

Supreme Court Adopts Heightened Standard For Pleading Scienter In Federal Securities Fraud Cases

June 21, 2007

Today, the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* defined what constitutes “a strong inference” of scienter for purposes of pleading a federal securities fraud claim under the Private Securities Litigation Reform Act (“PSLRA”). Under *Tellabs*, to survive a motion to dismiss, a plaintiff must allege particularized facts that give rise to an inference of defendant’s fraudulent intent that is “more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” The Court rejected a more lenient pleading standard adopted by the United States Court of Appeals for the Seventh Circuit, which sustained an allegation of scienter based on facts from which “a reasonable person could infer” that the defendant acted with fraudulent intent. The *Tellabs* decision is the latest in a series of recent Supreme Court decisions that impose stricter pleading requirements on class action plaintiffs alleging claims under federal securities laws.

BACKGROUND

The facts of *Tellabs* are straightforward. The company announced in June 2001 that demand for its “flagship” product had decreased “significantly” and that it was lowering earnings projections. Following the announcement, the company’s stock dropped. Shareholders brought claims under Section 10(b) and Rule 10b-5, alleging that, among other things, the company and its chief executive officer falsely represented that the demand for the company’s product was growing while, in fact, it was decreasing and falsely reported financial results through the use of “channel stuffing.” According to the plaintiffs, these misrepresentations artificially inflated the value of the company’s stock, which “inflation” dissipated when the company disclosed the “truth” about the alleged misrepresentations.

Congress enacted the PSLRA in 1995 to curb perceived abuses by class action plaintiffs who were filing non-meritorious complaints under Section 10(b) and Rule 10b-5 to extract from corporations nuisance value settlements. Under the PSLRA’s heightened pleading standards, a plaintiff asserting a 10b-5 claim must allege facts with particularity that give rise to a “strong inference” of scienter. The statute does not elaborate on what constitutes a “strong inference” of scienter. Circuit courts have interpreted the “strong inference” standard differently.

The district court in *Tellabs* dismissed the complaint for failure to plead scienter. The Seventh Circuit reversed, holding that the PSLRA’s “strong inference” standard was satisfied because the complaint alleged facts “from which, if true, a reasonable person could infer that the defendant acted with the required intent.” According to the Seventh Circuit, at the pleadings stage, courts are not permitted to weigh competing inferences from the allegations, including nonculpable inferences. They must

merely ascertain whether the inferences drawn by the plaintiff are reasonable. In so holding, the Seventh Circuit expressly declined to follow the “stiffer standard” advocated by the defendants and adopted by the Sixth Circuit—that the plaintiffs are entitled only to the “most plausible of competing inferences.” The Seventh Circuit reasoned that its more relaxed standard “[could not] be misunderstood as a usurpation of the jury’s role” and the right to a jury trial under the Seventh Amendment.

SUMMARY OF THE DECISION

In an opinion written by Justice Ginsburg, the Court reversed the Seventh Circuit in an 8-1 decision. Justices Scalia and Alito each filed concurring opinions. Justice Stevens dissented.

The Court held that, to survive a motion to dismiss under the PSLRA, a complaint in a Section 10(b) and Rule 10b-5 case must allege particularized facts from which an inference of fraudulent intent must be “more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.” In so doing, the Court expressly rejected the Seventh Circuit’s more relaxed standard. Under the uniform standard articulated in *Tellabs*, district courts must now consider all facts in the complaint “holistically” and evaluate all inferences to be drawn from those facts, including both the inferences urged by plaintiff as well as plausible nonculpable explanations for the defendant’s conduct. By eschewing the more relaxed pleading standard, the Court relied on the fact that, by enacting the PSLRA, Congress intended to curb securities class action abuses, including “nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.” The Court characterized the Seventh Circuit’s concern that a heightened standard impinged on Seventh Amendment rights as “undue” given Congress’ ability to legislate what must be pleaded to state a claim under federal statute.

IMPLICATIONS

Tellabs is the latest in a series of Supreme Court decisions imposing stricter pleading requirements for securities fraud (and other class action) lawsuits. This decision provides clear and forceful authority for district courts to dismiss securities fraud cases that are based on speculative, or even merely reasonable, scienter theories. *Tellabs* requires a showing that the inference of fraudulent intent be “cogent,” “compelling,” “powerful” and more than a mere possibility. Accordingly, *Tellabs* will be regularly cited by defendants seeking dismissal of future securities fraud complaints. We also anticipate that, just as in the aftermath of the Supreme Court’s loss causation decision last year in *Dura*, defendants in existing securities fraud cases may ask courts to take a fresh look at plaintiffs’ scienter allegations in light of *Tellabs*.

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