Legal Backgrounder

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EARLY INFERENCES FROM THE SUPREME COURT'S *TELLABS* RULING

by

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When the United States Supreme Court issued its opinion in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 127 S. Ct. 2499 (2007), addressing the standard for pleading scienter under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), the decision was received with strong, but conflicting reactions. *The New York Times* complained that *Tellabs* dealt "a blow to investors who want to sue companies and executives because of suspected fraud." Stephen Labaton, *Investors' Suits Face Higher Bar, Justices Rule*, N.Y. TIMES, June 22, 2007, at 1. Plaintiffs' attorneys, however, claimed that the *Tellabs* decision "tilts steeply in favor of plaintiffs." Christopher J. Keller and Michael W. Stocker, Tellabs: *PSLRA Pleading Test Comparative, Not Absolute*, 238 N.Y.L.J. 4 (col. 4) (Oct. 3, 2007). The purpose of this LEGAL BACKGROUNDER is to examine the early impact of *Tellabs*, based upon the cases that have been decided in the first few months since *Tellabs* was issued. These cases suggest that *Tellabs* has raised the bar nationwide for pleading securities fraud and has already had an impact on courts that previously were unwilling to look at competing inferences in evaluating scienter. But the bar is not so high that it will deter legitimate suits from going forward.

The PSLRA requires plaintiffs to "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). Congress left the term "strong inference" undefined in the PSLRA. In *Tellabs*, the Supreme Court fleshed out the standard that must be applied. The most significant part of the decision is the Court's holding that, in determining whether plaintiffs have pleaded facts giving rise to a "strong inference," a court "must take into account plausible opposing inferences." *Tellabs*, 127 S. Ct. at 2509. As the majority of the Court explained, while the inference need not be "the most plausible" of all available explanations to qualify as strong, "the inference of scienter must be more than merely 'reasonable' or 'permissible,' it must be cogent and compelling, thus strong in light of other explanations. 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 2510.

The Early Impact of Evaluating Competing Inferences. In reaching its holding in *Tellabs*, the Supreme Court resolved a split between the circuits, taking something of a middle ground. The impact that the decision will have will therefore depend on the law of the particular circuit that existed before the case was decided. *Tellabs* will have the most impact, however, on those circuits that did not engage in a

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weighing of inferences previously. The Seventh Circuit is a good example. *Tellabs* overruled the Seventh Circuit's holding that the "strong inference" standard could be met by satisfying a relatively low pleading standard: "if the complaint 'allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.'" 127 S. Ct. at 2504 (quoting *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 602 (7th Cir. 2006)).

The Seventh Circuit applied *Tellabs*' heightened standard in *Higginbotham v. Baxter International, Inc.,* 495 F.3d 753 (7th Cir. 2007), in upholding an order granting a motion to dismiss. Plaintiffs alleged that the defendant company made misrepresentations in its 10-Q that were intentional because it had been "notified" of fraud at its Brazilian subsidiary by an employee the same month the 10-Q was filed. *Id.* at 758. The court found that the evidence did not provide a "compelling" demonstration that the company knew of the fraud. Rather, the most it showed was that the company "learned enough to lead a reasonable person to conduct an investigation," which is exactly what the company did. *Id.*

The decision will also impact the securities litigation-heavy Second Circuit. Although the Second Circuit itself had not definitively addressed the issue, courts in the Second Circuit generally refused to look at competing inferences prior to *Tellabs*. *See, e.g., In re Keyspan Corp.,* No. 01 CV 5852, ARR, 2003 WL 21981806, at *16 (E.D.N.Y. July 30, 2003) (declining to consider "defendants' alternative explanations" in evaluating scienter because "a motion to dismiss is not a trial"). In a recent decision, however, the Second Circuit upheld dismissal of a claim for market manipulation, without leave to amend, in part because plaintiffs had failed to meet the *Tellabs* standard for pleading scienter. *See ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.,* 493 F.3d 87, 104 (2d Cir. 2007). In *ATSI,* plaintiffs accused defendants of deliberately causing a "death spiral" in ATSI's common stock through market manipulation involving preferred convertible stock and other trades. *Id.* at 96-97. The court found that, while the bonds created an opportunity for "market manipulation," they were a "legitimate investment vehicle," and there was a "'plausible nonculpable explanation []' for the defendants' actions that is more likely than any inference that the defendants intended to manipulate the market." *Id.* at 104 (quoting *Tellabs*, 127 S. Ct. at 2510).

In the relatively short time since *Tellabs* was decided, there have been three areas in particular where courts that did not previously assess non-culpable inferences have been willing to find that a competing inference negated the plaintiff's inference of scienter. The first is when the defendants promptly disclosed negative information or took corrective action to remedy it. *See, e.g., Winer Family Trust v. Queen,* No. 05-3622, 2007 WL 2753734, at *9 (3d Cir. Sept. 24, 2007) ("most plausible" inference from company's upward revision of previous estimate of renovation cost was that it was responding to "new information and to negotiations during the intervening time period"); *Mizarro v. Home Depot, Inc.,* No. 1:06-CV-11510, 2007 WL 2254693, at *8 (N.D. Ga. July 18, 2007) (most compelling inference was that once defendants learned of alleged scheme, they "acted immediately to correct the fraud"); *In re BearingPoint, Inc. Sec. Litig.,* No. 1:05-CV-454, 2007 WL 2713906, at *9 (E.D. Va. Sept. 12, 2007) (allegation that defendants intentionally withheld negative information in December 2004 did not satisfy *Tellabs* given defendants' subsequent disclosures in early 2005).

A second circumstance where the courts have applied *Tellabs* is to defeat the claim that executive departures give rise to an inference of scienter. *See, e.g., In re BearingPoint,* 2007 WL 2713906, at *16 ("The stronger inference is that the departures were part of a managerial reorganization, which commonly follows an announcement that a public company has been poorly managed."). *See also In re Cyberonics, Inc. Sec. Litig.,* No. H-05-2121, 2007 WL 2914995, at *5 (S.D. Tex. Oct. 4, 2007) (no inference of scienter arose from allegedly "forced" resignations in light of explanations given for resignations and fact that defendants were retained as consultants).

A third area in which courts have found non-culpable inferences sufficient to overcome an inference of scienter is in claims based on stock sales. In *Higginbotham,* for example, the Seventh Circuit found allegations that two managers engaged in significant stock sales in a particular month did not give rise to the strong inference required by *Tellabs* because "the *absence* of sales by other managers" who would have

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known of the fraud "implies that nothing was thought to be out of the ordinary." 495 F.3d at 759.

These cases support the conclusion that the pleading bar has been raised for circuits that previously did not consider competing inferences on a motion to dismiss. However, the holding in *Tellabs* adopted a standard that is less strict than that endorsed by some other circuits which, like the Sixth Circuit, held that "the 'strong inference' requirement means that plaintiffs are entitled only to the most plausible of competing inferences." *Helwig v. Vencor, Inc.,* 251 F.3d 540, 553 (6th Cir. 2001).[1] There are fewer cases in these circuits that have faced this issue, but the practical impact of *Tellabs* on decisions in these circuits is likely to be less strong.

In fact, in separate concurring opinions, Justice Scalia and Justice Alito both opined that, although they believed that the Court should have endorsed the higher standard, adopting the lower standard was "unlikely to make any practical difference." *Tellabs*, 127 S. Ct at 2516 (Alito, J., concurring); *see id.* at 2514 (Scalia, J., concurring) ("I doubt that in this instance what I deem to be the correct test will produce results much different from the Court's. How often is it that inferences are precisely in equipoise?"). This intuitively seems correct. It seems unlikely that a judge who finds that a plaintiff has truly met the *Tellabs* standard, by pleading allegations giving rise to an inference of scienter that is "cogent and compelling" and "at least as compelling as any opposing inference," *id.* at 2510, would be inclined to grant a motion to dismiss even under the higher standard.

One example of how circuits that had previously endorsed a higher standard have applied *Tellabs* is the District of New Hampshire's decision in *Sloman v. Presstek, Inc.,* No. 06-CV-377, 2007 WL 2740047 (D.N.H. Sept. 18, 2007). While acknowledging that *Tellabs* was less strict than the First Circuit's former approach requiring "the strongest of all competing inferences," the court noted that the decision nonetheless reinforces the comparative approach: it "vindicates the First Circuit's approach of viewing the complaint holistically and then taking into account the competing plausible inferences." *Id.* at *7. The court denied the motion to dismiss because the defendants' proposed inference was "no more compelling" than the inference advocated by the plaintiff. *Id.* at *10. However, it seems likely that the decision would have been the same even under the old standard, because the court did not appear to view the inferences as truly equal. The court stated that the defendants' proposed inference was arguably "less convincing" because some facts appeared to contradict it. *Id.* at *10 n.4.[2]

Impact on Confidential Witness Allegations. Plaintiffs in securities fraud cases frequently rely on confidential, unnamed witnesses to support their allegations of scienter. One early impact of *Tellabs* that could prove to be important is *Tellabs*' effect on the weight that will be given to such allegations in the future.

In *Higginbotham*, the Seventh Circuit held that "one upshot" of the *Tellabs* approach is that courts "must discount allegations that the complaint attributes to . . . 'confidential witnesses.'" *See Higginbotham*, 495 F.3d at 756. The court reasoned that anonymity "frustrates" the process of weighing competing inferences: "[i]t is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences. Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist." *Id.* at 757. The court concluded that, while it is "possible to imagine" situations where statements from confidential witness "may corroborate or

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[1]There are also other courts, like the Eighth Circuit, that previously endorsed a standard that was similar to *Tellabs. See, e.g., In re H&R Block Sec. Litig.,* No. 06-0236-CV-W-ODS, 2007 WL 2908649, at *5 (W.D. Mo. Oct. 4, 2007) ("The standard clarified in *Tellabs* is not significantly different than preexisting Eighth Circuit case law.").

[2]At least one court has found that the difference between "most plausible" and "just as convincing" did make a difference, however. In *Communications Workers of America Plan for Employees' Pensions and Death Benefits v. CSK Auto Corp.*, Nos. CV 06-1503, CV 06-1580, 2007 WL 2808652 at *3 (D. Ariz. Sept. 27, 2007), the court had granted a motion to dismiss plaintiffs' first complaint prior to the decision in *Tellabs*, because the court "readily could see non-fraudulent explanations for the various acts alleged." After *Tellabs,* the court felt compelled to allow the second complaint to survive because "a tie goes to the Plaintiff." *Id.*

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disambiguate evidence from disclosed sources," usually the discount given to such allegations "will be steep." *Id.* at 757.

At this point, relatively few cases have had the opportunity to comment on *Higginbotham*'s approach. However, several outside the Seventh Circuit have already adopted it. For example, in *Frank v. Dana Corp.*, the Northern District of Ohio cited *Higginbotham* in dismissing a complaint for failing to allege a strong inference of scienter, finding that the plaintiffs' reliance on anonymous sources was inadequate in light of *Tellabs*. No. 3:05CV7393, 2007 WL 2417372, at *7-8 (N.D. Ohio Aug. 21, 2007). Similarly, in *In re H&R Block Sec. Litig.*, the court dismissed the complaint, and, citing *Higginbotham,* instructed plaintiffs "to consider the diminished value of confidential informants in establishing scienter" if they choose to file an amended complaint. No. 06-0236-CV-W-ODS, 2007 WL 2908649, at *8 n.4 (W.D. Mo. Oct 14, 2007).

If the Seventh Circuit's approach in *Higginbotham* becomes widely accepted, this will be one of the most significant consequences of the *Tellabs* decision.

Recklessness: A Question for Another Day (Again). The Supreme Court has previously declined to address the issue of whether reckless behavior satisfies the scienter requirement under section 10(b) and rule 10b-5. In *Tellabs*, the Supreme Court again chose not to address this issue, because the issue was "not presented" by the case. 127 S. Ct. at 2507 n.3.[3] Nonetheless, at least one lower court has applied the *Tellabs* approach to allegations of recklessness. *See In re Bayou Hedge Fund Litig*., Nos. 06-MDL-1755 (CM), 06-CV-2943 (CM), 2007 WL 2319127, at *8 (S.D.N.Y. July 31, 2007) (holding that "inference of recklessness must be at least as compelling as any opposing inferences").[4] It remains to be seen whether other courts will adopt this reasoning, although it does seem consistent with *Tellabs*' approach. If a court must look at competing inferences in determining whether allegations of deliberate conduct satisfy the PSLRA's requirement of a "strong inference" of scienter, it seems logical that the court should be required to do so for allegations of recklessness as well.

Conclusion. While only time will tell, in the relatively short time since *Tellabs* has been decided, it has already had an impact by raising the bar in those circuits that previously declined to consider competing inferences in evaluating whether a complaint adequately alleges scienter under the PSLRA. One of the most significant effects may be the diminished value that courts are willing to place on allegations relating to confidential witnesses, if this approach becomes widely adopted. The impact of *Tellabs* on circuits that previously endorsed a higher standard is less clear, but as the Court itself noted, will likely be less significant.

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[3]The Court noted, however, that "[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required." *Tellabs,* 127 S. Ct. at 2507 n.3.

[4]Some courts have adopted the *Tellabs* approach of evaluating competing inferences even outside the scope of the PSLRA. *See*, *e.g., In re Crude Oil Commodity Litig*., No. 06 Civ. 6677 (NRB), 2007 WL 1946553, at *7 n.5 (S.D.N.Y. June 28, 2007) (applying *Tellabs* to claim of market manipulation under section 9(a) of the Commodities Exchange Act).

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