

CLIENT ADVISORY

FOURTH CIRCUIT ADOPTS STRICT STANDARD FOR PLEADING SCIENTER IN SECURITIES FRAUD CASES

Court Also Applies High Pleading Burden for Securities Act Claims

Parties to securities fraud lawsuits in the US Court of Appeals for the Fourth Circuit, and those who practice in the Fourth Circuit, should take note of a recent opinion on the issue of scienter.

In its first application of the US Supreme Court's holding in the pivotal *Tellabs*¹ case, the Fourth Circuit in *Cozzarelli v. Inspire Pharmaceuticals, Inc.*, 2008 WL 5194311 (4th Cir. Dec. 12, 2008) joined a number of circuit and district courts across the country in imposing the exacting pleading standard established by the Private Securities Litigation Reform Act (PSLRA) for plaintiffs advancing federal securities fraud claims. The decision is reflective of a growing proclivity among federal courts to assume the gatekeeping function contemplated by the PSLRA, as affirmed by *Tellabs*, in stemming the tide of frivolous securities fraud litigation.

SCIENTER UNDER RULE 10B-5

Scienter, or intent to defraud, has always been an essential element of a securities fraud claim. A plaintiff seeking to state a claim pursuant to Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), and Rule 10b-5 promulgated thereunder, must plead (1) a false statement or omission of material fact; (2) made with scienter; (3) upon which the plaintiff justifiably relied; and (4) that proximately caused the plaintiff's damages. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. With the passage of the PSLRA in 1995, Congress raised the bar for pleading the element of scienter by requiring litigants to "state with particularity facts giving rise to a strong inference" of fraudulent intent. However, the circuit courts soon diverged over the meaning of the phrase "strong inference." In an effort to resolve the circuit split and promote uniform application of the Act, *Tellabs* prescribed a rigorous interpretation that required the inference of scienter to be "more than merely reasonable or permissible," but "cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs*, 127 S. Ct. at 2510. Courts reviewing challenges to the

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This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.

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¹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007).

sufficiency of the complaint, thus, were required to engage in a comparative inquiry, taking into account “plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” *Id.* at 2509.

FACTS AND FINDINGS OF THE DISTRICT COURT IN *COZZARELLI* CASE

In *Cozzarelli*, Plaintiffs filed a consolidated class action against a pharmaceutical company and three of its directors on behalf of owners of the company’s stock, alleging violations of Section 10(b) of the Exchange Act and Rule 10b-5. The complaint alleged that Defendants intentionally misled the public to believe that a clinical study involving an experimental drug under development at the company was likely to succeed, thereby artificially inflating the company’s stock price to the benefit of the company and its directors. According to Plaintiffs, despite Defendants’ stated predictions, the clinical trial failed to meet its predetermined goal, or endpoint, causing company stock to plummet. Plaintiffs further alleged that Defendants violated Sections 11 and 12(a)(2) of the Securities Act of 1933 (the Securities Act) by including information in company prospectuses and registration statements about the study’s prospects of success that was misleading to investors.

In support of their theory of scienter, Plaintiffs pointed to a plethora of indirect circumstantial evidence suggesting that Defendants had various financial incentives to commit fraud. They claimed, *inter alia*, that the individual defendants sold large numbers of their own shares in the company while the clinical study was pending, that the company was in the midst of financial hardship and therefore in need of capital, and that the directors’ compensation was tied directly to the performance of the experimental drug. Defendants moved to dismiss under Federal Rule of Civil Procedure 12(b)(6).

The district court dismissed the complaint, holding that Plaintiffs had failed to allege facts giving rise to a strong inference of scienter as required by the PSLRA. The district court also dismissed the Securities Act claims because Plaintiffs “failed to sufficiently allege that Defendants made any misleading statement or omission in violation of these

rules.” *In re Inspire Pharm., Inc. Sec. Litig.*, 515 F. Supp. 2d 631, 641 (M.D.N.C. 2007).

FOURTH CIRCUIT OPINION ON RULE 10B-5 CLAIM

On appeal, the Fourth Circuit applied the three-part test articulated by the US Supreme Court in *Tellabs*. The Court accepted Plaintiffs’ factual allegations as true and viewed them collectively, going beyond the complaint itself to examine investment reports offered by Defendants in their motion to dismiss. After weighing the competing inferences discernable from the factual record, the Court concluded that the inference that Defendants withheld information from the market in order to protect the company’s business interests—a purpose that is neither unlawful nor illegitimate—was more compelling than the inference that Defendants acted with intent to defraud. The Court reviewed each of the alleged actions or omissions to which Plaintiffs had attributed a sinister motive, and concluded that a lawful business purpose was in all instances more plausible. See *Cozzarelli*, 2008 WL 5194311, at *7.

Noting that companies are routinely driven to increase their own capital, the Court was not persuaded by Plaintiffs’ contention that Defendants’ incentives to make public statements about the clinical study that were overly optimistic in order to maximize profit raised an inference of scienter that would satisfy the heightened pleading standard. Permitting such an inference, the Court reasoned, would unfairly equate the decision to seek a competitive advantage with the intent to deceive, and would defeat the explicit purpose of the PSLRA: “[a]ll investments carry risk, particularly in a field like biopharmaceuticals. If we inferred scienter from every bullish statement by a pharmaceutical company that was trying to raise funds, we would choke off the lifeblood of innovation in medicine by fueling frivolous litigation—exactly what Congress sought to avoid by enacting the PSLRA.” *Id.* at *8. The Court went on to caution against permitting financial loss, or so called “buyer’s remorse,” an inherent risk of investor speculation, to serve as the exclusive basis for securities fraud actions. *Id.* After concluding that the record as a whole did not support a strong inference of scienter,

the Court affirmed the district court's dismissal of Plaintiffs' 10(b) claims.²

FOURTH CIRCUIT OPINION ON SECURITIES ACT CLAIMS

Plaintiffs' claims under Sections 11 and 12(a)(2) of the Securities Act met a similar fate. Plaintiffs alleged that the company's registration statement and stock-offering prospectuses contained false and misleading information regarding the clinical trial's endpoint in violation of the Securities Act. While both provisions prohibit the sale of securities on the basis of false or misleading statements or omissions, neither require litigants to plead scienter as an element of the claim. Nonetheless, the Court held that the pleading burden on litigants advancing claims sounding in fraud pursuant to Sections 11 and 12(a)(2) is not made lighter by the absence of the scienter element because they remain subject to the strict pleading requirements of Federal Rule of Civil Procedure 9(b).

In contrast to the liberal pleading standard of Rule 8, Rule 9(b) provides that a party alleging fraud "must state with particularity the circumstances constituting fraud or mistake." Observing that Plaintiffs' claims were, in substance, claims of fraud, the Court rejected as conclusory Plaintiffs' disclaimer that they were not advancing a fraud claim: "[w]hen a plaintiff makes an allegation that has the substance of fraud ... he cannot escape the requirements of Rule 9(b) by adding a superficial label of negligence or strict liability. Allowing a plaintiff to do so would undermine one of the primary purposes of Rule 9(b): protecting defendants from the reputational harm that results from frivolous allegations of fraudulent conduct." *Cozzarelli*, 2008 WL 5194311, at *9. The Court agreed with the district court's conclusion that Plaintiffs failed to plead the falsity of the securities offering documents with sufficient particularity and affirmed the dismissal of the Securities Act claims.

CONCLUSION

In adherence to the Supreme Court's directive in *Tellabs*, the Fourth Circuit has shown that it will apply a strict standard in

evaluating securities fraud claims from the outset of a case, thus admonishing the prospective litigant that conclusory allegations of fraud unsupported by substantive evidence will not survive early dismissal. To this end, it seems that the Court will not hesitate to scrutinize the factual record, a function that historically was reserved for the summary judgment stage of a case. By extending the reach of the strict pleading standard—even to those claims that do not require a showing of scienter—the Court signaled its intent to be guided by the spirit and purpose of the PSLRA "to sort out the meritorious claims from abusive ones early in litigation," and to effectuate that purpose "with care." *Id.* at *5.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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² The Court also dismissed Plaintiffs' claims pursuant to Sections 20(a) and 20A of the Exchange Act as derivative of the 10(b) claims.