The US Supreme Court dramatically circumscribes the ability to sue for securities fraud

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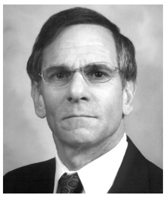
The US Congress enacted the Private Securities Litigation Reform Act of 1995 to make it more difficult to prosecute a securities fraud claim. Initially those restrictions were successful, but federal courts loosely enforced them in the wake of the corporate accounting frauds early in the decade. In three recent decisions, however, the Supreme Court has strictly construed Congress' restrictions on the ability of investors to assert securities fraud claims merely because they have suffered losses, and have provided strong defenses against those claims. The restraints come at the right time for defendants, as the turmoil in the securities and credit markets are prompting investors to sue a broad array of entities in an attempt to recover their losses.



During the Rehnquist Court, the US Supreme Court reviewed few business cases, let alone securities cases. During his confirmation hearings, Chief Justice John Roberts declared that one of his goals was to increase the Supreme Court's review of such cases. True to the Chief Justice's promise, over the last two and a half years, the Supreme Court has issued a series of decisions confronting the ability of investors to use the US securities laws to sue companies, investment banks and other firms for securities fraud.

In response to an increasing number of securities fraud class actions based merely on a decline in the stock price, the US Congress enacted the Private Securities Litigation Reform Act (the 'PSLRA'). The PSLRA and subsequent legislation in 1998 amended the federal securities laws for the express purpose of reducing the number of questionable lawsuits by toughening the requirements for securities fraud claims. Initially, those restrictions significantly curtailed the amount of securities fraud litigation. With the explosion of corporate accounting frauds in 2001 and 2002, however, many federal courts showed increased tolerance for those actions, in spite of the PSLRA's restrictions.

Defendants consequently sought appellate review of this expansion of the law, and the Supreme Court responded by accepting appeals in several cases. Consequently, in three pivotal decisions, the Supreme Court has substantially cut back on the relief granted by the lower courts, and has strictly construed the requirements imposed by the PSLRA. First, in *Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005)*, the Supreme Court held that a defendant's misleading statements must have actually caused investors' losses. Second, in *Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499 (2007)*, the Supreme Court held that plaintiffs must plead facts establishing a cogent and compelling inference that a defendant acted with the necessary fraudulent intent. Finally, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008)*, the Supreme Court rejected the theory of "*scheme liability*" and held that a secondary actor cannot be liable unless it has made deceptive statements on which investors have directly relied.

In *Stoneridge*, the Supreme Court expressed concern that expanded theories of liability are hurting the American securities markets and discouraging foreign entities from participating in them. These three decisions are a collective response to that well-founded concern, as they meaningfully restrict a plaintiff's ability to assert securities fraud claims against domestic and foreign issuers, investment banks and their advisors. In accordance with this trilogy, the US courts have begun to apply the principles articulated by the Supreme Court and to dismiss numerous securities fraud actions.

Loss causation

One of the key elements of a securities fraud claim is causation. A plaintiff's complaint must allege both transaction and loss causation. The loss causation requirement is satisfied by alleging that the loss was incurred as a result of the false and misleading conduct of a company and its representatives. Historically, the courts have been lenient with respect to that requirement. It was sufficient to allege merely that the price of the security was inflated at the time that it was purchased because of the alleged misrepresentation or omission.

In *Dura*, the Supreme Court ruled that such bare allegations are no longer acceptable: "*We concede that ordinary pleading rules are not meant to impose a great burden upon a plaintiff. But it should not prove burdensome for a plaintiff who has suffered an economic* *loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind. At the same time, allowing a plaintiff to forgo giving any indication of economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort that the statutes seek to avoid.*" 544 U.S. at 347 (citations omitted).

The Supreme Court recognised that there are numerous factors unrelated to the alleged misrepresentation that could affect the price of a stock: "*Given the tangle of factors affecting price, the most logic alone permits us to say is that the higher purchase price will sometimes play a role in bringing about a future loss. It may prove to be a necessary condition of any such loss, and in that sense one might say that the inflated purchase price suggests that the misrepresentation (using language the Ninth Circuit used) "touches upon" a later economic loss. But, even if that is so, it is insufficient. To "touch upon" a loss is not to cause a loss, and it is the latter that the law requires.*" Id. at 343 (citation omitted).

Thus, a plaintiff must both allege in the complaint and prove at trial that the misrepresentation played a substantial role in causing the loss. Otherwise, the securities fraud claim must be dismissed.

Since *Dura*, most courts have rigorously enforced the loss causation requirement. For instance, in *Teachers' Retirement System of Louisiana v. Hunter, 477 F.3d 162, 186-88 (4th Cir. 2007)*, the Fourth Circuit held that the plaintiff must plead the causal link between the representations and the loss with sufficient specificity to enable the court to evaluate whether a causal link actually exists. The court posited two possible ways of pleading loss causation: (i) the price declining in reaction to the disclosure of new facts that reveals that previous representations were fraudulent; or (ii) a risk had been concealed in a misleading disclosure had materialized and that fact was publicly disclosed.

The consequence of the Supreme Court's ruling is vividly demonstrated by the Fifth Circuit's decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007)*. In *Oscar*, the court extended the *Dura* holding to require the plaintiff to establish loss causation by a preponderance of admissible evidence in order for a class to be certified (Id. at 264). The court further held that causation must be based on an empirically-based inquiry, particularly when there is simultaneous disclosure of multiple pieces of negative information separate from the misleading statements (Id. at 266). The Fifth Circuit observed: "*The assumption that every material misrepresentation will move a stock in an efficient market is unfounded, at least as market efficiency is presently measured.*" Id. at 269. The court further observed that there are other explanations, besides immateriality of a misrepresentation, as to why the misrepresentation might not have affected the price of the stock.

At the same time, the courts have also increased their scrutiny of the reliance requirement, which is related to causation. In *In re Initial Public Offering Securities Litigation, 471 F.3d 24, 40 (2d Cir. 2006)*, the Second Circuit repudiated its long-standing rule, and held that a class may not be certified unless the district court makes findings, even if they involve factual disputes, that the plaintiff has satisfied each and every requirement for certification. Based on its analysis of the reliance requirement, the court refused to certify a class. Sharing the Fifth Circuit's discomfort with the fraud-on-the-market theory, the court held that the market for initial public offering shares is not efficient and therefore is not entitled to the presumption of reliance and that the plaintiffs could not establish that all the members of the class were ignorant of the alleged fraudulent conduct regarding underwriters' alleged after-market purchase requirements because of publicly available information regarding that conduct (Id. at 43).

Intent

Scienter, or intent, has always been a fundamental element of a securities fraud claim. Historically, it was sufficient for a plaintiff merely to allege that the false and misleading statements were made intentionally. In the PSLRA, Congress barred that practice by requiring a plaintiff to allege with "*particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind.*" 15 U.S.C. § 78u-4(b)(2). Thereafter, the courts throughout the US adopted inconsistent interpretations as to what Congress required by a "*strong inference*", as Congress had provided no guidance as to the phrase's meaning. Some courts accepted barely more than an allegation of intent, while other courts imposed a strict pleading requirement.

With its decision in *Tellabs*, the Supreme Court imposed a uniform standard. In defining that standard, the Supreme Court was guided by the fundamental purpose of the PSLRA: "*Private securities fraud actions, however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law. As a check against abusive litigation by private parties, Congress enacted the [PSLRA].*" 127 S. Ct. at 2504 (citations omitted).

Drawing on basic dictionary definitions of the word 'strong', the Supreme Court held: "*The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the*

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underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court must consider plausible nonculpable 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, i.e., of the 'smoking-gun' genre, or even the 'most plausible of competing inferences', ... Yet 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. A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." Id. at 2510 (citations and footnote omitted).

As a result, a plaintiff will have to allege detailed facts to support the contention that it is as likely, if not more likely, in light of all the circumstances that a defendant acted with the requisite intent.

The district courts have been quick to apply the *Tellabs* holding. In *In re Impax Laboratories, Inc. Securities Litigation, No. C 04-04802 JW, 2007 U.S. Dist. LEXIS 52356 at *31-32 (N.D. Cal. July 18, 2007)*, the court held that detailed allegations that the defendants had violated GAAP by improperly and prematurely recognising revenue for the company's largest drug product (which accounted for more than half of the company's revenues) supported a strong inference that the alleged conduct was reckless. In contrast, the court in *Elam v. Neidorff, No. 4:06CV1142 CDP, 2007 WL 1880747 at *5-6 (E.D. Mo. June 29, 2007)*, held that the plaintiff had not alleged sufficient facts because (i) there were no allegations that the defendants actually had access to the contrary information that was generally available in the public marketplace and (ii) the temporal proximity between the making of the representations and the revelation of the truth could not provide a reasonable inference of intent.

Further, the Court of Appeals for the Seventh Circuit, the court that wrote the decision that the Supreme Court reviewed in *Tellabs*, was the first appellate court to provide substance to the standard articulated by the Supreme Court. In *Higginbotham v. Baxter International, Inc., 495 F.3d 753 (7th Cir. 2007)*, the court ruled that allegations based on unidentified "*confidential*" witnesses cannot constitute "*compelling*" facts, as the sources' anonymity frustrates the ability of a court to fulfill its obligation to consider and compare plausible opposing inferences (Id. at 757). The court held that, with respect to the allegation that a subsidiary's financial information was false and misleading, it was necessary to proffer concrete facts that responsible individuals at Baxter's headquarters knew of or were recklessly indifferent to the subsidiary's accounting fraud (Id. at 757-58). In that regard, the court observed that the fact that Baxter had enough information to launch an investigation of the subsidiary "*is a very great distance from convincing proof of intent to deceive*." Id. at 758.

Notwithstanding the *Higginbotham* court's firm embrace of *Tellabs*, a modicum of disagreement has arisen among the Seventh Circuit's judges. In the Seventh Circuit's determination of the Tellabs case after remand from the Supreme Court, *Makor Issues & Rights, Ltd. v. Tellabs, Inc., No. 04-1687, 2008 WL 151180 (7th Cir. Jan. 17, 2008)*, that panel of judges expressed scepticism about the Supreme Court's holding, and held that there was a strong inference of scienter merely because the misrepresentations were sufficiently material and because it was therefore highly implausible that those statements were not recklessly made by senior management (Id. at *5). The court also attempted to limit *Higginbotham's* holding regarding confidential sources and was willing to credit confidential sources in this instance (Id. at *8-9).

The next year will reveal which view of *Tellabs* will prevail in the Seventh Circuit, but other circuits have not embraced the interpretation advanced in the most recent *Tellabs* decision. For instance, in *Key Equity Investors, Inc. v. Sel-Leb Marketing Inc., 246 Fed. Appx. 780 (3d Cir. 2007)*, the Third Circuit rejected the argument that there was a strong inference of scienter merely because the statements were false, and held that a plaintiff must establish that either there was a concrete and personal benefit arising from making the false statements or there had been an extreme departure from the standard of ordinary care to give rise to recklessness (Id. at 786-787).

Secondary liability

In its *Stoneridge* decision, the Supreme Court dealt with the last major issue regarding the breadth of securities fraud claims. Litigation arising out of accounting scandals had resulted in those claims being asserted against secondary actors such as banks and investment banks in connection with the collapse of those companies. The courts were split as to whether such claims could be asserted.

In *Stoneridge*, the Supreme Court confronted that divide. The Court premised its holding on one of the key elements of a securities fraud claim -- reliance. Extending its 1995 ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994)*, that no claim for aiding and abetting can be asserted under the securities laws, the Court held that a claim cannot be asserted against a secondary actor unless the plaintiff can establish direct reliance on that party's deceptive acts or statements (128 S. Ct. at 769).

The Supreme Court specifically rejected the theory of scheme liability: "*In effect, [the plaintiff] contends that in an efficient market investors rely not only upon the public statements relating to a security but upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule.*" Id. at 770.

The Court thus concluded: "*Were the implied cause of action to be extended to the practices described here, however, there would be a risk that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees. Our precedents counsel against this extension. Though § 10(b) is 'not limited to preserving the integrity of the securities markets', it does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way.*" Id. at 770-71 (citations omitted).

The Supreme Court concluded that the theory of scheme liability is inconsistent with congressional intent underlying the PSLRA, as Congress had refused to override *Central Bank* and instead granted only the SEC authority to pursue claims for aiding and abetting (Id. at 764). Further, echoing its concerns in *Tellabs*, the Supreme Court took into account the adverse "*practical consequences*" that would accompany the adoption of "*scheme liability*". Noting the substantial burdens that the securities fraud actions impose on parties, the Court stated: "*Adoption of [the plaintiff's] approach would expose a new class of defendants to these risks. As noted in Central Bank, contracting parties might find it necessary to protect against these threats, raising the cost of doing business. Overseas firms with no other exposure to our securities laws could be deterred from doing business here. This, in turn, may raise the cost of being a publicly traded company under our law and shift securities offerings away from domestic capital markets.*" Id. at 772 (citations omitted).

Immediately after the Supreme Court issued its decision, plaintiffs' lawyers attempted to create a distinction between defendants engaged in commercial transactions as in *Stoneridge* and defendants engaged in financial transactions such as investment banks, specifically in connection with the writ of *certiorari* seeking review of the Fifth Circuit's decision rejecting scheme liability in the *Enron* litigation. The Supreme Court, however, refused to make such a distinction, and denied the writ. As a result, a claim against a secondary actor is barred unless the plaintiff can establish that there was direct reliance on that party's deceptive acts or statements.

Conclusion

These decisions have fundamentally restricted the ability of investors to assert claims under the securities laws merely because they claim to have suffered losses. These restraints are particularly important given the turmoil in the credit and securities markets as a result of the collapse of the subprime market, which is prompting investors to sue a variety of potential defendants in an attempt to recover their dramatic losses. These decisions provide international and domestic corporations, investment banks and other defendants strong defenses. Plaintiffs will have to demonstrate that their losses are due to the alleged misleading statements (as opposed to the market decline and other factors in the market that may influence a security's price), that there was actual fraudulent intent and that there was direct reliance on the conduct and statements at issue. A defendant's success on any of those issues alone will eliminate the risk of liability. It is thus no wonder that plaintiff's lawyers are now questioning the Supreme Court's interpretation and enforcement of the PSLRA and seeking to contrive new ways to evade these requirements.

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