Tellabs, Inc. v. Makor Issues & Rights, Ltd. –
A Uniform Test for Pleading Scienter in Securities Fraud Cases

In its 8-1 decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd. (No. 06-484), issued on June 21, the US Supreme Court enunciated a uniform test for determining whether factual allegations in a federal securities fraud complaint give rise to a “strong inference of scienter,” as required by § 21D(b)(2) of the Private Securities Litigation Reform Act of 1995 (“PSLRA”).

To qualify as “strong” under that provision, the Court’s six-justice majority opinion declared, 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.”

Tellabs resolves a confusing, four-way split among the federal circuits over the right way to apply the PSLRA’s “strong inference” requirement. The Seventh Circuit’s expansive formulation of the test in Tellabs required the plaintiff only to allege facts from which “a reasonable person could infer that the defendant acted with the required intent.” This standard was barely distinguishable from the one applied to ordinary fraud claims under Federal Rule of Civil Procedure 9(b). In contrast, four other circuits had adopted a much more stringent test, concluding that an inference of scienter is “strong” only if it is “the most plausible of competing inferences” that can be drawn from the facts alleged.

Two other circuits agreed that “competing inferences” should be weighed, but rejected the conclusion that only the “most plausible” inference could pass muster under the test. Finally, the Second and Third Circuits hewed to their pre-PSLRA approach, holding that plaintiffs must plead either facts demonstrating defendants’ “motive and opportunity” to commit fraud or “strong circumstantial evidence of recklessness or conscious misbehavior.”

Among these multiple approaches, Justice Ginsberg’s pragmatic majority opinion in Tellabs attempts to steer a middle course, firmly rejecting the lenient standard favored by the Seventh Circuit but stopping short of some other circuits’ “most plausible inference” requirement. The Court eliminates any doubt, however, that the determination as to whether a complaint’s allegations give rise to a strong inference of scienter necessarily involves a “comparative inquiry,” one that contrasts markedly with the

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1 15 U.S.C. 78u-4(b)(2) (requiring that claims under § 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”) must “state with particularity facts giving rise to a strong inference of scienter”).
3 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 437 F.3d 588, 602 (7th Cir. 2006).
4 Helwig v. Vencor, 251 F.3d 540, 553 (6th Cir. 2001); *see also In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottoman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002).
5 *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003); *see also In re K-tel Int’l Inc. Securities Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002).
6 *Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000); *see also In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

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traditional analysis employed on motions to dismiss other kinds of claims. Under *Tellabs*, a claim under § 10(b) of the 1934 Act cannot survive such a motion merely because a reasonable person “could” infer, on the basis of the facts pleaded, that the defendant acted with the required intent. Rather, a reviewing court must identify and take into account “plausible opposing inferences” consistent with an innocent explanation for those alleged facts. The strong-inference requirement commands dismissal of the claim unless 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 *Tellabs* decision thus provides defendants with a powerful new platform for argument on motions to dismiss claims at the pleading stage in federal securities cases. In *Tellabs*, the Court enjoins the lower courts to conduct the comparative inquiry into competing inferences that several circuits had previously begun to employ. In those circuits that had not expressly adopted that framework, *Tellabs* will significantly alter the terms of the debate and – particularly in the Second and Third Circuits – will likely compel courts to consider seriously whether their long-standing “motive and opportunity” analysis remains viable. Moreover, the Court’s opinion embraces a robust new vocabulary – calling for “cogent” and “compelling” inferences which solidly hold their own against alternative explanations. The Court’s formulation of the strong-inference standard itself arguably signals that the standard is intended to have real bite.

Of course, plaintiffs’ counsel will not sit silent in the face of these arguments. They will surely point out that the *Tellabs* majority declined to tie the lower courts’ hands in significant respects. First, the Court specifically rejected the contention by *Tellabs* that the complaint’s failure to include allegations of motive on the part of the company’s CEO alone negated any inference of scienter. *Tellabs* argued that the CEO’s “evident lack of pecuniary motive” dictated dismissal of the alleged claims, since plaintiffs had not alleged that he sold any Tellabs shares during the putative class period. The Court, however, declined to give the absence of motive allegations such dispositive weight. Although motive may be a “relevant consideration” and personal financial gain may “weigh heavily” in the scienter equation, the Court declared that “the absence of a motive allegation is not fatal.” Instead, courts must consider all allegations “collectively,” and the significance of any motive allegations, or the lack thereof, “depends on the entirety of the complaint.”

Second, the *Tellabs* majority declined to adopt a rule that would bar courts from considering any individual factual allegation solely because the complaint does not set it forth with sufficient particularity. *Tellabs* contended that certain allegations, such as those concerning purported “channel-stuffing” by the company, failed to distinguish clearly between legitimate and illegitimate types of conduct. But, the Court refused to employ the PSLRA’s particularity requirement as a screen to remove vague or ambiguous allegations from the scienter analysis. Rather, the majority held that, although “omissions and ambiguities” may “count against inferring scienter,” courts are nonetheless obligated to evaluate all the allegations in the complaint “holistically.”

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7 *Tellabs*, 2007 WL at *10
8 Id. at *10 (emphasis added).
9 Id. at *11.
10 Id. (quoting § 78u-4(b)(2)).
11 Id.
In a separate concurring opinion, Justice Alito took the majority to task on this point, arguing that courts’ consideration of such vague or general allegations both violates the plain meaning of § 21D(b)(2) and deprives the particularity requirement of any practical effect.\textsuperscript{12} Similarly, Justice Scalia filed his own concurrence, in which he assailed the majority’s conclusion that an inference can be deemed strong even when it is not the most compelling inference among those reasonably supported by the complaint. In Scalia’s view, if two inferences are equally convincing – i.e., in “equipoise” – then neither one of them can be characterized as “strong.”\textsuperscript{13} The concurring opinions leave no doubt that their authors both would have imposed even more rigorous requirements on the strong-inference analysis than the majority were willing to sanction.

The Court’s 8-1 decision in \textit{Tellabs} redraws the semantic battle lines for future motions to dismiss under § 10(b). From now on, lower courts will have to determine whether an inference is “cogent” and “compelling” relative to other possible inferences from the alleged facts. That said, the actual impact of the decision on future cases is not clear. Indeed, the \textit{Tellabs} Court itself declined to apply its newly-adopted standard to the specific factual allegations in that case. Instead, the Court remanded the case for fresh consideration by the lower court, while offering few clues as to whether the § 10(b) claim should survive in light of the new standard.\textsuperscript{14} While \textit{Tellabs} defines an overarching standard and sets forth general guidelines for applying it, the Court is plainly leaving it to the lower courts to hash through the highly fact-specific allegations in individual cases and weigh their significance independently.

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\textsuperscript{12} \textit{Id.} at *16 (Alito, J., concurring).

\textsuperscript{13} \textit{Id.} at *14 (Scalia, J., concurring).

\textsuperscript{14} \textit{Id.} at *13.