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Eleventh Circuit Affirms Dismissal Of Options Backdating Securities Fraud Class Action For Failure To Meet Reform Act's Heightened Pleading Standards

In *Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, No. 09-10954, 2010 WL 154519 (11th Cir. Jan. 19, 2010), the United States Court of Appeals for the Eleventh Circuit affirmed the dismissal of securities fraud and insider trading claims arising out of options backdating. This decision represents the most recent effort by the Eleventh Circuit to apply the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 ("Reform Act") and the Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) [*see* blog article here], to allegations of securities fraud arising from options backdating.

Plaintiffs were a putative class of investors who purchased stock in Jabil Circuit, Inc., a publicly traded electronics and technology company, from September 19, 2001 through December 21, 2007. Plaintiffs alleged that Jabil issued stock options to executives and employees that were "backdated," such that their exercise or strike prices were lower than the market price of Jabil's stock on the true dates of their issuance. The company did this, plaintiffs alleged, despite representations by the company in filings with the Securities and Exchange Commission ("SEC"), including proxy statements, that the exercise price of stock options was always "at least equal to fair market value." The company also represented in its SEC filings that its accounting for employee stock options complied with Accounting Principles Board Opinion No. 25 ("APB 25"), which requires that options be recorded as a compensation expense to the corporation upon issuance if the exercise price is below fair market value. In the wake of an article by the *Wall Street Journal* surmising that Jabil's CEO may have received backdated stock options because the options he received were consistently timed at a low price and followed up by a significant price increase, and an informal investigation by the SEC, Jabil formed a special committee to examine the allegations. The special committee did not find that any of Jabil's executives issued backdated options to themselves, but it did find that the company misapplied APB 25. As a result of that misapplication, Jabil overstated its earnings by $54.3 million from 1996 through 2005, and was required to restate its financials for those periods.

Plaintiffs asserted five sets of claims against Jabil and certain of its senior officers. First, plaintiffs alleged that defendants made false statements regarding the accounting for employee stock options in Jabil's periodic SEC filings in violation of Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Second, plaintiffs alleged that the individual defendants engaged in insider trading in violation of Section 10(b) and Rule 10b-5, as well as Section 20A of the 1934 Act. Third, plaintiffs alleged that defendants made false projections regarding the company's business conditions in violation of Section 10(b) and Rule 10b-5. Fourth, plaintiffs alleged that the defendants made false statements regarding stock option practices in Jabil's proxy statements in violation of Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, promulgated thereunder. Fifth, plaintiffs alleged that the individual defendants were liable as controlling persons of Jabil under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a).

The United States District Court for the Middle District of Florida dismissed the amended complaint. The district court viewed the complaint as based on a scheme of backdating options, and found that the speculative allegations did not adequately plead backdating because they failed to detail the role of any of the individual defendants in the alleged scheme and did not identify when or how any stock option was backdated. As a result, the district court held that plaintiffs failed to plead both falsity and scienter (intent to commit fraud) sufficiently to satisfy the heightened pleading requirements of the Reform Act.

On appeal, the Court took a slightly broader view of plaintiffs' allegations, but nonetheless affirmed the dismissal of the amended complaint. Disagreeing with the district court, the Eleventh Circuit held that Jabil's restatement of its financials sufficed to support a finding that the company's SEC filings contained false statements. The Eleventh Circuit held, however, that the allegations of the amended complaint, viewed individual and in the aggregate, failed to raise a "cogent and compelling" inference that the company and its senior management acted intentionally or with severe recklessness in connection with Jabil's accounting for stock options. Among other things, plaintiffs did not plead particularized facts indicating that the individual defendants knew that any accounting standard was being violated or plead each individual defendant's trading history to support a showing that his class period stock sales were "dramatically" out of line with prior trading practices or otherwise sufficiently suspicious to support a strong inference of scienter.

Turning to plaintiffs' insider trading claim, the Eleventh Circuit agreed with the district court's holding that the complaint failed "to state which defendants knew what information and why the information was material." Although the complaint alleged numerous class period stock sales, it did not contain any "particularized allegation" that any of the individual defendants were aware of any accounting errors at the times they made their trades.

The Eleventh Circuit also rejected plaintiffs' claim that defendants violated Section 10(b) and Rule 10b-5 by making false quarterly projections. The Eleventh Circuit agreed with the district court that defendants were shielded from liability by the "safe harbor" provision of the Reform Act for forward-looking statements. As long as a forward-looking statement is accompanied by meaningful cautionary language, the Court recognized, the speaker is protected from liability irrespective of his state of mind. The Court emphasized that this holding was consistent with the language and purpose of the Reform Act, reaffirming Eleventh Circuit precedent on this point and rejecting plaintiffs' invitation to follow a Fifth Circuit decision to the contrary.

Finally, the Court affirmed the dismissal of plaintiffs' Section 14(a) claim on the ground that plaintiffs failed to demonstrate that they suffered any damages caused by the false statements regarding stock option practices, and affirmed the dismissal of plaintiffs' Section 20(a) claim on the ground that plaintiffs failed to plead a primary Section 10(b) claim.

Although the decision in *Jabil* is focused on the unique (and increasingly anachronistic) problem of options backdating, the Court's opinion offers clear and useful guidance to practitioners beyond that narrow area regarding the Reform Act's requirements for pleading scienter and the application of *Tellabs*, the Reform Act's safe harbor provisions for forward-looking statements, the law regarding insider trading, and causation and damages in proxy solicitation claims.

For further information, please contact John Stigi at (213) 617-5589 or Christopher Loveland at (202) 772-5313.