

Circuit Court Decisions Addressing the Requirements for Pleading Scienter

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First Circuit: Publication of Erroneous Interim Clinical Study Results, Standing Alone, Does Not Give Rise to an Inference of Scienter

On October 3, 2016, the First Circuit affirmed dismissal of a securities fraud action alleging that a pharmaceutical company and several of its executives “turned a blind eye” to “study results that seemed too good to be true” in order to reap “a windfall on the sale of their stock.” *Local No. 8 IBEW Ret. Plan & Tr. v. Vertex Pharm.*, 838 F.3d 76 (1st Cir. 2016) (Kayatta, J.). The court found the inference that the company knowingly or recklessly published the inaccurate study results was not “strong enough to equal the alternative inference that [the company] was negligent in viewing very good results as being even better than they in fact were.”

With respect to plaintiffs’ argument that [the company] itself described the study results as “unexpected,” the First Circuit explained that “many studies of new pharmaceutical products result in surprises, both good and bad.” The court also found there was no “legal requirement . . . that obligated the company to double-check the interim results before announcing them.”

Finally, the First Circuit rejected plaintiffs’ theory that defendants were financially motivated to overlook “the erroneous interpretation of the interim results because of the stock price spike precipitated by the error.” The court explained that “[a]nnouncing good results on such a study would have been clearly better for [the company] than announcing great results only to reduce them to good results by shortly thereafter confessing error, thereby harming the company’s credibility and its reputation for competence.”

Fifth Circuit: Courts Cannot Infer Scienter Based on an Executive’s Position in the Company Absent “Special Circumstances”

On January 13, 2016, the Fifth Circuit held that it could not infer scienter based on a corporate officer’s position at the company absent “special circumstances.” *Local 731 I.B. of T. Excavators and Pavers Pension Tr. Fund v. Diodes*, 810 F.3d 951 (5th Cir. 2016) (Jones, J.). The Fifth Circuit explained that “[t]he ‘special circumstances’ cases exhibit some combination of four considerations that might tip the scales in favor of an inference of scienter.” First, the court noted that “the smaller the company the more likely it is that corporate executives would be familiar with the intricacies of day to day operations.” A second factor is whether the transaction in question was “critical to the company’s

continued vitality.” A third factor is whether “the misrepresented or omitted information at issue would have been readily apparent to the speaker.” Finally, a fourth factor is whether the “defendant’s statements were internally inconsistent with one another.” The Fifth Circuit found none of these considerations were present in the case before it, and concluded that it could not infer scienter based solely on the executives’ positions within the company.

Sixth Circuit: A Corporate Executive’s State of Mind May Only Be Imputed to the Corporation for Scienter Purposes If the Executive Made a Public Misstatement

On May 24, 2016, the Sixth Circuit held a senior corporate executive’s state of mind could not be imputed to the corporation where the executive did not himself make any public statements. *Doshi v. Gen. Cable Corp.*, 823 F.3d 1032 (6th Cir. 2016) (Cook, J.). The Sixth Circuit reasoned that under its prior decision in *In re Omnicare Sec. Litig.*, 769 F.3d 455 (6th Cir. 2014), “a corporate executive’s or employee’s state of mind” may only be imputed “to a corporate defendant when such a person *makes a public misstatement*.” In the case before the court, plaintiffs alleged only that the executive “submitted [his division’s] financial data to [the company], not that he drafted, reviewed, or approved [the company]’s erroneous public financial statements.”

Tenth Circuit: Failure to Disclose Project Delays and Cost Overruns Reflected “Benign Optimism” Rather Than Scienter

On July 6, 2016, the Tenth Circuit held plaintiffs failed to raise a strong inference of scienter in connection with a company’s alleged misrepresentations of cost overruns and production delays. *Anderson v. Spirit Aerosystems Holdings*, 827 F.3d 1229 (10th Cir. 2016) (Bacharach, J.). The Tenth Circuit found it was “more probable that the [company] executives were overly optimistic and failed to give adequate weight to financial red flags.”

The Tenth Circuit rejected plaintiffs’ efforts to allege scienter based on a “recovery plan” to put one of the projects back on schedule. The court acknowledged the company’s “eventual announcement of a forward loss suggest[ed] that [the company] had placed too much confidence in the recovery plan.” But the court explained that “the same [could] always be said when a company delays announcement of a forward loss based on remedial efforts to increase profitability or production.”

The Tenth Circuit also held plaintiffs failed to allege scienter based on the CEO’s after-the-fact explanation of why the loss had occurred. The court found the CEO’s statements only “suggest[ed] an honest mistake in predicting [the company’s] future production and costs, not an inference of scienter.”

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