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Group Pleading Suffers Another Blow

Shareholder plaintiffs within the U.S. Court of Appeals for the Second Circuit have long enjoyed the benefit of the "group pleading" doctrine, which permits the attribution of alleged misstatements in group-published documents to particular individual defendants without specific factual allegations concerning their involvement in the misstatements.

The U.S. Court of Appeals for the Third Circuit has recently joined the U.S. Court of Appeals for the Fifth and Seventh circuits in holding that group pleading is no longer viable after the Private Securities Litigation Reform Act (PSLRA) to attribute either scienter or a misstatement to a defendant. *Winer Family Trust v. Queen*, 503 F.3d 319, 337 (3d Cir. 2007). Although these three influential circuit courts have rejected the doctrine, neither the Second Circuit nor the U.S. Court of Appeals for the Ninth Circuit, where the doctrine originated, has spoken.

The Group Pleading Doctrine

The group pleading doctrine developed in the late 1980s as an exception to Rule 9(b) particularity requirements for securities fraud suits. The doctrine embodies a judicial presumption that statements in group-published documents (such as prospectuses and annual reports) are attributable to officers and directors with day-to-day control or involvement in regular company operations, so that specific allegations connecting such actors to statements in group-published documents are unnecessary at the pleading stage. See *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987).

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The Second Circuit never explicitly endorsed the group pleading doctrine as such or defined its parameters. However, the group pleading doctrine was embraced by the district courts within the Second Circuit, based upon language in *DiVittorio v. Equidyne*, 822 F.2d 1242 (2d Cir. 1987). Although citing the general rules that the speaker of an allegedly fraudulent statement must be identified and that the individual roles of multiple defendants must be stated, the Second Circuit noted a limited exception that "no specific connection between fraudulent representations in [an] Offering Memorandum and particular defendants is necessary where, as here, defendants are insiders or affiliates participating in the offer of the securities in question." Id. at 1247 (quoting *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986)). The district courts expanded that exception to equate with the Ninth Circuit's group pleading presumption of responsibility for misstatements. See, e.g., *In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 142 (S.D.N.Y. 1999). The district courts, however, have limited its scope as applying only to "clearly cognizable corporate insiders with active daily roles in the relevant companies or transactions." *Polar Int'l Brokerage Corp. v. Reeve*, 108 F. Supp. 2d 225, 237 (S.D.N.Y. 2000) (citing *Ouaknine v. MacFarlane*, 897 F.2d 75, 80 (2d Cir. 1990)).

Rejection in Other Circuits

The group pleading doctrine came under fire after the passage of the PSLRA, with its heightened pleadings requirements. The Fifth Circuit, which had never adopted the group pleading doctrine, explicitly rejected it as inconsistent with the PSLRA in 2004, and the Seventh Circuit followed suit in 2006. See *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 364 (5th Cir. 2004); *Fin. Acquisition Partners L.P. v. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602-03 (7th Cir. 2006), rev'd on other grounds, 127 S. Ct. 2499 (2007). The Third Circuit recently became the third Court of Appeals to reject the group pleading doctrine as nonviable after the PSLRA in *Winer Family Trust v. Queen*, 503 F.3d 319 (3d Cir. 2007).

In *Winer*, plaintiff brought a §10(b) case against Pennexx Foods, Smithfield Foods, a creditor and large stockholder of Pennexx, and several officers and directors of both companies. Pennexx had bought a facility to expand its meat-processing operations, initially announcing that the facility would require minimal improvements. Over the next few months Pennexx began renovations and revised upward its estimates of the cost to renovate the facility; and then a few months later the project fell apart when Pennexx defaulted on its loan from Smithfield, which foreclosed on the facility and sold it. 503 F.3d at 322-23. Plaintiff alleged that Pennexx inflated its stock price through fraudulent public statements that understated the estimated cost of renovating the facility and omitted negative facts about a prior bad relationship between Smithfield and Pennexx. Id. at 323, 324.

The main issue was scienter. Plaintiff alleged that the earlier, more favorable statements were knowingly false. However, the complaint did not meet the Supreme Court's new *Tellabs* standard for pleading scienter, i.e., that the inference of fraudulent intent must be cogent and at least as compelling as any competing inference. Both the complaint and the proposed amended complaint were deficient because a much more plausible inference was that the company revised its preliminary cost estimates as it learned more about the costs. Id. at 328-29, 331-33.

The Third Circuit then took the opportunity to address plaintiff's effort to attribute §10(b) liability to Smithfield and the four individual defendants on the basis of the group pleading doctrine, ruling that the doctrine is no longer viable after the PSLRA. Id. at 334-37. Following the Fifth Circuit's analysis in *Southland,* the Third Circuit looked at the purpose and text of the PSLRA to conclude that group pleading could not meet its stringent, particularized pleading requirement for scienter. The general purpose of the statute was to heighten the pleading requirements for §10(b) cases. Its text requires the plaintiff to plead "with particularity" facts giving rise to a strong inference that "the defendant" acted with the required state of mind for "each act or omission" by "the defendant." 15 U.S.C. §78u-4(b)(2). Id. at 335.

The Third Circuit ruled that the group pleading doctrine's "presumption of particularity" is inconsistent with the PSLRA and, therefore, is not viable as a means either to plead scienter or to attribute misstatements to individual defendants. 503 F.3d at 337 & n.6. The plaintiff shareholder had acknowledged that group pleading would not serve for pleading scienter, but argued that it could still be used to attribute statements to individual defendants. The Third Circuit rejected this argument, in a footnote, as "illogical," for if *Winer* could plead scienter with the specificity required by the PSLRA, it would not need to resort to the group pleading doctrine in the first place. Id. n.6. The Third Circuit has thus abolished use of the group pleading doctrine for any purpose in private securities actions.

Status in Other Circuits

Although the group pleading doctrine is clearly rejected in the Third, Fifth, and Seventh circuits, its status is less certain in the others. The Ninth and Tenth circuits have continued to allow group pleading without discussing whether it survives the PSLRA. See *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061-63 (9th Cir. 2000); *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1254 (10th Cir. 1997).[1] The First, Sixth, and Eleventh circuits have recognized that a question exists as to whether the doctrine survived the PSLRA but have not decided it. See *In re Cabletron Sys., Inc.*, 311 F.3d 11, 40 (1st Cir. 2002); *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1018-19 (11th Cir. 2004); *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 689-90 (6th Cir. 2005).

The Second Circuit also has briefly recognized, but not decided, the survival issue. In *Yung v. Lee*, 2005 WL 3453820 (2d Cir. 2005), it affirmed the dismissal of a complaint, stating, "Assuming arguendo that the group pleading doctrine survives the strict pleading requirements of the [PSLRA], plaintiffs' argument fails" because they did not sufficiently plead the defendant's participation in the securities offer at issue. Id. at **4. This unpublished decision intimated no further view on the subject.

Meanwhile, the doctrine appears to be alive and well in the district courts within the Second Circuit. Although a few courts have found reliance on the group pleading doctrine inappropriate after the PSLRA,[2] the "majority rule" in the U.S. District Court for the Southern District is that "the group pleading doctrine has survived the PSLRA." *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388, 399 (S.D.N.Y. 2005); see *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 641-42 (S.D.N.Y. 2007). The reasoning is that the PSLRA did not explicitly abolish the pre-existing group pleading doctrine, and that there is no contradiction between the idea that each defendant's role must be pleaded with particularity and the fact that corporate officers may be presumed to work as a group to produce a particular document. *In re Refco*, 503 F. Supp. 2d at 641-42.

As Judge Lewis Kaplan observed in *In re BISYS Sec. Litig.*, 397 F.Supp. 2d 430, 439 (S.D.N.Y. 2005), "nothing in the [PSLRA's] statutory text or, for that matter, its legislative history addresses the group pleading doctrine, which was an established feature of federal securities law well before enactment of the PSLRA." Disagreeing with the Fifth Circuit's analysis in *Southland* (which was recently echoed in *Winer*), Judge Kaplan found that the group pleading doctrine does not conflict with the PSLRA's scienter pleading standard because, in this Circuit, group pleading is applied only for the attribution of statements, not for the pleading of scienter: The doctrine merely operates as a "presumption that certain kinds of statements were made by certain kinds of defendants. It does not permit plaintiffs to presume the state of mind of those defendants at the time the alleged misstatements were made." Id. at 440; see also *In re Yukos Oil Co. Sec. Litig.*, 2006 WL 3026024, *20 (S.D.N.Y. 2006). "The group pleading doctrine …simply recognizes, solely for pleading purposes, that some corporate documents, including SEC filings and the like, generally are not created by a single author, but by a group of corporate insiders involved in the daily management of a company. [The doctrine] allows a plaintiff to attribute certain documents to a corporate insider, regardless of whether that insider is the only defendant in the suit or one of many." *In re BISYS,* 397 F.Supp.2d at 440.

Conclusion

By permitting plaintiffs to avoid having to identify each act or omission of a defendant with particularity and to rely instead on a presumption arising from a defendant's job title, the group pleading doctrine, if not outright inconsistent with the language of the PSLRA, certainly appears inconsistent with Congress' intent to substantially heighten the pleading requirements in securities class action lawsuits.

And, many courts did not accept the doctrine even before the PSLRA, requiring instead that a plaintiff state facts connecting a defendant to the particular statement or omission alleged to be false or misleading. Ultimately, the issue boils down to one of policy. Although the plaintiff in *Winer* contended it was "untenable" to require that each individual involved in preparing public statements be identified at the pleading stage, that claim has been made with respect to virtually every heightened pleading requirement ever imposed.

And, despite the prevailing Southern District view that attribution can be wholly divorced from the stringent scienter requirements, there is considerable force to the Third Circuit view that it is "nonsensical" to meet stringent scienter standards for an act that a defendant is only being presumed to have performed in the first place.

Some lawyers (including the authors) were hoping that the Supreme Court would address the group pleading issue when it reviewed the Seventh Circuit's *Tellabs* decision, which had rejected group pleading as a means to impute scienter to the individual defendants. The Court acknowledged the conflicting views within the circuits, but, because the plaintiffs did not contest the Seventh Circuit's ruling, the Court declined to address it. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499, 2511 n.6 (2007).

The issue may yet reach the Supreme Court. At present, there is only a latent conflict among the circuits, as no circuit court has expressly held that group pleading is still permissible despite the PSLRA. Nonetheless, many district courts, particularly in the Second Circuit, have continued to apply the doctrine. It is difficult to predict where the Second Circuit would come out on this issue, given its silence to date. However, if it were to adopt the prevailing view of its district courts, that would create a clear conflict between circuit court holdings, which could send the issue to the Supreme Court.

1. The doctrine's status is subject to a lively conflict in the Ninth Circuit district courts. Compare *In re BP Prudhoe Bay Royalty Trust Sec. Litig.*, 2007 WL 3171435, *7 (D. Wash. Oct. 26, 2007) (doctrine survives), with *In re Hansen Natural Corp. Sec. Litig.*, 2007 WL 3244646, *8 (C.D. Cal. Oct. 16, 2007) (doctrine is dead).

2. See *In re Cross Media Marketing Corp. Sec. Litig.*, 314 F. Supp. 2d 256, 262 & n.7 (S.D.N.Y. 2004); *Bond Opportunity Fund v. Unilab Corp.*, 2003 WL 21058251, *4 (S.D.N.Y. 2003).