

Client Alert

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***Tellabs, Inc. v. Makor Issues & Rights, Ltd.:* Pleading Scier in Securities Fraud Cases**

Most press reports describing the United States Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,¹ have overstated the holding as a boon for corporate America. For example, the *Wall Street Journal* characterizes *Tellabs* as the latest in "a string of pro-business rulings," while *The New York Times* calls it "a blow to investors who want to sue companies." It is true that the Supreme Court overruled the Seventh Circuit's lenient standard for pleading scier in securities fraud action than authorized by the Private Securities Litigation Reform Act (PSLRA). Specifically, eight of the nine Justices agreed that non-culpable as well as culpable inferences must be weighed to determine whether a complaint establishes the requisite "strong inference of scier." This is a victory for defendants. No longer will district courts feel constrained to ignore obviously plausible explanations for circumstances alleged to be nefarious by plaintiffs. However, as the concurring opinions of Justices Scalia and Alito reveal, the Court did go as far as it could have or should have in effectuating Congress' expressed intent to limit abusive securities fraud lawsuits.

The Facts

A putative class of shareholders of *Tellabs, Inc.* sued *Tellabs* (and some

of its executives) for securities fraud under Section 10(b) of the Exchange Act.² The shareholders claimed that *Tellabs*' former CEO and president (Richard Notebaert) falsely stated that "Tellabs was continuing to enjoy strong demand for its products and earning record revenues," when, in fact, Notebaert knew the opposite was true.³ The District Court dismissed with prejudice, holding that shareholders had sufficiently pled that *Tellabs* made a false statement but had failed to identify facts supporting a strong inference of scier.

On appeal, the Seventh Circuit reversed, holding that the requisite strong inference of scier is satisfied where the complaint "alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."⁴ The Supreme Court granted certiorari to decide whether, and to what extent, a court must consider competing inferences in deciding motions to dismiss securities cases for failure adequately to plead scier.

The Pleading Standard

The PSLRA requires a securities fraud plaintiff to plead "with particularity facts giving rise to a strong inference that the defendant acted with" scier – a "mental state embracing intent

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to deceive, manipulate, or defraud.”⁵ The Supreme Court set forth three “prescriptions” to guide courts applying the PSLRA’s scienter pleading provisions on motions to dismiss in securities cases:

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.

Second, courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.

Third, in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.⁶

The Court then set about articulating the degree of strength necessary to survive a motion to dismiss. The Court observed that the Seventh Circuit’s lenient standard permitted a plaintiff to go forward if it pled “facts from which, if true, a reasonable person could infer” scienter.⁷ Alternatively, the Sixth Circuit employed a stricter test under which a plaintiff is entitled only to “the ‘most plausible of competing inferences.’”⁸ The Supreme Court rejected both approaches.⁹

The Court categorically rejected any notion that “[t]he strength of an inference” could be “decided in a vacuum,” holding that such an “inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts?”¹⁰ This holding is a victory for

the corporations wrongly accused of securities fraud. In the wake of *Tellabs*, motions to dismiss in securities fraud cases now have license to argue for “plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff,” all of which the Supreme Court held that district courts “must consider.”¹¹

The Court’s next step, however, was less beneficial. In order to be “strong,” the Court held, the inference of scienter “must be cogent and compelling,” and “at least as compelling as any opposing inference one could draw from the facts alleged.”¹² In other words, the majority decision appears to permit a plaintiff to survive a motion to dismiss on a tie of inferences. Justice Scalia properly questioned whether that decision is consistent with the statutory test:

I fail to see how an inference that is merely “at least as compelling as any opposing inference,” can conceivably be called what the statute here at issue requires: a “strong inference.” If a jade falcon were stolen from a room to which only A and B had access, could it *possibly* be said there was a “strong inference” that B was the thief?¹³

Since the plain language of the PSLRA requires a “strong inference,” the Supreme Court could have, and should have, required that the culpable inference offered by the plaintiff be more plausible than any nonculpable inference.

The difference, however, between the majority’s “at least as compelling” standard and Justice Scalia’s proposed “more plausible” standard may be largely academic. “How often is it that inferences are precisely in equipoise?” Scalia asked.¹⁴ Except in the extremely rare “precise[] equipoise” case, the set of cases that fail under the majority’s standard should precisely match the set of cases that would fail under Justice Scalia’s standard.

A Holistic Analysis

The Court repeatedly stressed that, on a 12(b)(6) motion, “[t]he 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.”¹⁵ This approach is somewhat confusing. How much weight should be accorded to a relatively weak allegation of scienter? Will five weak allegations of scienter in combination give rise to a strong inference? Or will it take 10 or maybe 20? Or will no number of weak allegations be sufficient without at least one allegation that can be regarded as independently strong? There is little guidance in regards to these questions within the Court’s opinion. Moreover, it does not seem reasonable to believe that the PSLRA would permit a complaint comprised solely of weak allegations of scienter to survive dismissal.

In any event, the Court appears to have indicated that a stronger allegation may be dragged down by deficiencies found elsewhere in the complaint. For example, on the facts of *Tellabs*, defendants argued that Notebaert had an “evident lack of pecuniary motive.”¹⁶ The Supreme Court acknowledged “that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference,” but also held that “the absence of a motive allegation is not fatal.”¹⁷ Applying its “holistic” rule, the Court held that the “allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.”¹⁸ *Tellabs* thus holds that the “lack ...of” a motive allegation, while not automatically fatal, can carry significance for “the entirety of the complaint.”¹⁹

The Court also applied its “holistic” approach to address “allegations [that] are too vague or ambiguous to

contribute to a strong inference of scienter.”²⁰ Justice Alito, in concurrence, chided the majority:

In dicta, however, the Court states that “omissions and ambiguities” merely “count against” inferring scienter, and that a court should consider all allegations of scienter, even nonparticularized ones, when considering whether a complaint meets the “strong inference” requirement. Not only does this interpretation contradict the clear statutory language on this point, but it undermines the particularity requirement’s purpose of preventing a plaintiff from using vague or general allegations in order to get by a motion to dismiss for failure to state a claim.²¹

The majority’s rule, however, does not appear to go as far as Justice Alito warns. What the majority actually said was:

We agree that omissions and ambiguities count against inferring scienter, for plaintiffs must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” § 78u-4(b)(2). We reiterate, however, that the court’s job is not to scrutinize each allegation in isolation but to assess all the allegations holistically. In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?²²

Justice Alito suggests that the majority’s reference to “allegations” includes “nonparticularized ones,” but that is true only in the most trivial sense – nonparticularized allegations are to be “assess[ed] ... holistically,” but that does not mean they must be given particular weight. Were it otherwise, the Court’s statement that “omissions

and ambiguities *count against* inferring scienter," citing § 78u-4(b)(2)'s particularized pleading requirement, would make very little sense. An "ambiguit[y]" can only "count against" the inference of scienter if a court is free to consider not just the *existence* of an allegation but also its *weight* as shown by its *particularity*.

The Standard of Proof

At oral argument, some Justices indicated interest in a constitutional issue latent in *Tellabs* – asking whether the Seventh Amendment would be violated if the pleading standard were set so high that a plaintiff who pled facts that, if proven, would allow a jury to find for him or her could nevertheless have his or her complaint dismissed. Justice Scalia suggested that the doctrine of constitutional avoidance might counsel in favor of finding that the PSLRA implicitly raised the standard of proof at trial (and, by extension, at summary judgment).

The Court did *not*, however, adopt that view in its opinion. Holding that Congress, "as creator of federal statutory claims, has the power to prescribe what must be pleaded," the Court avoided the Seventh Amendment issue by holding:

[T]hat under our construction of the 'strong inference' standard, a plaintiff is not forced to plead more than she would be required to prove at trial. A plaintiff alleging fraud in a 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference. At trial, she must then prove her case by a 'preponderance of the evidence.' Stated otherwise, she must demonstrate that it is *more likely* than not that the defendant acted with scienter.²³

This is the point at which the majority's disagreement with Justice Scalia has

traction. Under the majority's view, a motion to dismiss fails if the inferences are a tie – but at trial the plaintiff must do *better*, and prove scienter is "more likely than not."

Other Issues

Tellabs generally construes the PSLRA's requirements in a fashion likely to help securities defendants. The Court characterized the PSLRA as adopting "[e]xacting pleading requirements," and understood it as "[d]esigned to curb perceived abuses of the 10(b) private action – 'nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.'"²⁴ Indeed, the majority relies heavily on the Statement of Managers, a key document in the legislative history of the PSLRA, that is quite defense-friendly and useful in many motions to dismiss. Indeed, Justice Scalia scolded the majority for "its frequent indulgence in the last remaining legal fiction of the West: that the report of a single committee of a single House expresses the will of Congress."²⁵ After *Tellabs*, defendants can now cite the Statement of Managers as Supreme Court-endorsed authoritative guidance.

Finally, the Court reserved decision on two issues: whether the scienter required for a §10b-5 claim ("a mental state embracing intent to deceive, manipulate, or defraud") can be met by a showing of recklessness,²⁶ and whether "the group pleading doctrine survived the PSLRA."²⁷ Little to nothing can be inferred from the Court's failure to reach these important issues.

The Supreme Court's decision in *Tellabs* was, at least on its surface, a victory for corporations, but one cannot overlook its shortcomings. Many aspects of *Tellabs* are positive for securities defendants: making clear that competing inferences *must* be weighed on motions to dismiss, noting that omissions and ambiguities

weigh against a finding of scienter, and enshrining the defense-friendly Statement of Managers as authoritative guidance. Even the Court's "at least as strong as any opposing inference" standard²⁸ is helpful.

The decision could, however, have been much stronger – as Justices Scalia and Alito note in their concurrences, the statutory text really requires that a culpable inference be *stronger* than any nonculpable inference. Whether the difference will actually matter – *i.e.*, whether plaintiffs will actually prevail on motions to dismiss by pleading ties between culpable and nonculpable inferences – remains to be seen.

Endnotes

¹ — S. Ct. —, 2007 WL 1773208 (June 21, 2007).

² *Id.* at *5.

³ *Id.*

⁴ *Id.* at *6.

⁵ *Id.* at *7 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 & n.12 (1976)).

⁶ *Id.* at *9-10.

⁷ *Id.* at *10.

⁸ *Id.* (quoting *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001)(en banc)).

⁹ *Tellabs*, 2007 WL 1773208, at *10.

¹⁰ *Id.* at *10.

¹¹ *Id.* (emphasis added).

¹² *Id.* at *10.

¹³ *Id.* at *13 (Scalia, J. concurring).

¹⁴ *Id.* at *14 (Scalia, J. concurring).

¹⁵ *Id.* at *9; *see also id.* at *11 ("We reiterate, however, that the court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically.").

¹⁶ *Id.* at *11 (emphasis added).

¹⁷ *Id.* at *11.

¹⁸ *Id.* (emphasis added).

¹⁹ *Id.*

²⁰ *Id.* at *11.

²¹ *Id.* at *16 (Alito, J. concurring) (citations omitted).

²² *Id.* at *11.

²³ *Id.* at *12 (citations omitted).

²⁴ *Id.* at *4.

²⁵ *Id.* at *15 (Scalia, J. concurring).

²⁶ *See id.* at *7 n.3.

²⁷ *See id.* at *11 n.6.

²⁸ *Id.* at *11.

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