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Supreme Court Establishes New National Standard For Pleading Securities Fraud Cases

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On June 21, 2007, the Supreme Court ruled that a plaintiff filing a federal securities fraud complaint must do more than plead facts sufficient to support a reasonable inference that each defendant acted with "scienter," or wrongful intent. In *Tellabs v. Makor Issues & Rights, Ltd.*, No. 06-484 (June 21, 2007), an 8-1 majority of the Court resolved a split among the Circuit Courts over the interpretation of the governing statute, which mandates that a plaintiff's complaint must support a "strong inference" of scienter in order to survive a motion to dismiss.

The Court found that, unlike in other kinds of cases, a district court judge deciding a motion to dismiss under the securities laws must consider not only the plaintiff's theory of the case, but also innocent explanations for the facts and conduct the plaintiff calls fraud. The judge must then "engage in a comparative evaluation," and the case may survive a motion to dismiss only if the theory of fraud asserted by the plaintiff is "cogent and at least as compelling as any opposing inference of nonfraudulent intent." This new standard will make it difficult for plaintiffs to succeed by filing federal securities complaints based on speculative theories of fraud, and will enhance defendants' ability to weed out nonmeritorious cases soon after they are filed.

THE COURT AFFIRMS THAT SECURITIES PLAINTIFFS MUST SATISFY RIGOROUS PLEADING STANDARDS.

Congress passed the Private Securities Litigation Reform Act of 1995 (the "PSLRA") to curb abuse of private securities class action lawsuits, particularly "frivolous lawyer-driven litigation." To help accomplish its goal, the PSLRA amended the federal securities laws to add a series of requirements that a plaintiff must satisfy in order to plead a securities fraud claim. The law mandates that if these requirements are not met, the plaintiff's complaint must be dismissed at the outset of the lawsuit.

Since passage of the PSLRA, the application of these "exacting pleading requirements" has been the subject of much debate and disagreement. The Supreme Court accepted review in the *Tellabs* case to establish a uniform national standard for the PSLRA requirement that the plaintiff's complaint must "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).

In *Tellabs*, the Seventh Circuit Court of Appeals held that the PSLRA's "strong inference" standard could be satisfied simply if the complaint "allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." This contrasted with other courts' interpretations, including those of the Sixth Circuit and the Ninth Circuit, which held that competing nonculpable inferences should also be considered in deciding a motion to dismiss. In an opinion written by Justice Ginsburg, with Justices Scalia and Alito concurring and Justice Stevens dissenting, the Supreme Court reversed the decision of the Seventh Circuit, finding that its formulation of the pleading requirement "does not capture the stricter demand Congress sought to convey in [the PSLRA]."

A SECURITIES COMPLAINT MUST SUPPORT MORE THAN A REASONABLE INFERENCE OF FRAUD.

The Supreme Court defined its "task" in *Tellabs* as "prescrib[ing] a workable construction of the 'strong inference' standard." The Court started by establishing two preliminary "prescriptions." First, as with all motions to dismiss, the trial judge in a securities case must "accept all factual allegations in the complaint as true." Second, the judge should consider facts from other permissible sources, such as documents referenced in the complaint, and facts and materials which are subject to judicial notice. The judge is then to determine whether all of these facts, taken collectively, give rise to the requisite inference of scienter – the test is "not whether any individual allegation, scrutinized in isolation, meets the standard."

With respect to deciding whether an inference is "strong" enough to satisfy the PSLRA, the Court observed that "[t]he strength of an inference cannot be decided in a vacuum." The Court explained that "[t]he inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts?" Therefore, the Court reasoned, "[t]o determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court *must* consider plausible nonculpable explanations for the defendants' conduct, as well as inferences favoring the plaintiff." (emphasis added).

For the plaintiff to succeed, "[i]t does not suffice that a reasonable factfinder plausibly could infer from the complaint's allegations the requisite state of mind." The Court explained that "[a]n inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct." Consequently, "[t]o qualify as 'strong' within the intendment of [the PSLRA] . . . 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 . . . one could draw from the facts alleged."

TELLABS REFLECTS THE SUPREME COURT'S CONTINUING SCRUTINY OF SECURITIES CASES.

More than a decade after the PSLRA, the Supreme Court is demonstrating a keen interest in monitoring the standards governing securities cases. The *Tellabs* decision follows on the Court's seminal 2005 decision on "loss causation" in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), and the Court is due next year to address the issue of "scheme liability" – the extent to which those doing business with a public company may be liable under the federal securities laws to the company's shareholders. So far, in *Dura* and in *Tellabs*, the Court decided in favor of defendants. In both cases, the Court emphasized that private securities cases should be subject to rigorous standards to prevent abusive litigation.

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Paul Hastings' partner William F. Sullivan briefed and argued the *Dura* case before the Supreme Court, and the Paul Hastings securities litigation team submitted amicus briefs with the Supreme Court in support of the defendants in the *Tellabs* case.

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