

RAISING THE BAR: SUPREME COURT CLARIFIES SCIENTER PLEADING STANDARDS FOR FEDERAL SECURITIES FRAUD ACTIONS

June 26, 2007

To Our Clients and Friends:

On June 21, 2007, the Supreme Court added another decision to its recent series of rulings protecting businesses from abusive shareholder class actions and giving effect to legislation passed over a decade ago that was designed to do the same thing. By stiffening the requirement for pleading the mental state necessary to support a securities fraud claim under the Private Securities Litigation Reform Act of 1995 (the “PSLRA”), the Court has provided defendants with another weapon to use at the early motion-to-dismiss stage, which is often the true battleground for many shareholder class actions.

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, 2007 WL 1773208 (U.S. June 21, 2007), written for an 8-1 majority by Justice Ginsburg, the Court held that to qualify as “strong,” an inference of scienter “must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” In so ruling, the Court rejected the Seventh Circuit’s more lenient pleading standard, but it also rejected the more demanding standard sought by the defense bar and the SEC, which had urged the Court to require that plaintiffs allege facts that establish a “high likelihood” that the plaintiff acted with wrongful intent. The Court took the middle course, articulating a two-part standard that requires courts to evaluate the persuasiveness or “cogency” of plaintiffs factual claim and then to compare the inferences supported by those facts. If the unlawful inference proposed by plaintiffs is not at least as strong as competing, innocent inferences, plaintiffs’ case must be thrown out.

The *Tellabs* decision comes on the heels of another case limiting abusive litigation, *Credit Suisse Securities v. Billing*,¹ where the Court ruled that Wall Street underwriting practices that are subject to the antifraud provisions of the securities laws are immune from civil antitrust lawsuits, and a decision last term in *Merrill Lynch v. Dabit*,² where the Court closed a loophole

¹ 127 S. Ct. 2383 (2007).

² 547 U.S. 71 (2006).

that made it easier for plaintiffs to bring certain kinds of securities class actions in state court.

Although the *Tellabs* decision should make it more difficult for plaintiffs to pursue cases where the alleged fraudulent scheme is implausible, the plaintiffs' securities bar has proven resilient and resourceful in the face of similar judicial and legislative efforts to curtail strike suits. In other words, only time will tell.

PLEADING SCIENTER PRE-TELLABS

When Congress passed the PSLRA in 1995, over President Clinton's veto, one of the critical changes it made in the securities class action landscape was the addition of heightened mental state pleading requirements. Under the PSLRA, to state a claim for securities fraud, plaintiffs are required to plead, among other things, specific facts showing that defendants acted with wrongful intent – either intentionally or recklessly – when they made a misrepresentation or omission. Because it is typically difficult to plead facts showing this wrongful intent, Congress allowed courts to “infer” wrongful intent from whatever facts plaintiffs could plead, but required that the inference be a “strong” one. In the language of the PSLRA, to survive a motion to dismiss, plaintiffs must plead particularized facts supporting a “strong inference of scienter.” 15 U.S.C. §78u-4(b)(2).

In the years following passage of the PSLRA, scienter became the real battleground in securities class actions. But consensus on the meaning of the important term “strong” had eluded the courts across the country, resulting in, as is often the case, a patchwork of different standards. For instance, the Sixth Circuit adopted a defendant-friendly standard, which not only required consideration of competing inferences, but required dismissal unless the “most plausible” of these inferences favored the plaintiff.³ The Seventh Circuit, by contrast, set the pleading bar quite low, adopting the plaintiff-friendly rule that a complaint need only state facts from which a reasonable person could infer that the defendant acted with scienter, and in assessing these facts, a court is not required to consider any alternative, competing inferences.⁴

³ See *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004).

⁴ See *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006).

PLEADING SCIENTER POST-TELLABS

In *Tellabs*, the Court rejected the Seventh Circuit's more lenient pleading standard and specifically held that in considering whether an inference is "strong," the lower court *must* consider competing inferences. The Court noted that the determination of what constitute a "strong inference" is "inherently comparative," and that such inference "must be more than merely 'reasonable' or 'permissible' – it must be cogent and compelling, thus strong in light of other explanations." Plaintiffs can only survive a motion to dismiss under the *Tellabs* standard if "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inferences one would draw from the facts alleged."

The Supreme Court thus set out a two-part test for evaluating whether a plaintiff has pleaded sufficient facts regarding wrongful intent. This test must be applied to each defendant in a securities case:

First, courts must "holistically" consider the allegations of the complaint and any matters outside of the complaint that are of common or undisputed knowledge. Courts must then ask whether, taken together, those allegations support a "cogent" inference of wrongful intent. Although the Court provided little explanation of what is meant by "cogent," this is presumably what courts had required since the enactment of the PSLRA's requirement of "particularized facts giving rise ... strong inference of scienter."

Second, the court must compare the inference proposed by plaintiffs with any opposing or innocent inferences proposed by defendants or, presumably, even those divined by the court itself. If the inference advanced by plaintiffs is not at least as strong as the innocent inferences, the pleading standard has not been met and the case is over. This second prong of the analysis is the new development in *Tellabs*. Defendants will prevail if, based on plaintiffs' allegations and other matters that the court can consider, defendants can explain a course of conduct that is not unlawful and is more true to the facts than what plaintiffs have proposed.

In adopting this comparative inference approach, the Court expressly rejected the position that only inferences that favor the plaintiffs may be drawn from the allegations of the complaint. Significantly, the Court noted that either the *lack* of key allegations that one would expect if a defendant possessed scienter, or ambiguities in a complaint's allegations, are factors that undermine a finding of scienter. In addition, the Supreme Court expressly rejected the Seventh Circuit's suggestion that a comparative analysis of competing inference by the court would usurp the jury's role as fact-finder and violate the Seventh Amendment.

IMPACT OF TELLABS

Tellabs adds needed life to a provision of the PSLRA that had not proven as effective in deterring abusive litigation as Congress originally intended. The decision should make it more difficult for plaintiffs to bring cases whose allegations paint a picture of economically irrational conduct or that are based on nothing more than fraud-by-hindsight. Significantly, *Tellabs* increases the likelihood that meritless cases can be identified and rejected at the pleading stage, before the commencement of expensive discovery and disruptions to operations. In doing so, *Tellabs* advances both the intent of Congress and the recent Supreme Court trend in limiting abusive litigation against corporate defendants.

Please feel free to contact us with any questions.

John B. Missing

+1 202 383 8070

jmissing@debevoise.com

Jonathan R. Tuttle

+1 202 383 8124

jrtuttle@debevoise.com

Colby A. Smith

+1 202 383 8095

casmith@debevoise.com

Ada Fernandez Johnson

+1 202 383 8036

afjohnson@debevoise.com