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Legal Updates & News

Bulletins

The U.S. Supreme Court Confronted the Federal Securities Laws in Three Cases This Week

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The U.S. Supreme Court Confronted the Federal Securities Laws in Three Cases This Week

This week, the United States Supreme Court confronted three cases that require interpretation of the federal securities laws.

On Monday, the Supreme Court granted review in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 549 U.S. ____ (U.S. 06-43 Mar. 26, 2007). In *Stoneridge*, the Court will determine when, if at all, a private plaintiff can bring claims under the federal securities laws against secondary actors for participating in "schemes" to defraud shareholders. A discussion of *Stoneridge* is included in our previous client alert linked here. The parties will now file briefs on the merits over the summer, and oral argument before the Supreme Court will take place next fall.

The Supreme Court heard oral arguments in two securities cases earlier this week. One case tests the pleading and proof requirements applied in private securities class actions. The other case concerns the intersection of the antitrust and securities laws. Below, we provide commentary on both of these cases.

Pleading and Proving a "Strong Inference" of Scienter in Securities Fraud Cases

The Supreme Court heard oral argument this week in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,No. 06484. At issue in *Tellabs* is the scienter (or state of mind) requirement applicable in federal securities cases brought under Section 10(b) of the Securities Exchange Act of 1934, which is the statutory provision most frequently invoked by plaintiffs in federal securities class action lawsuits.

The *Tellabs* case turns on what Congress meant when it enacted legislation in 1995 that requires private plaintiffs to plead particularized facts that give rise to a "strong inference" of scienter when asserting claims under Section 10(b). When a complaint fails to meet this rigorous pleading standard, a federal court must dismiss the complaint.

What constitutes a "strong inference" of scienter under the statute, and how does a court make that determination? Federal courts have disagreed.

In the case under review, the Seventh Circuit held that it would not weigh competing inferences of innocence when ruling on whether a complaint pleads a "strong inference" of scienter. The Seventh Circuit observed that a court's weighing of inferences could result in a "usurpation of the jury's role" of weighing evidence, a potential infringement of a plaintiff's Seventh Amendment right to a jury trial, which had raised a concern on the part of the Sixth Circuit in an earlier case. Accordingly, the Seventh Circuit held that a complaint should not be dismissed if "it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required state of mind." Under that standard, the Seventh Circuit found that the plaintiffs had satisfied the "strong inference" standard.

Other Circuits, however, have interpreted the "strong inference" requirement more stringently. Unlike the Seventh Circuit, the other Circuits require district court judges to consider and weigh all possible inferences — culpable and innocent. Plaintiffs can proceed with their case only where their inferences are the "most plausible" of competing inferences.

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Now the Supreme Court is set to decide what "strong inference" means, whether a court can evaluate competing inferences of innocence, and whether that standard offends the Seventh Amendment.

During oral argument on Wednesday, the Court did not discuss the differing Circuit interpretations of "strong inference," but broadly considered whether a court could consider or weigh competing inferences. Justice Alito, for example, questioned how a district court judge could "assess the strength of the inference that can be drawn from the facts alleged in the complaint without considering all the inferences that could be drawn from those facts."

Several Justices also wondered whether the "strong inference" requirement could be reconciled with the traditional rule that a court consider all allegations in the light most favorable to a plaintiff when ruling on a defendant's motion to dismiss. Justice Souter asked whether the Court could "simply assume that the read most favorable to plaintiff rule is still in place, but that reading it most favorably to the plaintiff, it must rise to the level supporting the 'strong inference'" standard.

Much of the oral argument session centered on a possible disconnect between the "strong inference" pleading standard and the "preponderance of the evidence" proof standard (more likely than not) applied by juries in securities fraud cases. A majority of the Justices seemed concerned that the pleading standard might not be the same as the proof standard.

Some Justices wondered whether the "strong inference" standard could be equated with the preponderance of the evidence standard. Justice Breyer, however, observed that the "strong inference" standard "couldn't possibly be" the same as the preponderance of the evidence standard if the Court were to "remain true to the words of the statute which are 'strong inference.'" Justice Kennedy echoed the need for articulation of a standard that adheres to Congressional intent. He observed, "I hope we're going to recognize that Congress thought it was doing something" when it imposed the "strong inference" requirement. Several Justices questioned whether the Seventh Circuit's "reasonable person" standard could be reconciled with the heightened "strong inference" standard imposed by Congress.

The Justices did not appear to agree whether any perceived disconnect between the pleading and proof standards created a conflict with the Seventh Amendment, and a jury's role in resolving disputed issues of fact. Justice Breyer repeatedly raised the Seventh Amendment issue and appeared concerned that a pleading standard different from the instruction given to the jury could mean that the Seventh Amendment argument has "some more force."

To resolve an apparent disconnect between the pleading and proof standard, the Supreme Court could rule that Congress raised the proof standard when it raised the pleading standard in 1995. Altering the standard of proof applied in securities fraud cases would require the Court to reconsider its own precedent. Almost twenty-five years ago, in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 691 (1983), the Court ruled — in light of Congressional silence — that the standard of proof for securities fraud cases brought under Section 10(b) of the Exchange Act, is a "preponderance of the evidence," rather than a "clear and convincing" standard advocated by defendants in the case. The new "strong inference" pleading standard could, however, give the Court a basis for finding that *Huddelston* is no longer controlling if the Court finds that Congress has now "spoken" on the substantive standard of proof required.

The United States Assistant Solicitor General, who argued on behalf of the federal government as an *amicus*, urged that "it would be more consistent with Congress's intent to apply the strong inference requirement at the proof stage as well as the pleading stage rather than water down the strong inference requirement that Congress adopted at the pleading stage." Chief Justice Roberts remarked, "if you think the standards have to be the same at the pleading and at proof, and Congress says strong inference at pleading, it means you have to show a strong inference at proof, and that's why there's no Seventh Amendment problem."

Justice Scalia expressed doubts. He said, "I don't think Congress was trying to achieve an alteration in the ultimate standard . . . the jury standard." He added that Congress imposed the "strong inference" standard because "it was concerned with the enormous expense of discovery, [and] tried to set a high wall to get the discovery stage." Accordingly, the "strong inference" standard is just "an entry qualification for getting into court," that could be irrelevant to the proof standard and the Seventh Amendment issue.

Whatever standard the Supreme Court ultimately adopts, the Justices seemed to agree that the Court needs to provide clear guidance on this important issue and give some meaning to the "strong inference" language. The Court is expected to decide *Tellabs* by the end of June this year.

Intersection of Antitrust and Securities Laws

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The Supreme Court also heard oral argument this week in *Credit Suisse Securities (USA) LLC v. Billing*, No. 05-1157, a case that tests the boundaries between the federal securities laws and the federal antitrust laws.

In *Credit Suisse*, shareholders of approximately 900 technology companies that conducted initial public offerings ("IPOs") in the late 1990s filed a putative class action lawsuit against ten leading investment banks that managed the IPOs. The shareholders allege that the investment banks violated the antitrust laws by conspiring to artificially inflate the aftermarket prices of IPO stocks through various "tie-in" and "laddering" arrangements. In particular, the investment banks allegedly required their IPO customers to pay inflated commissions on other non-IPO securities, commit to purchasing less attractive non-IPO securities, and/or place bids for and purchase quantities of IPO stock in the aftermarket at prices above the IPO price.

The investment banks counter that they are immune from antitrust liability because their conduct was regulated by the Securities and Exchange Commission ("SEC"). The investment banks argue that, even if the specific conduct challenged by the shareholders was not specifically "authorized" by the SEC, it falls within its jurisdiction and its regulation of what investment banks can and cannot do during IPOs. The investment banks argue that the SEC's regulatory regime, therefore, gives them implied immunity from antitrust suits arising from securities offerings. To hold otherwise would place the antitrust laws on a collision course with the securities laws.

The district court sided with the investment banks. The Second Circuit, however, reversed, siding with the shareholders. Although the Second Circuit ruled that the SEC had jurisdiction to regulate the investment banks' conduct, the Second Circuit could find no basis for immunizing the bank's allegedly illegal conduct from antitrust lawsuits. The court ruled that there was neither evidence of a Congressional intent to immunize the investment banks' conduct nor any history of the SEC authorizing the specific conduct that allegedly violated the antitrust laws.

The Supreme Court may now decide who is right. During oral argument on Tuesday, the Supreme Court seemed tentatively skeptical of permitting the antitrust claims to go forward against the investment banks. The Court appeared concerned that the cost of defending meritless antitrust "strike" suits with the threat of treble damages could potentially deter investment banks from efficient capital-raising practices that are critical for the national economy.

Commenting on the threat of meritless claims, Chief Justice Roberts observed that Congress has been tightening the standard for bringing private securities class actions, and speculated that the shareholders were bringing "antitrust claims as a way to circumvent Congress's regulation." Justice Breyer similarly expressed doubts as to whether the shareholders should be able to pursue a remedy under the antitrust laws, which permit treble damages, when their claims arise, if at all, within the framework of the securities laws, which do not permit treble damage awards.

The Justices pondered how courts could differentiate between legal conduct that is implicitly immunized from the antitrust laws and conduct that is not — a way to "separate the sheeps from the goats," according to Justice Breyer.

The investment banks argue that there should be immunity whenever a regulatory agency actively, pervasively, and expertly supervises an industry. The Solicitor General filed an *amicus* brief on behalf of the United States, and both the Federal Trade Commission, and the Securities and Exchange Commission were on the brief along with the U.S. Department of Justice. The United States urged a slightly different standard. Under the federal government's proposed standard, conduct would be implicitly immune from liability if the challenged conduct is directly related to or "inextricably intertwined" with conduct that is expressly regulated by an agency like the SEC. The federal government's position would not give investment banks blanket immunity because the government wants to preserve its ability to prosecute antitrust violations.

The Court expressed doubts during oral argument about how the federal government's proposed standard could be fleshed out early in litigation in future cases when a defendant files a motion to dismiss based on an immunity defense. The need for evidence on the issue of immunity and expert testimony about the legality of conduct would likely require expensive and protracted litigation that many of the Justices seemed wary of allowing. Justice Scalia, for example, opined, "I wouldn't want to roll the dice on whether something is inextricably intertwined with treble damages at the end."

Justice Breyer posited an alternative approach to resolving the implied immunity issue. He suggested that the Court could resolve the case by invoking the primary jurisdiction doctrine. That doctrine would permit a district court to suspend litigation while the case is referred to an expert regulatory body, like the SEC, to determine whether the challenged conduct is legal or illegal. If the challenged conduct were deemed legal by the regulatory agency, it would be immune from liability arising out of conflicting regulations and laws. Justice

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Souter seemed interested in that view. Justice Scalia, however, expressed doubts. He questioned whether the primary jurisdiction doctrine might interfere with the right to a jury trial in an antitrust case, and might not accomplish much in any event.

Oral argument in *Credit Suisse* did not yield strong clues as to how the Supreme Court will ultimately resolve the implied immunity question. The Court seemed tentatively inclined towards adoption of some type of standard that would allow defendants to raise the immunity defense early in the litigation without having to face discovery and the other risks and expenses of protracted litigation. Justice Kennedy recused himself from the case. The Court is expected to issue an opinion by the end of June this year.

[Note that parallel securities class actions were also filed against the investment banks and others. In that parallel securities litigation, Morrison & Foerster LLP represents more than 30 issuers of securities and their executives and serves as liaison counsel for all issuer defendants in that matter. These entities were not parties in the *Credit Suisse* case.]

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