Supreme Court's *Twombly* Ruling Will Mean Higher Pleading Requirements for Some Securities Litigation Claims

by

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The Supreme Court's long-anticipated decision this month in the *Tellabs* case addressed the heightened pleading requirements that apply to securities fraud claims under the Private Securities Litigation Reform Act of 1995 (the “Reform Act”) and Federal Rule of Civil Procedure 9(b). There is also considerable focus on other securities cases currently before the Supreme Court (i.e., *Charter Communications and Enron*), which will impact the pleading and class certification standards applicable to federal securities fraud cases. What has received less attention is that many commonly litigated non-fraud securities claims are subject to the lower “notice pleading” standard under Federal Rule of Civil Procedure 8(a), and will not be directly affected by the *Tellabs* decision. The Supreme Court’s recent ruling in an antitrust case, *Twombly v. Bell-Atlantic Corp.*, will have a significant effect on how these non-fraud securities claims must now be pled.

Rule 8(a)(2) requires that a plaintiff must plead “a short and plain statement of the claim showing that the pleader is entitled to relief . . . .” In the *Twombly* decision, the Supreme Court strengthened the pleading standard that is required under Rule 8(a), holding that plaintiffs must now meet a pleading standard of “plausibility” in order to pursue their claims. This overruled the Court’s previously enunciated standard for notice pleading set forth in *Conley v. Gibson*, in which the Court ruled that a complaint should not be dismissed under the notice pleading standard unless “it appeared beyond doubt that the plaintiff could prove no set of facts in support of his claim which would entitle him to relief.” The *Twombly* Court “retired” this “no set of facts” test in favor of a more stringent standard requiring that plaintiffs must now plead a set of facts presenting a “plausible,” as opposed to simply possible, ground for relief in order to successfully plead a cause of action and survive a motion to dismiss.

Three commonly litigated areas in securities litigation that have been subject to the notice pleading standard are (i) shareholder derivative actions, (ii) claims brought under Section 11 and 12 of the Securities Act of 1933 (the “Securities Act”); and (iii) control person claims brought under Section 15 of the Securities Act and Section 20(a) of the Securities Exchange Act of 1934. Although in the shareholder derivative context, allegations pertaining to demand futility must typically be pled with particularity, other non-demand claims that do not sound in fraud are usually held by courts to be subject only to Rule 8(a)’s notice pleading standard, rather than the stricter pleading requirements for fraud under Rule 9(b). Similarly, Sections 11 and 12, which do not contain an explicit intent requirement, have been held to be subject to Rule

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was the fact that the ILECs apparently refrained against each other. The basis for these allegations entered into agreements to refrain from competing significant inroads. CLECs would have been able to make more market would have been much more open and the ILECs had parallel conduct on the basis that if any one of the customers. The complaint inferred that this was to sabotage the CLECs relationships with their inferior connections to the networks, overcharging the CLECs and billing the CLECs in such a way as to sabotage the CLECs relationships with their customers. The complaint inferred that this was parallel conduct on the basis that if any one of the ILECs had not engaged in such conduct, then the market would have been much more open and the CLECs would have been able to make more significant inroads.

The complaint alleged that the ILECs had entered into agreements to refrain from competing against each other. The basis for these allegations was the fact that the ILECs apparently refrained from pursuing business opportunities in nearby markets where they supposedly had a competitive advantage. Essentially, the complaint alleged Sherman Act violations based on the ILECs failure to compete with each other and on their parallel conduct in acting to prevent the CLECs from competing.

Judge Gerald Lynch of the United States District Court for the Southern District of New York dismissed the complaint for failure to state a claim, noting that allegations of parallel business conduct alone, without some facts excluding “independent self interested conduct” as an explanation for that parallel behavior, are insufficient to allege a claim under §1. The Court of Appeals for the Second Circuit reversed, ruling that such “plus factors were not required” for an antitrust claim based on parallel conduct to survive dismissal.

The Twombly Opinion

Justice Souter, writing for a 7-2 majority, addressed what plaintiffs are required to allege in order to survive a motion to dismiss under Rule 8(a)’s notice pleading standard. While acknowledging that a complaint does not need to contain detailed factual allegations, the Court held that “factual allegations must be enough to raise a right to relief above the speculative level.” In the context of a Sherman Act §1 claim, this means that a complaint must present facts suggesting that an agreement was made – facts presenting plausible, not just possible, grounds that an agreement was made. The complaint must show enough facts to “raise a reasonable expectation that discovery will reveal evidence of an unlawful agreement.” Allegations of only parallel conduct that are consistent with an illegal agreement are not enough to render an illegal agreement plausible because without more that conduct does not necessarily suggest a conspiracy occurred.

The Court held that such a standard of plausibility was well within the requirements of Rule 8(a). Mere allegations of parallel conduct “sto[p] short” of the “fine between possibility and plausibility of ‘entitlement to relief.’” The Court identified as a significant reason for requiring plaintiffs to plead plausible allegations, the fact that discovery in antitrust cases “can be expensive.”
Specifically, the Court recognized that the scope of discovery regarding the putative class would mean “many thousands of employees generating reams and gigabytes of business records.” Moreover, the Court observed that applying a plausibility requirement at the pleading stage was necessary because “it is self-evident that the problem of discovery abuse cannot be solved by ‘careful scrutiny of evidence at the summary judgment stage,’ much less ‘lucid instructions to jurors’” and “the threat of discovery expense will push cost-conscious defendants to settle even anemic cases before reaching those proceedings.” The Court cited its analysis in the Dura Pharmaceuticals, Inc. v. Broudo decision, noting that in that case it required something more beyond the mere possibility of loss causation must be pled in order for a securities complaint to survive a motion to dismiss. The concern is that courts must be cautious before allowing a meritless claim to proceed into often expensive discovery.

The Court dismissed plaintiffs’ arguments that this articulation of the pleading standard conflicted with Rule 8(a), or Justice Black’s discussion of the appropriate standard in Conley. In Conley, Justice Black wrote that it was an “accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.” Justice Souter observed that this language can be read, and has been read, to say that “any statement revealing the theory of the claim will suffice unless its factual impossibility may be shown from the pleadings.” Under such a standard, any conclusory claim could be allowed to proceed as long as the court determined that plaintiff might discover some undisclosed facts supporting recovery. This would dispense with the requirement that a plaintiff present some “reasonably founded hope” that it can make a claim.

The Court held that descriptions of behavior commonly alleged to be wrongful or illegal can often be just as easily innocuous conduct. With respect to the issue of what constitutes anticompetitive behavior in violation of §1, the Court noted that the most important question is whether the challenged behavior comes from an “independent decision or from an agreement, tacit or express.” Neither parallel conduct nor “conscious parallelism” are unlawful by themselves and though such behavior may be grounds for inferring an agreement not to compete, they are insufficient by themselves to conclusively establish an agreement. The Court noted that this requirement reflected the fact that much of the parallel conduct commonly complained of is inherently ambiguous: “consistent with conspiracy, but just as much in line with a wide swath of rational and competitive business strategy unilaterally prompted by common perceptions of the market.” In this light, the Court concluded that the “no set of facts” language from Conley is “best forgotten as an incomplete, negative gloss on an accepted pleading standard: once a claim has been stated adequately, it may be supported by showing any set of facts consistent with the allegations in the complaint.”

**Twombly’s Applicability to Securities Cases**

The Court's analysis of Rule 8(a) in Twombly, while specifically addressing the pleading of an antitrust claim, is not limited to that realm. The Court's rejection of the "no set of facts" language in Conley and its holding that a complaint must plead facts suggesting plausible grounds for relief, is generally applicable to other types of litigation. Indeed, there has been no delay in lower federal courts relying upon the Twombly decision in ruling upon motions to dismiss in a variety of non-antitrust cases. The Supreme Court has itself already cited to Twombly in describing the requirements for notice pleading under Rule 8(b) in at least one non antitrust case. Federal courts are also beginning to apply Twombly to securities litigation actions in which the notice pleading standard is appropriate.

**Shareholder Derivative Actions**

The Twombly decision raises the minimum pleading requirements for certain types of claims that are commonly asserted in shareholder derivative actions. Prior to the Twombly decision, many courts had applied Conley’s broader “no set of facts” test to determine whether non-demand and non-fraud shareholder derivative claims should be dismissed.
At least one court has already applied the holding of Twombly in ruling upon a motion to dismiss in a shareholder derivative action, quoting from Twombly that “a plaintiff’s obligation to provide the ‘ground’ of his ‘entitlement to relief’ requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do.” See In re Zoran Corp. Deriv. Litig., 2007 WL 1650948, *6 (N.D. Cal. June 5, 2007) (granting in part and denying in part motions to strike and to dismiss a derivative complaint relating to allegations of stock option backdating). In the Zoran decision, the defendants’ motion to dismiss breach of fiduciary duty claims against directors and officers of the company was denied where the complaint alleged facts in detail concerning plaintiffs’ use of an expert to analyze alleged favorable backdated grants and the statistical chances of selecting those grants, which the court concluded demonstrated a “striking pattern” which “seems hugely suspicious” with respect to at least one of the option grants at issue.25 After concluding that these allegations were sufficient to meet the heightened pleading requirements for securities fraud under the Reform Act, the court held that the claims for breaches of fiduciary duty based upon the same allegations were also sufficiently pled.26

Although the derivative claims in Zoran largely survived the defendants’ motion to dismiss, many derivative complaints, including those based on options backdating allegations, contain claims with far less detailed allegations. Under Twombly, non-fraud claims in derivative actions that do not involve demand issues, such as breach of fiduciary duty, negligence, and similar claims, must now be pled with facts sufficient to suggest that the allegations are plausible in order to survive the pleading stage. In the stock option backdating context, this will generally make it more difficult for plaintiffs to adequately plead claims of fiduciary breaches because those claims are often filed before the company’s internal investigation on those matters has been completed, and no publicly available conclusions or findings have yet been made. In many cases, the information available to plaintiffs at the time they file their complaint will not be sufficient to support a credible expert analysis as the plaintiffs were able to prepare in Zoran.

Securities Act Claims

Many courts have regularly applied the “no set of facts” language in denying defendants’ motions to dismiss claims brought under Sections 11 and 12 of the Securities Act.27 Although there is a split of authority regarding whether Securities Act claims are subject to Rule 9(b)’s heightened pleading requirement when “grounded in fraud” rather than negligence,28 most courts have agreed that the notice pleading requirements of Rule 8(b) apply when those claims unquestionably do not sound in fraud.

A common argument made by plaintiffs in opposition to motions to dismiss Securities Act claims is that they are essentially strict liability claims in that all plaintiffs must plead and prove is the existence of a material misstatement or omission. Once such a material misstatement or omission has been pled, plaintiffs have argued that the inquiry need go no farther at the pleading stage. However, the higher pleading requirement of plausibility set forth in Twombly means that plaintiffs must now plead sufficient facts to raise a reasonable expectation that discovery will reveal evidence of the materiality of the alleged misstatement or omission.

One example of how this could present a pleading problem on a Securities Act claim is where a misstatement or omission does not result in any discernible effect on the issuer’s stock price when the underlying “truth” is publicly disclosed. Notwithstanding the causation-related implications, the plausibility requirement strengthens the argument that the threshold requirement of materiality has not been sufficiently met. Under that scenario, it will be more difficult for a plaintiff to allege facts demonstrating a reasonable expectation that future evidence may show that the misstatement or omission was material.

Control Person Claims

Similarly, most federal courts prior to Twombly applied the broader “no set of facts” standard to determine whether Section 15 or 20(a) control person claims were adequately pled, while concurrently applying the Reform Act’s and Rule 9(b)’s heightened pleading requirements to the fraud claims alleged in the same complaint.29
Indeed, a number of district courts specifically relied upon the Second Circuit’s now reversed decision in *Twombly* to deny motions to dismiss control person claims pled in securities class actions. *See, e.g., In re Global Crossing, Ltd. Sec. Litig.,* 2005 WL 2990646, *8* (S.D.N.Y. Nov. 7, 2005) (“recent decisions, most notably the Second Circuit’s ruling in *Twombly* . . . emphasize that where Rule 8(a)’s pleading standard governs, dismissal is improper as long as the complaint furnishes adequate notice of the basis of the plaintiff’s claim (a requirement clearly satisfied here) and ‘relief could be granted under [some] set of facts consistent with the allegations.’”) (quotation omitted).

Under *Twombly*, it should no longer be sufficient to merely allege that an officer or director of a corporation was a control person within the meaning of the statutes. Plaintiffs alleging a control person claim under Section 15 or 20(a) are required to plead: (i) a primary violation of the securities laws; (ii) that defendant exercised actual power or control over the primary violator; and (iii) defendant possessed the power to directly or indirectly control the specific transaction or activity upon which the primary violation was predicated. Plaintiffs have previously had the burden of pleading and proving control person status, and of alleging facts identifying the acts or status which indicate control. Now, plaintiffs must plead sufficient facts showing not just that it is possible an individual was a control person, but that it is a plausible claim. As a practical matter, this may strengthen the ability of lower level and non-executive officers and outside directors to have control person claims against them dismissed.

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**Notes**

6. 425 F.3d 99, 114 (2d Cir. 2005).
8. *Id.* at 1965 (citing 5 C. Wright and A. Miller, Federal Practice and Procedure §1216, pp. 235-36 (3d ed. 2004)).
9. *Id.* at 1965 (emphasis added).
10. *Id.* at 1966 (quotation omitted).
11. *Id.* at 1967.
12. *Id.*
13. *Id.* at 1967 (quotation omitted).
17. *Id.* at 1969 (citing *Dura*, 544 U.S. 347).
18 Twombly, 127 S.Ct. at 1964 (citing Theatre Enterprises, Inc. v. Paramount Film Distributing Corp., 346 U.S. 547 (1954)).

19 127 S.Ct. at 1964.

20 Id. at 1969.


22 See Erickson v. Pardus, __, U.S. __, 127 S.Ct. 2197, 2200 (June 4, 2007) (pro se prisoner civil rights case).


26 Id. at *24-25.

27 In re DDI, Corp. Sec. Litig., 2005 WL 3090882, *10-13 (C.D. Cal. Jul. 21, 2005) (noting Rule 8(a)'s "extremely liberal pleading standard" in denying defendants' motion to dismiss Section 11 claims); Collmer v. U.S. Liquids, Inc., 268 F. Supp. 2d, 718, 756 (S.D. Tex. 2003) (holding that although plaintiffs' 10(b) claims were not pled with sufficient particularity, plaintiffs' Section 11 allegations were sufficient under Rule 8(a)).

28 See, e.g., Rombach v. Chang, 355 F.3d 164, 1717 (2d Cir. 2004) (“while a plaintiff need allege no more than negligence to proceed under Section 11 . . . claims that do rely upon averments of fraud are subject to the test of Rule 9(b)’’); Wagner v. First Horizon Pharm. Corp., 464 F.3d 1273, 1277 (11th Cir. 2002) (similar); Shapiro v. UJB Fin. Corp., 964 F.2d 272, 287-89 (3d Cir. 1992) (similar); Melder v. Morris, 27 F.3d 1097, 100 n.6 (5th Cir. 1994) (similar); Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990) (similar); In re Daou Systems, Inc., 411 F.3d 1006, 1027-28 (9th Cir. 2005) (but cf. In re NationsMarr Corp. Sec. Litig., 130 F.3d 309, 315 (8th Cir. 1997) (Rule 9(b) pleading particularity requirement does not apply to Section 11 claim because proof of fraud and scienter are not prerequisites); Lone Star Ladies Inv. Club v. Schlotzsky’s Inc., 238 F.3d 363 (5th Cir. 2001) (although Rule 9(b) applies to claims grounded in fraud, failure to comply does not warrant dismissal of Section 11 claim with prejudice).


31 Howard v. Everex Sys., Inc., 228 F.3d 1057, 1065-67 (9th Cir. 2000).
