

Corporate Officers & Directors Liability

COMMENTARY

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Raising the Bar: How the Supreme Court's Recent Decisions Are Good for Corporations And Their Insurers

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In a pair of recent decisions the Supreme Court continued its recent trend of limiting perceived litigation abuses directed at corporate defendants. The decisions are intended to restrict the types of claims that may be stated against those entities and stiffen the pleading requirements for the claims that are permitted. Both will have noticeable effects on the D&O landscape.

Tellabs v. Makor Issues & Rights

In *Tellabs Inc. v. Makor Issues & Rights Ltd.*, No. 06-484, 2007 WL 1773208 (U.S. June 21, 2007), the high court issued its first pronouncement on the requirement of the Private Securities Litigation Reform Act of 1995¹ that plaintiffs in securities class actions "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."²

The key term of this requirement — "strong inference" — was left undefined by Congress, and over the intervening decade there has been a growing divergence among the federal appeals courts as to what evidence the term demands. The Supreme Court granted *certiorari* in the *Tellabs* case to resolve "whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a 'strong inference' of *scienter*."³

Writing for the majority, Justice Ruth Bader Ginsburg said:

Congress did not merely require plaintiffs to "provide a factual basis for [their] *scienter* allegations, *i.e.*, to allege facts from which an inference of *scienter* rationally *could* be drawn. Instead, Congress required plaintiffs to plead with particularity facts that give rise to a "strong" — *i.e.*, a powerful or cogent — inference.

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.⁴

Finding that the U.S. Court of Appeals for the 7th Circuit had failed to engage in this balancing analysis, the high court vacated its opinion and remanded the case for further proceedings.

The Supreme Court's analysis suggests a three-part test for assessing the adequacy of *scienter* allegations.

First, courts must continue to examine whether a securities complaint alleges sufficient facts to satisfy the "particularity" requirements found in both the PSLRA (requiring securities plaintiffs to "state with particularity facts" in support of their claim) and Federal Rule of Civil Procedure 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

Second, courts must ask whether the plaintiff's allegations — taken "holistically," not individually — present a "cogent" inference of *scienter*. Although the Supreme Court declined to expound on the meaning of this term, a "cogent" theory of *scienter* presumably is one that, at a minimum, presents a compelling and rational basis (whether economic or otherwise) for the behavior.

Finally, courts must determine whether the plaintiff's inference, when balanced against all "plausible nonculpable explanations" for the alleged conduct, is "at least as compelling as any opposing inference one could draw from the facts alleged." Notably, the Supreme Court stopped short of requiring the plaintiff's inference to be *more* plausible than the defendant's, just so long as it is *not less* plausible.⁵

In theory, this so-far-untested barrier should discourage suits based on a "fraud by hindsight" theory — the failure of optimistic statements or projections to materialize means fraud must have occurred — or allegations of economically irrational behavior. It also should give defendants a much stronger hand at the motion-to-dismiss stage.

What does *Tellabs* mean for corporate defendants and their D&O insurers? For starters, in those circuits in which a lesser pleading standard has heretofore been the rule, one can expect a surge in motions to reconsider past denials of motions to dismiss. In cases filed from this point forward, insurers should expect to see motions to dismiss — already viewed as a watershed moment in securities class-action cases — take on even more significance. As the importance of asserting "plausible nonculpable explanations" early on in litigation grows, the time and expense spent framing and vetting those explanations — by counsel and, perhaps, consulting economics experts as well — are sure to see a corresponding increase.

Credit Suisse v. Billing

The Supreme Court's other recent decision of significance came in *Credit Suisse Securities (USA) LLC v. Billing*, 127 S. Ct. 2383 (2007). In *Billing* the court held that the federal

securities laws preempted both state and federal antitrust claims arising from certain investment banks' joint actions in the course of underwriting initial public offerings. While noting that the securities laws did not expressly preclude application of the antitrust laws to the underwriters, the court, in a 7-1 decision authored by Justice Stephen Breyer,⁶ nonetheless found implied preclusion based on a "plain repugnancy" between those authorities.

In support of its ruling, the court noted that:

- The practices at issue — the underwriters' joint promotion and sale of IPO securities — were "central to the proper functioning of well-regulated capital markets" and in the "heartland" of securities regulation;
- The broad scheme of the securities laws and regulations gave the Securities and Exchange Commission authority to supervise IPO marketing practices;⁷
- The SEC had "continuously exercised" that regulatory authority; and
- Prosecuting securities and antitrust challenges would prove "practically incompatible" because "there is no practical way to confine antitrust suits so that they challenge only activity ... that is presently unlawful and will likely remain unlawful under the securities law," thus running the risk of "unusually serious mistakes" by antitrust courts.⁸

On this last point, the Supreme Court observed that, indeed, "evidence tending to show unlawful antitrust activity and evidence tending to show lawful securities marketing activity may overlap, or prove identical." In a final, passing remark, the court noted that the PSLRA had been passed specifically to "weed out unmeritorious securities lawsuits" and that to allow what amounted to "a securities complaint in antitrust clothing" would circumvent those legislative intentions.

Although the facts of *Billing* are limited to the IPO context, its principles potentially extend far beyond. For example, are antitrust claims barred as to *all* conduct actively regulated by the SEC? Does the same principle bar private antitrust actions in areas where other federal agencies exercise broad regulatory authority? Could the reverse situation ever be true — might private securities actions be precluded in favor of the antitrust laws in another context?

Two issues we expect to receive additional judicial deliberation in this regard are whether a particular course

of conduct falls within the “heartland” of a regulated area and, second, the “practical incompatibility” concerns raised by the possibility of concurrent litigation brought under multiple statutes, particularly given the Supreme Court’s apparent rejection of the 2nd Circuit’s position in *Billing* that “actual” conflict was required for implied preclusion.

While we stand by for further developments, for now, *Billing* can be credited for having eliminated a source of potential liability for both corporate defendants and their D&O insurers.

Notes

¹ 15 U.S.C. § 78u.

² 15 U.S.C. § 78u-4(b)(2).

³ *Tellabs*, 2007 WL 1773208 at *6.

⁴ *Id.* at *10 (internal citations omitted; emphasis in original).

⁵ Justices Antonin Scalia and Samuel Alito argued in favor of the “more plausible” standard in their separate concurrences, see 2007 WL 1773208 at *13, *16, while Justice John Paul Stevens in his dissent urged application of a “probable cause” standard similar to that applied in criminal cases. *Id.* at *17.

⁶ Justice Anthony Kennedy took no part in the decision of the case while Justice Stevens concurred only in the result. See note 8, *infra*.

⁷ In his dissent, Justice Clarence Thomas argued that the “broad saving clauses” of the Securities Act of 1933 and the Securities Exchange Act of 1934 preserved the right for plaintiffs to pursue antitrust claims under the Sherman Act (enacted in 1890) at the same time as securities claims.

⁸ In a partial dissent, Justice Stevens objected to this element “play[ing] any role in the analysis of the question of law presented.” In his mind, the conduct complained of presented no “antitrust injury,” but rather a claim for breach of fiduciary duty at best. Accordingly, while he concurred in the judgment, he declined to concur in its rationale.

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