

## SECURITIES LITIGATION UPDATE

### ELEVENTH CIRCUIT ISSUES SIGNIFICANT DECISION APPLYING PSLRA SCIENTER PLEADING STANDARDS

On October 8, 2008, the United States Court of Appeals for the Eleventh Circuit issued its first opinion since the Supreme Court decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd. applying the heightened scienter pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). In Mizzaro v. Home Depot, Inc., the Eleventh Circuit affirmed the dismissal of a securities fraud complaint in an opinion that highlights the demanding standard by which a Rule 10b-5 plaintiff's allegations of scienter will be judged; rejects a theory that an alleged fraud was so pervasive that it "must have been known" by management; favorably clarifies the standard for pleading scienter at the corporate level; and limits the probative value of confidential witnesses allegations and parallel SEC investigations.

In Mizzaro, a putative class action plaintiff sued Home Depot and six officers and directors alleging a claim under Section 10(b) of the Securities Exchange Act and Rule 10b-5. The plaintiff alleged that, for four years, Home Depot falsely boosted its earnings by making chargebacks to vendors for merchandise that was claimed to be defective, but in reality was not. To establish the defendants' scienter – *i.e.*, intent or severe recklessness – the plaintiff asserted that the practice was so pervasive and longstanding that it must have been known to the individual defendants.

The plaintiff relied on the statements of six confidential witnesses – a division director and five store level employees – to the effect that a practice of making illegitimate chargebacks was commonplace and extensive. In addition, the complaint alleged that the widespread nature of the claimed fraud was corroborated by newspaper accounts, internal documents, a Sarbanes-Oxley whistleblower complaint by a former store employee, and the fact that the SEC had commenced an informal inquiry.

Affirming the district court's dismissal on grounds that the plaintiff had not satisfied the PSLRA's requirement that a securities fraud complaint plead particular facts giving rise to a "strong inference" of scienter, the Eleventh Circuit made a number of rulings that are positive for corporations and individuals defending Rule 10b-5 claims.

First, the court emphasized that the PSLRA's "strong inference" requirement, as interpreted by the Supreme Court in Tellabs, is a stringent and demanding one. In Tellabs, the Supreme Court held that a "strong inference" of scienter is one that is "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Emphasizing that this test involves a comparison of inferences for and against scienter – where omissions and ambiguities weigh against the plaintiff – the court held that a securities fraud complaint "must allege facts from which a reasonable person would infer that it is at least as likely as not that the individual high-ranking defendants either orchestrated the alleged fraud (and thus always knew about it) or learned about the alleged fraud ... or were otherwise severely reckless in not learning of the claimed fraud...."

If you have any questions, please feel free to contact Samuel J. Salario, Jr. or Kathryn H. Christian, members of Carlton Fields' Securities and Derivative Litigation Subgroup.



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Second, the court rejected the notion that the mere fact that the alleged fraud was widespread and long-standing permitted a “strong inference” that senior management must have orchestrated it or known about it. In evaluating this argument, the court found several factors relevant, including the following:

- The fraud was simple – store employees falsely told vendors that goods were damaged – and did not require senior management involvement to succeed.
- The fraud would have been difficult to detect: There were no clever cover-ups or accounting maneuvers that raised red flags.
- There was no allegation of any communication where senior management instructed or encouraged the fraud, which one would expect had senior management conceived and implemented it.
- Home Depot had established aggressive targets for reducing loss to theft or in-store damage, making the “most plausible inference” that the fraud began at the store level in response to this pressure on store managers.
- The amount of the fraud was not convincingly quantified, such that one would infer that it was so large that senior management must have known.
- There were no suspicious stock sales by the individual defendants, which weighed against a strong inference of scienter.

Third, the court weighed in on the frequently contested question of what a plaintiff must plead to show that a corporate defendant acted with scienter. The court adopted the stringent standard devised by the Fifth Circuit in Southland Secs. Corp. v. INSpire Ins. Solutions, Inc., which directs courts to “look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve its making or issuance, or who furnish information or language for inclusion therein, or the like).” Applying this relatively strict rule, the court concluded that the complaint did not adequately plead scienter against the

company because it did not create any inference that any individual defendant or other Home Depot official was both responsible for issuing the allegedly false statements and aware of the alleged fraud.

Fourth, the court clarified the standards applicable to allegations attributed to confidential witnesses. The court agreed that there are reasons “why courts may be skeptical of confidential sources cited in securities fraud complaints” and explained that a complaint must “unambiguously” provide in a “cognizable and detailed way the basis of the whistleblower’s knowledge” and “fully describe[] the foundation or basis of the confidential witness’s knowledge, including the position(s) held, the proximity to the offending conduct, and the relevant time frame.” Applying these standards, the court gave the plaintiff’s confidential witness allegations fairly little weight, largely because the confidential witnesses were relatively low level employees who could not claim even to have met any of the individual defendants and their statements failed to connect any individual defendant directly to the alleged fraud.

Fifth, the court expressed important skepticism about the probative value of allegations of a parallel SEC inquiry. With respect to these allegations, the court noted that the complaint failed to specify what prompted the investigation, the scope of the investigation, who the SEC talked to, or the results of the inquiry. Under the circumstances, the only fact of substance raised by the plaintiff’s allegations was that “at some point the SEC looked into Home Depot’s RTV chargeback practices.”

For defendants litigating securities fraud claims in the Eleventh Circuit, the Mizzaro decision provides much needed and generally positive guidance on many of the scienter allegations commonly advanced by plaintiffs in these cases.

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