

September 10, 2007

**Central Laborers' Pension Fund v. Integrated Electrical Services Inc.:**

**Fifth Circuit Provides Guidance Regarding Application of PSLRA Scienter Pleading Standards**

The Fifth Circuit recently issued a decision applying *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), as to the sufficiency of scienter allegations under the pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"). See *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*, No. 06-20135 (5th Cir. Aug. 21, 2007).

In *Central Laborers*, the plaintiff shareholder filed a purported securities class action against Integrated Electrical Services ("IES"), alleging that IES and certain of its officers made public false or misleading statements concerning the company's financial condition, in violation of Section 10(b) of the Securities Exchange Act of 1934. The defendants filed a motion to dismiss the plaintiff's complaint, which the District Court granted on the basis that the plaintiff did not meet the particularity requirement as to scienter under federal law.

The Fifth Circuit affirmed the dismissal of the complaint. The Court's weighing of the inferences arising from the plaintiff's scienter allegations, both individually and collectively, is instructive regarding the proper application of the PSLRA scienter pleading standards following the Supreme Court's decision in *Tellabs*.

***Accounting Violations: Some Inference of Scienter***

The plaintiff's accounting allegations were based on material weaknesses in IES's internal controls discovered by the company's internal auditors, which resulted in a restatement of two-and-a-half years of financial results. The Fifth Circuit acknowledged its prior case law holding that GAAP violations, without more, do not establish scienter. However, the Court found that the plaintiff had described IES's alleged GAAP violations in detail. Accordingly, in this particular case, the Court held that the allegations of IES's public statements and subsequent restatement due to GAAP violations provided some basis to infer scienter.

***Confidential Sources: No Strong Inference of Scienter***

The Fifth Circuit announced standards for sufficiency of confidential witness allegations. The complaint had allegations from two confidential informants who had purportedly suggested that the defendants ignored the accounting problems at IES. A former network technician at IES allegedly claimed that he overheard comments at headquarters about the company's accounting practices indicating that IES "lacked the internal controls it repeatedly lauded and embraced a culture of financial manipulation that favored hitting accounting numbers rather than accurate accounting." A former senior vice president allegedly stated that IES's CEO said that he did not want to know the details of a revenue issue so that he would not be liable. The defendants argued that these confidential source statements were of no scienter value because they lacked specific details such as particular job descriptions, individual responsibilities, and specific employment dates for the witnesses, and without such information there was an insufficient basis on which to evaluate the presented information. The Court agreed that the confidential source statements lacked sufficient detail to credit them as bases for a strong inference of scienter with respect to the particular allegations of fraud in the complaint.

### **Officers' Trading: Some Inference of Scienter**

The plaintiff alleged that IES's officers' trading of IES stock during the class period permitted a strong inference of scienter. The Fifth Circuit found one officer's trades supported an inference of scienter, but the other officer's trades did not. The Court held that such allegations were to be considered in light of: (i) established Circuit precedent that officer trading may give rise to an inference of scienter only if it is unusual in timing or scope; and (ii) the holding in *Tellabs* that a court's evaluation of scienter allegations must consider the plausible nonculpable explanations that favor the defendant, as well as inferences that favor the plaintiff.

The CEO had made a one-time sale of shares for a profit of more than \$225,000. The plaintiff argued that scienter could be inferred because the profit from this sale represented 43% of the CEO's 2004 annual salary. IES responded that this sale constituted only 4% of the CEO's shares during the class period, and his continued ownership of a large amount of stock compelled an inference of innocence. The Fifth Circuit characterized these trading allegations against the CEO as "skeletal" and held that they did not contribute to an inference of scienter.

The CFO's trades at issue were comprised of his exercise and sale of over 351,000 options during the class period for a profit of approximately \$1.4 million, retaining only 19,781 options near the end of the class period. The Fifth Circuit carefully weighed the parties' competing arguments as to whether these allegations gave rise to a strong inference of scienter:

- Temporal proximity between stock sales and resignation: the close proximity in time between the CFO's stock sales and his resignation from IES did not cut deeply in favor of either the plaintiff's or the defendants' arguments;
- Divorce decree: the CFO's divorce decree was properly considered by the District Court, but the implications of the decree were equivocal and did not support the conclusion urged by the defendants that the obligations created in the decree rendered the CFO's sale non-suspicious; and
- 10b5-1 plan: the defendants' attempt to use the CFO's 10b5-1 plan as indicia of a non-suspicious explanation for the sale was flawed because the CFO entered into the plan during the class period.

The Fifth Circuit concluded that the foregoing insider trading allegations contributed to an inference of scienter on the part of the CFO.

### **Sarbanes-Oxley Certifications: No Inference of Scienter**

The Fifth Circuit rejected the plaintiff's argument that scienter could be inferred solely on the basis of the Sarbanes-Oxley certifications signed by the CEO and CFO regarding the state of IES's internal controls. The Court cited *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006), as a more plausible interpretation of the Sarbanes-Oxley Act. *Garfield* held that an inference of scienter based on a Sarbanes-Oxley certification is proper only if "the person signing the certification had reason to know, or should have suspected, due to the presence of glaring accounting irregularities or other 'red flags,' that the financial statements contained material misstatements or omissions." *Id.* at 1256. The Fifth Circuit refused to infer scienter from the Sarbanes-Oxley certifications in this case because the plaintiff had not clearly explained the link between the statements in the certifications and the actual accounting and reporting problems that arose. Specifically, there was no allegation that, on the particular date the certifications were made, the internal controls at IES were inadequate.

**Collective Impact of Scierter Arguments: No Strong Inference of Scierter**

Having individually considered the plaintiff's scierter arguments, the Fifth Circuit then evaluated their collective impact. The Court held that the allegations read *in toto* did not permit the requisite "strong inference" of scierter because the plaintiff failed to "link the misstatements with the bases for inferring scierter."

**Futility of Amendment**

In its opposition to the defendants' motion to dismiss, the plaintiff argued that it should be allowed to correct infirmities in its complaint on the basis of corroborating testimony from two additional deposition transcripts that had not previously been alleged. Though the Fifth Circuit discouraged litigants from moving to amend in a haphazard fashion, it construed the plaintiff's request in this case as a proper motion to amend.

However, the Fifth Circuit held that the deposition transcripts at issue would not have cured the defects in the plaintiff's complaint. Specifically, the transcripts did not identify the CFO at all and only mentioned the CEO in passing during what was essentially speculation by the deponent. Accordingly, the District Court did not abuse its discretion in denying the motion to amend.

**Conclusion**

*Central Laborers* is significant because it is the first decision by the Fifth Circuit that applies the scierter pleading standards of the PSLRA pursuant to the analytical framework set forth in the *Tellabs* case. The Fifth Circuit's analytical approach in evaluating these common scierter allegations will provide district courts with valuable guidance when considering similar scierter allegations in future federal securities fraud cases.

If you have any questions regarding the foregoing, please feel free to contact one of the attorneys listed below.

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