PAUL, WEISS, RIFKIND, WHARTON & GARRISON

SECOND CIRCUIT REVIEW

PLEADING REQUIREMENTS UNDER PRIVATE SECURITIES REFORM ACT

MARTIN FLUMENBAUM - BRAD S. KARP

PUBLISHED IN THE *NEW YORK LAW JOURNAL*
JULY 25, 2001

In this month's column, we discuss a significant decision issued last month by the U.S. Court of Appeals for the Second Circuit further refining the pleading requirements for federal securities law claims brought under the Private Securities Litigation Reform Act of 1995[1] (PSLRA).

2d Circuit: Most Solicitous

In its ruling, the Second Circuit reaffirmed its position as the circuit most solicitous of a plaintiff's securities fraud claims—in sharp contrast to the stringent pleading standard adopted by the Ninth Circuit and the somewhat more rigorous pleading standards adopted by the Sixth and Eleventh Circuits.

In *In re Scholastic Corporation Securities Litigation*,[2] the Second Circuit, in an opinion written by Judge Richard J. Cardamone and joined by Judge Guido Calabresi and Judge Charles S. Haight, Jr. (United States District Court for the Southern District of New York, sitting by designation), reversed the district court's dismissal of plaintiffs' securities fraud claims under §§ 20(a) and 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, finding that the district court subjected plaintiffs to an overly stringent standard of pleading.

Scholastic Corporation (Scholastic) is a leading distributor of children's books, magazines, and educational products. Scholastic's best-selling product in the mid-1990s was a series of scary children's books called "Goosebumps." One of Scholastic's sales practices was to ship books to retailers and distributors and provide them with a full right to return the books. Under generally accepted accounting principles, Scholastic could record revenues upon shipment, provided that a sufficient reserve was taken for returned books. This practice was not made known to the public. Historically, the company's return rate for "Goosebumps" was the lowest in the industry at 15 to 20 percent.

In 1996, Scholastic suffered a financial decline due to a decrease in sales as well as an increase in Goosebumps returns. Throughout the fall of 1996, Scholastic's primary distributors were allegedly selling half as many Goosebumps books as they had sold the previous year. In December 1996, Scholastic allegedly learned from Toys 'R' Us that the new line of "Goosebumps" books was too scary. Also at that time, a Scholastic employee responsible for evaluating inventory levels allegedly communicated to Scholastic management that "the situation for 'Goosebumps' had taken a turn for the worse and returns would continue to mount because many titles were overstocked and overbought." In an attempt to reverse the trend of declining sales, Scholastic expanded "Goosebumps" distribution to mass merchandisers and other nontraditional retailers.

Scholastic, despite its alleged awareness of its financial troubles, allegedly represented to investors that its profits were continuing to grow at the same rate that they had grown the previous year. Even though Scholastic recorded a significant first-quarter loss in 1996 (particularly as compared to its performance in the first quarter of 1995), Merrill Lynch released a report, following discussions with Scholastic officials, indicating that Scholastic's return rates remained the lowest in the industry at 20 percent. In December 1996, Scholastic issued a press report announcing that its income was 24 percent more than its income for the same period in 1995. At the same time, senior Scholastic officials allegedly communicated to Merrill Lynch that sales in the second quarter had decreased from the previous year. Scholastic allegedly did not correct or explain these inconsistencies. Scholastic continued to maintain that sales remained constant as compared with the previous year in a prospectus issued on Dec. 18, 1996 as well as in a Form 10-Q filed in early January 1997.

In December 1996, Scholastic's vice president for finance and investor relations, defendant Raymond Marchuk, sold 80 percent of his stock holdings and received $1.25 million. This was the first time Mr. Marchuk had sold any stock since the beginning of 1995.

In January 1997, senior Scholastic officials communicated to Merrill Lynch that book returns had not increased. Merrill Lynch included that fact in a public report and raised its rating on Scholastic stock from neutral to accumulate. Scholastic announced that it agreed with analysts' income estimates of 64 to 73 cents a share. Scholastic again reported to Merrill Lynch in early February 1997 that returns remained at normal low levels. Allegedly, Scholastic knew at that time that book returns had soared and were at levels 150 percent greater than had been experienced the previous January.

Surprising investors, Scholastic issued a press release on Feb. 20, 1997, which announced an expected third-quarter loss of 70 to 80 cents per share. The next day, Scholastic's stock fell 40 percent to $24.75 per share.

In April 1997, plaintiff shareholders filed a class complaint in the United States District Court for the Southern District of New York, Richard Truncellito and the City of Philadelphia filed a class action complaint[3] in the United States District Court for the Southern District of New York that named Scholastic and Raymond Marchuk as defendants. Plaintiffs alleged federal securities law violations (§ 10(b); Rule 10(b)(5); § 20). The class period for the lawsuit began on Dec. 10, 1996, the day Scholastic announced in a press release that income in the second quarter increased by 24 percent over income realized in the second quarter of 1995, and ended on Feb. 20, 1997, the day Scholastic issued a press release reporting an expected third quarter loss of 70 to 80 cents per share.

The district court granted defendants' motion to dismiss the complaint, pursuant to Fed. R. Civ. P. 12(b)(6) and 9(b), on the grounds that plaintiffs failed adequately to allege the element of misrepresentation or omission of material fact by failing to identify adverse financial trends existing at the time of the misstatements and failed adequately to allege facts sufficient to support the element of scienter.

Plaintiffs appealed to the Second Circuit, which reversed the judgment of dismissal.

Material Misrepresentation

Material Misrepresentation or Failure to Disclose Material Information. Writing for the panel, Judge Cardamone ruled that plaintiffs' complaint sufficiently identified specific statements believed to be materially misleading and false. At the outset of the opinion, he noted that the PSLRA heightened the pleading standard for claims brought under the Securities Exchange Act and required a complaint to "identify the statements plaintiff asserts were fraudulent and why, in plaintiff's view, they were fraudulent, specifying who made them, and where and when they were made."[4]

The court ruled that plaintiffs satisfied this standard by identifying five specific statements. The first was Scholastic's Dec. 10, 1996 press release announcing its net income for the second quarter of fiscal year 1996. The second was a report by Deutsche Morgan Grenfell, based on information allegedly provided by Scholastic, stating that Scholastic maintained a 20 percent growth in its sales of "Goosebumps" books. The third statement, included in a prospectus issued on Dec. 18, 1996, touted that sales remained strong. The fourth was Scholastic's statement of profitable second quarter results in its Form 10-Q filed on Jan. 14, 1997. The fifth statement deemed actionable by the court, which was contained in a Merrill Lynch report dated Jan. 31, 1997, based on discussions with Scholastic senior officials, was that no rise in book returns had occurred. The court concluded that these statements, viewed in light of Scholastic's announcement of expected losses only weeks later, supported the allegations of false or misleading statements.

Criticizing District Court

The court criticized the district court for holding plaintiffs "to a more stringent standard than the law requires,"[5] in finding that plaintiffs did not adequately allege defendants' failure to disclose a trend of decreasing sales. Under 17 C.F.R. §229.303 (2000), corporations must disclose on a Form 10-Q any known trends that would have, or be reasonably likely to have, a material effect on revenues. The Second Circuit reasoned that plaintiffs' allegations—specifically, that sales to four of Scholastic's primary distributors of "Goosebumps" books had dropped significantly and that Mr. Marchuk knew of the increase in returns through internal company data—sufficiently pleaded a trend of declining profits.

The panel also observed that the district court should not have faulted plaintiffs for using pre-class period information in their pleadings. The court reasoned that because post-class period information is relevant in demonstrating what a defendant should have known during the class period, so, too, should pre-class data be permitted to show the defendant's state of mind during the class period. The panel emphasized that "any information that sheds light on whether class period statements were false or materially misleading is relevant."[6]

The court also criticized the district court for finding that plaintiffs' allegations of fact were too vague, declaring that even under the enhanced pleading standard of the PSLRA, "we do not require the pleading of detailed evidentiary matter in securities litigation."[7] Accordingly, the court found that plaintiffs satisfied the standard set forth in

San Leondro Emergency Medical Group Profit Sharing Plan v. *Philip Morris Companies*,[8] which requires plaintiffs to "specify the internal reports, who prepared them and when, how firm numbers were or which company officers reviewed them,"[9] to identify who prepared and reviewed the company reports and state how frequently they were prepared. The panel also noted that the allegations surrounding Scholastic's aggressive sales practices during the last two quarters of the year, as well as pre-tax special charges allegedly taken by defendants, supported plaintiffs' claim that defendants knew of (but did not timely disclose) Scholastic's financial downturn.

Scienter

The Second Circuit reaffirmed its interpretation of the PSLRA requirement that plaintiffs must plead scienter with particularity. It emphasized that a plaintiff will meet this standard by "alleging facts stating that defendants had both the motive and an opportunity to commit fraud or otherwise alleging facts to show strong circumstantial evidence of defendants' conscious misbehavior or recklessness."[10] The court stated that plaintiffs showed opportunity by reason of Mr. Marchuk's position as vice president for finance and investor relations and access to insider information.

The court also found that plaintiffs adequately pleaded motive. Allegations of "unusual" insider sales may be used to infer motive. The panel stated that factors considered in determining whether sales are "unusual" include the amount of profit from the sales, the change in volume in insider sales, the percentage of stockholdings sold and the number of insiders selling. The panel disagreed with the district court that "the sale of stock by one corporate insider does not give rise to a strong inference of fraudulent intent."[11] The court stated that in the context of a complaint that names only one corporate insider as a defendant, sales by other corporate officials are irrelevant. In addition, the court emphasized that the dollar amount of the sale must be considered in connection with the percentage of stockholdings sold. Therefore, even though the court previously had considered a $20 million return insufficient to prove unusual trading,[12] Mr. Marchuk's sale of $1.25 million in stock implied unusual insider trading because it amounted to 80 percent of his stockholdings.

The court also found that plaintiffs adequately alleged conscious misbehavior and recklessness, stating that reckless conduct is behavior that is "highly unreasonable" and "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[13] The Court considered "egregious"[14] plaintiffs' allegation that Scholastic, even though it knew that book return rates in January 1997 had increased by 150 percent over the previous January, nevertheless told Merrill Lynch that return rates remained at their historically low levels. The court also found that allegations that defendants discovered on a "daily, weekly, and monthly basis"[15] that the trade of "Goosebumps" books was suffering while reassuring the public otherwise would, if proved, amount to reckless conduct.

Conclusion

The Second Circuit's decision in *Scholastic*, which followed its 1999 decision in *Press* v. *Chemical Investment Services,*[16] places the Second Circuit squarely at odds with the Sixth, Ninth and Eleventh Circuits in terms of the pleading standards applicable under the PSLRA. Fully aware that the pleading standards often can be outcome dispositive, plaintiffs bringing class action suits under the PSLRA have gone out of their way in the past two years to file securities fraud complaints in district courts that comprise the Second Circuit and have avoided at all costs filing such claims in the Ninth Circuit. The issue is one that ultimately will require Supreme Court resolution.

* * *

Martin Flumenbaum and Brad S. Karp are partners in the New York office of Paul, Weiss, Rifkind, Wharton and Garrison.

ENDNOTES

1 Pub. L. No. 104-67, 109 Stat. 737 (1995).

2 252 F.3d 63 (2d Cir. June 1, 2001).

3 Plaintiff Lawrence B. Hollin filed the original complaint in the United States District Court for the Southern District of New York on April 7, 1997. A consolidated amended complaint was filed on Aug. 13, 1997, and was dismissed on Dec. 14, 1998 for failure to plead fraud with particularity under Fed. R. Civ. P. 9(b). The district court granted plaintiffs leave to amend and re-file.

4 252 F.3d at 3621 (quoting *Mills* v. *Polar Molecular Corp.*, 12 F.3d 1170, 1175 (2d Cir. 1993)).

5 252 F.3d at 3622.

6 252 F.3d at 72.

7 Id.

8 75 F.3d 801 (2d Cir. 1996).

9 252 F.3d at 72.

10 Id. at 74.

11 *In re Scholastic Corporation Securities Litigation*, 2000 WL 91939 (S.D.N.Y. 2000).

12 See *Rothman* v. *Gregor*, 220 F.3d 81, 94 (2d Cir. 2000).

13 252 F.3d at 76.

14 Id. at 77.

15 Id. at 76.

16 166 F.3d 529 (2d Cir. 1999).