June 21, 2007

Supreme Court Enforces Strict Pleading Standard
For Private Securities Actions

Securities class action defendants this morning won an important battle in the fight against meritless litigation. The Supreme Court has ruled that, to survive a motion to dismiss, a securities fraud plaintiff must plead facts establishing a “cogent and compelling” basis to conclude that the defendants intended to deceive. When lower courts rule on motions to dismiss, they must now “consider plausible nonculpable explanations for the defendants’ conduct.” Pleadings must raise an inference of scienter that is “more than merely ‘reasonable’ or permissible”; the inference must be “strong in light of” innocent explanations. “A complaint will survive . . . only if a reasonable person would”—and not could—“deem the inference cogent and as compelling as any opposing inference one could draw from the facts alleged.” *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, slip op. at 12-13.

Today’s decision interpreted a key provision of the Private Securities Litigation Reform Act of 1995, a law Congress enacted to curb abusive securities litigation, including the routine filing of class actions against issuers and others after any significant drop in an issuer’s stock price. Recognizing that pleading standards play a critical gatekeeping role because of the immense costs and risks that discovery and jury trials can impose in securities fraud actions, Congress required that plaintiffs plead “with particularity facts giving rise to a strong inference” of the defendant’s scienter, or fraudulent intent.

Federal courts of appeals had divided over the meaning of the “strong inference” standard—and in particular, whether it allowed district judges to weigh culpable inferences against innocent ones. In *Tellabs*, the Seventh Circuit had held that district courts could not weigh competing inferences, and that it was enough for a plaintiff to plead facts from which “a reasonable person could infer” fraudulent intent. The Supreme Court rejected that relatively lax standard, finding that it did not “capture the stricter demand Congress sought to convey” in the Reform Act. *Tellabs*, slip op. at 2.

*Tellabs* is a welcome development for defendants facing costly securities fraud litigation. It recognizes, as the Supreme Court put it, that “[p]rivate securities actions . . . if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law,” and that the Reform Act must be interpreted to carry out Congress’s intent “to curb frivolous, lawyer-driven litigation.” *Tellabs*, slip op. at 1, 10. The decision also continues recent efforts by the Supreme Court to provide lower courts with clear guidance on the tools they must employ to weed out meritless cases of all sorts at the threshold. See *Bell Atlantic Corp. v. Twombly*, No. 05-1126 (U.S. May 21, 2007), discussed in our memorandum of May 22, 2007.

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