

The Dell Case:  
The Doors to the Courts  
Close Further for Investors

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### Significance of the Case

In the recent decision, *Dell Inc., Securities Litigation*, the U.S. District Court for the Western District of Texas dismissed the action, chiefly for the reason that, according to the court, the complaint failed to allege sufficient facts showing fraudulent intent, or *scienter*, on the part of the defendants. In rendering its decision, the district court interpreted and applied the standard set forth by the United States Supreme Court in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007).

The Supreme Court, in *Tellabs*, interpreted the pleading requirement, set forth in the Private Securities Litigation Reform Act of 1995 (the PSLRA) that a complaint must set forth facts that present a “strong inference” of *scienter* on the part of defendants.

The *Tellabs* decision held that, to satisfy the PSLRA’s “strong inference” of *scienter* pleading requirement, a complaint does not need to plead any particular facts or specific circumstances to show fraudulent intent. Rather, a complaint must present facts that, when viewed as a whole, make the inference of *scienter*—again, fraudulent intent on the part of the defendants—more than merely plausible or reasonable. To use the words of the Supreme Court, the inference of *scienter* must be at least as compelling as any opposing inference of non-fraudulent intent.

In the *Dell* case, the district court held that the facts alleged in the complaint did not satisfy the *Tellabs* test. As summarized in the *Dell* decision, the complaint alleged that Dell had issued restatements to sixteen consecutive quarters covering a four-year period from 2003 to 2007. Dell restated income upward for some quarters, and downward for others, and the restatement resulted, overall, in a reduction in net income of less than one percent of the \$12 billion in net income for that period. According to the *Dell* court, the small size of the accounting restatement did not itself indicate fraud. In addition, the court found that the additional facts presented did not, in combination with the restatement, present circumstances from which fraud could be strongly inferred.

The complaint quoted ambiguous statements by Dell executives that they were “intimately involved” in running every aspect of the company, as well

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as similarly ambiguous statements by inside confidential witnesses, such as "there was always a scramble at the end of the quarter to make their sales." Though the company's bonus plan rewarded performance, that fact was not surprising or unusual. Finally, though two Dell executives had resigned, they left the company almost a year after the end of the relevant period, and there were no facts connecting their departures with untoward conduct.

In addition, the *Dell* court observed, based on the complaint, there was no suspicious insider trading by executives. Nor did the court find that there were circumstances alleged that indicated that Dell executives knew of accounting errors or internal control problems. The fact that certain officers had signed statutory certifications attesting to the accuracy of the company's financial statements also did not itself indicate fraud, since there were no glaring accounting irregularities that were red flags.

Accordingly, the *Dell* court held that the facts, as alleged in the complaint, did not satisfy *Tellabs*' requirements that the inference of fraud, as alleged, be at least as compelling as non-fraudulent intent. In short, according to the court, while the company's restatement may have resulted from negligence or oversight, it did not, as alleged in the complaint, strongly indicate fraud.

The court required plaintiffs in the *Dell* case to present facts in the complaint that were more compelling. While the *Dell* decision is illustrative of the more rigid standard of pleading facing plaintiff-investors today, by virtue of the application and interpretation of the *Tellabs* decision in courts throughout the federal system, it does not, based on the facts presented, necessarily reflect an extension of a stricter pleading standard beyond what plaintiffs have had to comply with to date.

### **Trends and Impacts**

Decisions such as *Dell* may give corporations greater leeway when they correct prior announcements as to their financial condition and operations or financial statements. Corporations may be more inclined to engage in borderline business or accounting practices, as they may believe they are more insulated from liability for their actions. Furthermore, unless there are egregious errors and glaring red flags present, more cases may face dismissal. While these cases may well be meritorious and worthy,

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shareholders may not see their day in court, in light of the high pleading burdens placed on their complaints.

Another point to note is that these high pleading burdens are, at some level, genuinely unfair. With cases such as *Dell*, plaintiffs are required to present to the court in their initial pleading, at the very outset of the case, information and facts that one should only reasonably expect to be available after vigorous discovery is obtained from the defendant companies and their officers. As mentioned, unless there are glaring and egregious facts that are immediately apparent to the public, a case may be dismissed. This is very unfortunate. There are without question many times when fraud, intentional deceit, and motive to defraud occur, but smoking guns are simply not found—or, at least, they are not found without exhaustive discovery and unrelenting determination and advocacy.

For example, in the *Dell* case, the court held that in and of itself, the positions of the executives did not allow the plaintiffs to make the allegation that the executives had knowledge of the company and its reporting practices that would give rise to a fraudulent intent. The court therefore seemed to require plaintiffs to specify what knowledge the executives would have apart from what knowledge one would assume they would have as executives of the company. With cases such as *Dell*, unless there are facially glaring accounting irregularities, courts are requiring shareholders to plead specific facts regarding the personal knowledge of company executives or blockbuster statements by insider witnesses. Again, this essentially forces plaintiffs into the untenable position of presenting detailed facts that one would assume could often only be found through discovery.

The dismissal in the *Dell* case is indicative of a trend where the federal courts are more likely than not to dismiss, at an early stage, cases that may have substance but require development. It seems likely that the very egregious cases will proceed and be litigated, as in the past, but the less obvious cases, while having substantial merit on their face, may not be given the opportunity to proceed. The trend of the courts is to limit the access of the shareholders to courts to seek recovery for investment losses incurred because of corporate and individual fraud, unless the fraudulent activities are substantial, however the court defines that standard.

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### **The Economic Crisis**

Today's financial environment has shown that regulation is not a bad thing, as some would attempt to have the public believe. Whether it is the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac), or AIG shareholders, in each case, the government has now been forced to step in to take action to support those organizations. The shareholders in AIG certainly have been diluted, because as currently structured, the government has taken an equity position in AIG. In Fannie Mae and Freddie Mac, it may come to that, as the government does have the right to take an 80 percent equity interest.

For years, financial instruments such as credit default swaps were allowed to be created, marketed, and sold in a market that had no reporting requirements for them. Companies were essentially given unfettered reign in creating financial products and profiting from them in various ways. The value of these instruments has collapsed, now that it has become clear that the assets underlying or related to the instruments were inflated in value. Even now, the government entities dealing with the financial crisis cannot make sense of the valuations of these instruments.

The economic crisis we have now should be a huge cautionary tale to all, as an indication of what can happen when corporate financial institutions are given too much leeway, without adequate checks and balances. Coupling a lack of oversight and regulation with higher pleading burdens for shareholders seeking remedy and recompense for the wrongful and unlawful conduct by those companies has created a scenario of investor-be-damned. As we see whole companies collapsing, no one knows what will be left and whether collection or recompense will be made to the shareholders.

In this regard, there is concern that corporations may use the current financial crises as a cover for fraudulent conduct. That is, some companies that have been less than forthcoming with their earnings and revenue calculations may use the claim that the financial crisis, not fraudulent conduct on their part, caused damage and loss to investors. Drawing on cases such as *Dell*, they may assert that they attempted as best they could to calculate and state their financial results and earnings accurately, and that, even if they were negligent, they did not commit fraud.

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Today, for example, executives of the companies that now have collapsed have been quoted as saying that no one knew the value of collateralized debt obligations. Corporate boards and executives may take the position that they had tried to value them as best they could, and thus take advantage of the courts' predisposition to look at this conduct as perhaps negligent, but not, in the courts' view, indicative of fraud. That is a great danger to the shareholders/owners of these businesses who have been financially destroyed by these corporate practices and who seek to remedy their situation by holding those in charge responsible for the conduct causing the harm.

The impact on the regulatory landscape will be to push Congress to increase effective and focused regulation, particularly in areas that have been free of regulation up to this point, and which clearly have had a major impact on the U.S. and world economies. For example, the government has been looking at regulating hedge funds, or at least getting financial reports from such funds for some time. In view of what has occurred in the financial crisis, there may be less resistance to an increase in the regulatory scheme, or at least—an increase in the coverage of the agencies comprising the regulatory scheme. There might now be a realization that prudent regulation is not a bad thing, that the enforcement of standards and requiring financial institutions to meet their reporting responsibilities is actually a good thing for investors, and in turn the economy as a whole. Further, perhaps Congress now will see fit to fund its regulatory agencies to the point where they can actually do the job they are empowered to do.

### **Legal Practice in this Environment**

Decisions such as the *Dell* case and the economic situation as a whole also have had an impact on the practice of law. Assessing whether to undertake representation in shareholder class actions and related cases requires considerable study at their inception, particularly given the fact that there are early dismissals and a developing trend of raising the bar to class certification. There is a great deal of professional work, effort, and expense involved in getting these cases prepared for trial, and the discovery process alone is particularly weighty. The volume of work is there right now, especially when one considers all of the various practices and failures of disclosure by financial institutions and companies that have led to today's crisis.

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Recent events have reaffirmed the importance of the practice of law on behalf of investor plaintiffs in class actions. It is a very significant, worthwhile area in which to practice, because we have just seen nearly \$1 trillion of people's savings evaporate, much as a result of fraudulent corporate activity. What plaintiff security class action attorneys attempt to do is champion the rights of the shareholders. The country needs and requires vigorous advocacy in this area. For attorneys who have not yet established themselves in a particular specialty, this area of practice is one that is very challenging, timely, and satisfying. This practice area is very rewarding in the benefits it brings to the clients you represent, because individuals with no other recourse than a concerted action with other investors turn to you for assistance. These individuals represented in the plaintiffs' class action can include those members of public employee pension funds and labor union pension funds who have worked their entire lives accumulating retirement benefits that are continually threatened and impacted by corporate misdeeds.

The trickle down effect is at work here. Individuals are being harmed in their own pensions. This situation is affecting the working class, middle-American people who have worked their whole lives and who expect to have a certain economic benefit at the end of the day. If their hard-earned economic security is being undermined by fraudulent illegal activities, those responsible have to be held accountable. We cannot have the American public, which seeks redress from these harms, turned away at every avenue. Fighting that battle in this practice area gives one great personal satisfaction.

Plaintiffs' law firms, however, must consider what kinds of obstacles will be presented in actually seeing the case through to fruition for the shareholders. Firms always have to be judicious in selecting the cases because of the enormous financial and time obligations and burden the attorneys assume. Unfortunately, given the increasingly stringent standards being applied to these cases at early stages, however, firms may have to forego pursuing cases that may very well be meritorious.

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*On July 1, 1977, Mr. Zwerling founded the Law Offices of Jeffrey C. Zwerling; on January 1, 1985 that firm became Zwerling, Schachter & Zwerling LLP. Prior to 1977, Mr. Zwerling was associated with the firms of Gasperini, Koch & Savage; Koch & Gluck; and Murray A. Gordon PC, with emphasis on civil litigation, real estate, and general corporate and commercial matters.*

*Mr. Zwerling has represented and advised the Uniformed Fire Officers Association in regard to its pension funds and annuity plans.*

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*Mr. Brodsky has published "The Time Is Right For Mid-Size Public Or Union Pension Funds To Be Lead Plaintiffs In Securities Class Actions," in Investment Management Weekly (Vol. 21, Issue No. 10, March 10, 2008); "Federal Courts in New York Provide Framework For Enforcing Preliminary Agreements," in the New York State Bar Association Journal (March/April 2001) and "Defending an Agent Against A Claim For Breach of Warranty of Authority," NY Litigator (Spring 2001). Prior to joining the Zwerling firm, Mr. Brodsky was associated with Sonnenschein Nath & Rosenthal LLP, where he practiced commercial litigation.*

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## Trends in Securities Class Action Suits

An Immediate Look at the Legal and Economic  
Ramifications of *In re Dell Inc. Securities Litigation*

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