Scinter and the Ninth Circuit’s Two-Part Test

*WPP Luxembourg Gamma v. Spot Runner, Inc.*

Under *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007), to allege a “strong inference” of scienter, the inference must be at least as compelling as any opposing inference of nonfraudulent intent. After *Tellabs*, the Ninth Circuit constructed a two-part test for scienter: first, the court determines whether any allegation in isolation creates a strong inference of scienter; and second, the court determines whether the allegations as a whole combine to create a strong inference of scienter. See, e.g., *New Mexico State Investment Council v. Ernst & Young LLP*, 641 F.3d 1089, 1095 (9th Cir. 2011). The Ninth Circuit’s recent decision *WPP Luxembourg Gamma v. Spot Runner*, No. 10-55401 (9th Cir. Aug. 23, 2011), provides an example of the court’s scienter standard as applied to fraudulent-omission and insider-trading claims.

In *WPP Luxembourg*, the plaintiffs alleged that Spot Runner and its executives violated the securities laws by making material omissions in connection with the sale of Spot Runner shares and engaging in insider trading. Three persons founded Spot Runner to develop and sell an internet-based platform that would service advertising needs for small businesses. WPP bought $10 million of newly-issued stock in Spot Runner. As part of its purchase, WPP received the right to notice if these founders intended to transfer any of
their shares and the right to sell its own shares pro rata with any sale by the founders.

On several occasions the founders sold their shares but did not tell WPP. And while selling their shares, the founders through Spot Runner, solicited new investment from WPP in both a new initial offering and a secondary offering of Spot Runner stock. One of the founders tempted WPP to participate in the secondary offering, but demanded that WPP waive its rights to notice. WPP invested another $1.7 million in the company; when it did so, the founders sold more shares without telling WPP. At this time, Spot Runner was losing 30 to 40 million dollars per year.

The Ninth Circuit concluded that WPP adequately alleged that the founders acted with scienter, but not that the company acted with scienter. With respect to the founders, the court concluded that the allegations essentially described a “pump and dump” scheme: the founders inflated the value of their stock through misleading statements and then dumped their overvalued shares. Further, the court concluded that the allegations stated a strong inference of scienter individually and collectively against the founders. First, the court held that the fact that the founders knew of the notice requirements, ignored them, and sold their own shares after the secondary offering when the company was losing a significant amount of money strongly suggested that they acted with intent to defraud WPP--Spot Runner needed continued infusion of investment capital to stay afloat. Second, the court continued, the allegations taken together likewise state a strong inference of scienter. The court noted that the founders repeatedly ignored their disclosure obligation, surreptitiously sold shares, and went to great lengths to conceal their sales.

The plaintiffs also alleged that the company engaged in inside trading in violation of Section 10(b) and Rule 10b-5. The PSLRA’s heightened pleading standard for scienter also applies to insider-trading claims. The Ninth Circuit concluded that WPP did not allege that Spot Runner acted with scienter because in isolation and collectively, WPP did not adequately explain why the company would enable its executives to engage in this “pump and dump” scheme. According to the court, the founders’ motive to commit fraud is not ascribed to the company, and here, the company looks like the victim as the founders diverted much-needed capital from Spot Runner.
The Ninth Circuit’s decision is available here: