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SECURITIES LAW
Courts interpret 'Tellabs'

They appear to view case as heightening standard for pleading scienter.

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IN *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007), the U.S. Supreme Court provided guidance for applying a critical pleading requirement contained in the Private Securities Litigation Reform Act of 1995 (PSLRA). In the eight months since *Tellabs*, several courts of appeals and numerous district courts from all circuits have had the opportunity to apply *Tellabs* to securities fraud complaints. This article looks at how the lower courts have applied *Tellabs* in light of pre-existing precedent within the various circuits.

In 1995, Congress enacted the PSLRA in response to evidence of "abusive practices committed in private securities litigation." H.R. Conf. Rep. No. 104-369, at 31, reprinted in 1995 U.S.C.C.A.N. 730. Among the many reforms Congress enacted in this legislation were "more stringent pleading requirements to curtail the filing of meritless lawsuits." Id. at 41. Congress intended this new, more stringent pleading standard to be "uniform" in order to address the "distinctly different standards among the circuits" in applying then-existing pleading requirements. Id. One of the elements of the new pleading standard was a requirement that the plaintiff in a private action asserting a violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," i.e., scienter. 15 U.S.C. 78u-4(b)(2). The PSLRA, however, did not define "strong inference" or otherwise provide guidance as to what facts and circumstances alleged in a complaint might give rise to a strong inference of a defendant's scienter.

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In the years following the enactment of the PSLRA, courts struggled with the meaning of "strong inference." As early as 1999, it was apparent that different interpretations were developing in the various circuits. Compare, e.g., *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) ("The Second Circuit has been lenient in allowing scienter issues to withstand summary judgment based on fairly tenuous inferences....[W]e are not inclined to create a nearly impossible pleading standard when the 'intent' of a corporation is at issue."), with *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975 (9th Cir. 1999) ("We embrace the approach requiring a strong inference of deliberate recklessness....We do this because we believe that Congress intended to bar those complaints that fail to raise a strong inference of intent or deliberateness.").

At issue is the 'strong inference' standard.

By 2006, the splits among the circuits became pronounced. Compare, e.g., *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 48-49 (1st Cir. 2005) ("Scienter allegations do not pass the 'strong inference' test when, viewed in light of the complaint as a whole, there are legitimate explanations for the behavior that are equally convincing.") (citation and quotation omitted), with *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) ("Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."). In 2007, the U.S. Supreme Court granted certiorari in *Tellabs* in order to resolve the split.

In *Tellabs*, the Supreme Court reversed the 7th U. S. Circuit Court of Appeals, holding that the 7th Circuit's "reasonable person" test was not faithful to the more stringent "strong inference" requirement in the PSLRA. The Supreme Court, though, declined to adopt one circuit's standard over another's. Instead, the court set out a new standard to guide lower courts in applying the "strong inference" pleading requirement. "To qualify as 'strong' within the intendment of [the PSLRA]," the court held, "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." Id. at 2504-05. Some aspects of the new standard mirrored then-existing standards in certain of the circuits. For example, the Supreme Court echoed *Gompper v. VISX Inc.*, 298 F.3d 893 (9th Cir. 2002), among other courts, holding that a court must consider all inferences that flow from the pleaded facts, not just inferences that favor the pleader. 127 S. Ct. at 2510.

Since *Tellabs*, more than 100 reported decisions from courts of appeals and district courts have applied *Tellabs*' "strong inference" standard. Most courts have focused on whether the inference of scienter drawn from the pleaded facts is sufficiently "cogent" and on implementing what is generally perceived as the "tie goes to the plaintiff" rule when balancing the "compelling" nature of competing inferences.

Back to the 7th Circuit

The most interesting discourse about the meaning of *Tellabs* has taken place within the circuit that issued the decision reversed by the Supreme Court: the 7th. In *Higginbotham v. Baxter International Inc.*, 495 F.3d 753 (7th Cir. 2007), the 7th Circuit considered the implications of the Supreme Court's decision in *Tellabs* for the first time. Writing for the panel in *Higginbotham*, Chief Judge Frank H. Easterbrook affirmed the district court's dismissal of the complaint. In his analysis, Easterbrook focused primarily on the plaintiff's heavy reliance upon information attributed in the complaint to unnamed confidential sources. The court held that the "upshot" of *Tellabs* was that allegations of confidential witnesses must be "discount[ed]," and that such a discount would typically be "steep" (id. at 756-58), because it was "hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences" when the statements of such sources, by virtue of their anonymity, "can't be checked." Id. at 757. Easterbrook thus applied *Tellabs* as a single test of comparative cogency.

In *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702 (7th Cir. 2008), the case on remand from the Supreme Court, the 7th Circuit took a somewhat different approach. Writing for the panel, Judge Richard A. Posner—who was also a member of the panel in *Higginbotham*—held that the plaintiffs had succeeded in pleading scienter in conformity with the PSLRA. Id. at 712. Posner interpreted the Supreme Court's decision as creating a two-prong test: "first the inference must be cogent, and second it must be as cogent as the opposing inference, that is, the inference of lack of scienter." Id. at 705.

Posner decided to address the second prong first

by examining the defendant's opposing inference: namely, that misstatements regarding the two key products was a "merely careless mistake." Id. at 709. Rejecting this inference, the court concluded that it was "exceedingly unlikely" that senior management authorized to make public statements about demand for the company's two flagship products would be unaware that such statements were false. The court then turned to the question of whether the plaintiff's inference was "cogent." Because the defendant's explanation of the events was "far less likely than the hypothesis of scienter," the court held that the plaintiff's hypothesis "must be considered cogent" (id. at 711), effectively collapsing the first prong of the *Tellabs* test into the second prong. Unlike Easterbrook in *Higginbotham*, Posner in *Tellabs* addressed the sufficiency of the plaintiff's confidential source allegations only after reaching his conclusions regarding the comparative strength of the opposing inferences.

Most have focused on whether inference is sufficiently 'cogent.'

Other circuits

The impact of *Tellabs* on pre-existing case law in other circuits is less clear. As noted above, the Supreme Court in *Tellabs* expressly rejected the 7th Circuit's prior approach to the "strong inference" requirement. In doing so, the court contrasted the 7th Circuit's standard against the 6th Circuit's more stringent standard expressed in, among other cases, *Helwig v. Vencor Inc*., 251 F.3d 540 (6th Cir. 2001) (en banc). In *Helwig*, the 6th Circuit held that the plaintiff was entitled only to the "most plausible of competing inferences." Id. at 553. In seeking something of a middle ground, the Supreme Court expressly declined to adopt the 6th Circuit's "most plausible of competing inferences" standard. See *Tellabs*, 127 S. Ct. at 2510. As a result, district courts in the 6th Circuit generally have applied *Tellabs* without significant reference to prior 6th Circuit case law interpreting the "strong inference" requirement. See, e.g., *In re National Century Fin. Enters. Inc. Inv. Litig*., [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,467 (S.D. Ohio Dec. 20, 2007); *In re ProQuest Sec. Litig.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 94,510 (E.D. Mich. Nov. 6, 2007).

Some circuits view 'Tellabs' as consistent with prior authority.

Courts in other circuits whose prior case law was not addressed as directly by *Tellabs* have attempted to reconcile *Tellabs* with prior law. The 2d and 3d circuits previously applied a "strong inference standard" that predated the PSLRA. Courts in those circuits held that a complaint could support a strong inference of scienter with allegations of "strong circumstantial evidence" that a defendant acted with scienter or, alternatively, allegations that a defendant had "motive and opportunity" to commit fraud. See, e.g., *Kalnit v. Eichler*, 264 F.3d 131 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999). This analysis did not expressly involve consideration of competing inferences of nonfraudulent intent (although as a practical matter such competing inferences often crept into the consideration of motive).

Since *Tellabs*, courts in the 2d and 3d circuits have merged pre-*Tellabs* law with the Supreme Court's new *Tellabs* standard. See, e.g., *ATSI Communications Inc. v. The Shaar Fund Ltd*., 493 F.3d 87 (2d Cir. 2007); *Key Equity Investors Inc. v. Sel-Leb Marketing Inc*., 246 Fed. Appx. 780 (3d Cir. 2007). This has led at least one court to hold that the new test materially altered prior law by making it more difficult for plaintiffs to state a claim. See *In re Bisys Sec. Litig*., 496 F. Supp. 2d 384 (S.D.N.Y. 2007).

Applying prior authority

Other circuits view *Tellabs* as fully consistent with prior authority. The 5th Circuit in *Central Laborers' Pension Fund v. Integrated Electrical Services Inc*., 497 F.3d 546 (5th Cir. 2007), quoted the *Tellabs* standard, yet largely relied upon prior 5th Circuit case law and analysis in analyzing the complaint. For instance, the court referred to *Tellabs* in its analysis of the individual defendants' stock sales to support prior 5th Circuit authority holding that stock sales are probative of scienter only if they are unusual in timing or scope. In *Tellabs* parlance, the court held, routine stock sales give rise to an inference of nonfraudulent intent that is more compelling than an inference of scienter.

Courts in the 8th and 11th circuits likewise view pre-*Tellabs* authority as consistent with *Tellabs*. See, e.g., *Intrepid Global Imaging 3D Inc. v. Athayde*, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,445 (M.D. Fla. Dec. 13, 2007) ("The Eleventh Circuit has followed *Tellabs*") (citing a pre-*Tellabs* case, *Garfield v. NDC Health Corp*., 466 F.3d 1255 (11th Cir. 2006)); *In re Winn-Dixie Stores Inc. Sec. Litig*., [Current] Fed. Sec. L. Rep. (CCH) ¶ 94,532 (M.D. Fla. Dec. 4, 2007) (same); *In re H&R Block Sec. Litig*., [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,414 (W.D. Mo. Oct. 4, 2007) ("The standard clarified in *Tellabs* is not significantly different than preexisting 8th Circuit case law."); *Elam v. Neidorff*, 502 F. Supp. 2d 988, 993 (E.D. Mo. 2007) ("The vast majority of the Eighth Circuit decisions might just as well have been decided under the 'at least as compelling' standard.").

Courts in the 4th and 10th circuits also appear to assume prior law is consistent with *Tellabs*. See, e.g., *In re AAIPharma Inc. Sec. Litig.*, 521 F. Supp. 2d 507 (E.D.N.C. 2007); *Britton v. Parker*, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,473 (D. Colo. Sept. 26, 2007); *In re BearingPoint Inc. Sec. Litig*., 525 F. Supp. 2d 759 (E.D. Va. 2007); *In re NPS Pharmaceuticals Inc. Sec. Litig.*, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,372 (D. Utah July 3, 2007).

The 9th Circuit's pre-*Tellabs* case law suggested a "tie goes to the defendant" rule when considering competing inferences. See *Gompper*, 298 F.3d 893. Nevertheless, few if any courts in the 9th Circuit actually applied *Gompper* to dismiss complaints when the competing inferences were determined to be "tied." Thus, as a practical matter, courts in the 9th Circuit appear to consider *Tellabs* consistent with prior 9th Circuit authority. For example, in *In re Adecco S.A. Securities Litigation*, No. 06-55640, 2007 U.S. App. Lexis 27114 (9th Cir. Nov. 20, 2007), the 9th Circuit affirmed the dismissal of a securities fraud complaint in a three-paragraph memorandum opinion. Although the 9th Circuit quoted from *Tellabs*, the court affirmed the dismissal based upon the district court's "well-reasoned conclusion," which predated *Tellabs*, that the plaintiffs failed to plead a strong inference of scienter. Id. at *3.

Similarly, in *Wollrab v. Siebel Systems Inc*., [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,368 (9th Cir. Dec. 21, 2007), a different panel of the 9th Circuit affirmed a dismissal in a short memorandum opinion that both cited *Tellabs* and relied upon pre-*Tellabs* authority. This view was confirmed by *Middlesex Retirement System v. Quest Software Inc*., 527 F. Supp. 2d 1164, 1181 (C.D. Calif. 2007), in which the district court held that "in *Tellabs* the Supreme Court explicitly approved the Ninth Circuit's *Gompper* standard" and noted that "the Ninth Circuit's language [in *Gompper*] is virtually identical to the language in *Tellabs*."

But 1st Circuit found 'Tellabs' overruled one of its precedents.

The 1st Circuit has been most forthright about how *Tellabs* did and did not alter prior precedent. In *ACA Financial Guaranty Corp. v. Advest Inc*., 512 F.3d 46 (1st Cir. 2008), the court held that *Tellabs* confirmed much of the 1st Circuit's prior authority. See id. at 59 (citing, inter alia, *In re Cabletron Sys. Inc*., 311 F.3d 11 (1st Cir. 2002); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72 (1st Cir. 2002); *Greebel v. FTP Software Inc*., 194 F.3d 185 (1st Cir. 1999)). "However," the court explained, "*Tellabs* has overruled one aspect of the rule this court stated in *Credit Suisse*. *Credit Suisse* held that where there were equally strong inferences for and against scienter, this resulted in a win for the defendant. This is no longer the law." Id. at 59 (citation omitted). The court nevertheless affirmed the dismissal, holding that the inference against scienter in the complaint was stronger than the inference for scienter.

Finally, the D.C. Circuit has recognized that *Tellabs* changed prior law, and remanded a dismissal to the district court for the specific purpose of reconsidering the sufficiency of the complaint in light of *Tellabs*. See *Belizan v. Hershon*, 495 F.3d 686 (D.C. Cir. 2007).

A more stringent standard

Overall, the decisions to date from all circuits since *Tellabs* suggest that courts are applying a more stringent pleading standard. Of 102 reported decisions reviewed applying *Tellabs*, 64 reflect dismissals (albeit some with leave to amend). On its face, this (unscientific) survey reflects a dismissal rate higher than historical norms. See NERA, 2007 Year End Update, Recent Trends in Shareholder Class Actions, at 7, www.nera.com/image/BRO_Recent_Trends_12-07_web_3_-FINAL.pdf (two-year dismissal rates of up to 40%, depending upon the circuit).

This result should not be particularly surprising, however. The 2d, 3d and 7th circuits appear to recognize *Tellabs* as materially heightening the requirements for pleading scienter. In the 1st, 6th and 9th circuits, where *Tellabs*' "tie goes to the plaintiff" rule on competing inferences can be viewed as lowering the bar for plaintiffs, because competing inferences rarely are "precisely in equipoise" (*Tellabs*, 127 S. Ct. at 2514 (Scalia, J., concurring)), the difference between "tie goes to the defendant" and "tie goes to the plaintiff" is not practically important. Since it is unlikely that the Supreme Court will undertake to clarify its *Tellabs* standard any time soon, we can expect further debate within and among the circuits in the months and years to come. NLJ