

Several Justices Question Seventh Circuit's *Tellabs* Holding

March 29, 2007

On March 28, 2007, the United States Supreme Court heard oral argument in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S.), a case concerning the standard for pleading scienter under the Private Securities Litigation Reform Act of 1995 (PSLRA). The questions and comments from the bench suggest that a number of the Justices consider the standard applied by the Seventh Circuit to fall short of the requirements of the PSLRA. The Court seemed uncertain, however, how to articulate the stricter standard that should apply, and the outcome may well turn on what standard can garner the necessary five votes.

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. Parting ways with other circuits,¹ the Seventh Circuit 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." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006), *cert. granted*, 75 U.S.L.W. 3207 (U.S. Jan. 5, 2007) (No. 06-484). Applying this standard, the Seventh Circuit 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. Tellabs then petitioned for certiorari, which was granted with the following question presented:

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.

Through their questions and comments at oral argument, a number of the Justices expressed disagreement with the Seventh Circuit's standard. Chief Justice Roberts said that the standard did not reflect Congress's requirement that plaintiffs state with particularity facts giving rise to a strong inference of scienter. Transcript,

p. 42.² Justice Breyer discussed a hypothetical complaint containing extremely weak allegations of scienter that a judge would nonetheless have to allow to proceed to discovery under the Seventh Circuit's standard because a reasonable person conceivably could infer that defendants acted with scienter. *Id.* at 35-36. Justice Kennedy said, "I hope we're going to recognize [in our ruling] that Congress thought it was doing something [in passing the PSLRA]," implying that plaintiffs were defending the type of lenient standard for pleading scienter that Congress expressly sought to change through passage of the PSLRA. *Id.* at 41. Finally, Justice Alito said he could not understand how one could assess the strength of the inference of scienter that can be drawn from facts alleged in a complaint without considering all the inferences that could be drawn from those facts—a step that the Seventh Circuit's standard does not require and arguably does not permit. *Id.* at 36-37.

Two Justices appeared concerned about preserving the traditional rule requiring a court deciding a motion to dismiss to read the complaint's allegations in the light most favorable to plaintiffs. Justice Ginsburg asked *Tellabs*'s counsel whether consideration of competing inferences would abrogate this rule; counsel responded that Congress absolutely intended to change this traditional rule in securities fraud cases. *Id.* at 51-52. Justice Souter asked whether it would be possible to preserve the traditional rule, and to examine at the pleading stage whether a complaint's allegations, read in the light most favorable to plaintiff, meets the PSLRA's strong inference requirement. Counsel for the government, arguing as *amicus curiae* supporting *Tellabs*, responded that a district court should be free to consider all inferences from a complaint's allegations, and that the traditional rule would preclude such consideration.

If the Court decides to reverse the Seventh Circuit's decision and articulate a different standard, it may have to consider Seventh Amendment right-to-jury-trial issues in doing so. Respondents argued in their brief that a pleading standard that is more demanding than the preponderance of the evidence standard that would be applied at trial would run afoul of the Seventh Amendment since judges would be disposing of claims that plaintiffs were entitled to have heard by a jury. A number of the Justices seemed concerned about a pleading standard that was more rigorous than the merits standard for this reason.

Other Justices appeared not to be concerned about this issue. Justice Scalia suggested that a Seventh Amendment issue could be avoided if the pleading standard were viewed as an entry qualification, like the diversity requirement for federal jurisdiction—a requirement that, although it keeps plaintiffs from having claims heard by juries, is not thought to violate the Seventh Amendment. *Id.* at 30-31. Alternatively, Chief Justice Roberts suggested that the Court could avoid any Seventh Amendment problem if the strong inference standard were applied both at the pleading stage and at trial, suggesting that he might be willing to reconsider the preponderance of the evidence standard supplied by *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 (1983). Transcript at 34. *Tellabs* had requested that the Court reconsider *Huddleston* if it had Seventh Amendment concerns about the pleading standard being more demanding than the standard applied at the summary judgment phase or at trial.

A number of the Justices sought to quantify the PSLRA's strong inference requirement. In response to questions from Justices Stevens and Kennedy, *Tellabs*'s counsel said that the requirement was hard to quantify, but that it

was certainly greater than 50%. *Id.* at 8. Plaintiffs' counsel also said that it was hard to quantify the requirement, but suggested that it might be as low as 40%. *Id.* at 44.

During argument, Justice Scalia expressed the hope that the Court would decide the case in a manner that establishes standards for how a district court should go about determining whether a complaint pleads facts that give rise to a strong inference of scienter. Tellabs's counsel echoed that sentiment in his closing comments, urging the Court to rule that district courts should review the entirety of a complaint, and make both positive and negative inferences in determining whether the complaint meets the strong inference standard of the PSLRA.

A decision in the case is expected by the end of June.

¹ See Jonathan M. Jacobs, *The U.S. Supreme Court Grants Certiorari in Case Concerning the Standard for Pleading Scienter in Securities Fraud Suits, Executive Summary Alert*, January 18, 2007 (available at http://www.wileyrein.com/publication_newsletters.cfm?id=6&publication_ID=12916).

² A transcript of the hearing is available at http://www.supremecourtus.gov/oral_arguments/argument_transcripts/06-484.pdf. This is an official transcript, but it is subject to final review by the Court.