

Motive and Opportunity Are Not Enough

By Stephen L. Ascher and Daniel B. Tehrani

In light of the Supreme Court's decision last year in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,¹ the Second and Third Circuits should finally discard the "motive and opportunity" test that they have long used to determine whether a securities fraud plaintiff has adequately alleged fraudulent intent. This test was always ill suited to its purpose. Almost all businesses and businesspeople have motives and opportunities to commit securities fraud, and facts bearing on motive and opportunity are no more probative of fraudulent intent than numerous other categories of facts. Without specific factual allegations suggesting that a particular defendant knew or should have known that he or she was involved in wrongdoing, mere motive and opportunity do not justify putting a defendant to the burden of defending a securities fraud claim.

Last year's decision in *Tellabs* compels this conclusion. *Tellabs* interpreted a provision in the Private Securities Litigation Reform Act of 1995 (PSLRA) that requires a securities fraud plaintiff to plead a "strong inference" of fraudulent intent.² In *Tellabs*, the Supreme Court held that, under this rule, the plaintiff must allege an inference of fraudulent intent that is at least as "cogent and compelling" as an inference against it.³ In determining whether a claim satisfies this standard on a motion to dismiss, the court must engage in a "comparative analysis" that considers *all* the facts alleged in a complaint, *all* the inferences from those facts, and even the defendant's interpretations of those facts, "collectively" and "holistically."⁴

The "motive and opportunity" test violates the standard articulated in *Tellabs*. Isolating two categories of factual allegations to the exclusion of all others, and thereby ignoring the plaintiff's inability to plead any other types of allegations, is not a "holistic" or a "comparative" analysis. Under *Tellabs*' interpretation of the "strong inference" requirement, if a plaintiff alleges that a particular defendant had the motive and opportunity to commit a fraud, but the plaintiff is unable to plead any other indicia of fraudulent intent, then the claim against that defendant should ordinarily be dismissed.

The "Motive and Opportunity" Test

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder requires proof that the defendant acted with scienter,⁵ which the Supreme Court has defined as the "intent to deceive, manipulate, or defraud."⁶ The courts

of appeals unanimously agree that scienter can be established by proof of intentional wrongdoing or recklessness.⁷

The PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."⁸ Even before *Tellabs*, the Second and Third Circuits held that this provision was satisfied so long as plaintiffs alleged facts either "(1) showing that the defendants had both motive and opportunity to commit the fraud, or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness."⁹

This "motive and opportunity" test is widely considered the most lenient of all the pleading standards applied by the various courts of appeals.¹⁰ Before *Tellabs*, other circuits rejected the "motive and opportunity" test and formulated very different tests for determining whether the plaintiff has pleaded facts constituting scienter. The Ninth Circuit required plaintiffs to allege "specific facts indicating no less than a degree of recklessness that strongly suggests actual intent."¹¹ Under this much stricter, pro-defendant standard, allegations relating only to motive and intent are clearly insufficient.¹² Almost all the remaining circuits have taken a middle ground and required a plaintiff to demonstrate recklessness based on all the alleged facts and inferences therefrom. Under this test, allegations of motive and opportunity are relevant, but neither necessary nor sufficient.¹³

Tellabs

In *Tellabs*, the Supreme Court granted certiorari to decide the meaning of the "strong inference" language in the PSLRA provision quoted above. Although the Court focused primarily on the meaning of the phrase "strong inference" and did not expressly consider the circuit split described above concerning the types of facts that must be alleged, a close reading of *Tellabs* makes it clear that the Supreme Court rejected the "motive and opportunity" test.

Tellabs holds that in deciding whether a securities fraud claim pleads a "strong inference" of scienter, a court must determine whether the complaint gives rise to an inference of scienter that is "cogent and at least as compelling" as alternative, nonfraudulent explanations.¹⁴ In making this assessment, the court must evaluate all the allegations and inferences of the complaint

“collectively” and “holistically.”¹⁵ “The inquiry, as several Courts of Appeals have recognized, is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.”¹⁶

The *Tellabs* Court also held that a court must “take into account plausible opposing inferences” offered by the defendant, in addition to the supporting inferences urged by the plaintiff.¹⁷ As part of this “comparative analysis,” “omissions and ambiguities [in the plaintiff’s allegations] count against inferring scienter.”¹⁸ Thus, although the court is bound to accept the plaintiff’s allegations as true,¹⁹ the court must also consider the defendant’s responses to, and explanations for, the plaintiff’s allegations.

The “motive and opportunity” test is inconsistent with the approach mandated by *Tellabs*. Under *Tellabs*, the court cannot isolate two categories of facts—those relating to motive and those relating to opportunity—to find a strong inference of scienter, no matter what else is (or is not) alleged.

Indeed, although the viability of the “motive and opportunity” test was not expressly addressed by the Supreme Court, *Tellabs* implicitly rejected the test. After noting the importance of considering all the plaintiffs’ allegations “collectively,” the Supreme Court went on to address the contention by *Tellabs*’ CEO that his absence of motive required a finding that he lacked scienter:

While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal. As earlier stated, allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.²⁰

If the significance of motive must be evaluated in the context of the entire complaint, then clearly courts should not use a test for which motive is dispositive.

The Flaws in the “Motive and Opportunity” Test

Despite *Tellabs*’ apparent rejection of the “motive and opportunity” test, courts in the Second and Third Circuits have continued to cite the test in cases decided after *Tellabs*.²¹ Although these decisions have not explicitly addressed whether the “motive and opportunity” test is consistent with the standard articulated in *Tellabs*, they ought to do so. In addition to being inconsistent with *Tellabs*, the test is severely flawed analytically and

permits courts to sustain claims that ought to be dismissed on the pleadings.

Even before *Tellabs*, courts in the Second and Third Circuits recognized that the “motive and opportunity” test, if applied literally, would be absurdly permissive. Virtually every company, and every officer and director of every company, has a financial motive and an opportunity to commit securities fraud. Thus, in order for the “motive and opportunity” test to perform any meaningful gatekeeping function, “[m]otives that are generally possessed by most corporate directors and officers [can] not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud.”²²

But courts have struggled mightily to distinguish “concrete and personal benefits” that are sufficient to plead scienter from motives held by virtually all defendants, which are not sufficient. In evaluating claims against individual officers or directors, for example, some courts have held that the desires to increase one’s compensation and to retain an executive position are insufficient to establish the requisite motive.²³ Even stock options and incentive payments cannot be used to establish scienter because, as a district court in the Second Circuit has noted, “[i]n today’s corporate environment, . . . nearly all executives are compensated with stock options and incentive bonuses. . . .”²⁴ On the other hand, a defendant’s sale of stock at artificially inflated prices may be sufficient evidence of motive under the “motive and opportunity” test²⁵ if the sales are deemed “unusual.”²⁶

This distinction is artificial and unhelpful. The difference between selling stock and obtaining stock options is not a meaningful indicator of a person’s intent, and sales of stock are not “cogent and compelling” evidence of fraudulent intent. Individual officers and directors should not be put to the burden of defending a securities fraud claim simply because they happened to sell some stock while their colleagues were allegedly engaged in fraud.

Claims against companies have been decided with equally artificial line-drawing. Courts have dismissed

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claims predicated on a company's desire to earn ordinary business profits²⁷ but have found scienter based on the desire to increase the company's stock price in advance of a stock offering²⁸ or to earn interest on certain funds.²⁹ Once again, however, it is hard to see why the desire to earn profits in advance of a perfectly legal corporate transaction such as a stock offering, or to profit from an ordinary interest rate, gives rise to a strong inference of fraudulent intent.

Finally, the "motive and opportunity" test has been used to permit claims against third-party service providers (accountants, bankers, or lawyers) who are alleged to be liable for their clients' securities fraud. In this context, courts have held that the service provider's desire to earn ordinary fees is not a sufficient motive, but that the desire to retain substantial clients,³⁰ or to reduce affiliates' risk exposure, is.³¹ This distinction also is not sufficiently powerful to provide a "cogent and compelling" inference of fraudulent intent. Although profits above and beyond a service provider's usual fee may be very powerful drivers of its behavior, they do not, without more, suggest that the service provider intended to engage in fraudulent activity conducted in the first instance by its client.

The fact is, motive and opportunity are not particularly probative of intent. "Motive" is certainly less probative of fraudulent intent than numerous other factors, such as whether a defendant personally made false statements (including false exculpatory statements), whether the defendant was personally involved in misconduct that was fraudulent on its face, and whether the defendant ignored "red flags" of wrongdoing by others.³² And "opportunity" does not bear on the question of intent at all; if a defendant did not even have the opportunity to commit a particular fraud, then he or she simply could not have committed the fraud, regardless of intent.

At bottom, the "motive and opportunity" test seems to be predicated on the Second Circuit's concern that a plaintiff cannot realistically plead facts providing a "strong inference" of fraudulent intent without a smoking gun reflecting a particular defendant's innermost thoughts.³³ Although the Second Circuit is correct that this type of evidence is difficult to obtain in discovery, and almost impossible to obtain before discovery, this concern is both overstated and inappropriate—overstated, because this kind of smoking gun is not the only way to establish scienter, and inappropriate, because the Second Circuit's concern directly contradicts the purpose of this provision of the PSLRA: to protect defendants from securities fraud claims unless the plaintiff already has substantial evidence of the defendant's liability *before* conducting discovery.

Conclusion

Eliminating the "motive and opportunity" test will advance the gatekeeping function that Congress intended in passing the PSLRA and should lead to much more principled and consistent decisions with respect to claims against individual and corporate defendants. After *Tellabs*, it is clear that a defendant should not be subjected to discovery and potential liability simply because she was in the wrong place at the wrong time—a position where she could benefit from a securities fraud and commit a securities fraud. ✨

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1. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).
 2. Pub. L. No. 104-67, 109 Stat. 737, § 21D(b)(2), codified at 15 U.S.C. § 78u-4(b)(2) (2000).
 3. *Tellabs*, 127 S. Ct. at 2510.
 4. *Id.* at 2511.
 5. *See, e.g.*, *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001).
 6. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).
 7. *See Tellabs*, 127 S. Ct. at 2507 n.3 (observing that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly").
 8. 15 U.S.C. § 78u-4(b)(2).
 9. *ATSI Comme'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007); *see also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534–35 (3d Cir. 1999).
 10. *See Svezese v. Duratek, Inc.*, 67 Fed. Appx. 169, 172 (4th Cir. 2003); *see also In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) ("Our holding rests, in part, on our conclusion that Congress intended to elevate the pleading requirement above the Second Circuit standard . . .").
 11. *In re Silicon Graphics*, 183 F.3d at 979.
 12. *Id.*
 13. *See, e.g.*, *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003) (collecting cases from the First, Fifth, Sixth, Eighth, and Tenth Circuits); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 601 (7th Cir. 2006), *rev'd on other grounds*, 127 S. Ct. 2499 (2007).
 14. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007).
 15. *Id.* at 2511.
 16. *Id.* at 2509 (emphasis in original; citing cases from the Fifth and Ninth Circuits, which have explicitly rejected the "motive and opportunity" test).
 17. *Id.* at 2510.
 18. *Id.*

19. *Id.* at 2509.
20. *Id.* at 2511 (citations omitted).
21. *See, e.g.,* ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99 (2d Cir. 2007); Key Equity Investors, Inc. v. Sel-Leb Mktg. Inc., 246 Fed. Appx. 780, 784–85 (3d Cir. 2007).
22. Kalnit v. Eichler, 264 F.3d 131, 139 (2d Cir. 2001); *see also* GSC Partners CDO Fund v. Washington, 368 F.3d 228, 237 (3d Cir. 2004).
23. *See Kalnit*, 264 F.3d at 139.
24. Malin v. XL Capital Ltd., 499 F. Supp. 2d 117, 158 (D. Conn. 2007).
25. *See Kalnit*, 264 F.3d at 139.
26. *See In re* Scholastic Corp. Sec. Litig., 252 F.3d 63, 74–75 (2d Cir. 2001); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 540 (3d Cir. 1999); Gargiulo v. Isolagen, Inc., 527 F. Supp. 2d 384, 390 (E.D. Pa. 2007).
27. *See GSC Partners CDO Fund*, 368 F.3d at 237–38.
28. *See In re* Res. Am. Sec. Litig., 2000 WL 1053861, at *6 (E.D. Pa. July 26, 2000).
29. Press v. Chem. Inv. Servs. Corp., 166 F.3d 529 (2d Cir. 1999).
30. *See In re* Res. Am., 2000 WL 1053861, at *8–9 (refusing to dismiss securities fraud claim against accounting firm based largely on the fact that the accounting firm's client was part of a particularly lucrative client group).
31. *See* AIG Global Sec. Lending Corp. v. Banc of Am. Sec., LLC, 2005 WL 2385854, at *9 (S.D.N.Y. Sept. 26, 2005); *In re* Indep. Energy Holdings PLC Sec. Litig., 154 F. Supp. 2d 741, 766 (S.D.N.Y. 2001).
32. *See, e.g.,* Greebel v. FTP Software, Inc., 194 F.3d 185, 196 (1st Cir. 1999) (listing at least nine different types of facts that have been cited to show scienter, the majority of which are unrelated to motive or opportunity).
33. *Press*, 166 F.3d at 538 (“To require more in pleading of motive . . . would make virtually impossible a plaintiff's ability to plead scienter in a financial transaction involving a corporation, institution, bank or the like that did not involve specifically greedy comments from an authorized corporate individual.”).