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ANTIFRAUD

Splitting the Jade Falcon: The Supreme Court Sets A New Standard for Scienter in Securities Fraud Cases

BY ROBERT PLOTKIN AND JEREMY FREEMAN

In *Tellabs v. Makor Issues and Rights* (No. 06-484) 2007 WL 1773208 (“*Tellabs*”), decided June 21, the Supreme Court resolved a critical issue with respect to pleading “scienter,” the appropriate mental state necessary to sustain a securities fraud claim. The Court articulated a more precise and uniform standard for determining what is a “strong inference” of scienter, ending a rift among the Courts of Appeals. To find a “strong” inference of scienter, a reviewing court now “must take into account plausible opposing inferences,” and a securities fraud complaint will pass muster “only if a reasonable person would deem the inference of scienter cogent and *at least as compelling* as any plausible opposing inference one could draw from the facts alleged.” *Tellabs* at *10 (emphasis added).

The decision has been praised by corporate America for providing greater protection from frivolous and costly litigation. Conversely, the investing community has decried the decision, claiming that it will prevent

victims of corporate fraud from obtaining redress and compensation. But in crafting its *Tellabs* opinion, the Supreme Court may have actually taken a centrist view of the “strong inference” standard in light of the varied court interpretations over the years.

Decade-Old Dispute: Pleading Scienter Under the Private Securities Litigation Reform Act of 1995. *Tellabs* is part of the perennial struggle to balance the need to provide recourse to investors harmed by financial fraud against the need to protect legitimate businesses from frivolous lawsuits. *Id.* at *8. While both goals are essential to maintaining healthy financial markets, striking the proper balance has proven very difficult. The modern securities laws were designed to “maintain public confidence in the marketplace . . . by deterring fraud, in part, through the availability of private securities fraud actions.” *Id.* at *7 (quoting *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336, 345 (2005)). Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder, created new rights for investors to sue companies and individuals for fraud-based losses.

As the public markets grew and thrived, so did the number of lawsuits filed under Section 10(b). By the 1990’s, many commentators believed that it was too easy to bring such claims, and that many of these suits were simply illegitimate “strike suits” designed to “shake down” innocent companies. This, according to

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proponents of corrective legislation, resulted in the fleeing of productive companies, damaging competitiveness and creating uncertainty in the financial markets.

To end this perceived abuse, Congress passed the Private Securities Litigation Reform Act of 1995 (“PSLRA”). *Tellabs* at *8. One significant element of the PSLRA was designed to weed out frivolous lawsuits by raising the initial pleading standards that plaintiffs had to satisfy in order to keep their cases in court. *Id.* at *8-*9. Specifically, the PSLRA required that such complaints 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) (emphasis added). This phrase was intended to create “heightened” and thus more stringent pleading requirements to curtail the filing of meritless lawsuits. *Tellabs* at *8-*9; see *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006) (quoting H.R. Conf. Rep. No. 104-369 at 30-41). However, Congress did not define what constitutes a “strong inference,” forcing the courts to fill in the blank with their own varied interpretations. *Tellabs* at *9. It was this fortification of the pleading requirements that became anything but “uniform” in its application, led to a wide split among the circuits, and ultimately led to *Tellabs*.

The Circuits Split on Pleading a ‘Strong Inference’ of Scienter. The lack of guidance as to the meaning of a “strong inference” resulted in the gradual balkanization of federal courts’ views on pleading scienter. *Id.* Most of the debate concerned how much, in the way of factual detail in the pleadings, is required to create a “strong inference” of scienter. At least three discernible views emerged over the last decade.

The interpretation of the PSLRA’s “strong inference” language that is arguably closest to that adopted by the Supreme Court in *Tellabs* required courts to consider only the “most plausible” of “competing inferences raised by all of the factual allegations of the complaint.” *Id.* at *6-*7; *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004); see also *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001) (en banc); *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002). Under the “most plausible” approach, which the *Tellabs* Court attributes to the Sixth Circuit, where a complaint alleges facts that are consistent both with scienter and with an alternative innocent explanation, the court can draw a “strong inference” of scienter only where the “guilty” inference is more credible than any other reasonable “innocent” inference. As the Sixth Circuit put it: “the strong inference requirement creates a situation in which ‘plaintiffs are entitled only to the most plausible of competing inferences,’ but that it does not mandate that the inference be ‘irrefutable.’” *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004) (quoting *Helwig*, 251 F.3d at 553).

The Second and Third Circuits adopted the view that the “strong inference” language was actually an endorsement of the Second Circuit’s pre-PSLRA decisions, which required plaintiffs to plead facts demonstrating either the defendant’s “motive and opportunity” to commit fraud, or “strong circumstantial evidence of recklessness or conscious misbehavior.” *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000); see

also *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

A third approach, adopted by the Eighth and Tenth Circuits, required a “strong inference” to be determined by whether a plaintiff’s allegations are “‘strong’ in light of its overall context.” *Pirraglia v. Novell, Inc.*, 339 F.3d 1182 (10th Cir. 2003); see also *In re K-tel Int’l Inc. Securities Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002).

The Seventh Circuit’s *Tellabs* Decision. It was against this backdrop of conflicting theories that the Seventh Circuit confronted the “strong inference” question in the securities action against *Tellabs* and its executives. The Seventh Circuit declined to follow any of the approaches utilized by other Circuits, and substituted its own rule that a securities fraud complaint is adequate if it alleges “facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” *Tellabs* at *6. The Seventh Circuit added that where a “reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal.” *Id.*, quoting *Makor v. Tellabs*, 437 F.3d 588, 602 (7th Cir. 2006). It was this “reasonable person” test that broke the proverbial camel’s back and set the stage for Supreme Court review of the “strong inference.”

The test was applied to a complex set of factual allegations involving a rather sophisticated high tech company. *Tellabs*, a fiber optic cable networking company, issued press releases stating that the company was earning record revenues and that there was strong demand for its next generation products, which were already “available for delivery.” *Tellabs* at *5; *Makor v. Tellabs*, 437 F.3d at 596-598. *Tellabs*’s Chief Executive Officer (“CEO”) predicted that there also would be continuing sales growth of *Tellabs*’s current products as well. *Tellabs* at *5; *Makor v. Tellabs*, 437 F.3d at 596-598. However, indications that *Tellabs*’s business was not as healthy as reported began to appear. *Tellabs* twice reduced its quarterly sales projections and, soon after that, announced that its actual sales were significantly below original projections. The next day, *Tellabs*’s stock price plunged. *Tellabs* at *5-*6; *Makor v. Tellabs*, 437 F.3d at 593-599.

Shareholders sued *Tellabs* and ten of its executives for securities fraud. The complaint alleged that *Tellabs* knowingly lied to the public about the availability and success of its products. The district court dismissed the initial complaint because it failed adequately to allege that the defendants met the scienter standard for securities fraud. *Tellabs* at *5; *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 944-945 (N.D. Ill. 2004). The plaintiffs filed an amended complaint, bolstering their allegations with references to 27 confidential sources, reducing the number of defendants and claims, and adding more specific scienter allegations against each of the remaining defendants. *Tellabs* at *6; *Makor v. Tellabs*, 437 F.3d at 594. The District Court nonetheless again dismissed the case for failure to allege a “strong inference” of scienter. *Tellabs* at *6; *Johnson*, 303 F. Supp. 2d at 971. The plaintiffs appealed the dismissal, arguing that their amended complaint provided more than enough detail to support a “strong inference” of scienter.

As noted, the Seventh Circuit reversed the lower court and found that the plaintiffs had pled a satisfac-

tory claim because “a reasonable person could infer that the defendant acted with the required intent.” *Tellabs* at *6; *Makor v. Tellabs*, 437 F.3d at 602. The Seventh Circuit said that while the PSLRA did “raise the bar for pleading scienter,” it did not “throw much light on what facts will suffice to create such an inference.” *Tellabs* at *9; *Makor v. Tellabs*, 437 F.3d at 601.

Supreme Court Takes on *Tellabs*. The Supreme Court granted certiorari to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a “strong inference” of scienter. *Tellabs* at *9.

Significantly, the United States Government joined the *Tellabs* fray by filing a brief in support of the company, asking the Supreme Court to reject the Seventh Circuit’s standard because it was not strong enough to meet the PSLRA pleading standards. The Government contended that a “strong” inference arises only where the facts alleged, if true, would create a “high likelihood that the conclusion that the defendant possessed scienter follows from those facts.” U.S. Amicus Br. In Support of Petitioner at 8-9. The Securities Industry and Financial Markets Association (“SIFMA”) also filed an amicus brief, advocating that plaintiffs must plead facts that “strongly tend to exclude the possibility” of alternative innocent inferences. SIFMA Amicus Brief in Support of Petitioner at 9.

The Holding. In an eight to one majority opinion, written by Justice Ruth Bader Ginsberg, the Court reversed the Seventh Circuit, dismantling its “reasonable person” standard. Justice Ginsberg explained that Congress, “as creator of federal statutory claims, has power to prescribe what must be pleaded to state the claim, just as it has power to determine what must be proved to prevail on the merits.” *Tellabs* at *11 (citing *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 512-513 (2002)) (recognizing that the heightened pleading requirements can be established by Federal Rule, citing Fed. R. Civ. P. 9(b), which requires that fraud or mistake be pleaded with particularity). Seizing upon Congress’s unequivocal raising of the bar for pleading securities fraud claims in the PSLRA, the Supreme Court saw as its “task” to “prescribe a workable construction” for identifying a “strong inference” in accordance with the PSLRA’s “twin goals” of reducing frivolous securities fraud lawsuits and simultaneously preserving investors’ “ability to recover on meritorious claims.” *Tellabs* at *9.

The Supreme Court’s prescription was to soften the so-called “most plausible” standard attributed to the Sixth Circuit, by requiring a court to take into account all of the “plausible opposing inferences” and determine whether a “reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one can draw from the facts alleged.” *Tellabs* at *10. Although it was raising the standard, the Court was unequivocal that, under its new test, a plaintiff was not “forced to plead more than she would be required to prove at trial.” *Id.* at *12.

Moreover, the *Tellabs* Court clarified that the “inference that the defendant acted with scienter need not be irrefutable . . . or even the most plausible of competing inferences,” *id.* at *10, stopping short of the “most plausible” standard originally adopted by the Sixth Circuit. Justice Ginsberg said that “the strength of an inference cannot be decided in a vacuum” and in order to deter-

mine whether “the plaintiff has alleged facts that give rise to the requisite ‘strong inference’ of scienter, a court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” *Tellabs* at *10. A plaintiff’s allegations must be “strong in light of other explanations” and thus “a complaint will survive . . . 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.” *Id.* at *10. These need not be tantamount to a “smoking gun” or even be the “most plausible” of competing inferences. *Id.* All of the allegations and potentially exculpatory explanations must be considered “collectively” and the significance “that can be ascribed to an allegation of motive, or lack thereof, depends upon the entirety of the complaint.” *Id.* at *9, *11. Thus, omissions and ambiguities in the complaint could certainly “count against” an inference of scienter. However, “the court’s job is not to scrutinize each allegation in isolation, but to assess all the allegations holistically.” *Id.* at *11.

The Supreme Court skirted making any determinations about the facts of *Tellabs*, stating, “[W]hile we reject the Seventh Circuit’s approach . . . , we do not decide whether, under the standard we have described . . . the Shareholders’ allegations warrant a strong inference that the defendants acted with the requisite state of mind. . . .” *Id.* at *13 (internal quotation marks omitted). Thus, it remanded the case for further proceedings.

Concurring and Dissenting Opinions. Justices Antonin Scalia and Samuel Alito concurred with the majority decision to reverse the Seventh Circuit, but each believed that the majority’s standard did not go far enough to weed out insufficient scienter allegations. Arguing that the bar should be much higher, Justice Scalia advocated that the test should be “whether the inference of scienter (if any) is more plausible than the inference of innocence.” *Id.* at *13. This test, according to Justice Scalia, is far more workable than having to ascertain whether the allegations constitute a draw under the majority’s “at least as compelling” standard. *Id.* at *13-*15. Justice Scalia demonstrated his view by reference to the theft of a “Jade Falcon . . . from a room to which only A and B had access.” *Id.* at *13. According to Justice Scalia, there could not possibly be a strong inference against B in such circumstances because it is equally plausible that A was the thief. Justice Alito likewise contended that the appropriate standard should require that the winning inference be the one that is “more likely than not correct.” *Id.* at *15-*16.

Justice John Paul Stevens, on the other hand, dissented because he saw the bar as too high. Although “the majority crafts a perfectly workable definition of the term,” he believed that a test patterned on the “probable-cause” standard employed in criminal actions would be more appropriate. *Id.* at *17. Explaining that it is “most unlikely that Congress intended us to adopt a standard that makes it more difficult to commence a civil case than a criminal case,” Justice Stevens argued that “using a probable-cause standard would avoid the unnecessary conclusion that in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.” *Id.* Justice Stevens found the majority standard inappropriate because,

“[T]here are times when an inference can easily be deemed strong without any need to weigh competing inferences.” *Id.*

Significance of the Tellabs Decision. Although some may characterize *Tellabs* decision as a defense victory, clearly the Supreme Court compromised and bridged the gap between the “reasonable person” standard espoused by the Seventh Circuit and the “most plausible”

standard applied by the Sixth Circuit. Indeed, it was precisely this gap that produced opinions at each end of the spectrum, arguing that the standard was too tough or too lax. However, such a compromise may best reflect that delicate balance between investor recourse and strike suits. In the real world of securities litigation, it is almost assured that the mystery of the stolen Jade Falcon would include lawsuits against *both* A and B.