March 26, 2007

Tellabs, Inc. v. Makor Issues & Rights, Ltd.: What Does It Take to Allege a "Strong Inference" of Scienter?

On March 28, the US Supreme Court will hear oral argument in one of the most significant securities cases of the current Term, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* (No. 06-484). In *Tellabs*, the Court has the opportunity to define a uniform pleading standard for determining whether the factual allegations in a securities fraud complaint give rise to the "strong inference of scienter" required under the Private Securities Litigation Reform Act of 1995 ("PSLRA"). The Court's decision could have a major impact on the ability of defendants in securities class actions to obtain early dismissal of plaintiffs' claims, without facing costly discovery and, in many cases, overwhelming pressure to settle before trial.

Under the PSLRA, a securities fraud complaint alleging material misstatements or omissions must "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind."[1] With the sole exception of the Ninth Circuit,[2] the federal courts of appeals have agreed that the PSLRA did *not* alter the established standard permitting securities fraud plaintiffs to prove scienter under § 10(b) of the Securities Exchange Act by demonstrating the defendant's "recklessness," not actual knowledge of the fraud. The circuits have clashed sharply, however, over the proper methodology for gauging the strength of the inferences to be drawn from the specific factual allegations contained in a complaint.

At least four different approaches to this issue have emerged among the various federal circuits to date. The most burdensome standard for plaintiffs prevails in the First, Fourth, Sixth and Ninth Circuits, which hold that the PSLRA's "strong inference" requirement allows courts to credit only "the *most plausible* of competing inferences" raised by all of the factual allegations in the complaint.[3] Thus, if the complaint alleges facts that are consistent both with scienter and with an alternative innocent explanation, the court should draw an inference of scienter only if it is more credible than any other reasonable inference.

In contrast, the Eighth and Tenth Circuits have expressly rejected the "most plausible of competing inferences" approach. Refusing to accept the view that only the "most plausible of competing inferences" is "strong," these circuits "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."[4]

---

[1] 15 U.S.C. 78u-4(b)(2) (emphases added).

[2] *In re Silicon Graphics Secs. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999).

[3] *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001) (emphasis added); *see also In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman 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).

[4] *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)

Meanwhile, the Second and Third Circuits have forged yet another path. These courts have adopted the view that the "strong inference" requirement of the PSLRA essentially ratified the Second Circuit's pre-PSLRA approach to scienter under § 10(b), which allowed plaintiffs to survive a motion to dismiss by pleading *either* facts demonstrating defendants' "motive and opportunity" to commit fraud *or* "strong circumstantial evidence of recklessness or conscious misbehavior."[5] Other circuits have disagreed with this approach, pointing to legislative history of the PSLRA indicating that Congress did *not* intend merely to codify the Second Circuit's standard.

In *Tellabs*, the Seventh Circuit declined to adopt any of the above approaches. Instead, the court concluded that, even under the PSLRA, a securities-fraud complaint will survive provided that it "alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Conversely, "[i]f a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal." On this basis, the Seventh Circuit partly reversed the lower court's ruling that the plaintiffs had failed to satisfy the PSLRA requirement, on the grounds that plaintiffs' allegations against Tellabs' CEO (and, consequently, the company) contained enough detail to establish a strong inference that the officer knew certain statements about the company's product sales and financial performance were false or misleading when made.[6]

The *Tellabs* decision has been met with a hail of criticism by commentators, and the SEC recently joined this assault by filing an amicus brief urging the Supreme Court to reject the Seventh Circuit's lenient formulation of the "strong inference" standard. The SEC's brief, however, itself has been attacked as lopsidedly favoring defendants' interests. In the SEC's view, 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." While stopping short of endorsing the "most plausible inference" approach, the SEC argues that courts must examine the "relative strength" of alternative inferences to determine whether such a high likelihood exists.[7]

Scienter is adequately pled if:

7th Circuit	2nd and 3rd Circuits	8th and 10th Circuits
"a reasonable person could infer that the defendant acted with the required intent"	plaintiff pleads "motive and opportunity" or "strong circumstantial evidence"	plaintiff's inference is "strong" in light of other inferences

1st, 4th, 6th, 9th Circuits	SEC/DOJ
plaintiff's inference is the "most plausible of competing inferences"	plaintiff pleads a "high likelihood that the conclusion at issue follows from the underlying facts"

[5] *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).

[6] 437 F.3d at 602, 604-05.

[7] SEC Amicus Br. in Supp. of Pet'r at 8-9. A separate amicus brief filed by the Securities Industry and Financial Markets Association (SIFMA) echoes the SEC's brief in this regard, arguing that plaintiffs must plead facts that "strongly tend to exclude the possibility" of alternative innocent inferences. SIFMA Amicus Br. in Supp. of Pet'r at 9.

Since Congress clearly intended the PSLRA to ratchet up the pleading requirements for securities fraud claims, it appears unlikely that the Supreme Court will accept the wording of the "strong inference" standard adopted by the Seventh Circuit. Indeed, it is difficult to perceive any material difference between the Seventh Circuit's formulation in *Tellabs* and the ordinary standard for surviving a motion to dismiss applied to non-securities claims. Against that backdrop, the battle lines in the Supreme Court are more likely to be drawn over how best to define and articulate the "something more" that a "strong inference" presumably requires.

It remains to be seen whether the Court will speak with a sufficiently unified voice to end the judicial debate over this issue in the lower courts. Moreover, even a more stringent formulation of the "strong inference" standard by the Court would not necessarily lead to reversal of the Seventh Circuit's conclusion that the *Tellabs* plaintiffs had succeeded in satisfying that requirement as to certain defendants. The Court could articulate new, more demanding language defining the standard, yet hold that the plaintiffs still should survive Tellabs' motion to dismiss in this case. Ultimately, the significance of the Supreme Court's decision may depend less on the specific words that the Court chooses than on the manner in which it applies those words to the particular allegations set forth in the plaintiffs' complaint.

A decision by the Supreme Court in *Tellabs* is anticipated later this spring. We will provide a summary and analysis of the Court's decision in another Advisory at that time.

* * *

If you have any questions concerning the material discussed in this client alert, please contact the following members of our securities litigation practice group:

David B. Bayless	414.591.7005	dbayless@cov.com
P. Benjamin Duke	212.841.1072	pbduke@cov.com
Linda C. Goldstein	212.841.1059	lgoldstein@cov.com
Peter A. Laveran-Stiebar	44.(0).20.7067.2021	plaveran@cov.com
David B.H. Martin	202.662.5128	dmartin@cov.com
C. William Phillips	212.841.1091	wphillips@cov.com