No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INC., ET AL. ,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF FOR THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, BDO SEIDMAN, LLP, DELOITTE & TOUCHE USA LLP, ERNST & YOUNG LLP, GRANT THORNTON LLP, KPMG LLP, AND PRICEWATERHOUSECOOPERS LLP AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF AMICI CURIAE*

Amici curiae include the American Institute of Certified Public Accountants (AICPA), the national organization of the certified public accounting profession. The AICPA's nearly 340,000 members, all of whom are certified public accountants, provide accounting services to companies through firms of all sizes, as solo practitioners, and as employees of companies, governments, and academic institutions. Among the AICPA's most important roles is the promotion and maintenance of high professional standards among its members. To this end, the AICPA has been a principal force in developing accounting and auditing standards, drafting model legislation, sponsoring educational programs, and issuing professional publications to improve the quality of the services provided by accountants. The AICPA also has a strong interest in judicial decisions affecting the scope and bases of accountants' liability under the federal securities laws, and has participated as *amicus* in some of this Court's most significant securities-fraud cases. *See*, *e.g.*, *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336 (2005); *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

Amici also include America's leading accounting firms: BDO Seidman, LLP, Deloitte & Touche USA LLP, Ernst & Young LLP, Grant Thornton LLP, KPMG LLP, and PricewaterhouseCoopers LLP. Collectively, these *amici* provide audit services to most of the publicly owned companies whose shares are traded on American exchanges. As a result of their audit engagements, accountants are regularly named as defendants in private lawsuits filed under the federal securities laws. Accordingly, *amici* have a keen interest in cases,

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* This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici*, their members, and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of the brief and copies of their letters of consent have been lodged with the Clerk of the Court.

such as this one, concerning the standards required to plead and prove a securities-fraud violation. Accounting firms have previously participated in such cases in this Court, either as *amici*, *e.g.*, *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), or as parties, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

The present case concerns the pleadings standards established by the Private Securities Litigation Reform Act of 1995 (PSLRA). In the PSLRA, Congress required securities-fraud plaintiffs to plead particularized facts leading to a "strong inference" that each defendant acted, or failed to act, with the requisite "*scienter*"—the culpable mental state necessary to establish liability under the federal securities laws. 15 U.S.C. § 78u-4(b)(2). This rigorous pleading standard is of particular importance to secondary actors such as auditors, who often are targeted when those more centrally involved in the alleged misconduct are unavailable or have become judgment-proof. *See* S. Rep. No. 98, 104th Cong., 1st Sess. 9 (1995) ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant in a securities class action.").

SUMMARY OF ARGUMENT

To discourage frivolous securities-fraud litigation, Congress requires private plaintiffs to plead "with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

I. The plain language of the PSLRA—which requires a "strong inference" of *scienter*—imposes meaningful constraints on a private plaintiff attempting to plead a securities-fraud case. An "inference" is a conclusion drawn from facts assumed be true. "Strong" in this context means "cogent" or "convincing." Reading the PSLRA in light of these definitions, the plaintiff must plead particularized facts that, if proven, lead convincingly to the conclusion that the defendant acted with *scienter*. This construction has two corollaries.

First, to be "strong," an inference must be more than merely plausible or possible. Rather, the plaintiff must plead facts from which a reasonable person would be convinced of the defendant's mental state. This can be considered an *absolute* constraint on the pleading.

Second, to be "strong," an inference must be free of significant doubt. Rather, the plaintiff must plead facts from which a reasonable person would be convinced of the defendant's culpable mental state despite—or when compared to—alternative innocent explanations. This can be considered a *relative* constraint on the pleading.

Both the absolute and the relative constraints on the pleading are implicit in the words used by Congress and are necessary to give effect to the statutory standard of "strong inference." A particular inference of *scienter* might be plausible, but unlikely; such an inference would not be "strong" in the absolute sense. Likewise, an inference could be likely, but no more likely than the alternatives; such an inference would not be "strong" in the relative sense. Thus, to satisfy the "strong inference" standard of the PSLRA, the particularized facts must give rise to an inference of *scienter* that is both (absolutely) likely and (relatively) more likely than competing non-culpable inferences.

II. The policies that led Congress to enact the PSLRA support imposition of meaningful constraints on the pleading. Congress sought to prevent and deter meritless "strike suits." Imposing an absolute threshold on securities plaintiffs will further the congressional objective by precluding suits in which intentional misconduct is not a forceful conclusion from available evidence. Similarly, imposing a relative check will preclude suits in which the plaintiffs' theory is placed into significant doubt by the available alternative explanations.

Meaningful constraints are of particular importance in claims against peripheral actors such as auditors, who often are targeted when those more directly responsible for the alleged misconduct are unavailable or have become judgment-proof. Congress was concerned about the impact of vexatious litigation on secondary actors such as accounting firms when it passed the PSLRA. The audit process involves the application of judgment to complex, and potentially competing, accounting pronouncements. To effectuate Congress's intent in enacting the PSLRA, a plaintiff suing an auditor must plead facts that, if proven, would convince a reasonable person both that the auditor departed from the wide zone of discretion afforded under applicable professional standards and that such departure was made with the requisite mental state. Absent particular facts from which a reasonable person should *strongly infer* intentional misconduct, accounting firms and others should not face the crippling expense of defending against securities lawsuits.

III. Giving full effect to the pleading requirements imposed by the PSLRA creates no concern under the Seventh Amendment. Consistent with its power to define what type of securities-fraud claims can be redressed in federal court and to legislate the "forms and procedure" for litigation in federal court, Congress may establish evidentiary and pleading standards that a plaintiff must meet *before* its case is submitted to the jury. That is precisely what Congress did in setting the "strong inference" threshold for access to federal court by securities plaintiffs. Enforcing that threshold by requiring that the inference raised by a plaintiff's allegations is, in fact, "strong" presents no constitutional difficulty.

ARGUMENT

Most private securities lawsuits allege a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5. Securities fraud under the statute and rule is an intentional tort; negligent conduct is not actionable. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214-15 (1976). As this Court recently emphasized, a required element in a 10b-5 action is "*scienter*, *i.e.*, a wrongful state of mind." *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 341 (2005).

Securities-fraud claims against auditors are typically premised on the auditors' alleged failure to detect a fraud allegedly committed by the public company audit client, with the result that the auditors' report on the company's financial statements is said to be false. But errors in the financial statements do not in themselves establish that the auditors departed from the requisite standard of care in auditing those statements, much less that they did so with *scienter*. Nonetheless, claims of "audit failure" are easy to make, and are extremely costly for auditors to defend against. As this Court has observed, "[l]itigation under 10b-5 . . . requires secondary actors to expend large sums even for pretrial defense and the negotiation of settlements." *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 189 (1994) (highlighting statements in the congressional record that in 83% of Rule 10b-5 cases major accounting firms pay $8 in legal fees for every $1 paid in claims). When such "peripheral defendants are sued, the pressure to settle is overwhelming—regardless of the defendant's culpability." S. Rep. No. 98, 104th Cong., 1st Sess. 21 (1995).

Concluding that the "private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits," Congress enacted the PSLRA in 1995 to "implement[] needed procedural protections to discourage frivolous litigation." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31-32 (1995); *see*, *e.g.*, *Behlen* v. *Merrill Lynch*, 311 F.3d 1087, 1091 (11th Cir. 2002), *cert. denied*, 539 U.S. 927 (2003); *Lander* v. *Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001). One of the PSLRA's most significant reforms was the creation of new and rigorous pleading requirements for private securities fraud actions. 15 U.S.C. § 78u-4; *see*, *e.g.*, *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 978-79 (9th Cir. 1999); Christopher M. Fairman, *Heightened Pleading*, 81 Tex. L. Rev. 551, 600 (2002) ("Congressional motivation for enacting the [heightened pleading standards of the] PSLRA was [that] . . . private securities fraud litigation was seen as largely frivolous").

With respect to *scienter*, the PSLRA requires a civil plaintiff to plead "with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added). Construing this provision, the Seventh Circuit held that it "will 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." Pet. App. 20a (emphasis added). The Seventh Circuit also refused to consider competing inferences in evaluating the sufficiency of the complaint. *Id.* at 20a-21a. As explained below, the Seventh Circuit got it wrong.

I. The Plain Language Of The PSLRA Requires That The Scienter "Inference" Be "Strong"

In construing a statute, this Court begins, of course, with the plain language of the statute. *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-54 (1992). Congress used a particular formulation—"strong inference"—in describing the conclusion a reasonable person would have to draw from particularized factual allegations in order for a securities-fraud complaint to survive a motion to dismiss. Where, as here, Congress uses ordinary words, this Court will give them their ordinary meaning. *FDIC* v. *Meyer*, 510 U.S. 471, 476 (1994).

An inference is "a truth or proposition drawn from another which is admitted or supposed to be true," or "a logical conclusion from given data or premises." *Webster's New International Dictionary* 1273 (2d ed. 1949); *see also*, *e.g.*, *Black's Law Dictionary* 793 (8th ed. 2004) (a "conclusion reached by considering other facts and deducing a logical consequence from them"); *Merriam-Webster's Collegiate Dictionary* 598 (10th ed. 1996) ("the act of passing from one proposition . . . considered as true to another whose truth is believed to follow from that of the former").

When referring to an argument or evidence, "strong" means "powerful[,] forcible[,] [or] cogent." *Webster's*, *supra*, at 2499; *see also*, *e.g.*, *Black's Law Dictionary* 1423 (6th ed. 1990) ("cogent, powerful, forcible, forceful"); *Merriam-Webster's*, *supra*, at 1166 ("forceful" or "cogent"). "Cogent," in turn, means "convincing or strongly tending to convince," or "compelling." *Webster's*, *supra*, at 520. And "convincing" means "[s]atisfying or assuring by argument or proof." *Id.* at 584.

Reading the PSLRA in light of these definitions, the plaintiff must plead particularized facts that, if proven, lead convincingly to, or "compel," the conclusion that the defendant acted with the requisite mental state. This construction has two important corollaries.

First, a "strong inference"—a proposition that convincingly follows from the factual allegations—must be more than merely plausible or possible. Rather, a plaintiff must plead facts from which, if true, a reasonable person would be *convinced* ("satisf[ied] or assur[ed]") that the defendant had the requisite mental state. This can be considered an *absolute* constraint on the pleading—that is, regardless of the strength or weakness of other possible inferences, the plaintiff's proposed inference must, on its own terms, be "strong."

It is not enough, as the Seventh Circuit thought, for a plaintiff to plead facts from which a jury "could infer" *scienter*. Such a standard means only that the complaint contains allegations from which, if proven, a rational trier of fact *might* conceivably infer that the defendant acted intentionally—but might not. This merely restates the standard under pre-PSLRA law, which provided that a complaint would be sustained if the allegations raised *an* inference of *scienter*. *Conley* v. *Gibson*, 355 U.S. 41, 45-46 (1957) (motion to dismiss should not be granted "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"). Congress clearly intended the PSLRA to impose a *higher* pleading standard in securities-fraud actions. But the Seventh Circuit's "could infer" formulation does not give effect to the changes wrought by Congress in enacting the PSLRA, particularly the statutory requirement that the plaintiff must plead specific facts giving rise to a *strong* inference of the requisite mental state, and thus impermissibly renders the PSLRA's "strong inference" standard superfluous. *Pennsylvania Dep't of Pub. Welfare* v. *Davenport*, 495 U.S. 552, 562 (1990) ("Our cases express a deep reluctance to interpret a statutory provision so as to render superfluous other provisions in the same enactment"); *United States* v. *Menasche*, 348 U.S. 528, 538-39 (1955) ("It is our duty 'to give effect, if possible, to every clause and word of a statute'") (citation omitted).

Where securities plaintiffs have not alleged anything that convincingly shows *scienter*, they cannot rest on that non-allegation. In *PR Diamonds, Inc.* v. *Chandler*, 364 F.3d 671 (6th Cir. 2004), for example, the plaintiffs alleged that auditors acted with *scienter* in failing to discover that the accounts receivable reserve was understated, because the auditors could see that in the particular year, revenue increased by 8 percent but the accounts receivable increased by 14 percent. *Id.* at 693. Of course, absent more, an increase in accounts receivable relative to revenue is equally consistent with an accurate reserve, so the court held that the facts did not give rise to an adequate allegation of *scienter* because plaintiffs made "no specific allegation that [the auditors] knew that certain accounts were not collectible." *Id.* at 695. That conclusion was unquestionably correct. *Cf. Associated Gen. Contractors* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983) ("It is not . . . proper to assume that [a plaintiff] can prove facts that it has not alleged or that the defendants have violated the antitrust laws in ways that have not been alleged").

A recurrent problem in securities-fraud cases is that allegations might raise, at best, only a *weak* inference of *scienter*. For instance, companies and their auditors are often sued based on the mere presence of an accounting mistake and an allegation that the mistake must have been made (or concealed) intentionally because of the desire for continued or increased financial rewards. But such an inference of *scienter*, if accepted, would lead to the absurd result that all people who fear losing their job would be deemed to have an intent to defraud, deceive or manipulate. *See*, *e.g.*, *Acito* v. *Imcera Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) ("Plaintiffs' allegation that defendants were motivated to defraud the public because an inflated stock price would increase their compensation is without merit. If scienter could be pleaded on that basis alone, virtually every company in the United States that experiences a downturn in stock price could be forced to defend securities fraud actions."); *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) ("To allege a motive sufficient to support the inference [of fraudulent intent], a plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold").

Accounting firms have even less direct financial incentive to commit or condone fraud than those who manage a company and whose compensation might be closely tied to reported profits or increases in stock price. Indeed, auditors have little to gain but much to lose by not exposing a client's fraud—*i.e.*, by issuing a misleading audit report. *See*, *e.g.*, *DiLeo* v. *Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses [the accountant] would suffer from a perception that it would muffle a client's fraud."); *Melder* v. *Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) (rejecting as "economically irrational" plaintiff's proposed *scienter* inference based on accounting firm's purported motive to garner fees). An auditor's receipt of its normal fees thus raises no inference of intentional misconduct. *A fortiori*, the congressional requirement of a "strong inference" cannot be met by such allegations. The same is true with respect to other routine aspects of the audit process, such as the auditors' access to the books and records of a corporation.

Second, to be "convincing," a proposition must be free of significant doubt. *See Webster's*, *supra*, at 584 ("[t]o convince" means "to bring by argument to yield assent or have belief beyond doubt"); *Oxford English Dictionary* 879-80 (2d ed. 1989) ("convincing" means evidence that "brings conviction to the mind"; a "conviction" is a "strong belief on the ground of satisfactory reasons or evidence"). Accordingly, a plaintiff's proposed inference must be compelling despite—or when compared to—alternative explanations, including those raised by the absence of factual averments. This does not mean, of course, that plaintiffs must prove an inference beyond any reasonable doubt. But the doubt cannot be *as* plausible as the inference, otherwise the inference could not be said to follow from the alleged facts. It cannot be at the same time true that one is both "convinced" and also has significant doubt about a given proposition, such as whether the defendant acted with the requisite mental state. This can be considered a *relative* constraint on the pleading—that is, the court cannot exclude or ignore the doubt raised by alternative inferences in evaluating whether the inference raised by the plaintiff's allegations is "strong."

Indeed, this Court has already recognized that a plaintiff must show that the inference of *scienter* is "reasonable in light of the *competing inferences* of [innocent] action" that can also be drawn from the given facts. *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (emphasis added). *Matsushita* relied on *Monsanto Co.* v. *Spray-Rite Service Corp.*, 465 U.S. 752 (1984), which had held "that conduct as consistent with permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy." *Matsushita,* 475 U.S. at 588. Accordingly, *Matsushita and Monsanto* teach that, in determining intent based on circumstantial evidence, competing inferences must be weighed.

Although *Matsushita* and *Monsanto* were antitrust cases, it was the requirement of intentional conduct and not the nature of the underlying claim that limited the range of permissible inferences. *Monsanto* explained that "[t]o permit the inference of *concerted* action" on the basis of conduct that is equally consistent with independent action would "emasculate the terms of the statute." 465 U.S. at 764 (internal quotation marks omitted, alteration in original). That is, the term "concerted" would be read out of the statute if one could reasonably infer, from the anti-competitive effect of an action, that the action was "in concert" (*i.e.*, that there was anti-competitive intent) notwithstanding that the given facts equally support an "inference" of "independent action" (*i.e.*, an innocent state of mind). Similarly, the requirement of "*scienter*" would be read out of the securities laws if it would be permissible to infer *scienter* from the mere presence of facts that are equally consistent with innocent behavior.

Brown v. *Credit Suisse First Boston LLC*, 431 F.3d 36 (1st Cir. 2005), illustrates this point. In dismissing the complaint, the court of appeals explained that the fact that a stock analyst believed that a company's competitors had more robust growth than the company did not give rise to an inference that the analyst issued a "buy" recommendation against his personal belief, because the analyst might have rated the competitors as "strong buys" (based on their "strong" growth) when he gave the company a less aggressive, though still positive, "buy" rating (based on its "reasonable" growth). The court criticized the complaint for leaving "these and a myriad of other possibilities wide open," that is, for failing to allege sufficient additional facts that would make the fraud inference more likely. *Id.* at 51.

It also frequently occurs that the complaint pleads facts that negate, or undermine, any inference of *scienter* on behalf of a particular defendant. For example, a complaint alleging that the company concealed the fraud effectively negates *scienter* on the part of the auditor. *See*, *e.g.*, *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 390 (D. Md.

2004). The most convincing inference here is not that the accountants were in on the alleged scheme, but that they were tricked or misled by their client (and thus should be dismissed from the lawsuit). Refusing to consider the inference raised by the "concealment" allegation cannot be reconciled with the statutory directive to dismiss complaints that do not allege facts giving rise to a *strong* inference of *scienter*.

* * *

Both the absolute and the relative constraints on the pleading are implicit in the words used by Congress and are necessary to give effect to the statutory standard of "strong inference." A particular inference of *scienter* might be plausible, but unlikely; such an inference would not be "strong" in the absolute sense. Likewise, an inference could be likely, but no more likely than the alternatives; such an inference would not be "strong" in the relative sense. Thus, to satisfy the "strong inference" standard of the PSLRA, the particularized facts must give rise to an inference of *scienter* that is both (absolutely) likely and (relatively) more likely than competing non-culpable inferences.

II. The Policies Animating The PSLRA Require Meaningful Constraints On Scienter Pleading

The legislative history of the PSLRA shows that Congress sought to prevent and deter meritless "strike suits" that forced securities defendants to capitulate to avoid the massive costs of discovery and merits litigation. According to the Conference Committee, the PSLRA was intended to eliminate some of the abuses experienced in private securities litigation, such as "the routine filing of lawsuits . . . whenever there is a significant change in an issuer's stock price," the "abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle, and with only faint hope that the discovery process might lead eventually to some plausible cause of action," and the "manipulation by class action lawyers of the clients they purportedly represent." *See* H.R. Conf. Rep. No. 369, *supra*, at 31.

The "strong inference" language in the PSLRA was drawn from a line of Second Circuit decisions that imposed a heightened pleading standard on securities-fraud plaintiffs. *See*, *e.g.*, S. Rep. No. 98, *supra*, at 15 ("[T]he Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit. Regarded as the most stringent pleading standard, the Second Circuit requires that the plaintiff plead facts that give rise to a strong inference of defendant's fraudulent intent."); H.R. Conf. Rep. No. 369, *supra*, at 41 (the "Conference Committee language is based *in part* on the pleading standard of the Second Circuit," which was "[r]egarded as the most stringent pleading standard") (emphasis added). The legislative history thus shows that Congress sought to impose a standard that was at least as demanding as that applied in the Second Circuit. *See Nathenson* v. *Zonagen Inc.*, 267 F.3d 400, 412 (5th Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531-35 (3rd Cir. 1999). The Conference Committee pointedly stated, however, that "it d[id] not intend to codify the Second Circuit's case law interpreting this pleading standard." *Id*. at 532; *see also* H.R. Conf. Rep. No. 369, *supra*, at 41 n.23 ("For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness"). Accordingly, the Court should construe the "strong inference" standard—which is "no less" stringent than that of the Second Circuit—without the gloss that the Second Circuit has applied to that phrase.

Imposing an absolute threshold on securities plaintiffs will further the congressional objective by precluding suits in which intentional misconduct is not a forceful conclusion from available evidence. Similarly, imposing a relative check will preclude suits in which the plaintiffs' theory is placed into significant doubt by the available alternative explanations. The imposition of these requirements will not deter meritorious lawsuits, because cases in which adequate information is alleged are mostly likely to present a "strong inference" of *scienter*. Of course, cases with insufficient, conclusory information will be precluded; but that, after all, was the purpose of the PSLRA.

Meaningful constraints are of particular importance in claims against peripheral actors such as auditors, who often are targeted when those more directly responsible for the alleged misconduct are unavailable or have become judgment-proof. Congress was concerned about the impact of vexatious litigation on secondary actors such as accounting firms when it passed the PSLRA. *See* S. Rep. No. 98, *supra*, at 9 ("Underwriters, lawyers, accountants, and other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a *marginal* party will be named as a defendant in a securities class action") (emphasis added); *id*. at 21 (when "peripheral defendants are sued, the pressure to settle is overwhelming—regardless of the defendant's culpability").

Since this Court's rejection of secondary liability in *Central Bank*, accounting firms can no longer be sued for aiding and abetting securities fraud. But accounting firms are still sued, as they were in aiding and abetting cases, for peripheral conduct. In the decade since *Central Bank*, securities plaintiffs usually have sued accounting firms not for participating in a scheme to defraud with the audited company, but for their audit report—due to a failure to detect the accounting errors or fraud *committed by the audited company*. Although some plaintiffs have alleged that an audit report is misleading merely because it states that, in the auditor's opinion, the financial statements "fairly present" the financial position of the company, the auditors' alleged misstatement would not have happened absent an underlying error or fraud committed by the client in the first place. In that sense, the auditor's conduct remains secondary to the underlying fraud.

The main difference between the aiding-and-abetting suits filed before *Central Bank* and "primary" liability cases is the presence of an allegedly false or misleading sentence in the auditor's report—*i.e.*, that, in the auditor's opinion, the company's financial statements have been presented in accordance with generally accepted accounting principles. But even an attestation that appears incorrect in hindsight does not prove that it was made with an "intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 185, 188. To the contrary, without more, failure to detect fraud by others usually involves at most negligent conduct, which does not violate the securities laws. *Ibid*. In the accounting context, moreover, errors in the company's financial statements do not in themselves establish that the auditors departed from the requisite standard of care in auditing those statements, much less that they did so with *scienter*. Due to the sampling nature of an audit and the necessity to rely on information received from the client, "even a properly planned and performed audit may not detect a material misstatement resulting from fraud." SAS 99 (§ 316.12) (AICPA 2002); *see also Bily* v. *Arthur Young & Co.*, 834 P.2d 745, 749 (Cal. 1992) ("For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business. The planning and execution of an audit therefore require a high degree of professional skill and judgment."); *In re IKON Office Solutions, Inc.*, 277 F.3d 658, 673 (3d Cir. 2002) ("[E]ven an audit conducted in strict accordance with professional standards countenances some degree of calibration for tolerable error which, on occasion, may result in a failure to detect a material omission or misstatement").

The PSLRA was enacted, in part, to prevent the reflexive naming of accountants as defendants without regard to actual conduct. H.R. Conf. Rep. No. 369, *supra*, at 31 (noting that the PSLRA was meant to reduce abusive suits, particularly "the targeting of deep pocket defendants, including accountants . . . , without regard to their actual culpability"). But a decade after the PSLRA's enactment, the liability exposure of accounting firms "exceeds the combined partner capital of the Big Four firms." Interim Report of the Committee on Capital Markets Regulation 87 (2006) available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_R eportREV2.pdf. "Any future lawsuits would only aggravate the exposure problem," because (*inter alia*) "[l]arge audit firms self-insure because third party insurance is unavailable." *Ibid*. The liability exposure also decreases the ability of accounting firms to retain and hire qualified talent, which could significantly reduce audit capacity for the thousands of companies requiring audit services. *Ibid*. "More fundamentally, such litigation could bankrupt another Big Four firm, with disastrous consequences for corporate governance worldwide." *Id*. at 86.

The audit process involves the application of judgment to complex, and potentially competing, accounting pronouncements. *See*, *e.g.*, *Shalala* v. *Guernsey Mem'l Hosp.*, 514 U.S. 87, 100 (1995) ("Financial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a 'process [that] involves continuous judgments and estimates.'") (alteration in original; citation omitted); *see also id.* at 101 ("There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question"); *Bily*, 834 P.2d at 763 ("[The audit] report is the final product of a complex process involving discretion and judgment on the part of the auditor at every stage. Using different initial assumptions and approaches, different sampling techniques, and the wisdom of 20-20 hindsight, few CPA audits [are] immune from criticism."). To effectuate Congress's intent in enacting the PSLRA, a plaintiff suing an auditor must plead facts that, if proven, would convince a reasonable person both that the auditor departed from the wide zone of discretion afforded under applicable professional standards and that such departure was made with the requisite mental state.

Accordingly, because peripheral conduct is usually less likely to involve *scienter*, inferences relating to the *scienter* of peripheral actors must be particularly strong, and necessitate comparison of competing inferences. *See PR Diamonds*, 364 F.3d at 693. Absent particular facts from which a reasonable person should *strongly infer* intentional misconduct, accounting firms and others should not face the crippling expense of defending against securities lawsuits.

III. Enforcing The Letter And Spirit Of The PSLRA Gives Rise To No Seventh Amendment Concerns

The Seventh Circuit expressed concern that giving full effect to the pleading requirements imposed by the PSLRA would somehow "usurp[] the jury's role." Pet. App. 13a. To the contrary, no Seventh Amendment issue arises from enforcing congressional constraints on pleading. Indeed, the *Matsushita* Court required consideration of competing inferences over a dissent that, among other things, advanced a similar Seventh Amendment objection. *See* 475 U.S. at 601 (White, J., dissenting).

"The jury was not absolute master of fact in 1791. Then as now courts excluded evidence for irrelevancy and relevant proof for other reasons"—that is, judges "weighed the evidence." *Galloway* v. *United States*, 319 U.S. 372, 390 (1943). Under this Court's Seventh Amendment jurisprudence, only "reasonable" inferences are for the jury. *Id.* at 395 ("the essential requirement is that mere speculation be not allowed to do duty for probative facts, after making due allowance for all *reasonably* possible inferences favoring the party whose case is attacked") (emphasis added). Indeed, it has long been understood that a case need not be submitted to the jury if the complaint is not supported by reasonable inferences. *Pawling v. United States*, 8 U.S. (4 Cranch) 219, 221-22 (1808) ("The party demurring admits the truth of the testimony to which he demurs and also those conclusions of fact which a jury may fairly draw from that testimony. Forced and violent inferences he does not admit"); *Western & Atl. R.R.* v. *Hughes*, 278 U.S. 496, 497-98 (1929) ("submission to the jury of contested issues of fact is not required in the federal courts, if there is only a scintilla of evidence").

Congress has authority to create or eliminate federal causes of action, and to define the elements of a federal cause of action. *Plaut* v. *Spendthrift Farm, Inc.*, 514 U.S. 211, 228-29 (1995). In doing so, Congress can require that only claims that are well-pleaded at the time of filing may proceed in federal court. Fraud claims have always been subject to more exacting standards of pleading than other claims. *See* Fed. R. Civ. P. 9(b) ("the circumstances constituting fraud . . . shall be stated with particularity"). This Court has never suggested that there is any Seventh Amendment difficulty in rejecting a complaint that does not plead fraud with the required particularity. *See Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 513 (2002) (noting that Rule 9(b) imposes more rigorous pleading standards on certain claims); *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993) (same). In the securities-fraud context, moreover, Congress was concerned about "the perceived inability of Rule 9(b) to prevent abusive, frivolous strike suits," and imposed an even higher pleading standard. *Nathenson*, 267 F.3d at 407; *see* S. Rep. No. 98, *supra*, at 4.

Congress may also alter "matters of form or procedure" without running afoul of the Seventh Amendment. *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935). In particular, it can set "standards and boundaries," including "evidentiary standards," based on which a judge must evaluate a case *before* that case is even submitted to a jury. *Anderson* v. *Liberty Lobby*, 477 U.S. 242, 252-55 (1986); *see also Galloway*, 319 U.S. at 390 (explaining that "higher standards of proof" do not implicate the Seventh Amendment because the Amendment does not "bind the federal courts to the exact procedural incidents or details of jury trial according to the common law in 1791").

The "strong inference" requirement of the PSLRA is precisely the type of evidentiary standard that may be imposed by Congress, which has made a cost-benefit determination, binding on the courts, that cases with pre-discovery information insufficient to indicate a strong likelihood that defendant acted intentionally cannot go forward into costly discovery—even if, had these cases gone into discovery, additional information could have been discovered that would have created at least a jury issue on whether the defendant acted with *scienter*. Ignoring that congressional determination "would permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence." *Dura*, 544 U.S. at 347 (internal quotation omitted; alteration in original). By contrast, enforcing the congressional standard, which requires a plaintiff to plead particularized allegations giving rise to a "strong inference" of *scienter* as a precondition to allowing the case to proceed past the pleading stage, presents no constitutional difficulty.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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