The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2007

PHILADELPHIA, TUESDAY, AUGUST 28, 2007 VOL 236 • NO. 41 $3.00 ALM

U.S. Supreme Court Renders Investor-Friendly Decision in *Tellabs*

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Special to the Legal

On June 21, the U.S. Supreme Court issued its decision in *Tellabs Inc. v. Makor Issues & Rights*. The 8-1 opinion, written by Justice Ruth Bader Ginsburg, reaffirms the longstanding policy that private securities litigation is essential to the regulatory scheme of transparency codified in the federal securities laws. The Supreme Court's decision also underscores the importance of private securities litigation to protecting the integrity of domestic capital markets from the effects of fraud.

The opinion, however, has been routinely described in the media as a "pro-business ruling" that will make it "harder for shareholders alleging securities fraud to file suits against companies." *The Wall Street Journal's* headline encapsulates this view: "High Court Raises the Bar for Filing Shareholder Suits." But is that what the Supreme Court did? The answer is "no." A careful reading of the opinion reveals a helpful pleading guide for investors seeking to hold companies and their management accountable for securities fraud.

The opinion begins with a clear statement in favor of private enforcement of the federal securities laws:

"This court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement action brought, respectively, by the Department of Justice and the Securities and Exchange Commission.

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The Supreme Court explained that Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) "[a]s a check against abusive litigation by private parties." Congress included in the PSLRA "exacting pleading requirements." The focus of the *Tellabs* opinion is the PSLRA's requirement that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The *Tellabs* opinion describes what constitutes a "strong inference" of the required state of mind, or scienter, at the pleading stage of a securities class action.

The *Tellabs* case arrived at the Supreme Court after the U.S. District Court for the Northern District of Illinois dismissed the case against the defendant, Tellabs' CEO and president, holding that investor plaintiffs had failed to sufficiently allege that he had acted with the requisite scienter. The 7th U.S. Circuit Court of Appeals reversed, holding that the scienter allegations were sufficient.

The 7th Circuit "recognized that the PSLRA 'unequivocally raise[d] the bar for pleading scienter' by requiring plaintiffs to 'plea[d] sufficient facts to create a strong inference of scienter," and held that a complaint will survive a challenge "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. ... If a reasonable person could not draw such an inference from the alleged facts, then defendants are entitled to dismissal."

After reviewing the PSLRA and its legislative history, the Supreme Court noted that Congress did not give much guidance as to what facts create the strong inference, or "what degree of imagination courts can use in divining whether the requisite inference exists." The court framed the question before it as: "Our task is to prescribe a workable construction of the "strong inference" standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."

In answering this question, the Supreme Court held that "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." The court explained: "The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court must consider plausible nonculpable explanations for the defendants' conduct, as well as inferences favoring the plaintiff. ...

"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."

The court also offered an alternative formulation: "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?"

The Supreme Court's opinion has been described by the business community and the press as endorsing a stricter standard for investors alleging securities fraud. But does it? The opinion no doubt articulates a clear standard for pleading the strong inference of scienter required by the PSLRA. But the opinion also states that the standard adopted does not force a plaintiff "to plead more than she would be required to prove at trial." And the opinion holds that when weighing

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competing explanations for the defendant's conduct, "[t]he inference that the defendant acted with scienter need not be irrefutable, i.e. of the 'smoking gun' genre, or even the 'most plausible of competing inferences.'"

In addition to the rulings on scienter, the Supreme Court considered a number of other issues about which there has been confusion and disagreement among the lower courts. All of these issues were decided in favor of investors.

For example, the Supreme Court held that when faced with a motion to dismiss a fraud action brought under the federal securities laws, a trial court must "accept all factual allegations in the complaint as true." The court also definitively ruled that a trial court "must consider the complaint in its entirety" when considering a motion to dismiss.

The 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.

This is an important ruling that is helpful to investors, because some lower courts have, to the contrary, looked at the allegations of the complaint individually and required that each separate allegation demonstrate the requisite amount of scienter.

The Supreme Court also ruled that the absence of an allegation of motive is not fatal to scienter allegations. This has been an extremely contentious issue in the lower courts. Securities fraud defendants often argue that they sold no stock during the class period and thus did not profit from any wrongdoing, demonstrating that they had no motive to defraud. Therefore, they argued that they had no scienter. Some lower courts accepted this defense. The Supreme Court now makes it clear that motive or bad faith is not required to prove scienter.

The Supreme Court's *Tellabs* decision therefore does not ring the death-knell for securities fraud class actions. The decision is not a harbinger of caveat emptor; it is not a warning of buyer beware. On the contrary, in some respects the *Tellabs* decision makes the plaintiff's burden easier. A plaintiff's theory of scienter must simply be at least as plausible as a defendant's theory. Defrauded investors, armed with solid allegations of wrongdoing and clear and cogent allegations of the defendants' scienter, will still have their day in court. •