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Securities Litigation Trends

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United States Supreme Court Resolves Circuit Split Regarding Scope of SLUSA Preemption

The Securities Litigation Uniform Standards Act (SLUSA) preempts certain class actions based on alleged misrepresentations or omissions "in connection with the purchase or sale" of nationally traded securities. *See* 15 U.S.C. §§ 77p, 78bb(f). The primary goal of SLUSA is to prevent plaintiffs from circumventing federal pleading standards by filing class-action securities claims in state court.

In 2005, the Seventh Circuit held that SLUSA preemption was not limited to purchasers and sellers of securities, but also extended to class actions brought on behalf of plaintiffs who refrained from purchasing or selling securities based on alleged misrepresentations and omissions (*i.e.*, so-called "holder claims"). *Kircher v. Putnam Funds Trust*, 2005 U.S. App. LEXIS 7914 (7th Cir. May 2, 2005), *cert. granted*,—U.S.L.W.— (U.S. Apr. 24, 2006) (No. 05-409). By contrast, the Second Circuit held in 2005 that SLUSA does not preempt such actions. *Dabit v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005). The Supreme Court had previously held that only purchasers and sellers of securities had standing to bring private securities fraud actions under Rule 10b-5 of the Securities Exchange Act. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

In *Dabit*, the Supreme Court Unanimously Held That SLUSA Preempts State Law Class Actions Brought on Behalf of Persons Who Were Induced to Hold Securities

In *Dabit*, the Supreme Court clarified that its earlier decision to limit the potential scope of Rule 10b-5 cases was based on policy considerations, not on an attempt to define the phrase "in connection with the purchase or sale." Rather, the Court has generally "espoused a broad interpretation" of that phrase, holding that "it is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else." The Court stated that this type of broad interpretation must have been anticipated by Congress when it drafted SLUSA and used the "in connection with" language. Given that class actions brought by holders pose a special risk of "vexatious litigation," it would be odd if SLUSA exempted that subset of class actions from its range of authority. Moreover, the Supreme Court reasoned that allowing plaintiffs to bring holder claims in state court "would give rise to wasteful, duplicative litigation" if parallel state court (holders) and federal court (purchasers) class actions were brought based on the same facts.

IN THIS ISSUE

The Seventh Circuit Weighs In on the PSLRA

Plaintiff Must Plead Sufficient Facts to Create Strong Inference of Scienter under PSLRA

More than ten years after the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), the United States Court of Appeals for the Seventh Circuit has finally issued an opinion addressing the heightened pleading requirements of the PSLRA. With the circuit courts of appeals split in their interpretations of these pleading requirements, commentators, practitioners and investment firms had been waiting for some time for the Seventh Circuit to weigh in.

History of the PSLRA

Enacted in 1995, the PSLRA imposes a heightened pleading requirement on plaintiffs alleging securities fraud. One of the primary purposes of the statute is to deter "strike suits" where, as an alternative to the expensive discovery process, shareholders file meritless securities fraud suits to pressure corporate defendants into settling claims. Enactment of the PSLRA was generally supported by businesses and the securities defense bar, but was criticized by consumer groups and the plaintiffs' bar. To serve its stated purpose of deterring frivolous securities fraud claims, the PSLRA heightens the pleading requirements for private litigants by requiring plaintiffs alleging securities fraud claims to "state 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). However, the PSLRA does not define the requisite state of mind or provide a benchmark for courts to use in determining whether that state of mind has been adequately pled.

Three Different Approaches Have Been Used to Determine Whether a "Strong Inference" of Scienter Has Been Pled

In determining whether a plaintiff has pled sufficient facts to create a "strong inference" of scienter, the Second and Third Circuits have adopted the Second Circuit's pre-PSLRA standard for pleading scienter: motive or opportunity, or strong circumstantial evidence of recklessness or conscious misbehavior. *See Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999). The Ninth and Eleventh Circuits have rejected the Second Circuit's approach and opted for a higher standard. In those circuits, motive and opportunity alone are not enough to plead scienter. *See In re Silicon Graphics Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999). The other six Circuits (the First, Fourth, Fifth, Sixth, Eighth and Tenth) have taken a middle ground, reasoning that Congress chose neither to adopt nor to reject any particular method for pleading scienter but, instead, only required plaintiffs to plead facts that, in their totality, establish a strong inference of scienter. These Circuits require that all of the allegations in the complaint be examined collectively to determine whether a strong inference has been pled. *See Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338 (4th Cir. 2003); *accord Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645 (8th Cir. 2001); *Natheson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001); *City of Phila. v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001) (*en banc*); *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999).

The Seventh Circuit Weighs In

In *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), a putative class of Tellabs, Inc. shareholders accused Tellabs' then-current CEO (Notebaert) and then-Chairman and previous CEO

(Birck), as well as Tellabs, of violating § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. According to the plaintiffs, Notebaert and Birck "knowingly lied to the public" by overstating the demand for Tellabs' product; misstating the availability of those products; misstating Tellabs' financials; and exaggerating its earnings and revenue projections. The plaintiffs' first complaint was dismissed, with leave to amend. In their amended complaint, plaintiffs attempted to bolster their allegations of scienter. The amended complaint was also dismissed.

On appeal, the Seventh Circuit affirmed dismissal of plaintiffs' claims against Birck but reversed dismissal as to Notebaert. The court held that the plaintiffs' allegations as to Notebaert were sufficient to establish a strong inference that he acted with fraudulent intent. As Tellabs' CEO, Notebaert's scienter could then be imputed to Tellabs. In reaching its conclusion, the Seventh Circuit made several significant holdings with respect to pleading scienter.

First, the court rejected the notion that the PSLRA raised the substantive state of mind requirement to deliberate or conscious recklessness, as the Ninth Circuit held in *In re Silicon Graphics Securities Litig*., 183 F.3d 970 (9th Cir. 1999). The court noted that, prior to the passage of the PSLRA, every circuit to consider the substantive scienter standard, including the Ninth, had held that a showing of recklessness was sufficient to allege scienter. The court reasoned that, if Congress had wanted to impose a more stringent scienter standard, it would have done so explicitly. Therefore, the court concluded that a pre-PSLRA scienter standard should be applied.

Second, the Seventh Circuit rejected the "motive and opportunity" approach adopted by the Second and Third Circuits, and adopted the middle-ground approach, requiring all of the allegations in the complaint to be examined collectively to determine whether they establish a strong inference of scienter. On this point, the court stated that "motive and opportunity may be useful indicators, but nowhere in the statute does it say they are either necessary or sufficient."

Third, the Seventh Circuit addressed whether scienter allegations made against one defendant can be imputed to other defendants in the same action. Quoting the district court's ruling with approval, the court stated that: "the answer, in our view, lies in the language of the statute. Section 78v-4(b)(2) requires that the complaint state, with particularity, facts giving rise to a strong inference that *the defendant* acted with the required state of mind." Accordingly, the court held scienter allegations against one defendant cannot be imputed to all other defendants in the same action.

What the *Makor* Ruling Means for Securities Litigants in the Seventh Circuit

Following *Makor*, securities fraud claimants in the Seventh Circuit will have to allege particular facts that together create a strong inference that would convince a reasonable person that the defendant knew the statement made was false or misleading. Claimants also will have to allege these facts relative to each defendant. Unless plaintiffs can satisfy these requirements, they will struggle in pursuing their claims, and may look to file their actions elsewhere.

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If you have any questions regarding material in this issue of *Securities Litigation Trends* or suggestions for a specific topic you would like addressed in a future issue, please contact the editor, **Thomas P. Cimino, Jr., at 312/609-7784** or at tcimino@vedderprice.com. **Jon P. McCarty** (312/609-7572 or jmccarty@vedderprice.com) and **Timothy J. Carroll** (312/609-7709 or tcarroll@vedderprice.com) assisted in the publication of this issue.

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Members of the Securities Litigation Team:

James S. Montana *(Practice Leader)* 312/609-7820
David E. Bennett 312/609-7714
Timothy J. Carroll 312/609-7709
Thomas P. Cimino, Jr. 312/609-7784
David L. Doyle 312/609-7782
John H. Eickemeyer *(New York)* 212/407-7760
James V. Garvey 312/609-7712
Dan L. Goldwasser *(New York)* 212/407-7710
Randall M. Lending 312/609-7564
Jon P. McCarty 312/609-7572
Timothy M. Schank 312/609-7585
Michael J. Waters 312/609-7726

Other Commercial Litigation Attorneys:

Margaret A. Arnold 312/609-7629
Anthony J. Ashley 312/609-7884
Thomas A. Baker 312/609-7507
Stanley B. Block 312/609-7505
Charles Caranicas *(New York)* 212/407-7712
Michael G. Davies *(New York)* 212/407-6930
Thomas R. Dee 312/609-7746
Brian C. Dunning *(New York)* 212/407-6960
Andrew M. Gardner 312/609-7724
Daniel C. Green *(New York)* 212/407-7735
John C. Grosz *(New York)* 212/407-7770
Jeffery M. Heftman 312/609-7728
Diane M. Kehl 312/609-7664
Frederic T. Knape 312/609-7559
Ludwig E. Kolman 312/609-7566
Kevin J. Kuhn 312/609-7652
Allan E. Lapidus 312/609-7570
Karen P. Layng 312/609-7891
Michael R. Mulcahy 312/609-7513
Bruce C. Nelson 312/609-7823
Bruce A. Radke 312/609-7689
Richard C. Robin 312/609-7655
Chad A. Schiefelbein 312/609-7737
Joseph A. Strubbe 312/609-7765
Cindy S. Stuyvesant 312/609-7675
Kelly A. Tautges 312/609-7845
Ursula Taylor 312/609-7635
Gregory G. Wrobel 312/609-7722
M. Derek Zolner 312/609-7578

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005
Robert J. Stucker

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799
Neal I. Korval

New Jersey
Five Becker Farm Road
Roseland, New Jersey 07068
973/597-1100
Fax: 973/597-9607
John E. Bradley

www.vedderprice.com