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CURTIS LITIGATION CLIENT ALERT

SUPREME COURT CLARIFIES EXACTING PLEADING REQUIREMENTS FOR SECURITIES FRAUD CLAIMS

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Last week, the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. ____ (2007), issued an important decision for public companies, their officers and directors, their auditors, and the securities industry. The Court held that in securities fraud cases, the requirement that plaintiffs must plead a “strong inference” of scienter—the mental state embracing intent to deceive, manipulate or defraud—means that the inference rather than being simply plausible or reasonable, must be “powerful or cogent” and, after considering plausible nonculpable explanations for defendants’ conduct, at least as compelling as any inference that defendants acted without fraudulent intent.

In *Tellabs*, a proposed class of plaintiff investors asserted securities fraud claims against the company, its chief executive officer, and other executives, accusing them of deceiving the investing public about the true value of Tellabs’s stock. A federal district court found that plaintiffs adequately alleged that the statements at issue were misleading, but they had insufficiently alleged that the CEO acted with fraudulent intent. The Court of Appeals for the Seventh Circuit reversed. In finding that the plaintiffs had sufficiently alleged the CEO acted with the necessary state of mind, the Seventh Circuit held that the requirement in the Private Securities Litigation Reform Act of 1995 (“PSLRA”) that plaintiffs’ allegations give rise to a “strong inference” of fraudulent intent is

met if a complaint alleges facts which, if true, would allow a reasonable person to infer that the defendant acted with the requisite intent. The Seventh Circuit expressly declined to weigh competing inferences of non-fraudulent intent that could be drawn from the same facts.

In reversing, the Supreme Court adopted a more stringent pleading requirement. While continuing to recognize, as the Court has in the past, that meritorious private securities fraud suits “are an essential supplement to criminal prosecutions and civil [SEC] enforcement actions,” the Court noted that they must be “adequately contained” to avoid abuses that impose “substantial costs on individuals whose conduct conforms to the law.” The Court found that the Seventh Circuit’s approach did not capture the “exacting pleading requirements” of the PSLRA that were among the measures Congress enacted to curb abuses.

The Court held that it was not sufficient “that a reasonable fact finder plausibly could infer from the complaint’s allegations the requisite state of mind.” Rather, when determining whether plaintiffs’ allegations constitute the requisite strong inference of scienter, courts must engage in a comparative evaluation of both the inferences urged by plaintiffs and competing inferences of plausible nonculpable explanations for the defendant’s conduct. Courts cannot consider one allegation in isolation; rather, they should consider whether

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the facts alleged, taken as a whole, give rise to a strong inference. The Supreme Court explained that a strong inference must be more than simply a plausible or reasonable inference—it must be “powerful or cogent” and at least as compelling as any opposing, non-fraudulent inference.

Conclusion

In clarifying the exacting pleading requirements of the PSLRA, the Supreme Court made it more difficult for plaintiffs to allege a sustainable securities fraud claim. While, in certain circuits, plaintiffs previously could have argued that courts should not consider non-culpable explanations for conduct offered by defendants, plaintiffs must now be able to overcome any opposing inferences of non-fraudulent intent suggested by defendants. Unless inferences of fraudulent intent are at least as compelling as non-fraudulent

explanations, plaintiffs will not be able to demonstrate the “strong inference” of scienter required by the PSLRA.

The *Tellabs* decision also continues the recent trend by the Supreme Court and the lower federal courts toward tightening requirements for plaintiffs bringing securities fraud actions. See, e.g., *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (holding that an investor may not establish loss causation by alleging merely that a securities’ price was inflated); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006) (eliminating holder class actions in securities fraud cases); and *In re Initial Public Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006) (imposing stricter requirements on plaintiffs to obtain class action certification). The combination of these decisions will strengthen defendants’ position in defending securities class actions.

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