

Securities Litigation Alert

Tellabs, Inc. et al. v. Makor Issues & Rights, Ltd., et al.

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On March 28, 2007, the United States Supreme Court heard oral argument in *Tellabs, Inc., et al. v. Makor Issues & Rights, Ltd., et al.*, a case that promises to resolve a significant and long-standing disagreement among courts on interpretation of the requirement that plaintiffs in securities fraud actions plead a “strong inference” of scienter.

The Private Securities Litigation Reform Act (“PSLRA”) requires that a complaint “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” At issue in *Tellabs* was the extent to which a court must weigh competing factual inferences in determining whether a strong inference of scienter has been alleged. The Seventh Circuit ruled that irrespective of whether there were other plausible competing inferences weighing against a finding of scienter, a court should “allow a complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” Other circuits, including the Ninth, have ruled that instead of interpreting all facts alleged in a complaint in favor of the plaintiff, as courts traditionally do, the PSLRA requires the court to weigh all competing inferences, *including those unfavorable to the plaintiff*.

Surprisingly, the justices spent a significant portion of the argument discussing whether a heightened pleading standard would violate the Seventh Amendment by demanding a higher showing at the pleading stage than at trial, where only a preponderance of the evidence would be required. Justices Scalia and Breyer seemed to suggest that such a heightened standard could pass constitutional muster given that other barriers to entry into federal courts created by Congress are deemed permissible.

Other justices, however, expressed concern about a pleading standard that might be higher than the ultimate standard of proof for a jury. In response, counsel for both *Tellabs* and the Solicitor General—who were advocating the heightened pleading standard that takes all reasonable inferences into consideration—argued that those concerns could be properly addressed by raising the ultimate standard of proof at trial, rather than watering down

the “strong inference” pleading standard mandated by Congress.

Also of note was a discussion of whether a court could infer from a CEO’s position alone that he must have had knowledge about alleged financial misconduct. Shareholders’ counsel argued that it was unlikely that a CEO would not have knowledge of important financial issues, while *Tellabs*’ counsel argued that the plaintiff must plead particularized facts regarding the CEO’s scienter.

The Supreme Court may also address in its opinion several other important issues in its opinion that were not substantively discussed in the oral arguments. These include: whether plaintiffs who purport to rely upon “confidential sources” to bolster their allegations must identify those sources; whether the PSLRA raised the *substantive scienter standard* for securities fraud cases, as opposed to merely the requirements for pleading that element; and whether the PSLRA requires a strong inference of scienter to be alleged separately for each person named as a defendant (rather than permitting the plaintiffs to resort to so-called “group pleading”). A decision is expected by the end of June.

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