

The Supreme Court Rejects the Seventh Circuit's Lenient Standard for Pleading Securities Fraud

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On June 21, 2007, the U.S. Supreme Court issued a decision that addresses the standard for pleading a strong inference of scienter in securities fraud suits. In an 8-1 decision authored by Justice Ginsburg, the Court rejected the lenient standard applied by the Seventh Circuit and held that a plaintiff must plead facts that render an inference of scienter at least as compelling as any plausible opposing inference. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (U.S. June 21, 2007).

The Private Securities Litigation Reform Act of 1995 (PSLRA) instituted numerous reforms to address abuses in federal class action securities fraud litigation. Among other measures, the Act requires a plaintiff alleging securities fraud to state with particularity evidence that the defendant acted with scienter (*i.e.*, fraudulent intent). As set forth in the PSLRA, a plaintiff must "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 *Tellabs* decision concerns the standard for pleading a "strong inference" of scienter, a standard that Congress did not supply. In the proceedings below, the Seventh Circuit, reversing the District Court's dismissal of plaintiffs' complaint, held that a complaint alleges a strong inference of scienter "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). In doing so, the Seventh Circuit expressly declined to engage in a comparative evaluation of competing inferences that could be drawn from plaintiffs' complaint, the approach followed in certain other circuits and advocated by defendants. *Id.*

Upon review, the Supreme Court rejected the Seventh Circuit's standard. The Court ruled that to determine whether a complaint alleges a "strong" inference of scienter, a court must compare inferences of scienter with competing, nonculpable explanations of a defendant's alleged conduct. The Court therefore held that the Seventh Circuit's standard, which evaluated whether a reasonable person *could* infer scienter from a complaint—and did not permit consideration of other plausible inferences—failed to "capture the stricter demand Congress sought to convey" with the PSLRA's "strong inference" requirement. Slip op. at 2.

In articulating a standard consistent with the PSLRA, the Court established a three-step process. First, when reviewing a motion to dismiss a § 10(b) action, "courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true." *Id.* at 11. Second, courts must consider the complaint in its entirety, along with all other sources that may be considered at the pleading stage, to determine whether "all of the facts alleged, taken collectively, give rise to a strong inference of scienter . . ." *Id.* (emphasis in original). Third, in determining whether the pleaded facts give rise to a "strong" inference of scienter, courts must consider plausible opposing inferences. *Id.* An inference of scienter arising from a complaint cannot be merely "reasonable" or "permissible," but instead must be "strong in light of other explanations." *Id.* at 12. The inference of scienter need not be the most plausible of competing inferences, but it must be "cogent and at least as compelling as any opposing inference [of non-fraudulent intent] one could draw from the facts alleged." *Id.* at 12-13.

In accordance with its long-standing practice, the Court did not apply its new standard to plaintiffs' complaint, but rather vacated the Seventh Circuit's judgment and remanded the case so the lower courts could perform that task.

Key Impacts

- The *Tellabs* decision resolves a split among the circuits, and will make it more difficult for plaintiffs to state a cause of action for securities fraud in circuits in which courts previously were not permitted to consider competing inferences of intent at the pleading stage.
- The standard articulated by the Court—that an inference of scienter is "strong" if it is as compelling as competing inferences—is less stringent than the standard previously applied in those circuits that required a plaintiff to allege an inference of scienter that is *more* compelling than competing inferences. *Tellabs* and the government had advocated positions consistent with the more demanding standard. However, in concurring opinions, Justices Scalia and Alito both opined that the difference between the two standards will make little practical difference because opposing inferences of intent drawn from a complaint are not likely to be precisely in equipoise.
- In the course of its Opinion, the Court stated that while a district court must consider all the allegations of a complaint "holistically" when evaluating a motion to dismiss, "omissions and ambiguities [in the allegations] count against inferring scienter." *Id.* at 14. This statement will provide additional ammunition for defendants attacking vague and ambiguous allegations of scienter.