Legal Opinion Letter

WLF Washington Legal Foundation
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2009 Massachusetts Avenue, NW
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Vol. 17 No. 6 March 23, 2007

HIGH COURT TO EXAMINE SCIENTER PLEADING STANDARD IN SECURITIES FRAUD SUITS

by
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Between 1976, when the U.S. Supreme Court ruled scienter—a culpable mental state—is a required element of a claim under Section 10(b) of the Securities Exchange Act of 1934, and the passage of the Private Securities Litigation Reform Act (the "Reform Act") in 1995, the circuit courts of appeals set different standards for pleading scienter. The Reform Act set a uniform, and more stringent, standard for pleading scienter. The Reform Act places upon a Section 10(b) plaintiff the burden of pleading particular facts that support a "strong inference" of each defendant's scienter. 15 U.S.C. § 78u-4(b)(2). In most cases, a plaintiff gets the benefit of all reasonable inferences. By codifying a uniform higher standard for pleading scienter, Congress intended to reduce the number of Section 10(b) actions that survived a motion to dismiss.

It is ironic that in the decade since the Reform Act became law, the circuit courts again have split on what it takes to plead scienter. In particular, the circuits are split on whether and to what extent a court may consider or weigh competing inferences from the record. The Supreme Court granted certiorari in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*¸ a case in which the U.S. Court of Appeals for the Seventh Circuit articulated a particularly plaintiff-friendly interpretation of the "strong inference" standard, set an expedited briefing schedule, and will hear arguments on March 28. Barring an unusual disposition, the Court will rule by June, resolving the split and setting a nationwide standard for satisfying the Reform Act's "strong inference" requirement. This decision will be of critical importance to litigants in securities cases for years to come.

Background. The classic setting for a Section 10(b) class action is when a company announces bad news, prompting a tumble in the company's share price, followed by one or more complaints asserting that earlier positive announcements were false or misleading, and were made recklessly or intentionally. With most companies having tens of millions, if not hundreds of millions, of shares outstanding, a sharp share price decline tied to a negative announcement raises the specter of potential damages of hundreds of millions, even billions, of dollars, far outstripping insurance. If the complaint survives the motion to dismiss, discovery usually will be extremely expensive and disruptive to business operations. The expense and disruption, and the exposure from even a small probability of a plaintiff's verdict on a several hundred million dollar damages claim, lead many defendants to settle rather than litigate to a judgment. Acting to stem what it identified as a pattern of abusive "strike suits" asserting securities fraud, Congress overrode President Clinton's veto and passed the Reform Act.

The Split Among the Circuit Courts in Interpreting the "Strong Inference" Requirement. Among the requirements that were enacted in the Reform Act, the "strong inference" requirement is one of the most important, if not the most important. The circuit courts, however, are divided on what

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constitutes a "strong inference" of scienter. Some courts (the First, Fourth, Sixth, and Ninth Circuits) have held that an inference of scienter must be the most plausible that may be drawn from the record for the inference to be "strong." In other circuits (the Eighth and Tenth Circuits) a tie goes to the plaintiff—if inferences of scienter favoring the plaintiff and favoring the defendant are equally strong, the complaint will survive the motion to dismiss. In 2006, the Seventh Circuit held that the "strong inference" requirement is satisfied if a plaintiff pleads facts from which "a reasonable person *could* infer that the defendant acted with the required intent." *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) (emphasis added).

The facts of *Tellabs* illustrate why the interpretation of the "strong inference" requirement matters. Plaintiffs sued after Tellabs' stock price fell approximately twenty-five percent after a June 2001 announcement in which Tellabs significantly reduced its sales forecasts, citing a sharp decline in sales of the TITAN 5500, one of its key products. The company and several executives were sued for allegedly violating Section 10(b) and other related statutes. Plaintiffs alleged that the class period began in December 2000, and alleged several positive public statements during the class period by Tellabs' CEO about the company's key products, sales forecasts, and projected growth were false or misleading.

The district court dismissed all claims, but the Seventh Circuit reversed as to Tellabs and its CEO. The Seventh Circuit noted that plaintiffs had cited a consultant's report from early 2001 that allegedly described a decline in demand for the TITAN 5500. The plaintiffs also cited confidential witnesses who allegedly confirmed that internal reports, including a March 2001 report, stated that the TITAN 5500's market was shrinking. Plaintiffs did not specifically allege that the CEO had seen these reports, or that he had heard contemporaneous information from the confidential witnesses contradicting his statements about the TITAN 5500. The Seventh Circuit acknowledged that it was "conceivable" the CEO had not seen the negative reports. 437 F.3d at 603. The Seventh Circuit nevertheless held that plaintiffs had satisfied the strong inference requirement for pleading the CEO's scienter, reasoning that it was "sufficiently probable" that he had information suggesting that his statements were false, because he was the CEO and had access to internal reports. *Id*.

The Seventh Circuit did not consider inferences from the fact the CEO did not sell any shares of the company's stock during the proposed class period, and that he was not alleged to have received any improper gain or to have had a motive to mislead investors. The Sixth and Ninth Circuits have stated that the absence of a motive works against or can negate an inference of scienter, and the Second and Eighth Circuits have stated that the absence of a motive means scienter allegations must be particularly strong. Nor did the Seventh Circuit draw positive inferences from the fact that Tellabs had publicly reduced sales projections during the class period, which could be viewed as inconsistent with carrying out a scheme to avoid disclosing negative information about sales projections. In seeking certiorari, Tellabs argued that, putting aside the unclear allegations of when the CEO supposedly learned of the reports, the consultant report from early 2001 and the March 2001 internal report pre-dated a major downward revision of publicly forecasted sales in mid-April 2001—supporting an inference that the company was reporting negative information, not concealing or misrepresenting it. In sum, it is clear there were competing inferences to draw from the record in *Tellabs*, and difficult to conclude that a negative inference was the most plausible. Other circuit courts most likely would have affirmed the dismissal.

Seventh Amendment Issue. The Supreme Court may also address the Seventh Circuit's concern that the Seventh Amendment — ensuring a right to a jury — may preclude a court from weighing inferences in ruling on a motion to dismiss, lest the judge usurp a fact-finding role reserved for the jury. The United States Department of Justice and the SEC, in an *amicus* brief supporting reversal of the Seventh Circuit, demonstrated that Congress may control the procedural requirements for stating a claim — such as by requiring specificity in allegations — without trespassing on the Seventh Amendment.

Conclusion. If the Supreme Court agrees that an inference of scienter must be the most plausible inference to be a "strong inference," it will resolve the circuit split in a way that follows the letter and spirit of the Reform Act.

ISBN 1056 3059