

The US Supreme Court Issues Its Opinion in Tellabs

Background

The Supreme Court has issued its much-anticipated opinion in the *Tellabs* case. The case examined the question of what a plaintiff must plead under the Private Securities Litigation Reform Act (PSLRA) in order to establish a "strong inference" that the defendant acted with the requisite mental state to commit securities fraud. The Court declined to adopt either the more lenient or more demanding requirements that interested parties had sought. Rather, the Court adopted a "balanced" approach and formulated a requirement that, in order to be sufficiently "strong," the inference that the plaintiff seeks to draw must be *at least as* plausible as other inferences. This article discusses the Supreme Court's decision and makes some preliminary assessments of the decision's likely impact.

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The Court's Opinion

The Supreme Court's opinion, written for an 8-1 majority by Judge Ruth Bader Ginsburg, rejected both the Seventh Circuit's standard (by which the statutory requirements could be met if the complaint alleged facts "from which, if true, a reasonable person could infer that the defendant acted with the required intent") and the more demanding standard sought by the SEC in its amicus brief (urging the Court to require the plaintiff to allege facts that establish a "high likelihood" that the plaintiff acted with intent).

The Court held that to qualify as "strong," 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 non-fraudulent intent." The Court specifically held that in considering whether an inference is "strong," a court must consider competing inferences, something which the Seventh Circuit had expressly declined to do, out of concerns that this comparative analysis would invade the jury's province. The inquiry, the Court said, is "inherently comparative." The inference "need not be irrefutable"; but "it must be more than merely 'reasonable' or 'permissible' -- it must be cogent and compelling, thus strong in light of other explanations." A complaint should survive a motion to dismiss only if "a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inferences one would draw from the facts alleged."

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The Sights

By saying that the district court must weigh competing inferences, the Supreme Court rejected the Seventh Circuit's suggestion that this type of comparative process usurps the jury's role and violates the Seventh Amendment: "A Court's comparative assessment of plausible inferences, while constantly assuming the plaintiff's allegations to be true, we think it plain, does not impinge upon the Seventh Amendment right to a jury trial."


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In looking at the *Tellabs* case itself, the Court noted that "motive can be a relevant consideration" and that "personal financial gain may weigh heavily in favor of a scienter inference" but the Court also agreed that "the absence of a motive allegation is not fatal." The significance of an allegation of motive "depends on the entirety of the complaint." The court's job "is not to scrutinize each allegation in isolation but to assess all the allegations holistically." The court's job is to ask: "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?"

Because neither the District Court nor the Seventh Circuit "had the opportunity to consider the matter in light of the prescriptions we announce today," the Court vacated the Seventh Circuit's judgment and said that the case should be reexamined in accord with the Court's construction of the PSLRA.

The Heart of the Issue: The PSLRA says that, in order for a suit to go forward, the plaintiff must allege a "strong inference" that the defendant intended to commit securities fraud. But what is a "strong inference" and who gets to decide if a "strong inference" exists?

The "lenient" view: a "strong inference" is a "*plausible or reasonable inference*" and the **jury** should decide if the plaintiff's inference is "strong".



The "demanding" view: a "strong inference" must be "*more plausible than any other inference*" and the **Judge** decides if the plaintiff's inference is "strong" before the suit proceeds.

The "majority" view of the Supreme Court:
 A "strong inference" is an inference that is "*at least as plausible as any other inference*" and the **Judge** decides if a suit will be allowed to proceed *and* may consider competing inferences when deciding if the inference is indeed "strong."

Analysis

The *Tellabs* case had the potential to significantly affect the outcome of future securities cases. Had the Supreme Court affirmed the Seventh Circuit's relatively more lenient standard, plaintiff's allegations would have been likelier to survive motions to dismiss, and with this more permissive standard, it might have been possible that more complaints would have been filed. The more demanding standard that the SEC had sought would have resulted in a greater number of dismissals, and might well have led to a reduction of the number of lawsuits.

However, the Supreme Court did not follow either of these more determinative approaches. The Court clearly sought a balanced approach. It described its task in ruling on the *Tellabs* case as being to "prescribe a workable construction of the 'strong inference' standard" and to come up with "a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."

And while the majority accepted the notion that trial courts must weigh inferences in determining whether the PSLRA's requirements must be met, it expressly rejected the position urged by Justices Scalia and Alito in their concurring opinions that "the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence" (italics in Justice Scalia's original concurring opinion). The majority's rejection of this more demanding standard is consistent with the Court's stated goal of prescribing a workable construction that balances the "twin goals" of the PSLRA.

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Because the Court's opinion is built around balancing the PSLRA's twin goals, it seems unlikely that this decision will have a determinative impact on the outcome of a significant number of future securities suits, much less on whether or not suits get filed in the first place. The more demanding standard Justices Scalia and Alito urged might well have had a more significant impact, but the majority's approach seems less likely to have as significant of an impact. A *Wall Street Journal* article discussing the opinion quotes Barbara Hart of the Labaton Sucharow & Rudoff law firm as saying, "these are the types of cases we are bringing already; our cases already meet this [the majority] standard."

The early commentary seems consistent with Hart's view. For example, the *Business Law Prof blog* notes:

The majority standard is not what the defense bar wanted; they wanted the standard of the concurring judges, which the court rejected. This is not a defense bar victory; it is a draw at best. Reporters will fail to get this correct and rack it up as another victory for corporate America; it is not.

The *SEC Actions Blog* agreed, noting:

The decision should not be viewed as a clear victory for either side. Rather, the decision reflects a balance between the competing interests Justice Ginsburg sought to reflect in her opinion, permitting meritorious classes to proceed, but weeding out those that lack merit... In the standard adopted today, the Court blended together the requirement that plaintiffs plead a cause of action properly and the heightened pleading requirements of the PSLRA. At the same time, the Court rejected definitions of “strong inference” that would have made it virtually impossible to plead such a case. Overall, it was a balanced decision by the Court.

Of course, it remains to be seen how the lower courts ultimately will implement the Supreme Court’s opinion in *Tellabs*, but at this point, it seems as if the case will not have as dramatic an impact on private securities litigation as it potentially might have.

About the Author

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A version of this article previously appeared on The D & O Diary, the author’s Internet weblog. To monitor developments on this and other important topics relating to directors’ and officers’ liability, readers are encouraged to regularly refer to The D&O Diary, the author’s Internet weblog. You can access the weblog via our website at www.oakbridgeins.com.

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