

Ninth Circuit: Strong Inference of Scienter Not Supported Where Plaintiff Failed to Plead a Plausible Motive

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On April 8, 2021, the Ninth Circuit affirmed the dismissal of a putative securities fraud class action against an investment bank, in which plaintiffs alleged that the bank sought to fraudulently inflate a company's stock price by publishing a report setting a target price of \$7 per share without disclosing that its investment banking department would act as the placement agent for a dilutive offering pricing the stock at \$6 per share announced later that same day. *Prodanova v. H.C. Wainwright*, 2021 WL 1307882 (9th Cir. 2021) (Lee, J.). The court held that because the complaint did not offer a plausible motive for the bank's actions, or provide compelling and particularized allegations about scienter, it did not support a strong inference that the bank intentionally made false or misleading statements or acted with deliberate recklessness.

Plaintiff Failed to Plead a Plausible Theory of Defendants' Motive

Plaintiff maintained that the bank deliberately published the report without disclosing the impending offering to drive up the company's stock price. Plaintiff claimed that the bank's "motive was to increase its own compensation from the Offering, as it was set to receive 5% of the Offering's gross proceeds." Noting that plaintiff "appears to assert two formulations of this motive," the court held that "neither theory is plausible" and neither "create[s] a strong inference of scienter."

The court observed that plaintiff's first theory alleged that the bank had an incentive to boost the company's stock price because its overall compensation from the offering would somehow increase if the stock price were higher. Plaintiff's second theory similarly asserted that the bank "had an interest in generating buying activity at an artificially inflated price to ensure a profitable offering[]," which would lead to greater compensation for the bank. As there was no predetermined minimum number of shares to be sold in the offering, under plaintiff's theory, the bank had an incentive to generate interest in the company's stock so that as many shares as possible would be sold and publishing the report could generate such interest. The court determined that "[n]either theory is persuasive or plausible, as both are divorced from common experience." The court explained that "we expect that a financial motive for securities fraud will be clear; for example, someone inside a company stands to gain a substantial profit by engaging in deceptive behavior, such as selling shares before the company discloses negative information." However, the court stated that in this case, "neither theory provides a clear financial incentive."

An Apparent Error, Even if Embarrassing or Inexplicable, Does Not Establish Fraudulent Intent Especially in the Absence of a Plausible Motive

The court explained that the “first theory [of fraudulent intent] does not make sense for a couple of reasons.” First, the bank was set to receive 5% of the offering’s gross proceeds and plaintiff did “not explain how the share price would affect the Offering’s gross proceeds, which in turn determine [the bank’s] compensation.” The court pointed out that the bank “would have received the same compensation for a \$61 million Offering, no matter if the share price was \$6 or \$7.” Second, the court observed that the bank “would stand to lose more from its allegedly fraudulent actions than it would gain.” The court explained that the bank’s “apparent snafu—issuing a \$7 target price in a Report just before a dilutive offering of \$6 per share—likely strained its longstanding relationship with [the company].” The court reasoned that the “risk of losing a longtime client and publicly sullyng its own reputation in the industry far outweighs the benefit of a slightly higher return on one transaction.” The court concluded that “a company’s apparent error—even an embarrassing or inexplicable one—does not establish fraudulent intent, especially if the plaintiff cannot offer a plausible motive for the company’s conduct. [Plaintiff] thus does not plausibly allege scienter on this theory.” The court stated that plaintiff’s “second theory [of fraudulent intent] is even more speculative.” The court found that plaintiff “alleges no facts to show that the Offering would not have sold out but for the Report’s publication and the later increase in [the company’s] share price and trading volume.”

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