

## Client Alert

# U.S. Supreme Court to Review Standard for Pleading Scienter in Securities Fraud Actions

The U.S. Supreme Court has granted certiorari in a case that is likely to resolve a split of authority concerning the requirements for pleading scienter in federal securities fraud actions. The applicable standard is set forth in the Private Securities Law Reform Act of 1995 (PSLRA), which requires that “the complaint shall . . . state with particularity facts giving rise to a strong inference” that the defendant acted with scienter, i.e., fraudulent intent. In adopting that standard, Congress meant to provide a heightened, nationally uniform standard for the pleading of scienter in federal securities fraud complaints. Almost from the moment the PSLRA’s ink was dry, however, the Circuits began to differ markedly on exactly how the standard should be applied.

Certain circuits, the First, Fourth, Sixth and Ninth, ruled that a court must consider all reasonable inferences from the specific facts alleged – inferences of fraudulent intent as well as innocent – and then compare the relative plausibility of those inferences. Unless the inference of fraudulent intent was the most plausible, these Circuits ruled that the inference did not qualify as a “strong inference” under the PSLRA and that the complaint must be dismissed. See *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001); *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002).

The case which the Supreme Court recently accepted for review comes from the Seventh Circuit, which adopted a far more lenient approach. In *Makor Issues & Rights Ltd v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), the Seventh Circuit ruled that courts may not engage in an evaluation of competing inferences, such as that required by the First, Fourth, Sixth and Ninth Circuits, because such an evaluation would intrude upon the jury’s function in possible violation of the U.S. Constitution’s Seventh Amendment. To avoid that possibility, the Seventh Circuit held that a securities fraud complaint should survive as long as it alleges facts from which a “reasonable person could infer” fraudulent intent.

Applying this standard, the Seventh Circuit reinstated certain claims from the complaint that the District Court had previously dismissed in its entirety. The defendants petitioned for a writ of certiorari, arguing that the Supreme Court needed to resolve the split among the Circuits, which entails not only the two approaches described above, but also two other approaches: that of the Eighth and Tenth Circuits, which permit consideration of competing inferences but do not require that the inference of fraudulent intent be the most plausible, see *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666-67 (8th Cir. 2001); *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003), and that of the Second and Third Circuits, which have avoided ruling on the need to consider competing inferences, while adopting their own distinct test for whether allegations give rise to a “strong inference” of scienter, see *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999). Defendants further argued that the Seventh Circuit’s lenient approach is “inconsistent with Congress’s expressed desire to end the pernicious practice of pleading fraud with hindsight whenever a company’s stock price tumbles, subjecting businesses to the Hobson’s choice of paying out a quick settlement for a baseless claim or incurring massive risk and litigation costs.” In an Order issued January 5, 2007, the Supreme Court granted defendants’ petition.

In its Order granting certiorari, the Supreme Court directed that briefing be completed by March 20, 2007, thus making it likely that the Court will render a decision in this Term. Whatever approach the Court adopts, its decision promises to be significant, and should bring some consistency and clarity to an area of the law that has strayed far from what Congress intended – a uniform and rigorous national standard for pleading the elements of federal securities law claims.

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