

**SUPREME COURT HEIGHTENS SCIENTER PLEADING STANDARD
IN SECURITIES FRAUD CASES**

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, the Supreme Court raised the bar for securities fraud complaints faced with a motion to dismiss. In an 8-1 decision, the Court held that “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’s holding resolved a split among federal appeals courts regarding the proper approach to pleading scienter under the Private Securities Litigation Reform Act of 1995 (the “PSLRA”) and strengthened the PSLRA’s intended function as a “check against abusive litigation by private parties.” However, as the concurring opinions of Justices Scalia and Alito suggest, the Court’s interpretation is by no means the strictest approach it could have adopted, and there is significant uncertainty as to how trial courts will apply the new standard.

Background

In late 2002, shareholders of Tellabs, Inc., a manufacturer of equipment used in fiber optic networks, filed a class action in the U.S. District Court for the Northern District of Illinois alleging that Tellabs and its CEO and president had committed securities fraud by intentionally misleading the public about the company’s financial condition and the value of its stock. Specifically, the shareholders alleged, among other things, that Tellabs had made false statements about demand for one of the company’s key products and had falsely overstated the company’s revenue projections. The District Court dismissed the shareholders’ class action complaint without prejudice for failure to plead their allegations with the particularity required under the PSLRA. *See Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 945 (N.D. Ill. 2004). The shareholders amended their complaint, adding references to confidential sources and more detailed allegations with respect to the CEO’s mental state in connection with the public misrepresentations. The District Court again dismissed, this time with prejudice, on the ground that the shareholders had failed to plead scienter sufficiently. *See id.* at 971.

The U.S. Court of Appeals for the Seventh Circuit reversed, holding that a securities fraud complaint survives dismissal “if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006). The Seventh Circuit expressly declined to adopt the stricter pleading standard of the Sixth Circuit, pursuant to which “plaintiffs are entitled only to the most plausible of competing inferences.” *Id.* (quoting *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004)). Applying a more relaxed standard, the Seventh Circuit reasoned that a reasonable person could infer scienter from the allegations in the shareholders’ amended complaint.

The Supreme Court granted certiorari “to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a ‘strong inference’ of scienter.” *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, ___ S. Ct. ___ (2007).

Decision

In *Tellabs*, the Supreme Court grappled with the proper interpretation of § 21D(b)(2) of the PSLRA, which requires plaintiffs to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Writing for the majority, Justice Ginsburg noted that Congress left the phrase “strong inference” undefined and provided no clear guidance other than “its intent[ion] to strengthen existing pleading requirements,” as voiced in legislative history. Seeking to accommodate the PSLRA’s “twin goals” of curbing frivolous litigation while protecting defrauded investors’ right to seek recovery, the Court concluded that a “strong inference” requires courts to weigh competing inferences of intent based on the facts alleged in the complaint. The Court elaborated: “[A] court must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” And although the inference of scienter “need not be irrefutable,” it must be more than “reasonable” or “permissible.” The Court concluded: “A complaint will survive, we hold, 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.”

The Court vacated the Seventh Circuit’s decision so that the lower court could reexamine the case in light of the Court’s opinion.

In separate concurrences, Justices Scalia and Alito agreed with the judgment but disagreed with the majority interpretation of “strong inference.” Justice Scalia argued that “the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence.” Justice Alito endorsed Justice Scalia’s test and added his own requirement that “only those facts that are alleged ‘with particularity’ may properly be considered in determining whether the allegations of scienter are sufficient.”

Justice Stevens authored a lone dissent in which he advocated a “probable cause” approach to pleading scienter under the PSLRA.

Conclusion

The heightened scienter pleading standard adopted by *Tellabs* will make it harder for securities fraud plaintiffs to survive the early stages of litigation and proceed to discovery. But the *Tellabs* test, short of clearly mandating a comparative analysis of competing inferences, does not provide trial courts with significant guidance on how to assess whether an inference of scienter is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.” As trial courts contend with the application of this pleading standard, we can expect plaintiffs to bring more carefully crafted securities fraud claims in an effort to present as compelling a case on scienter as possible at the outset of the litigation.

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