

Tellabs Decision Should Reduce Frivolous Fraud Suits

Thursday, Jul 05, 2007 --- On June 21, the United States Supreme Court issued its much anticipated decision in *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, number 06-484, 2007 U.S. LEXIS 8270 (June 21, 2007), resolving divisions among the various federal circuit courts of appeals over the threshold for pleading the intent required to state a securities fraud claim under the Private Securities Litigation Reform Act of 1995.

The Court's 8-1 decision handed an important victory to defendants in private securities fraud lawsuits regarding what is required in order to satisfy the PSLRA's requirement that the pleading "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind" (i.e., with the "intent to deceive, manipulate or defraud," also known as *scienter*).

The impact of *Tellabs* comes from its treatment of two issues regarding *scienter* on which the circuit courts of appeal had been divided. First, *Tellabs* rejected approaches to analyzing *scienter* which ascribed dispositive importance to particular types of factual allegations (such as allegations of motive and opportunity), and instead held that all the allegations of the complaint needed to be assessed "holistically." Second, *Tellabs* held that the inference of *scienter* from those allegations "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 key teaching that *Tellabs* now decisively establishes is that, in assessing whether *scienter* has been adequately pled under the PSLRA, courts must engage in a comparative analysis of potential inferences. Gone are the days when only those inferences most favorable to the plaintiff would be considered. Courts must now weigh the factual allegations that seem to suggest fraudulent intent against plausible innocent explanations of the defendant's conduct. The complaint will only survive if, upon such weighing, the inference of *scienter* is at least as strong as the potential nonculpable explanations of the defendant's intent—a rule that appears to greatly increase the opportunities for defendants to get securities fraud complaints dismissed at the pleadings stage.

The PSLRA Pleading Requirements and the Circuit Split They Created

The Court in *Tellabs* began by noting that "meritorious" private securities fraud actions are an "essential supplement" to governmental enforcement (civil and criminal) of the federal securities laws, but that if such private lawsuits are not "adequately contained," they could be employed "abusively to impose substantial costs" on even law-abiding defendants. As "a check

against abusive litigation by private parties,” Congress adopted the PSLRA, which imposed “exacting pleading requirements” as part of its “control measures” over such private litigation. One such control measure was § 21D(b)(2) of the PSLRA, which requires a securities fraud complaint to “state 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).

Congress left the key term “strong inference” undefined in the PSLRA, however. Accordingly, the circuit courts of appeals over the last dozen years have wrestled with the issue of what types of allegations would suffice to provide the requisite “strong inference” of scienter for purposes of pleading a threshold claim of securities fraud under the PSLRA. The result was a welter of conflicting tests and approaches. (See January 19, 2007, Chadbourne & Parke LLP Client Alert, “U.S. Supreme Court to Review Standard for Pleading Scienter in Securities Fraud Actions.”) The divisions among the circuits arose from differing views they took on three distinct questions that came into play when securities fraud scienter was at issue:

--what are the types of facts or information that must be pled in order for the complaint to sufficiently demonstrate a “strong inference” of fraudulent intent;

--whether, and to what extent, the court must also consider possible “competing inferences” from the allegations of the complaint in determining whether those allegations gave rise to a “strong inference” of scienter; and

--under what circumstances could allegations of recklessness satisfy the scienter requirement?

On [the issue of “strong inference”], three different approaches had developed among the circuits:

--The Second and Third Circuits took the position that because the PSLRA’s “strong inference” terminology came from pre-PSLRA Second Circuit scienter case law, the statute’s intent was to adopt the Second Circuit’s pre-PSLRA pleading standard for scienter, under which plaintiffs stated a claim “by pleading either motive and opportunity or strong circumstantial evidence of reckless or conscious misbehavior.” See *Novak v. Kasaks*, 216 F.3d 300, 309-10 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-35 (3d Cir. 1999).

--The Ninth and Eleventh Circuits took the view that Congress intended to adopt a more rigorous pleading standard than the existing “motive and opportunity” or simple recklessness analysis, such that facts showing motive and opportunity cannot alone establish a strong inference of scienter. See *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999).

--The other six circuits that had considered the issue took what has been referred to as a “middle ground,” neither adopting nor rejecting a particular method of pleading scienter (such as alleging facts showing motive and

opportunity), but instead requiring plaintiffs to plead facts that, taken together, would permit a “reasonable person” to draw a strong inference of scienter. The Seventh Circuit decision that was under review in *Tellabs* adopted this approach. See 437 F.3d 588, 601-02 (7th Cir. 2006).

The Seventh Circuit in *Tellabs* had taken a lenient approach on [the issue of “competing inferences”], which was favorable to securities fraud plaintiffs, declining to engage in an analysis of the competing inferences and simply allowing 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.” 437 F.3d 588, 602 (7th Cir. 2006). The Sixth Circuit, as well as other circuits, had adopted a considerably stiffer standard that was more favorable to defendants, holding that PSLRA’s requirement that there be a “strong inference” of scienter meant plaintiffs were entitled only to “the most plausible of competing inferences.” *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004).

While the Supreme Court has never definitively addressed the issue [of scienter], every circuit court of appeals that has considered the issue has held that scienter may be established by allegations of recklessness as well as by allegations of intentional misconduct. However, the circuits have differed on the degree of recklessness required. Some circuits, including the Second Circuit, have adhered to a simple recklessness standard; others have defined recklessness to require “severe recklessness”; and the Ninth Circuit has enunciated a more stringent standard of “deliberate recklessness,” requiring plaintiffs to “state facts that come closer to demonstrating intent.” See generally *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003) (summarizing cases).

The Supreme Court did not reach this third issue in *Tellabs*, noting that “whether and when recklessness satisfies the scienter requirement is not presented in this case.” This third issue thus continues to remain ripe for potential future Supreme Court review.

*The *Tellabs* Litigation*

Tellabs was a shareholder class action brought under § 10(b) of the Securities Exchange Act of 1934 against *Tellabs, Inc.*, a manufacturer of specialized equipment used in fiber optic networks, and its then-Chief Executive Officer. The plaintiff shareholders alleged that the company and its CEO had falsely reassured investors that *Tellabs* was enjoying strong demand for its products and earning record revenues so as to inflate *Tellabs*’ share price.

When the sufficiency of the pleading was challenged on a motion to dismiss, the Seventh Circuit (reversing the district court) held that the complaint sufficiently alleged that the defendants acted with the requisite scienter to support the claim. The allegations were sufficient, according to the Seventh Circuit, because a reasonable person could infer from all the allegations of the complaint that the defendants had acted with the required intent. In the Seventh Circuit’s view, no comparative weighing of the competing inferences

that could be drawn from those allegations was required as part of this analysis.

The Supreme Court's Opinion

The Supreme Court opinion in *Tellabs* acknowledged the division among the circuits regarding scienter pleading requirements under the PSLRA, but it spent little time exploring the various circuits' approaches before announcing its own. The Court expressly rejected the suggestion that because Congress took the PSLRA's "strong inference" terminology from pre-PSLRA Second Circuit scienter case law, it must have intended to codify that Second Circuit case law in the statute. Rather, the Court explained that, given the lack of clear guidance from Congress, its task was "to prescribe a workable construction of the 'strong inference' standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."

Under the standard prescribed by the Court in *Tellabs*, a court on a motion to dismiss a § 10(b) securities fraud claim must accept all factual allegations in the complaint as true. The court must also consider the complaint (as well as incorporated documents and relevant judicial notice materials) in their entirety, with the inquiry being "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." (Emphasis in original.)

Most importantly, though, the court must also take into account "plausible opposing inferences," i.e., "plausible nonculpable explanations of the defendant's conduct, as well as inferences favoring the plaintiff." The court "must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged. An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct."

The Court explained that this comparative approach was necessitated by the statutory requirement of a "strong" inference of scienter, because "[t]he strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative." The Court stressed that the inference of scienter "need not be irrefutable, i.e., of the 'smoking-gun' genre, or even the 'most plausible of competing inferences,'" but it "must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations. A complaint will survive, we hold, 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." As the Court noted, "[a]n inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct."

The Court rejected the defendants' suggestion that the lack of any allegation of pecuniary motive in the complaint should be dispositive of the issue of

scienter. While the presence or absence of such an allegation could be a “relevant consideration,” the complaint’s allegations nevertheless “must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.” While other kinds of “omissions and ambiguities” likewise can “count against inferring scienter,” the Court reiterated that its job “is not to scrutinize each allegation in isolation but to assess all the allegations holistically.”

The Supreme Court did not decide whether or not the particular factual allegations of the Tellabs complaint were sufficient to satisfy the PSLRA’s “strong inference” requirement under the standards enunciated by the Court. Since the lower courts had not had the opportunity to review those allegations in light of the standards the Supreme Court enunciated in its opinion, it remanded the case for further proceedings by them so they could reexamine the complaint in accordance with the Court’s ruling.

Conclusion

The Supreme Court in Tellabs has now established a set of prescriptions for how courts should analyze the sufficiency of allegations intended to plead a “strong inference” of scienter under the PSLRA. The requirement to consider all the allegations in a securities fraud complaint collectively, rather than focusing discretely on the presence or absence of any particular kinds of allegations, imposes a stiffer burden on securities fraud plaintiffs than they had faced previously in certain circuits, such as the Second Circuit. Tellabs also then imposes the additional requirement that lower courts must also consider the competing pro-defendant inferences that can be drawn from the complaint when assessing the sufficiency of scienter allegations. This latter point represents a very significant advance for securities fraud defendants, particularly given the requirement that the inference in favor of scienter must be “at least as likely as any plausible opposing inference” in order for the complaint to survive. (Emphasis in original.)

As a practical matter, Tellabs is likely to lead to even more rigorous and intensive scrutiny of the factual allegations in securities fraud complaints, with more such complaints being dismissed at an early pre-discovery stage as a result. Tellabs also solidifies the role of the federal judiciary as the gatekeeper in determining the sufficiency of scienter allegations in such lawsuits, and removing from the system those cases that seem most likely to represent abusive applications of private securities fraud litigation.

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