

40 The Supreme Court's Decision in *Tellabs*

The media reports about the United States Supreme Court's recent decision in *Tellabs, Inc v Makor Issues & Rights, Ltd*,¹ got it all wrong. Many media outlets initially reported, for example, that the Court's decision makes it "significantly harder," "sets tougher standards," and "tightens rules" for shareholders to file securities fraud class action lawsuits.² These statements misreported the holding in *Tellabs*. *Tellabs* actually represents a significant victory for shareholders because, contrary to the media reports, the Court liberalized the pleading standards that had been established in most circuits for plaintiffs to successfully assert fraud in securities class actions.

The Private Securities Litigation Reform Act (PSLRA),³ which was passed by Congress in 1995 to reform securities fraud class actions, created a heightened pleading standard for plaintiffs asserting securities fraud. Before its enactment, securities fraud plaintiffs were required to plead scienter—fraudulent intent—with particularity, and courts were required to give plaintiffs the benefit of all reasonable inferences. The PSLRA, however, dramatically changed the standard for pleading scienter. It instituted a requirement that plaintiffs asserting fraud must state with particularity facts giving rise to a "strong inference" that the defendant acted with intent or recklessness.⁴ Congress did not define what it meant by a strong inference, and as a result, the circuit courts struggled with the requisite pleading standard, leading to varying and inconsistent re-

sults. The standards that were adopted permitted courts to weigh factual allegations at the pleading stage, sometimes imposing even a higher burden to plead scienter in a complaint than would be required to win on the same claims at trial. Thus, securities fraud class actions were often won or lost on the basis of the strength of the plaintiffs' scienter allegations.

In *Tellabs*, the Court finally resolved the issue whether, and to what extent, courts must consider competing inferences in determining if a complaint satisfied the strong-inference requirement. In reversing an overly lenient pleading standard that was applied by the Seventh Circuit, the Court established a more liberal standard than adopted by most circuit courts. Contrary to the media reports, *Tellabs* represented a swing of the pendulum back toward the middle, making it much easier for plaintiffs in most circuits to assert meritorious claims.

Differences Among the Circuits

Before *Tellabs*, each circuit developed separate standards for what a plaintiff asserting securities fraud in a class action must plead to satisfy the PSLRA's strong-inference requirement. The circuit courts generally established four distinct standards. The most stringent pleading standard existed in the Sixth Circuit, where the court held in *Helwig v Vencor, Inc*, that "plaintiffs are

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The Death Knell for Securities Fraud Class Actions? **Not so Fast.** By E. Powell Miller

Fast Facts:

The majority of media outlets reported that the recent United States Supreme Court decision in *Tellabs, Inc v Makor Issues & Rights, Ltd* made it more difficult for plaintiffs to assert securities fraud class action lawsuits. However, the Court's new balancing test actually decreases the plaintiff's burden to plead scienter in most circuits. Therefore, this decision represents a significant victory for shareholders.



entitled only to the most plausible of competing inferences”⁵ to establish whether a defendant acted with scienter. Adopting a less stringent test, the First, Fourth, Fifth, Eighth, Ninth, Tenth, and Eleventh Circuits required a plaintiff to plead scienter by alleging facts showing a defendant’s “intentional misconduct” or “deliberate recklessness.”⁶ The Second and Third Circuits had a more lenient standard, requiring a plaintiff to allege that the defendants had a motive and opportunity to defraud.⁷ Finally, the most lenient standard, adopted by the Seventh Circuit, held that a plaintiff properly alleged scienter if the factual allegations would permit a reasonable person to infer that the defendant acted with the requisite intent, presumably without weighing any competing inference that could be drawn from such factual allegations.⁸ Likewise, the circuit courts adopted varying standards with regard to whether allegations could be read in a piecemeal fashion or should be read as a whole.

The Most Stringent Pleading Requirement: The Most Plausible Inference Test

The Sixth Circuit adopted the most stringent pre-*Tellabs* pleading standard. The Sixth Circuit held that a plaintiff alleging scienter was entitled to only the “most plausible of competing inferences”⁹ from the factual allegations of scienter—a standard that the Supreme Court in *Tellabs* likened to a “smoking-gun” claim.¹⁰ Under this test, courts in the Sixth Circuit were required to “take into account inferences drawn from a complaint’s allegations that cut against scienter—i.e., explanations of the statements or events in question that do not indicate fraud—in determining whether a strong inference has been pleaded.”¹¹ The Sixth Circuit’s stringent standard arguably created a higher burden for the plaintiff at the pleading stage than the plaintiff’s burden to prove the same allegations at trial.

Before the Supreme Court’s decision in *Tellabs*, there was some confusion in the Sixth Circuit regarding whether courts should take a holistic approach and consider whether “the facts argued collectively... give rise to a strong inference of at least recklessness”¹² or whether courts may read allegations separately to determine if each allegation, taken alone, sufficiently established fraud.¹³ The Sixth Circuit was not the only circuit with a seemingly inconsistent standard, and, consequently, this was an issue that the Supreme Court sought to resolve in *Tellabs*.

A Less Stringent Standard: Intentional Misconduct/Deliberate Recklessness Test

The Ninth Circuit established a standard that, although easier to satisfy than the Sixth Circuit’s, was subjective and inconclusive. The Ninth Circuit’s standard required a plaintiff to allege “in great detail” facts that “constitute circumstantial evidence of deliberately reckless behavior or conscious misconduct.”¹⁴ Unlike those in the Sixth Circuit, courts in the Ninth Circuit were required to consider “all the allegations in their entirety.”¹⁵ Ninth Circuit courts also had to consider any reasonable inferences

from the facts to determine if “on balance, the plaintiffs’ complaint gives rise to the requisite inference of scienter.”¹⁶

The Tenth Circuit categorically rejected the Sixth Circuit’s standard, holding that it is not for courts to weigh inferences at the pleading stage: “Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail.”¹⁷

The First Circuit held in *In re Credit Suisse First Boston Corp.*¹⁸ that the sufficiency of a plaintiff’s scienter allegation must be determined by a statement-by-statement analysis and must establish that there is a “strong probability” that the defendants acted with the requisite intent.

The Most Lenient Pre-*Tellabs* Standard

The Seventh Circuit developed perhaps the most lenient standard for a plaintiff to plead scienter. The Seventh Circuit’s standard merely required allegations that “if true, a reasonable person could infer that the defendant acted with the required intent.”¹⁹ Presumably, there was no requirement for lower courts to draw any competing inferences from the allegations of scienter. This meant that as long as the plaintiff’s complaint pointed to facts that allowed a court to reasonably conclude that the defendant acted with intent to defraud, the court would not dismiss the complaint. This standard, however, did not appear to take into account the PSLRA’s strong-inference requirement, but merely adopted the reasonable-inference standard of Rule 9 of the Federal Rules of Civil Procedure. As a result, the Court in *Tellabs* overruled this standard as applied by the Seventh Circuit.

The New Supreme Court Balancing Test: No Longer a Smoking-Gun Standard

Writing for a 6-2-1 majority in *Tellabs*, Justice Ruth Bader Ginsburg noted the benefit of class actions, overturned the Seventh Circuit’s lenient scienter standard, and adopted a liberalized balancing test, making it much easier for securities fraud plaintiffs to allege scienter. Justices Scalia and Alito wrote separate decisions concurring in the result only, but expressing frustration over the new liberalized pleading standard. In sum, the Supreme Court held that a plaintiff alleging fraud in a securities class action “must plead facts rendering an inference of *scienter at least as likely* as any plausible opposing inference.”²⁰ Thus, the Court further held that “[t]o qualify as ‘strong’ within the intendment of [the PSLRA],... 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 non fraudulent intent.”²¹

Tellabs significantly lowered the standard for pleading a securities fraud case in nearly every circuit, given that the Supreme Court’s new balancing test was different from any that previously existed. Indeed, Justice Scalia’s concurrence suggested that the Court’s decision was not pro-defendant, as the media originally reported. Justice Scalia, who at oral argument was characterized by plaintiffs’ counsel, Professor Arthur Miller, as “never [having]

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met a plaintiff [he] really liked,"²² was sharply critical of the majority's liberal pleading standard. However, the majority rejected his objections, claiming:

Justice Scalia objects to this standard on the ground that "[i]f a jade falcon were stolen from a room to which only A and B had access," it could not "possibly be said there was a 'strong inference' that B was the thief".... I suspect, however, that law enforcement officials as well as the owner of the precious falcon would find the inference of guilt as to B quite strong—certainly strong enough to warrant further investigation. Indeed, an inference at least as likely as competing inferences can, in some cases, warrant recovery.... In any event, we disagree with Justice Scalia that the hardly stock term "strong inference" has only one invariably right ("natural" or "normal") reading—his.²³

Tellabs also rejected those courts' standards that considered allegations in a piecemeal fashion or took certain allegations out of context. *Tellabs* adopted a holistic approach. The Court held that lower 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.... The inquiry, as several Courts of Appeals have recognized, 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.²⁴

Thus, to determine whether a plaintiff has successfully pleaded securities fraud under *Tellabs*, a court is now required to take into account the totality of the circumstances or the cumulative effect of a plaintiff's alleged facts and inferences.

Conclusion

The PSLRA established an amorphous standard that permitted courts to weigh factual allegations in varying degrees. While courts are now required under *Tellabs* to weigh facts at the pleading stage, the standard is much easier to achieve. No longer does the inference that the defendant acted with scienter need to be "irrefutable, i.e., of the 'smoking-gun' genre, or even the 'most plausible of competing inferences,'" as previously required by the former Sixth Circuit standard. The plaintiff's pleading burden is now clearly less than what is required for him to prove his case at trial ("more likely than not"). Under *Tellabs*, the weight of the factual allegations indicating fraudulent intent need only be "as likely as" any inferences that the defendants acted with a non-fraudulent intent.²⁶

Too often, reforms tend to swing the pendulum too far and eliminate meritorious cases. On this occasion, the Supreme Court moved the pendulum back closer to the middle, imposing a more reasonable burden for plaintiffs to meet. The Supreme Court's new balancing test should enable plaintiffs to bring meritorious securities fraud lawsuits.



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FOOTNOTES

1. *Tellabs, Inc v Makor Issues & Rights, Ltd*, ___ US ___, 127 S Ct 2499; 168 L Ed 2d 179 (2007).
2. See, e.g., Barnes & Johnson, *Pro-business decision hews to pattern of Roberts Court*, Washington Post, June 22, 2007, at D01, available at <<http://www.washingtonpost.com/wp-dyn/content/article/2007/06/21/AR2007062100803.html>> (accessed September 14, 2007) (claiming that the Supreme Court's *Tellabs* decision set stricter guidelines for plaintiffs alleging securities fraud); Labaton, *Investors' suits face higher bar, justices rule*, New York Times, June 22, 2007 (stating that the "Supreme Court decision sets higher standard for investors' class-action lawsuits against companies and executives suspected of fraud; 8-to-1 ruling says investors must show 'cogent and compelling' evidence of intent to defraud"); see also Kaplan, *Supreme Court makes U.S. securities fraud suits harder*, Information Week, June 22, 2007; Miller, *Investors have more to prove in fraud suits*, Chicago Tribune, June 21, 2007 (reporting that the Supreme Court's "ruling... will make it significantly harder for shareholders to file securities-fraud suits against corporations"); Supreme Court imposes stricter standards on shareholder suits, June 21, 2007 <<http://www.cnbc.com/id/19352585>> (accessed September 14, 2007).
3. 15 USC 78u-4, et seq.
4. 15 USC 78u-4(b)(2).
5. *Helwig v Vencor, Inc*, 251 F3d 540, 553 (CA 6, 2001) (en banc).
6. See Ericson, Flanders & Keyko, *Bulletin 01-30, Securities Fraud: Courts Set Different Scienter Pleading Standards*, available at <<http://www.pillsburylaw.com/LawPortal/ep/paPubDetail.do/pub/00004F26/channelId/-8595/taId/5/pageTypeld/9208>> (accessed October 3, 2007).
7. See, e.g. Bailey, *Securities Litigation Reform: The Growing Importance of Scienter*, available at <<http://library.findlaw.com/2000/Aug/1/128952.html>> (accessed October 3, 2007), citing both *In re Advanta Corp Sec Lit*, 180 F3d 525 (CA 3, 1999), and *Press v Chemical Inv Servs Corp*, 166 F3d 529, 538 (CA 2, 1999).
8. *Makor Issues & Rights, Ltd v Tellabs, Inc*, 437 F3d 588, 602 (CA 7, 2006).
9. *Helwig*, 251 F3d at 553.
10. *Tellabs*, 127 S Ct at 2510.
11. Brownlie & Priebe, *Supreme Court clarifies pleading standards for securities fraud cases*, available at <[http://www.dlapiper.com/files/upload/Securities Litigation_Alert_Jun07.html](http://www.dlapiper.com/files/upload/Securities%20Litigation_Alert_Jun07.html)> (accessed September 14, 2007). See *In re Federal Mogul Corp Securities Litigation*, 166 F Supp 2d 559 (CA 6, 2001), citing *Helwig*, 251 F3d at 553.
12. *PR Diamonds, Inc v Chandler*, 364 F3d 671, 683; see also *Haagland v Group Infotech Inc*, 2006 US Dist LEXIS 36292, 19 (WD Mich, 2006).
13. *Miller v Champion Enterprises, Inc*, 346 F3d 660 (CA 6, 2003).
14. *In re Silicon Graphics Inc Securities Litigation*, 183 F3d 970 (CA 9, 1999).
15. *Gompper v VISX, Inc*, 298 F3d 893, 896 (CA 9, 2002).
16. *Id.* at 897.
17. *Pirraglia v Novell, Inc*, 339 F3d 1182, 1188 (CA 10, 2003).
18. *In re Credit Suisse First Boston Corp*, 431 F3d 36, 49-51 (CA 1, 2005).
19. *Makor Issues*, 437 F3d at 602.
20. *Tellabs*, 127 S Ct at 2513.
21. *Id.* at 2504-2505.
22. Arthur Miller's oral argument on behalf of plaintiffs, available at <http://www.supremecourtus.gov/oral_arguments/argument_transcripts/06-484.pdf>, p 44, lines 1-2 (accessed September 15, 2007).
23. *Tellabs*, 127 S Ct at 2510 n 5 (emphasis in original).
24. *Id.* at 2509.
25. *Id.* at 2510 (citation omitted).
26. *Id.* at 2513.