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Supreme Court Upholds Strict Pleading Requirement in Securities Fraud Litigation

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, the Supreme Court held that, in considering a motion to dismiss a securities fraud claim on scienter grounds, courts must do the sort of weighing of facts traditionally reserved for post-discovery proceedings. Plaintiffs' allegations in support of a conclusion that defendants acted with the requisite intent must be balanced – at the motion to dismiss phase – against the facts tending to show an absence of intent. The claim may proceed only if the inference of intent is at least as strong as the inference against it. The Court thus adopted an approach that offers defendants a significant opportunity to dispose of weak securities fraud claims before discovery begins.

In the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Congress added to the Securities Exchange Act of 1934 a requirement that plaintiffs seeking to pursue fraud claims "state with particularity [in their complaint] facts giving rise to a strong inference that the defendant acted with the requisite state of mind." 1934 Act § 21D(b)(2). It did so based on its finding that securities lawsuits were routinely filed whenever issuers' stock prices dropped "without regard to any underlying culpability of the issuer . . . ." But Congress did not specify exactly what a plaintiff had to allege in a complaint to establish a "strong inference" of scienter. The courts of appeals adopted varying formulations. One principal area of disagreement among them was whether a court – at the motion to dismiss stage – should examine only the allegations in favor of scienter urged by the plaintiffs in the complaint for their sufficiency, or should instead weigh competing inferences for and against scienter, permitting the case to proceed only if the inferences for scienter are at least as strong as those against. For example, a plaintiff may allege that a corporation was motivated to inflate its earnings because it was about to use its stock to acquire another company; the defendant may want the court to consider the fact that the exchange ratios were set before the earnings were issued, or other circumstances undercutting the plaintiff's theory of motive.

The Supreme Court held that, to satisfy the PSLRA's requirements, "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." It described a three-step analytical process a district court must apply in resolving the adequacy of allegations of intent:

1. It must accept all factual allegations as true.

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2. It must consider the complaint in its entirety, as well as other sources normally examined; in particular, it must consider documents incorporated into the complaint by reference and matters of which courts may take judicial notice. It must also consider omissions from and ambiguities in plaintiffs' allegations, which weigh against the sufficiency of the complaint.

3. It must consider plausible opposing inferences – those supporting scienter and those suggesting nonculpable explanations for the conduct. It is only if the inference of scienter is at least as compelling as the contrary inference that the claim may proceed.

The Court's holding bolsters the effectiveness of the approach increasingly taken by defendants in motions to dismiss securities fraud complaints: developing and arguing what amounts to a factual record undermining plaintiffs' claim. Plaintiffs typically cherry-pick those facts most favorable to them in drafting a complaint. In most areas of litigation, this approach undermines the ability of defendants – unable to introduce additional or contradictory facts – to file an effective motion to dismiss. In moving to dismiss a securities fraud claim, however, defendants can introduce not only the full text of the documents and statements plaintiffs cite in the complaint, but other important materials eligible for judicial notice. These often include other SEC filings by the issuer, public disclosures, published analyst reports, stock price charts, and disclosures of stock transactions by senior executives, among others. The Court's opinion invites submission of these materials, and requires district courts to consider this entire record and to determine whether it is more likely than not that scienter is present. The effect – as Congress intended – is to make the motion to dismiss a challenging hurdle in order to weed out weak claims before defendants become subject to the enormous discovery costs and settlement pressures associated with defending a securities fraud lawsuit.

The Court's opinion includes two footnotes referring to other issues of interest in securities litigation that may warrant attention:

First, it explicitly reserved the question of whether recklessness is sufficient to satisfy the scienter requirement under § 10(b). (Op. at 7 n.3) This is an issue on which all of the courts of appeals have so long agreed (in the affirmative) that it is somewhat surprising the Supreme Court would go out of its way to highlight the fact that it has not adopted this view. Defendants may want to consider raising and preserving the issue in lower court proceedings for possible future Supreme Court review.

Second, it noted the court of appeals' rejection in this case of the "group pleading" doctrine with respect to scienter – a doctrine that excuses plaintiffs from pleading facts supporting an inference of scienter as to each particular named defendant, permitting them instead to make generalized allegations covering the entire group. The Court observed that the various courts of appeals are divided as to the validity of this doctrine. The Court said that plaintiffs had not contested the court of appeals' rejection of the doctrine in this case, "and we do not disturb it." (Op. at 15 n.7) It may be too much to read the Court's use of this phrase – instead of, for example, "we need not address it" – as implicit support for the court of appeals' rejection of group pleading. However, the Court's general tenor, joined in substance by eight of the nine justices,

was a forceful affirmation of Congress' stated intent to forbid pleading shortcuts that can turn meritless lawsuits into expensive, protracted proceedings.

This is the second case this term in which the Court has given district courts a mandate to weed out weak claims in complex litigation at the motion to dismiss stage. It did so a month ago in *Bell Atlantic Corp. v. Twombly*, No. 05-1126, which tightened the standards for pleading an antitrust conspiracy. It is worth considering whether these cases are part of a broader trend undermining the traditional plaintiff-friendly standards applied to motions to dismiss, replacing them with an early, meaningful judicial look at the substance of complaints that threaten to be complex, burdensome and expensive.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum may be directed to any of the following:

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