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Securities Litigation  
June 22, 2007

# Client Alert

## Supreme Court Clarifies Securities Fraud Standards

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**In a new 8-1 decision favorable to issuers, the U.S. Supreme Court has interpreted the pleading requirements for securities fraud claims under section 10(b) of the Securities Exchange Act as imposing a heightened burden on allegations concerning a defendant's state of mind.**

The opinion in *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 06-484 (June 21, 2007) clarifies the provision of the Private Securities Litigation Reform Act of 1995 ("PSLRA") that obligates securities fraud plaintiffs to allege "facts giving rise to a strong inference" that the defendant acted with "scienter"—a mental state embracing recklessness or the intent to deceive, manipulate or defraud. Resolving multiple lower court interpretations of the "strong inference" standard, the Supreme Court concludes in *Tellabs* that the inference of scienter must be more than merely reasonable or permissible, and that it is not sufficient for a plaintiff merely to plead facts from which recklessness or intent could be inferred. Instead, the *Tellabs* Court holds that, when considering a motion to dismiss under the PSLRA, a reviewing court must construe the complaint in its entirety, weighing the inference of scienter against all plausible opposing inferences. And to be "strong" enough to survive a motion to dismiss, the inference of scienter must be "cogent and at least as compelling" as any reasonable alternate explanation for the defendant's conduct.

### Underlying Facts

In 2001, the stock price of Tellabs, Inc. fell on news that demand for its products was down. A number of shareholders sued the company and its former CEO in a putative class action. The plaintiffs alleged that the company illegally inflated revenues in the fourth quarter of 2000 and that its CEO made false projections in 2001, supposedly assuring analysts that demand was growing when defendants knew the market was evaporating.

## Rulings Below

Defendants moved to dismiss the action for failing to satisfy the requirements of the PSLRA, which Congress enacted to curb perceived abuses of private securities actions. Among other things, the PSLRA imposes heightened pleading standards providing that all private securities complaints alleging false or misleading statements must (1) “specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading,” and (2) “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” 15 U.S.C. §78 u–4(b).

The District Court twice granted Tellabs’ motion to dismiss, the second time with prejudice. It found that while the shareholders had met the first PSLRA pleading requirement by sufficiently alleging misleading statements by the CEO (which were imputed to Tellabs), the shareholders had failed to allege facts giving rise to a strong inference of scienter.

On appeal, the Seventh Circuit reversed the District Court’s opinion and revived the plaintiffs’ fraud claims. It agreed that the shareholders sufficiently pled the misleading character of the CEO’s alleged misstatements, but it disagreed with the District Court’s ruling that the scienter allegations were defective. Applying a relatively weak pleading standard, the Seventh Circuit stated that it would allow a securities fraud complaint to survive a motion to dismiss merely if “it alleges facts from which, if true, a reasonable person could infer that defendants acted with the requisite intent.”

## Proceedings in the Supreme Court

Tellabs appealed this decision to the Supreme Court, arguing that “[t]he approach adopted by the Seventh Circuit in this case does serious violence to the deliberately high pleading standard adopted by Congress and to its desire to provide business with relief from costly strike suits.” The Securities Industry and Financial Markets Association and the U.S. Chamber of Commerce filed an *amicus* brief in support of Tellabs’ position. The United States Solicitor General filed an *amicus* brief to reflect the interests of the Securities and Exchange Commission and Department of Justice, which also supported Tellabs.

The majority opinion, authored by Justice Ginsburg, was intended to “prescribe a workable construction of the ‘strong inference’ standard, a reading geared to the PSLRA’s twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims.” To accomplish this, the *Tellabs* Court adopted a three-tiered approach that courts now must follow when ruling on motions to dismiss securities fraud claims:

- *First*, courts must accept all factual allegations in the complaint as true.
- *Second*, courts must “consider the complaint in its entirety,” along with “other sources courts ordinarily examine when ruling on ... motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which the court may take judicial notice.”
- *Third*, “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.”

The Court reasons that “the strength of an inference cannot be decided in a vacuum,” and that to be “strong,” an inference of scienter must be weighed against reasonable alternate rationales that do not require the defendant to have a culpable state of mind. Yet, the Court says it is not necessary that the inference of scienter be “irrefutable, *i.e.*, of the ‘smoking-gun’ genre, or even the ‘most plausible of

competing inferences.” Still, the inference must be “cogent and compelling, thus strong in light of other explanations.” In sum, the Court holds: “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.”

Tellabs had argued that if competing inferences were considered, the absence of any allegations that the CEO gained monetarily from the alleged misconduct would be dispositive. Tellabs also argued that the shareholders’ scienter allegations were too vague and ambiguous to survive dismissal. The Supreme Court did not reach these conclusions. Its decision simply vacated the judgment of the Court of Appeal, and remanded to the Seventh Circuit to reevaluate the matter in light of the new “strong inference” standard.

The Supreme Court did state, however, that a defendant’s motive is a “relevant consideration,” and that “financial gain may weigh heavily in favor of a scienter inference.” But it also states that “the absence of a motive allegation is not fatal.” Further, the Court agreed with Tellabs that “omissions and ambiguities count against inferring scienter,” insofar as the PSLRA requires plaintiffs to state “with particularity” the facts supporting the “strong inference” of scienter. But the Court did not expressly preclude the consideration of vague or ambiguous scienter allegations, saying, instead, “that the court’s job is not to scrutinize each allegation in isolation but to assess all the allegations holistically.” *Tellabs* enunciates the basic question that all courts must consider when ruling on motions to dismiss under the PSLRA as follows:

When 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?

In a concurring opinion, Justice Scalia disagreed with the majority’s conclusions that a “strong inference” need not be “the most plausible of competing inferences.” He argued that “the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence.” Justice Alito’s concurring opinion addressed a separate point—his concern that the majority’s construction might be read so as to permit a reviewing court to consider “nonparticularized” allegations of scienter when deciding if the “strong inference” standard had been met. “Not only does this contradict the clear statutory language on this point,” he wrote, “but it undermines the particularity requirement’s purpose of preventing a plaintiff from using vague or general allegations in order to get by a motion to dismiss for failure to state a claim.”

In the lone dissenting opinion, Justice Stevens suggested that the majority could have avoided several complications by borrowing a familiar standard from criminal law and ruling that defendants will not be subject to the intrusion of a securities fraud action unless there is “probable cause to believe them guilty of misconduct.” He stated that while the probable cause standard is not capable of precise measurement, “its meaning is roughly the same as ‘strong inference.’” Justice Stevens’ concern was that by always requiring reviewing courts to take plausible competing inferences into account, the majority may be making it harder to bring civil actions than a criminal ones. To illustrate this, he suggested a hypothetical: “[I]f a known drug dealer exits a building immediately after a confirmed drug transaction, carrying a suspicious package, a judge could draw a strong inference that the individual was involved in the aforementioned drug transaction without debating whether the suspect might have been leaving the building at that exact time for another unrelated reason.” After applying his standard to the allegations of the *Tellabs* complaint, Justice Stevens concluded that there is “probable cause” to believe the CEO acted with the requisite intent, and, therefore, he would have affirmed the judgment of the Court of Appeals.

## Conclusion

*Tellabs* is a positive development for public companies and others facing the risk of frivolous securities claims, but it is not without potential repercussions. As Justice Scalia recognizes, the majority opinion will require lower courts to grapple with plaintiffs' arguments that allegations can establish a strong inference of scienter, even if the inference is not "the most plausible." As Justice Alito noted, lower courts might be tempted to construe the majority's opinion as allowing the consideration of "nonparticularized" scienter allegations, which would be contrary to the express language of the PSLRA. Additionally, the majority opinion acknowledges the importance of private securities fraud actions, describing them as an "essential supplement to criminal prosecutions and civil enforcement actions brought by the Department of Justice and the Securities Exchange Commission." This "essential supplement" language is sure to become a standard feature in plaintiffs' briefs opposing motions to dismiss.

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