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The SEC Pleading Standard For Scienter

Law360, New York (September 10, 2009) -- More than 30 years ago the U.S. Supreme Court held that a private litigant must sufficiently plead scienter to make out a claim under the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.[1] Allegations of negligence would not suffice.

The court reasoned that the plain language of Section 10(b), including terms like "manipulative," "device" and "contrivance," demonstrated a congressional intent to prohibit only "knowing or intentional misconduct."[2]

The question remained, however, whether scienter was also a requirement for enforcement actions brought by the U.S. Securities and Exchange Commission for violations of Section 10(b) and Rule 10b-5.

A few years later the Supreme Court answered that question in the affirmative.[3] Regardless of the identity of the plaintiff or the nature of the relief sought, scienter is an element of a violation of Section 10(b) and Rule 10b-5.[4]

Defendants facing securities fraud charges frequently move to dismiss for failure adequately to plead scienter. The strength of such a motion depends in large part on the standards for pleading scienter.

Over the years both Congress and the courts have addressed those standards. Congress addressed the issue in the Private Securities Litigation Reform Act of 1995.

Drawing on the Second Circuit's jurisprudence regarding the standard for pleading securities fraud "with particularity" in compliance with Federal Rule of Civil Procedure 9(b), Congress mandated that private litigants must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[5]

In Tellabs Inc. v. Makor Issues & Rights Ltd., the Supreme Court elucidated the meaning of "strong inference," which Congress had left undefined in the PSLRA.[6]

The Supreme Court held that to be "strong," "an inference of scienter must be more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[7]

But as the pleading standard for scienter arguably crystallized with the advent of the PSLRA as construed in Tellabs, courts and litigators are grappling with the same type of question that arose over 30 years ago:

Is the SEC, like private litigants, required to plead facts showing a "strong inference" of scienter to survive a motion to dismiss? And, if so, does the comparative evaluation required by the Supreme Court in Tellabs also apply to enforcement actions brought by the SEC?

This article suggests that the answer to both questions should be yes.

Pre-PSLRA Case Law Recognizing a Requirement to Plead a "Strong Inference" of Scienter in Securities Fraud Cases

Although courts uniformly hold that the PSLRA does not apply to actions brought by the SEC,[8] this does not answer whether the SEC must still plead a "strong inference" of scienter or meet the comparative inquiry of Tellabs to survive a motion to dismiss.

This is because even before the PSLRA the federal courts recognized that a plaintiff alleging securities fraud must comply with Federal Rule of Civil Procedure 9(b), which requires fraud claims to be alleged "with particularity." Rule 9(b) applies to all civil actions, including those brought by the SEC.

Both the Second and Third Circuits have long interpreted Rule 9(b)'s particularity requirement to require that a plaintiff alleging securities fraud plead facts establishing a "strong inference" of scienter.[9]

Thus, those courts have long recognized a pleading requirement for scienter in all securities fraud cases — public and private — that uses the same "strong inference" language codified in the PSLRA.

The question, therefore, is whether Tellabs' interpretation of the "strong inference" requirement in the PSLRA is, logically, equally applicable to Rule 9(b) and, hence, the SEC.

Tellabs' Recognition That a "Strong Inference" Can Be Determined Only Based on an Evaluation of Competing Inferences

The Supreme Court granted certiorari in Tellabs to resolve disagreement among the courts of appeal regarding whether and to what extent courts must consider competing inferences in determining whether a securities fraud complaint gives rise to a "strong inference" of scienter.

The Seventh Circuit had concluded that a complaint would survive if "a reasonable person could infer that the defendant acted with the required intent" and that no comparison of the relative strength of competing inferences was required.[10]

The Sixth Circuit, on the other hand, reached the opposite determination, holding that a plaintiff is entitled only to the "most plausible of competing inferences."[11]

In resolving the issue, the Supreme Court concluded that "the strength of an inference cannot be decided in a vacuum."[12]

Therefore, it held, in assessing whether the complaint allegations satisfy the "strong inference" requirement, a court must consider plausible nonculpable explanations for the defendant's conduct as well as inferences favoring the plaintiff.[13]

A complaint will survive only if a reasonable person would consider the inference of scienter "cogent" and "at least as compelling as any opposite inference one could draw from the facts alleged."[14]

Judicial Decisions Addressing Whether the Tellabs Analysis Should Apply Equally to the SEC Under Rule 9(b)

A handful of lower courts have considered whether the Tellabs analysis applies outside the context of the PSLRA and have reached conflicting conclusions.

For instance, in SEC v. Boling III, the U.S. District Court for the District of Columbia found the Supreme Court's instruction in Tellabs to take into account plausible opposing inferences relevant in determining whether the SEC had adequately pleaded scienter.[15]

And in Glidepath Holding BV v. Spherion Corporation, a court in the Southern District of New York extended the Tellabs analysis beyond the securities fraud context and applied the comparative inference inquiry in a common law fraud action.[16]

Other courts have been hostile to the idea that Tellabs applies in any context outside of the PSLRA and have refused to apply it to actions brought by the SEC.[17]

Some courts reason that although the SEC must plead a "strong inference" of scienter under Rule 9(b), this "strong inference" is different from and less rigorous than the "strong inference" required under the PSLRA, and the comparative evaluation required by Tellabs therefore only applies to actions brought under the PSLRA.[18]

Other federal courts have followed the Ninth Circuit's holding that Rule 9(b) does not require a plaintiff to plead facts giving rise to a "strong inference" of scienter.

These courts conclude that, by its terms, Rule 9(b) requires that the facts constituting fraud or mistake to be stated with particularity, but that intent or knowledge need only be alleged generally.[19]

Under that reasoning, there is no Rule 9(b) "strong inference" pleading requirement, and the question whether the Tellabs comparative analysis regarding the PSLRA "strong inference" requirement is equally applicable to Rule 9(b) and, therefore, to SEC cases, is moot.

A third approach to the issue is simply to duck it. Some courts have avoided directly answering whether the comparative inference analysis of Tellabs applies to actions governed by Rule 9(b), but not subject to the PSLRA, simply concluding that, even if the heightened standard were applicable, scienter has been pleaded sufficiently.[20] These courts leave the question open for another day.

A Uniform "Strong Inference" Standard Should Apply to Both SEC and Private Securities Fraud Claims

There are persuasive arguments for applying the Tellabs comparative inference analysis to complaints brought by the SEC.

First, it is desirable to have a uniform and consistent body of caselaw construing scienter, a critical component of any securities fraud suit.

To have two different standards apply based on the identity of the plaintiff can only lead to inconsistent results and confusion among the courts.[21] The trend among courts of avoiding the issue merely perpetuates the confusion.

Second, although the Tellabs holding does not apply to the SEC because the Court was interpreting the PSLRA, the logic underlying the Tellabs comparative inference inquiry applies equally outside the PSLRA context.

Whether an inference is strong is, necessarily, a comparative judgment that depends on whether there are competing nonfraudulent inferences.

Indeed the SEC itself recognized this in its amicus brief to the Supreme Court in Tellabs, stating that, to determine whether facts give rise to a strong inference of scienter, "a court will necessarily have to consider whether the facts leave open nonculpable explanations for the defendant's conduct."[22]

Third, the proposed uniform pleading standard should not unreasonably burden the SEC or hinder it from pursuing an effective enforcement program.

The SEC has the power to conduct an extensive investigation prior to filing suit, including obtaining documents and testimony. After months and sometimes years of document collection and interviews the SEC should be able to plead facts giving rise to

an inference of scienter that is at least as compelling as any inference of nonfraudulent intent.

It hardly seems unreasonable to require the SEC to meet this standard, which applies to private plaintiffs who lack the SEC's ability to conduct pre-complaint investigations.

Fourth, the justification for the rigorous scienter standard imposed on private litigants in the PSLRA also applies to the SEC. To be sure, the SEC does not have the financial incentive of private plaintiffs to bring suits that may have little merit but create pressure for big settlements.

But the current climate, in which there is tremendous pressure from Congress and the public for aggressive enforcement, creates similar risks of overzealousness.

The fact that the plaintiff is the governmental enforcement agency, with its accompanying power and presumption of credibility, only exacerbates those dangers.

Requiring the SEC to meet the Tellabs standard may act as a check against potential over-reaching prosecution.

It should not be too much to ask the SEC to comply with the competing inference standard it advocated in its amicus brief to the Supreme Court in Tellabs and which it should be capable of satisfying after its prefiling investigation.

Although there are compelling reasons why the SEC should be subject to the same pleading standard for scienter as private litigants, courts will likely be reluctant to expand the Tellabs comparative inference inquiry to SEC enforcement actions in the current economic and political climate.

It may well be that the resolution of the issue will have to await resolution by the Supreme Court of the proper construction of Rule 9(b). Until the issue is resolved, the SEC may be wise to frame complaints that can satisfy a Tellabs comparative inference standard, which defense lawyers surely will continue to advocate.

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[1] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

[2] Id. at 197.

[3] Aaron v. SEC, 446 U.S. 680, 691 (1980).

[4] Id.

[5] 15 U.S.C. § 78u-4(b)(2).

[6] Tellabs Inc. v. Makor Issues & Rights Ltd., 551 U.S. 308 (2007).

[7] Id. at 314.

[8] See, e.g., SEC v. Dunn, 587 F. Supp. 2d 486, 501 (S.D.N.Y. 2008); SEC v. Lucent Techs. Inc., No. Civ. 04-2315 (WHW), 2005 WL 1206841, at *5 (D.N.J. May 20, 2005).

[9] In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1422 (3rd Cir. 1997); Shields v. Citytrust Bancorp Inc., 25 F.3d 1124, 1129 (2d Cir. 1994); In re Ross v. A.H. Robins Co., 607 F.2d 545, 558 (2d Cir. 1979); SEC v. Collins & Aikman Corp., 524 F. Supp. 2d 477, 487-88 (S.D.N.Y. 2007); Lucent, 2005 WL 1206841, at *5.

[10] Major Issues & Rights Ltd. v. Tellabs Inc., 437 F.3d 588, 591 (7th Cir. 2006), rev'd, 551 U.S. 308 (2007).

[11] Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004).

[12] Tellabs, 551 U.S. at 323.

[13] Id.

[14] Id.

[15] SEC v. Boling III, Civ. A. N. 06-1329(RMC), 2007 WL 2059744, at *4 n.1 (D.D.C. July 13, 2007).

[16] Glidepath Holding BV v. Spherion Corp., 590 F. Supp. 2d 435, 451 (S.D.N.Y. 2007).

[17] SEC v. Pentagon Capital Mgmt. PLC, 612 F. Supp. 2d 241, 263-64 (S.D.N.Y. 2009); SEC v. Dunn, 587 F. Supp. 2d 486, 501 (S.D.N.Y. 2008).

[18] Dunn, 587 F. Supp. 2d at 501.

[19] In re GlenFed Inc. Sec. Litig., 42 F.3d 1541, 1546-47 (9th Cir. 1994) (en banc), overruled on other grounds by PSLRA; SEC v. Berry, 580 F. Supp. 2d 911, 920-21 (N.D. Cal. 2008) (finding SEC not required to plead "strong inference" of scienter under Rule 9(b)).

[20] SEC v. Collins & Aikman Corp, 524 F. Supp. 2d 477, 488 (S.D.N.Y. 2007); see also SEC v. Badian, No. 06 Civ. 2621 (LTS) (DFE), 2008 WL 3914872, at *6 (S.D.N.Y. Aug. 22, 2008) (noting that the Second Circuit has not yet applied the Tellabs test outside the PSLRA context, but even were the court to apply it, the facts alleged in the complaint support an inference of scienter at least as strong, if not stronger, than any inference of lawful market activity); SEC v. Espuelas, 579 F. Supp. 2d 461, 470 n.3 (S.D.N.Y. 2008) (noting that Tellabs "may not be directly controlling," but declining to reach the issue because the court would reach the same decision even if it applied the rule in Tellabs).

[21] We recognize that the elements of an SEC claim under Section 10(b) are not identical to those for a private plaintiff. Unlike a private plaintiff, the SEC does not have to allege or prove reliance or damages. See, e.g., Geman v. SEC, 334 F.3d 1183, 1191 (10th Cir. 2003); GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 206 n.6 (3rd Cir. 2001). Our point is that elements that are identical should truly be identical.

[22] Brief for the United States as Amicus Curiae Supporting Petitioners at 24.