BakerHostetler

Winning Motions to Dismiss in Securities Class Actions

By Doug Greene

Securities class actions allege that executives made false statements to increase their company's stock price. Our lead argument is nearly always that our clients did not make false statements. The law governing securities claims gives courts wide latitude to dismiss litigation, or not. If the judge is persuaded that the defendants tried to tell the truth, he or she will usually find a way to dismiss. Building on the arguments against falsity, we then present various other arguments in favor of dismissal.

A. The Importance of Defending the Truth of What the Defendants Said

In defending a securities class action, filing a motion to dismiss is almost automatic and, in virtually all cases, it makes good strategic sense. In most instances, there are only four main arguments in favor of the motion:

1. The complaint hasn't pleaded a false or misleading statement.
2. The challenged statements are protected by the safe harbor for forward-looking statements.
3. The challenged statements weren't made with scienter, even if the complaint has adequately pleaded their falsity.
4. The complaint hasn't adequately pleaded loss causation.

The core argument of virtually every brief should be falsity; standing up for a client's statements provides the foundation for all the other arguments. For most clients, it is important to stand up and say, "I didn't lie." And an emphasis on challenging the falsity allegations encompasses clients' most fundamental responses to the lawsuit, i.e., they reported accurate facts, made forecasts that reflected their best judgment at the time, gave opinions about their business that they genuinely believed, issued financial statements that were the result of a robust financial reporting process, etc.

The Private Securities Litigation Reform Act of 1995 (the Reform Act) and the cases that have interpreted it provide securities defense lawyers with broad latitude to attack falsity. A proper falsity analysis always starts by examining each challenged statement individually and matching it with the facts that the plaintiffs allege illustrate its falsity. Then, defense counsel can usually support the truth of what the clients said in numerous ways that are still within the proper scope of the motion-to-dismiss standard:

- Showing that the facts alleged do not actually undermine the challenged statements because of mismatch of timing or substance.
- Putting the defendants' allegedly false or misleading statements in their full context to show that they were not misleading.
- Pointing to incorporated or judicially noticeable facts that contradict the plaintiffs' theory.
- Pointing out gaps, inconsistencies, and contradictions in the plaintiffs' allegations.
- Showing that the facts the plaintiffs assert are insufficiently detailed under the Reform Act.
- Attacking allegations that the plaintiffs claim to be facts but that are actually opinions, innuendo, speculation and unsupported conclusions.

These arguments must be supplemented by a robust presentation of the relevant factual background, which defines and frames the direction of any argument we ultimately make based on the complaint, documents incorporated by reference and judicially noticeable facts. Such an analysis is not simply allowed but is required by the Supreme Court's decision in *Omnicare, Inc. v. Laborers Dist. Council Const. Industry Pension Fund*, 135 S. Ct. 1318 (2015), which makes clear that a court must consider the full context of a statement in determining whether it is "misleading." We helped shape the Court's decision through an amicus brief we wrote on behalf of Washington Legal Foundation.

Yet many motions to dismiss do not make a forceful argument against falsity supported with specific challenges to the "facts" alleged by the plaintiffs. Some motions superficially assert that the allegations are too vague to satisfy the pleading standard and do not engage in a detailed defense of the statements with the available facts. Others simply attack the credibility of the "confidential witnesses" without addressing in sufficient detail the content of the information the complaint attributes to them. Still others fall back on the doctrine of "puffery," which posits that even if false, the challenged statements were immaterial.

By focusing on these and similar approaches, a brief may leave the judge with the impression that defendants concede falsity or are relying on technicalities, and that the real defense is that the false statements were not made with scienter.

That's risky for several reasons. First, detailed, substantive arguments against falsity are some of the strongest arguments that defendants can make. Second, they provide the foundation for the rest of the motion. A weak falsity argument undermines the argument against scienter and fails to paint the best possible no-fraud picture for the judge, which is ultimately what helps a judge be comfortable in granting a motion to dismiss.

1. Emphasizing the Truth of What the Defendants Said Strengthens the Scienter Argument

The element of scienter requires a plaintiff to demonstrate that each defendant said something knowingly or recklessly false. In order to do this, plaintiffs must tie their scienter allegations to each particular challenged statement. It is not enough to generally allege, as plaintiffs often do, that defendants had a general "motive to lie."

When we analyze scienter allegations, we ask, "Scienter as to *what*?" Asking this question often unlocks strong arguments against scienter, because complaints often make scienter allegations that are largely detached from their allegations of falsity. Often this is the case because the falsity allegations are insufficient to begin with. But many motions to dismiss are unable to point out this lack of connection because they don't focus on falsity in a rigorous and thorough way.

Focusing on falsity is also important to scienter because of how courts analyze these two elements. Although falsity and scienter are separate elements that should be analyzed separately, courts often analyze them together. Arguing a lack of falsity thus provides essential ingredients for this combined analysis.

Even when courts analyze falsity and scienter separately, a proper scienter analysis requires a foundational falsity analysis because, as noted above, scienter analysis asks whether the defendant knew that a particular statement was false. Without an understanding of exactly why that challenged statement was false and what facts allegedly demonstrate that falsity, the scienter analysis meanders, devolving into an analysis of knowledge of facts that may or may not be probative of the speaker's state of mind with respect to that statement.

The tendency to lump scienter and falsity together is exemplified by the scienter doctrines that we call "scienter shortcuts": (1) the corporate scienter doctrine and (2) the core operations inference of scienter. Under these doctrines, courts draw inferences about what the defendants knew based on the prominence of the falsity allegations. The more blatant the falsity, the more likely courts are to infer scienter. A superficial falsity argument weakens defendants' ability to attack these scienter shortcuts, which plaintiffs are asserting more and more routinely.

2. Emphasizing the Truth of What the Defendants Said Makes the Judge Feel Better About Dismissing the Litigation

It is a good strategy for a defendant to thoroughly argue lack of falsity even if (1) there are better alternative grounds for dismissal and (2) the challenge to falsity is unlikely to be successful as an independent ground for dismissal. This is for the simple reason that judges are human – they will feel better about dismissing a case based on other grounds if you can make them feel comfortable that there was not a false statement to begin with.

For example, courts are often reluctant to dismiss a complaint solely on safe harbor grounds because that is seen as giving a "license to lie," so it is wise also to argue that forward-looking statements were not false in the first place. Similarly, even if lack of scienter is the best basis for dismissal, it is a good strategy to defend on the basis that no one said anything wrong rather than appearing to concede falsity and being left to contend "but they didn't mean to."

In most cases, judges have enough latitude under the pleading standards to dismiss if they believe that is the right result. The pivotal "fact" is whether the judge feels the case is really a fraud case. A motion to dismiss that vigorously defends the truth of what the defendants said is more likely to make the judge feel that there really is no fraud there.

Conversely, if the defendants make an argument that essentially concedes falsity and relies solely on the argument that the falsity was immaterial, wasn't intentional, or is not subject to challenge under the safe harbor, a judge may stretch to find a way to allow the case to continue.

Put simply, a judge is more likely to dismiss a case in which a defendant says "I didn't lie" than to dismiss a case in which the defendant argues "I may have lied, but I didn't mean to," "I may have lied, but it doesn't matter," or "I may have lied, but the law protects me anyway." Even when a complaint might ultimately be dismissed on other grounds, a strong challenge to falsity is essential to help the judge feel that he or she has reached a just and equitable result.

3. The Supreme Court's Decision in *Omnicare* Makes It Easier to Defend the Truth of Both Opinions and Statements of Fact

Omnicare held that a statement of opinion is false under the federal securities laws only if the speaker does not genuinely believe it, and it is misleading only if it omits information that, in context, would cause the statement to mislead a reasonable investor.

The Court's ruling in *Omnicare* was a significant victory for the defense bar for two primary reasons.

1. The Court made clear that an opinion is false only if it was not sincerely believed by the speaker at the time it was expressed, which is a concept sometimes referred to as "subjective falsity." The Court thus explicitly rejected the possibility that a statement of opinion could be false because "external facts show the opinion to be incorrect," a company failed to "disclose some fact cutting the other way," or the company didn't disclose that others disagreed

with its opinion. This ruling resolved two decades of confusing and conflicting case law regarding what makes a statement of opinion false, which had often permitted meritless securities cases to survive dismissal motions.

2. *Omnicare* declared that whether a statement of opinion (and by clear implication, a statement of fact) was misleading "always depends on context." The Court emphasized that showing a statement to be misleading is "no small task" for plaintiffs, and that courts must consider not only the full statement being challenged and the context in which it was made but also other statements made by the company and other publicly available information, including the customs and practices of the relevant industry.

Evaluating challenged statements in their broader context almost always benefits defendants because it helps the court better understand the challenged statements and makes them seem fairer than they might in isolation. *Omnicare* now explicitly requires courts to evaluate challenged statements within their broader contexts.

Although *Omnicare* arose from a claim under Section 11 of the Securities Act, all of its core concepts are equally applicable to Section 10(b) and other securities claims with similar falsity elements. Due to the importance of its holdings and the detailed way in which it explains them, *Omnicare* is the most significant post-Reform Act Supreme Court case to analyze the falsity element of a securities class action claim. It lays out the core principles of falsity in the same way that the Court did for scienter in its 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007). *See generally* "*Omnicare*, Five Years Later: Strategies for Securities Defense Lawyers' More Effective Use of the Decision."

B. Forward-Looking Statements and the Reform Act's Safe Harbor

Public companies around the country labor under a misunderstanding that the Reform Act's safe harbor protects them from liability for their guidance and projections if they simply follow the statute's requirements. But the safe harbor is not so safe; some judges think the Reform Act goes too far, so they go to great lengths to avoid the statute's plain language. However, companies and their securities litigation defense counsel can usually work around this judicial attitude and take advantage of the statute's protections with the right approach to preparing and defending the company's disclosures.

The safe harbor was a key component of Congress' 1995 reforms to the statutes governing securities class actions. Congress sought "to encourage issuers to disseminate relevant information to the market without fear of open-ended liability." H. R. Rep. No. 104-369, at 32 (1995), as reprinted in 1995 U.S.C.C.A.N. 730, 731. The safe harbor straightforwardly says that a forward-looking statement is not actionable if it is (1) "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement," "or" (2) immaterial, "or" (3) made without actual knowledge of its falsity. 15 U.S.C. § 77z-2(c)(1); 15 U.S.C. § 78u-5(c)(1) (emphasis added).

Yet courts' application of the safe harbor has been anything but straightforward. Indeed, courts have committed some basic legal errors in their attempts to nullify it. Foremost among these is the tendency to collapse the three prongs – essentially reading "or" to mean "and" – and to hold that actual knowledge that the forward-looking statement is false means that the cautionary language can't be meaningful. Courts also engage in other types of legal gymnastics, such as straining to convert forward-looking statements into present-tense declarations, in order to take statements out of the safe harbor.

Beyond prominent instances of judicial error, judges frequently evade the safe harbor by simply avoiding defendants' safe harbor arguments, choosing either to treat the safe harbor as a secondary issue or to avoid dealing with it altogether. The safe harbor was meant to create a clear disclosure system; if companies have meaningful risk disclosures, they can make projections without fear of liability. When judges avoid the safe harbor, companies' projections are judged by legal rules and pleading requirements that result in less-certain and less-protective outcomes, even if judges get to the right result on other grounds. And if companies come to realize that they do not have the clear safe harbor protection Congress meant to provide, they will make fewer and/or less meaningful forward-looking statements.

The root of these problems is that many judges don't like the idea that the safe harbor allows companies to escape liability for knowingly making false forward-looking statements. Indeed, some courts have explicitly questioned the safe harbor's effect. For example, in *In re Stone & Webster, Inc. Securities Litigation*, the First Circuit called the safe harbor a "curious statute, which grants (within limits) a license to defraud." 414 F.3d 187, 212 (1st Cir. 2005).

This judicial antipathy for the safe harbor won't change. So it is up to companies to draft cautionary statements that will be effective in the face of this skepticism, and it is up to securities defense counsel to make safe harbor arguments that resonate with dubious judges.

For these reasons, we take a dual approach to defending forward-looking statements.

1. A forward-looking statement is also an opinion under *Omnicare*, so we start by arguing that the forward-looking statement is not false in the first place. We have found that judges who believe that the forward-looking statements are not false (and are thus assured that they were not knowingly dishonest) are more comfortable applying the safe harbor.
2. We then argue the safe harbor as an additional basis for dismissal and use that discussion to demonstrate that the company's safe harbor cautionary statements show that it really did its best to warn of the risks it faced. Judges can tell if a company's risk factors aren't thoughtful and customized. Too often, the risk factors become part of the SEC-filing boilerplate and don't receive careful thought with each new disclosure; risk factors that don't change from period to period, especially when it's apparent that the risks have changed, are less likely to be found meaningful. And even though many risks don't fundamentally change every

quarter, facets of those risks often do, or there might be another, more-specific risk that could be added. We can help convince judges of the defendants' candor and good faith, as well as the applicability of the safe harbor, by demonstrating the thoughtful evolution of tailored risk factors over time.

Ultimately, the least effective arguments are those that rest on the literal terms of the safe harbor, which create the impression that defendants are trying to skate on a technicality. It is these types of arguments – lacking sophisticated supporting analysis of either the context of the challenged forward-looking statements or the thoughtfulness of the cautionary language – that cause courts to try to evade what they see as the unjust application of the safe harbor. Effective defense counsel should appreciate that safe harbor "law" includes not only the statute and decisions interpreting it but also the skepticism with which many judges evaluate safe harbor arguments.

C. The Importance of Focusing the Scienter Analysis on Knowledge of Falsity

Scienter allegations are of two types, with the second far more prevalent:

1. Allegations pleading facts about what the defendant knew in an attempt to plead that he or she knew the challenged statements were false.
2. Allegations that the defendant "must have" meant to lie, based on circumstantial considerations such as a defendant's stock sales, corporate transactions, the temporal proximity of the challenged statement to the disclosure of the "truth" and the relationship of the subject of the challenged statements to the company's "core operations."

As with falsity, the primary flaw in most defense arguments against scienter is their failure to engage in a fact-specific analysis of the complaint's allegations about what the defendants knew in regard to each specific challenged statement. All too often, defendants allow themselves to be drawn onto the plaintiffs' preferred ground of battle, focusing on arguing about the sufficiency of the circumstantial evidence that plaintiffs use to create the impression that the defendants must have done something wrong.

Circumstantial scienter allegations are only ways to try to make an educated guess about what the speaker knew or intended. But the Reform Act's scienter standard requires particularized pleading yielding a "strong inference" that the defendant lied on purpose – a very high standard at the motion-to-dismiss stage. So it makes no sense for defense counsel not to approach the issue directly by demonstrating that the speaker did not lie and holding plaintiffs to the strict standard of showing specific scienter as to each challenged statement.

For this reason, all effective motions to dismiss start by testing the complaint's allegations that the defendants actually knew, or were intentionally reckless about not knowing, the facts establishing falsity. This means that for each statement and each defendant, the motion to dismiss must isolate the statement and the reasons that the complaint alleges it was false and analyze what the complaint alleges each defendant knew about those facts at the time he or she made each challenged statement. Without this careful attention to each challenged statement, the scienter inquiry is vague and becomes more about whether the defendant seems bad, or had generally bad motives, than about whether he or she lied on purpose. A good motion to dismiss does not let plaintiffs get away with these kinds of generalized allegations.

The problem becomes worse if defense counsel approaches falsity categorically, without careful scrutiny of why the complaint alleges the challenged statements were false. Without this focus, defense counsel can't meaningfully answer the central question in the Reform Act analysis – "Scienter as to what?" – because there isn't a sufficient nexus between the challenged statements and contemporaneous facts that made the statements false. The scienter inquiry thus becomes unmoored from knowledge that specific statements were false.

The result is a lower burden for plaintiffs. If they are able to plead falsity and the defendants seemed to know something about the general subject matter, scienter is almost a foregone conclusion.

This problem is even worse under the "core operations" inference of scienter and the "corporate scienter" doctrine. Each of these theories allows a plaintiff to avoid pleading specific facts establishing the speaker's scienter. For example, the core operations inference posits that scienter can be inferred where it would be "absurd to suggest" that a senior executive doesn't know facts about the company's "core operations." Many motions to dismiss set up some formulation of this statement as a legal rule and make a simplistic syllogistic argument from it. Such arguments devolve into "did not, did so" debates and thus play into plaintiffs' hands because they are detached from knowledge of falsity.

Instead, the right approach to the core operations inference is to understand that it requires a falsity so blatant that we can strongly infer that the executive had knowledge of the exact facts that made the statement false – not just knowledge of the subject matter of the facts. The most effective defense against the core operations inference thus focuses on falsity first to show that even if a statement is false, it is at least a close call, which makes it hard for plaintiffs to contend that defendants must have known of this falsity.

Conclusion

Securities class actions can be defeated at the motion-to-dismiss stage with the right approach. We do not rely on technicalities or gotchas; they send the wrong signal to the judge, and they do not work in most cases. Instead, we emphasize that our clients told the truth. With that argument as our foundation, we then present the full set of available arguments so that the judge has a menu of options for dismissing the litigation.

Securities and Governance Litigation Team

Our nationwide team of more than 50 attorneys comprises full-time securities litigators, former Securities and Exchange Commission (SEC) and Department of Justice enforcement trial lawyers, and prominent commercial litigators. Our turnkey team features the full skill set our clients need to win at each stage of the litigation.

We are devoted to winning every case at the earliest possible time. We have an excellent track record of obtaining full dismissals prior to any discovery. But if the case survives a motion to dismiss, we don't just throw in the towel; we stand ready to defeat or limit class certification, prevail on summary judgment and take the case to trial. We are committed to putting "litigation" back in securities and governance litigation.

Of course, we are always attuned to the right time to engage in mediation. Litigating to win – up to and including trial if necessary – best positions our clients to achieve favorable settlements that protect their reputations and resources. Through decades of experience, we have gained the respect of key mediators, plaintiffs' counsel, and D&O insurers and brokers. These relationships are critical to effective resolution of securities and governance matters.

We also are sensitive to the economics of each case. We have the ability to scale our team and approach to defend every case both efficiently and effectively. We also are highly experienced in the use of document-processing technology to handle discovery documents and help marshal key facts – which leads to significant efficiencies.

All of this is about protecting people. At the core of every securities or governance case are people accused of doing something wrong – not just directors and officers but also hardworking company employees who find themselves at the center of a securities suit. We focus our defense of each case on these people. From designing legal arguments that defend their honesty to client-focused economics that maximize their insurance protection to sensitivity to the stress the litigation may cause them, we work hard to protect people and keep them as comfortable as possible. This is our top priority in every case and at the heart of everything we do.

About the Author

Doug Greene leads BakerHostetler's firmwide Securities and Governance Litigation team.

Doug is one of the most experienced and successful securities and governance litigators in the United States. He defends and counsels clients in securities class actions, shareholder derivative actions, shareholder challenges to mergers and acquisitions, SEC investigations, and internal investigations.

Doug has focused his practice exclusively on such cases since 1997 and is one of only a handful of full-time practitioners nationwide. He has handled more than 100 securities and corporate governance litigation matters, defending companies of every size and industry – from aerospace giant Boeing to beverage manufacturer Jones Soda.

Securities and governance litigation can be frustrating – it accuses good people of doing bad things. Doug is devoted to helping clients through it as quickly and comfortably as possible. His defense emphasizes his clients' honesty and good faith, defending the truth of what they said and their intent to do and say the right thing. He doesn't rely on technicalities or gotchas.

Doug also works hard to shape securities law so that executives can speak publicly and make business decisions without fear of unfair liability. He founded and wrote a pioneering securities and governance litigation blog. He has published dozens of articles and is a sought-after speaker. He authored U.S. Supreme Court amicus briefs in the *Omnicare*, *Cyan* and *Quality Systems* securities class actions. In *Omnicare*, Doug contributed to the groundbreaking Supreme Court decision that executives cannot be liable for voicing their honestly held opinions – a position he had long championed.

Clients refer to Doug as an "expert securities litigator." One client said, "Doug Greene came to the [counsel selection] meeting with an in-depth understanding of the specific details of the case and proposed a strategy on how to move forward with a realistic timeline." Another client said, "Doug makes himself available seven days per week, and the first thing he provides is his cellphone number along with a promise to be available at any time, even if it's just to alleviate my worries. … I would use [him] again in a heartbeat."

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