A Major Victory for Defendants in Securities Class Actions: *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*

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On June 21, 2007, the U.S. Supreme Court handed down a decision that provides welcome news to any public company, officer or director facing the prospect of a securities class action lawsuit. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* the Court resolved a significant and long-standing split on how courts should interpret the "strong inference" of scienter pleading standard set forth in the Private Securities Litigation Reform Act of 1995 ("Reform Act") for securities fraud actions. After emphasizing that "securities fraud actions… if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law," the Court made clear that courts must be vigilant in scrutinizing – and filtering – such actions at the pleading stage. In particular, the Court held that a securities fraud complaint may survive dismissal only if the inference of scienter arising from the well-plead facts stated therein was "cogent and at least as compelling as any opposing inference one could draw from the facts alleged."

Background

The Reform Act sets forth a heightened pleading standard for securities fraud complaints. With respect to the scienter requirement of a claim under Section 10(b) of the Securities Exchange Act of 1934, the Reform Act requires that a complaint "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind [*i.e.*, the intent to deceive investors]." At issue in *Tellabs* was the extent to which a court must weigh competing factual inferences in determining whether a strong inference of scienter had been plead. Some circuits had ruled that, in effect, a court should consider only those inferences favorable to plaintiffs. Other courts, including the Ninth Circuit, held that the Reform Act instead requires courts to consider the factual allegations and weigh all competing inferences, including those unfavorable to the plaintiff.

The plaintiffs in *Tellabs* purported to represent a class of shareholders who purchased stock between December 11, 2000 and June 19, 2001. Their complaint was premised principally on allegedly false and misleading statements by the CEO concerning the company's financial health.

Tellabs moved to dismiss the complaint on the ground that plaintiffs had failed to plead their claims with the factual particularity required by the Reform Act. The District Court agreed that plaintiffs failed to plead scienter on the part of the CEO, and dismissed the complaint with prejudice. The Seventh Circuit Court of Appeals reversed in relevant part, holding that the plaintiffs had sufficiently alleged facts sufficient to support an inference of scienter.

Supreme Court's Opinion

In an 8-1 decision, the Supreme Court reversed the Seventh Circuit, and rejected the appellate court's formulation of the term "strong inference" as only meaning "facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Rather, the Court made clear that the Congress intended to mandate a more stringent requirement: specifically, that all of the relevant factual allegations, considered in their entirety, must give rise to an inference of fraud that is not merely "plausible" or "reasonable," but is "*cogent* and *at least as compelling* as any opposing inference of nonfraudulent intent." (Emphasis added).

Thus, the court in a securities fraud case must assess the relevant facts at the pleading stage and engage in a comparative inquiry of factual inferences – *i.e.*, it must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff, and measure their relative merits. Unless plaintiffs can show that the inferences weigh in their favor, or are at least equal to those favoring the defendants, the complaint should be dismissed.

The majority also rejected the argument that the Reform Act's heightened pleading standard violates the Seventh

Amendment by demanding a higher showing at the pleading stage than at trial. The majority concluded that the “strong inference” standard does not demand that a plaintiff plead more than she would be required to prove at trial. To the contrary, the requirement that a pleading set forth facts showing that a plausible inference of fraud is *at least as likely as* any opposing inference is entirely consistent with plaintiff’s ultimate burden at trial to prove her case by a “preponderance of the evidence.”

Implications of the Ruling

By underscoring the potential abuses of securities fraud actions and the critical gatekeeping role that courts must play to curtail such harm, the *Tellabs* ruling is a major victory for defendants. There is no longer any doubt that a court must carefully examine all relevant facts at the pleading stage, evaluate the competing inferences to be drawn from those facts, and dismiss an action if the scale tips even slightly toward defendants. This standard is substantially higher than the lenient “notice pleading” required in most cases, and is even more stringent than the heightened requirements applicable to other types of fraud cases (as set forth in Federal Rule of Civil Procedure 9(b)). Accordingly, the Supreme Court has confirmed that, as the Ninth Circuit previously stated in *Ronconi v. Larkin*, 253 F.3d 423, 437 (9^{th} Cir. 2001), “[i]n few other areas are motions to dismiss … so powerful.”

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