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In Discretion: The Consequences of *Twombly* and *Iqbal*

By Kenneth S. Klein

For the foreseeable future, judges and attorneys will debate the contours, impact, and import of the Supreme Court opinion in *Ashcroft v. Iqbal*.[1] But most of these debates will pay little or no heed to the impact *Iqbal* will have on something at least as significant to the litigants and lawyers—the expansion of discretion that trial courts will have to summarily dismiss virtually any civil lawsuit. Simply put, the combination of the twin opinions in *Iqbal* and its predecessor, *Bell Atlantic Corp. v. Twombly*,[2] reflect the grant of an unprecedented level of discretion to the trial courts. The two opinions equate to a directive from the U.S. Supreme Court to district-court judges to aggressively identify and dismiss any civil complaint that smells of being "frivolous," and not to worry about appellate reversal. This is a dramatic contrast to the heretofore procedural approach that potentially factually frivolous complaints were dealt with under Rules 11, 12(c), and 56—all of which allowed for an opportunity to develop a factual record, and to have a jury decide disputed facts. The shift of power from jury to judge, and to a juncture pre-answer and pre-discovery, is a groundbreaking grant of discretion, with real consequences for civil litigants and lawyers.

Through *Twombly* and *Iqbal*, the Court has held that for any case pleaded under Rule 8, if a civil plaintiff does not come into

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What *Ashcroft v. Iqbal* Means for Securities Pleading Standards

By Nicholas G. Sladic, Carla R. Walworth, and Mor Wetzler

In *Ashcroft v. Iqbal*, the Supreme Court clarified that plaintiffs must plead a "plausible" claim to survive a motion to dismiss under Federal Rule of Civil Procedure 8.[1] But how does the *Iqbal* Rule 8 "plausibility" standard impact securities cases that also are subject to other pleading standards under Rule 9 and the Private Securities Litigation Reform Act (PSLRA)? Although *Iqbal* may be a latecomer to the securities pleading standards, it nonetheless is the governing pleading standard for key elements of securities claims.

Federal Rules of Civil Procedure and the Securities Acts

Most securities class actions allege violations of the Securities Act of 1933 or the Securities Exchange Act of 1934, and each has its own elements and corresponding pleading standard(s). Claims under the '33 act typically fall under Federal Rule of Civil Procedure (FRCP) 8(a)(2). That rule requires that plaintiffs set forth a "claim for relief" containing a "short plain statement of the claim showing that the pleader is entitled to relief."

In *Twombly v. Bell Atlantic*, an antitrust case, the Supreme Court explained that to satisfy FRCP 8, a complaint must

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Securities Pleading Standards

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contain sufficient factual allegations, accepted as true, to "state a claim to relief that is plausible on its face." This pleading standard is meant to avoid unduly burdensome discovery on a meritless, albeit significant, claim. Citing a securities case, the Court explained that requiring only a "possibility" of wrongdoing would allow "a plaintiff with a largely groundless claim" to "take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value."[2]

Last year, the Supreme Court in *Ashcroft v. Iqbal* explained that the *Twombly* pleading standard applies to *all* civil cases, because *Twombly* interprets FRCP 8. *Iqbal*, a national-security case, specifically notes the effect the litigation would have on government officials. Noting the potential of "disruptive discovery," the Court made clear that FRCP 8 "does not unlock the doors of discovery for a plaintiff armed with nothing more than conclusions." Thus, *Twombly* addresses the "unusually high cost of discovery in antitrust cases" and recognizes that "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases." 550 US at 558–59. In *Iqbal*, the Court reasoned that litigation against government officials potentially entitled to qualified immunity "exacts heavy costs in terms of efficiency and expenditure of valuable time and resources that might otherwise be directed to the proper execution of the work of the Government." The Court added that the "costs of diversion are only magnified" where the officials are charged with responding to "a national and international security emergency unprecedented in the history of the American Republic." 129 S.Ct. at 1953. The concern with unduly burdensome discovery again drove the Court's application of the "plausibility" standard.

Iqbal requires "facial plausibility" of all civil complaints. Given the potential for extensive discovery, there is little doubt that *Iqbal* applies to securities class actions, at least in general. To survive a motion to dismiss, a securities complaint must state a claim to relief that is plausible on its face, with sufficient factual content to support a reasonable inference that defendant is liable for the misconduct alleged. But satisfying the "facial plausibility" test alone is not enough to survive a motion to dismiss.

Application of FRCP 9(b) to Securities-Fraud Claims

Most claims under the '34 act are brought under section 10(b) and Rule 10b-5, promulgated under section 10, which together prohibit *fraudulent* conduct in the sale and purchase of securities.[3] To state a claim, these claims require (1) a material misrepresentation or omission, (2) scienter, i.e., a wrongful state of mind, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation.[4] Because these claims allege fraud, in addition to "plausibility" under FRCP 8, a '34 act claim for fraud is subject to a heightened pleading standard under FRCP 9(b). (Even claims under the '33 act fall under the FRCP 9(b) heightened standard for fraud if they rely on averments of fraud.[5])

FRCP 9 requires a party to "state with particularity the circumstances constituting fraud or mistake." The plaintiff must "(1) specify the statements that the plaintiff contends were fraudulent (2) identify the speaker (3) state where and when the statements were made, and (4) explain why the statements were fraudulent."[6] One court has said that FRCP 9(b) requires pleading "the who, what, when, where, and how: the first paragraph of any newspaper story" about the fraud, an oft-repeated characterization.[7] Courts had long applied FRCP 9(b) to dismiss securities-fraud claims.[8]

Given this standard, how does *Iqbal* apply to a securities-fraud case governed by FRCP 9(b)? Some courts have ignored *Iqbal* in deciding fraud-based cases, or have limited *Iqbal* to its national-security context.[9] Other courts have applied FRCP 8 in conjunction with FRCP 9(b), interpreting *Iqbal* as generally setting forth the process to adjudicate a motion to dismiss, while FRCP 9(b) applies to the fraud allegations.[10] This approach makes sense, because *Iqbal* itself directed that "[d]etermining whether a complaint states a plausible claim for relief will . . . be a context-specific task."[11] Applying *Iqbal*, a court "should not credit 'mere conclusory statements' or 'threadbare recitals of the elements of a cause of action.'"[12] Accepting creditable allegations as true, a court must next determine whether the remaining allegations plausibly suggest an entitlement to relief.[13] Viewed in this procedural context, *Iqbal* does not contradict FRCP 9(b)'s requirement that the circumstances constituting fraud or mistake be stated with particularity. Rather, determining "facial plausibility" can be done concurrently with examining whether FRCP 9(b)'s particularity requirements are also met on the fraud allegations. Under this approach, if a complaint does not set forth sufficient facts to state a claim for relief that is plausible on its face, dismissal is warranted and a court need not consider FRCP 9(b). For example, in the securities context, where a complaint fails to allege a misrepresentation, the court need not determine whether the complaint complies with FRCP 9(b).[14] To pass muster, a fraud-based securities claim must survive analysis under FRCP 8 and *Iqbal*, as well as under FRCP 9(b). Under this approach, a '34 act claim must be "plausible" on its face under FRCP 8 and must plead fraud with particularity under FRCP 9.

The PSLRA: Further Heightening Securities Pleading Standards

Claims under the '34 act are subject to FRCP 9(b) *and* to the PSLRA.[15] The PSLRA was passed to curb the "abusive practices committed in private securities litigation" including "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action."[16] The PSLRA requires a plaintiff to identify in his complaint "each statement alleged to

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have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The PSLRA also requires specific factual allegations that the defendant acted with a state of mind known as scienter, showing that the defendant knew the challenged statement was false at the time it was made, or was reckless in not recognizing that the statement was false. In alleging scienter under the PSLRA, a plaintiff must, "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[17]

Satisfying the "facial plausibility" test alone is not enough.

Given the Supreme Court's concern regarding burdensome discovery, it is no surprise that "plausibility" resurfaced in a securities decision just one month after *Twombly*. In *Tellabs v. Makor Issues & Rights Ltd*, the Supreme Court explained what a plaintiff must plead to allege "scienter" under the PSLRA as part of a securities-fraud claim. The Court explained that it was not enough that a reasonable fact finder could "plausibly infer" the requisite state of mind. Neither must the inference of scienter be the "most plausible"[18] of any opposing inference. Rather, a plaintiff must plead facts rendering an inference of wrongdoing "*at least as likely as* any plausible opposing inference."[19]

The PSLRA undoubtedly demands more from a complaint than *Iqbal* does. How much more? *Iqbal* requires that a complaint be "plausible on its face." "Under the PSLRA's heightened pleading instructions," however, a plaintiff must do more.[20] To properly allege scienter, a complaint must, "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). To qualify as "strong," the 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."[21] Therefore, a *plausible* inference of scienter may satisfy *Iqbal*, yet nonetheless fail the heightened pleading requirement under the PSLRA.

The PSLRA's pleading standard for scienter also is higher than that imposed by FRCP 9(b).[22] Before the PSLRA, courts disagreed regarding what must be alleged as to state of mind under FRCP 9(b). The Ninth Circuit relied on FRCP 9(b)'s language that "intent, knowledge, and other condition of mind of a person may be averred generally." The Second Circuit on the other hand required that facts be alleged that created a strong inference of scienter. The PSLRA made clear that scienter cannot be averred generally. A complaint that merely satisfies FRCP 9(b)'s pleading requirement falls short of the PSLRA's heightened pleading requirements. To survive a motion to dismiss, a securities-fraud complaint must be "plausible" on its face under FRCP 8, must plead fraud with particularity under FRCP 9, and must plead scienter with specificity under the PSLRA.

Making Sense of the Pleading Standards

Courts analyzing securities-fraud claims thus have a choice of where to begin their analysis. If the complaint fails to allege scienter as required under the heightened pleading standards of the PSLRA, the complaint may be dismissed. In that situation, the court need not even consider whether *Iqbal*'s pleading standard is met.[23] On the other hand, there are elements of a securities-fraud claim that do not fall under the PSLRA's heightened pleading standard. For example, if a complaint fails to plausibly allege a misrepresentation, the court need not determine whether the complaint sufficiently alleges the necessary mental state related to the misrepresentation.[24] This alternative approach for dismissing securities fraud cases under *Iqbal* applies to other elements of a securities-fraud claim, such as reliance and loss causation.[25]

The courts' menu of options is highlighted by the decision in *McAdams v. McCord*.[26] In *McAdams*, the securities-fraud complaint alleged that defendant executives and auditor defrauded the plaintiffs by inducing them to invest in a company through misrepresentations and false statements about the company's financial condition. The district court held that the complaint failed to plead with particularity the circumstances of the alleged fraud as well as the facts giving rise to a strong inference of scienter. It therefore dismissed the claims under FRCP 9(b) and the PSLRA. The district court did not address the defendant's argument that the complaint also did not adequately plead loss causation, an analysis that would have been governed by FRCP 8.

On appeal, the Eighth Circuit Court of Appeals stated that it "need not decide whether the complaint adequately states with particularity facts giving rise to a strong inference that [the defendant] acted with scienter." Rather, the court pointed out that it "may affirm the district court's judgment on any basis supported by the record." [27] The court then applied *Iqbal* to the loss-causation pleading requirement. The court referenced what it called the complaint's "threadbare, conclusory allegation" that as a "direct and proximate cause" of the defendants' fraud, the plaintiffs had lost their investments. The court noted that this allegation failed to "specify" how the defendant's alleged statements, "as compared to the complaint's long list of alleged misrepresentations and omissions by the executives, proximately caused the investors' losses." The court concluded that without these allegations, "the complaint does not show that the investors' losses were caused by [the defendant's] misstatements," which "defeats the plausibility of the investors' claims that [the defendant's] opinions . . . caused their losses." The Court thus applied *Iqbal* in lieu of the other available pleading standards the district court had used to dismiss the complaint.

The effect of these multi-layered pleading standards extends beyond motions to dismiss for failure to state a claim. The Supreme Court's decision in *Merck v. Reynolds*[28] demonstrates another effect of this complexity. In *Merck*, the Court held that plaintiffs must

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have a reasonable opportunity to discover facts that show scienter before the statute of limitations begins to run. This avoids the situation of a plaintiff with a nearly time-barred potential claim who nevertheless does not have enough information to allege a claim that satisfies *Iqbal* or the PSLRA's pleading requirements. The Court specifically addressed the PSLRA's heightened pleading standards for scienter, but then explicitly declined to consider whether *other* elements subject to different pleading standards—reliance, loss, loss causation—are among those facts that must be discovered for a claim to accrue. This interplay between the pleading standards remains to be resolved.

The Courts' Choice of Standards

The *McAdams* decision joins others in confirming that *Iqbal*'s "facial plausibility" test applies to a securities class-action complaint—at least for those elements where the PSLRA or FRCP 9 do not specify heightened pleading requirements. But *McAdams* goes further. It suggests that the combination of pleading standards offers courts the option of choosing the weakest link in a complaint and dismissing under whichever pleading standard most easily warrants dismissal.

This "easiest out" approach has been endorsed by the Supreme Court in at least one other context. In setting forth the test for ineffective-assistance-of-counsel claims, the Court worried that such claims "not become so burdensome to defense counsel that the entire criminal justice system suffers as a result." Under the two-part test established in *Strickland v. Washington*, a criminal defendant must establish both: (1) counsel's deficient performance, and (2) resulting prejudice.[29] Not only must defendants challenging their convictions establish both inadequate performance and prejudice, but courts faced with ineffectiveness claims can address the two prongs of the test in either order. Taking the analysis one step further, the Court explained that "[i]f it is easier to dispose of an ineffectiveness claim on the ground of lack of sufficient prejudice, . . . that course should be followed."[30]

> Securities-fraud class actions fall into this same category. A court may find that any required element was not properly alleged under that element's relevant pleading standard. In addition, a court may consider any applicable pleading standard to find that the complaint is deficient. Once the court finds an element fails the pleading standard, it might not need to consider whether the other elements were sufficiently pled. Expanding the issues on appeal, the reviewing court can dismiss by analyzing a different element, even if it is analyzed under a different pleading standard. *McAdams v. McCord* followed such a path. The district court did not consider loss causation, but dismissed for failure to meet the pleading requirements of FRCP 9 and the PSLRA.[31] On appeal, the court analyzed loss causation under *Iqbal* and *Dura*, and affirmed the dismissal on the grounds of insufficient loss-causation plausibility. Although the appellate court was silent on its rationale for choosing a different standard as a basis for dismissal, the choice may have been driven by the fact that there is binding Supreme Court precedent on loss causation. Yet other courts facing the same option have dismissed on other grounds.[32]

Putting It All Together—Order from Chaos

Iqbal's "facial plausibility" test applies to allegations required to state *any* civil cause of action. For claims that "sound in fraud," plaintiffs must also meet the requirements of FRCP 9(b). In private securities-fraud litigation, complaints also must satisfy the additional hurdle of the PSLRA's pleading requirements. This jumble of standards, together with the unclear definition of "plausibility," leaves some courts and litigants fumbling.[33] Parties may be left to argue each pleading standard that applies to each element. Likewise, courts, able to dismiss for failure to plead any necessary element under any applicable standard, may be affirmed on any other element's pleading failure.

Despite the confusion of heightened and varying pleading standards, this state of the law appears to serve a purpose in the securities context. The Supreme Court has noted sensitivity to the burdens of highly complex cases and the potential for discovery to coerce unwarranted settlements, and Congress passed the PSLRA specifically to limit abusive filing of securities lawsuits.[34] Case law will continue to clarify the pleading standards and the process courts may apply. However, one clear point in the maze of securities-fraud pleading standards is that *Iqbal* is a guidepost that defendants can use to argue for dismissal and that courts can use to dismiss.

Endnotes

1. 129 S.Ct. 1937 (2009).
2. 550 US. 544, 557–58 (2007) (internal quotations and alterations omitted) (citing Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347 (2005)). According to a report released in March 2010 by consulting firm Cornerstone Research, 2009 saw 103 securities class-action settlements with a total value of $3.8 billion, and an average settlement of $37 million. According to the report, while the largest number of settlements involved cases against financial-services companies, the wave of cases linked to the 2008 financial crisis has yet to crest.
3. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
4. *Dura Pharm.*, 544 U.S. at 341–42.
5. *See, e.g.,* Rombach v. Chang, 355 F.3d 164, 171 (2d Cir. 2004); Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719, 723–24 (5th Cir. 2003) (same).
6. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994). Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990).
7. *See, e.g.,* DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).
8. *See, e.g., Shields*, 25 F.3d 1124; Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 361 (1st Cir. 1994) (listing cases).
9. *See, e.g.*, Smith v. Duffey, 576 F.3d 336, 340 (7th Cir. 2009).
10. *See, e.g.,* Stephenson v. Citco Group Ltd., No. 09 CV 00716, 2010 WL 1244007, at *16 (SDNY Apr. 1, 2010) (citing *Iqbal*, 129 S.Ct. at 1949).
11. *Iqbal*, 129 S.Ct. at 1950.
12. *Stephenson*, 2010 WL 1244007, at *16.
13. *Id. See* Harris v. Mills, 572 F.3d 66, 72 (2d Cir. 2009) (adopting this reading of *Iqbal*).
14. *E.g.,* Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC, 594 F.3d 383, 387 n.3 (5th Cir. 2010).
15. Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737. The PSLRA does not apply to SEC enforcement actions.
16. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. 730. Cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740–43 (1975).
17. 15 U.S.C. § 78u-4(b)(2).
18. 551 U.S. 308, 324 (2007)
19. *Id.* at 329.

20. *Id.* at 313, 321.

21. *Id.* at 314 (emphasis added). *Cf. Iqbal*, 129 S.Ct. at 1949 ("A claim has facial *plausibility* when the plaintiff pleads factual content that allows the court to draw the *reasonable* inference that the defendant is liable for the misconduct alleged.") (emphasis added).

22. The Second and Third Circuits have expressly stated that the PSLRA's additional requirement that facts pertaining to scienter be pleaded "with particularity" represents a "heightening of the [pleading] standard." Novak v. Kasaks, 216 F.3d 300, 310–11 (2d Cir.), *cert. denied* Kasaks v. Novak, 531 U.S. 1012 (2000); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir.1999).

23. W. Va. Inv. Mgmt. Bd. v. Doral Fin. Corp., 2009 WL 2779119, at *3 (2d Cir. Sep 03, 2009).

24. *Lone Star Fund*, 594 F.3d at 387 n.3.

25. *See, e.g., In re* Mut. Funds Inv. Litig., 566 F.3d 111 (4th Cir. 2009).

26. 584 F.3d 1111 (8th Cir. 2009).

27. *Id.* (quotation omitted) (citing *In re* K-tel Int'l, Inc. Sec. Litig., 300 F.3d 881, 889 (8th Cir. 2002)).

28. Merck & Co., Inc. v. Reynolds, No. 08-905, 2010 WL 1655827 (Apr. 27, 2010).

29. Strickland v. Washington, 466 U.S. 668 (1984).

30. *Id.*, 466 U.S. at 697.

31. It should be noted that the district court dismissed the complaint on March 27, 2007, before either *Twombly* or *Iqbal* were decided. McAdams v. McCord, No. 06-6020 (W. D. Ark Mar. 27, 2007). The district court stated that "a dismissal under Rule 12(b)(6) should be granted only in the unusual case in which a plaintiff has presented allegations that show on the face of the complaint that there is some insuperable bar to relief." *Id.* (citing Coleman v. Watt, 40 F.3d 255, 258 (8th Cir. 1994) and Conley v. Gibson, 355 U.S. 41, 45-46 (1957)).

32. *See, e.g.*, Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 594 F.3d 783, 792–93 (11th Cir. 2010). (affirming dismissal of 10(b) claim for failure to adequately plead scienter under PSLRA), Campo v. Sears Holdings Corp., No. 09-3589-cv, 2010 WL 1292329 (2d Cir. Apr. 6, 2010).

33. Some courts have dismissed securities claims without citing *Iqbal*, without mentioning plausibility, or without tying pleading deficiencies to a specific standard. *See, e.g., In re* Lehman Bros. Sec. & ERISA Litig., No. 09 MD 2017 (LAK), 2010 U.S. Dist. LEXIS 13856 (S.D.N.Y. Feb. 17, 2010).

34. *Twombly*, 550 U.S. at 559 (quotation omitted); *Blue Chip Stamps*, 421 U.S. at 740–43; H.R. Rep. No. 104-369, at 31. *See also Brace v. Comm. of Mass*, 673 F. Supp. 2d 36, 42 (D. Mass. 2009).