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## A Securities Law Update

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### U.S. Supreme Court Construes “Strong Inference” of Scienter Requirement Under PSLRA in Favor of Defendants

The Private Securities Litigation Reform Act (“PSLRA”) was enacted in 1995 as a check against abusive private federal securities fraud lawsuits, and requires plaintiffs bringing such suits to meet exacting pleading requirements. On June 21, 2007, the United States Supreme Court decided *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, \_\_\_ S.Ct. \_\_\_, 2007 WL 1773208, a class action alleging that defendants engaged in securities fraud in violation of Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. In *Tellabs*, the Court resolved a disagreement among the federal Courts of Appeals whether, and to what extent, a court must consider competing inferences in determining whether a plaintiff’s securities fraud complaint gives rise to a “strong inference” that the defendants acted with “scienter,” meaning that they intended to “deceive, manipulate or defraud,” as required under the PLSRA’s heightened pleading requirements, 15 U.S.C. § 78u-4(b)(2).

The Supreme Court ruled that in determining whether a complaint’s scienter allegations are sufficient to survive a motion to dismiss under the PLSRA, a court must review and compare all competing inferences arising from the allegations; thus, the court “must consider not only inferences urged by plaintiff, ... but also competing inferences rationally drawn from the facts alleged.” The Court stated further that “[t]o qualify as ‘strong’ within the intentment of [PLSRA] § 21D(b)(2), we hold, 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.”

The district court and Seventh Circuit Court of Appeals both found that the complaint in *Tellabs* sufficiently specified the defendants’ allegedly misleading statements and why they were misleading, but in reversing the district court’s dismissal of the complaint, the Seventh Circuit expressly declined to consider any plausible competing inferences negating defendants’ alleged scienter. Accordingly, the Supreme Court vacated the Seventh Circuit’s judgment and remanded the *Tellabs* case for reexamination in light of the Court’s construction of § 21D(b)(2).

Justices Alito and Scalia concurred in the judgment but would have framed the proper test as whether the inference of scienter (if any) is *more plausible* than the inference of innocence.

Justice Stevens dissented from the Court's opinion and would have framed the test using a "probable cause" standard.

The standard announced in *Tellabs* is consistent with the construction of the PLSRA's scienter requirement that has unfolded in the decisions of the Ninth Circuit Court of Appeals, which governs the federal district courts in the Pacific Northwest. For example, in *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002), the Ninth Circuit ruled that, "when determining whether plaintiffs have shown a strong inference of scienter, the court must consider all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs" *Id.* at 897 (emphasis in original).

As a result, the *Tellabs* decision should have little or no effect as a practical matter on the determinations of federal district and appellate courts here whether to dismiss federal securities lawsuits for failure to meet the heightened scienter pleading requirement set forth in the PLSRA. Nevertheless, the Supreme Court's holding in *Tellabs* will end any further debate as to whether the Ninth Circuit's construction of the PLSRA went too far in protecting defendants from unwarranted federal securities lawsuits.

## **Washington Court of Appeals Affirms Dismissal of Washington State Securities Act Claims Based on Statute of Limitations**

In an unpublished decision, Division One of the Court of Appeals of Washington affirmed the dismissal of investors' Washington State Securities Act ("WSSA") claims as barred by WSSA's three-year statute of limitations. *Alexander v. Cadaret, Grant & Co.*, \_\_\_ Wn.App.2d \_\_\_, 2007 WL 1041380 (April 9, 2007).

In 1999, the plaintiff/investors invested funds with their long time financial advisor, Steve Bastrom, in a private placement program offered by Resource Development International ("RDI"). RDI turned out to be a Ponzi scheme. From the time of their investment until February 2001, the investors received their promised payments, but in March 2001, the payments stopped. For over a year, RDI assured investors through a series of letters that the hold on their money was temporary and that investors could expect payments soon. In March 2002, the SEC raided RDI's offices and charged its principals with securities fraud, and the *Tacoma News Tribune* published a story on these events.

In March 2005, more than three years after receiving the last letter from RDI, but less than three years after the *Tacoma News Tribune* article appeared, the investors sued Bastrom's former securities broker, Cadaret, alleging violations of WSSA. Cadaret moved for summary judgment arguing that the investors' claims were barred by WSSA's three-year statute of limitations, which includes a "discovery rule." Both the trial court and the Court of Appeals agreed that the investors' claims were time-barred. The investors argued that the statute of limitations under WSSA should be based on a "subjective standard" such that a cause of action does not accrue until the relevant facts are public knowledge, and the plaintiff understands the legal significance of those facts.

The Court of Appeals, however, ruled that the test was an “objective” standard and that a cause of action accrues when the plaintiff knows or should know the relevant facts of the alleged fraud, whether or not the plaintiff also knows that these facts are sufficient to establish a valid, legal cause of action. The court reasoned that a plaintiff must exercise due diligence in discovering the basis for a cause of action, and that the plaintiff’s actions are judged against those of a reasonable investor. Here, the court ruled as a matter of law that once the investors received the last letter from RDI, which was nearly a year after receiving their last payment from RDI, they were on notice of the fraud.

The Court of Appeals declined to extend a “lulling doctrine” to civil WSSA claims because the doctrine is already inherent in the language of WSSA’s statute of limitations with its discovery rule. Because the Alexander decision is unpublished, it is of limited precedential value pursuant to RCW 2.06.040. It does, however, evince a perhaps surprisingly pro-defense result under the generally very pro-investor WSSA case law in Washington, and it serves as a road map for defendants to respond to similar arguments from plaintiff’s or claimant’s counsel in other cases.

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