Supreme Court Clarifies “Strong Inference” Pleading Standard Under the PSLRAs

In its second major securities litigation decision last week, the Supreme Court on June 21 addressed one of the heightened pleading requirements under the Private Securities Litigation Reform Act of 1995 (“PSLRA”). The case, **Tellabs, Inc. v. Makor Issues & Rights, Ltd.** (No. 06-484), marked the Court’s effort to define when a complaint adequately alleges a defendant’s “scienter”—the intent to deceive. The Court, articulating a new test for evaluating the sufficiency of a pleading, held that, under this provision, “an inference of scienter . . . must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.”

**Tellabs** appears to be a mixed blessing for potential defendants in private lawsuits under the federal securities laws. While the Court rejected the anomalously pro-plaintiff standard adopted by the Seventh Circuit, the Supreme Court’s holding and other language in the opinion suggest a somewhat more plaintiff-friendly view of securities class actions than had previously prevailed in many circuits. Significantly, the Court did not apply the standard it articulated, but left this for further development in the lower courts. It declined to determine whether the complaint passed muster under the PSLRA, and instead remanding the case to the Seventh Circuit for further proceedings.

**Background**

A plaintiff’s ability to plead scienter is often the critical factor in keeping a case alive past the pleading stage. At issue in **Tellabs** was the requirement under Section 21D(b)(2) of the PSLRA that, in order to survive a motion to dismiss, a complaint in a private securities action must “state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind.”1 This provision compels plaintiffs who bring a case under Section 10(b) and Rule 10b-5—the principal weapons of the plaintiffs’ bar—to allege facts that, if true, would satisfactorily prove scienter. This requirement was a major component of the reforms adopted in the PSLRA to curb speculative and meritless securities class actions.

The underlying case was a suit brought against Tellabs, a manufacturer of fiber optic network equipment, and its CEO, Richard Notebaert. The plaintiffs accused the defendants of engaging in a scheme to defraud the public by misrepresenting the financial condition of the company, as well as the availability of and demand for certain of the company’s products. After an initial complaint was dismissed by the District Court for failure to plead with sufficient particularity,2 the plaintiffs filed an amended complaint that added several specific allegations concerning Notebaert’s mental state.

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The District Court dismissed the complaint with prejudice, holding that plaintiffs’ allegations that Notebaert acted with scienter were insufficient under the PSLRA.3

On appeal, the Seventh Circuit reversed, holding that under the PSLRA, a complaint should survive “if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent”4 irrespective of the comparative strength of other possible inferences. In so holding, the Seventh Circuit explicitly rejected the stricter standard used by the Sixth Circuit, which requires that “plaintiffs are entitled only to the most plausible of competing inferences.”5 The Supreme Court granted certiorari in order “to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inferences” in determining whether a complaint satisfies the heightened pleading requirement of the PSLRA.

The Supreme Court’s Rulings

The Supreme Court squarely rejected the Seventh Circuit’s standard, and held that the PSLRA text requires the weighing of competing inferences. Writing for a six-justice majority, Justice Ginsburg reiterated the Court’s stance “that private securities litigation [i] is an indispensable tool” for defrauded investors, but recognized that the PSLRA was “[d]esigned to curb perceived abuses of the §10(b) private action,” and that the heightened pleading requirement was one of the means by which Congress chose to do so. Therefore, she wrote, the Seventh Circuit’s interpretation failed to “capture the stricter demand Congress sought to convey in §21D(b)(2).” Instead, “an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” The Court described this new standard as satisfying “the PSLRA’s twin goals... of [curb[ing] frivolous, lawyer-driven litigation, while preserving investors’ ability to recover on meritorious claims.”

The Court described the required analysis under the PSLRA as “inherently comparative,” and said that in performing this analysis, courts “must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.”6 The Court emphasized, however, that in this comparison, the inference that the defendant acted with scienter need not be irrefutable, or a “smoking gun,” but rather must be “cogent and compelling, and thus strong in light of other explanations.” The Court was also explicit in stating that under the new standard, a plaintiff need not plead more than he would be required to prove at trial, where the claim must be proved by “a preponderance of the evidence.”

Importantly, in response to the defendant’s argument that some of plaintiffs’ allegations were too vague or ambiguous to contribute to a strong inference of scienter, the Court stated that, while “omissions and ambiguities count against inferring scienter,” a court should not “scrutinize each allegation in isolation,” but should instead endeavor to assess all the allegations “holistically.”

The Court also made some potentially important pronouncements about a defendant’s alleged motive. Makor, in its complaint, did not allege that Notebaert sold any stock during the class period. Tellabs argued that the lack of allegation of motive “color[ed] all the other allegations putatively giving rise to an inference of scienter.” The Court agreed

3 Id. at 971.
4 Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006).
5 Id. at 601, 602 (quoting Fidel v. Farley, 392 F.3d 220, 226 (6th Cir. 2004)).
that motive was a relevant consideration in assessing inference of scienter, but stopped short of saying that allegations of motive are essential to establishing that inference. Rather, the Court agreed with the Seventh Circuit that while “personal financial gain may weigh heavily in favor of a scienter inference, . . . absence of a motive allegation is not fatal” to a complaint.

Justices Scalia and Alito, writing in separate concurrences, advocated a tougher test than that adopted by the Court. Both opined that, under a plain reading of the language of the PSLRA’s pleading requirement, the test should be “whether the inference of scienter . . . is more plausible than the inference of innocence.” (emphasis in original). Justice Alito additionally rejected the holistic approach to pleadings, objecting to the Court’s apparent willingness to consider any individual scienter allegation that failed, on its own, to meet the PSLRA’s particularity requirements. Justice Stevens offered the only dissent, proposing a “probable cause” standard, and disagreeing with the Court’s requirement of a comparative analysis of competing inferences.

Comparison With Prior Law

While any effort to definitively assess Tellabs’ impact is plainly premature, some tentative comparisons with prior law are worth attempting. While the Supreme Court has now made clear that the floor for PSLRA pleading standards is above that established by the Seventh Circuit in its outlier opinion, the Court’s language and holding also suggest that the ceiling on these pleading standards is somewhat below that suggested by some prior circuit opinions. In particular:

- To the extent that the Court’s newly articulated “cogent and at least as compelling” standard indicates that “the tie goes to the plaintiff,” it is substantially similar to the standard of only one other circuit that has previously ruled on this issue. It appears to be a rejection of the standards adopted by at least four other circuits, which required that the inference of scienter be stronger than competing inferences suggesting nonculpable behavior.

- The Court’s willingness to at least give some consideration (however slight) to non-particularized allegations of scienter also may signify a break with the rule in at least one circuit. See, e.g., California Public Employees’ Retirement Sys. v. Chubb Corp., 394 F.3d 126, 145 (3d Cir. 2004) (“unless plaintiffs in securities fraud actions allege facts supporting their contentions of fraud with the requisite particularity … they may not benefit from inferences flowing from vague or unspecific allegations – inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis” ) (citations and internal quotation marks omitted).

- The precise import of the Court’s statement that “personal financial gain may weigh heavily in favor of a scienter inference” is not yet clear. The suggestion that such so-called motive allegations may be entitled to “heav[y]” weight may provide a slight boost to plaintiffs in some circuits. Compare with, e.g., Florida State Board of Admin v. Green Tree Financial Corp., 270 F.3d 645, 660 (8th Cir. 2001) (describing motive and opportunity allegations as “generally relevant to a fraud case” and a showing of “unusual or heightened motive will often form an important part of a [sufficient] complaint”). But the Supreme Court stopped short of endorsing language in some Second and implicitly adopted a similar standard. See In re K-tel Int’l, Inc. Sec. Litig., 300 F.3d 881, 889 n.6 (8th Cir. 2002).

8 See Helwig v. Vencor, Inc., 251 F.3d 540, 553 (6th Cir. 2001) (“plaintiffs are entitled only to the most plausible of competing inferences”); In re Credit Suisse First Boston Corp., 431 F.3d 36, 49 (1st Cir. 2005) (allegations insufficient when “there are legitimate explanations for the behavior that are equally convincing”); Gompper v. VISX, Inc., 298 F.3d 893, 897 (9th Cir. 2002); Ottman v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 350 (4th Cir. 2003) (both holding that complaint is insufficient if “it is equally if not more plausible” that plaintiff’s conduct was nonculpable).
Third Circuit opinions suggesting that motive allegations can be independently sufficient to satisfy the PSLRA pleading requirements.

Concededly, as Justice Scalia recognized in his concurrence, potential distinctions such as these may make little difference in practice. Indeed, when it comes to securities litigation pleading standards, the devil is in the details. What often matters most is how the standards are applied given the relatively slight differences among the standards themselves and the highly fact intensive nature of judicial assessment of a specific complaint. See generally Phillips, Maletta & Terris, “Securities Litigation” in Business and Commercial Litigation in the Federal Courts (2d ed. 2005) § 62:45 at 987. Thus, while Ninth Circuit cases are often regarded as having articulated the most pro-defendant pre-

**Conclusion**

The impact of **Tellabs** on private securities litigation is difficult to predict, for the decision sends some mixed signals, and leaves important issues—especially how the standard is to be applied—unaddressed.

Another potentially more significant case is waiting in the wings. This fall, the Court hears arguments in **Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.**, which concerns the question of whether and to what extent “secondary” actors such as accountants, lawyers and underwriters of securities offerings may be liable as primary violators of Section 10(b) and Rule 10b-5. These potential deep-pocket defendants often have been protected by the Supreme Court’s 1994 **Central Bank** decision, which held that there was no private right of action under Section 10(b) and Rule 10b-5 for aiding and abetting violations of the securities laws.9

For more information on **Tellabs**, **Stoneridge**, or any of the issues discussed in this Alert, please contact one of the authors listed on the first page.

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