

The U.S. Supreme Court Grants Certiorari in Case Concerning the Standard for Pleading Scienter in Securities Fraud Suits

January 18, 2007

On January 5, 2007, the United States Supreme Court granted certiorari in a case concerning the standard for pleading scienter under the Private Securities Litigation Reform Act of 1995 (PSLRA).

The Court agreed to review a decision of the Court of Appeals for the Seventh Circuit that articulates a standard that is more lenient than the standard applied by other circuits. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), *cert. granted*, 75 U.S.L.W. 3207 (U.S. Jan. 5, 2007) (No. 06-484). This marks the first time the Supreme Court will consider the standard for pleading scienter under the PSLRA.

Under the PSLRA, a plaintiff alleging securities fraud must, with respect to each allegedly false or misleading statement or omission, "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).

The required state of mind for liability for securities fraud – an intent to deceive or a specified level of recklessness (depending on the relevant circuit) – is not at issue in the case. Rather, the case concerns the standard that a court should apply in determining whether a complaint adequately pleads a "strong inference" that the defendant acted with the required state of mind.

Prior to the Seventh Circuit's decision in *Tellabs*, courts of appeal in six circuits held that in addition to considering inferences of scienter arising from a complaint's allegations, a court should also consider inferences of an innocent mental state.

In four circuits, courts will not find a complaint to allege a strong inference of scienter unless the culpable inferences are more plausible than innocent inferences. See *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005) ("Scienter allegations do not pass the 'strong inference' test when, viewed in the light of the complaint as a whole, there are legitimate explanations for the behavior that are equally convincing."); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003) (rejecting inference of scienter because it "was just as likely" that the fact pattern alleged by plaintiffs was the result of an innocent "overgeneralization as it was the product of intentional deception or recklessness"); *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (rejecting proposed inference of scienter where "it is equally if not more

plausible" that defendants acted without fraudulent intent); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) ("plaintiffs are entitled only to the most plausible of competing inferences").

In two other circuits, courts will consider inferences of an innocent mental state in determining whether a complaint's allegations of scienter are "strong," but without weighing the relative plausibility of the competing inferences. See *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003) ("we consider the inference suggested by the plaintiff while acknowledging other possible inferences, and determine whether plaintiff's suggested inference is 'strong' in light of its overall context," but "it is inappropriate for us to make a determination as to which [of two seemingly equally strong competing] inference[s] will ultimately prevail, lest we invade the traditional role of the factfinder"); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 667 (8th Cir. 2001) (taking innocent inferences into account, but concluding that they do not "sap[] the investors' allegations of their force at this procedural stage"); see also *In re K-tel Int'l, Inc., Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002) (*Green Tree* did not adopt a most-plausible-of-competing-inferences standard).

The Seventh Circuit's decision in *Tellabs* is the first circuit court decision that arguably rejects consideration of inferences of an innocent state of mind in determining whether a complaint alleges a strong inference of scienter.

The Seventh Circuit's Decision

Tellabs, Inc., is a manufacturer of specialized equipment used in fiber optic cable networks. Plaintiffs allege that Tellabs and certain of its executives artificially inflated the company's stock price by engaging in channel stuffing in 2000 and making false revenue predictions for 2001. The District Court dismissed plaintiffs' Second Amended Complaint on the grounds that, *inter alia*, it failed to allege a strong inference of scienter.

The Seventh Circuit's decision, issued January 25, 2006, was the court's first opinion concerning the heightened pleading requirements of the PSLRA. With respect to the PSLRA's "strong inference" requirement, the Court voiced concern that the Sixth Circuit's "most plausible of competing inferences" standard might infringe upon plaintiffs' Seventh Amendment right to a jury trial. *Tellabs*, 437 F.3d at 602. Without expressing a view on that issue, the Court stated that it would be wise to adopt a standard that steered clear of it. *Id.* The Court then held that

"[i]nstead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we 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." *Id.* (emphasis added).

Applying this standard, the Court concluded that plaintiffs had adequately alleged a strong inference of scienter on the part of Tellabs's CEO with respect to a number of alleged misstatements, including an April 2001 statement that demand for Tellabs's leading product was growing.

Although the Court recognized that plaintiffs' allegations left open the possibility that the CEO had not yet seen reports that allegedly revealed that demand had faded, it stated that "[g]iven the significance of the [product] and the number of reports suggesting that it was in trouble, we find it sufficiently probable that [the CEO] had information suggesting that his statements were false." *Id.* at 603. Based on this and rulings on

other issues, the Court reversed in part the District Court's dismissal of the Second Amended Complaint and remanded the case for further proceedings.

It is not clear from the Seventh Circuit's opinion whether the standard it articulated permits consideration of innocent inferences in determining whether a complaint adequately alleges that a defendant acted with scienter. The standard, like those adopted by the Eighth and Tenth Circuits, might allow consideration of innocent inferences in determining whether a complaint's allegations, viewed in their totality, give rise to a strong inference of scienter. But the Court's discussion of its Seventh Amendment concern suggests that its standard was designed to avoid having innocent inferences play any role in a court's evaluation, since a decision by a court to give weight to such inferences might be viewed as usurping the role of the jury.

At the very least, the Court's use of the word "could" in its standard – instead of "would" – suggests that innocent inferences are to play a very minor role in a court's evaluation of a complaint, if any at all, since a reasonable person "could" infer scienter even in circumstances in which innocent inferences arguably should and "would" lead a reasonable person to conclude that scienter has not been adequately alleged.

The Petition for a Writ of Certiorari

Tellabs's Petition for a Writ of Certiorari urged the Supreme Court to accept review of the Seventh Circuit's decision so that it could resolve the circuit split over the consideration of innocent inferences, and thereby provide the uniformity with respect to pleading standards that Congress sought to achieve in enacting the PSLRA. Petition for Writ of Certiorari at 5-6, 16, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (No. 06-484) (Oct. 3, 2006).

Tellabs also argued that the standard adopted by the Seventh Circuit "does serious violence to the deliberately high pleading standard adopted by Congress, and to its desire to provide businesses with relief from costly strike suits." *Id.* at 17. In this regard, Tellabs argued that the Seventh Circuit's standard will encourage plaintiffs to plead with "strategic ambiguity" and allow more suits to survive motions to dismiss, which would in turn result in the more frequent "imposition of massive litigation costs on businesses based on little more than a downturn in share price." *Id.* at 27.

Tellabs proposed the following Question Presented, which the Supreme Court accepted: "Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a 'strong inference' that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995." *Id.* at i.

Key Impacts

- Although the *Tellabs* decision is only a year old, the standard it articulated with respect to the pleading of scienter has already had a significant impact on securities litigation in the Seventh Circuit. *See, e.g., Roth v. Aon Corp.*, 411 F. Supp. 2d 973, 977 (N.D. Ill. 2006) (declining to consider innocent inferences and denying motion to dismiss based on *Tellabs*); *Takara Trust v. Molex Inc.*, 429 F. Supp. 2d 960, 971 (N.D. Ill. 2006) (applying *Tellabs* pleading standard and denying motion to dismiss). The Supreme

Court's review of the decision could result in the rejection of that standard, and the adoption of a standard that allows courts to weigh competing inferences when evaluating a complaint's allegations concerning scienter.

- A resolution of the circuit split may occur more quickly than in the ordinary course. The Supreme Court has ordered expedited briefing and scheduled oral argument for March 28, 2007. Tellabs's opening brief is due to be filed by February 7, respondents' brief is due to be filed by March 9, and any reply brief must be filed by March 20.
- *Tellabs* addressed a second issue concerning the pleading of scienter that is the subject of disagreement among the circuits – the role played by allegations of "motive and opportunity." Some circuits hold that the pleading of motive and opportunity is sufficient to plead scienter, others disagree, and the majority take a middle ground approach that requires an inquiry into whether all of the allegations of a complaint together give rise to a strong inference of scienter. See *Tellabs*, 437 F.3d at 601. The Seventh Circuit adopted this middle ground approach, holding that "[m]otive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient." *Id.* While this issue is not before the Supreme Court in connection with the *Tellabs* appeal, the Court's opinion might contain broad language that provides guidance with respect to this issue.