COZEN O'CONNOR.

SECURITIES AND FINANCIAL SERVICES LITIGATION

Alert!

News Concerning Recent Securities and Financial Services Litigation Issues

June 25, 2007

SUPREME COURT REFINES PLEADING REQUIREMENTS IN PRIVATE SECURITIES FRAUD LITIGATION

By: George Gowen, Esq.

COZEN O'CONNOR
1900 Market Street • Philadelphia, PA 19103
Phone: 215.665.2000 • Fax: 215.665.2013
ggowen@cozen.com

On June 21, 2007, the United States Supreme Court reached its much-anticipated decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[1], clarifying the requirements for pleading fraud in private securities litigation. *Tellabs* concerns Congress's requirement, in the Private Securities Litigation Reform Act (the "PSLRA"), that private plaintiffs allege specific facts giving rise to "strong inference" of a defendant's fraudulent intent. The Supreme Court held that lower courts must weigh the competing inferences permitted by the plaintiff's allegations. It also held that the courts must dismiss a complaint, even if its allegations allow a reasonable inference of intent, if its allegations also permit a more plausible, nonculpable inference.

The uncertainty resolved by *Tellabs* was over a decade in the making. In 1995, Congress passed the PSLRA, with the intent to curb frivolous securities fraud suits. Among other things, the PSLRA required private securities plaintiffs to plead, "with particularity," facts supporting a "strong inference" that the defendant acted with "scienter"—*i.e.*, knowledge. Over the years, the federal circuit courts of appeal reached different interpretations of the "strong inference" requirement. In particular, the courts differed on whether the PSLRA required them to weigh competing inferences in deciding whether an inference of scienter is "strong." Several circuits, including the Second, Third, Eighth, and Tenth, did not require a lower court to weigh the various inferences provoked by

1 __ U.S. __, 2007 WL 1773208 (June 21, 2007).

the plaintiff's allegations. Other circuits, such as the Sixth, attached far greater consequence to the "strong inference" requirement, holding that a plaintiff must plead facts that give rise to an inference of scienter that is the most plausible of the inferences those facts support. In other words, in those circuits, trial courts must weigh the competing inferences available from the plaintiff's allegations and must grant a motion to dismiss where the allegations support an equally plausible inference that the defendant acted without the requisite intent.

In *Tellabs*, the Seventh Circuit joined the fray, on the plaintiff-friendly side. While recognizing that the PSLRA "unequivocally raise[d] the bar for pleading scienter," the court held that a plaintiff satisfies the "strong inference" requirement where it alleges facts from which a reasonable person could infer that the defendant acted with the necessary intent. The Seventh Circuit rejected the "most plausible inference" regime imposed by other circuit courts.

The Supreme Court granted a writ of *certiorari* to resolve the conflict. Proceedings before the Court garnered much attention and included some surprises. The Securities and Exchange Commission and the Department of Justice filed a joint brief as *amicus curiae*, in opposition to the Seventh Circuit's plaintiff-friendly decision. Citing the language of and background to the PSLRA, the government argued that a plaintiff must allege facts that, if true, allow the court to determine that there is a high likelihood that the defendant possessed scienter. At the March 28, 2007 oral argument, the Justices were as concerned with the Constitution as the securities laws. They debated the Seventh Circuit's concern that any other standard would force securities plaintiffs to allege more than they were required to prove—arguably violating plaintiffs' Seventh Amendment rights.

With only Justice Stevens dissenting, the Supreme Court vacated the Seventh Circuit's decision. The Court held that allegations do not give rise to a "strong inference" of fraudulent intent where they merely permit such an inference by a reasonable person. Rather, "[t]he inquiry is inherently comparative," and the inference must be "cogent and compelling, thus strong in light of other explanations." The Court did not embrace, however, the Sixth Circuit's and other circuit's requirement that the inference be the "most plausible" allowed by the allegations. The Court held that a complaint may survive "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."

The Court's decision, which governs the all-too critical pleadings stage of private securities fraud litigation, should have a significant effect. The decision changes the rules of engagement in many circuits in addition to the Seventh, such as the Second and Third, where many securities fraud cases are litigated. Courts in those circuits now must weigh competing inferences. While the Court did not require that an inference of scienter be stronger than any competing innocent inferences, the practical effect of that distinction likely will be slight. Justice Scalia, who endorsed the Sixth Circuit's approach, conceded that inferences rarely "are precisely in equipoise" and doubts that "what I deem to be the correct test will produce results much different from the Court's." Thus, at least in many circuits, *Tellabs* should help defendants argue for dismissal of securities fraud complaints.

* * *

THE COZEN O'CONNOR SECURITIES AND FINANCIAL SERVICES LITIGATION GROUP

The attorneys in Cozen O'Connor's securities and financial services litigation practice fully understand the threat and disruption that securities litigation, investor disputes, regulatory enforcement and similar matters represent to any business, private or public. With a firm grasp of our clients' business interests, we secure a swift and seamless resolution of these disputes, minimizing the business interruption, adverse publicity, regulatory scrutiny and strain on investor relations that they may bring.

In addition to appearing in court, our attorneys appear before regulatory agencies and securities exchanges, perform internal investigations and counsel management and boards of directors. Our clients include public and private companies, mutual funds, investment banks and broker-dealers, and their directors, executives and trustees. Our litigators specialize in the full complement of necessary disciplines, including the securities laws, the investment company and advisory laws, corporate law, white collar criminal law, antitrust, tax and employment law.