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SECURITIES LITIGATION UPDATE

ELEVENTH CIRCUIT ISSUES DECISION APPLYING SCIENTER PLEADINGS STANDARDS TO STOCK OPTIONS BACKDATING CLAIM

To keep our clients and colleagues abreast of recent securities litigation developments in the Southeast, Carlton Fields' Securities and Derivative Litigation Practice Group has prepared this Securities Litigation Update.

On January 9, 2009, the United States Court of Appeals for the Eleventh Circuit affirmed the dismissal with prejudice of a Rule 10b-5 claim based on alleged stock options backdating for failure to plead a "strong inference" of scienter in accord with the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). Following on the heels of its October 2008 opinion in Mizzaro v. Home Depot, Inc.,[1] the Eleventh Circuit's decision in Rosenberg v. Gould shows that the court will continue to bring exacting scrutiny to bear upon a 10b-5 plaintiff's allegations of scienter.

Rosenberg involved allegations that the former CEO of Witness Systems, Inc. granted backdated stock options in 2000 and 2001, resulting in overstated earnings in the company's SEC filings between 2004 and 2006. After the company's options practices were publicly questioned by Deutsche Bank, the company conducted an investigation and announced that it would record an additional $10 million of non-cash expenses for periods preceding 2005 to account for certain discrepancies in the dating of stock options. The company's stock price allegedly dropped on these announcements.

On behalf of a putative class of purchasers of Witness stock, the plaintiffs asserted claims against, among others, the company and the CEO under Rule 10b-5. The district court dismissed the complaint with prejudice, holding that the complaint failed to satisfy the PSLRA's standards for pleading scienter – i.e., fraudulent intent – and failed adequately to plead loss causation. By dismissing with prejudice, the district court sub silentio denied the plaintiffs' request for leave to amend, which had been placed in a footnote in their opposition to defendants' motion to dismiss.

Without reaching the causation question, the Eleventh Circuit affirmed on grounds that the complaint failed to satisfy the PSLRA's mandate that a plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter. The court explained that the element of scienter required that the defendants' conduct meet the "exacting standard" of "severe recklessness" and, relying on the Supreme Court decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd., that the plaintiffs' allegations of scienter must be "at least as compelling as any opposing inference of nonfraudulent intent."

To support their allegations that the CEO, and hence the company, acted with severe recklessness, the plaintiffs pleaded that (i) the CEO had the sole responsibility and authority to grant the options at issue; (ii) inaccurate measurement dates were used for substantially all grants prior to 2002; (iii) the CEO sat on the Options Committee of the board; (iv) the CEO personally received a large number of options that were either backdated or springloaded; (v) the CEO sold 39% of his personal holdings of company stock during the class period; (vi) the company used the "artificial inflation" in its stock price to make an acquisition and raise capital, and (vii) the CEO resigned a few months after the alleged corrective disclosures.

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[1] We have previously reported on the Eleventh Circuit's decision in Mizzaro, and our update on that case is available on the web at www.carltonfields.com/securitieslitigation/.

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The court found these allegations "insufficient to establish an inference of fraudulent intent" because "[t]he complaint contain[ed] no allegation that [the CEO] had any knowledge of the accounting principles relating to stock options." As a result, "[t]he inference that [the CEO] knew that backdated options in 2000 to 2001 had led to overstated earnings during the class period in 2004 to 2006 is not as compelling as the competing inference that he was unaware that backdated options had affected financial statements several years later." Moreover, the financial impact of the alleged backdating was only 0.5 percent of revenue in 2004 and 0.17 percent of revenue in 2005, which the court described as a "de minimis change in the financial statements [that] does not amount to a glaring 'red flag'" that would have put the CEO on notice that the company was overstating earnings in its class period financial statements.

In the absence of such allegations, the complaint's averments of scienter boiled down to "speculation and conclusory allegations" that did not satisfy the PSLRA. And because the plaintiffs' request for leave to amend was simply "imbedded within an opposition memorandum," the district court was correct to dismiss the case with prejudice instead of allowing leave to replead.

The Rosenberg decision establishes that, at least where the impact of backdating on a company's financial statements is relatively small, a plaintiff must adequately allege that the relevant corporate actor was knowledgeable of and ignored the correct accounting treatment or that the backdating gave rise to glaring accounting irregularities that would have been obvious. The opinion will doubtless be helpful to defendants contesting such claims as well as Rule 10b-5 claims more generally.

For more information, please contact Samuel J. Salario, Jr. at 813.229.4337 or Christopher M. Sacco at 813.229.4237.

Samuel J. Salario, Jr.
813.229.4337
ssalario@carltonfields.com

Christopher M. Sacco
813.229.4237
csacco@carltonfields.com