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The Ninth Circuit Adopts "Holistic" Approach to Scienter and Raises the Bar for Securities Fraud Plaintiffs

On January 12, 2009 the Ninth Circuit Court of Appeals reinforced the protections of the Private Securities Litigation Reform Act of 1995 (PSLRA) through its first substantial interpretation of the Supreme Court's *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* decision regarding the pleading requirements for scienter in securities fraud complaints. In *Zucco Partners, LLC v. Digimarc Corp.*, the Ninth Circuit confirmed that *Tellabs* did not "materially alter" the Ninth Circuit's pleading requirements for scienter, but only requires an additional "holistic" review of allegations to determine if "allegations combine to create a strong inference of intentional conduct or deliberate recklessness." The *Zucco* decision also appears to go further than *Tellabs* by requiring allegations to create an inference of scienter that is "more compelling than an alternative innocent explanation."

Case Background

The PSLRA was enacted to deter the filing of abusive securities fraud claims, in part by raising the pleading standards required for private plaintiffs. One often litigated feature of the PSLRA requires a securities fraud plaintiff to plead facts giving rise to a "strong inference" of the required state of mind, that is, scienter. In 1998 the Ninth Circuit's *In re Silicon Graphics* decision held that this standard required a securities fraud plaintiff to plead facts establishing "a strong inference of deliberate recklessness." The court further stated that to show "a strong inference of deliberate recklessness" a plaintiff must "state facts that come closer to demonstrating intent as opposed to mere motive and opportunity."

In its 2007 *Tellabs* decision, the Supreme Court sought to define the term "strong inference," noting that Congress had left the term undefined and the Courts of Appeals were divided on its meaning. The Supreme Court held that a securities fraud claim will survive only "if a

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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." In other words, a "tie" goes to the plaintiff at the pleading stage. The *Tellabs* decision, however, left the Ninth Circuit's scienter jurisprudence in an uncertain state. Did the *In re Silicon Graphics* line of jurisprudence still apply in the Ninth Circuit? The *Zucco* decision answers the question and appears to require a higher pleading standard than allowable under *Tellabs*.

The *Zucco* Decision

In *Zucco*, the appellant contended that the district court erred by applying a more stringent standard than *Tellabs* required. The Ninth Circuit rejected this argument and reaffirmed the *In re Silicon Graphics* line of jurisprudence, finding that *Tellabs* "did not materially alter the particularity requirements for scienter claims established in our previous decisions." The court did, however, find that courts must consider a "holistic" component when analyzing scienter. Accordingly, courts in the Ninth Circuit will now conduct a dual inquiry: first, the court will "determine whether any of plaintiff's allegations standing alone, are sufficient to create a strong inference of scienter; second, if no individual allegations are sufficient [the court] will conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference of intentional conduct or deliberate recklessness."

Zucco, however, appears to mandate application of a more stringent standard than *Tellabs* allows, possibly resulting in a conflict with the Supreme Court's decision. While discussing the new "holistic" approach, the *Zucco* decision stated that the inference of scienter created by a "set of allegations . . . must still be *more* compelling than an alternative innocent explanation." (emphasis added). In other words, the "tie" goes to the defendant, an approach advocated by Justice Scalia's concurrence in *Tellabs*. Such a rule appears to conflict with the *Tellabs* majority opinion, which give the "tie" to the plaintiff at the pleading stage.

By reaffirming the Ninth Circuit's pre-*Tellabs* jurisprudence and applying the balancing approach mandated by *Tellabs*, the *Zucco* decision reinforces the PSLRA's strict securities fraud pleading requirements. *Zucco*'s impact on securities fraud lawsuits, however, remains uncertain. The new "holistic" approach may not have a profound impact on courts' approach to scienter allegations because courts in the Ninth Circuit often considered complaints as a whole when evaluating scienter allegations. Further, it remains to be seen whether courts in the Ninth Circuit will become more deferential to defendants by giving them the "tie," or whether *Zucco* improperly overstepped the bounds set by *Tellabs*. Look for plaintiffs and defendants to test these new pleading standards in the near future; securities class action filings increased significantly in 2008 and are likely to continue with the recent dramatic fall in the

value of many securities. Defendants in securities fraud actions must be mindful that effective application of these strict pleading standards may defeat securities fraud claims early in litigation and before costly phases of litigation commence, such as discovery.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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