OUTSIDE PERSPECTIVES

Securities Litigation Relief On The Horizon?

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There are few companies who need not be concerned with developments in securities litigation. With private plaintiffs and regulators "following the money" into private finance, companies held both privately and publicly must stay informed. Two critical issues in this area — pleading fraudulent intent and third party liability — are currently before the U.S. Supreme Court. Greater clarity, and perhaps some relief for corporate counsel, should emerge this year.

Pleading Fraudulent Intent—A Clarification Twelve Years in the Making

The Private Securities Litigation Reform Act (PSLRA) of 1995 requires private securities fraud plaintiffs to plead "with particularity" facts supporting a "strong inference" that the defendant acted with the required intent. The "particularity" requirement represented a significant and unambiguous departure from the default rules for pleading intent.

The federal circuit courts of appeal have divided, however, on the effect of the "strong inference" requirement. Several circuits (the Second, Third, Eighth and Tenth) have held that a court is not required to weigh the various inferences provoked by the plaintiff's allegations. Other circuits (the First, Fourth, Sixth and Ninth) have attached far greater consequence to the "strong inference" requirement, mandating trial courts to consider competing inferences available from the plaintiff's allegations and to dismiss the complaint when they support an equally or more plausible inference that the defendant acted without the requisite intent. This is a significant departure from default rules of pleading.

In *Tellabs, Inc. v. Makor*, the Seventh Circuit joined the fray, on the plaintiff-friendly side, holding that a plaintiff satisfies the "strong inference" requirement where it alleges facts from which a reasonable person could infer the defendant acted with the necessary intent, and rejecting the "most plausible inference" regime imposed by other circuit courts.

The Supreme Court decided to resolve the conflict, and recent proceedings included interesting twists. The SEC and the DOJ filed a joint *amicus curiae* brief opposing the Seventh Circuit's plaintiff-friendly decision. The government argued that, based on the language of and background to the PSLRA, a plaintiff must allege facts that, if true, allow the court to determine there is a high likelihood that the defendant possessed scienter. During the recent oral argument, the Justices were as concerned with the Constitution as the securities laws. They mulled the Seventh Circuit's concern that the Sixth Circuit's standard would force securities plaintiffs to allege more than they were required to prove—arguably violating plaintiffs' Seventh Amendment rights.

Much will turn on the Court's decision. Scienter is not easy to plead, especially with specificity, but it is what separates securities fraud from mistakes in judgment. Allowing securities plaintiffs to proceed on facts supporting innocent and culpable inferences equally makes pleading these cases too easy and, many have argued, ignores the heightened standard intended by Congress. The Court may reverse the Seventh Circuit and adopt the reasoning of the Sixth Circuit, thus imposing a heavy pleading burden on plaintiffs. In any event, the case, which as of this writing is not decided, likely will provide more clarity.

Third-Party Liability—Clarifying *Central Bank*

The Supreme Court also will opine this year on the scope of primary liability to private plaintiffs for securities fraud under Section 10(b) of the Securities Exchange Act of 1934. Private plaintiffs often seek to recover from not only the issuer of the securities and its controlling individuals, but also from third-party

entities that allegedly assisted the primary defendant in committing fraud. Under the Supreme Court's seminal ruling in *Central Bank*, however, Section 10(b) does not give rise to liability for merely "aiding and abetting" another's fraud. Thus, plaintiffs must demonstrate that such third-party entities are primary violators themselves.

Again, the federal courts of appeal have split on the extent of primary liability, in particular liability for engaging in a "deceptive act" under Rule 10b-5(c), as opposed to an actual misstatement. The most recent is the Fifth Circuit's decision concerning Enron, in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.* With Enron's assets depleted, its shareholders sought to recoup their alleged losses from certain of Enron's banks. They alleged the banks had knowingly participated in a fraudulent scheme, by entering into circular transactions that allowed Enron to misstate its financial condition. In the context of class certification, the court held that, although the banks allegedly entered into the arrangement knowing that Enron would use the transactions to make misstatements to shareholders, "[a]n act cannot be deceptive within the meaning of §10(b) where the actor has no duty to disclose."

The banks had no duty to Enron's shareholders, nor had they made any public statements rendered misleading by omitting the transactions' circular nature. Rather, the plaintiffs alleged only that the banks aided Enron's deception, albeit knowingly, which does not give rise to primary liability under Section 10. Pleading that the banks acted through a "scheme" or "act," as opposed to a misrepresentation, did not allow the plaintiffs to escape the requirement that these actions must be deceptive. In short, the Fifth Circuit held the lower court's interpretation of a "deceptive act" conflicted with *Central Bank*.

The Eighth Circuit agreed, holding that "deceptive" conduct requires a misstatement or a breach of a duty to disclose. The Ninth Circuit, however, in *Charter Communications*, has determined that conduct creating a false appearance in deceptive transactions as part of a scheme to defraud is "deceptive" under Section 10. And, it held that plaintiffs may be presumed to have relied on such a scheme if a misrepresentation enabled by the defendants' participation is disseminated into the marketplace. The SEC advocated this broader interpretation in an *amicus curiae* brief submitted to the Ninth Circuit. The Supreme Court will begin hearing the case in October 2007, and its decision should determine whether private plaintiffs may sue companies for engaging in transactions associated with another company's alleged fraud.

However the Supreme Court rules, this year should bring significant developments in securities litigation. Indeed, the scope of private liability for securities fraud and the ability to plead it, both may soon be reduced.

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