

5th Circ. Reaffirms High PSLRA Pleading Standards

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The heightened pleading requirements of the Private Securities Litigation Reform Act (PSLRA) remain strong in the Fifth Circuit. On Jan. 13, 2016, the Fifth Circuit in *Local 731 I.B. of T. Excavators and Pavers Pension Trust Fund v. Diodes Inc.*, 810 F.3d 951 (5th Cir. 2016) affirmed the district court's dismissal of a securities class action, holding that the complaint failed to adequately allege facts concerning the defendants' state of mind in making alleged misstatements or omissions to stockholders. In its decision, the court reaffirmed several principles establishing a high bar to satisfying the PSLRA's scienter pleading requirements. The court additionally reined in the somewhat nebulous line of cases holding that an officer's position in a company may support an inference of scienter when "special circumstances" are present.

The plaintiffs in the case were putative stockholders in Diodes Inc., a Texas-based semiconductor company with a major manufacturing operation in China. In February 2011, Diodes warned its investors of anticipated labor shortages in China, which would adversely affect the company's manufacturing output. Based on the expected shortages, the company predicted that revenue would be down in the first quarter while Diodes hired and trained new workers. Diodes followed this announcement with a statement in May 2011 that the company expected that the labor shortage would be resolved in the second quarter, with gross profit margins being comparable to the first quarter. In June 2011, Diodes noted a "slower than expected" recovery in China and revised its guidance to predict a slightly lower gross profit margin. Following both the May and June announcements, Diodes' stock price dropped.

The plaintiffs filed their securities fraud class action almost two years later against Diodes and two of its corporate officers. The plaintiffs did not allege that the company's forward-looking statements in the first two quarters of 2011 were false — indeed, Diodes' predictions largely turned out to be accurate. Rather, the plaintiffs claimed that the statements were misleading because the defendants improperly omitted details regarding the extent and cause of the labor shortages, which the plaintiffs alleged were due to the company's labor policies in China. The plaintiffs argued that there were three different factors that raised a strong inference that the defendants "must have known" that Diodes' internal policies would cause the labor shortage.

First, the plaintiffs argued that the corporate officer defendants must have known by virtue of their



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positions as top company executives. While the plaintiffs acknowledged the “predominant theme” in Fifth Circuit case law that an officer’s position with a company does not suffice to create an inference of scienter, the plaintiffs nonetheless argued that the defendants’ positions, taken together with “special circumstances,” were sufficient to infer a culpable mental state. The plaintiffs based this argument on a handful of Fifth Circuit cases.

Surveying these cases, the court in *Diodes* derived four considerations that may suggest “special circumstances” sufficient to tip the scales in favor of an inference of scienter: (1) whether the company is small, thus making it more likely that executives are familiar with the intricacies of day-to-day operations; (2) whether the transaction at issue was critical to the company’s existence; (3) whether the misrepresented or omitted information would have been readily apparent to the speaker; and (4) whether the defendants’ statements were internally inconsistent.

The court found none of the above four factors to be present. *Diodes* was a large company with more than 4,000 employees. There was no indication that the labor shortages at issue threatened the company’s continued vitality, nor was there any indication that the defendants were aware that the company’s policies were a significant contributor to the shortages. Finally, the defendants’ statements were both consistent and accurate regarding the extent of the labor shortage, as well as its effects on the company’s revenue.

Second, the plaintiffs sought to draw a strong inference of scienter from *Diodes*’ early shipments of orders without prior customer authorization. The plaintiffs argued that this practice was intended to conceal the true impact of the labor problems by artificially propping up earnings. The court did not find this argument persuasive, noting that early shipping is a legal practice that may be supported by any number of legitimate reasons. The court additionally reasoned that shipping orders early would actually deplete inventory and exacerbate any manufacturing issues caused by a labor shortage. Therefore, the practice did little to indicate the defendants’ intent to conceal the shortage from investors.

Third, the plaintiffs argued that the timing and nature of certain stock transactions made by one of the defendant corporate officers created an inference of scienter. The court acknowledged that some of the stock sales pointed out by plaintiffs could be viewed as suspicious in isolation because they were out of line with the officer’s typical trading behavior. However, the court declined to draw an inference of scienter from the sales because they represented a relatively small amount of the officer’s total stock ownership (about 12 percent) and because there were no other corroborating factors sufficiently alleged.

Considering these factors individually and as a whole, the Fifth Circuit held that the plaintiffs’ allegations failed to satisfy the PSLRA’s requirement to plead with particularity facts supporting a strong inference of scienter. Notably, in considering each of the plaintiffs’ allegations, the court repeatedly referenced the fact that the company had warned investors of a labor shortage during the class period on multiple occasions and even accurately predicted the labor shortage’s impact on *Diodes*’ financial results. Undoubtedly, these were important facts to the Fifth Circuit, which appeared tempted to dismiss the case on those grounds alone. The court saw little need for requiring additional disclosure, observing that “[m]ost reasonable investors would rather receive an accurate ‘bottom line’ assessment of a disclosed company problem than all its assumptions and nuances.”

In addition to broadly supporting the heightened pleading requirements of the PSLRA, the Fifth Circuit’s opinion in *Diodes* is important for a couple of reasons. First and foremost, it illustrates how favorably courts in securities fraud actions may view companies that have been forthcoming about anticipated

negative results. While the Fifth Circuit in *Diodes* did not expressly affirm dismissal based on the adequacy of the company's disclosures, the court did note "the curious nature of [the plaintiffs'] claims," and even expressed skepticism "that a case [could] theoretically be made for more disclosure." This leaves open the possibility that similar cases alleging insufficient disclosure despite accurate warnings of anticipated poor economic performance may be subject to dismissal regardless of how well the scienter allegations are pleaded.

The *Diodes* decision is also important because it provides guidance as to what kind of "special circumstances" may be required in order to overcome the Fifth Circuit's general rule that an officer's position with a company is insufficient to create an inference of scienter. Prior to *Diodes*, the Fifth Circuit largely determined whether such circumstances were present on an ad hoc basis, making it difficult to anticipate when an officer's position in a company would support an inference of scienter and when it would not. Although the decision in *Diodes* by no means forecloses the possibility of finding additional special circumstances, it is significant that the Fifth Circuit considered only the four factors announced in determining the plaintiffs had failed to plead sufficient circumstances in that case. Plaintiffs in future Fifth Circuit securities fraud cases will therefore want to be careful to plead some combination of the four factors set forth in *Diodes* if they would rely on an officer's position in order to establish an inference of scienter.

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