

Client Alert

A report
for clients
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of the Firm June 2007

Supreme Court Clarifies Standard for Pleading Scienter Under the Private Securities Litigation Reform Act

On June 21, the Supreme Court held that a complaint governed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 109 Stat. 737, will survive a motion to dismiss only "if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inferences one could draw from the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, — S.Ct. —, Case No. 06-484, June 21, 2007, at *12-13. In reviewing the complaint, a court must engage in a "comparative evaluation" and consider not only inferences urged by the plaintiff, but also competing inferences rationally drawn from the factual allegations. *Id.* at *2.

In this important decision, the Court provided its first interpretation of the PSLRA's requirement that plaintiffs allege with particularity facts giving rise to a "strong inference" that defendants acted with the required state of mind. PSLRA, §21D(b)(2). The standard adopted by the Court was more stringent than the standard that had been applied by the Seventh Circuit, but less stringent than the standard adopted by the Sixth Circuit. Nonetheless, the Supreme Court has confirmed that the burden imposed on plaintiffs by the PSLRA is a weighty one, requiring them to plead facts establishing that intent to defraud is at least as plausible an explanation for the challenged conduct as is any benign explanation.

The Complaint in *Tellabs*

Tellabs manufactured specialized equipment used in fiber optic networks. In December 2002, following several reductions in the company's sales projections, shareholders filed a class action complaint alleging that

earlier, more optimistic statements by the company and its chief executive violated Section 10(b) of the Securities Exchange Act of 1934.

In particular, the shareholders alleged that Tellabs' chief executive falsely reassured public investors that Tellabs was continuing to enjoy strong demand for its products and earning record revenue when the CEO purportedly knew that the opposite was true. The complaint alleged that Tellabs' CEO (a) falsely stated that demand for the company's flagship product was continuing to grow when demand for the product actually was waning; (b) falsely stated that the company's principal new product was ready for delivery, when it was not; (c) falsely represented the company's financial results and condoned the practice of "channel stuffing" by which customers were flooded with unwanted products to inflate Tellabs' revenue; and (d) overstated the company's revenue projections.

On the basis of these allegations, the shareholders asserted that Tellabs and its CEO had both engaged in securities fraud, and that the CEO was a "controlling person" under §20(a) of the 1934 Act and therefore derivatively liable for the company's fraudulent acts.

The Lower Court Decisions

Defendants moved to dismiss the complaint on the ground that the shareholders had failed to plead with the particularity required by the PSLRA. The District Court agreed and dismissed the complaint without prejudice. *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 945 (N.D. Ill. 2004). Subsequently, the shareholders amended their complaint, incorporating references to confidential sources and more specific allegations concerning the mental state of Tellabs' chief executive. Again, the District Court dismissed, this time with prejudice. *Id.* at 971. While the shareholders had sufficiently pleaded that the statements were misleading, the District Court held that they had insufficiently alleged that the statements were made with scienter, namely an intent to deceive, manipulate, or defraud.

The Court of Appeals for the Seventh Circuit reversed. 437 F.3d 588, 591 (2006). The Court of Appeals found

that the shareholders had pleaded the misleading character of the statements with sufficient particularity, and that the shareholders had sufficiently alleged that the statements were made with scienter. *Id.* at 595-600, 603-05. In evaluating whether plaintiffs had alleged facts creating a strong inference of scienter, the Court of Appeals stated “courts [should] examine all of the allegations in the complaint and then . . . decide whether collectively they establish such an inference.” *Id.* at 601. The Seventh Circuit held that a complaint will survive “if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal.” *Id.* at 602.

The Supreme Court Decision

The Supreme Court, in a 8-1 majority decision authored by Justice Ginsburg, rejected the standard adopted by the Seventh Circuit and held that in evaluating the sufficiency of the scienter allegations, the court “must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged.” Slip Op. at *2. After conducting such a “comparative evaluation,” the court must dismiss the complaint, unless it determines that the inference of scienter is “cogent and at least as compelling as any opposing inference of nonfraudulent intent.” *Id.*

The Court based its decision on three prescriptions that provide guidance to lower courts in applying the standard. *First*, “faced with a Rule 12(b)(6) motion to dismiss a §10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true.” *Id.* at *11.

Second, courts must consider the entire complaint and all other sources courts typically examine when ruling on Rule 12(b)(6) motions to dismiss, particularly documents referenced in the complaint and matters of which a court may take judicial notice. “The inquiry . . . is whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.” *Id.*

Third, contrary to the ruling of the Seventh Circuit, courts *must* take into account plausible opposing inferences. Noting that Congress required plaintiffs to plead with particularity facts that give rise to a “strong” inference, the Court observed that the “strength of an inference cannot be decided in a vacuum.” *Id.* at *12. Rather, this “inquiry is inherently comparative.” *Id.* While a court must consider “plausible nonculpable explanations” for the defendant’s conduct, the “inference that the defendant acted with scienter need not be irrefutable, i.e., of the ‘smoking-gun’ genre, or even the ‘most plausible of competing inferences.’” *Id.* (citations omitted). “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.” *Id.* at *12-13.

The Court did not decide whether the shareholders’ allegations in their amended complaint established the requisite inference of scienter under the newly-adopted standard. Rather, the Court vacated the Seventh Circuit’s judgment and remanded the case for further proceedings consistent with its construction of §21D(b)(2) and the three prescriptions described above.

In providing further guidance to the review on remand, the Court held that the CEO’s lack of pecuniary motive to commit fraud was relevant but not dispositive. The Court stated: “While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal.” *Id.* at *13-14. The significance of any one factor, such as the defendant’s lack of financial motive, depends on the entirety of the complaint, leaving the court with the task “to assess all the allegations holistically.” *Id.* at *14.

While the Court rejected the lenient standard applied by the Seventh Circuit, the Court did not accept the more stringent standard applied by the Sixth Circuit, under which the plaintiff must demonstrate that the inference of scienter is the “most plausible of competing inferences.” See, e.g., *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004). In separate opinions concurring in the judgment, Justices Scalia and Alito argued in favor of a stricter standard, similar to the standard previously applied by the Sixth Circuit.

Finally, in footnotes, the Court left undecided two other important issues. First, the Court once again declined to provide definitive guidance on whether reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5, noting that every Court of Appeals that has considered the issue has ruled that a plaintiff may meet the scienter requirement by showing that the defendant acted recklessly or intentionally, but that the question of “whether and when” recklessness satisfies the scienter requirement was not presented in *Tellabs*. *Id.* at *7, n. 3. Second, the Court noted the Circuits’ disagreement on whether the group pleading doctrine had survived the PSLRA. *Id.* at *14, n. 6. However, the Court stated it would not disturb the Seventh Circuit’s holding that allegations of scienter made against one defendant cannot be imputed to all other individual defendants.

The Practical Effects of the Decision

The Court’s decision provides for a single, unified standard to evaluate allegations of scienter under the PSLRA. The standard is relatively stringent and will serve the PSLRA’s underlying purpose of weeding out meritless securities fraud litigation at an early stage, before defendants are compelled to incur substantial costs. The district courts must now determine how to apply this standard to the different factual allegations that plaintiffs may present, and determine from the totality of the pleading whether the inference of scienter is cogent and at least as compelling as opposing inferences. And, the Circuit Courts of Appeals will need to grapple with the proper standard of review.

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