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Supreme Court Further Limits Securities Fraud Actions

In *Tellabs, Inc., et al. v. Makor Issues & Rights, Ltd., et al.*, No. 06-484 (June 21, 2007), the U.S. Supreme Court (Court) raised the bar for pleading securities fraud by holding that plaintiffs must allege “cogent” and “compelling” evidence before a lawsuit can proceed past the pleading stage. To survive a motion to dismiss, plaintiffs must allege facts supporting a “strong inference” of culpable intent pursuant to the Private Securities Litigation Reform Act of 1995 (PSLRA). The Court interpreted the “strong inference” requirement to mean an inference from plaintiff’s allegations that is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.”

Plaintiffs in *Tellabs* were a class of Tellabs, Inc. shareholders who claimed that Tellabs and its CEO at the time, Richard Notebaert, had engaged in securities fraud by misleading the investment public by making false statements regarding the demand for Tellabs’ products, misrepresenting the expected delivery date for next-generation Tellabs products, misrepresenting Tellabs’ financial results, stuffing distribution channels to manipulate financial results, and making overstated revenue projections. Plaintiffs argued that Tellabs and Notebaert violated Section 10(b) of the Securities Exchange Act of 1934 (1934 Act) and Rule 10b-5 thereunder, and that as a controlling person under Section 20(a) of the 1934 Act, Notebaert also was liable for fraudulent acts by the company. The district court granted without prejudice defendants’ motion to dismiss, holding that plaintiffs had failed to plead their case with the particularity required by the PSLRA. After plaintiffs amended their complaint, the district court granted, this time with prejudice, defendants’ motion to dismiss the complaint. In dismissing the complaint the second time, the district court found that while plaintiffs’ allegations regarding Notebaert’s misleading statements were sufficient, their allegations as to scienter were insufficient. The Seventh Circuit reversed the district court, holding that plaintiffs had pled facts sufficient to give rise to a strong inference of scienter, as required by the PSLRA. In so ruling, the Seventh

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Circuit declined to engage in an assessment of competing inferences out of concern that such an assessment could lead to an infringement of plaintiffs' Seventh Amendment rights.

In an opinion by Justice Ginsburg, with concurrences by Scalia and Alito and a dissent by Stevens, the Supreme Court reversed the Seventh Circuit, holding that a "strong inference" of scienter must be "cogent and at least as compelling as any opposing inference of nonfraudulent intent."

The Court explained that it sought to "prescribe a workable construction of the 'strong inference' standard," the meaning of which had confounded courts of appeals and led to a split among the circuits. In doing so, the Court set forth a three-step procedure for assessing a Rule 12(b)(6) motion to dismiss a §10(b) securities fraud action. First, courts must accept all factual allegations in the complaint as true. Second, courts must consider whether all of the facts alleged, whether in the complaint, documents incorporated in the complaint by reference, or issues of which the court may take judicial notice, when taken collectively, give rise to a strong inference of scienter. Third, when determining whether an inference of scienter is sufficiently strong to satisfy the pleading requirements of the PSLRA, courts must take into account "plausible opposing inferences." The Court explained that "the strength of an inference cannot be decided in a vacuum." And, as opposed to the Seventh Circuit's finding that inferences favoring the defendants' innocence could not be considered, the Court found that innocent explanations for the defendants' conduct, as well as inferences championed by plaintiffs, must be considered by courts.

In applying the new rule to the facts of the case before it, the Court assessed two competing arguments advanced by the parties. First, the Court assessed Tellabs' argument that Notebaert's lack of motive defeated any inferences of scienter. The Court noted that motive can be "a relevant consideration," but sided with the Seventh Circuit and found the absence of a

motive was not dispositive. Second, the Court addressed Tellabs' argument that plaintiffs' allegations were too vague to support a strong inference of scienter. The Court noted that "omissions and ambiguities count against inferring scienter." The Court explained that, when evaluating competing inferences of scienter, lower courts must ask, "[w]hen the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference."

The Court disposed of the Seventh Circuit's concern that the new standard might impinge on plaintiffs' Seventh Amendment rights by characterizing the new rule as "prescribing the means of making an issue." The Court noted that once plaintiffs had successfully made an issue, the case would fall within the province of a jury.

Justice Scalia, in his concurrence, objected to the argument that an inference of scienter can be a "strong inference" when other, nonculpable inferences, are equally as strong. Justice Scalia gave, as an illustration, the example of a jade falcon being stolen from a room to which only two people had access. Clearly the inferences that either is the thief are equally as strong. Justice Scalia advocated instead for a test requiring the inference of scienter to be "more plausible than the inference of innocence." The Court rejected Justice Scalia's position on the grounds that the PSLRA does not require the inference of scienter to be irrefutable, that, as in the case of the jade falcon, in certain instances both of the competing inferences warrant investigation, and that, in some cases, equally strong competing inferences can warrant recovery.

Justice Alito also concurred. He noted that there is an inconsistency between the PSLRA, which requires that a strong inference of scienter arise from facts pled with particularity, and the Court's statement that omissions and ambiguities only count against scienter but courts should consider all allegations collectively. Justice Alito also noted that, because Justice

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Scalia's proposed test is similar to the test employed at the summary judgment and judgment as a matter of law stage, it is likely that Congress meant to adopt this test rather than the previously unknown test adopted by the majority.

Justice Stevens dissented. He noted that Congress had delegated to the judiciary the authority to define "strong inference," but that he was persuaded that a "probable cause" test would be more appropriate.

The interpretation of the PSLRA's requirements announced in *Tellabs* appears to require a stronger showing by plaintiffs than previously has been required by most lower courts. While not expressly adopting the rule advocated by Justice Scalia that a "tie" between competing inferences would result in a dismissal, the Court did reject the much more permissive "probable cause" approach advocated by Justice Stevens in dissent.