

# Supreme Court Endorses Strict Pleading Standard for Private Securities Fraud Actions

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## Introduction

The requirement that investors in a private securities fraud action state facts that the defendants acted with a strong inference of scienter has been interpreted by the Supreme Court to mean that the fraud claim will survive only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference. This was the Court's ruling on a provision of the Private Securities Litigation Reform Act (PSLRA) providing that plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (US S. Ct. 2007), Dkt. No. 06-484, FED. SEC. L. REP. ¶94,335.

Importantly, the allegations must also be considered collectively. A federal judge must not scrutinize each allegation in isolation, said the Court, but must assess all the allegations "holistically." In sum, the reviewing court must ask the question of when the allegations are accepted as true and taken collectively would a reasonable person deem the inference of scienter at least as strong as any opposing inference one could draw from the alleged facts.

In an opinion written by Justice Ginsburg, the Court crafted what it called a "workable construction" of the strong inference standard that is designed to achieve the PSLRA's goal of curbing frivolous, lawyer-driven litigation, while preserving the ability of investors to recover on meritorious claims. Justices Scalia and Alito filed opinions concurring in the judgment; and Justice Stevens filed a dissenting opinion.

Congress included exacting pleading requirements among the control measures in the reform act. The Act requires plaintiffs to state with particularity both the facts constituting the alleged violation and the facts evidencing scienter, which is an intent to defraud. But Congress left undefined the key term strong inference, noted the Court, and the federal courts of appeals have divided on its meaning.

In this case, the Seventh Circuit Court of Appeals held that the strong inference standard would be met if the complaint alleged facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. Rejecting that formulation, the Supreme Court said that it does not capture the stricter demand Congress sought to convey in the PSLRA. It does not suffice that a reasonable fact finder plausibly could infer from the allegations the requisite state of mind. Rather, to determine whether scienter allegations can survive a threshold inspection for sufficiency, instructed Justice Ginsburg, a court must engage in a comparative evaluation and consider, not only inferences urged by the plaintiff, but also competing inferences rationally drawn from the facts alleged.

An inference of fraudulent intent may be plausible, yet less cogent than other, non-culpable explanations for the defendant's conduct. To qualify as strong, reasoned the

Court, 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 non-fraudulent intent.

Further, the judicial inquiry must be into whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard. Moreover, in determining whether the stated facts give rise to a strong inference of scienter, a federal judge must take into account plausible opposing inferences. The Seventh Circuit expressly declined to engage in such a comparative inquiry.

The Court also noted that the strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative and centers on how likely it is that one conclusion, as compared to others, follows from the underlying facts. To determine whether the alleged facts give rise to a strong inference of scienter, a court must consider plausible non-culpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff.

The inference that the defendant acted with scienter need not be irrefutable, said the Court, that is, it need not be of the "smoking-gun genre," or even the most plausible of competing inferences. That said, however, the inference of scienter must be more than merely reasonable or permissible. It must be cogent and compelling, thus strong in light of other explanations.

### **Seventh Amendment Issue**

The Court dismissed as undue the Seventh Circuit's concerns, raised on its own initiative, that the standard being adopted would usurp the jury's role. In the Court's view, mandating a comparative assessment of plausible inferences, while assuming the allegations to be true, does not impinge on the Seventh Amendment right to a jury trial. As the creator of federal statutory claims, reasoned the Court, Congress has the power to prescribe what must be pleaded to state the claim. More specifically, Congress has the prerogative to allow, disallow, or shape the contours of securities fraud actions, including the pleading and proof requirements.

On this issue, the Court also emphasized that its construction of the strong inference standard does not force investors to plead more than they would be required to prove at trial. A plaintiff alleging fraud in a securities fraud action must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference.

In addition, provided that the shareholders have satisfied the congressionally prescribed means of making an issue, said the Court, the case will fall within the jury's authority to assess the credibility of witnesses, resolve any genuine issues of fact, and make the

ultimate determination whether the CEO and, by imputation, the company acted with scienter.

Investors alleging securities fraud must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference. At trial, they must then prove their case by a preponderance of the evidence. Stated otherwise, they must demonstrate that it is *more likely* than not that the defendant acted with scienter.

### **Recklessness as Tantamount to Scienter**

As part of its opinion interpreting what constitutes a strong inference of fraud under the Private Securities Litigation Reform Act, the Supreme Court also mentioned that it had previously reserved the question of whether reckless behavior is sufficient for civil liability under Rule 10b-5. See *Ernst & Ernst v. Hochfelder* (US S. Ct. 1976), 425 U. S. 185, 1975-76 CCH Dec. ¶95,479, n. 12. In other words, the issue of whether recklessness is tantamount to scienter or an intent to defraud has never been decided by the Supreme Court. And, unfortunately, the question whether and when recklessness satisfies the scienter requirement is not presented in the *Tellabs* case.

But in fn. 5 of its opinion, the Court did say that every federal court of appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required. The Court cited the Fourth Circuit panel opinion in *Ottmann v. Hanger Orthopedic Group* (CA-4 2003), 353 F. 3d 338, 2003-04 CCH Dec. ¶92,645.

The type recklessness we are talking about here is an act so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it. Such severe recklessness is essentially a slightly lesser species of intentional misconduct.

Following the enactment of the PSLRA, questions had arisen concerning the validity of pre-PSLRA federal court decisions holding that scienter could be established by a showing of recklessness. See *Nathenson v. Zonagen Inc.* (CA-5 2001), 267 F.3d 400, 2001 CCH Dec. ¶91,548. In *Ottmann*, the Fourth Circuit panel concluded that the PSLRA did not alter the substantive standard for proving scienter in securities fraud actions.

It is possible that, in fn. 5, the Supreme Court was giving its tacit approval to the conclusion that passage of the PSLRA did not affect judicial holdings that severe recklessness is tantamount to scienter. The Court reached out to mention that all of the federal appellate courts that have considered this issue have held that recklessness is

tantamount to scienter for Rule 10b-5 purposes. The Court did not have to do this to decide the case.

### **Endorsement of Private Action**

The Court also took the opportunity to deliver a fairly strong endorsement of private securities fraud actions. The Court said that it has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Justice Department and the SEC. As far back as 1964, the Court was saying that private securities fraud actions provide a most effective weapon in the enforcement of securities laws and are a necessary supplement to SEC action. See *J.I. Case Co. v. Borak*, (US S. Ct. 1964), 377 US 426, 1961-64 CCH Dec. ¶91,382. Justice Ginsburg very effectively reaffirms this position.

The Court also noted that nothing in the PSLRA casts doubt on the conclusion that private securities litigation is an indispensable tool with which defrauded investors can recover their losses, which is a matter crucial to the integrity of domestic capital markets.

### **Pecuniary Motive**

In their securities fraud action, the investors alleged that the company and its CEO, as well as several other corporate executives, engaged in a scheme to deceive the investing public about the true value of company stock. They charged that the CEO, and by imputation the company, falsely reassured investors, in a series of statements, that the company was continuing to enjoy strong demand for its products and earning record revenues, when, in fact, the CEO knew that the opposite was true.

The company stressed that the CEO sold no shares during the class period. But the Court rejected the company's related contention that the CEO's lack of pecuniary motive is dispositive when competing inferences are considered. While it is true that motive can be a relevant consideration and personal financial gain may weigh heavily in favor of a scienter inference, acknowledged the court, the absence of a motive allegation is not fatal. Rather, reminded the Court, allegations must be considered collectively and the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.

### **PSLRA**

The Private Securities Litigation Reform Act of 1995 represented the most sweeping and comprehensive reform of the securities laws in 20 years and was enacted to reform the nation's securities class action litigation system. The Act reflected a congressional belief

that frivolous strike suits alleging securities fraud were increasing the cost of raising capital.

As part of this reform, the Act required that facts giving rise to a strong inference that the defendant acted with the requisite state of mind be specifically alleged. While the strong inference standard unequivocally raised the bar for pleading scienter and signaled a congressional purpose to promote greater uniformity among the circuits, observed the Court, Congress did not throw much light on what facts suffice to create a strong inference, or on what degree of imagination courts can use in divining whether the requisite inference exists.

The PSLRA created a uniform and stringent pleading requirement modeled on the standard of the Second Circuit Court of Appeals. But while adopting the Second Circuit's strong inference standard, Congress did not codify that circuit's case law interpreting the standard. In fact, Congress rejected an amendment offered by Sen. Arlen Specter that would have set forth how a strong inference may be established by reference to Second Circuit case law. With no clear guide from Congress other than its intention to strengthen existing pleading requirements, courts of appeals diverged in construing the term strong inference.