



JONES DAY
COMMENTARY

U.S. SUPREME COURT RULES THAT SECURITIES FRAUD SUITS MUST BE DISMISSED UNLESS PLAINTIFFS PLEAD FACT ESTABLISHING A “COGENT AND COMPELLING INFERENCE” OF FRAUDULENT INTENT

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484 (June 21, 2007), the U.S. Supreme Court strengthened the main weapon available to securities fraud defendants for defeating lawsuits before the onset of full-blown litigation.

The ruling made clear that the pleading requirements of the Private Securities Litigation Reform Act have real teeth, holding that securities fraud complaints cannot escape dismissal unless they plead facts making the inference of fraudulent intent (or “scienter”) “more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” In short, *Tellabs* raises a significant obstacle to the tactic of filing a securities fraud suit in the hope of acquiring the necessary evidence of fraud in discovery; under *Tellabs*, the suit must be dismissed at the threshold unless the plaintiffs can show *before* discovery that fraud is at least as likely as any non-fraud explanation of the relevant events and statements.

LEGAL BACKGROUND

In 1995, Congress enacted the Private Securities Litigation Reform Act (“PSLRA”), which was intended to curb abusive private securities fraud suits. The legislation reflected Congress’s belief that, as the Supreme Court put it in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975), “litigation under Rule 10b-5 presents a danger of vexatiousness different in kind from that which accompanies litigation in general,” and, equally, the belief that traditional pleading standards had failed to protect defendants against such frivolous suits. One of the centerpieces of the Act—and the principal opportunity for defendants to seek dismissal at the outset of a securities fraud case—was the imposition of a heightened pleading standard, requiring that securities fraud complaints be dismissed unless the plaintiffs could “state with *particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2) (emphasis added).

Tellabs arose out of disagreement in the lower courts over the meaning of the phrase “strong inference,” which Congress did not define. In particular, lower courts disagreed over two basic questions: (1) Can a court weigh competing (non-fraud) inferences, or must it address the plaintiffs’ proposed inference of fraud in isolation? (2) How strong is a “strong” inference? Must fraud be the *most* likely of inferences, merely a plausible inference, or somewhere in between? Different federal courts of appeals had taken different views. Compounding the problem, district courts varied widely in their application of the standard, turning it into something of an “I know it when I see it” rule whose meaning depended on the identity of the district judge.

THE *TELLABS* CASE

Tellabs is a manufacturer of specialized equipment used in fiber optic cable networks. On December 3, 2002, investors filed class action securities fraud claims against Tellabs and its officers, alleging a fraudulent scheme to deceive the investing public about the true value of Tellabs’ stock. Tellabs and its officers had issued various statements over the course of a seven-month class period that, according to plaintiffs, misled investors about the availability of and demand for certain products, falsely represented certain financial results, and exaggerated future earnings and revenue projections. On the last day of the class period, Tellabs announced a substantial reduction in its second quarter projections based almost entirely on a sharp decline in equipment sales, and Tellabs’ stock price fell to a new low.

The U.S. District Court granted the defendants’ motion to dismiss the complaint, holding that the shareholders had failed to adequately allege scienter for any of the defendants. The Seventh Circuit affirmed in part and reversed in part, holding (in relevant part) that the shareholders had alleged facts sufficient to support a “strong inference” that Tellabs and its then-CEO had acted with scienter. In response to the defendants’ argument that the facts alleged by the plaintiffs were more susceptible to a non-fraud inference than they were to an inference of fraud, the court declined to weigh the inferences against each other, on the ground that such balancing could encroach on the province of the jury. The court further reasoned that a securities fraud complaint need only

“allege[] facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent.” (Emphasis added.)

THE SUPREME COURT DECISION

The Supreme Court reversed, 8-1, concluding that the Seventh Circuit’s test “did not capture the stricter demand Congress sought to convey in [the Reform Act].” Justice Ginsburg, writing for the Court, first rejected the lower court’s conclusion that competing inferences could not be weighed, noting that the determination of whether pleaded facts give rise to a “strong” inference of scienter “is inherently comparative,” and that a court must therefore consider plausible nonculpable explanations for the defendant’s conduct. The Court dismissed the concern that such weighing of inferences would violate the Seventh Amendment by invading the province of the jury, observing that “Congress, as creator of federal statutory claims, has power to prescribe what must be pleaded to state the claim, just as it has power to determine what must be proved to prevail on the merits.”

The Court likewise rejected the Seventh Circuit’s view that it was sufficient for a plaintiff to plead facts from which a reasonable inference of fraud “could” be drawn, holding that a “strong” inference necessarily must be “powerful or cogent,” and must be “at least as compelling” as any opposing inference. The Court declined, however, to go further, expressly rejecting a Sixth Circuit rule requiring that the inference of fraud be the “most plausible” of competing inferences. Justices Scalia and Alito, concurring in the judgment, would have taken that further step. Justice Stevens dissented, arguing that “probable cause” would have been a more appropriate standard.

CONCLUSION

The *Tellabs* opinion sends a strong message that securities fraud lawsuits cannot be based on a mere suspicion of fraud, or even on facts that make the possibility of fraud seem plausible. The standard the Court endorsed will undoubtedly help companies and their officers and directors defeat lawsuits in many cases before having to undergo expensive and

time-consuming discovery—and it will be a particular obstacle to the type of lawsuit that seemingly gets filed reflexively, without much real evidence of fraud, as soon as a company announces some bad news that makes its stock drop.

That is not to say that the decision is without some saving graces for plaintiffs. The Court continued to characterize meritorious private securities suits as “an essential supplement” to civil and criminal actions brought by the government, and it refrained from adopting the stricter pleading standard advocated by Justices Scalia and Alito. (It remains to be seen whether the difference between “at least as compelling” and “more compelling” will affect the results in many cases.) It also stressed the traditional rule that all factual allegations in a complaint must be accepted as true for purposes of a motion to dismiss. Finally, the Court included a somewhat confusing passage in which it apparently rejected *Tellabs*’ argument that vague or ambiguous allegations should not count toward establishing scienter, holding instead that all allegations must be considered “holistically,” with omissions and ambiguities merely “count[ing] against” inferring scienter. Plaintiffs will likely seek to capitalize on this passage to argue that even vague and conclusory allegations—such as generic allegations that “the defendants received reports making clear that their public statements were false”—must be accepted as true under *Tellabs*. Such a reading of *Tellabs* seems far from persuasive, but the Court’s imprecision in this regard makes it highly likely that the argument will have to be addressed.

At the end of the day, however, the importance of the Supreme Court’s proclamation of a strict pleading standard is hard to overstate. *Tellabs* should go a long way toward ensuring that the lower courts enforce the PSLRA’s heightened standard as a real obstacle to vexatious securities fraud suits.

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