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Pleading 'Strong Inference' of Scienter Under PSLRA

After more than a decade of struggle by district and circuit courts with statutory ambiguity and extensive, but conflicting and inconclusive, legislative history, the U.S. Supreme Court will consider the heightened standard for pleading scienter under the Private Securities Litigation Reform Act.[1]

The Court has agreed to review a U.S. Court of Appeals for the Seventh Circuit decision that articulates an extremely lenient standard for determining whether the facts alleged in a complaint asserting a violation of the federal securities laws give rise to a "strong inference" that the defendant acted with the required state of mind. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F3d 588 (7th Cir. 2006), cert. granted, 75 U.S.L.W. 32 WL 3207 (U.S. Jan. 5, 2007) (No. 06-484).

Substantive Scienter Standard

In *Makor*, the Seventh Circuit addressed several important issues pertaining to the requirement that scienter be pleaded and proved as an element of a claimed violation of §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. In deciding the first of those issues, whether recklessness or a stronger variant approaching actual intent is now the minimum "required state of mind," the Seventh Circuit joined the majority of circuit courts (all but the U.S. Court of Appeals for the Ninth Circuit) that have held that the PSLRA did not raise the substantive state of mind pleading requirement from ordinary recklessness to deliberate or conscious recklessness evidencing actual intent.[2] The court noted that, prior to the passage of the PSLRA, every circuit to consider the substantive scienter standard had held that the assertion of facts showing ordinary recklessness was sufficient to allege scienter. The court reasoned that, if Congress had wanted to impose a more stringent scienter pleading standard, it would have done so explicitly. Therefore, the court concluded, the pre-PSLRA scienter standard should be applied. That standard requires "an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it." *Makor*, 437 F3d at 600.

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Pleading an Inference of Scienter

The Seventh Circuit reviewed the different approaches taken by the various circuit courts in determining the sufficiency of the scienter pleading, identifying three different approaches circuit courts have used to evaluate the required "strong inference." The Second and Third circuits, noting that the PSLRA adopted the Second Circuit's pre-PSLRA "strong inference" pleading standard for scienter, have held that plaintiffs may also continue to state a claim requiring scienter by the same pleading as required before, either (1) motive and opportunity or (2) strong circumstantial evidence of recklessness or conscious misbehavior.[3] The U.S. Courts of Appeals for the Ninth and Eleventh circuits have concluded that Congress intended to elevate the pleading requirement above the Second Circuit's standard, opting instead for the more onerous burden of pleading a "strong inference" of deliberate or conscious recklessness and rejecting the motive and opportunity analysis.

The Seventh Circuit concluded it was joining with six other circuits to adopt the "middle ground" approach, reasoning that Congress chose neither to adopt nor reject particular types of information or methods required to plead scienter and, in particular, did not codify the Second Circuit's motive and opportunity analysis. Since Congress did not provide guidance on what suffices to create a "strong inference" of scienter, the Seventh Circuit concluded that the best approach is for courts to examine all of the allegations in the complaint to make that determination. While motive and opportunity allegations may be "useful indicators," "nowhere in the PSLRA does it say they are either necessary or sufficient." 437 F3d at 601.

The 'Makor' Decision

The allegations in *Makor* are unremarkable. Tellabs is a manufacturer of specialized equipment used in fiber-optic cable networks. Plaintiffs, representing a proposed class of stockholders, accused the company and several of its officers and directors of violating §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. According to plaintiffs, defendants engaged in a scheme to deceive the investing public about the true value of Tellabs' stock. Defendants allegedly engaged in "channel stuffing" in the fourth quarter of 2000, reported inflated earnings for 2000, and made false revenue predictions for 2001. Allegedly, the company and its officers knowingly lied to the public by overstating the demand for Tellabs' products when they knew that sales of those products were declining.

The district court, while finding that the complaint adequately alleged false or misleading material statements, twice dismissed the complaint holding plaintiffs failed to adequately allege scienter for any of the defendants. On appeal, the Seventh Circuit affirmed in part and reversed in part, agreeing with the district court's dismissal of plaintiffs' claims against Tellabs' chairman, but reviving plaintiffs' claims against the company and its CEO. With respect to the chairman, the court noted that his alleged misleading statement about the strength of the market for Tellabs' primary product preceded the point in time at which it was alleged that the critical weakness in that market became obvious. The court also rejected the argument that the chairman's insider trading (less than one percent of his holdings) was sufficient circumstantial evidence of scienter. With respect to the allegations of materially false financial statements, which was signed by the chairman and the CEO, the Seventh Circuit concluded that although the chairman "should have assured himself that the numbers being represented were accurate, his trust in his CEO does not constitute the level of recklessness that that statute requires." 437 F3d at 604.

However, with regard to the CEO, the court held that the allegations concerning negative marketing, sales, and production information available to the

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CEO and his contemporaneous or subsequent positive public statements were sufficient to establish a strong inference that he acted with fraudulent intent. Based largely on allegations recounting the statements of confidential sources within the company, the court concluded that it was "sufficiently probable" the CEO had information suggesting that his statements were false and a reasonable person could infer that the CEO knew they were false.

Finding a 'Strong Inference'

The central issue presented in the certiorari petition to the Supreme Court is whether and to what extent a court should consider or weigh competing inferences in determining whether a securities fraud complaint has alleged facts sufficient to establish a "strong inference" of scienter.[4]

As described by the Seventh Circuit in *Makor*, the concern "is the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" 437 F3d at 601. That concern is of no small moment. Nearly every complaint alleging a violation of the antifraud provisions of the federal securities laws is challenged by a motion addressed to the adequacy of the complaint, and the sufficiency of the scienter allegations is frequently the centerpiece of that challenge. Quite literally, millions, tens of millions, or hundreds of millions of dollars may ride on how the district court assesses the relative strength of the inference arising from the particularized facts alleged.

The Seventh Circuit recognized the possibility that allegations in a complaint might give rise to competing inferences with respect to a defendant's mental state, and that district courts must decide whether and, if so, how much to credit possible innocent inferences against possible culpable ones. The court observed that the Sixth Circuit had held that a strong inference must be the "most plausible of competing inferences," although the inference does not have to be "irrefutable."[5] However, the Seventh Circuit pointed out that the Sixth Circuit itself has suggested that this standard might infringe upon a plaintiff's Seventh Amendment rights.[6] In the referenced Sixth Circuit case, the court observed: "One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." 437 F3d at 602.

Although it expressed no view as to whether the Sixth Circuit approach is, in fact, unconstitutional, the Seventh Circuit was evidently concerned about invading the jury's province if it were to set a standard which considered the comparative strength of innocent and culpable inferences. The court concluded that it would be "wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role" and held instead that a complaint could survive if a reasonable person could infer from the facts alleged that the defendant acted with the required intent. In doing so, the court explicitly found that it would be "inappropriate" to determine which of two seemingly equally strong inferences would ultimately prevail "lest we invade the traditional role of the factfinder."[7]

In its petition for a writ of certiorari, Tellabs argued that the Seventh Circuit's standard, which it referred to as "the most lenient of any circuit," "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."[8] Tellabs argued that the Seventh Circuit's lax standard incentivizes plaintiffs to plead with "strategic ambiguity,"[9] and is inconsistent with Congress' intent "to end the pernicious practice of pleading fraud with hindsight whenever a company's stock price tumbles."[10]

As the Seventh Circuit said in 'Makor,' the concern "is the degree of imagination courts can use in divining whether a complaint creates a 'strong inference of scienter.'"

Tellabs argued that the various courts of appeals have adopted four meaningfully different interpretations of the "strong inference" standard, resulting in a 4-2-2-1 split of authority. Four circuits, the First, Fourth, Sixth and Ninth, require a direct comparison of the plausibility of competing inferences. Unless the culpable inference is the "most plausible," it is not "strong" and the complaint should be dismissed. Two circuits, the Eighth and the Tenth, consider all inferences, both of scienter and of an innocent mental state, using the innocent inferences to test whether the culpable interest is strong, but do not directly weigh one against the other. The Second and Third circuits divide the factual allegations bearing on a defendant's mental state into categories, "motive and opportunity" and "strong circumstantial evidence" of knowing or reckless conduct, either of which may independently satisfy the strong inference requirement. And, the Seventh Circuit, in *Makor*, did not consider competing inferences, but concluded that if an inference of culpability exists, the pleading is sufficient. While arguing that the Seventh Circuit has weakened the "strong inference" protection of the PSLRA, Tellabs does not suggest what the proper standard should be.

Conclusion

The diverse approaches currently existing in the circuit courts are directly contrary to Congress' intent to create a uniform standard of pleading securities fraud. By granting Tellabs' petition, the Supreme Court has recognized the need for guidance on this critical issue. And, it is predictable that the *Makor* standard, to permit a "strong inference" to arise from any reasonable inference will not survive as the standard set by the Supreme Court.

Indeed, it would seem impossible to determine a "strong inference" of scienter without considering any alternative innocent inferences. In an amici brief to the certiorari petition, the Securities Industry and Financial Markets Association and the U.S. Chamber of Commerce argue that the correct standard is to "require dismissal unless the facts alleged strongly tend to exclude innocent explanations for the challenged conduct."[11] As argued in the certiorari petition, if an inference of innocence is equal to that of scienter, the inference of scienter cannot be "strong." Therefore, unless the statutory requirement of a "strong inference" is abandoned altogether, as the Seventh Circuit appears in effect to have done, innocent inferences must be considered, whether styled as a direct "weighing" of the inferences to find the "most plausible," or testing the strength of a culpable inference by considering the innocent alternative. In practice, these two "alternatives" may actually be distinctions without a meaningful difference. The perceived constitutional problem, which gave rise to these distinctions, is questionable, since courts engage in weighing facts in many contexts, including all motions to dismiss, with or without heightened pleading requirements.

At the same time the Supreme Court clarifies the PSLRA "strong inference" standard, it may also, and hopefully will, clarify the standards for group pleading of scienter (rejected by the Seventh Circuit in *Makor*, but still the subject of significant debate among the various circuits) and pleading corporate scienter (imputed by the Seventh Circuit to Tellabs based on the CEO's alleged knowledge of the falsity of his statements while acting within the scope of his position), about which we have written in the past.[12]

1. See 15 USC §78u-4(b)(2).
2. Compare *In re Silicon Graphics Sec. Litig.*, 183 F3d 970, 979 (9th Cir. 1999) (determining that a plaintiff must allege facts that create a strong inference of "deliberate or conscious recklessness" that strongly suggests "actual intent") and *Makor*, 437 F3d at 600 ("all other circuits to have considered this issue have concluded that the substance [an extreme departure from the standards of ordinary care] remained unchanged [by the PSLRA].")
3. In its first post-PSLRA decision, *Novak v. Kasaks*, 216 F3d 300 (2d Cir. 2000), the Second Circuit recognized that "the absence of statutory reference to "motive and opportunity" and the confusing and conflicting legislative history of the PSLRA suggested that "we need not be wedded to these concepts in articulating the prevailing standard."
4. Petition for a Writ of Certiorari, No. 06-484, 2006 WL 2849388 (filed on Oct. 3, 2006) (petition).
5. *Fidel v. Farley*, 392 F3d 220, 227 (6th Cir. 2004) (quoting *Helwig v. Vencor, Inc.*, 251 F3d 540, 553 (6th Cir. 2001) (en banc)).
6. *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F3d 651, 683 n. 25 (6th Cir. 2005).
7. 437 F3d at 602 (quoting *Pirraglia v. Novell, Inc.*, 339 F3d 1182, 1188 (10th Cir. 2003).
8. Petition, 2006 WL 2849388, at *17.
9. Id. at *27.
10. Id. at *5.
11. Brief in Support of Petitioners, 2006 WL 3608188, at *4 (filed on Dec. 6, 2006).
12. See Gold, Sarah S. and Spinogatti, Richard L., "Guidance Sought on Pleading Corporate Scienter," New York Law Journal, Aug. 9, 2006.