

News from our Securities Litigation Group

Supreme Court Adopts a High Pleading Standard for Securities Class Actions

On June 21, 2007, the United States Supreme Court issued an important ruling that clarified and strengthened the pleading standard in securities fraud class action cases. The Court's 8-1 opinion in *Tellabs, Inc. v. Makor Issues & Rights* will make it more difficult for plaintiffs to survive a motion to dismiss with weak or conclusory allegations of fraud. See the complete opinion at www.supremecourt.us/opinions/06pdf/06-484.pdf.

Background: Federal Securities Litigation and the Private Securities Litigation Reform Act

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA). The legislative history of the PSLRA shows that Congress was greatly concerned that frivolous securities lawsuits were causing significant damage to investors, the securities markets and the national economy. In particular, the pleading standards for securities complaints were felt to be too low, allowing too many frivolous suits to survive a motion to dismiss and imposing on defendants the significant costs of discovery and trial. To remedy this situation, Congress adopted new procedural hurdles for federal securities class action lawsuits, including stricter requirements for pleading fraud and an automatic stay of all pre-trial discovery until after a court had determined that the complaint might have merit.

For most federal cases, the rules governing pleading reflect a presumption that the plaintiff is entitled to proceed to discovery

and trial unless the complaint is clearly groundless. A complaint need only set forth a "short and plain statement of the claim." Fraud cases require, in addition, that "the circumstances constituting fraud . . . be stated with particularity." In ruling on a motion to dismiss, the court must draw all reasonable inferences from the facts alleged in favor of the plaintiff.

The PSLRA made these requirements stricter by requiring that a complaint in a securities case "state with particularity facts giving rise to a strong inference" that the defendant acted with intent to deceive. Congress, however, did not define what it meant by a "strong inference." This was the issue before the Court in *Tellabs*.

Over the past few years, the federal appeals courts issued conflicting opinions on how lower courts should analyze complaints under the PSLRA. The Ninth Circuit, for example, ruled that instead of indulging all inferences in favor of the plaintiff, courts should consider "all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." Under this view, it was not enough for the allegations in the complaint merely to suggest that a defendant might have committed fraud. In *Tellabs*, however, the Seventh Circuit ruled that a complaint would be sufficient even if it only alleged "facts from which, if true, a reasonable person could infer that the defendant acted with the required intent," even if the same facts could be interpreted to suggest an absence of intent to deceive.

The Seventh Circuit's ruling was in conflict with, and considerably weaker than, the stricter standards of other appellate courts. Had it been adopted by the Supreme Court, the plaintiffs' task in securities cases would have been made considerably easier.

The Supreme Court's Ruling

The Supreme Court reversed the Seventh Circuit. Justice Ginsburg explained that "[to] qualify as strong," an inference of intent to deceive "must be more than merely plausible or reasonable. It must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Thus, lower courts must consider "not only inferences urged by the plaintiff . . . , but also competing inferences rationally drawn from the facts alleged." To survive a

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motion to dismiss, a complaint must plead facts rendering an inference of intent to defraud “*at least as* likely as any plausible opposing inference.”

The plaintiffs argued, among other things, that dismissing complaints that alleged facts that might suggest fraud usurped their constitutional right to a jury trial. The Court easily rejected this argument, holding that Congress is entitled to determine the standards of pleading and proof in civil claims that arise under federal statutes.

Conclusion

In its recent cases, the Court has signaled its continuing concern about the potential for abuse in securities class actions, and has consistently upheld strict standards for pleading and proof in these cases. *Tellabs* sets forth a unified standard for analyzing securities complaints, reaffirming stricter standards adopted by some appeals courts and making it more difficult for plaintiffs in other jurisdictions to survive a motion to dismiss. The Court’s ruling will also benefit defendants by preventing plaintiffs’ attorneys from engaging in “forum shopping” in order to file complaints in circuits with more lenient standards.

If you have questions about this *Alert*, please contact one of the attorneys listed above. ■