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The Impact of *Iqbal* on Securities Class Actions

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Last year, in *Ashcroft v. Iqbal*, the Supreme Court held that Rule 8 of the Federal Rules of Civil Procedure requires a complaint to "contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'"[1] The Court explained: "A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged."[2]

Iqbal was a watershed decision. Supreme Court specialist Thomas C. Goldstein[3] referred to the decision as "the most significant Supreme Court decision in a decade for day-to-day litigation."[4] Nevertheless, *Iqbal* has barely provoked a yawn from many securities lawyers—especially those on the plaintiffs' side of the bar.

In this article, we answer four questions. First, why is *Iqbal* so important? Second, why is it receiving such little attention from securities lawyers? Third, how does *Iqbal* impact complaints that allege violations of the Securities Act of 1933? Fourth, how does *Iqbal* impact cases with claims raised under the Securities Exchange Act of 1934?

The Importance of *Iqbal*

Some background on Rule 8 and its interpretation shows why, if anything, Mr. Goldstein may have understated the significance of *Iqbal*.

Since 1957, lower courts had been required to apply the standard articulated by the Supreme Court in *Conley v. Gibson* when deciding whether to dismiss a claim. In *Conley*, the Supreme Court held 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."[5] A complaint only needed to "give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests."[6]

While the lower courts continually raised the pleading bar for certain types of claims, the Supreme Court's position remained the same.[7] In 1993, the Supreme Court unanimously stated: "In *Conley v. Gibson*, we

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said in effect that the Rule meant what it said."[8] And in 2002, the Supreme Court issued yet another unanimous opinion declaring, "Rule 8(a) establishes a pleading standard without regard to whether a claim will succeed on the merits."[9]

A mere five years later in 2007, a majority of seven Justices knocked the "no set of facts" standard loose from its mooring in *Bell Atlantic Corp. v. Twombly*, an antitrust case. In *Twombly*, the Court stated that "*Conley*'s 'no set of facts' language has been questioned, criticized, and explained away long enough," and declared that this standard had "earned its retirement."[10] The Court held that a complaint needed to state "enough factual matter" to make the claim "plausible."[11]

But just two weeks later, the Supreme Court gave reason to believe that while the "no set of facts" standard might be retired, notice pleading was still active. In *Erickson v. Pardus*, the Court issued a *per curiam* decision in a case involving a prisoner who filed a *pro se* suit against prison officials, alleging that they had wrongly terminated his liver treatment in violation of the Eighth and Fourteenth Amendments. After quoting *Twombly*, the Court explained:

> **The complaint stated that Dr. Bloor's decision to remove petitioner from his prescribed hepatitis C medication was "endangering [his] life." It alleged this medication was withheld "shortly after" petitioner had commenced a treatment program that would take one year, that he was "still in need of treatment for this disease," and that the prison officials were in the meantime refusing to provide treatment.[12]**

"This alone was enough to satisfy Rule 8(a)(2)," according to the Supreme Court. [13]

Twombly and *Erickson* left the lower courts confused and judges began to expressly state that the Supreme Court had given them "conflicting signals."[14] Jose Cabranes, a well-respected Second Circuit judge, even went so far as to write in a concurrence, "it is worth underscoring that some of those precedents are less than crystal clear and fully deserve reconsideration by the Supreme Court at the earliest opportunity; to say the least, 'the guidance they provide is not readily harmonized.'"[15] It isn't every day that judges ask the Supreme Court to reconsider its opinion or state that it is being "less than crystal clear."

Thus, the Supreme Court granted *certiorari* in *Iqbal*, a case in which Javaid Iqbal, a Pakistani Muslim, detained in the aftermath of the terrorist attacks on September 11, 2001, had sued, among other people, former U.S. Attorney General, John D. Ashcroft, and Robert S. Mueller, III, the current director of the Federal Bureau of Investigation. Iqbal alleged that they had violated the First and Fifth Amendments by imposing harsh conditions on him during his detention because of his race and religion.

The Supreme Court held that Iqbal had failed to state a claim under Rule 8 and, in so doing, a five-Justice majority made it clear that the new plausibility standard applies outside the context of antitrust claims. More importantly, *Iqbal* substantially raised the requirement as to what plaintiffs must plead in their complaints. *Iqbal* may be interpreted as "allow[ing] federal courts to dismiss a complaint whenever they believe that, given the allegations in the complaint, it is more likely than not that no illegal conduct occurred."[16] Notice pleading is dead.

Why Securities Lawyers, Especially on the Plaintiffs' Side, Are Ignoring *Iqbal*

Iqbal may be one of the most important cases of the last five decades, but securities lawyers seem to have paid little attention to it. The reasons, we believe, are fairly straight-forward. First, securities fraud actions have always been subject to a heightened pleading standard under Rule 9(b) of the Federal Rules of Civil Procedure. Second, since 1995, securities fraud actions have been subject to heightened pleading standards with respect to misleading statements and scienter under the Private Securities Litigation Reform Act of 1995 (PSLRA).[17]

Then, the Supreme Court's 2007 decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* put an exclamation point on the PSLRA's heightened pleading standard by holding that "[a] complaint

will survive … only if a 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."[18] Thus, the logic seems to go, if securities fraud plaintiffs are already burdened with Rule 9(b), the PSLRA and *Tellabs*, not to mention what appears to be an increasingly skeptical bench, *Iqbal*'s plausibility requirement should have little effect on motions to dismiss securities class actions.

But, as we explain below, this conclusion is myopic as *Iqbal's* heightening of Rule 8 promises to impact securities claims in significant ways.

How *Iqbal* Impacts Complaints with Securities Act Claims

As every securities lawyer knows, in the aftermath of the Great Depression, Congress enacted two landmark pieces of securities legislation: the Securities Act and the Exchange Act. The Securities Act regulates the offering and sale of securities in the initial markets, while the Exchange Act regulates the buying and selling of these securities in the aftermarkets (*e.g.*, on the NYSE).

Sections 11, 12(a)(2), and 15 of the Securities Act impose liability on certain participants in a registered securities offering when the publicly filed documents used during the offering contain material misstatements or omissions. Section 11 applies to registration statements, Section 12(a)(2) applies to prospectuses and oral communications, and Section 15 imposes liability on anyone who is a "control person" of a person who violates the Securities Act.

A purchaser of securities only needs to show a material misstatement or omission to establish a *prima facie* case. Once these elements are shown, liability is virtually absolute, even for innocent misstatements.[19] Intent to deceive is usually considered to be an essential characteristic of "fraud." Thus, Securities Acts claims are not fraud claims because plaintiffs do not need to prove anything about defendants' state of mind to prevail.

While the PSLRA amended both the Securities Act and Exchange Act, Congress was principally concerned with "securities fraud actions" at least with respect to imposing new pleading requirements. The subsection that raises the pleading standard is entitled, "Requirements for securities fraud actions."[20] Moreover, this subsection only applies to "any private action arising under this chapter…."[21] Courts have held that "this chapter" refers to the Exchange Act and therefore "the PSLRA pleading requirements have no application to claims that arise under Section 11 or other provisions of the Securities Act (*e.g.*, Section 15)."[22]

Courts have also held that Rule 9(b) of the Federal Rules of Civil Procedure does not apply to Securities Act claims because these are not securities fraud claims. Under Rule 9(b), "a party must state with particularity the circumstances constituting fraud or mistake." This rule, however, only applies when a party is in fact "alleging fraud or mistake . . . ."[23] Defendants will often argue that a Securities Act claim "sounds in fraud." Nonetheless, many courts have not accepted this argument on the grounds that intent is not an essential element of Securities Act claims and therefore only apply Rule 8.[24]

And that's one reason why *Iqbal* has, and will continue to have, an impact on securities class actions. Prior to *Iqbal*, lawyers could argue that investors merely needed to satisfy Rule 8 and *Conley*'s "no set of facts" standard when alleging Securities Act claims. After *Iqbal*, plaintiffs must plead facts that demonstrate their Securities Act claims are "plausible" on their face.

How much does heightening the pleading standard for Securities Act claims affect the approximately 170 to 200 securities class actions filed every year? For the last few years, investors have increasingly included Securities Act claims in their complaints. As Cornerstone Research has reported, "[t]he percentage of filings with Section 11 and Section 12(2) claims continued to increase in 2009, accounting for 26% and 24% of 2009 filings respectively."[25] The simple fact is that these claims are now more likely to be scrutinized under *Iqbal*.

Moreover, heightening the pleading requirements for Securities Act claims will likely affect the dismissal rates for Exchange Act claims as well. Jonathan Eisenberg, Of Counsel at Skadden, Arps, Slate, Meagher & Flom LLP, recently

authored an article entitled *Subprime Securities Class Action Decisions: Who's Winning, Who's Losing and Why*? "Curiously," Eisenberg wrote, "in every case in which claims under Section 10(b) were asserted in cases with Sections 11 and 12(a)(2) claims, plaintiffs' Section 10(b) claims survived motions to dismiss. In contrast, defendants prevailed two-thirds of the time when there were only Section 10(b) claims."[26]

We have a hypothesis for this curious finding. A court is much more likely to deny a motion to dismiss a Securities Act claim because only Rule 8 applies. Because the court then knows that discovery will commence and the case will remain on the court's docket regardless of whether it dismisses the Exchange Act claims, the court is more likely to allow all of the claims to survive. After all, allowing the claims to proceed is not going to substantially increase the burden to the defendant or court.

If this is true, then *Iqbal* will affect the dismissal rates for Exchange Act claims to the extent they are included in complaints that have Securities Act claims. Now that Securities Act claims will face increased scrutiny, courts are more likely to dismiss them and companion claims as well.

How *Iqbal* Impacts Complaints that Only Have Exchange Act Claims

Iqbal does more than affect complaints with Securities Act claims as it also heightens the pleading requirement for the various elements of a securities fraud claim that were untouched by the PSLRA. As the Supreme Court has explained: "In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[27]

The pleading requirements of the PSLRA only address a few of the elements—most notably, scienter, and specifying "each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading…."[28] For example, the PSLRA addresses loss causation in terms of what a plaintiff must prove by stating "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."[29]

Given the fundamental difference between pleading and proving, which Congress recognized in the text of the PSLRA, investors had a solid argument that they were only required to satisfy the Federal Rules for most of the elements of its claim. For example, under Rule 8, plaintiffs easily pleaded loss causation by providing "some indication of the loss and the causal connection" to the alleged fraud.[30]

Iqbal requires investors to plead more than a conclusory allegation. Even if Rule 8 only applies to loss causation, plaintiffs must now plead facts from which a court may draw the reasonable inference that the defendants' misstatements are the proximate cause of the investor's loss and therefore the defendant may be held liable. The same is true with respect to the other elements of a securities fraud claim such as materiality or, arguably, requirements such as subject matter jurisdiction.

The final way that *Iqbal* affects securities class actions with Exchange Act claims is more amorphous but perhaps the most profound: "The motion to dismiss," according to District Judge Shira Scheindlin of the United States District Court for the Southern District of New York, "may be seen as the new summary judgment motion, and we will see a continuing trend toward judges determining outcomes rather than juries."[31] Scholars have already found that, once the Supreme Court eliminated notice pleading, lower courts increasingly granted motions to dismiss civil rights and disability claims.[32] Since many judges have likewise disfavored securities fraud claims, one can expect the same result.

In short, absent congressional intervention that returns us back to notice pleading, every lawyer, including those who specialize in securities class actions, should expect to become very familiar with *Iqbal* and its progeny for decades to come.

NOTES

1. *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949, 173 L. Ed. 2d 868, 2009-2 Trade Cas. (CCH) ¶ 76785, 73 Fed. R. Serv. 3d 837 (2009)(quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007)).
2. *Iqbal*, 129 S. Ct. at 1949.
3. Thomas C. Goldstein is currently a partner and co-leader of the litigation management committee of Akin Gump Strauss Hauer & Feld LLP. Mr. Goldstein also is the publisher of SCOTUSBlog, one of the most widely read blogs on the activities and decisions of the Supreme Court.
4. Adam Liptak, *9/11 Case Could Bring Broad Shift on Civil Suits*, N.Y. Times, July 20, 2009 (quoting Thomas C. Goldstein).
5. *Conley v. Gibson*, 355 U.S. 41, 45-46, 8 S. Ct. 99, 2 L. Ed. 2d 80, 9 Fair Empl. Prac. Cas. (BNA) 439, 41 L.R.R.M. (BNA) 2089, 1 Empl. Prac. Dec. (CCH) P 9656, 33 Lab. Cas. (CCH) P 71077 (1957) (abrogated by, *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929, 2007-1 Trade Cas. (CCH) ¶ 75709, 68 Fed. R. Serv. 3d 661 (2007)).
6. *Conley,* 355 U.S. at 47.
7. See Fairman, *The Myth of Notice Pleading*, 45 Ariz. L. Rev. 987, 1014-15 (2003); Marcus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 Colum. L. Rev. 433, 433 (1986).
8. *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 168, 113 S. Ct. 1160, 122 L. Ed. 2d 517, 8 I.E.R. Cas. (BNA) 428, 25 Fed. R. Serv. 3d 1 (1993).
9. *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 515, 122 S. Ct. 992, 152 L. Ed. 2d 1, 88 Fair Empl. Prac. Cas. (BNA) 1, 82 Empl. Prac. Dec. (CCH) P 40899, 51 Fed. R. Serv. 3d 781, 182 A.L.R. Fed. 725 (2002).
10. *Twombly*, 550 U.S. at 546, 562-563.
11. *Twombly,* 550 U.S. at 556.
12. *Erickson v. Pardus*, 551 U.S. 89, 94, 127 S. Ct. 2197, 167 L. Ed. 2d 1081 (2007).
13. *Erickson*, 551 U.S. 89.
14. *Iqbal*, 490 F.3d at 157.
15. *Iqbal,* 490 F.3d at 178.
16. *Pleading Standards*, 123 Harv. L. Rev. 252, 253 (2009).
17. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.); *see also* PSLRA, 15 U.S.C.A. § 78u-4(b) (entitled "Requirements for securities fraud actions").
18. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007).
19. *Panther Partners Inc. v. Ikanos Communications, Inc.*, 2009 WL 2959883 (2d Cir. 2009).
20. PSLRA, 15 U.S.C.A. § 78u-4(b).
21. PSLRA, 15 U.S.C.A. § 78u-4(b).
22. In re Initial Public Offering Securities Litigation, 241 F. Supp. 2d 281, 338, Fed. Sec. L. Rep. (CCH) P 92282 (S.D. N.Y. 2003) (*IPO*).
23. Fed. R. Civ. P. 9(b).
24. *See generally IPO*, 241 F. Supp. 2d at 338.
25. Cornerstone Research, *Securities Class Action Filings 2009: A Year in Review* at 26 (2010), *available at* http://securities.cornerstone.com/pdfs/Cornerstone_Research_Filings_2009_YIR.pdf.
26. Eisenberg, *Subprime Securities Class Action Decisions: Who's Winning, Who's Losing and Why*?, Bloomberg L.R., Jan. 2010, *available at* http://www.skadden.com/content/Publications/Publications1962_0.pdf.
27. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157, 128 S. Ct. 761, 169 L.Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008).
28. PSLRA, 15 U.S.C.A. § 78u-4(b)(1).
29. PSLRA, 15 U.S.C.A. § 78u-4(b)(4).
30. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 347, 125 S. Ct. 1627, 161 L. Ed. 2d 577, Blue Sky L. Rep. (CCH) P 74529, Fed. Sec. L. Rep. (CCH) P 93218 (2005).
31. Scheindlin, *The Future of Litigation*, N.Y. L.J., Feb. 5, 2010, *available at* http://www.nylj.com/nylawyer/adgifs/decisions/020510scheindlin.pdf.
32. *See* Scheindlin, *The Future of Litigation*, at nn.13 & 14 (citing Hatmayar, *The Tao of Pleading: Do Twombly and Iqbal Matter Empirically?*, AM. U. L. Rev. 553 (2010), *available at* http:// ssrn.com/abstract=1487764; Steiner, *Pleading Disability*, 51 B.C. L. Rev._, 30 (forthcoming)).