New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
Web address: http://www.nylj.com
VOLUME 237—NO. 72 MONDAY, APRIL 16, 2007 ALM

OUTSIDE COUNSEL

BY BRAD S. KARP AND CHRISTOPHER HYDE GIAMPAPA

Supreme Court to Decide PSLRA Pleading Standard

On March 28, 2007, the U.S. Supreme Court heard oral argument in a matter with profound implications for the future of pending and future securities fraud class actions, *Tellabs Inc. v. Makor Issues & Rights Ltd.*, No. 06-484.

The question before the Court in *Tellabs* is what a plaintiff must allege to state a claim for securities fraud under the Private Securities Litigation Reform Act (PSLRA). The PSLRA requires a private plaintiff, among other things, to "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."[1]

Courts Divided

The federal courts of appeal and district courts have divided sharply over the meaning of the "strong inference" requirement. Relying primarily on the PSLRA's statutory language, the U.S. Court of Appeals for the Sixth Circuit has concluded that a private plaintiff's allegations of scienter are "entitled only to the most plausible of competing inferences."[2] Although a "strong inference" need not be "irrefutable[,]" the court reasoned, under the PSLRA "[a] mere reasonable inference is insufficient to survive a motion to dismiss."[3] The Sixth Circuit ruled that the PSLRA's "strong inference" requirement "represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff the benefit of *all* reasonable inferences."[4]

The U.S. Court of Appeals for the Seventh Circuit, in contrast, concluded that it would "allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."[5] In rejecting the "most plausible of competing inferences" approach, the Seventh Circuit expressed concern that the U.S. Court of Appeals for the Sixth Circuit's standard "potentially infringe upon plaintiffs' Seventh Amendment rights" to a jury trial.[6] The Seventh Circuit's ruling, which reinstated securities fraud charges against Tellabs Inc. and one of its officers, has generated substantial criticism and

Brad S. Karp *Christopher Hyde Giampapa*

prompted one prominent scholar to observe that "there seems little chance that the 7th Circuit's more permissive approach will be upheld, as it seemingly reduces the statutory 'strong inference' standard to only a 'reasonable inference' standard."[7]

The Court granted certiorari and is now expected to resolve the conflict among the circuits. *Tellabs* has drawn a bevy of amicus briefs, including Brandeis briefs from a variety of business and consumer groups addressing the effects of the PSLRA on private securities litigation and the international competitiveness of the U.S. capital markets.

The question before the Court in 'Tellabs' is what a plaintiff must allege to state a claim for securities fraud under the Private Securities Litigation Reform Act.

It is widely expected that the Court will reverse the Seventh Circuit's decision, but it remains unclear how stringent the "strong inference" pleading standard will be. There is a range of interpretations in the federal courts of appeal, with the Sixth Circuit's standard the most stringent and the Seventh Circuit's standard the least demanding. Likewise, a variety of alternative formulations have been offered by various amici, and the Court, of course, may formulate its own standard. However, at least one thing became apparent at oral argument: the Court's interpretation of the PSLRA is likely to turn in substantial part on its view of the Seventh Amendment concerns expressed by the Court of Appeals in *Tellabs*. As Justice Stephen Breyer observed at oral argument, "I think we have to reach it…either Congress can do it, or it can't[.]"[8]

Violation of Seventh Amendment?

This article examines the claim that the heightened pleading standard imposed by the PSLRA violates the Seventh Amendment. It does not. The language and history of the provision, the Court's Seventh Amendment jurisprudence, and comparisons to other procedures that have been upheld against constitutional challenge suggest that Congress may, consistent with the Seventh Amendment, create heightened pleading standards, such as the PSLRA's "strong inference" requirement.

Because there is no Seventh Amendment violation, the Court should be free to interpret the PSLRA's "strong inference" language as imposing "uniform and more stringent pleading requirements" on private plaintiffs. Such a result would comport with Congress' stated goals of permitting meritorious private actions and deterring abusive actions and their corresponding discovery costs.[9]

The Seventh Amendment provides in relevant part: "[i]n [s]uits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved[.]"[10] This rather odd formulation—that the right of trial by jury "shall be preserved" —reflects the absence of any uniform practice among the states concerning the scope or form of the jury trial at the time of the Seventh Amendment's passage. The Constitution's omission of a right to a civil jury trial had been a major objection to its ratification; this objection was overcome at both the Constitutional Convention and in the subsequent ratification debates, however, because of the difficulty (or impossibility) of promulgating a formulation that would encompass the diversity of practice in the several states. As a result, the new constitutional guarantee would "preserve" the basic right of a jury trial, but would not adopt the civil jury trial practices or procedures of any of the 13 states.

Accordingly, the Court has held that "the [Seventh] Amendment was designed to preserve the basic institution of jury trial in only its most fundamental elements, not the great mass of procedural forms and details, varying even then so widely among common-law jurisdictions."[11] As a result, the Seventh Amendment is not implicated—must less violated —by a statute or rule like the PSLRA, which regulates procedural matters such as pleading standards. Indeed, the Court held in *Parklane* that the Seventh Amendment does not restrict "procedural devices" or mandate a particular

Brad S. Karp *is the co-chair of the litigation department of Paul, Weiss, Rikind, Wharton & Garrison LLP and writes a monthly Second Circuit Review column for this paper.* **Christopher Hyde Giampapa** *is a litigation associate at the firm.*

"system of pleading[.]"[12] Likewise, the Court has found both that "Congress has undoubted power to regulate the practice and procedure of federal courts"[13] and that "[t]he Seventh Amendment… does not attempt to regulate matters of pleading or practice[.]"[14]

Notably, Congress' authority to regulate matters of procedure, such as pleading standards and evidentiary rules, is itself grounded in the Constitution. U.S. Const. Art. I, §3, Cl. 8 & 18. In the well-known post-*Erie* case of *Hanna v. Plumer*, the Court held that Congress' Article I power to create lower courts, along with the Necessary and Proper Clause, "carries with it congressional power to make rules governing the practice and pleading in those courts."[15] That authority, in turn necessarily includes the "power to make rules governing the practice and pleading… which in turn includes a power to regulate matters which, though falling within the uncertain area between substance and procedure, are rationally capable of classification as either."[16]

Moreover, nothing in the records from the constitutional convention, congressional debates concerning the passage of the Bill of Rights or the states' ratifying conventions suggests that the Seventh Amendment was intended to restrict Congress' authority to promulgate rules of procedure for the federal courts or to affect the relative role of the judge and jury.[17] The acts of the First and Second Congress illustrate that there is no conflict between the preservation of the right to a jury trial and Congress' power to proscribe rules of procedure. Both the Judiciary Act of 1789 and the Permanent Process Act of 1792 grant to the Court the power to make all necessary rules for the operation of the inferior federal courts.[18] Similarly, the Rules Enabling Act, Congress' delegation to the Court of its power to promulgate rules of procedure, originally granted the Court the power to prescribe rules concerning a variety of matters, expressly including "pleadings."[19]

Thus, Congress' authority to set pleading standards comports fully with the language and history of the Seventh Amendment.

PSLRA, Jury Trials

The primary Seventh Amendment objection to the Sixth Circuit's "strong inference" standard is that it would prevent a jury from deciding claims upon which, if adequately pleaded and substantiated during discovery, a reasonable jury could find in favor of the plaintiff. For example, the *Tellabs* plaintiffs contend that "[a]ny interpretation of the PSLRA's standard requiring more than an inference strong enough to support a reasonable jury's finding that the defendant acted with scienter violates the Constitution's jury trial guarantee."[20]

Implicit in this argument is the idea that modern practice of notice pleading under FedRCivP 8 is constitutionally required. It is not. Neither the Seventh Amendment nor any other provision of the Constitution mandates notice pleading (or even refers to pleading). Likewise, the practice of construing a pleading in favor of the pleader is not constitutionally required. Instead, that practice derives from Rule 8. The error in effectively attempting to constitutionalize Rule 8 is apparent when one considers the common law and code-based systems of pleading in place prior to the introduction of the modern federal rules in 1938.

Under earlier common-law and code-pleading standards, a party was required to plead all facts required to prove a claim to a jury. Common-law pleading entailed a variety of procedural devices such as the demurrer, the nonsuit and the directed verdict, through which a jury trial might be avoided or a trial's result either reversed or vacated for new trial. For example, the demurrer to the evidence operated "to take from the jury and to refer to the judge, the application of the law to the fact[.]"[21] Although a detailed analysis of these procedural devices is beyond the scope of this article, the Court has relied on them in upholding a variety of procedural devices against Seventh Amendment challenges. Under these code and common-law procedures, the pleading requirements were highly technical, and many cases were dismissed as a result of pleading defects. Such results were not thought to implicate any Seventh Amendment concern.

Notwithstanding the claim that the PSLRA's "strong inference" standard invades the province of the jury, the PSLRA neither requires a judge to evaluate the credibility of witnesses nor to receive and weigh evidence. Instead, the court examines all the allegations in the complaint to determine whether, if true, they supply a "strong inference" that the scienter requirement is satisfied. After that required determination, the jury's role as fact-finder is unchanged.

Enforcing any pleading standard may result in some claims as to which, had they been adequately pleaded and substantiated by sufficient evidence in discovery, a reasonable finder of fact could have returned a verdict for the plaintiff. Even absent the PSLRA, a plaintiff who fails to allege facts concerning matters such as fraud "with particularity" may find his or her claim dismissed before discovery.[22] In some cases, such discovery could lead to evidence upon which the plaintiff's claim might be sustained at trial. Yet heightened pleading standards for allegations of fraud, such as those embodied in the PSLRA and Rule 9(b), are deeply rooted in the common law and cannot give rise to a Seventh Amendment violation.

A contrary result would render not just the PSLRA, but any motion to dismiss, constitutionally suspect. The Court, however, has repeatedly recognized Congress' authority to impose heightened pleading requirements, and has never held that such requirements violate the Seventh Amendment.[23]

Other Procedures

Courts routinely make decisions on matters of procedure that circumscribe the available inferences a jury may draw without running afoul of the Seventh Amendment. For example, under the Federal Rules of Evidence, courts necessarily rule on preliminary questions concerning the qualifications of witnesses, the susceptibility of facts to judicial notice, and the admissibility of evidence on grounds including relevance, undue prejudice and hearsay. Judges perform a similar gatekeeper functions in screening potential expert testimony under *Daubert v. Merrell Dow Pharms., Inc.*,[24] or instructing juries on presumptions.[25]

All of these procedures affect the inferences a jury may make, but none has been found to abridge the Seventh Amendment right to trial by jury. To the contrary, the Court has repeatedly held that procedures such as summary judgment and the directed verdict do not violate the Seventh Amendment.[26]

Conclusion

Congress could raise the burden of proof required at trial for private securities claims by, for example, requiring clear and convincing evidence. That Congress did not do so in the PSLRA, however, indicates that the Court will need to decide the merits of the Seventh Amendment issue before it. As Justice Anthony Kennedy remarked at the *Tellabs* oral argument, "I hope we're going to recognize that Congress thought it was doing something."[27]

Although the Court could avoid the constitutional question by raising the burden of proof at trial in private securities actions to correspond to the heightened pleading standard, such a result is unlikely. Instead, because Congress has the constitutional authority to raise pleading requirements without contravening the Seventh Amendment, the Court is likely to reverse the Seventh Circuit in *Tellabs* and articulate a pleading standard in which a "strong inference" means more than a "reasonable inference."

Understanding precisely how much more is required under the PSLRA will necessarily have to wait until June when the Court is likely to rule in *Tellabs*. Depending on the clarity of the Court's pronouncement, the wait may be much longer. One thing that appears certain, however, is that the securities laws, corporations and investors will be deeply affected by the Court's ruling.

1. 15 USC §78u-4(b)(2).
2. *Helwig v. Vencor, Inc.*, 251 F3d 540, 553 (6th Cir. 2001) (en banc).
3. *PR Diamonds, Inc. v. Chandler*, 364 F3d 671, 692 (6th Cir. 2004) (citations omitted).
4. *Helwig*, 251 F3d at 553 (emphasis in original).
5. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F3d 588, 602 (7th Cir. 2006), cert. granted, 127 S. Ct. 853 (2007).
6. Id. (citing *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F3d 651, 682 n.25 (6th Cir. 2005)); see also *Pirraglia v. Novell*, 339 F.3d 1182, 1187-88 (10th Cir. 2003).
7. John C. Coffee Jr., "Law & Politics of Scienter," Nat'l L. J. 12 (col. 1) (March 13, 2007); accord Brief for the United States as amicus curiae, 23 n.7 ("The [PSLRA] clearly requires more than a permissible inference; it requires a strong one.").
8. March 28, 2007 Tr. 49.
9. H.R. Rep. No. 104-369, at 31, 37 (1995) (Conf. Rep.); S. Rep. No. 104-98, at 14 (1995).
10. U.S. Const. Amend VII.
11. *Parklane Hosiery Co., Inc. v. Shore*, 439 US 322, 337 (1979) (quoting *Galloway v. United States*, 319 U.S. 372, 390 (1943)); accord *Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 657 (1935).
12. Id. at 336-37.
13. *Sibbach v. Wilson & Co.*, 312 US 1, 9-10 (1941); accord The Federalist No. 83, supra, at 454 ("[The] power to constitute courts is a power to prescribe the mode of trial[.]").
14. *Walker v. New Mexico & S. Pac. R.R. Co.*, 165 U.S. 593, 596 (1897).
15. 380 US 460, 472 (1965).
16. Id.
17. Edith Guild Henderson, "The Background of the Seventh Amendment," 80 Harv. L. Rev. 290, 292 (1966).
18. Judiciary Act of 1789, ch. 20, §9, 1 Stat. 73, 77 (1789); Permanent Process Act of 1792, ch. 36, §2, 1 Stat. 275, 276 (1792).
19. *Hanna*, 380 US at 464 (quoting 28 USC §2072 (1958 ed.)).
20. Resp. Br. 16. But see, e.g., United States Br. 25 (arguing that when "the facts alleged in the complaint give rise to a substantial possibility that the defendant acted without scienter, the necessary 'strong inference' of scienter will be lacking"); Pet. Br. (arguing plaintiffs must "allege facts that, if proven true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities"); SEC Br. 24 (arguing that courts must evaluate "other possible explanations" or "any competing inferences and nonculpable explanations").
21. 3 Holdsworth, "The History of English Law," 639 n. 2 (1927).
22. FedRCivP 9(b).
23. See, e.g., *Swierkiewicz v. Sorema N.A.*, 534 US 506, 513 (2002); *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993).
24. 509 US 579, 590 (1993); see also Fed. R. Evid. 702-05.
25. See, e.g., 4 Leonard B. Sand, et al, "Modern Federal Jury Instructions-Civil," ¶75.02, p. 75-24.1 ("A presumption requires