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely* as any plausible opposing inference. *Id.* at 2512.

2. The PSLRA was designed as a "check" on meritless suits. Section 21D(b)(2) is one of those checks. Under that section, plaintiff must plead a "strong inference" of scienter. "To qualify as strong within the intendment of Section 21D(b)(2), we hold, an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfradulent intent." *Id.* at 2504-2505.

3. In the PSLRA, Congress sought to craft a uniform standard for pleading. Congress imposed substantive and procedural limits to

make sure that only proper actions were brought. *Id.* at 2508. The "strong inference" standard raised the bar for pleading scienter. While Congress did not specifically define the standard, it is clear that it adopted the language of the Second Circuit while not codifying its case law defining that language.

4. In applying the standard, the court must do three things: First, under Rule 12(b)(6), the factual allegations in the complaint must be accepted as true. Second, the complaint in its entirety must be considered, which is the traditional Rule 12(b)(6) standard. Third, "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." *Id.* at 2509.

5. "Strong" means "powerful or cogent." Alternate definitions include "'[p]owerful to demonstrate or convince'" (quoting the Oxford English Dictionary 949 (2d ed. 1989). *Id.* at 2510. The strength of that inference can not be tested in a vacuum. Rather, it must be considered in the context of the entire complaint. Thus "[a] complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* The court went on to note that motive can be a relevant consideration, but its absence is not necessarily fatal. On the other hand, omissions and ambiguities "count against inferring scienter." *Id.* at 2511. "In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" *Id.*

6. "A plaintiff alleging fraud in a Section 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely* as any plausible opposing inference. At trial, she must prove her case by a 'preponderance of the evidence.' Stated otherwise, she must demonstrate that it is *more likely* than not that the defendant acted with scienter." *Id.* at 2513 (emphasis original). In making the determination, the court must consider all the facts in the complaint, those in exhibits incorporated by reference into the complaint and those in documents of which the court may properly take judicial notice.

7. The Court did not consider what type of evidence must be presented to plead a strong inference of scienter, a question the circuits grappled with for years. Rather, the Court stressed that all of the allegations in the complaint (and related documents) must be

considered. Vague allegations and omissions could be considered against the pleader. The Court did not define scienter.

C. *Tellabs* resolved a split among the circuits over the pleading standard. Following the passage of the PSLRA, the circuit courts split over two key issues concerning Section 21D(b)(2). The first concerned what constitutes a "strong" inference, while the second dealt with how to assess the inference.[2] As to the first:

1. The Second and Third Circuits adopted the pre-PSLRA Second Circuit test. *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529 (2nd Cir. 1999); *In re Advanta Corp., Sec. Litig.*, 180 F.3d 525 (3rd Cir. 1999).

2. The Ninth Circuit adopted a heightened standard of "deliberate recklessness." *Silicon Graphics,* 183 F.3d at 979.

3. The First, Fourth, Sixth, Eighth, Tenth and Eleventh Circuit took a intermediate positions. Some circuits found that motive and opportunity evidence may be sufficient while others concluded it was only some evidence and that the totality of the facts need to be considered. *See, e.g., Greebel v. FTP Software, Inc.,* 194 F.3d 185 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999); *Helwig v. Vencor, Inc.,* 251 F.3d 540 (6th Cir. 2001) (en banc) (PSLRA is concerned with quantum of evidence and not necessarily motive and opportunity); *City of Philadelphia v. Fleming Co., Inc.* 265 F.3d 1245 (10th Cir. 2001); *Florida State Board of Admin. v Green Tree Fin. Corp.,* 270 F.3d 646 (8th Cir. 2001); *Ottmann v. Hanger Orthopedic Group,* 353 F.3d 338 (4th Cir. 2003).

D. The circuits also split on how to deal with the question of competing inferences.

1. The First Circuit concluded that there is no change from standard Rule 12(b)(6) practice under which all inferences are drawn in favor of plaintiff. *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72 (1st Cir. 2002); *but see Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999) ("Congress has effectively mandated a special

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[2] While the section does not specify the "required state of mind," virtually every circuit agreed that it is scienter, the same as prior to the passage of the Act. *Ottmann v. Hanger Orthopedic Group,* 353 F.3d 338, 343 n. 3 (4th Cir. 2003) (collecting cases); *but see In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 974 (1999) (holding that there must at a minimum be "deliberate recklessness"). Prior to the passage of the PSLRA, the Ninth Circuit had been in agreement with other circuits that scienter was the applicable standard. *See, e.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2nd Cir. 1978).

standard for measuring whether allegations of scienter survive a motion to dismiss.”).

2. The Ninth Circuit adopted a similar approach to that of the First, but concluded that there is a “tension” between the Rule and the PSLRA and that the latter required the court to consider all facts in the complaint. Subsequently, the Fifth Circuit adopted essentially the same approach, but without commenting on the impact of the PSLRA on Rule 12(b)(6). *Gompper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir. 2002); *see also In Re Credit Suisse First Boston Corp.*, 431 F.3d 36, 48 (1st Cir. 2005).

3. The Tenth Circuit concluded that all inferences must be considered if they are drawn from facts pled with particularity. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187 (10th Cir. 2003).

4. The Sixth Circuit, sitting *en banc*, adopted a rule which varied from standard Rule 12(b)(6) practice, concluding that plaintiffs are entitled only to the most plausible of competing inferences. *Helwig*, 251 F.3d at 553. A variation of this rule was adopted by the Eighth Circuit in *Green Tree Fin. Corp.*, 270 F.3d at 660, under which “catch-all” and “blanket” assertions that do not meet the particularity requirements are discarded.

III. The Impact of *Tellabs*

A. *Tellabs on Remand:* On remand, the successful Petitioner--defendants ended up in the same place as before -- Seventh Circuit concluded that the complaint was adequate and could proceed. Subsequently, the district court dismissed the insider trading claims but the case proceeded. *Makor Issues & Rights, Inc. v. Tellabs, Inc.*, 2008 U.S. Dist. LEXIS 41539 (May 23, 2008). Recently, plaintiffs’ motion for class certification was granted in part, *Johnson v. Tellabs, Inc.*, Case No. 1:02-CV-04356 (N.D. Ill.).

1. The Seventh Circuit again considered the sufficiency of the allegations as to whether a strong inference of scienter had been pled. Again the court ruled in favor of plaintiffs. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 706 (7th Cir. Jan. 17, 2008) (“*Makor Issues & Rights II*”).

a. In its initial decision, the court reviewed the allegations regarding scienter using a variation of the intermediate position: “we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 602 (7th Cir. 2005), *rev'd*, 127 S. Ct. 2499 (2007) ("*Makor Issues & Rights I*"). The court specifically declined to weigh the inferences, viewing that task as reserved for the jury. Under this approach, the court concluded that the allegations in the complaint were sufficient.

b. On remand, the Seventh Circuit applied the teachings of the Supreme Court, which had adopted a higher pleading standard. Essentially, the court viewed the facts as presenting two competing inferences. Under one theory, erroneous statements were made by senior corporate officials but as a result of errors by lower employees that were not detected. Under this theory, the plaintiff's complaint would fail. Under the alternative, the senior officials who made the false statements were responsible. The court considered the inference of corporate scienter more likely than the opposing inference because of the importance of the statements and the products to the company. Thus, the circuit court concluded: "So the inference of corporate scienter is not only as likely as its opposite, but more likely. And is it cogent? Well, if there are only two possible inferences, and one is *much* more likely than the other, it must be cogent." *Makor Issues & Rights II*, 513 F.3d at 710. The allegations in the complaint are sufficient, the court concluded.

2. Prior to the remand of *Tellabs*, the Seventh Circuit upheld the dismissal of a securities fraud complaint based on a review of the totality of the inferences. *Higginbotham v. Baxter International, Inc.*, 495 F.3d 753 (7th Cir. 2007). The Supreme Court decided *Tellabs* after argument, but before decision.

a. There, Baxter International announced that it would restate the preceding three years' earnings to correct errors resulting from fraud in its Brazilian subsidiary. The managers in the subsidiary created the illusion of growth by at first prematurely recognizing sales and later recording fictitious sales. When the problem was announced, the stock dropped about 4.6%. Later, the stock price corrected when the restatement showed that the impact was not as large as initially thought. Plaintiffs claim that by March 12 or May 10 Baxter's senior managers knew the Brazilian data to be false, that the controls were inadequate and they should not have waited until July 22 to disclose the problem.

b. The district court's order of dismissal was affirmed. Citing the Supreme Court's decision in *Tellabs*, the Court noted that a complaint can only survive this standard if "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 756. The standard is higher than probable cause, but, less than the more-likely-than-not threshold used a trial.

c. Essentially, the court reviewed each arguments raised by plaintiffs. The fact that on April 29 Brazil's government accused Baxter's subsidiary of raising prices by participating in a cartel did not alert the defendants to the fraud as plaintiff's claim. Accusations differ from proof and executives do not necessarily know what government officials know. More importantly, cartels improve profits through antitrust violations. That differs from reporting non-existent sales.

d. The fact that the reporting systems turned out to be weak does not support the complaint as plaintiffs argue. "That's no news; by definition, *all* fraud demonstrates the 'inadequacy' of existing controls, just as all bank robberies demonstrate the failure of bank security." *Id.* at 760 (emphasis original).

e. The court also rejected the claim that the fraud should have been disclosed in June or early July rather than in the first quarter at the end of July: "What rule of law requires 10-Q reports to be updated on any cycle other than quarterly? That is what the 'Q' means. Firms regularly learn financial information between quarterly reports, and they keep it under their hats until the time arrives for disclosure. Silence is not 'fraud' without a duty to disclose . . . Taking the time necessary to get things right is both proper and lawful. Managers cannot tell lies but are entitled to investigate for a reasonable time, until they have a full story . . . After all, delay in correcting a misstatement does not create the loss; the injury to investors comes from the fraud, not from a decision to take the time necessary to endure that the corrective statement is accurate. Delay may affect which investors bear the loss but does not change the need for some investors to bear it, or increase its amount." *Id.* at 761.

3. While the approach used by the Supreme Court in *Tellabs* contrasts sharply with the earlier one employed by the Seventh Circuit, it appears to have had little impact.

B. *Lower pleading standards:* The First and Sixth Circuits have specifically acknowledged that *Tellabs* lowered the standard for pleading scienter in their circuit.

1. In *ACA Financial Guaranty Corp., v. Advest, Inc.,* 512 F.3d 46 (1st Cir. 2008), the First Circuit affirmed the dismissal of a suit by bond holders following default on those bonds based on claims that they had been misled at the time of purchase.

a. In affirming the dismissal of the complaint, the court stated that *Tellabs* affirmed in part its prior case law: "*Tellabs* affirms our case law that plaintiffs' inferences of scienter should be weighed against competing inferences of non-culpable behavior. *See, e.g., Greebel v. FTP Software, Inc.,* 194 F.3d 185, 203 (1st Cir. 1999). *Tellabs* also affirms our rule that the complaint is considered as a whole rather than piecemeal." *ACA Financial*, 512 F.3d at 52.

b. At the same time, the circuit court acknowledged that *Tellabs* altered it prior case law in favor of plaintiffs: "However, *Tellabs* has overruled one aspect of the rule this court stated in *Credit Suisse. Credit Suisse* held that where there were equally strong inferences for and against scienter, this resulted in a win for the defendant…This is no longer the law." *Id*. at 59. Thus, *Tellabs* lowered the standard in this circuit.

2. In *Mississippi Public Employees' Retirement System v. Boston Scientific Corp.,* 523 F.3d 75 (1st Cir. 2008), the First Circuit reversed, under *Tellabs*, the dismissal of a securities complaint which was based on allegations involving the launch of a new product and its eventual recall. In reaching its conclusion, the court carefully reviewed all of the allegations in the complaint. The court then concluded that reversal was required because *Tellabs* lowered the scienter pleading standard: "The district court did not have the benefit of the *Tellabs* opinion, which reversed a higher standard for scienter imposed by the prior

law of this circuit. We apply *Tellabs* and that leads us to a different result. While there is support for defendants' inferences, we think, at this stage, that plaintiff's inferences are at least equally strong." *Id*. at 87.

3. In *Frank v. Plumbers & Pipefitters National Pension Fund v. Dana Corp.*, 547 F.3d 564, 571 (6th Cir. 2008), the court reached a similar conclusion.

   a. *Dana* is a securities class action brought initially against Dana Corp., a now-defunct auto parts manufacturer and two of its officers claiming securities fraud. Specifically, the complaint claimed that Michael Burns and Robert Richter, Dana's Chief Executive Officer and Chief Financial Officer, respectively, misled investors by reporting strong earnings, declaring positive financial outlooks, and touting sound internal accounting procedures, none of which were true. In addition, for each quarter during the class period of April 21, 2004 through October 7, 2005, plaintiffs claimed that the two officer defendants executed false SOX Section 302 certifications.

   b. The district court granted defendants' motion to dismiss, concluding that plaintiffs failed to comply with the pleading requirements of the PSLRA. The court held in part that the plaintiffs were required to "establish an inference of scienter that is more plausible and powerful than competing inferences of defendants' state of mind." *Id.* at 571.

   c. The Sixth Circuit reversed. The court began by noting that *Tellabs* requires a three step analysis when determining whether a strong inference of scienter has been pled. First, the factual allegations in the complaint must be accepted as true. Second, the court must consider the complaint in it is entirety. Here, the court must consider if the inference of scienter is "cogent and compelling, thus strong in light of other explanations." *Id.* at 570. Finally, the court must consider the opposing inference. The complaint will survive if a reasonable person would conclude that the inference of scienter is at least as compelling as any opposing inferences.

d. Here, the Circuit Court concluded that the district court properly analyzed the first two prongs of the *Tellabs* test. However, in considering the third, it followed the circuit's prior decision in *Helwig v. Vencor, Inc.*, 251 F. 3d 540 (6th Cir. 2001) (en banc), which had held that the strong inference standard "means that plaintiffs are entitled only to the most plausible of competing inferences," quoting from *Helwig. Id.* at 571. That standard is "no longer good law" after *Tellabs*, the Court held.

C. *Higher standard:* The Fourth and Fifth Circuits have each decided one post-*Tellabs* case, while the Eight Circuit has handed down two decision which have considered the question of pleading a strong inference of scienter. The decisions in the Fourth and Fifth Circuits do not specifically state that the Supreme Court's decision raised the standard, but the analysis of the courts suggests that fact. In the Eight Circuit, the analysis in one case suggested *Tellabs* raised the pleading standard while the other applied both *Tellabs* and the circuit's prior jurisprudence regarding pleading scienter without commenting on the impact of the Supreme Court's decision. The second decision by the Eighth Circuit calls into question the suggestion from the first decision in that circuit that *Tellabs* may have in fact increased the pleading standard.

1. Fourth Circuit: In *Cozzarelli v. Inspire Pharmaceuticals, Inc.,* 549 F.3d 618 (4th Cir. 2008), the court affirmed the dismissal of a securities fraud complaint for failing to properly plead a strong inference of scienter.

a. Plaintiffs claimed that Inspire Pharmaceuticals and certain of its officers made false and misleading statements regarding a new product and its FDA trial. Specifically, the complaint alleged that before a new drug could come to market, the company had to conduct a clinical trial with a predetermined goal or endpoint that had to be satisfied. The company conducted the test. During the trial, company officials noted that it was underway and that an earlier test was similar. When the trial was completed, the company disclosed that it failed to meet its primary endpoint. The share price fell 44.5 % on the day of the announcement. Suit was filed.

b. Plaintiffs claimed that defendants misled the public to believe that the test was likely to succeed, thereby artificially inflating the stock price. This claim was based on the argument that defendant's knew the end point of the study and made misleading statements about it. The court concluded however that plaintiffs' complaint is little more than "a series of isolated allegations without considering the necessary context." *Id.* at 625.

c. Citing *Tellabs* for the propositions that the allegations must be considered collectively and that when a complaint contains selected quotes from material the entire document should be reviewed, the court placed the allegations in context by reading the reports referenced in the complaint. Viewed in this context, the isolated quotes in the complaint coupled with the material from the balance of the documents revealed adequate business reasons for defendants actions and thus failed to support a strong inference of scienter.

2. Fifth Circuit: In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*, 497 F.3d 546 (5th Cir. 2007), the court relied only on *Tellabs* and not its prior cases in affirming the dismissal of a securities class action.

a. In August 2004, Integrated Electrical Services, Inc. ("IES") announced it would not be able to file its quarterly financial statements on time. The company was conducting an on-going evaluation of accounting issues at two subsidiaries and its auditors had identified two material weaknesses in the internal controls. Later, IES announced a restatement covering two and one half years. Plaintiffs brought a financial fraud securities suit.

b. After restating the holding of *Tellabs*, the court assessed all of the inferences raised by the complaint by considering each argument advanced to support scienter. GAAP violations, without more, do not establish scienter. A restatement based on GAAP violations does provide some basis on which to infer scienter.

c. The court rejected claims that the resignation during the period and trading by the CFO of less than 5% of his holdings supported a strong inference of scienter. The court noted that the fact that he did not insulate his trading by using a Rule 10(b)5-1 plan provided some support for finding scienter.

d. Over the objection of plaintiffs, the court considered innocent explanations about the trading based on the fact that the CFO was in the midst of a divorce and need to cash to make payments to his former wife.

e. The court refused to draw an inference of scienter from the fact that the officer signed a SOX certification. Following the lead of the Eleventh Circuit in *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1266 (11th Cir. 2006), the court held that such an inference would only be proper if the person knew or should have suspected due to glaring accounting irregularities or other red flags that the financial statements were false. Here, there were no such red flags.

3. Eighth Circuit: In *In re: Ceridian Corporation Securities Litigation,* 542 F.3d 240 (8th Cir. 2008), the court reviewed the dismissal of a securities fraud class action complaint which had been dismissed prior to the Supreme Court's decision in *Tellabs.* The court affirmed, concluding that the district court's opinion was consistent with *Tellabs* and prior circuit decisions.

a. This is a financial fraud complaint where there was a parallel SEC investigation. Between 2004 and 2005, the company restated its financial statements five times. The complaint, which alleged dozens if not hundreds of accounting errors according to the court, essentially claimed that defendants did a series of restatements to slowly put the information in the market place and walk down the stock price. Plaintiffs argued that the sheer number of accounting violations inferred fraud supported by the stock sales by insiders and the Sarbanes Oxley certifications of two defendants which subsequent events demonstrated were wrong. These allegations were also supported by information from confidential informants.

b. The Court noted that prior to *Tellabs* it had frequently applied the "strong inference" test without defining the "quantum of pleaded facts that give rise to an inference that is 'strong.'" *Id.* at 244. In this regard, the circuit's view was that "strong" means "strong." Thus, it is not sufficient for the facts pled to only give rise to a weak, plausible or reasonable inference. *Tellabs*, however, altered this, according to the court, since "[i]n resolving a conflict among other circuits, the Supreme Court in *Tellabs* both confirmed the district court's plain-meaning observation that 'strong means strong,' and added an additional hurdle for Eight Circuit plaintiffs to overcome to satisfy this pleading requirement. Not only must a plaintiff state with particularity facts giving rise to an inference of scienter that is strong when viewed in isolation, the inference "must be more than merely plausible or reasonable--it must be cogent and *at least as compelling as any opposing inference of nonfraudulent intent.* [quoting *Tellabs*,] 127 S.Ct. at 2504-05." *Id.*

c. The court then reviewed each of the allegations plaintiffs claimed supplied the requisite strong inference and concluded that the district court had properly dismissed the case.

4. Eighth Circuit: In *Elam v. Neidorff*, 544 F.3d 921 (8th Cir. 2008), the court cited *Tellabs* and applied its prior rulings which included the motive and opportunity test developed by the Second Circuit in affirming the dismissal of a securities class action complaint. The court did not comment on the impact of *Tellabs* on its prior case law.

a. This action was brought against Centene Corporation and its CEO Michael Neidoff, Vice President Karey Witty and CFO J. Per Bordin. Centene, which acts as an intermediary between the government and Medicaid recipients in certain states, reports in its quarterly income the costs incurred and billed for the quarter and an estimate of claims liability for certain events. In making those reports, the company cautions that the estimates may be inaccurate.

b. On July 2006, Centene issued a press release which announced that its second quarter earnings would be substantially lower than expected because of additional claims in March, April and June. Statements regarding the financial position of the company made by the individual defendants did not mention these additional claims or that the company results would fall below guidance. According to the press release, the lower income resulted from adjustments which had to be made as a result of unexpected claims relating to March. Following the announcement the share price of the company dropped from $21.04 to $13.60 or about 35%. Plaintiffs filed suit alleging that the April and June statements were false. The district court granted a motion to dismiss.

c. The circuit court affirmed. Plaintiffs claimed that they had pled facts demonstrating a strong inference of scienter by pointing to defendants' stock sales, demonstrating that they had access to information that conflicted with their public statements, showing that the medical cost information went to core operations that defendants would be expected to know and demonstrating the close temporal proximity of the alleged misrepresentations to the announcement.

d. The court held that plaintiffs can demonstrate scienter in three ways: "(1) from facts demonstrating a mental state embracing an intent to deceive, manipulate or defraud; (2) from conduct which rises to the level of severe recklessness; or (3) from allegations of motive and opportunity." *Id.* at 928. In addition, the plaintiffs must meet the *Tellabs* test. Here, after carefully reviewing each of plaintiff's claims the court concluded that plaintiffs had failed to adequately plead a strong inference of scienter. The approach here is substantially similar to the decisions in the Second Circuit discussed below. It also is not entirely consistent with the earlier decision in this circuit.

D. *Same standards:* In three post-*Tellabs* decisions, the Second Circuit cited its prior case law in analyzing the question of whether scienter had been properly pled. In two of those decisions the Circuit Court also cited *Tellabs* while one opinion it did not. The analysis offered by the court in each instance appears little changed by *Tellabs.*

1. In *ATSI Communications, Inc. v. The Shaar Fund, Ltd.,* 493 F.3d 87 (2nd Cir. 2007), the court used the "motive and opportunity" test it developed prior to the passage of the PSLRA, along with the holding of *Tellabs,* to evaluate the adequacy of the facts pled regarding scienter.

a. This is a suit by an issuer of "floorless preferred" against the purchasers. Essentially, ATSI Communications alleged that defendants, who purchased the floorless preferred in private placements, later manipulated the stock by selling short and driving the price down, sending the company into a death spiral. The circuit court affirmed the dismissal of the complaint.

b. To plead scienter under the Section 21D(b)(2), the plaintiff must state with particularity facts giving rise to a strong inference of scienter. Plaintiff can meet this burden "by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." *Id* at 98. This is the court's pre-*Tellabs* case law.

c. The court went on to note that in determining whether the facts pled give rise to a "strong" inference of scienter the court must take into account plausible opposing inferences and it must be such that "a reasonable person [must] deem [it] cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 99, quoting *Tellabs* at 2509.

2. In *Bay Harbour Management LLC v. Carothers,* 282 Fed. Appx. 71 (2nd Cir. 2008), the court reviewed the dismissal of a securities fraud complaint for failing to comply with the pleading requirements of Federal Civil Rule 9(b), which requires that fraud be pled with particularity, and the PSLRA. The court affirmed the dismissal.

a. In discussing the adequacy of the complaint with respect to pleading scienter, the court did not discuss *Tellabs.* Rather it relied on its own pre-*Tellabs* decisions, applying the two-prong test crafter prior to the passage of the PSLRA: "We have held that a securities fraud plaintiff's scienter allegations must 'give rise to a strong inference of fraudulent intent,' and that such a plaintiff may establish the requisite intent 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." *Id*. at 76 (*quoting Lerner v. Fleet Bank, N.A.,* 459 F. 3d 273, 290-91 (2nd Cir. 2006).

b. Remarkably, the court also did not cite its earlier decision in *ATSI Communications.* Rather the test used here is the same "motive and opportunity" test used both before and after the passage of the PSLRA.

3. In *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.,* 553 F.3d 187 (2nd Cir. 2009), the court affirmed the dismissal of a securities class action complaint against JP Morgan Chase Co.

a. The complaint was based on claims that the financial institution defrauded its shareholders, causing its share price to be improperly inflated. The alleged fraud centered on claims that JP Morgan "created disguised loans for Enron and concealed the nature of these transactions by making false statements or omissions of material fact" in its accounting statements and SEC filings. *Id*. at 193. The district court concluded, among other things, that the complaint failed to comply with the pleading standards of the PSLRA.

b. In analyzing the question of whether a strong inference of scienter had been pled, the court began with a discussion of *Tellabs.* The court went on to note however that "[t]he requisite scienter can be established by alleging facts to show either (1) that defendants had the motive and opportunity to commit fraud, or (2) strong circumstantial evidence of conscious misbehavior or recklessness. This is the same "motive and opportunity" test the circuit court employed prior to *Tellabs.*

c. In this case, the court reviewed each of the allegations in the complaint and concluded that it had been properly dismissed.

E. *No obvious impact:* Decisions by the Third Circuit do not comment on the impact of *Tellabs* on its jurisprudence. The court's opinions do not demonstrate any readily distinguishable impact from the Supreme Court's decision. In many ways, the debate over what constitutes a strong inference and how to measure it may be summed up by considering the majority and dissenting opinions in *Key Equity Investors* where each analyzes the same allegations and comes to opposite conclusions. This suggests that a "strong inference" may in fact be in the eye of the beholder.

1. In *The Winer Family Trust v. Queen*, 503 F.3d 319 (3rd Cir. 2007), the court did not cite its prior standards in analyzing whether there was a strong inference of scienter. Using the *Tellabs* standard, the circuit court affirmed the dismissal of the complaint.

a. Winer claimed that Pennex, Smithfield Foods, and executives and officers of both companies inflated the price of the stock through public statements and earning reports that omitted material facts. Many of the allegations focused on a deal in which Pennex purchased and renovated a facility and equipments and the related values and costs. Plaintiffs argued that a press release announcing the deal is false and misleading because it fails to disclose that the facility needs a major overhaul costing over $18 million and expert supervision. Defendants did not disclose that Smithfield Foods, not Pennex, controlled the renovation.

b. Under *Tellabs,* the district court correctly considered inferences which point in each direction as well as documents attached to the complaint.

c. The court rejected the arguments that the press release supported an inference of scienter because the costs were disclosed after it was issued. The court also rejected the plaintiff's claim that the failure to disclose the fact that Smithfield controlled the renovation supported a strong inference of scienter because there was no duty to disclose the fact.[3]

2. In *Key Equity Investors Inc., v. Sel-Leb Marketing Inc.,* 246 Fed. Appx. 780 (3rd Cir. 2007), the court used a different approach. Here, the court cited its prior standards for determining whether there was a strong inference of scienter and the *Tellabs* standard. The court's prior standards followed the "motive and opportunity" test of the Second Circuit (discussed above). A review of the majority opinion and the dissent illustrates the different views that can be taken of the same facts and the different results that can be achieved.

a. The complaint alleges that the defendant company and its officers failed to disclose that the pretax earnings for 2001 were materially overstated; that it had a pre-tax loss for 2002; that it was in default under the terms of its credit facility; and that its financial statements had not been prepared in accord with GAAP. The stock is now virtually worthless.

b. The circuit court affirmed the dismissal of the complaint.

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[3] *See also Globis Capital Partners v. Stonepath Group, Inc.,* 241 Fed. Appx. 832 (3rd Cir. Jul. 10, 2007). Here, the plaintiffs brought a financial fraud complaint following a large share price drop after a third restatement. In affirming the dismissal of the complaint, the circuit court simply reviewed the factual arguments offered in support of a strong inference of scienter by plaintiffs and rejected them. The court did not cite its prior scienter pleading standards. In a footnote at the end of the opinion the court cited the recently decided *Tellabs* decision, noting that it "removes any doubt that the PSLRA's scienter pleading requirement is a significant bar to litigation that *Globis* has failed to meet." *Id.* at 837, fn. 1.

c. To plead a strong inference of scienter the court held that plaintiff may allege: 1) facts show that the defendants had both motive and opportunity to commit fraud or 2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. Under *Tellabs*, the complaint only presents a strong inference of scienter if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference. Plaintiffs may not benefit from an inference "flowing from vague or unspecific allegations-inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis." *Id.* at 785.

d. The dissent argues that in view of the fact that the overstatement of earnings is 400% and in the midst of the crisis, Merrill Lynch tightened the terms of the credit line, inferences of scienter are sufficient. First, Merrill Lynch repeatedly tightened the terms of the credit facility, thus demonstrating its concern about the financial condition of the company. This was not properly disclosed and what was disclosed was buried. Second, the magnitude of the overstatements is significant and bolsters the inference of scienter. Together these facts demonstrate conscious behavior of wrongdoing.

F. The Ninth Circuit: The circuit has handed down four decisions applying the Supreme Court's teachings in *Tellabs.* In those cases, the court combined its prior jurisprudence with the teachings of *Tellabs,* the same approach used by the Second Circuit. The decisions incorporating this approach in the Ninth Circuit raise significant questions as to whether the court is adhering to the teachings of the Supreme Court.

1. The first decision in the circuit construing *Tellabs* is *Metzler Investment GMBH v. Corinthian Colleges, Inc.*, 540 F. 3d 1049 (9th Cir. 2008). In this case, the court affirmed the dismissal of the third amended class action securities fraud complaint brought by an institution investor against Corinthian Colleges, Inc. and three of its officers.

a. The complaint alleged that defendants engaged in a series of fraudulent practices designed to maximize the amount of federal Title IV funding, Corinthian's major source of revenue. These included a series of manipulative devices including falsifying financial aid applications, encouraging students to falsify their financial aid forms, manipulating student grades to maintain eligibility, and other techniques. A *Financial Times* article detailed the fraud which was under investigation by the Department of Education. After the class period, the company restated its financial statements.

b. To plead scienter, the plaintiffs relied on three key allegations: suspicious stock sales, a "hands on" management and one defendant's knowledge of the company's revenue recognition practices.

c. To state a claim for securities fraud, the securities law plaintiff must plead scienter. Quoting from its seminal decision in *Silicon Graphics,* the court noted that "'plaintiffs proceeding under the PSLRA can no longer aver intent in general terms of mere 'motive and opportunity' or 'recklessness,' but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggest actual intent . . . [t]o meet this pleading requirement.'" *Id*. at 1066. The court then went on to state that "'[t]o meet this pleading requirement, the complaint must contain allegations of specific contemporaneous statements or conditions that demonstrate the intentional or the deliberately reckless false or misleading nature of the statements when made.' quoting *Ronconi v. Larkin*, 253 F. 3d 423, 432 (9th Cir. 2001) (which follows *Silicon Graphics*)." *Id*.

d. Quoting from *Tellabs* the court went on to note that all inference must be considered collectively to determine whether there is a strong inference of scienter. In a footnote, the court stated that "[t]he *Tellabs* Court cited with approval this court's decision in *Gompper,* which articulated a standard for evaluating a securities fraud complaint's scienter allegations similar to the standard ultimately adopted by the Court. 127 S.Ct. at 2509 (citing *Gompper*, 298 F. 3d at 897 ('the court must consider *all* reasonable inferences to be drawn from the allegations, including references unfavorable to the plaintiffs.') (emphasis in original). We thus rely on the Ninth Circuit's pre-*Tellabs* decisions interpreting the PSLRA's scienter requirement where appropriate here." *Id.*

e. Under this standard, the court reviewed each of plaintiff's three key allegations regarding scienter. The allegations concerning the stock sales by insiders were found insufficient because the trades were neither large nor inconsistent with prior trading. The allegations regarding a comprehensive management information system were not sufficient because they represent little more than a general awareness of day to day operations and were not specific enough. Likewise, the claims regarding one defendant's knowledge of the company's revenue recognition policies lacked sufficient detail and, in the context of other allegations, were insufficient.

2. In *South Ferry LP v. Killinger,* 542 F.3d 776 (9th Cir. 2008), the court vacated a judgment of dismissal in part and remanded the case to the district court.

   a. The securities fraud complaint was brought against Washington Mutual, Inc. and two of its officers. The complaint claimed that the individual defendants made fraudulent statement regarding certain risks related to the mortgage loan portfolio of the company. In support of their scienter allegations, plaintiffs pointed to key facts in the information systems of the company and argued that they were "core facts" about the business which could be fairly attributed to the individual defendants because of the positions in the company.

   b. The court began by reciting the PSLRA pleading standard regarding state of mind. Citing *Silicon Graphics,* the court noted that a strong inference of scienter must be pled under the PSLRA. *Id*. at 782. The required state of mind is "knowing" or "intentional" conduct. Recklessness is sufficient if it reflects some degree of intentional or conscious misconduct or what the court calls "deliberate recklessness." *Tellabs,* the court noted, requires that a strong inference be cogent and compelling in light of all other explanations. "Before the *Tellabs* decision, we construed this pleading standard in light of the applicable substantive legal standard, explaining that 'the PSLRA requires plaintiffs to plead, at a minimum, particular facts giving rise to a strong inference of deliberate recklessness,' [quoting] *Silicon Graphics,* 183 F.3d at 979." *Id.*

   c. Here the plaintiffs relied primarily on allegations regarding the so-called "core operations of the company." Under the Circuit's pre-*Tellabs* decisions, such allegations would not be sufficient. The district court relied on those decisions. However, under *Tellabs,* all of the allegations in the complaint must be considered collectively, even those which lack detail. Under this approach, allegations regarding core operations may be sufficient in some instances. Accordingly, the court remanded the case to the district court for reconsideration of this issue.

3. In *Zucco Partners, LLC v. Digmarc Corporation,* 552 F.3d 981 (9th Cir. 2009), the court reviewed the dismissal of a securities fraud complaint for, among other things, failing to adequately plead scienter. The circuit court concluded that "*Tellabs* does not materially alter the particularity requirements for scienter claims established in our previous decisions, but instead only adds an additional 'holistic' component to those requirements." *Id.* at 986. There, the court affirmed the dismissal.

   a. Digmarc Corporation, a provider of secure personal identification documents, and two of its officers were named as defendants in a securities fraud case. The complaint alleged that defendants purposefully manipulated the financial results of the company by capitalizing internal software development expenditures that should have been expensed. These improper practices resulted in a restatement of Digmarc's financial statements.

   b. After reviewing the particularity pleading requirements of the PSLRA, the court turned to the question of pleading state of mind. The PSLRA requires that a strong inference of the requisite state of mind be pled. "Strong inference" was defined by *Tellabs.* That decision requires that the entire complaint be considered and all facts assessed in determining whether a strong inference has been pled. This includes opposing inferences.

   c. To adequately demonstrate that the defendants acted with the "requisite state of mind" plaintiff must allege facts demonstrating either intentional conduct or "deliberate recklessness," the court noted. *Id*. at 991.

   d. Continuing its discussion of scienter, the court noted that mere recklessness or motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, but not a strong inference of deliberate recklessness. The court then noted that "we recognize that *Tellabs* calls into question a methodology that relies exclusively on a segmented analysis of scienter. We read *Tellabs* to mean that our prior, segmented approach is not sufficient to dismiss an allegation of scienter. Although we have continued to employ the old standards in determining whether, a plaintiffs allegations of scienter are as cogent or compelling as an opposing innocent inference, *see, e.g., Metzler Investment* . . . we must also view the allegations as a whole, *See South Ferry LP No. 2 v. Killinger.*" *Id.* at 991-992.

e. The court then went on to announce its new two pronged approached: "Thus, following *Tellabs*, we will conduct a dual inquiry: First, we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient, we will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness." *Id*. at 992.

4. In *Rubke Trustee v. Capital Bancorp LTD,* 551 F.3d 1156 (9th Cir. 2009), the court affirmed the dismissal of a securities fraud complaint brought against Capital Bancorp and two of its officers based in part for a failure to plead a strong inference of scienter. The court reiterated the holding of *Digmarc Corporation* without citing that decision. Rather, citing *South Ferry* and *Killinger,* as the court did in *Digmarc Corporation,* the court noted that its old segmented approach was insufficient. Now the new two step approach first considering each separate allegation and second all allegations as a whole would be used. The *Silicon Graphics* requirement of "intentionally" or "deliberate recklessness" was again invoked and relied on.

IV. Analysis And Conclusions

A. In *Tellabs* the Supreme Court sought to resolve a split among the circuits regarding the interpretation of Section 21D(b)(2). That section of the PSLRA requires that the securities law plaintiff plead facts which demonstrate a "strong inference" of the requisite state of mind.

1. Congress included Section 21D(b)(2) in the PSLRA in part to establish a stringent uniform pleading standard. As the Court in *Tellabs* made clear, the purpose of the standard is to help weed out non-meritorious suits while permitting those with merit to go forward.

2. Prior to the PSLRA, there had been a split among the circuits over the pleading standards in securities fraud suits. The Second Circuit had adopted the most stringent standard. The Ninth Circuit had the weakest.

3. Following the passage of the PSLRA, the Second Circuit continued to adhere to its pleading standard which it viewed as incorporated in the Act. The Ninth Circuit adopted a standard of "deliberate recklessness," concluding that while the Act included the Second Circuit's "strong inference" standard it did not incorporate that circuit's case law interpreting what constitutes a strong inference. Rather, the Ninth Circuit concluded that more than evidence of motive and opportunity is required. In this context, the Ninth Circuit concluded that the securities law plaintiff must, at a minimum plead facts demonstrating "deliberate recklessness." *In re Silicon Graphics, Inc. Securities Litigation*, 183 F. 3d 970, 979 (9th Cir. 1999) (en banc) ("It follows that plaintiffs proceeding under the PSLRA can no longer aver intent in general terms of mere 'motive and opportunity' or 'recklessness" but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent. Thus, we agree with the district court that the PSLRA requires plaintiffs to plead, at a minimum, particular facts giving rise to a strong inference of deliberate or conscious recklessness.").

B. *Tellabs* has clearly had an impact in certain circuits.

1. *Lower standards*: The First and Sixth Circuits have concluded that *Tellabs* lowered the standard for pleading scienter.

a. Previously the First Circuit required that the "strong inference" more than equal other inferences. *Tellabs* requires only that it at least equal others.

b. Prior to *Tellabs* the Sixth Circuit concluded that a strong inference means that plaintiffs are only entitled to the "most plausible" of competing inferences. *Tellabs* requires that all inferences be considered.

2. *Higher standards*: Decisions in the Fourth, Fifth and Eight Circuits at least suggest that *Tellabs* has raised the pleading standard in those circuits. Only one decision in the Eighth Circuit specifically states that *Tellabs* increased the standard. The other decisions in these circuits do not specifically state the court's view regarding the impact of the Supreme Court's decision. However, the analysis followed in the text of the other opinions from these

circuits, and their reliance on *Tellabs* suggest a increase in the overall difficulty of pleading a strong inference of scienter.

3. *Same standards*: Decisions in the Third and Seventh Circuits do not demonstrate any discernable impact from *Tellabs.* While those Circuits cite and appear to apply the decision of the Supreme Court, an analysis of the opinions in those circuits does not demonstrate and readily discernable impact from the Supreme Court's decision.

   a. This point is perhaps best demonstrated by considering the majority and the dissent in the Fifth Circuit's *Key Equity Investors* decision. There the majority and the dissent apply *Tellabs* to the same facts and reach opposite conclusions.

   b. This same point is illustrated by the Seventh Circuit's consideration of *Tellabs* on remand. Prior to the Supreme Court's decision the Circuit Court reversed the dismissal of the complaint using a "reasonable" standard which the Supreme Court rejected as to low. Following the Supreme Court's decision the Circuit Court again found the complaint sufficient despite the application of a higher pleading standard.

4. *Inconsistent with Supreme Court.* The decisions in the Second and Ninth Circuits are arguably inconsistent with the Supreme Court's decision in *Tellabs.*

   a. The Second Circuit. In each of its post-*Tellabs*, decision the Circuit has cited the Supreme Court's case and applied its two prong pre-*Tellabs* test. That test is arguably inconsistent with the Supreme Court's decision.

      i. For example, in *ATSI Communications, Inc.* the court held that a plaintiff can plead a strong inference of scienter "by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." This is the same test used by the court prior to *Tellabs.*

      ii. Reliance on evidence of motive and opportunity alone is arguably inconsistent with *Tellabs.* In this regard, the Supreme Court stated "While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal . . . As earlier stated . . . allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint." *Tellabs* at 2511.

iii. To the extent the Second Circuit's reliance on its pre-*Tellabs* case law permits a plaintiff to rely on allegations of motive and opportunity alone to demonstrate a strong inference of scienter, the standard appears to be inconsistent with the Supreme Court's directive.

b. The Ninth Circuit. In its post *Tellabs* decisions, the circuit adopted a two prong approach relying first on its pre-*Tellabs* decisions and second on *Tellabs.* As with the Second Circuit, the standard being used by the circuit appears to be inconsistent with the directive of the Supreme Court. This is apparent for two reasons.

i. First, *Tellabs* construed the "strong inference" test of Section 21D(b)(2). In doing so it did not adopt a "deliberate" reckless test. *Silicon Graphics*, however, crafted the "deliberate recklessness" test not as a definition of scienter (which *Tellabs* did not decide) but as a construction of the "strong inference" test of the PSLRA based on its reading of the legislative history. Accordingly, the circuit court's decision appears to be inconsistent with *Tellabs.*

ii. The Section 21D(b)(2) standard is a pleading standard. As *Tellabs* made clear "under our construction of the 'strong inference' standard, a plaintiff is not forced to plead more than she would be required to prove at trial." *Id.* at 2513. Yet, in the Ninth Circuit, the "deliberate recklessness" standard is a pleading standard which exceeds that required at trial. United States Court of Appeals for the Ninth Circuit, Office of the Circuit Executive, *Ninth Circuit Model Civil Jury Instructions Section*

18.3, (2007), *available at* http://207.41.19.15/web/sdocuments.nsf/1ae2dda702db203388256aae0064d796/$FILE/3.2009%20final%20civil.pdf. (Circuit jury instructions do not require "deliberate recklessness.")

iii. The Circuit seems to rely on the notion that because *Tellabs* cited its decision in *Gompper* that the High Court somehow approved of its jurisprudence on this point. *Gompper v. VISX, Inc*., 298 F.3d 893, 897 (9th Cir. 2002). This is incorrect however. *Tellabs* cited *Gompper* for the proposition that competing inference should be considered, not for the *Silicon Graphics* "deliberate reckless" standard.

iv. The Ninth Circuit decisions are not uniform. In *South Ferry*, which the circuit court repeatedly cites, the court remanded a dismissed complaint noting that under *Tellabs* allegations which lacked specificity could be considered and, together with others, were sufficient to warrant reversal. While this approach would suggest that *Tellabs* lowered circuit pleading standards it appears inconsistent with the Supreme Court's teachings. Nothing in *Tellabs* suggests that allegations need not be pled with specificity. Indeed, the Supreme Court specifically noted that vague allegations and omissions could be held against the pleader. In any event, the court does not seem to follow this approach in post-*South Ferry* decisions, although the court does cite that decision.

v. Alternatively, if the Ninth Circuit "deliberate recklessness" standard is viewed as a definition of recklessness it would not be inconsistent with the definition of "strong inference" in *Tellabs.* As a definition of scienter, it would also be inconsistent with those adopted by other circuits.

5. *Impact:* There appears to be a split in the circuits between at least the Second and Ninth over the application of *Tellabs* and what constitutes a Section 21D(b)(2) strong inference of scienter.

a. The Second Circuit now appears to have a lower pleading standard than that required by the Supreme Court.

b. The Ninth Circuit appears to have a slightly higher standard than that required by the Supreme Court.

c. Since most securities damage actions are brought in the Second and Ninth Circuits, this means that most securities damage actions are being reviewed under the wrong standard. Press Release, Securities Class Action Clearinghouse in connection with Cornerstone Research, *Litigation against Financial Services Firms Dominates Securities Class Action Filings According to Annual Report by Stanford Law School and Cornerstone Research* (2008), *available at* http://securities.stanford.edu/scac_press/20090106_YIR08_Press_Release.pdf ("The Second Circuit (which includes New York) had the most securities class action complaints filed in 2008 with 92, followed by the Ninth Circuit (which includes California) with 28, and the Eleventh Circuit (Florida/Georgia/Alabama) with 17. These three circuits were also the most active in 2007 for securities class action litigation.").

6. Ultimately the Second and Ninth Circuits have recreated the split congress and Supreme Court sought to resolve.

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MISSISSIPPI PUBLIC EMPLOYEES' RETIREMENT SYSTEM, Plaintiff, Appellant, v. BOSTON SCIENTIFIC CORPORATION; James R. Tobin; Paul A. LaViolette; Fredericus A. Colen; Lawrence C. Best; Stephen F. Moreci; Robert G. MacLean; Peter M. Nicholas; Paul W. Sandman; James H. Taylor, Jr., Defendants, Appellees.

No. 07-1794

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

523 F.3d 75*; *2008 U.S. App. LEXIS 8140*; *Fed. Sec. L. Rep. (CCH) P94,645

April 16, 2008, Decided

PRIOR HISTORY: [**1]
APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MASSACHUSETTS. [Hon. Joseph L. Tauro, U.S. District Judge].
In re Boston Sci. Corp. Sec. Litig., 490 F. Supp. 2d 142, 2007 U.S. Dist. LEXIS 44772 (D. Mass., 2007)

COUNSEL: Carolyn G. Anderson with whom Timothy J. Becker, Anne T. Regan, Zimmerman Reed, P.L.L.P., David S. Nalven, Steve Berman, Hagens Berman Sobol Shapiro, LLP, Richard A. Lockridge, Gregg M. Fishbein, Lockridge Grindal Nauen, P.L.L.P., Mike Moore, and Moore Law Firm were on brief for appellant.

Stuart J. Baskin with whom John Gueli, Kirsten M. Nelson, Shearman & Sterling LLP, William H. Paine, Timothy J. Perla, and Wilmer Cutler Pickering Hale & Dorr LLP were on brief for defendants.

JUDGES: Before Torruella, Circuit Judge, Tashima, Senior Circuit Judge, * and Lynch, Circuit Judge.

* Of the Ninth Circuit, sitting by designation.

OPINION BY: LYNCH

OPINION

[*78] **LYNCH, *Circuit Judge***. This securities case was brought against Boston Scientific, a publicly traded manufacturer of medical devices based in Natick, Massachusetts. The appeal concerns dismissal of claims based on the company's launch of a new product, the drug-eluting TAXUS coronary stent, and its eventual recalls. Plaintiff, a Mississippi pension fund and purchaser of Boston Scientific stock, alleges that company executives both withheld material [**2] information about problems with the stent and decisions addressing those problems, and made misleading positive statements, in violation of sections 10(b) and 20(a) of the Securities Exchange Act of 1934, *15 U.S.C. § 78j(b)* and *78t(a)*, and the attendant rules and regulations, including *Rule 10b-5*, *17 C.F.R. § 240.10b-5*.

Plaintiff appeals the district court's grant of defendants' motion to dismiss under *Federal Rule of Civil Procedure 12(b)(6)*. The district court held, in a thoughtful decision, that plaintiff failed to meet the heightened pleading requirements imposed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737. *In re Boston Scientific Corp. Sec. Litig., 490 F. Supp. 2d 142, 152, 162 (D. Mass. 2007)*.

Applying the standards recently articulated by the Supreme Court in *Tellabs, Inc., v. Makor Issues & Rights, Ltd., U.S. , 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007)*, and by this court in *ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. 2008)*, we hold that plaintiff has pled claims sufficient to withstand a motion [*79] to dismiss and so we remand the case. Our remand permits the court, should it choose to do so, to allow a limited discovery [**3] period on the issues raised. *See, e.g., Greebel v. FTP Software, Inc., 194 F.3d 185, 188 (1st Cir. 1999)*; *Gross v. Summa Four, Inc., 93 F.3d 987, 990 (1st Cir. 1996)*. "Our ruling does not mean that plaintiffs' claims have any merit. It means only that the claims are not to be dismissed at this very early stage. Nothing has been proven yet." *In re Cabletron Sys., Inc., 311 F.3d 11, 20 (1st Cir. 2002)*.

I.

On September 23, 2005, the Public Employees' Retirement System of Mississippi ("PERS") brought suit in federal district court as the lead plaintiff in a class action against Boston Scientific and company executives Peter M. Nicholas (Chairman of the Board of Directors); James R. Tobin (President and Director); Paul A. LaViolette (Chief Operating Officer and member of the Executive Committee [1]); Fredericus A. Colen (Senior Vice President and Chief Technology Officer); Lawrence C. Best (Senior Vice President and Chief Financial Officer); Stephen F. Moreci (Senior Vice President and Group President of Endosurgery); Robert G. MacLean (Vice President of Human Resources); Paul W. Sandman (Senior Vice President, Secretary, and General Counsel); and James H. Taylor, Jr. (Senior Vice President [**4] of Corporate Operations). Consolidated Am. Compl. ("CAC") PP 1, 15-23.

1 LaViolette became Chief Operating Officer in 2004, after the beginning of the class period.

Plaintiff sued on behalf of a putative class of individuals and entities who purchased equity securities in Boston Scientific from March 31, 2003 to August 23, 2005. *Id.* P 1. Plaintiff alleged that during that period, defendants made false and misleading statements and caused the market price of the company's securities to be artificially inflated, both harming investors and allowing the individual insider defendants to enrich themselves in excess of $ 332 million. *Id.*

Plaintiff's original complaint divided into four categories its allegations regarding defendants' statements about a civil lawsuit with Medinol Ltd., a Department of Justice investigation into a 1998 product recall, the company's introduction of TAXUS stents to the market, and FDA investigations and warnings regarding Boston Scientific's plants. Only the TAXUS stent issue is before us on appeal following the dismissal of all claims.

In particular, plaintiff advances these theories. By late 2003 defendants became aware of serious problems in patients in Europe [**5] resulting from the insertion of the new TAXUS stent, not yet introduced in the United States. The TAXUS stent was introduced in the United States in March 2004; American doctors reported similar problems. In the spring of 2004 defendants made affirmative statements attributing the problems reported about the new TAXUS stent to the unfamiliarity of doctors with the new stent. They did not correct the statements even though they had become aware that the problem was not doctor unfamiliarity, but rather a manufacturing defect in the stent that caused the balloon to fail to deflate. Defendants continued to withhold information about a manufacturing change Boston Scientific had instituted in December 2003 which would address the defect. They withheld the information to build up inventory, in order to preserve market share, before announcing recalls of TAXUS stents based [*80] on the potential defects. Meanwhile, while withholding this material information, several of the individual defendants traded on the open market in unusual patterns and unusual amounts. When the material information was finally and belatedly disclosed, the market price for Boston Scientific stock plummeted downward. The [**6] stock price dropped 7.6% after the company announced an expanded recall and revealed that three deaths and several dozen serious injuries had been connected to balloon deflation failure, and it dropped another 6.6% when the company expanded the recall of the TAXUS stent for a second time. CAC PP 100, 102.

The defendants' theory is that at the time the company received some thirty to forty reports of problems in Europe of balloon non-deflation following stent insertion, it was unable to identify anything about the device itself that would cause the problem and attributed the problem to doctor unfamiliarity. Defendants' brief argues that independently and

> [i]n an effort to improve the device, Boston Scientific tried completely to eliminate the possibility of balloon non-deflation. It eventually identified a means to do so, by changing the manner of bonding the delivery catheter to the balloon and by implementing an additional

> inspection test at the end of the manufacturing process. These proposed modifications were submitted to the FDA for approval in April 2004 and approved by the FDA the following month. In June 2004 Boston Scientific began manufacturing the "new" device.
>
> *After* it identified [**7] how to completely eliminate what was already an infrequently occurring issue, Boston Scientific was able to re-analyze its "old" Taxus inventory. That process led to the identification of specific lots that had the *potential* for non-deflation. Out of an abundance of caution, Boston Scientific voluntarily recalled a limited number of specific production lots of its "old" Taxus stents in July and August 2004.

It is the company's position that the changes would have been implemented "whether it got a complaint or not." The removal of the possibility that the balloon would fail to deflate by the manufacturing change did not prove there was a defect, much less that the company knew at an earlier date of a connection between the manufacturing change and the problem that necessitated the recalls, or that it was obliged to disclose it.

A. *Plaintiff's Allegations*

Plaintiff brought the suit as a putative class action. The class period plaintiff claims is relevant to this narrowed appeal is December 2, 2003 to August 5, 2004.

In 2001, Boston Scientific decided to produce a drug-eluting stent [2] to compete with a similar product manufactured by Johnson & Johnson. CAC P 86. Boston Scientific's product [**8] is known as TAXUS (R) Express Paclitaxel-Eluting Monorail (R) Coronary Stent System. *Id.*

> 2 Coronary stents are tiny tubes placed in patients' arteries to ameliorate blockages and facilitate blood flow. Drug-eluting stents (also called "coated" or "medicated" stents) slowly release drugs aimed at reducing restenosis, a narrowing of the arteries that can occur after a stent is implanted. Stents are implanted in arteries using a delivery catheter.
>
> In 2002, Boston Scientific marketed a coronary stent system called the Express (R), which combined its highly successful Express (R) coronary stent and Maverick (R) balloon dilation catheter, which uses a tiny balloon to inflate the artery and permit the stent to be inserted. TAXUS uses the same delivery catheter as the Express (R); the systems differ in that Express is a bare metal stent whereas TAXUS is a drug-eluting stent.

[*81] TAXUS debuted in Europe in January 2003. *Id.* PP 87, 92. Plaintiff alleges that defendants felt "tremendous pressure" to introduce TAXUS into the U.S. market because the company was losing market share to Johnson & Johnson. *Id.* PP 87. While in the process of obtaining final FDA approval for TAXUS, defendants allegedly downplayed [**9] news that could delay the U.S. launch, such as failing to disclose in a timely manner an FDA major deficiency letter that the company received in September 2003. *Id.* P 89. Meanwhile, defendants "provided to the investment community a drum roll leading up to the FDA's approval of TAXUS which was deafening." *Id.* P 90. Plaintiff alleges that in anticipation of FDA approval and in response to positive comments made by defendants, analysts upgraded their rating of Boston Scientific stock, and by March 2004, the price of Boston Scientific stock on the New York Stock Exchange hit a new high, trading at over $ 40 a share. *Id.* PP 15-23, 91, 100.

On March 4, 2004, the FDA approved TAXUS for marketing and distribution in the United States. *Id.* P 92. Plaintiff alleges that Boston Scientific "trumpeted [TAXUS's] immediate impact in the Company's effort to take over market share for stents." *Id.* Meanwhile, defendants did not disclose complaints they had received from doctors in Europe that the balloon used during insertion of the TAXUS stent did not deflate. *Id.* P 93. Defendants also knew that the Express metal stent, upon which the new TAXUS stent was based, "had a history of significant problems." [**10] *Id.*

Despite this knowledge, defendants "minimized and misrepresented . . . problems," including in the company's Form 10-Q for the quarter ending March 31, 2004, which Boston Scientific filed with the SEC on May 7, 2004. This report stated that the company was "reviewing a limited number of reports related to balloon withdrawal difficulty during TAXUS angioplasty procedures." *Id.* In meetings with analysts, defendants "further downplayed the complaints" by attributing the problems to doctor unfamiliarity with TAXUS rather than balloon non-deflation. *Id.*

Meanwhile, plaintiff alleges, defendants knew "the problems with TAXUS were much more significant, based on the complaints they had received out of Europe and the complaints which were rolling in as a result of the product rollout in the United States." *Id.* P 95. In December 2003 defendants allegedly had begun planning a manufacturing change for TAXUS because they had become aware that the problem with TAXUS was not doctor unfamiliarity but rather a "manufacturing defect." This manufacturing change, which according to defendants was approved by the FDA in May 2004, related to the manner of the laser bonding of the delivery catheter and [**11] balloon. Defendants did not disclose this manufacturing change to the public prior to July 2, 2004, when they referred to it in a conference call with analysts. *Id.* PP 95, 98. Defendants also discussed the manufacturing change in the press releases announcing subsequent recalls on July 16 and August 5.

Plaintiff alleges that defendants had an obligation to disclose this manufacturing change to the public at some point prior to July 2 because it was necessary to correct defendants' earlier and continuing statements that the adverse reports related to U.S. doctors' unfamiliarity with TAXUS rather than to a defect with the product itself. As plaintiff put it at oral argument: "The disclosure that we are asking for is that as soon as they learned that . . . the problems with TAXUS were not related to doctor [un]familiarity . . . they had a duty to disclose that."

[*82] In the months following the U.S. launch of TAXUS, Boston Scientific's stock price rose and defendants began to sell large quantities of their own stock. CAC P 96. Plaintiff specifically points to the following stock sales, all of which occurred within two months of the FDA's March approval of TAXUS: over $ 40 million by James R. [**12] Tobin; over $ 54 million by Lawrence C. Best; over $ 4 million by Fredericus A. Colen; and over $ 3 million by Robert G. MacLean. *Id.* Additionally, defendant Paul LaViolette sold approximately $ 3 million worth of company stock in June of 2004. *Id.* P 18. Plaintiff argues that these sales demonstrated "unusual patterns" and occurred in "unusual amounts."

On July 2, 2004, Boston Scientific announced that it was voluntarily recalling two lots of TAXUS stents (a total of 200 stents), which had not yet been implanted in patients. *Id.* P 97. In a press release announcing the recall, the company stated that the FDA had received reports of one death and sixteen serious injuries associated with balloon non-deflation, along with eight reports of balloon malfunction that had not caused injury. *Id.* The press release explained that the recall was due to "characteristics . . . related to a narrowing in the area where the catheter and balloon are laser welded," a problem referred to as "focal neckdown." "This narrowing resulted in the potential for impeded deflation and removal of the balloon after stent placement."

The manufacturing change that defendants had put into motion in December 2003 addressed [**13] the problem of focal neckdown by changing the manner of the laser welding of the catheter and balloon. In a conference call with analysts on July 2, defendants asserted that this manufacturing change had been in progress before the TAXUS launch and "would have been submitted whether we got a complaint or not." *Id.* P 98.

Two weeks later, on July 16, defendants voluntarily expanded the company's recall to 85,000 TAXUS stents and 11,000 Express (R) stents -- which use the same delivery catheter as TAXUS -- and admitted knowing of two additional serious injuries associated with TAXUS as well as two deaths and twenty-five serious injuries associated with balloon deflation failure in Express (R) stents. *Id.* P 100. In a press release announcing this recall, defendants assured the public: "The Company implemented review of its manufacturing process, additional inspections, and an FDA-approved modification to the manufacturing process for these products. The current and future production are not expected to experience similar balloon deflation problems."

After defendants announced this expanded recall on July 16, Boston Scientific's stock price dropped $ 3.09 per share, or 7.6%, to $ 37.40. *Id.* P 100. [**14] Plaintiff connects the drop in stock price to the revelations of the deaths and injuries associated with the TAXUS and Express (R) stents. *Id.*

Plaintiff alleges that during July and early August 2004, defendants "continued to try to reassure the market about the safety of the Company's products through the issuance of public statements which were false and misleading." *Id.* 101. In particular, during a conference call with analysts on July 26, 2004, defendant Paul LaViolette responded to concerns about TAXUS by saying, "[Y]ou are dealing with simple lag time in the marketplace conversion of newer products, not necessarily a continuation of complaints from the new issue product." *Id.* At a meeting with a local hospital official on July 29, LaViolette stated that the company had "identified and fixed the problem." *Id.* On August 4, [*83] he stated that the problem was a "nuisance." *Id.*

On August 5, Boston Scientific announced that it was voluntarily recalling an additional 3,000 TAXUS stents. [3] *Id.* P 102. The press release announcing the recall stated that it was prompted by the company's "ongoing monitoring" and noted that since the company had "modified its manufacturing process, implemented [**15] new tracking software and introduced new inspection protocols," it had not had any confirmed non-deflation problems caused by focal neckdown in the units made with these changes in place. At this time, the company's stock price dropped another $ 2.41, or 6.6%. *Id.*

3 The complaint states the date of the third recall as August 4, but the press release announcing the recall is dated August 5.

By the end of 2004, Boston Scientific had recalled 99,000 TAXUS and Express (R) stents because of manufacturing defects that plaintiff alleges had caused three deaths and dozens of serious injuries. *Id.* P 103. The company spent over $ 57 million on these recalls. *Id.* P 101. Between July 2, 2004, when the first recall was announced, and August 5, 2004, when the recall was expanded for a second time, the company's stock price dropped 21%. *Id.* P 103.

Plaintiff's theory is that the investing world was aware of reports of patient death and injury involving TAXUS. However, defendants said that the problems with the TAXUS stents were caused by doctor unfamiliarity with the new product. It was natural for investors to conclude the problems would disappear over time as doctors became more familiar with the product, [**16] and there would be no recalls. Having given that explanation, the defendants, plaintiff argues, were required to disclose as soon as they could the connection between the patient problems, the manufacturing defect, and the manufacturing change remedying this problem.

B. *District Court Opinion*

In dismissing the TAXUS claims, the district court reasoned in a series of discrete steps. [4] It first noted that there was no violation in not disclosing the FDA major deficiency letter regarding TAXUS that Boston Scientific had received in September 2003, before the U.S. release of the product. Rather, the major deficiency letter was simply "a step in the FDA approval process which [Boston Scientific] had no duty to disclose." *In re Boston Scientific, 490 F. Supp. 2d at 158*; *see also id. at 158 n.91* (citing *21 C.F.R. § 814.37(b)* ("A major deficiency letter informs the applicant that its PMA [Premarket Approval Application] lacks significant information needed for FDA to complete the scientific review of, and render a final decision on, the PMA.")).

4 We discuss the district court's opinion only as it pertains to the TAXUS claims because only that part of the opinion is being appealed.

The court next [**17] turned to the adverse reports from doctors that defendants received prior to announcement of the recalls of the TAXUS and Express (R) stents in July and August of 2004. The court examined the company's statements that complaints received from American doctors in the spring of 2004 were comparable to complaints it had received the previous year from European doctors. Plaintiff asserted that these statements were false when made because the company knew that the problems in both Europe and the United States resulted from a product flaw rather than from the stated reason of doctor unfamiliarity with TAXUS. However, the district court concluded, plaintiff provided [*84] "little in the way of facts to support this claim. Lead Plaintiff pleads no facts to suggest that the complaints [Boston Scientific] received from American doctors were different than those it received from European doctors." *Id. at 159*.

With respect to the manufacturing change which Boston Scientific initiated prior to the U.S. launch of TAXUS, the court rejected plaintiff's allegations that this change was evidence that defendants knew TAXUS was defective and that the change was material information that should have been disclosed. [**18] *Id.* Here the district court invoked the doctrine of fraud by hindsight. The court reasoned that a manufacturing change does not necessarily mean that a product is defective or that a company knows that a product is defective since "[c]ompanies frequently adjust and change their products, and no rule requires a company to inform the public every time it modifies its manufacturing process." *Id.* The court pointed out that Boston Scientific's manufacturing change was conducted with the FDA's knowledge, at a time when the company had received only a limited number of complaints from European doctors, which had been tapering off. *Id. at 160*. Plaintiff did not contest that the manufacturing change was set in motion before TAXUS's release in the United States and would have been made regardless of whether the company received complaints from U.S. doctors. *Id.* The district court further noted that "[t]he recalls were limited, and only applied to a fraction of the TAXUS stents released on the domestic market." *Id.* Thus, the court concluded, while "[i]n hindsight . . . it appears that this manufacturing change may indeed have been material," *id. at 159*, plaintiff failed "to allege facts that [**19] provide a strong inference that at the time of the manufacturing change, Defendants knew that TAXUS was defective or that the product would later be recalled," *id. at 160*.

With respect to defendant Paul LaViolette's July 29, 2004 remarks that Boston Scientific had identified and fixed the problem with TAXUS, the district court also invoked the doctrine of fraud by hindsight. A week after LaViolette's statements, the company initiated an additional recall of 3,000 TAXUS stents. However, the district court reasoned, there is no liability where "a plaintiff's claim rests on the assumption that the defendants 'must have known of the severity of their problems earlier because conditions became so bad later on.'" *Id.* (quoting *In re Boston Tech., Inc. Sec. Litig., 8 F. Supp. 2d 43, 53 (D. Mass. 1998))*. Here, the court concluded that plaintiff failed to allege facts giving rise to a strong inference that LaViolette knew at the time of his remarks that they were false or that an additional recall would be necessary. *Id.*

II.

On appeal, plaintiff argues that the district court erred in several respects. It argues that the court misapplied the doctrine of fraud by hindsight, resulting in the imposition [**20] of too stringent a pleading standard. More specifically, it claims that the court erroneously drew factual inferences against plaintiff regarding the manufacturing change and failed to account for the materiality of the change. Plaintiff further argues that the court misapplied the fraud by hindsight doctrine to LaViolette's remarks by discounting the temporal proximity between his statements and the third TAXUS recall, and it challenges the district court's factual assumption that the recall was limited in scope. Finally, plaintiff faults the district court for failing to consider the allegations of insider trading presented in the complaint. Overall, plaintiff argues the district court atomized the [*85] complaint and did not look at the overall pattern.

A. *Pleading Requirements*

We evaluate de novo whether a complaint meets the requirements of the PSLRA. *ACA Fin., 512 F.3d at 58*. As with any *Rule 12(b)(6)* motion to dismiss, we accept well-pled factual allegations in the complaint as true and make all reasonable inferences in plaintiff's favor. *Id.* The standard most recently articulated by the Supreme Court is that a complaint must allege "a plausible entitlement to relief" in order to withstand [**21] a motion to dismiss under *Rule 12(b)(6)*. *Bell Atl. Corp. v. Twombly, U.S. , 127 S. Ct. 1955, 1967-69, 167 L. Ed. 2d 929 (2007)*; *ACA Fin., 512 F.3d at 58*.

A claim for securities fraud under *section 10(b)* and *Rule 10b-5* must contain six elements: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. *ACA Fin., 512 F.3d at 58* (citing *Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005))*. Only the first two elements are at issue in this appeal.

Information is material if a reasonable investor would have viewed it as "having significantly altered the total mix of information made available." *Gross, 93 F.3d at 992* (quoting *Basic Inc. v. Levinson, 485 U.S. 224, 232, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988))* (internal quotation marks omitted). The PSLRA provides that a misleading statement or omission is alleged when plaintiff claims that defendant made "an untrue statement of a material fact," *15 U.S.C. § 78u-4(b)(1)(A)*, or "omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading," *id. § 78u-4(b)(1)(B)*. "While a company need [**22] not reveal every piece of information that affects anything said before, it must disclose facts, 'if any, that are needed so that what was revealed [before] would not be so incomplete as to mislead.'" *Cabletron, 311 F.3d at 36* (quoting *Backman v. Polaroid Corp., 910 F.2d 10, 16 (1st Cir. 1990)* (en banc)).

Scienter is a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976)*; *ACA Fin., 512 F.3d at 58*. This circuit has held that a plaintiff can demonstrate scienter by showing that defendants either "consciously intended to defraud, or that they acted with a high degree of recklessness." *Aldridge v. A.T. Cross Corp., 284 F.3d 72, 82 (1st Cir. 2002)*.

Securities fraud allegations also must meet the standards of *Federal Rule of Civil Procedure 9(b)* [5] and the PSLRA, which imposes heightened pleading requirements on private securities litigation. The PSLRA requires that when alleging that a defendant made a material misrepresentation or omission, a complaint must "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading." *15 U.S.C. § 78u-4(b)(1)*. If the allegation [**23] is "made on information and belief," then the complaint must "state with particularity all facts on which that belief is formed." *Id.*

5 *Rule 9(b)* requires that in alleging fraud or mistake, "a party must state with particularity the circumstances constituting fraud or mistake." *Fed. R. Civ. P. 9(b)*. In securities fraud cases, this requirement is comparable to and effectively subsumed by the requirements of the PSLRA. *See ACA Fin., 512 F.3d at 58 n.7*.

[*86] With respect to scienter, the complaint must, "with respect to each act or omission . . ., state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." *Id. § 78u-4(b)(2)* (emphasis added). This requirement that plaintiffs plead facts giving rise to a strong inference of scienter differs from the general rule applied to other cases that a reasonable inference is sufficient to survive a *Rule 12(b)(6)* motion; in the PSLRA "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss." *Greebel, 194 F.3d at 195*.

The Supreme Court's recent decision in *Tellabs* clarified that scienter should be evaluated with respect to "the [**24] complaint in its entirety, as well as other sources courts ordinarily examine when ruling on *Rule 12(b)(6)* motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." *Tellabs, 127 S. Ct. at 2509*; *see also ACA Fin., 512 F.3d at 58*. "The inquiry . . . is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Tellabs, 127 S. Ct. at 2509*. *Tellabs* also directed that courts consider "not only inferences urged by the plaintiff . . . but also competing inferences rationally drawn from the facts alleged," *id. at 2504*, and held that a complaint survives when there are equally compelling inferences for and against scienter, *id. at 2510*; *see also ACA Fin., 512 F.3d at 59*.

B. *Plaintiff's Allegations*

We evaluate plaintiff's allegations in this context. In reviewing a motion to dismiss under *Rule 12(b)(6)*, courts ordinarily will consider only documents attached to the complaint, but have made exceptions "for documents the authenticity of which are not disputed by the parties; for official [**25] public records; for documents central to plaintiffs' claim; [and] for documents sufficiently referred to in the complaint." *Watterson v. Page, 987 F.2d 1, 3 (1st Cir. 1993)*. [6]

6 We do not consider the transcripts of conference calls mentioned by both parties in their briefs and attached as an appendix to plaintiff's brief. In an order dated October 30, 2007, we rejected plaintiff's motion to expand the record before this court to include three transcripts that were not before the district court. We held that plaintiff had not demonstrated the "extraordinary circumstances" necessary to invoke this court's power to supplement a record under *Federal Rule of Appellate Procedure 10(e)(2)*. *United States v. Muriel-Cruz, 412 F.3d 9, 12 (1st Cir. 2005)*. We further held that although the complaint "contained some brief quotations from the documents, it did not expressly incorporate the entire documents, including the additional statements that [plaintiff] relies upon in its appellate brief." We also noted that regardless of whether the district court could have considered the transcripts if they were offered below, they had not been so offered.

1. *Manufacturing Change*

Plaintiff alleges that defendants [**26] failed to disclose information about the manufacturing change prior to July 2, 2004, and this information was material.

The primary motive alleged for the delay is that defendants wanted to build up inventory before announcing product recalls. Under the requirements of *section 10(b)* and *Rule 10b-5*, plaintiff must demonstrate both that the defendants omitted material information and that they did so with the requisite scienter.

Securities actions raise questions of what corporate managers knew and when they knew it. These issues are pertinent [*87] both to materiality and to scienter. Moreover, something may be material because of other information or explanations that have been given by defendants. Thus plaintiff does not need to rely on a theory that there was an independent duty to disclose the manufacturing change. Further, we do not reach the district court's reasoning on the materiality, standing alone, of either manufacturing changes or the receipt of FDA major deficiency letters.

The existence of a material omission is usually a question for the trier of fact. *See ACA Fin., 512 F.3d at 65* (citing *Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1217 (1st Cir. 1996))*. In this case, we cannot [**27] say that as a matter of law the complaint fails to raise a reasonable inference that this was a material omission.

The company's own statements draw a connection between the manufacturing change and the resolution of the balloon non- deflation problems, whether or not the earlier product had a defect. Indeed, Boston Scientific's Form 10-Q for the quarter ending June 30, 2004 included the following statements: "As a result of its investigation, the Company has implemented reviews of its manufacturing process, additional inspections, and an FDA-approved modification to the manufacturing process for [TAXUS and Express (R) stents]. The Company believes these measures will be effective in reducing the occurrence of balloon non-deflation."

Because the manufacturing change, in combination with other changes, would have the effect of reducing balloon non-deflation, a jury could find that the company's continuing assertions that reported problems about TAXUS in the United States resulted from doctor unfamiliarity with the product rather than any defect in the product were misleading unless accompanied by disclosure of the manufacturing change and its connection to the balloon non-deflation problem. [**28] *See Cabletron, 311 F.3d at 36*. Among other things, the existence of this manufacturing change was pertinent to the issue of potential recalls, and it would raise the question whether, if there were continuing problems or recalls, the company would have on hand sufficient new products incorporating the manufacturing change in order to allow the company to replace the original TAXUS stents and maintain market share.

Assuming that a jury could find a material omission, the next requirement under *section 10(b)* and *Rule 10b-5* is that defendants acted with the requisite scienter in not disclosing the manufacturing change sooner, i.e., prior to the first recall announced on July 2, 2004. Knowingly omitting material information is probative, although not determinative, of scienter. *Aldridge, 284 F.3d at 83* ("[T]he fact that the defendants published statements when they knew facts suggesting the statements were inaccurate or misleadingly incomplete is classic evidence of scienter."); *see also ACA Fin., 512 F.3d at 65*.

Plaintiff alleges that at some point prior to the FDA approval of TAXUS in March 2004, defendants knew that the problem with TAXUS was not doctor unfamiliarity but rather a manufacturing [**29] defect, and the company had already determined how to fix that defect. Specifically, plaintiff alleges that prior to the U.S. launch of TAXUS, defendants knew of adverse reports from doctors in Europe about balloon non-deflation, and that they also knew that the Express (R) metal stent, which used the same delivery system as TAXUS, had a "history of significant problems." CAC P 93. Plaintiff also alleges that defendants received numerous adverse reports in the spring of 2004 from U.S. doctors, which [*88] they "minimized and misrepresented," and attributed to doctors' unfamiliarity with the new product. *Id.* Yet defendants proceeded with the U.S. launch of TAXUS and did not disclose this information until July 2, 2004.

Plaintiff alleges that defendants withheld this information to allow the company to build up its inventory of new, non-defective products which had been made with the manufacturing change in place, in order to avoid loss of market share. [7] Plaintiff also alleges that several of the defendants engaged in insider trading during this lag period, benefitting from the delay.

7 Companies, of course, have other reasons not to have made an announcement from which some might have inferred [**30] there may have been a product defect causing injury and death, which could have been avoided by using different manufacturing techniques.

Inferences supporting plaintiff's allegations about defendants' knowledge can be drawn from statements in Boston Scientific's Form 10-Q for the quarter ending June 30, 2004, filed on August 9, 2004. The Form 10-Q discusses the company's voluntary recall of the TAXUS Express (R) stent "due to characteristics in the delivery catheters that have the potential to impede balloon deflation during a coronary angioplasty procedure. Further analysis and investigation of the TAXUS Express (R) (paclitaxel-eluting) and Express (R) (bare metal) stent systems, both of which share the same delivery catheter, revealed that certain additional production lots exhibited these same characteristics." This statement acknowledges a connection between the balloon non-deflation problem and the characteristics of the delivery catheter. The statement also acknowledges that the company had been conducting ongoing analysis and investigation of the problem and as a result voluntarily expanded its recall on July 16. The statement goes on to say that the company would continue [**31] to work with the FDA to monitor the non-deflation problem.

Tellingly, the statement also says that "*[a]s a result of its investigation*, the Company has implemented . . . an FDA-approved modification to the manufacturing process." (Emphasis added.) To the extent the company may be arguing that there was no connection between the manufacturing change and any characteristics of the catheter, defendants' own statements can be read to say that they implemented the manufacturing change *in response to* adverse reports, not independent of them.

Defendants made a similar statement in the press release announcing the July 16 expanded recall. After noting that the company had conducted "further analysis and investigation" that demonstrated the need for an expanded recall, the press release states: "The Company implemented review of its manufacturing process, additional inspections, and an FDA-approved modification to the manufacturing process for these products. The current and future production are not expected to experience similar balloon deflation problems."

Defendants make a different argument, addressed below, that even if the manufacturing change did solve the problem by preventing balloon [**32] non-deflation, that does not mean they knew the connection or were obliged to disclose it earlier.

Plaintiff gave a reason why defendants withheld information: so that they could build up an inventory of "new" TAXUS stents prior to announcing the recalls, thereby minimizing supply disruptions and maximizing profit. In support of this theory is the fact that defendants asserted in [*89] their Form 10-Q for the quarter ending June 30, 2004 that they had been able to use their "existing supply of coronary stents not subject to the recall to replenish the U.S. market," although they also noted that they were unable to replenish the European market with existing stock and were hoping to do so during the third quarter of 2004. Similarly, in the press release announcing the July 16 recall, defendant James Tobin stated that, "We're fortunate that current TAXUS inventory levels will minimize service disruption in the United States, but we do expect some disruption internationally."

Plaintiff's proposed inferences are that defendants knew about the connection between adverse reports and the manufacturing change well before July 2, and withheld that information in order to build up inventory prior to [**33] announcing recalls. Under the PSLRA these inferences must be strong and must be weighed against competing ones. Defendants' inferences are that the manufacturing change was implemented for "innocuous" reasons not owing to any defect in the product, and that they did not know of a connection between the manufacturing change and the adverse reports they were receiving from U.S. doctors until the time of the first recall. Defendants' inferences are supported by the fact that balloon non-deflation complaints that defendants received from doctors in Europe in 2003 faded over time, indicating that such complaints were in fact tied to doctor unfamiliarity. Additionally, defendants' press releases and Form 10-Q for the quarter ending June 30, 2004 stated that it was not the manufacturing change alone but rather this change in combination with others, including an improved inspection process, that would prevent non-deflation in the future. At no point did defendants communicate that the manufacturing change alone would fix the non-deflation problem.

Given these allegations, the district court held that plaintiff failed to plead facts providing a strong inference that at the time of the manufacturing [**34] change, defendants had the requisite scienter. *In re Boston Scientific, 490 F. Supp. 2d at 160*. It reasoned that the manufacturing change was implemented with the FDA's knowledge and approval, at a time when the company had received only a "limited number of complaints from Europe which had tapered off after the product's release." *Id.* Moreover, defendants asserted and plaintiff did not dispute that the manufacturing change would have been put into place regardless of whether the company received complaints from doctors in the United States. *Id.* The district court did not address the key question of inferences about whether defendants knew that the manufacturing change was related to non-deflation complaints at some point prior to the July 2 recall, not just when they first initiated the change. [8]

8 Plaintiff and defendants dispute the extent of the recall, with plaintiff arguing that all pre-manufacturing change stents were recalled and defendants responding that approximately 445,000 "old" TAXUS stents had already been shipped and implanted and therefore were not problematic or recalled. We need not resolve this factual question at this point because the extent of the recall is largely [**35] irrelevant to our analysis. There seems not to be a dispute that a connection existed between the manufacturing change and the non-deflation problem that necessitated the recall.

The district court did not have the benefit of the *Tellabs* opinion, which reversed a higher standard for scienter imposed by the prior law of this circuit. We apply *Tellabs* and that leads us to a different result. While there is support for defendants' inferences, we think, at this stage, that plaintiff's inferences are at least equally strong. First, there is a very reasonable [*90] inference that defendants initiated the manufacturing change as a result of non-deflation complaints it had received from Europe, even if these complaints had tapered off over time.

Other inferences may be drawn favorable to plaintiff by proper recognition of the limits of the doctrine of fraud by hindsight. Fraud by hindsight refers to allegations that assert no more than that because something eventually went wrong, defendants must have known about the problem earlier. "[A] plaintiff may not simply contrast a defendant's past optimism with less favorable actual results, and then 'contend[] that the difference must be attributable to [**36] fraud.'" *Shaw, 82 F.3d at 1223* (quoting *DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990))*.

The doctrine has been applied in a number of different situations. We recognize that the effect of use of the doctrine at the *Rule 12(b)(6)* dismissal stage is to cut off the case as a matter of law, without further factual development. As some commentators have stated, "[A]t this stage, a court must be cautious. The case has not yet developed. In cutting off the case on the pleadings by citing hindsight, the court is essentially making a prediction that the discovery process will yield only evidence that requires the benefit of the hindsight bias to seem adequate [to support the allegations]." M. Gulati, J. Rachlinski & D. Langevoort, *Fraud by Hindsight, 98 Nw. U.L. Rev. 773, 787 (2004)*. Meanwhile, at the pleadings stage, "a bad outcome truly is relevant to the likelihood of fraud." *Id. at 815*. Indeed, this court has held that "in determining the adequacy of a complaint . . . we cannot hold plaintiffs to a standard that would effectively require them, pre-discovery, to plead evidence." *Shaw, 82 F.3d at 1225*. The law "proscribes the pleading of 'fraud by hindsight,' but neither can plaintiffs [**37] be expected to plead fraud with complete insight." *Id.* (quoting *Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978)* (Friendly, J.)).

In *Shaw*, we held that the doctrine did not apply when plaintiffs provided "a series of factual allegations relating to a combination of developments known to the company . . . that could have provided a basis for advance knowledge of the information" which was eventually disclosed. *Id. at 1224*. We held that these allegations of developments known to the company, along with (admittedly weak) evidence of insider trading and the temporal proximity between the date of the alleged omission and the eventual disclosure (less than a month), were sufficient to survive a motion to dismiss. [9] *Id. at 1225*.

9 *Shaw* was decided before the PSLRA was enacted, but *Rule 9(b)*'s particularity requirement is similar to the requirements of the PSLRA. *See supra* n.5.

Defendants in this case urged, and the district court accepted, that plaintiff's allegations amounted to nothing more than an allegation of fraud by hindsight: that simply because the manufacturing change eventually was linked as a remedy for the balloon non-deflation problem, defendants must have known about the connection [**38] earlier. This approach fails to consider the other allegations that plaintiff made from supporting documents. For instance, there is no dispute that the manufacturing change related to the laser welding of the delivery catheter and balloon, and it may be inferred this addressed the same problem which resulted in the recalls. It is also clear that defendants had received non-deflation reports from doctors in Europe before instituting the manufacturing change, as well as numerous non-deflation complaints from U.S. doctors while the company was in the process of implementing the change. Moreover, defendants' [*91] own SEC filings and press releases reveal that they reassured the public that they had implemented the manufacturing change *in response* to complaints of non-deflation, so that the "new" TAXUS would not suffer from the same problems. The company said it had been monitoring, analyzing, and investigating the problem and appropriate responses. It is fair to infer the company has highly effective information systems. *Cf. id. at 1224 n.38*. Defendants are in a highly regulated industry and the company, it can be inferred, constantly monitors reports of patient injury and death and looks [**39] for prompt solutions to such problems.

This is not the classic fraud by hindsight case where a plaintiff alleges that the fact that something turned out badly must mean defendant knew earlier that it would turn out badly. *Denny, 576 F.2d at 470*. Nor is this a case where there is no contemporaneous evidence at all that defendants knew earlier what they chose not to disclose until later. *DiLeo, 901 F.2d at 626-7*.

2. *LaViolette's Statements*

Plaintiff also disputes the district court's rejection of the LaViolette allegations under the doctrine of fraud by hindsight. The allegations are that defendant Paul LaViolette made public statements that were "false and misleading" and constituted a "misrepresentation" (1) when he stated on July 29 -- a week before the third recall was announced on August 5 -- that the problem with TAXUS had been "fixed," and (2) when he stated on July 26 that there was simply a "lag time" in the marketplace's conversion to the improved version of TAXUS. CAC P 101.

Plaintiff's complaint may be read as alleging a material omission and as supporting scienter. LaViolette's remarks were misleading not because the problem had not been "fixed," but because LaViolette excluded [**40] any mention of the upcoming recall. In other words, it was misleading for LaViolette to say that the problem had been "fixed" while failing to mention that a third recall, of another 3,000 stents, would be announced a week later.

As with plaintiff's allegations regarding the manufacturing change, we cannot say that LaViolette's omission was immaterial as a matter of law. The investors with whom LaViolette was speaking in the conference call would very well have wanted to know about the existence of an upcoming recall in addition to hearing LaViolette's assurances that the TAXUS problems were in the past.

With respect to scienter, the district court held that plaintiff was merely alleging fraud by hindsight because plaintiff was claiming no more than that LaViolette should have known about the recall earlier. According to the district court, "Lead Plaintiff fails to allege facts that provide a strong inference that Defendant LaViolette knew that an additional recall was necessary or that his remarks were false when he made them." *In re Boston Scientific, 490 F. Supp. 2d at 160*. We disagree.

This fails to account for the very short amount of time between LaViolette's remarks, some of which [**41] were made on Thursday, July 29, and the third recall, which was announced the following Thursday, August 5. Temporal proximity alone is insufficient to establish a claim for fraud, *see Shaw, 82 F.3d at 1225*, but this court has insisted on a "fact-specific inquiry" regarding scienter. *Greebel, 194 F.3d at 196*. The extremely short time period here is strong evidence.

Moreover, LaViolette was the company's Chief Operating Officer and a point person on TAXUS, and so he would presumably [*92] have been aware of the status of the company's "ongoing monitoring" of "old" TAXUS stents. CAC PP 18, 93. The third recall, like the two before it, was voluntary and initiated by Boston Scientific rather than the FDA.

3. *Insider Trading*

Because the district court dismissed on scienter grounds, it did not consider the insider trading allegations. We do consider these allegations in the overall mix.

Insider trading cannot establish scienter on its own, but it can be used to do so in combination with other evidence. *Greebel, 194 F.3d at 197-98*; *Shaw, 82 F.3d at 1224*. Insider trading in suspicious amounts or at suspicious times may be probative of scienter. *Greebel,* *194 F.3d at 197*; *Greenstone v. Cambex Corp., 975 F.2d 22, 26 (1st Cir. 1992)*. [**42] Plaintiff alleges that all defendants engaged in insider trading during the narrowed class period of December 3, 2003 to August 5, 2004, *see* CAC PP 15-23, and they argue that stock sales of $ 40.82 million by James R. Tobin, $ 54.2 million by Lawrence C. Best, $ 4.2 million by Fredericus A. Colen, and $ 3.3 million by Robert G. MacLean within the two months following the FDA's approval of TAXUS are particularly suspicious, *see id.* P 96.

However, we acknowledge that plaintiff's complaint has allegations going the other way. Plaintiff alleges that all but one (Tobin) of these defendants engaged in insider trading at periods outside of the narrowed class period, including some after the recalls were announced and the manufacturing change was disclosed. This undermines the inference that the timing of the trading was suspicious. *Id.* PP 15-23. Plaintiff also does not allege that the particular timing of the trading was suspicious other than that it occurred during the eight-month period to which the appeal is limited: the trading has not been linked, for instance, to defendants' non-disclosed knowledge of the manufacturing change or problems with TAXUS.

Defendants respond that many of these [**43] stock sales, including all of Best's and many of Tobin's, were effectuated pursuant to *Rule 10b5-1* trading plans that removed control of the sales from the individual defendants. It was defendants' choice to move to dismiss the case on the pleadings without presenting evidence. As a result, there is no evidence of when the trading plans went into effect, that such trading plans removed entirely from defendants' discretion the question of when sales would occur, or that they were unable to amend these trading plans.

The insider trading claims as alleged are on the weaker end of the spectrum. But, as in *Shaw*, "we think that the plaintiffs' allegations of insider trading, inasmuch as they are at least consistent with their theory of fraud, provide some support against the defendants' motion to dismiss." *82 F.3d at 1224*; *see also Greebel, 194 F.3d at 197-98* ("The vitality of the inference to be drawn depends on the facts, and can range from marginal to strong." (citations omitted)).

Plaintiff has alleged a significant amount of insider trading in the months before the announcement of recalls in July, which caused the stock price to drop. CAC PP 100, 102. The company's stock price was at [**44] an all-time high in the months before the recalls were announced, often closing above $ 40. *Id.* PP 15-23, 96, 100. It fits with plaintiff's theory that defendants would have sold stock at this time, knowing that the price would drop when the manufacturing change, acknowledging a defect, was announced. If defendants were unaware of the connection between [*93] the non-deflation reports they were receiving and the manufacturing change, a fact finder could reasonably ask why they would have sold so much stock at a time when the company appeared to be soaring on the strength of TAXUS.

Given plaintiff's specific factual allegations, the temporal proximity between LaViolette's statements and the third recall, and the alleged insider trading, we think that plaintiff has pled enough to give rise to inferences that are at least as strong as any competing inferences regarding scienter.

C. *Group Pleading*

Defendants argue that plaintiff has engaged in impermissible group pleading and that several of the defendants should be dismissed from the case now that the subject area has been narrowed on appeal because they are not specifically alleged to have been involved with TAXUS. [10] The district court did not [**45] address the issue. We decline to address the issue in the first instance.

> 10 Under the group pleading presumption, a court may attribute all statements to the defendants as collective actions without considering the liability of each individual defendant. This court has recognized "a very limited version of the group pleading doctrine for securities fraud." *Cabletron, 311 F.3d at 40*. There has been "great debate about the doctrine's continued existence after enactment of the PSLRA," a question on which this circuit has not taken a position. *Id.* We need not here resolve whether group pleading survives the PSLRA.

We take into account, as in *Cabletron*, the fact that the overall complaint survives, the pre-discovery posture of the case, and the fact that all of the individual defendants held positions of significant responsibility within the company and therefore potentially face control person liability under *section 20(a)*. *Cabletron, 311 F.3d at 41*. We think the questions should be resolved in the first instance by the district court.

D. *Section 20(a) Liability*

Plaintiff has also made allegations against defendants under *section 20(a)*, which establishes liability for any person who "directly [**46] or indirectly[] controls any person liable" for a violation of securities laws. *15 U.S.C. § 78t(a)*. The district court summarily dismissed the *section 20(a)* claims on account of its dismissal of the *section 10(b)* claims. Reinstatement of *section 20(a)* claims is generally appropriate when *section 10(b)* claims have been reinstated and the *section 20(a)* claims had been dismissed by the district court because of its dismissal of the *section 10(b)* claims. *Cabletron, 311 F.3d at 41*; *see also Nathenson v. Zonagen Inc., 267 F.3d 400, 426 n.29 (5th Cir. 2001)*; *Hollin v. Scholastic Corp. (In re Scholastic Corp. Sec. Litig.), 252 F.3d 63, 77-78 (2d Cir. 2001)*.

On appeal, defendants claim that plaintiff has failed to allege facts demonstrating that any of the individual defendants are subject to control person liability and therefore the *section 20(a)* claims should be dismissed even if the *section 10(b)* claims are allowed to stand. We disagree. "Control is a question of fact that 'will not ordinarily be resolved summarily at the pleading stage.' The issue raises a number of complexities that should not be resolved on such an underdeveloped record." *Cabletron, 311 F.3d at 41* (citation omitted) (quoting [**47] 2 T.L. Hazen, *Treatise on the Law of Securities Regulation* § 12.24(1) (4th ed. 2002)). The practical effect of reinstating the *section 20(a)* claims is small since the same defendants are involved as with the *section 10(b)* claims, and individual [*94] defendants are not foreclosed from challenging their liability under *section 20(a)* in the future. *Id. at 41-42*.

III.

We do not address the other requirements of *section 10(b)* and *Rule 10b-5*, which were not raised in this appeal by either party.

We reverse the dismissal and remand the case to the district court for further proceedings consistent with this opinion.

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ATSI COMMUNICATIONS, INC., a Delaware Corporation, Plaintiff-Appellant, -v.- THE SHAAR FUND, LTD., SHAAR ADVISORY SERVICES, N.V., RGC INTERNATIONAL INVESTORS, LDC, ROSE GLEN CAPITAL MANAGEMENT, L.P., CORPORATE CAPITAL MANAGEMENT, INTERCARIBBEAN SERVICES LTD., CITCO FUND SVCS., LUC HOLLMAN, SAM LEVINSON, HUGO VAN NEUTEGEM, DECLAN QUILLIGAN, WAYNE BLOCH, GARY KAMINSKY, STEVE KATZNELSON, TRIMARK SECURITIES, INC., LEVINSON CAPITAL MANAGEMENT, and W.J. LANGEVELD, Defendants-Appellees, MARSHALL CAPITAL SERVICES, LLC., JESUP & LAMONT STRUCTURED FINANCE GROUP, MG SECURITY GROUP, INC., CROWN CAPITAL CORPORATION, JOHN DOES 1-50, KENNETH E. GARDINER, NATHAN LIHON, and SEI INVESTMENT CO., Defendants. ATSI COMMUNICATIONS, INC., a Nevada Corporation, Plaintiff-Appellant, -v.- URI WOLFSON, SAM LEVINSON, Defendant-Appellee, Defendant.

Docket No. 05-5132-cv, Docket No. 05-2593-cv

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

493 F.3d 87*; *2007 U.S. App. LEXIS 16382*; *Fed. Sec. L. Rep. (CCH) P94,363

November 29, 2006, Argued
July 11, 2007, Decided

SUBSEQUENT HISTORY: Sanctions allowed by, in part *ATSI Communs., Inc. v. Shaar Fund, Ltd., 2008 U.S. Dist. LEXIS 30624 (S.D.N.Y., Mar. 27, 2008)*

PRIOR HISTORY: [**1]

Appeals from judgments of the United States District Court for the Southern District of New York (Lewis A. Kaplan, Judge), dismissing plaintiff ATSI Communications, Inc.'s complaints alleging, inter alia, securities fraud in violation of *§ 10(b)* of the Securities Exchange Act of 1934 and *Rule 10b-5* promulgated thereunder. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 357 F. Supp. 2d 712 (S.D.N.Y. 2005)*.
ATSI Communs., Inc. v. Shaar Fund, Ltd., 357 F. Supp. 2d 712, 2005 U.S. Dist. LEXIS 2833 (S.D.N.Y., 2005)

DISPOSITION: AFFIRMED.

COUNSEL: THOMAS I. SHERIDAN III (Andrea Bierstein, Melissa C. Welch, on the brief), Hanly Conroy Bierstein & Sheridan LLP, New York, New York, for ATSI Communications, Inc.

JONATHAN M. SPERLING (Amanda J. Gourdine, on the brief), Covington & Burling, New York, New York, for The Shaar Fund, Ltd., Shaar Advisory Services, N.V., Levinson Capital Management, Sam Levinson, and Uri Wolfson.

J. KEVIN MCCARTHY (Joanne L. Monteavaro, on the brief), Wilmer Cutler Pickering Hale and Door LLP, New York, New York, for Rose Glen Capital Management, L.P., RGC International Investors, LDC, Wayne Bloch, Gary Kaminsky, and Steven Katznelson.

DAVID G. CABRALES (W. Scott Hastings, Jeffrey A. Logan, on the brief), Locke Liddell & Sapp LLP, Dallas, Texas; Cahill Gordon & Reindel LLP (Thorn Rosenthal, Janet A. Beer, [**2] on the brief), New York, New York, for Trimark Securities, Inc.

MICHAEL J. DELL (Elaine Golin, on the brief), Kramer Levin Naftalis & Frankel LLP, New York, New York, for Citco Fund Services (Cura§ ao) N.V., InterCaribbean Services, Ltd., Hugo van Neutegem, Wim Langeveld, Luc Hollman, and Declan Quilligan.

Berkman, Henoch, Peterson & Peddy, P.C. (Ronald M. Terenzi, on the brief), Garden City, New York, for Corporate Capital Management.

JUDGES: Before: JACOBS, Chief Judge, WALKER and RAGGI, Circuit Judges.

OPINION BY: JOHN M. WALKER, JR.

OPINION

[*93] JOHN M. WALKER, JR., *Circuit Judge*:

These appeals arise from judgments of the United States District Court for the Southern District of New York (Lewis A. Kaplan, *Judge*), dismissing plaintiff ATSI Communications, Inc.'s ("ATSI") complaints under *Fed. R. Civ. P. 12(b)(6)* in two separate actions arising from the same events. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 357 F. Supp. 2d 712 (S.D.N.Y. 2005)*. ATSI alleges that the defendants made misrepresentations in connection with securities transactions and engaged in market manipulation in violation of *§ 10(b)* of the Securities Exchange Act of 1934 ("Exchange Act"), *15 U.S.C. § 78j(b)*, and *Rule 10b-5* promulgated thereunder, *17 C.F.R. § 240.10b-5*, [**3] or were liable as control persons under *§ 20(a)* of the Exchange Act, *15 U.S.C. § 78t(a)*. ATSI claims that the defendants fraudulently induced it to sell to them its convertible preferred stock. The defendants then aggressively short sold ATSI's common stock and converted the preferred stock to cover their short positions. The alleged consequence was a "death spiral" in the price of ATSI's stock and enormous profit for the defendants.

We affirm the judgments of the district court.

BACKGROUND

The following facts are taken from ATSI's complaints and supporting documents, which we must assume to be true in reviewing a *Fed. R. Civ. P. 12(b)(6)* dismissal. *See Rothman v. Gregor, 220 F.3d 81, 88 (2d Cir. 2000)*.

A. ATSI and Its Efforts to Raise Money

ATSI was founded in December 1993 and hoped to become a leading provider of retail communications services in Mexico in the wake of the deregulation and privatization in Latin America's telecommunications markets. It never turned a profit. By 1999, ATSI needed an infusion of capital to expand its U.S. customer base and [*94] further develop its telephone network in Mexico.

To raise money, ATSI issued four series of cumulative convertible preferred stock ("Preferred [**4] Stock"): Series B, C, D, and E. Each transaction included a Securities Purchase Agreement, a Certificate of Designation, and a Registration Rights Agreement. Each series included a risk-mitigating conversion feature that worked as follows. Upon conversion, a "Market Price" was calculated as the average of the lowest five closing bid prices during the ten-day period preceding the conversion date. The "Conversion Price" was calculated as the lesser of (1) the closing bid price on a trading day fixed by the Certificate of Designation and (2) the Market Price discounted by 17% to 22% depending upon the series. ATSI would then issue a number of shares of common stock equal to (1) the number of shares of Preferred Stock to be converted (2) multiplied by the Preferred Stock's stated value of $ 1,000 per share (3) divided by the Conversion Price. Because there is no limit on the number of common shares into which the Preferred Stock could convert, securities such as these are called "floorless" convertibles. The obvious inference from ATSI's sale of these securities is that these unfavorable terms were necessary to attract investors because ATSI was continuously losing money. In fact, ATSI [**5] acknowledged that in light of its financial condition, it might "not be able to raise money on any acceptable terms." American Telesource International, Inc., Annual Report (Form 10-K), at 16 (July 31, 2000).

1. Sales to the Levinson Defendants

On a "road show" in Dallas, Texas in March 1999, defendant Corporate Capital Management ("CCM") introduced ATSI executives to defendant Sam Levinson, the managing director of Levinson Capital and the Shaar Fund. Shaar Advisory Services, N.V. ("Shaar Advisory") served as executive officer and general partner of the Shaar Fund. Defendant Uri Wolfson controls the Shaar Fund. Collectively, Levinson, Levinson Capital, the Shaar Fund, and Shaar Advisory constitute the "Levinson

Defendants."

During a May 1999 telephone conversation, CCM told ATSI that the Shaar Fund had invested in several strong, successful companies and that the Levinson Defendants were interested in ATSI's long-term growth. During a June meeting, Levinson told ATSI, inter alia, that the Levinson Defendants sought a long-term investment in ATSI and would not engage in any activity to depress its stock. ATSI claims that all of these representations were false and misleading because CCM [**6] and Levinson knew otherwise and the Levinson Defendants were actually market manipulators that profited at the expense of the companies in which they invested.

Over the next six months, ATSI entered into the following securities transactions with the Shaar Fund.

Transaction Date	**# of Preferred Shares Purchased**	**# of Warrants Purchased**	**Total Purchase Price**
July 2, 1999	2,000 Series B	50,000	$ 2,000,000
Sept. 24, 1999	500 Series C	20,000	$ 500,000
Feb. 22, 2000	3,000 Series D	150,000	$ 3,000,000

[*95] The Securities Purchase Agreement for each transaction included written representations that:

> 1. The Shaar Fund was an "accredited investor" within the meaning of *Rule 501* of Regulation D under the Securities Act of 1933; and
>
> 2. "Neither [the Shaar Fund] nor its affiliates nor any person acting on its or their behalf has the intention of entering, or will enter into, prior to the closing, any put option, short position, or other similar instrument or position with respect to the Common Stock [of ATSI] and neither [the Shaar Fund] nor any of its affiliates nor any person acting on its or their behalf will use at [**7] any time shares of Common Stock acquired pursuant to this Agreement to settle any put option, short position or other similar instrument or position that may have been entered into prior to the execution of this Agreement."

ATSI claims that these representations were false because (1) the Shaar Fund's net worth was not high enough to meet the requirements for being an accredited investor and (2) the Shaar Fund intended to engage, and did engage, in short selling and manipulation of ATSI's stock before, during, and after entering into these agreements.

The Registration Rights Agreement in each transaction contained a merger clause stating that:

> There are no restrictions, promises, warranties, or undertakings, other than those set forth or referred to herein. This Agreement, the Securities Purchase Agreement, the Escrow Instructions, the Preferred Shares and the Warrants supersede all prior agreements and undertakings among the parties hereto with respect to the subject matter hereof.

The Registration Rights Agreements contemplated that the Shaar Fund would soon sell its converted common stock into the public markets. They required ATSI to use its "best efforts" to register the common stock [**8] to be issued upon conversion of the Preferred Stock within 90 days of closing and to take all reasonable steps to help the Shaar Fund sell the common stock. They also imposed, at most, a 90-day holding period before the Shaar Fund could convert its Preferred Stock. The only restriction upon the Shaar Fund's ability to sell the common stock was if ATSI notified it of a material misstatement in the stock's prospectus.

2. Sales to Rose Glen

In September 1999, ATSI decided to issue $ 15 million in its equity to fund an acquisition. Defendant Crown Capital Corporation ("Crown Capital"), acting as placement agent, recommended defendants RGC

International Investors, LDC, and Rose Glen Capital Management, L.P. Defendants Wayne Bloch, Gary Kaminsky, and Steve Katznelson were employees of Rose Glen Capital Management. We refer collectively to all of these defendants as "Rose Glen."

During negotiations, Rose Glen allegedly made false verbal representations similar to those made by the Levinson Defendants.

On September 27, 2000, Rose Glen submitted a draft term sheet to ATSI offering a $ 10 million investment. ATSI claims that it then fell victim to a bait-and-switch when, on October 16, 2000, Rose [**9] Glen submitted closing documents providing for only a $ 2.5 million investment in Series E Preferred Stock, with a promise of further [*96] investment of up to $ 10 million if certain conditions were met. ATSI says it was forced to accept these terms because it was required to pay $ 2 million to vendors in Mexico the next day. ATSI sold Rose Glen additional Series E Preferred Stock in March and July of 2001.

The Purchase Agreement pursuant to which these securities were sold included two representations by Rose Glen that ATSI claims to be false on the same basis as the Levinson representations:

> 1. Rose Glen was an accredited investor; and
>
> 2. Rose Glen was purchasing the Preferred Stock and common stock issuable upon conversion:
>
> for its own account and not with a present view towards the public sale or distribution thereof except pursuant to sales registered or exempted from registration under the 1933 Act; *provided, however* that by making the representation herein, the Buyer does not agree to hold any of the Securities for any minimum or other specific term and reserves the right to dispose of the Securities at any time in accordance with or pursuant to a registration statement or exemption [**10] under the 1933 Act.

The Registration Rights Agreements also contained a merger clause similar to the one in the Shaar Fund transaction documents.

B. The "Death Spiral" Financing Manipulation Scheme

In addition to these misrepresentations, ATSI claims that all of the defendants manipulated the market in ATSI's common stock by bringing about a "death spiral" in the price of ATSI's common stock. The scheme, as alleged, worked as follows. The shareholder would short sell the victim's common stock to drive down its price. [1] He then converts his convertible securities into common stock and uses that common stock to cover his short position. The convertible securities allow a manipulator to increase his profits by allowing him to cover with discounted common shares not obtained on the open market, to rely on the convertible securities as a hedge against the risk of loss, and to dilute existing common shares, resulting in a further decline in stock price. ATSI was aware of the risk of dilution; for example, it disclosed in the registration statement on its Form S-3 that it expected the Shaar Fund to convert shortly after the registration became effective and that future issuances of Preferred [**11] Stock would put downward pressure on and dilute its common stock.

1 An investor sells short when he sells a security that he does not own by borrowing the security, typically from a broker. *See Levitin v. PaineWebber, Inc., 159 F.3d 698, 700 (2d Cir. 1998)*. At a later date, he "covers" his short position by purchasing the security and returning it to the lender. *Id.* A short seller speculates that the price of the security will drop. *Id.* If the price drops, the investor profits by covering for less than the short sale price. *Id.* If, on the other hand, the price increases, the investor takes a loss. A short seller's potential losses are limitless because there is no ceiling on how high the stock price may rise.

ATSI accuses the Levinson Defendants, Wolfson, and Rose Glen of deliberately causing a "death spiral" in its common stock. The Shaar Fund began converting its Preferred Stock shortly after it was contractually permitted to do so. During the first two quarters of fiscal year 2000, it had converted all of its Series B shares into approximately 2.6 million common shares. Although ATSI's April 14, 2000 Form S-3 states that the Shaar Fund sold the common stock, the complaints do not

[**12] allege any such sales. Between December [*97] 12, 2000 and January 23, 2002, the Shaar Fund converted its Series D shares into 8,331,454 shares of ATSI common stock. Between March 8, 2001 and August 14, 2002, Rose Glen converted its Preferred Stock into over nineteen million shares of common stock.

ATSI does not allege any specific acts of short selling by the Levinson Defendants, but it includes circumstantial allegations. It alleges that searches in the SEC's Edgar database reveal that of the 38 companies that reported the Levinson Defendants as investors, 30 experienced stock price declines indicative of a "death spiral" financing scheme. Its allegations against Rose Glen are of like kind.

ATSI also relies on the magnitude and timing of changes in its stock price and trading volume. At the time of the Series B transaction in July 1999, its stock traded at $ 1.50 per share. Two months later, it traded at $ 1.08 per share. In February 2000, the Series D Preferred Stock purchase was preceded by a significant increase in the daily trading volume of ATSI's shares and a dramatic rise in ATSI's share price to $ 9 per share (perhaps not coincidentally as ATSI listed its stock on the American Stock [**13] Exchange ("AMEX") during that period). April 2000 saw massive stock sales and large price declines in ATSI's stock. For example, between April 13, 2000 and April 18, 2000 - during which time ATSI filed a registration statement for the common stock into which the Series C and D Preferred Stock would convert - the price fell from $ 6.50 per share to $ 3.62 per share on heavy volume. ATSI claims that these price movements could only have resulted from sales by the Levinson Defendants, despite Levinson's claim that the Shaar Fund was not selling.

ATSI's stock price climbed up to $ 6 per share by early-June 2000. On September 8, 2000, ATSI's registration of common stock for the Series C and D Preferred Stock became effective and, by November 28, 2000, its price had fallen to $ 0.75 per share, and plummeted to $ 0.09 per share on August 16, 2002.

In addition to these price fluctuations, ATSI relies more specifically on price movements and trading volume around the time that the Shaar Fund and Rose Glen converted their Series D and E Preferred Stock, which worked to their benefit. ATSI further points to instances where its stock price reacted negatively to positive news. ATSI also points to [**14] a 10-trading-day period between December 31, 2002 and January 14, 2003 in which Depository Trust Company records show that over eight million shares were traded in excess of settlement, which it claims could only result from sham trading.

C. Other Defendants

ATSI alleges that any manipulation had to involve defendant Trimark Securities, Inc. ("Trimark"), which served as the principal market maker in ATSI's stock.

ATSI also alleges that several defendants, hereinafter referred to as the "Citco Defendants," caused the Shaar Fund to engage in the charged misconduct. Defendant Citco Fund Services (Cura§ ao) N.V. is the parent of defendant InterCaribbean Services, Ltd., the Shaar Fund's sole director. Declan Quilligan is a director of InterCaribbean. W.J. Langeveld, Hugo Van Neutegem, and Luc Hollman served as Managing Directors of Shaar Advisory.

D. ATSI's Demise

Telecom stocks were generally hard-hit during the period in which ATSI alleges manipulation. Between February 22, 2000 (the date on which ATSI issued the Series D Preferred Stock) and October 31, 2002 [*98] (the date on which ATSI filed its first suit), the AMEX North American Telecom Index (of which ATSI's stock was not a component) dropped [**15] by 73%. When ATSI filed its complaint, its stock traded at $ 0.02 per share. Its financial impairment has rendered it unable to raise capital to maintain or expand its business.

E. ATSI's Claims and Procedural History

ATSI claims that the Levinson Defendants, Wolfson, Langeveld, Rose Glen, CCM, and Crown Capital are liable for misrepresentations under *§ 10(b)* and *Rule 10b-5*; that these same defendants and Trimark are also liable for market manipulation in violation of *Rule 10b-5*; and that the Citco Defendants and others not relevant to this appeal are liable as control persons under *§ 20(a)*. ATSI also asserts various state law claims.

ATSI filed its complaint in the first suit in October 2002 against all defendants except Wolfson ("*ATSI I*"). In March 2004, the district court dismissed ATSI's first amended complaint against the Levinson Defendants and Rose Glen for failing to satisfy the pleading requirements of *Fed. R. Civ. P. 9(b)* and the Private Securities Litigation Reform Act ("PSLRA"), *15 U.S.C. § 78u-4(b)*. It dismissed as to the other defendants for improper service and lack of personal jurisdiction. Second and third amended complaints followed and, in July 2004, ATSI filed a largely [**16] identical complaint against Levinson and Wolfson in a separate suit ("*ATSI II*"). In February 2005, the district court dismissed the third amended complaint in *ATSI I* under *Fed. R. Civ. P. 12(b)(6)* with prejudice for again failing to satisfy *Rule 9(b)* and the PSLRA's pleading requirements. *See ATSI Commc'ns, 357 F. Supp. 2d at 720*. Because subject matter jurisdiction was based solely on ATSI's federal claims, the district court did not separately consider the state law causes of action. The district court entered judgment under *Fed. R. Civ. P. 54(b)*, and the parties in *ATSI II* stipulated to dismissal based on the district court's order in *ATSI I*.

ATSI's timely appeals followed.

DISCUSSION

I. Legal Standards

We review a district court's dismissal of a complaint pursuant to *Fed. R. Civ. P. 12(b)(6)* de novo, accepting all factual allegations in the complaint and drawing all reasonable inferences in the plaintiff's favor. *Ganino v. Citizens Utils. Co., 228 F.3d 154, 161 (2d Cir. 2000)*. In addition, we may consider any written instrument attached to the complaint, statements or documents incorporated into the complaint by reference, legally required public disclosure documents filed with the [**17] SEC, and documents possessed by or known to the plaintiff and upon which it relied in bringing the suit.

Rothman, 220 F.3d at 88. To survive dismissal, the plaintiff must provide the grounds upon which his claim rests through factual allegations sufficient "to raise a right to relief above the speculative level." [2] *Bell Atl. Corp. v. Twombly, 127 S. Ct. 1955, 1965, 167 L. Ed. 2d 929 (2007)*. Once a claim has been adequately stated, it may be supported by showing any set of facts consistent with the allegations in the complaint. *Id. at 1969*.

2 We have declined to read *Twombly*'s flexible "plausibility standard" as relating only to antitrust cases. *See Iqbal v. Hasty, - F.3d -, 490 F.3d 143, 2007 U.S. App. LEXIS 13911, 2007 WL 1717803, at *11 (2d Cir. June 14, 2007)*. "Some of [*Twombly*'s] language relating generally to *Rule 8* pleading standards seems to be so integral to the rationale of the Court's parallel conduct holding as to constitute a necessary part of that holding." *Id.*

[*99] Securities fraud claims are subject to heightened pleading requirements that the plaintiff must meet to survive a motion to dismiss. First, a complaint alleging securities fraud must satisfy *Rule 9(b)*, *Ganino, 228 F.3d at 168*, which requires that "the circumstances constituting [**18] fraud . . . shall be stated with particularity," *Fed. R. Civ. P. 9(b)*. This pleading constraint serves to provide a defendant with fair notice of a plaintiff's claim, safeguard his reputation from improvident charges of wrongdoing, and protect him against strike suits. *Rombach v. Chang, 355 F.3d 164, 171 (2d Cir. 2004)*. A securities fraud complaint based on misstatements must (1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent. *Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000)*. Allegations that are conclusory or unsupported by factual assertions are insufficient. *See Luce v. Edelstein, 802 F.2d 49, 54 (2d Cir. 1986)*.

Second, private securities fraud actions must also meet the PSLRA's pleading requirements or face dismissal. *See 15 U.S.C. § 78u-4(b)(3)(A)*. In pleading scienter in an action for money damages requiring proof of a particular state of mind, "the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the [**19] required state of mind." [3] *Id. § 78u-4(b)(2)*. The plaintiff may satisfy this requirement by alleging facts (1) showing that the defendants had both motive and opportunity to commit the fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Ganino, 228 F.3d at 168-69*. Moreover, "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." *Tellabs, Inc. v. Makor Issues & Rights, Ltd., 168 L. Ed. 2d 179, 127 S. Ct. 2499, 2007 WL 1773208, at *10 (June 21, 2007)*. For an inference of scienter to be strong, "a reasonable person [must] deem [it] cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged." *Id.* (emphasis added).

> 3 In a *Rule 10b-5* action, scienter requires a showing of "intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976)*, or reckless conduct, *In re Carter-Wallace, Inc. Sec. Litig., 220 F.3d 36, 39 (2d Cir. 2000)*; *SEC v. U.S. Envtl., Inc., 155 F.3d 107, 111 (2d Cir. 1998)* (stating in dicta that reckless behavior is sufficient to plead scienter).

If the plaintiff alleges a false statement [**20] or omission, the PSLRA also requires that "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *15 U.S.C. § 78u-4(b)(1)*.

II. ATSI's Market Manipulation Claims

A. Market Manipulation and Short Selling

Section 10(b), in proscribing the use of a "manipulative or deceptive device or contrivance," *id. § 78j(b)*, prohibits not only material misstatements but also manipulative acts. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994)*. Under the statute:

> "Manipulation" is "virtually a term of art when used in connection with securities [*100] markets." The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity. *Section 10(b)*'s general prohibition of practices deemed by the SEC to be "manipulative" - in this technical sense of artificially affecting market activity in order to mislead investors [**21] - is fully consistent with the fundamental purpose of the [Exchange] Act "to substitute a philosophy of full disclosure for the philosophy of caveat emptor . . . ."

Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476-77, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977) (alteration in original) (citations omitted). Thus, manipulation "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Ernst & Ernst, 425 U.S. at 199*. The critical question then becomes what activity "artificially" affects a security's price in a deceptive manner.

Although not explicitly described as such, case law in this circuit and elsewhere has required a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have valued a security. The deception arises from the fact that investors are misled to believe "that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators." *Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999)*; *see also Mobil Corp. v. Marathon Oil Co., 669 F.2d 366, 374 (6th Cir. 1981)* (stating that the Supreme [**22] Court has indicated that manipulation under *§ 10(b)* refers to "means unrelated to the natural forces of supply and demand"); *cf. Pagel, Inc. v. SEC, 803 F.2d 942, 946 (8th Cir. 1986)* (agreeing with the SEC that "[w]hen individuals occupying a dominant market position engage in a scheme to distort the price of a security for their own benefit, they violate the securities laws by perpetrating a fraud on all public investors"); *Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 796 (2d Cir. 1969)* (holding that nondisclosure of large open market purchases combined with large secret sales to deter stockholders from participating in a competing tender offer violated *Rule 10b-5* by "distort[ing] the market picture and deceiv[ing] the [issuer's] stockholders").

In identifying activity that is outside the "natural interplay of supply and demand," courts generally ask whether a transaction sends a false pricing signal to the market. For example, the Seventh Circuit recognizes that one of the fundamental goals of the federal securities laws is "to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though [**23] not necessarily accurate) estimates of the underlying economic value of the securities traded," and thus looks to the charged activity's effect on capital market efficiency. [4] *See Sullivan & Long, Inc. v. Scattered Corp., 47 F.3d 857, 861 (7th Cir. 1995)*. The Seventh Circuit's focus on disruptions to the efficient pricing of a security is consistent with our view that in preventing market rigging, *§ 10(b)* seeks a market where "competing judgments of buyers and sellers as to the fair price of the security brings about a situation where the market price reflects as [*101] nearly as possible a just price." *SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1466 (2d Cir. 1996)* (quoting H.R. Rep. No. 73-1383, at 11 (1934)). In an efficient market, trading engineered to stimulate demand can mislead investors into believing that the market has discovered some positive news and seeks to exploit it, *see In re Initial Pub. Offering Sec. Litig., 383 F. Supp. 2d 566, 579 (S.D.N.Y. 2005), aff'd Tenney v. Credit Suisse First Boston Corp., No. 05-3450-cv, 2006 U.S. App. LEXIS 13050, 2006 WL 1423785 (2d Cir. May 19, 2006)*; the duped investors then transact accordingly. To prevent this deleterious effect on the capital markets, the Third [**24] Circuit distinguishes manipulative from legal conduct by asking whether the manipulator "inject[ed] inaccurate information into the marketplace or creat[ed] a false impression of supply and demand for the security . . . for the purpose of artificially depressing or inflating the price of the security." *GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 207 (3d Cir. 2001)*; *see also Jones v. Intelli-Check, Inc., 274 F. Supp. 2d 615, 627-28 (D.N.J. 2003)*.

4 The efficient capital market hypothesis, as adopted by the Supreme Court, posits that "the market price of shares traded on well-developed markets reflects all publicly available information." *See Basic Inc. v. Levinson, 485 U.S. 224, 246, 108 S. Ct. 978, 99 L. Ed. 2d 194 & n.24 (1988)*.

Market manipulation is forbidden regardless of whether there is a fiduciary relationship between the transaction participants. *See United States v. Russo, 74 F.3d 1383, 1391-92 (2d Cir. 1996)*; *United States v. Regan, 937 F.2d 823, 829 (2d Cir. 1991)*. A market manipulation claim, however, cannot be based solely upon misrepresentations or omissions. *Lentell v. Merrill Lynch & Co., 396 F.3d 161, 177 (2d Cir. 2005)*. There must be some market activity, such as "wash sales, matched orders, [**25] or rigged prices." *See Santa Fe, 430 U.S. at 476*.

Furthermore, short selling - even in high volumes - is not, by itself, manipulative. *GFL, 272 F.3d at 209*. Aside from providing market liquidity, short selling enhances pricing efficiency by helping to move the prices of overvalued securities toward their intrinsic values. *See id. at 208*; *Sullivan & Long, 47 F.3d at 861-62* (discussing the defendants' short sales as arbitrage that eliminates disparities between price and value); *In re Scattered Corp. Sec. Litig., 844 F. Supp. 416, 420 (N.D. Ill. 1994)*; John D. Finnerty, Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation 2-3 (Mar. 2005), *available at* http://www.sec.gov/rules/petitions/4-500/jdfinnerty050505.pdf; Ralph S. Janvey, *Short Selling*, 20 Sec. Reg. L.J. 270, 272 (1992). In essence, taking a short position is no different than taking a long position. To be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security. Similarly, purchasing a floorless convertible security is not, by itself or when coupled with short selling, inherently manipulative. [**26] Such securities provide distressed companies with access to much-needed capital and, so long as their terms are fully disclosed, can provide a transparent hedge against a short sale.

B. Pleading Market Manipulation

Market manipulation requires a plaintiff to allege (1) manipulative acts; (2) damage (3) caused by reliance on an assumption of an efficient market free of manipulation; (4) scienter; (5) in connection with the purchase or sale of securities; (6) furthered by the defendant's use of the mails or any facility of a national securities exchange. *See Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 448 (S.D.N.Y. 1999)*; *Cowen & Co. v. Merriam, 745 F. Supp. 925, 929 (S.D.N.Y. 1990)*.

Because a claim for market manipulation is a claim for fraud, it must be pled with particularity under *Rule 9(b)*. *See Internet Law Library, Inc. v. Southridge* [*102] *Capital Mgmt., 223 F. Supp. 2d 474, 486 (S.D.N.Y. 2002)*; *U.S. Envtl., 82 F. Supp. 2d at 239*; *see also Rooney Pace, Inc. v. Reid, 605 F. Supp. 158, 162-63 (S.D.N.Y. 1985)* (applying *Rule 9(b)* to a market manipulation claim). A claim of manipulation, however, can involve facts solely within the defendant's knowledge; therefore, at the early stages of litigation, [**27] the plaintiff need not plead manipulation to the same degree of specificity as a plain misrepresentation claim. *See Internet Law Library, 223 F. Supp. 2d at 486*; *U.S. Envtl., 82 F. Supp. 2d at 240*; *cf. Rombach, 355 F.3d at 175 n.10* (relaxing the standard where information was likely to be in the exclusive control of the defendants and analysts).

Accordingly, a manipulation complaint must plead with particularity the nature, purpose, and effect of the fraudulent conduct and the roles of the defendants. *See In re Blech Sec. Litig., 928 F. Supp. 1279, 1291 (S.D.N.Y. 1996)* (adopting this test as set forth in the unpublished decision *Baxter v. A.R. Baron & Co., No. 94 Civ. 3913, 1995 U.S. Dist. LEXIS 14882, 1995 WL 600720 (S.D.N.Y. Oct. 12, 1995))*; *see also Compudyne Corp. v. Shane, 453 F. Supp. 2d 807, 821 (S.D.N.Y. 2006)*; *United States CFTC v. Bradley, 408 F. Supp. 2d 1214, 1222 (N.D. Okla. 2005)* (market manipulation under the Commodity Exchange Act); *Fezzani v. Bear, Stearns & Co., 384 F. Supp. 2d 618, 642 (S.D.N.Y. 2004)*; *In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 372 (D. Md. 2004)*; *Log On Am., Inc. v. Promethean Asset Mgmt., 223 F. Supp. 2d 435, 445 (S.D.N.Y. 2001)*; *U.S. Envtl., 82 F. Supp. 2d at 240*; [**28] *In re Blech Sec. Litig., 961 F. Supp. 569, 580 (S.D.N.Y. 1997)*. *But see Intelli-Check, 274 F. Supp. 2d at 629* (articulating requirements for a less stringent pleading standard in the Third Circuit). General allegations not tied to the defendants or resting upon speculation are insufficient. This test will be satisfied if the complaint sets forth, to the extent possible, "what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue." *Baxter, 1995 U.S. Dist. LEXIS 14882, 1995 WL 600720, at *6*; *see also Miller v. Lazard Ltd., 473 F. Supp. 2d 571, 587 (S.D.N.Y. 2007)*; *In re Sterling Foster & Co. Sec. Litig., 222 F. Supp. 2d 216, 270 (E.D.N.Y. 2002)*; *Blech, 961 F. Supp. at 580*. This standard meets the goals of *Rule 9(b)* while also considering which specific facts a plaintiff alleging manipulation can realistically plead at this stage of the litigation.

Because a claim for market manipulation requires a showing of scienter, the PSLRA's heightened standards for pleading scienter also apply. Therefore, the complaint must plead with particularly facts giving rise to a strong inference that the defendant [**29] intended to deceive investors by artificially affecting the market price of securities. *See 15 U.S.C. § 78u-4(b)(2)*; *Section II.A, supra*. This pleading requirement is particularly important in manipulation claims because in some cases scienter is the only factor that distinguishes legitimate trading from improper manipulation.

C. Manipulation by the Levinson Defendants, Wolfson, and Rose Glen

ATSI's allegations that the Levinson Defendants, Wolfson, and Rose Glen manipulated the market are based on (1) high-volume selling of ATSI's stock with coinciding drops in the stock price, (2) trading patterns around conversion time, (3) the stock's negative reaction to positive news, and (4) the volume of trades in excess of settlement during a 10-day period in 2003. We agree with the district [*103] court that these allegations are inadequate under *Rule 9(b)*. In sum, ATSI has offered no specific allegations that the defendants did anything to manipulate the market; it relies, at best, on speculative inferences. Moreover, ATSI has failed to adequately plead scienter.

ATSI's complaint alleges high-volume selling between April 13, 2000 and April 18, 2000, resulting in a 44% decline in stock price. ATSI [**30] narrows the list of potential culprits to these defendants because ATSI's major shareholders said that they were not selling stock, leaving only the defendants with large enough blocks of shares to trade at the observed volumes. These allegations fail to state even roughly how many shares the defendants sold, when they sold them, and why those sales caused the precipitous drop in stock price. And the complaint is devoid of facts supporting ATSI's belief that these defendants had sufficient shares to engage in the high-volume trading alleged. Even though the complaint alleges trading volumes of up to 1.5 million shares per day, ATSI reported in its April 14, 2000 Form S-3 that the Shaar Fund held only 492,308 shares of its common stock. The complaint and relevant documents do not reveal how many shares Wolfson and Rose Glen held. ATSI argues that the Shaar Fund's 3,000 shares of Series D Preferred Stock were eventually converted into 8.3 million common shares-sufficient to support the observed trading volumes. This allegation does not help ATSI, however, because the complaint states that the Shaar Fund did not begin converting those preferred shares until December 12, 2000, many months [**31] after the high-volume selling.

The complaint then alleges that there was a drop in ATSI's stock price in the days leading up to the defendants' conversion of the Preferred Stock. It alleges that in the absence of manipulation, (1) the Reference Price for conversion should approximate the average price during the 30 days prior to the look-back period and (2) that trading volumes during the look-back periods should have been equal to the average for the previous quarter. We agree with the district court's view that

ATSI's "position is ludicrous." *ATSI Commc'ns, 357 F. Supp. 2d at 719*. One does not observe constant prices or trading volumes in the stock markets. *Cf. Cent. Nat'l Bank of Mattoon v. U.S. Dep't of Treasury, 912 F.2d 897, 902 (7th Cir. 1990)* ("[T]he value of a company is rarely constant over an entire year . . . .").

The complaint next alleges that manipulation may be inferred from the stock's negative reaction to positive news. The district court was mistaken in dismissing this circumstance on the grounds that "the announcement concerns events with no apparent connection to the defendants or this case." *ATSI Commc'ns, 357 F. Supp. 2d at 719*. The premise of ATSI's theory is [**32] that an issuer's stock price, in the absence of manipulation, should increase when good news is announced. [5] Under such a theory, the subject of the news and the defendants do not need to be connected.

5 The strength of this broad proposition is questionable. *Cf. United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991)* ("[W]hether a public company's stock price moves up or down or stays the same after the filing of a Schedule 13D does not establish the materiality of the statements made, though stock movement is a factor the jury may consider relevant."). For example, the stock price may not move if the market already knew about the good news, or if the market believes the news is overblown or false, or if adverse developments in the company or industry are anticipated or rumored.

Nevertheless, this allegation cannot save the complaint because ATSI pleads no particular connection between the negative reaction [*104] of the stock price and anything the defendants did. Adopting ATSI's reasoning would subject large holders of convertible preferred stock to the risk of suit under *§ 10(b)* whenever the stock price does not react to news as the issuer expects. *See Rombach, 355 F.3d at 171* (stating [**33] that *Rule 9(b)* serves, inter alia, to safeguard a defendant's reputation from improvident charges of wrongdoing and protect him against strike suits).

Finally, the complaint rests on an inference of manipulation based upon Depository Trust Company records showing that 8,256,493 shares were traded in excess of settlements during the 10-day period before the AMEX suspended trading of ATSI's stock. Trading volume increased over this period, yet the percentage of trading volume that settled decreased. ATSI claims that the only plausible explanation is that the trades did not result in any change in beneficial ownership, indicating "wash trades, matched trades, phantom shares, and other manipulative trading."

The inference ATSI asks us to draw is too speculative even on a motion to dismiss. *See Segal v. Gordon, 467 F.2d 602, 606, 608 (2d Cir. 1972)* (holding that "distorted inferences and speculations" could not meet *Rule 9(b)*'s requirements). Nowhere does ATSI particularly allege what the defendants did-beyond simply mentioning common types of manipulative activity-or state how this activity affected the market in ATSI's stock. This data could easily be the result of internal settlements [**34] within broker-dealers that do not involve the Depository Trust Company. Manipulation is also unlikely given that ATSI's closing share price during this period started at $ 0.08 per share and ended at $ 0.08 per share.

For similar reasons, none of these allegations, nor anything else in the complaint, meets the PSLRA's requirements for pleading scienter. *See 15 U.S.C. § 78u-4(b)(2)*. A strong inference of scienter is not raised by alleging that a legitimate investment vehicle, such as the convertible preferred stock at issue here, creates an opportunity for profit through manipulation. *See Ganino, 228 F.3d at 168-69*. These circumstances are present for any investor in floorless convertibles. *Cf. Chill v. GE, 101 F.3d 263, 267 & n.5 (2d Cir. 1996)* (holding that a generalized motive that an issuer wishes to appear profitable, which could be imputed to any public for-profit enterprise, was insufficiently concrete to infer scienter); *In re Alstom SA Sec. Litig., 454 F. Supp. 2d 187, 197 (S.D.N.Y. 2006)* (stating a similar proposition for corporate insiders). Accordingly, there is a "plausible nonculpable explanation[]" for the defendants' actions that is more likely than any inference [**35] that the defendants intended to manipulate the market, *see Tellabs, 168 L. Ed. 2d 179, 2007 WL 1773208, at *10*: ATSI and the defendants simply entered into mutually beneficial financing transactions. Further, because ATSI has not adequately pled that the defendants engaged in any short sales or other potentially manipulative activity, there is no circumstantial evidence of manipulative intent. *See Ganino, 228 F.3d at 168-69*. Accordingly, more specific allegations are required.

D. Manipulation Claims Against Trimark

The complaint is plainly insufficient in alleging that Trimark engaged in market manipulation. [6] It only alleges that [*105] Trimark was the principal market maker in ATSI's stock, that Trimark knew or should have known of the manipulation, and that ATSI "believes" that Trimark was a cooperating broker-dealer. Wholly absent are particular facts giving rise to a strong inference that Trimark acted with scienter in manipulating the market in ATSI's common stock and any allegations of specific acts by Trimark to manipulate the market, much less how those actions might have affected the market.

6 Rose Glen and Trimark also argue that ATSI lacks standing to bring a *Rule 10b-5* claim against them because ATSI [**36] sold its Preferred Stock and warrants to the defendants in primary market transactions and did not transact in the allegedly manipulated secondary market. Because ATSI's complaints do not meet the pleading requirements, we choose not to reach this statutory standing question. *See Coan v. Kaufman, 457 F.3d 250, 256 (2d Cir. 2006)* ("Unlike Article III standing, which ordinarily should be determined before reaching the merits, statutory standing may be assumed for the purposes of deciding whether the plaintiff otherwise has a viable cause of action." (citations omitted)); *see also Official Comm. Of Unsecured Creditors of Worldcom, Inc. v. SEC, 467 F.3d 73, 80-81 (2d Cir. 2006)*; *cf. Steel Co. v. Citizens for a Better Env't, 523 U.S. 83, 97 n.2, 118 S. Ct. 1003, 140 L. Ed. 2d 210 (1998)*.

III. ATSI's Misrepresentation Claims

To state a claim under *Rule 10b-5* for misrepresentations, a plaintiff must allege that the defendant (1) made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) upon which the plaintiff relied, and (5) that the plaintiff's reliance was the proximate cause of its injury. *Lentell, 396 F.3d at 172*. The district court properly dismissed [**37] the misrepresentations claims.

A. Levinson Defendants and Wolfson

Of the misrepresentations that ATSI claims, we can quickly dispose of all except the two alleged in the transaction agreements. The Registration Rights agreement between ATSI and the Shaar Fund plainly states that the only promises, restrictions, and warranties to the transaction were those set forth in the transaction documents. Where the plaintiff is a sophisticated investor and an integrated agreement between the parties does not include the misrepresentation at issue, the plaintiff cannot establish reasonable reliance on that misrepresentation. *See Emergent Capital Inv. Mgmt. v. Stonepath Group, Inc., 343 F.3d 189, 196 (2d Cir. 2003)*; *Dresner v. Utility.com, Inc., 371 F. Supp. 2d 476, 491-93 (S.D.N.Y. 2005)*. By engaging in these private placements of complex securities, ATSI is clearly a sophisticated investor. Accordingly, to the extent ATSI's causes of action are based on alleged misrepresentations made during negotiations preceding the defendants' investment, those claims are barred by the merger clauses.

1. Promise Not to Short Sell

The complaint alleges, on information and belief, a fraudulent misrepresentation [**38] by the Shaar Fund in promising, in the Securities Purchase Agreement, not to enter a short position prior to closing or cover a short position entered into prior to execution of the agreement using converted common stock. The complaint fails to sufficiently allege that this representation was false when made. While the failure to carry out a promise in connection with a securities transaction might constitute breach of contract, it "does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform or knew that he could not perform." *Gurary, 190 F.3d at 44* (internal quotation marks omitted). The speculative allegations that the Levinson Defendants and Wolfson engaged in short selling are deficient for the same reasons that they did not establish manipulation.

[*106] ATSI asks us to infer that the Levinson Defendants never intended to honor this promise because they had previously engaged in "death spiral" financing schemes, as evidenced by the declining stock prices of unspecified companies in which they invested. These allegations fail *Rule 9(b)*'s requirement of stating with particularity why the statement was fraudulent and the PSLRA's requirement [**39] of stating the facts on which a belief is based. The complaint does not specify which companies experienced a decline in share price or when they experienced the decline (other than that they occurred within 1 year of an unspecified time of investment). It also fails to allege with particularity what, if anything, the defendants did to cause the decline; it

simply offers a generalized allegation that the defendants engaged in death spiral financing combined with a detailed definition of how death spiral financing works. *Cf. United States ex rel. Walsh v. Eastman Kodak Co., 98 F. Supp. 2d 141, 147 (D. Mass. 2000)* (holding that fraud was not adequately pled under *Rule 9(b)* where the plaintiff only alleged a method by which the defendants could produce false invoices without specifying instances of false claims arising from false invoices). Holding otherwise would expose investors in start-ups and risky, distressed companies to fraud claims based solely on the (unsurprisingly) poor performance of their portfolios. *See Rombach, 355 F.3d at 171*.

In response, ATSI argues that it adequately identified the defendants' victims by detailing how the companies could be found by searching the SEC's [**40] publicly-available Edgar database. It also contends that the defendants have personal knowledge of what investments they made and when the stock prices of those investments declined.

ATSI cannot sufficiently plead fraud by simply providing a method for the defendant to discover the underlying details. If ATSI had access to the details necessary to make these allegations, it must plead them and not just tell the defendants to go find them.

We also reject ATSI's argument that it adequately pled fraud by pointing to the drop in the stock prices of the defendants' other investments because that information is relevant under *Fed. R. Evid. 404(b)* and *406* and supports "a reasonable inference of fraud." No inference of sabotage is available from the circumstance that some (or many) risky investments come to nothing. Moreover, the allegations fail to point to any specific actions by the defendants with respect to those investments and thus fail to establish that the defendants' promise was fraudulent. To the extent the Southern District of New York's decision in *Internet Law Library, 223 F. Supp. 2d 474*, is to the contrary, we reject it.

2. Investor Profile Representation

ATSI also claims that [**41] the representation in the Securities Purchase Agreement that the Shaar Fund was an accredited investor was fraudulent. The complaint does not sufficiently allege loss causation with respect to this misrepresentation. A plaintiff is required to prove both transaction causation (also known as reliance) and loss causation. *Lentell, 396 F.3d at 172*; *see also 15 U.S.C. § 78u-4(b)(4)*. Transaction causation only requires allegations that "but for the claimed misrepresentations or omissions, the plaintiff would not have entered into the detrimental securities transaction." *Lentell, 396 F.3d at 172* (quoting *Emergent Capital, 343 F.3d at 197*). Loss causation, by contrast, is the proximate causal link between the alleged misconduct and the plaintiff's economic harm. *See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346,* [*107] *125 S. Ct. 1627, 161 L. Ed. 2d 577 (2005)*; *Lentell, 396 F.3d at 172*. To that end, the plaintiff's complaint must plead that the loss was foreseeable and caused by the materialization of the risk concealed by the fraudulent statement. *See Lentell, 396 F.3d at 173*.

The complaint alleges losses (1) through the tremendous decline in ATSI's share price, impairing its access to capital and its viability as a business; and [**42] (2) by ATSI's sale of its own stock at depressed prices. It fails, however, to establish any causal connection between those losses and the misrepresentation that the Shaar Fund was an accredited investor. In what appears to be an attempt to meet *Lentell*'s requirements, ATSI contends that it adequately pled loss causation because the Levinson Defendants made this misrepresentation to induce ATSI to enter into the transaction under the pretense that they were "trustworthy, reputable and long-term investor[s]," and that when the true risk of their plans materialized through their manipulative acts, ATSI suffered losses. This allegation might support transaction causation; it fails, however, to show how the fact that the Shaar Fund was not an accredited investor caused any loss. *See id. at 174* ("Such an allegation-which is nothing more than a paraphrased allegation of transaction causation-explains why a particular investment was made, but does not speak to the relationship between the fraud and the loss of the investment." (internal quotation marks omitted)).

ATSI is wrong in claiming that these allegations are sufficient to establish loss causation under our decision in *Weiss v. Wittcoff, 966 F.2d 109 (2d Cir. 1992)* [**43] (per curiam). In *Weiss*, the plaintiff agreed to merge his business with the defendant's on the latter's representation that his other company would supply goods and services. *Id. at 110*. When the defendant sold his other company a year after the transaction, *id. at 110, 112*, the plaintiff's business suffered subsequent losses from higher costs, *id. at 110-11*. We held that the complaint adequately pled loss causation because the plaintiff's losses were "clearly a proximate result of his reliance on defendants' promises, since defendants' failure to fulfill those promises foreseeably caused [the business's] financial condition to deteriorate." *Id. at 111*.

Weiss is easily distinguishable. There, the complaint established a causal connection between (1) the promise to provide for the business's needs and (2) the business's increased costs when the promise turned out to be false. *See id.* ATSI, by contrast, fails to show that the subject of the fraudulent statement proximately caused any loss. *See Lentell, 396 F.3d at 173* ("Thus to establish loss causation, 'a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered . . [**44] . .'" (alteration in original)).

B. Misrepresentations by Rose Glen

The misrepresentations attributed to Rose Glen suffer from largely the same defects as those against the Levinson Defendants. ATSI cannot claim reliance on Rose Glen's pre-contractual, verbal representations because of the merger clause in the Registration Rights Agreement.

The only representation in the Securities Purchase Agreement that merits discussion is the one in which Rose Glen represented that it was purchasing the Preferred Stock:

> for its own account and not with a present view towards the public sale or distribution thereof except pursuant to sales registered or exempted from registration under the 1933 Act; *provided, however* that by making the representation [*108] herein, the Buyer does not agree to hold any of the Securities for any minimum or other specific term and reserves the right to dispose of the Securities at any time in accordance with or pursuant to a registration statement or an exemption under the 1933 Act.

In addition to failing to plead falsity under *Gurary*, ATSI's complaint fails to plead that Rose Glen even broke this promise, much less that it secretly intended to break it.

ATSI also alleges that [**45] Rose Glen engaged in a bait-and-switch scheme by first promising in its draft term sheet to invest $ 10 million, then offering only $ 2.5 million at closing. The district court properly dismissed this claim. First, it is time-barred. Prior to the passage of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002), the statute of limitations required that a *Rule 10b-5* claim be brought within one year of discovery of the facts constituting the violation and within three years of the violation. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364, 111 S. Ct. 2773, 115 L. Ed. 2d 321 (1991)*. ATSI learned of the alleged falsity of this representation when it signed the closing documents on October 16, 2000, but did not commence its action against Rose Glen until October 31, 2002-more than two years later. *See LC Capital Partners, LP v. Frontier Ins. Group, Inc., 318 F.3d 148, 154 (2d Cir. 2003)* (stating that the limitations period begins to run, inter alia, after the plaintiff receives actual knowledge of the facts giving rise to the action). Second, ATSI has not pled falsity or reliance because the term sheet expressly stated that Rose Glen's "obligation to fund is subject to satisfactory [**46] due diligence, in RGC's sole discretion."

C. Misrepresentations by CCM

ATSI claims that CCM made misrepresentations very similar to those alleged against Rose Glen. Largely for the same reasons as above, the district court properly dismissed those claims.

IV. Control Person Liability

ATSI alleges control person liability under *§ 20(a)* against the Levinson Defendants, Wolfson, Rose Glen, and the Citco Defendants. To establish a prima facie case of control person liability, a plaintiff must show (1) a primary violation by the controlled person, (2) control of the primary violator by the defendant, and (3) that the defendant was, in some meaningful sense, a culpable participant in the controlled person's fraud. *First Jersey, 101 F.3d at 1472*. ATSI fails to allege any primary violation; thus, it cannot establish control person liability.

V. Leave to Amend

ATSI argues that even if the district court properly dismissed its complaints under *Fed. R. Civ. P. 12(b)(6)*, it should have granted leave to amend. We review a district court's denial of leave to amend for abuse of discretion. *Grace v. Rosenstock, 228 F.3d 40, 54 (2d Cir. 2000)*. In *ATSI I*, ATSI submitted three amended complaints; in

ATSI [**47] *II*, it submitted a complaint largely identical to *ATSI II*'s third amended complaint. The district court had already dismissed *ATSI I*'s first amended complaint for failure to meet *Rule 9(b)* and the PSLRA's pleading requirements on many grounds similar to its final dismissal. District courts typically grant plaintiffs at least one opportunity to plead fraud with greater specificity when they dismiss under *Rule 9(b)*. *See Luce, 802 F.2d at 56*. ATSI was given that opportunity. The district court did not abuse its discretion in declining to grant further leave to amend.

[*109] **CONCLUSION**

For the foregoing reasons, the judgments of the district court are AFFIRMED.

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ZUCCO PARTNERS, LLC; REX BOGGS; KENNARD MCADAM; GLEN THOMAS, Plaintiffs-Appellants, v. DIGIMARC CORPORATION; BRUCE DAVIS; E. K. RANJIT, Defendants-Appellees.

No. 06-35758

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

552 F.3d 981*; *2009 U.S. App. LEXIS 583*; *Fed. Sec. L. Rep. (CCH) P95,038

August 26, 2008, Argued and Submitted, Seattle, Washington
January 12, 2009, Filed

PRIOR HISTORY: [**1]
Appeal from the United States District Court for the District of Oregon. D.C. No. CV-04-01390-AJB. Anna J. Brown, District Judge, Presiding.
Zucco Partners, LLC v. Digimarc Corp., 445 F. Supp. 2d 1201, 2006 U.S. Dist. LEXIS 54887 (D. Or., 2006)

DISPOSITION: AFFIRMED.

COUNSEL: For Plaintiffs-Appellants: David F. Rees, Gary M. Berne, and Mark A. Friel, Stoll Stoll Berne Lokting & Lokting P.C., Portland, Oregon; Lori G. Feldman and Karen T. Rogers, Milberg Weiss LLP, New York, New York.

For Defendants-Appellees: Barnes H. Ellis, Lois O. Rosenbaum, and Brad S. Daniels, Stoel Rives LLP, Portland, Oregon.

JUDGES: Before: Thomas G. Nelson, Michael Daly Hawkins, and Jay S. Bybee, Circuit Judges. Opinion by Judge Bybee.

OPINION BY: Jay S. Bybee

OPINION

[*986] BYBEE, Circuit Judge:

Zucco Partners, LLC and other named plaintiffs (collectively, "Zucco"), on behalf of those who purchased publicly-traded securities of Digimarc Corporation ("Digimarc" or "the Company") between April 22, 2003 and July 28, 2004, appeal the District of Oregon's dismissal of their Second Amended Complaint, which alleges that Digimarc (and two of its officers, Bruce Davis and E. K. Ranjit) violated *sections 10(b)* and *20(a)* of the Securities Exchange Act of 1934 and the regulations promulgated thereunder, including *Rule 10b-5*. Zucco contends that the district court erred in determining [**2] that its complaint [*987] failed to allege a strong inference of scienter as required by the Private Securities Litigation Reform Act ("PSLRA") because that court applied a more stringent standard than required by the Supreme Court's recent decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007)*. Although we have previously evaluated the sufficiency of such claims under the PSLRA by the standards of *In re Silicon Graphics Inc. Securities Litigation, 183 F.3d 970 (9th Cir. 1999)*, and *In re Daou Systems, Inc. Securities Litigation, 411 F.3d 1006 (9th Cir. 2005)*, we have yet to fully explain how the Court's Tellabs decision relates to much of our analysis under those cases.

The district court determined that, pursuant to *Daou*, the plaintiffs' complaint failed to allege scienter with the requisite particularity to survive dismissal under the PSLRA's heightened pleading standard. Because we hold that the Court's decision in *Tellabs* does not materially alter the particularity requirements for scienter claims established in our previous decisions, but instead only adds an additional "holistic" component to those requirements, we affirm the district court's dismissal of the [**3] complaint with prejudice and hold that Zucco has failed to adequately plead a strong inference of scienter. [1]

1 Because we find that the district court correctly dismissed Zucco's claims for failure to plead scienter, we do not reach the questions of whether the complaint adequately pleads loss causation, *see Daou, 411 F.3d at 1025*, or whether certain statements relied upon by the complaint as false representations are forward-looking statements protected from liability under the PSLRA's "safe harbor" provision, *15 U.S.C. § 78u-5*. *See Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co., 353 F.3d 1125, 1131-33 (9th Cir. 2004)*.

I

Accounting for the costs of internal software development is not a simple task. In order to comply with Generally Accepted Accounting Principles ("GAAP"), a company that engages in internal software development projects must make subtle differentiations between three stages of development that determine whether expenditures incurred must be "expensed" (recorded immediately on the company's financial statement as a cost incurred) or "capitalized" (recorded as a cost incurred in increments over several financial statements). This distinction [**4] is important because if an expenditure is capitalized rather than expensed a company will (in the absence of other factors) look more profitable in the short term (albeit less profitable in the long term) and show a more consistent pattern of reported income--because its expenditures are spread out over a longer period of time. Under GAAP, if a software development project is in the "preliminary project stage," wherein the company is evaluating development and marketing alternatives; or in the "post-implementation/ operation stage," in which the developed software is placed into service, most expenditures related to the project must be expensed. If, however, a project is in the "application development stage," in which management authorizes the project and has settled on a comprehensive development and marketing strategy, most expenditures incurred must be capitalized. Capitalized expenditures are amortized on a straight-line basis over the estimated useful life of the software developed (which, for a company like Digimarc, is generally three to five years).

According to Zucco, Digimarc, a fledgling Delaware corporation headquartered in Oregon, whose business centers on providing secure [**5] personal identification documents (such as drivers licenses) based on [*988] digital watermarking technology, purposefully manipulated its financial prospects by, *inter alia*, capitalizing internal software development expenditures that should have been expensed. Zucco's compendious 130-page Second Amended Complaint ("SAC") claims that Digimarc "used two primary accounting manipulations to deceptively bolster Digimarc's financial condition." Namely, Digimarc "capitalize[d] on its asset balance sheet ordinary payroll costs that Digimarc paid to its software engineers and other employees so that the Company could avoid recognizing these expenses on its income statements." Also, Digimarc allegedly "fail[ed] to recognize ordinary expenses incurred by the Company" and instead "improperly moved or retained these expenses in Digimarc's inventory or property and equipment accounts as purported 'project development expenses.'" The net effect of these manipulations, Zucco contends, was to deceive investors into believing that the young corporation had "turned the corner" from its early losses and had become profitable.

On September 13, 2004, Digimarc publicly announced that it had erroneously accounted [**6] for internal software expenditures and that due to these accounting errors it had likely overestimated earnings for the previous six quarters. The September announcement listed the improper capitalization of internal software development costs as the most likely source of these accounting errors, and also cited "other project cost capitalization accounting practices" of Digimarc's ID Systems division (acquired from Polaroid in December 2001 and which represented 89 percent of the corporation's revenue in 2003 and 2004) as containing potential errors that "may also result in additional adjustments which may affect prior periods." On September 13, Digimarc estimated these accounting errors to "be in the range of approximately $ 1.2 million to $ 2.0 million" and to possibly "require a restatement of prior period financial statements."

Although the full extent of these accounting errors (approximately $ 2.7 million in overstated earnings) was not revealed until April 5, 2005, when Digimarc's formal restatement was issued, the corporation's September 2004 announcement was enough to trigger a number of class action lawsuits. Zucco, which had purchased fifty shares of Digimarc stock in March [**7] 2004 (at a price of $ 12.76 per share) filed a class action lawsuit in the District of Oregon fifteen days after the corporation's public announcement, alleging that defendants Digimarc, its Chief Executive Officer Bruce Davis, and its former Chief Financial Officer E. K. Ranjit violated *sections 10(b)* and *20(a)* of the Securities Exchange Act of 1934 and its implementing regulations, including *Rule 10b-5*. Similar suits, which followed on October 5th and 6th, were eventually consolidated with Zucco's action on December 16, 2004. Two unrelated actions alleging violations of California corporations law, meanwhile, were filed in California state court on October 19th, and subsequently re-filed in the District of Oregon. *See In re Digimarc Corp. Derivative Litig., 549 F.3d 1223, No. 06-35838, 2008 U.S. App. LEXIS 24967, 2008 WL 5171347 (9th Cir. Dec. 11, 2008)*.

Although there was no question that Digimarc erroneously capitalized expenditures that should have been expensed, the plaintiffs had difficulty providing detailed allegations that the defendants did so either intentionally or with deliberate recklessness. Indeed, Zucco provided the district court with three iterations of its allegations--none of which, according [**8] to that court, was sufficient to survive a motion to dismiss. First, after several additional named plaintiffs were added to its consolidated class action, Zucco amended its original class action complaint, adding significant detail to its formerly skeletal allegations. This First [*989] Amended Complaint was filed on May 16, 2005, on behalf of all those who purchased the publicly traded securities of Digimarc between April 22, 2003 and July 28, 2004 (the "class period"), and alleged that Digimarc and the individual defendants engaged in the manipulative accounting methods described above. Digimarc filed a *Federal Rule of Civil Procedure 12(b)(6)* motion to dismiss the First Amended Complaint, claiming that Zucco had failed to satisfy the loss causation and scienter requirements of *section 10(b)* of the Securities Exchange Act of 1934, as mandated by the Private Securities Litigation Reform Act, *15 U.S.C. § 78u-4*. The district court granted this motion on November 30, 2005. In its order dismissing the complaint, the district court held that Zucco's First Amended Complaint had satisfied the loss causation pleading requirements, but had failed to properly allege scienter. *See Zucco Partners,* [**9] *LLC v. Digimarc Corp.*, No. CV 04-1390-BR (D. Or. Nov. 30, 2005).

The district court dismissed the complaint without prejudice, giving Zucco leave to amend. According to the district court, the Second Amended Complaint was no better. After that complaint was filed on January 17, 2006, Digimarc responded with another motion to dismiss, contending that Zucco had again failed to plead scienter adequately under the PSLRA. This motion was granted on August 4, 2006, when the district court dismissed the complaint with prejudice. *See Zucco Partners, LLC v. Digimarc Corp., 445 F. Supp. 2d 1201 (D. Or. 2006)*. After dismissal, Zucco filed a timely appeal to this Court.

II

Zucco argues that the district court failed to properly analyze its allegations of scienter under the standard recently expounded by the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 127 S. Ct. 2499, 168 L. Ed. 2d 179 (2007)*. We review challenges to a dismissal for failure to state a claim under *Federal Rule of Civil Procedure 12(b)(6)* de novo. *Livid Holdings, Ltd. v. Solomon Smith Barney, Inc., 416 F.3d 940, 946 (9th Cir. 2005)*. Such review is generally limited to the face of the complaint, materials incorporated into the complaint [**10] by reference, and matters of which we may take judicial notice. *Metzler Inv. GMBH v. Corinthian Colls., Inc., 540 F.3d 1049, 1061 (9th Cir. 2008)* (citing *Tellabs, 127 S. Ct. at 2509*). In undertaking this review, we will "accept the plaintiffs' allegations as true and construe them in the light most favorable to plaintiffs," *Gompper v. VISX, Inc., 298 F.3d 893, 895 (9th Cir. 2002)*, and will hold a dismissal inappropriate unless the plaintiffs' complaint fails to "state a claim to relief that is plausible on its face." *Bell Atl. Corp. v. Twombly, 550 U.S. 544, 127 S. Ct. 1955, 1974, 167 L. Ed. 2d 929 (2007)*. Where, as here, the district court dismisses the complaint without leave to amend, such prejudicial dismissal is reviewed for abuse of discretion, *see Gompper, 298 F.3d at 898*, and "is improper unless it is clear that the complaint could not be saved by any amendment." *Livid Holdings, 416 F.3d at 946*.

A

Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations [**11] as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." *15 U.S.C. § 78j(b)*. One such rule promulgated under the Act is SEC *Rule 10b-5*, which provides, *inter alia*, "It shall be unlawful for any person . . . [t]o engage in any act, [*990] practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *17 C.F.R. § 240.10b-5(c)*.

Section 20(a) of the Act makes certain "controlling" individuals also liable for violations of *section 10(b)* and its underlying regulations. Specifically, *section 20(a)* provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a). Thus, a defendant employee of a corporation who has violated the securities [**12] laws will be jointly and severally liable to the plaintiff, as long as the plaintiff demonstrates "a primary violation of federal securities law" and that "the defendant exercised actual power or control over the primary violator." *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp. ("America West"), 320 F.3d 920, 945 (9th Cir. 2003)* (quoting *Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065 (9th Cir. 2000))* (quotation marks omitted); *Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 96 F.3d 1151, 1161 (9th Cir. 1996)*. This inquiry is normally an "intensely factual question." *Paracor Finance, 96 F.3d at 1161* (quoting *Arthur Children's Trust v. Keim, 994 F.2d 1390, 1396 (9th Cir. 1993))*. *Section 20(a)* claims may be dismissed summarily, however, if a plaintiff fails to adequately plead a primary violation of *section 10(b)*. *See In re Verifone Sec. Litig., 11 F.3d 865, 872 (9th Cir. 1993). See, e.g., In re Metawave Commc'ns Corp. Sec. Litig., 298 F. Supp. 2d 1056, 1087 (W.D. Wash. 2003)*.

Five elements are required in order to prove a primary violation of *Rule 10b-5*. In particular, a plaintiff must demonstrate "(1) a material misrepresentation or omission of fact, [**13] (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss." *Daou, 411 F.3d at 1014*. At the pleading stage, a complaint stating claims under *section 10(b)* and *Rule 10b-5* must satisfy the dual pleading requirements of *Federal Rule of Civil Procedure 9(b)* and the PSLRA.

Federal Rule of Civil Procedure 9(b) provides, "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." This requirement has long been applied to securities fraud complaints. *See Semegen v. Weidner, 780 F.2d 727, 729, 734-35 (9th Cir. 1985)*. Accordingly, before 1995 we required "falsity" to be pled with particularity, and "scienter" to be alleged generally. *See Ronconi v. Larkin, 253 F.3d 423, 429 n.6 (9th Cir. 2001)*.

All securities fraud complaints since 1995, however, are subject to the more exacting pleading requirements of the PSLRA, which "significantly altered pleading requirements" in securities fraud cases. *Gompper, 298 F.3d at 895* (quotation marks omitted). The PSLRA amended the Securities [**14] Exchange Act to require that a complaint "plead with particularity both falsity and scienter." *Id*. (quoting *Ronconi, 253 F.3d at 429*). Thus, to properly allege falsity, a securities fraud complaint must now "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the [*991] statement or omission is made on information and belief, . . . state with particularity all facts on which that belief is formed." *Id*. (quoting *15 U.S.C. § 78u-4(b)(1)*)(quotation marks omitted). To adequately plead scienter, the complaint must now "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2). See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976)*.

The Supreme Court recently defined "strong inference" in *Tellabs*, concluding that a securities fraud complaint will survive a motion to dismiss under *Federal Rule of Civil Procedure 12(b)(6)* "only if a reasonable person would deem the inference of scienter *cogent and at least as compelling* as any opposing inference one could draw from the facts alleged." *127 S. Ct. at 2510* (emphasis [**15] added). Thus, a court now reviewing a complaint's scienter allegations under the PSLRA must "consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on *Rule 12(b)(6)* motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice." *Id. at 2509*. The court must determine whether "*all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id*. Finally, when "determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." *Id*. This "inquiry is inherently comparative." *Id. at 2510*. A court must compare the malicious and innocent inferences cognizable from the facts pled in the complaint, and only allow the complaint to survive a motion to dismiss if the malicious inference is at least as compelling as any opposing innocent inference. *See id. at 2510*. *See also Metzler Investment, 540 F.3d at 1066*.

To adequately demonstrate that the "defendant acted with the required [**16] state of mind," a complaint must "allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness." *Daou, 411 F.3d at 1014-15* (citing *Silicon Graphics, 183 F.3d at 974*). In *Silicon Graphics*, we defined the "deliberate recklessness" standard, noting that "we continue[ ] to view it as a form of intentional or knowing misconduct." *183 F.3d at 976*. More specifically, "although facts showing mere recklessness or a motive to commit fraud and opportunity to do so may provide some reasonable inference of intent, they are not sufficient to establish a *strong* inference of deliberate recklessness." *Id. at 974*. Rather, the plaintiff must plead "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and 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." *Id. at 976* (quoting *Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990)*; *Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977))* (quotation marks omitted).

Although [**17] we have developed a set of rules to analyze different types of scienter allegations, we recognize that *Tellabs* calls into question a methodology that relies exclusively on a segmented analysis of scienter. We read *Tellabs* to mean that our prior, segmented approach is not sufficient to dismiss an allegation of scienter. Although we have continued to employ the old standards in determining whether, a plaintiff's allegations of scienter are as cogent or as compelling as an opposing innocent [*992] inference, *see, e.g., Metzler Investment, 540 F.3d at 1065-69*, we must also view the allegations as a whole. *See South Ferry LP, No. 2 v. Killinger, 542 F.3d 776, 784 (9th Cir. 2008)* ("*Tellabs* counsels us to consider the totality of the circumstances, rather than to develop separately rules of thumb for each type of scienter allegation."). Thus, following *Tellabs*, we will conduct a dual inquiry: first, we will determine whether any of the plaintiff's allegations, standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient, we will conduct a "holistic" review of the same allegations to determine whether the insufficient allegations combine [**18] to create a strong inference of intentional conduct or deliberate recklessness.

B

The SAC relies on several types of factual allegations to plead the requisite intentional or deliberately reckless conduct, including (1) statements of six confidential witnesses, (2) Digimarc's April 5, 2005 restatement of earnings, (3) the resignations of Ranjit, two members of the accounting department, and the corporation's auditing firm during the class period, (4) statements made in filing the corporation's Sarbanes-Oxley certifications, (5) the compensation packages of the individual defendants, (6) the stock sales of the individual defendants occurring during the class period, and (7) a private placement by the corporation during the class period. We address each of these allegations in turn, and then, as *Tellabs* instructs, consider the allegations collectively to determine whether the complaint as a whole raises a strong inference of scienter.

1

Zucco first alleges scienter with respect to Digimarc's improper capitalization of internal software development costs, including capitalization of the payroll costs of software engineers and other personnel. The

SAC contends that Digimarc and its senior [**19] management deliberately capitalized internal software development costs, including payroll costs, that they knew should have been expensed under GAAP. This improper accounting, according to the SAC, occurred when Digimarc capitalized, rather than expensed, internal software development costs for software projects in the "preliminary stage" (where a company is in the process of evaluating alternatives for the software development) and in the "post-implementation/operation stage" (when the company places the software into service). To support this allegation of scienter, the SAC relies primarily on the statements of six confidential witnesses.

According to Confidential Witness # 2 ("CW2"), in early 2003 Digimarc (and CFO Ranjit in particular) "eliminated internal control processes intended to prevent the improper capitalization of payroll expenses." CW2 states that in early 2003, he was personally instructed by Val Ford, who reported to Ranjit, to "reprogram the time and expense software to eliminate the required supervisor or manager approval of time" and to give administrative assistants in the finance department authority to enter time for software engineers. Moreover, CW2 reports [**20] that Confidential Witness # 1 ("CW1") sent an email to Ranjit about the changes to the time-reporting software, and received in return an email saying "that it was what Ranjit wanted and that he expected CW1 to take care of it." Confidential Witness # 4 ("CW4"), who worked at the company earlier, recalls that this accounting behavior was typical--specifically, that "decisions about what to capitalize were made either by highly-placed finance employees, or made by corporate-level employees at Digimarc and Digimarc ID Systems."

[*993] Confidential Witness # 3 ("CW3") indicates that Jennifer Walden, a Digimarc financial analyst, told him/her that Indra Paul, the President of Digimarc's ID Systems business unit, instructed employees "to assign more payroll time to projects that were at a point where the payroll costs could be capitalized, even if the employee's time was not spent working on the projects that were appropriate for capitalization." Additionally, CW3 states that several unnamed project managers told him/her that they were upset that their time was being assigned improperly, and that this was occurring "merely so that this time could be capitalized and not recognized as expenses, thereby [**21] improperly and falsely boosting the Company's reported income."

Confidential Witness # 5 ("CW5") recounts that, following his/her departure from Digimarc, "he/she had discussions with employees who still worked at the Company, and heard that time was being changed and hours reassigned improperly, resulting in more payroll expense being capitalized improperly as assets." CW5 also reports hearing "once or twice in mid-2003, from finance people," that some expenses not directly related to a program were being charged to that program. Confidential Witness # 6 ("CW6") reports he/she "understood that some employees were improperly capitalizing labor on contracts."

CW1 states that Susan Scacchi, a former ID Systems controller who reported directly to Ranjit, told him/her that, Ranjit once ordered Scacchi to make last-minute journal entries that increased the amount of payroll that would be capitalized. CW1 reports that Scacchi objected, and later left as a result of this incident--and that Martin Day, then Digimarc's Controller, told CW1 that the journal entries were made despite Scacchi's objections. CW6, in corroboration, describes how Scacchi worked at Digimarc for only six weeks, and says [**22] that Scacchi announced publicly that she was leaving because her supervisors "asked her to do some things she believed were unethical."

Finally, CW1 reports that Ranjit, at the close of every accounting period, required the IT Department to copy all the data from the corporation's Great Plains accounting system into spreadsheets, so that management could analyze the data. CW1 asserts that the "real purpose" of this data extraction was to allow management to determine what "adjustments" were necessary to meet analysts' expectations.

The SAC also employs confidential witnesses to support its allegations of scienter with respect to Digimarc's improper capitalization of inventory and fixed assets. According to Zucco, the corporation misrepresented its inventory numbers by (1) using an improperly low "scrap rate" to calculate inventory lost over the relevant period, (2) creating separate Access databases to track inventory that could be manipulated by Digimarc's officers, (3) booking purchases to projects that would require the purchases to be capitalized, rather than expensed, and (4) leaving obsolete and overvalued inventory on its balance sheet.

The SAC alleges that "Digimarc purchased [**23] raw materials that went through several production processes with numerous vendors before [they were] ready for use, and that each production process resulted in a loss of some of the materials being processed." When accounting for this loss of materials, the SAC contends that the "scrap rate" used to estimate the loss of raw materials was "unreasonably low." CW1 states that he/she calculated the "correct" scrap rate (60 percent), met with a consultant for the company's accounting system and Rahoul Banerja (then Digimarc's ID Systems' Vice President of [*994] Finance), and informed both that "the Company had a problem with 'seriously overvalued inventory'" and that "the Company was not accounting for scrap properly." CW1 also recalls meeting frequently with senior management to discuss the scrap rate, and sending senior management a detailed email describing why his/her scrap rate was preferable to Digimarc's current scrap rates (between five and thirty percent).

Second, the SAC alleges that Digimarc set up "databases to track inventory separate from the Company's Great Plains accounting system," and then used these databases, rather than the Great Plains system, to record its inventory values [**24] at the end of each quarter. According to CW1 and CW2, Ranjit and others in charge of these separate databases used them to improperly increase the amount of inventory reported by Digimarc. CW1 and CW2 claim that "Ford and other finance department personnel munged [sic] the data in the separate Access databases at the end of the month" to boost its reported income. Also, CW6 reports that Banerjea was "accessing Digimarc's inventory accounts on his own and manipulating the value of the Company's inventory." CW6 recalls that Banerjea met frequently with Ranjit and other management to discuss "the Company's problems accounting for inventory," and that Ranjit "had to have known what was going on with respect to the Company's inventory accounting manipulation."

According to several confidential witnesses, these Access databases were used despite reassurances from Microsoft (the creator of the Great Plains accounting software) that the Great Plains system was producing accurate numbers. CW1 reports meeting with Ranjit and other senior management several times in Fort Wayne, Indiana, and discussing the inventory valuation and the use of the Great Plains system. CW1 also recounts talking over [**25] the telephone with a Microsoft representative about the Great Plains system while Ranjit and Banerjea observed. During this phone conversation, "the Microsoft consultant walked through the process of how the inventory numbers were created in the Great Plains system and confirmed that the numbers were correct."

The SAC additionally alleges that Digimarc booked purchases of materials "to the wrong project so that the purchases could be capitalized, rather than expensed, thereby improving the Company's bottom line." Specifically, CW3 reports that Claudia Rao, a former staff accountant in the ID Systems division, told CW3 that "she was directed by senior management (who were in turn commanded by Defendant Ranjit) to improperly book [materials] purchases in an account for a drivers licence program that was still in the [application development] stage so that the purchase expense could be capitalized." Rao also told CW3 that Rao "was never instructed to close out projects with capitalized expenses and therefore the research and development expenses that were being capitalized were improperly accumulating on the Company's balance sheet."

Finally, Zucco contends that Digimarc left obsolete and [**26] overvalued inventory on its balance sheet, thereby over-reporting the value of inventory Digimarc purportedly owned. According to CW1, who early in 2004 became Director of Supply Chain Management, "the Company had approximately $ 2 million in book value of cameras and laminate inventory in its warehouse that was obsolete and substantially overvalued on the Company's balance sheet." Also, CW1 states that Digimarc reported $ 130,000 of inventory value on its books for worthless laminate inventory that had been shredded. CW1 says he/she was specifically ordered by Ranjit "not to write [*995] down obsolete inventory because, according to Ranjit . . . writing down obsolete inventory would result in the Company missing market expectations."

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As we have explained in *Daou*, a complaint relying on statements from confidential witnesses must pass two hurdles to satisfy the PSLRA pleading requirements. First, the confidential witnesses whose statements are introduced to establish scienter must be described with sufficient particularity to establish their reliability and personal knowledge. *Daou, 411 F.3d at 1015-16* (citing *Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226, 1233 (9th Cir. 2004)*; [**27] *Silicon*

Graphics, *183 F.3d at 985*). Second, those statements which are reported by confidential witnesses with sufficient reliability and personal knowledge must themselves be indicative of scienter. *See id. at 1022*. [2]

2 Some circuits have questioned whether *Tellabs* requires a stricter standard for evaluating the sufficiency of securities fraud complaints relying on confidential witnesses. *See Ind. Elec. Workers Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 535 (5th Cir. 2008)* ("Following *Tellabs*, courts must discount allegations from confidential sources."); *Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753, 756-57 (7th Cir. 2007)* (*Tellabs* requires courts to "discount allegations that the complaint attributes to . . . 'confidential witnesses'" because "it is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences" when the confidential witnesses could be lying or nonexistent). Because we conclude the complaint here fails the PSLRA's strong inference requirement even under our standard in *Daou*, we need not decide whether *Tellabs* requires us to further "discount" the use of confidential [**28] witness statements.

The first prong of this two-part confidential witness test analyzes whether a complaint has provided sufficient detail about a confidential witness' position within the defendant company to provide a basis for attributing the facts reported by that witness to the witness' personal knowledge. In *Daou*, we explicitly adopted this approach as an amalgam of the "Second Circuit's standard for evaluating personal sources of information" and "the First Circuit's suggested criteria for assessing reliability of confidential witness." *411 F.3d at 1015*. Under this approach, therefore, a complaint may rely on confidential witnesses in two situations. Where a complaint relies on both confidential witnesses and other factual information, such as documentary evidence, the plaintiffs '"need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false.'" *Id*. (quoting *Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000))*.

Where as here, however, such additional evidence is absent, confidential witness statements may only be relied upon where the confidential witnesses are described "with sufficient particularity to [**29] support the probability that a person in the position occupied by the source would possess the information alleged." *Id*. (quoting *Novak*, *216 F.3d at 314*). Accordingly, the complaint must provide an adequate basis for determining that the witnesses in question have personal knowledge of the events they report. *Id*. (citing *In re Cabletron Sys., Inc., 311 F.3d 11, 29 (1st Cir. 2002))*. To determine whether the complaint has done so, we look to '"the level of detail provided by the confidential sources, the corroborative nature of the other facts alleged (including from other sources), the coherence and plausibility of the allegations, the number of sources, the reliability of the sources, and similar indicia.'" *Id*. (quoting *Cabletron, 311 F.3d at 29-30*).

[*996] Although the SAC describes the confidential witnesses' job titles and employment information with ample detail to satisfy *Daou*'s [**30] requirement that a complaint make apparent a confidential witnesses' position within the defendant corporation, we conclude that the SAC fails to allege with particularity facts supporting its assumptions that the confidential witnesses were in a position to be personally knowledgeable of the information alleged.

As in *Daou*, the plaintiffs here "describe the confidential witnesses with a large degree of specificity"--the SAC "number[s] each witness and describe[s] his or her job description and responsibilities." *Id. at 1016*. CW1 is described as "Director of the IT Department of Digimarc's ID Systems" who "report[ed] directly to . . . Ranjit." He is alleged to have "worked extensively on Digimarc's accounting system software" and on Digimarc's attempt to "track[ ] and value[ ] inventory." CW2 is identified as an anonymous IT employee, who "worked extensively on Digimarc's implementation of the Great Plains accounting system, and had direct knowledge of how Digimarc accounted for its inventory during the [relevant time period]." CW3 was purportedly a "financial analyst in Digimarc's ID Systems finance department" who "worked closely with other finance department employees involved in [**31] creating forecasts of Digimarc's financial performance" and "worked extensively attempting to resolve the Company's serious accounting problems regarding its inventory in 2004." [3] CW4, according to the SAC, was a Human Resources manager until 2002 who reported to John Munday, a former ID Systems President. CW5 was ostensibly the ID

Systems Controller who reported to Ranjit from December 2001 until mid-2002. Finally, CW6 was the Vice President of Supply Chain Management at the ID Systems unit from 2002 until early 2005. He was based in Fort Wayne, Indiana, and was "involved in tracking inventory, and purchasing and distribution of materials." Such descriptions are undoubtedly sufficient under *Daou*.

> 3 Although the SAC does not reveal the exact job titles of CW2 and CW3, this is not fatal to the complaint. In *Daou*, we held that plaintiffs had pled facts sufficient to meet the PSLRA standard when plaintiffs relied on six confidential witnesses described in several cases simply by business department and general duties. *See 411 F.3d at 1016*.

The SAC, however, does not provide the requisite particularity to establish that certain statements of these confidential witnesses are based on the [**32] witnesses' personal knowledge. *See Cabletron, 311 F.3d at 30* (validating the confidential source statements in a securities fraud complaint only when they "are not conclusory allegations of fraud, but specific descriptions of the precise means through which it occurred, provided by persons said to have personal knowledge of them"). Some of the confidential witnesses were simply not positioned to know the information alleged, many report only unreliable hearsay, and others allege conclusory assertions of scienter. These allegations are not sufficient to raise a strong inference of scienter because they demonstrate that the confidential witnesses are not reliable. *See Daou, 411 F.3d at 1015*.

Two of the witnesses, CW4 and CW5, were not employed by Digimarc during the time period in question and have only secondhand information about accounting practices at the corporation during that year. CW4 was a human-resources employee who, even while employed at Digimarc, had no firsthand knowledge of the workings of the finance or corporate departments. He supplies no basis for his claim that "decisions about what to capitalize were made . . . by highly-placed finance employees." Likewise, although [**33] [*997] CW5 was the ID Systems Controller for at least six months between 2001 and 2002, and may have had some personal knowledge about the inner workings of Digimarc's accounting and financial reporting at that time, the only facts he reports to indicate scienter are hearsay statements from anonymous finance personnel employed by Digimarc in mid-2003. The lack of detail in CW5's allegations (he claims only that sometime in 2003, "some expenses not directly related to a program were charged to that program" and that "[employee] time was being changed," and fails to provide specifics or dates for these activities) further support the conclusion that CW5's allegations are not reliable enough to support the SAC's allegations of scienter. *See Daou, 411 F.3d at 1015*.

A majority of the confidential witnesses base their knowledge on vague hearsay, which is not enough to satisfy Daou's reliability standard. [4] For example, CW3 reports that Jennifer Walden, a Digimarc financial analyst, told him/her that Indra Paul, the President of Digimarc's ID Systems business unit, instructed employees "to assign more payroll time to projects that were at a point where the payroll costs could be capitalized, even [**34] if the employee's time was not spent working on the projects that were appropriate for capitalization." This triple hearsay, accompanied by no details describing which projects or what employees were affected, is not detailed enough to pass muster under *Daou*. Likewise, CW1's statement that Susan Scacchi, a former ID Systems controller who reported directly to Ranjit, told him/her that, "at the close of the first quarter of 2003 . . . Ranjit ordered [Scacchi] to make last-minute journal entries that improperly increased the amount of payroll that was capitalized" is based on at least one level of hearsay, and includes no details specifying the nature of these entries. CW1's additional hearsay statements (that Martin Day, then Digimarc's Controller, told CW1 that the journal entries were made despite Scacchi's objections, and that Raoul Banerjea told CW1 that Digimarc had eliminated inventory reserves at the bequest of Ranjit to meet market expectations [5]) are similarly vague and unreliable, as are CW3's statements that Claudia Rao, a Digimarc staff accountant, told him/her that she was instructed by Ranjit to book purchases "improperly." Even more unreliable [*998] are suggestive statements [**35] by several confidential witnesses that some employees were upset about their time being reassigned, that corporate officers "munged" the financial data through separate spreadsheets at the end of each month, and that Banerjea was "accessing Digimarc's inventory accounts on his own and manipulating the value of the Company's inventory." None of these confidential witness statements establishes the witnesses' personal knowledge or reliability by recounting the particulars of the alleged transgressions.

4 We agree with Zucco that, under the Court's test in *Tellabs*, which explicitly rejected any standard which would "transpose to the pleading stage the test that is used at the summary judgment and judgment-as-a-matter-of-law stages," *127 S. Ct. at 2510 n.5* (quotation marks omitted), the fact that a confidential witness reports hearsay does not automatically disqualify his statement from consideration in the scienter calculus. *See Cabletron, 311 F.3d at 33* (noting that "the rigorous standards for pleading securities fraud do not require a plaintiff to plead evidence."). However, a hearsay statement, while not automatically precluded from consideration to support allegations of scienter, [**36] may indicate that a confidential witnesses' report is not sufficiently reliable, plausible, or coherent to warrant further consideration under *Daou. See Daou, 411 at 1015* (quoting *Cabletron, 311 F.3d at 29*).

5 It is also notable that despite the many allegations in the SAC relating to Digimarc's fraudulent use of inventory reserves the corporation did not restate inventory reserves when it formally published its restatement on April 5, 2005. Since we find that Zucco has failed to properly allege scienter, however, we need not also analyze whether the falsity of Zucco's inventory reserve representations is pled with the requisite particularity. *See Daou, 411 F.3d at 1014* ("A securities fraud complaint must now 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.'" (quoting *Gompper, 298 F.3d at 895*)).

Finally, several confidential witnesses report only conclusory assertions about the defendants' scienter. We have previously cautioned that such assertions [**37] are usually insufficient, standing alone, to adequately allege scienter. *See In re Worlds of Wonder Securities Litigation, 35 F.3d 1407, 1426-27 (9th Cir. 1994)*. For example, CW6 claims that Ranjit "had to have known what was going on with respect to the Company's inventory accounting manipulation," and CW3 contends that certain project managers *knew* that the controls on the time-entry system were altered "merely so that this time could be capitalized and not recognized as expenses, thereby improperly and falsely boosting the Company's reported income." These generalized claims about corporate knowledge are not sufficient to create a strong inference of scienter, since they fail to establish that the witness reporting them has reliable personal knowledge of the defendants' mental state.

The few allegations that have the requisite level of particularity to withstand the first prong of the *Daou* confidential witness test fail to demonstrate the deliberate recklessness required to survive the second prong. Instead, these remaining allegations demonstrate only that there was some disagreement within the corporation over its accounting processes, and not that Digimarc's management was deliberately [**38] reckless in its capitalization of certain software development costs in violation of GAAP. *See Silicon Graphics, 183 F.3d at 974*.

CW2 recounts that he/she was personally instructed by Ford (and Ranjit) to "re-program the time and expense software to eliminate the required supervisor or manager approval of time" and to allow "administrative assistants working in the finance department [to] enter time for the [software] engineers, rather than having the engineers enter their time directly." But, as the district court concluded, "it is questionable whether it is inherently improper to allow finance personnel access to the payroll system in order to categorize engineers' time spent on software development as ordinary expenses or capital expenses." *Zucco Partners, 445 F. Supp. 2d at 1205*. There is nothing so necessarily nefarious about a time-entry system supervised by the finance department to suggest that an inference of deliberate recklessness in such a situation is equally as cogent and as compelling as an innocent explanation. Indeed, this allegation demonstrates only "motive and opportunity," which, without more, is not enough to establish a cogent and compelling inference of scienter. [**39] *See DSAM Global Value Fund v. Altris Software, Inc., 288 F.3d 385, 389 (9th Cir. 2002)* (quoting *Silicon Graphics, 183 F.3d at 974* ("To allege a strong inference of deliberate recklessness, Appellants must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity.") (internal quotation marks omitted)).

CW1, who was the Director of the IT Department, reports from personal knowledge that Ranjit, at the close of every accounting period, required the IT Department to copy all the data from the corporation's Great Plains accounting system [*999] into spreadsheets, so that management could analyze the data. But the existence of the separate databases, which were allegedly used in preparing Digimarc's financials, indicates only motive and opportunity--not scienter. In fact, the SAC supplies facts indicating that management sincerely believed the numbers generated by the Great Plains system were incorrect and wanted to confirm these numbers through the use of separate databases. The SAC describes several meetings wherein Digimarc's management openly questioned the formulae used by the Great Plains system to calculate inventory levels, and at least one telephone [**40] call between management and a Microsoft representative to resolve the perceived issues. At best, CW1's account establishes "disagreement and questioning within [Digimarc] about the [accounting numbers]," and fails to demonstrate that "[Digimarc's] external auditors counseled against the practice or that [management] admitted or was aware that [using the separate databases] was improper." *Metzler Investment, 540 F.3d at 1069*. This is far from the deliberate, conscious recklessness required for a strong inference of scienter under the PSLRA.

Likewise, the SAC's many specific allegations about improper inventory scrap rates and obsolete inventory only demonstrate disagreement within Digimarc over the proper percentage of raw materials that should have been recorded on its balance sheets. CW1 alleges that his scrap rate of sixty percent was "correctly calculated," but that management at Digimarc refused to implement such a high (or individualized) scrap rate, and instead applied a uniform scrap rate of between five and thirty percent. CW1 specifically recollects sending an email to management about his preferred scrap rates. Mere knowledge of alternative scrap rates, however, or disagreement [**41] among employees with regard to the proper scrap rate, is not enough to establish a cogent or compelling scienter allegation--especially where, as here, there is no indication that Digimarc's management acted with deliberate recklessness in choosing the lower uniform scrap rates. Indeed, nothing in the SAC suggests using the chosen scrap rate violated GAAP. *See Metzler Investment, 540 F.3d at 1069*. Likewise, CW1's statements about specific obsolete inventory held within the corporation do not present a cogent and compelling inference of scienter. Obsolete inventory may be retained for a variety of reasons, including to satisfy the repair demands of prior customers.

The lone fact in the SAC reported by a confidential witness that is in any way indicative of scienter is too contradictory to be compelling. CW1 specifically reports that he/she was directly ordered by Ranjit in 2004 "not to write down obsolete inventory because, according to Ranjit . . . writing down obsolete inventory would result in the Company's missing market expectations." Although this statement, considered in isolation, might be enough to demonstrate scienter, it is notable that Digimarc *did* write down significant [**42] amounts of obsolete inventory in 2004. CW1's statement, therefore, is simply incongruous with Digimarc's public actions alleged in the complaint. As we have recently noted, "a plaintiff cannot avoid dismissal by reliance on an isolated statement that stands in contrast to a host of other insufficient allegations." *Metzler Investment, 540 F.3d at 1069*. Especially as here, where a single statement indicative of scienter is contradicted by readily available physical evidence, it is impossible to conclude that the statement creates an inference of scienter sufficiently cogent or compelling to survive under *Tellabs*.

As a whole, the SAC's plethora of confidential witness statements fail to create a an inference of scienter more cogent or [*1000] compelling than an alternative innocent inference. *Tellabs, 127 S. Ct. at 2510*. The complaint's only specific allegation that could be used to infer scienter (that Ranjit ordered CW1 to write-down inventory) is contradicted by other physical evidence. The remaining confidential witness statements are either not indicative of scienter or so vague and of such unreliable origin as to be unpersuasive.

2

In addition to the number of confidential witnesses Zucco [**43] relies upon in its Second Amended Complaint, it also contends that certain of Digimarc's public actions support an inference of scienter--first among which is the issuance of the restatement of earnings on April 5, 2005.

In general, the mere publication of a restatement is not enough to create a strong inference of scienter. In particular, we have previously found inadequate complaints alleging that "facts 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." *In re Read-Rite Corp. Sec. Litig., 335 F.3d 843, 848 (9th Cir. 2003)* (quotation and emphasis omitted). *See also DSAM Global Value Fund,* *288 F.3d at 390* ("Thus, mere allegations that an accountant negligently failed to closely review files or follow GAAP cannot raise a strong inference of scienter.").

Recently, however, we have recognized two exceptions to this general rule, and have found bare allegations of falsely reported information probative under certain narrow conditions. *See South Ferry, 542 F.3d at 785* (summarizing the exceptions). Specifically, falsity may itself be indicative of scienter where it is combined [**44] with "allegations regarding a management's role in the company" that are "particular and suggest that the defendant had actual access to the disputed information," and where "the nature of the relevant fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge of the matter." *Id. at 786* (quotation marks and citation omitted).

The first exception permits general allegations about "management's role in a corporate structure and the importance of the corporate information about which management made false or misleading statements" to create a strong inference of scienter when these allegations are buttressed with "detailed and specific allegations about management's exposure to factual information within the company." *Id. at 785*. To satisfy this standard, plaintiffs might include in their complaint "specific admissions from top executives that they are involved in every detail of the company and that they monitored portions of the company's database," *id*. (quoting *Daou, 411 F.3d at 1022-23*), a specific admission from a top executive that "'[w]e know exactly how much we have sold in the last hour around the world,'" *id*. (quoting *Nursing Home, 380 F.3d at 1231*), [**45] or other particular "details about the defendants' access to information within the company." *Id.*

The SAC fails to allege such particular details. Although the SAC includes allegations that senior management (and Ranjit, in particular) closely reviewed the accounting numbers generated by Digimarc each quarter (through the use of the Access databases), and that top executives had several meetings in which they discussed quarterly inventory numbers, this is not enough to satisfy the narrow exception to *Read-Rite*. Allegations that Digimarc's management had access to the purportedly manipulated quarterly accounting numbers, or that the management analyzed the inventory numbers closely, do not support the inference that management was in a position to know that such [*1001] data was being manipulated. Nothing in the complaint suggests that Ranjit had access to the underlying information from which the accounting numbers were derived.

The second exception to *Read-Rite* permits an inference of scienter where the information misrepresented is readily apparent to the defendant corporation's senior management. Where the defendants "must have known" about the falsity of the information they were providing [**46] to the public because the falsity of the information was obvious from the operations of the company, the defendants' awareness of the information's falsity can be assumed. *See Berson v. Applied Signal Tech., Inc., 527 F.3d. 982, 987-89 (9th Cir. 2008)*. Nevertheless, reporting false information will only be indicative of scienter where the falsity is patently obvious--where the "facts [are] prominent enough that it would be 'absurd to suggest' that top management was unaware of them." *Id. at 989* (quoting *America West, 320 F.3d at 943 n.21*). In *Berson* we found that the defendant company's misrepresentation of the status of stop-work orders was enough to infer scienter when the four stop-work orders had respectively "halted between $ 10 and $ 15 million of work on the company's largest contract with one of its most important customers," "halted $ 8 million of work," "caused the company to reassign 50-75 employees," and "required [Defendant] to complete massive volumes of paperwork." *See id. at 988 n.5* (quotation marks omitted).

In this case, unlike in *Berson*, the alleged misrepresentations do not concern especially prominent facts. In particular, Digimarc admitted in its restatement that [**47] "certain costs had been erroneously capitalized because either a portion of such costs did not qualify for capitalization (e.g., costs related to the preliminary or post-implementation stages [of a software project]) or the project itself did not qualify as internal-use software (e.g., costs related to a non-software project)." Because these misrepresentations are largely definitional, the falsity of the original representations would not be immediately obvious to corporate management. For example, management would have to be aware that a software development project had reached the "post-implementation" stage or that computer engineers were working on software that did not qualify for "internal use." There is no indication that the differences between the "preliminary project" stage, the "application development" stage, and the "post-implementation" stage of a software project would be operationally visible to executives not intimately connected with the development process and GAAP's definitions. Although the difference between an "internal software project" and a more general research and development software project might be slightly more apparent to the lay observer, some research [**48] and development projects might be closely integrated with software development. In any case, there is no indication that the reclassification of a development project along these lines would, as in *Berson*, "cause [Digimarc] to reassign 50-75 employees" or "complete a massive volume of paperwork." *Id*. These misrepresentations are not the type that qualifies for the narrow exception to the general rule that falsity alone cannot create a strong inference of scienter.

3

Zucco also claims that the resignation of several members of Digimarc's financial department can be used to infer scienter. The SAC points to the resignation of (1) Digimarc's CFO Ranjit, in early 2004, (2) two Digimarc controllers (Scacchi, after only six weeks of work, and Diana King, in late 2003); and (3) KPMG as Digimarc's independent accounting firm on June 14, [*1002] 2005, shortly after the restatement was issued as evidence that Digimarc was conscious of the accounting misrepresentations.

Although resignations, terminations, and other allegations of corporate reshuffling may in some circumstances be indicative of scienter, the resignations at issue here are not so numerous or suspicious as to raise such an inference. Where [**49] a resignation occurs slightly before or after the defendant corporation issues a restatement, a plaintiff must plead facts refuting the reasonable assumption that the resignation occurred as a result of restatement's issuance itself in order for a resignation to be strongly indicative of scienter. *See, e.g., In re U.S. Aggregates, Inc. Sec. Litig., 235 F. Supp. 2d 1063, 1074 (N.D. Cal. 2002)* ("Plaintiff can point to no particularized allegation refuting the reasonable assumption that [defendant's employee] was fired simply because the errors that lead to the restatement occurred on his watch or because he failed adequately to supervise his department."). Here, the resignation of KPMG as Digimarc's independent accounting firm a month after the restatement was issued is not surprising--it had just been partially responsible for the corporation's failure to adequately control its accounting procedures. This is not enough to support a strong inference of scienter.

For other resignations occurring during the relevant time period, a plaintiff must allege sufficient information to differentiate between a suspicious change in personnel and a benign one. Mere conclusory allegations that a financial [**50] manager resigns or retires during the class period or shortly before the corporation issues its restatement, without more, cannot support a strong inference of scienter. *Cf. Silicon Graphics, 183 F.3d at 986* (holding that stock sales of individual defendants are only indicative of scienter where they are "dramatically out of line with prior trading practices" (quoting *In re Apple Computer Sec. Litig., 886 F.2d 1109, 1117 (9th Cir. 1989)))*. Absent allegations that the resignation at issue was uncharacteristic when compared to the defendant's typical hiring and termination patterns or was accompanied by suspicious circumstances, the inference that the defendant corporation forced certain employees to resign because of its knowledge of the employee's role in the fraudulent representations will never be as cogent or as compelling as the inference that the employees resigned or were terminated for unrelated personal or business reasons.

In this case, the SAC alleges that Digimarc's CFO Ranjit retired "just prior to the disclosure of Digimarc's improper accounting and lack of financial controls during his tenure." The complaint does not indicate whether Ranjit was nearing retirement age, [**51] whether he left to pursue other opportunities, or even the length of his tenure. Thus the bare fact of Ranjit's retirement cannot support Zucco's allegations of scienter. Similarly, the SAC's allegations that Scacchi and King (two Digimarc controllers) resigned during the class period are not enough, absent particular facts about Digimarc's hiring and firing of controllers during the class period, to create a compelling inference of scienter. Although Zucco contends that both left because they believed management was unethical, these accounts are based on vague hearsay allegations and are not specific enough to extract a strong inference of scienter from otherwise mundane turnover in the corporation's financial department.

4

The SAC also alleges that boilerplate Sarbanes-Oxley certifications signed by the individual defendants, Davis and Ranjit, are strongly indicative of scienter. [*1003] Specifically, pursuant to *section 302(a)* of the Sarbanes-Oxley Act, a company's "principal executive officer or officers and the principal financial officer or officers" must certify the accuracy and reliability of its quarterly financial reports. *See 15 U.S.C. § 7241(a)*. A signing officer must certify that [**52] he has reviewed the report, that based on his knowledge the report "does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made . . . not misleading," and that the report and any information included within the report "fairly present in all material respects the financial condition and results of operations of the issuer . . . ." *15 U.S.C. § 7241(a)(1), (2), (3)*. Moreover, the officer must certify that he is "responsible for establishing and maintaining internal controls," *15 U.S.C. § 7241(a)(4)(A)*, and that he has "evaluated the effectiveness of the issuer's internal controls" within the past ninety days and has "presented in the report [his] conclusions about the effectiveness of [the corporation's] internal controls based on [his] evaluation as of that date." *15 U.S.C. § 7241 (a)(4)(B)-(D)*. Zucco alleges that compliance with *section 302(a)*--and in particular, specific language in Digimarc's "Controls and Procedures" section of its Form 10-Q for the second quarter of 2003 announcing its compliance with that section--is indicative of scienter. [6]

6 Zucco also erroneously alleges that the omission of certain [**53] language in Digimarc's March 31, 2004 10-Q, which was present in its March 31, 2003 10-Q, is indicative of scienter. The language in question read:

> The registrant's other certifying officer and I have indicated in this quarterly report *whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls* subsequent to the date of our most recent evaluation . . .

As the district court correctly pointed out, however, this language was omitted from subsequent certifications by governmental mandate (through amendments to the SEC rules which became effective August 14, 2003). Thus, the changes cannot be indicative of scienter. *See Zucco Partners, 445 F. Supp. 2d at 1208-09*.

The SAC alleges that the following language in the "controls and procedures" section of Digimarc's Form 10-Q for the second quarter of 2003, certified by Davis and Ranjit, can raise an inference of scienter:

> As of June 30, 2003 our management evaluated, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures. Based on [**54] this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in this report. Our management also evaluated, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, any charge that occurred in our internal control over financial reporting during the fiscal quarter ended June 30, 2003. No such change materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Although this language is mandated by the Securities and Exchange Commission, Zucco argues that at least one district court, *see In re Lattice Semiconductor Corp. Sec. Litig., No. CV04-1255-AA, 2006 U.S. Dist. LEXIS 262, 2006 WL 538756, at *18 (D. Or. Jan. 3, 2006)*, has held that such language gives rise to a strong inference of scienter (once the language's falsity is shown).

Boilerplate language in a corporation's 10-K form, or required certifications [*1004] under Sarbanes-Oxley *section 302(a)*, however, add nothing substantial to the scienter calculus. Our sister circuits to rule on such questions have unanimously [**55] agreed that allowing Sarbanes-Oxley certifications to create an inference of scienter in "every case where there was an accounting error or auditing mistake made by a publicly traded company" would "eviscerat[e] the pleading requirements for scienter set forth in the PSLRA." *Garfield v. NDC*

Health Corp., 466 F.3d 1255, 1266 (11th Cir. 2006); *accord In re Ceridian Corp. Sec. Litig., 542 F.3d 240, 248 (8th Cir. 2008)*; *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 545 (5th Cir. 2008)*; *Central Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 555 (5th Cir. 2007)*. We have recently joined these circuits and have ruled that "Sarbanes-Oxley certifications are not sufficient, without more, to raise a strong inference of scienter." *Glazer Capital Mgmt., LP v. Magistri, 549 F.3d 736, 2008 WL 5003306 at *9 (9th Cir. 2008)*. Thus, we reject Zucco's invitation to undermine the PSLRA's distinct requirements for pleading falsity and scienter, and hold that Zucco's Sarbanes-Oxley certifications are not enough to create a strong inference of scienter and do not make Zucco's otherwise insufficient allegations more compelling by [**56] their presence in the same complaint.

5

The SAC additionally alleges that Davis' and Ranjit's executive compensation packages, which included significant bonuses tied to Digimarc's financial performance, are indicative of scienter because they demonstrate that the individual defendants had a pecuniary motive to inflate the corporation's financial performance. In particular, the SAC notes that Davis' compensation was being evaluated during the class period, that his bonus was "based in part on Digimarc's 'operating profit,'" and that based on the financial results reported in 2003, Davis received a bonus of $ 113,000. Zucco's complaint also alleges that Davis and Ranjit were rewarded for Digimarc's 2003 financial performance with substantial stock option grants: specifically, on January 2, 2004, Digimarc granted Davis 110,000 stock options and Ranjit 25,000 stock options (which effectively doubled the amount of shares Ranjit beneficially owned).

A strong correlation between financial results and stock options or cash bonuses for individual defendants may occasionally be compelling enough to support an inference of scienter. *See America West, 320 F.3d at 944*. In *America West*, we noted that [**57] because "none of the [defendant's] executive officers received options awards in 1997 . . . [but defendant] awarded [thousands of options to executive officers] in March 1998 [for performance allegedly increased by misrepresentations] . . . a strong inference of scienter can be inferred from Plaintiffs' allegations." *Id.; see also Tellabs, 127 S. Ct. at 2511* ("[P]ersonal financial gain may weigh heavily in favor of a scienter inference.").

Zucco, however, has failed to provide the particularity we found persuasive in *America West*. Although Zucco's SAC alleges that Davis and Ranjit received bonuses and stock option grants in part based on Digimarc's financial performance, there is no allegation indicating how intimately the bonuses were tied to the company's financials. In *America West*, we found it significant that the individual defendants' compensation was based "principally" on the defendant company's financial performance. *320 F.3d at 944*. The complaint at issue in *America West* established this fact by comparison of the individual defendants' prior year's compensation with the year in question, noting that while "none of the executive officers received [*1005] option awards in 1997 for the [**58] previous year," in the year in question "America West awarded Franke 350,000 options . . . [and] awarded 110,000 options to Goodmanson, 35,000 options to Parker, and 20,000 options to Garel in March 1998." *Id*.

Here, Zucco's SAC makes only the bare assertion that executive-level bonuses were "based in part" on Digimarc's financial performance--the complaint fails to provide specifically, with comparisons to prior years bonuses, the correlation between Davis' and Ranjit's compensation and Digimarc's bottom line. Such "generalized assertions of motive, without more, are inadequate to meet the heightened pleading requirements of *Silicon Graphics*" and *Tellabs*. *Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1038 (9th Cir. 2002)*. If simple allegations of pecuniary motive were enough to establish scienter, "virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions." *Id*. (quoting *Acito v. IMCERA Group, Inc., 47 F.3d 47, 54 (2d Cir. 1995)*.

6

Next, Zucco alleges that the individual defendants' stock sales during the class period are strongly indicative of scienter. The SAC notes several sales during the class period, [**59] alleging that Davis sold approximately 4.5% and Ranjit sold approximately 48% of their "total personal Digimarc stock holdings, including options," during the period between May 23, 2003 and May 4, 2004. During this period, according to the SAC, Davis sold 38,750 shares of stock for a total of $ 610,375.00, and Ranjit sold 30,000 shares of stock for a total of $ 392,750.00. The SAC also alleges that Davis sold a substantially greater percentage of his stock options that were "in the money" during the class period (those exercisable options that had a stock price above the market price of Digimarc's stock).

As we have previously articulated, "[a]lthough 'unusual' or 'suspicious' stock sales by corporate insiders may constitute circumstantial evidence of scienter, insider trading is suspicious only when it is 'dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information.'" *Silicon Graphics, 183 F.3d at 986* (citing *Apple Computer, 886 F.2d at 1117*) (internal citation and quotation marks omitted). Among three factors that must be considered to determine whether stock sales raise a strong inference of deliberate [**60] recklessness are: "(1) the amount and percentage of shares sold by insiders; (2) the timing of the sales; and (3) whether the sales were consistent with the insider's prior trading history." *Id. at 986*.

As the district court correctly noted, the SAC "fail[s] to provide any information on the trading history of Davis or Ranjit for purposes of comparison to the stock sales at issue." *Zucco Partners, 445 F. Supp. 2d at 1210*. For individual defendants' stock sales to raise an inference of scienter, plaintiffs must provide a "meaningful trading history" for purposes of comparison to the stock sales within the class period. *See In re Vantive Corp. Sec. Litig., 283 F.3d 1079, 1095-96 (9th Cir. 2002)*. Even if the defendant's trading history is simply not available, for reasons beyond a plaintiff's control, the plaintiff is not excused from pleading the relevant history. *See id. at 1095* (noting that "[b]ecause [the defendant] joined Vantive four months into the class period, he has no relevant trading history," and thus finding that "[b]ecause [the defendant] had no trading history, we cannot conclude that his trades were out of line with his past practice"); *Ronconi, 253 F.3d at 435-36*; *Silicon Graphics, 183 F.3d at 987-88* [**61] (rejecting an inference of scienter when a [*1006] defendant sold over 75.3 percent of stock holdings during the class period, because the defendant was "legally forbidden to trade" for a long period before the class period and thus had no meaningful trading history). There is no indication that *Tellabs* has altered our pleading standard based on suspicious stock sales. *See Metzler Investment, 540 F.3d at 1066-67* (reaffirming the tripartite *Silicon Graphics* test after *Tellabs*). Thus, since there is no allegation within the SAC that Davis and Ranjit's stock sales, though significant, are inconsistent with their usual trading patterns, no inference of scienter can be gleaned from Zucco's stock sale assertions.

7

Similarly, the SAC's allegations about Digimarc's private placement of stock during the class period do not contain enough relevant comparative history to create a strong inference of scienter. Zucco alleges that on August 25, 2003, Digimarc "completed a private placement offering whereby it sold 1,785,996 units to institutional and accredited investors, raising net proceeds of $ 23.5 million for Digimarc." Each unit included one share of stock and a warrant to purchase 0.15 shares of common [**62] stock at an exercise price of $ 14 per share.

Although "corporate acquisitions" may, when combined with "specific allegations of deliberate accounting misfeasance," create a strong inference of scienter, *see Daou, 411 F.3d at 1024*, mere generalized assertions about "routine business objectives, without more" cannot support such an inference. *See Lipton, 284 F.3d at 1038*. To create a strong inference of scienter, therefore, the corporate stock sales must be significant enough and uncharacteristic enough to cast doubt on the defendant company's motives. In *Daou*, for example, we held that a company's *eleven* stock-funded acquisitions during the class period were at least partially indicative of scienter where the company "exchang[ed] over 6.6 million shares" of its stock and, if the stock had been properly valued, would have been required to exchange 19,642,865 more shares of its stock to accomplish the same purpose. *411 F.3d at 1023-24*. The stock placement in this case is far less disproportionate than in *Daou*. Moreover, Zucco has failed to allege that the Digimarc's stock placement was in any way inconsistent with the corporation's traditional business practices. *See Silicon Graphics, 183 F.3d at 986*. [**63] Thus, the SAC's allegations about Digimarc's private placement do not create a strong inference of scienter.

C

Although none of the SAC's allegations of scienter is individually cogent or compelling enough to survive under the PSLRA, we must also "consider the complaint in its entirety" to determine whether "*all* of the facts alleged, taken collectively, give rise to a strong inference of scienter." *Tellabs, 127 S. Ct. at 2509*. As we have recently articulated, "*Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement." *South Ferry, 542 F.3d at 784*. Accordingly, even "[v]ague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter." *Id*. When conducting this holistic review, however, we must also "take into account plausible opposing inferences" that could weigh against a finding of scienter. *Tellabs, 127 S. Ct. at 2509*. Even if a set of allegations may create an inference of scienter greater than the sum of its parts, it must still be more compelling than an alternative innocent explanation.

[*1007] Although the allegations in this case are legion, [**64] even together they are not as cogent or compelling as a plausible alternative inference--namely, that although Digimarc was experiencing problems controlling and updating its accounting and inventory tracking practices, there was no specific intent to fabricate the accounting misstatements at issue here. Instead, the facts alleged by Zucco point towards the conclusion that Digimarc was simply overwhelmed with integrating a large new division into its existing business. The SAC notes that Digimarc in 2001 significantly expanded the scope of its business by acquiring its ID Systems unit from Polaroid. This acquisition eventually mandated the integration of several accounting systems into the new Great Plains system. As the SAC reports, Digimarc's 2004 Form 10-K admitted that this integration resulted in problems including inadequate training of personnel in the new Great Plains system, duplicate recording of purchases, and other classification errors. It is more plausible that Digimarc's management was unable to control the accounting processes within the corporation during this integration than that it was systematically using accounting manipulations to make the company seem slightly [**65] more financially successful. As a result, we hold that the district court did not err when it dismissed Zucco's Second Amended Complaint for failure to sufficiently allege scienter under *Federal Rule of Civil Procedure 9(b)* and the PSLRA.

III

Because the district court dismissed the complaint with prejudice, we must finally consider whether the district court abused its discretion in refusing to grant Zucco leave to amend its complaint. *See Gompper, 298 F.3d at 898*. Under *Federal Rule of Civil Procedure 15(a)(2)*, federal courts are instructed to "freely give leave [to amend] when justice so requires." A district court, however, may in its discretion deny leave to amend "due to 'undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, [and] futility of amendment.'" *Leadsinger, Inc. v. BMG Music Publ'g, 512 F.3d 522, 532 (9th Cir. 2008)* (quoting *Foman v. Davis, 371 U.S. 178, 182, 83 S. Ct. 227, 9 L. Ed. 2d 222 (1962))*. Since the district court determined that any attempt to amend would be futile, "we will affirm the district court's dismissal on this basis [**66] if it is clear, upon *de novo* review, that the complaint could not be saved by any amendment." *Id*. (quotation marks and citation omitted). As here, where the plaintiff has previously been granted leave to amend and has subsequently failed to add the requisite particularity to its claims, "[t]he district court's discretion to deny leave to amend is particularly broad." *Read-Rite, 335 F.3d at 845* (quoting *Vantive, 283 F.3d at 1097-98*).

The district court, when dismissing the First Amended Complaint, held that Zucco had failed to satisfy the scienter requirements of the PSLRA with respect to its allegations based on confidential witness statements and stock sales. The fact that Zucco failed to correct these deficiencies in its Second Amended Complaint is "a strong indication that the plaintiffs have no additional facts to plead." *Vantive, 283 F.3d at 1098*. Accordingly, the district court did not err when it dismissed the SAC with prejudice, since it was clear that the plaintiffs had made their best case and had been found wanting. *See Metzler Investment, 540 F.3d at 1072* (upholding a dismissal with prejudice where, *inter alia*, the deficiencies at issue "persisted in every prior iteration [**67] of the [complaint]").

[*1008] IV

The allegations of scienter in the SAC, though voluminous, are not pled with the particularity required to survive a *Federal Rule of Civil Procedure 12(b)(6)* dismissal under the standards enumerated in *Federal Rule of Civil Procedure 9(b)* and the PSLRA. Instead, the plaintiffs in this case assume that compiling a large quantity of otherwise questionable allegations will create a strong inference of scienter through the complaint's emergent properties. Although *Tellabs* instructs us to view such compilations holistically, even such a comprehensive perspective of Zucco's complaint cannot transform a series of inadequate allegations into a viable inference of scienter. We therefore affirm the district court's dismissal of the Second Amended Complaint with prejudice.

AFFIRMED.