

The Pending Tellabs Case: Why It Will Matter

On March 28, 2007, a case will be argued before the U.S. Supreme Court that has the potential to significantly alter the securities litigation landscape for public companies and their officers and directors. The case, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, involves the question of what “state of mind” allegations are required for a complaint to survive a motion to dismiss under the Private Securities Litigation Reform Act’s (PSLRA) “heightened pleading standard.” This article reviews the case’s background, takes a look at what the case is about, and discusses why the outcome of the case will matter.

What the Case is About

The plaintiffs’ second amended complaint alleges that Tellabs and six individual defendants violated the securities laws in a series of statements between December 2000 and June 2001. Essentially, the plaintiffs allege that the defendants misrepresented demand for Tellabs’ flagship product; misrepresented the commercial availability of a new product; and inflated Tellabs’s reported revenue by “channel stuffing.” The district Court dismissed the second amended complaint, and the plaintiffs appealed to the United States Circuit Court of Appeals for the Seventh Circuit.

The Seventh Circuit reversed, in part, the district Court’s dismissal, finding that the standard that the lower Court applied to determine whether the second amended complaint had sufficiently pled “scienter” (the state of mind required to support a securities fraud allegation) had been too strict.

Under the PSLRA, a complaint must, “state with particularity facts giving rise to a strong inference that the defendants acted with the required state of mind.” In order to determine what is required to establish a “strong inference,” the Seventh Circuit reviewed the various approaches that the other Circuit Courts had adopted. The Seventh Circuit rejected the Ninth Circuit’s conclusion that the PSLRA had raised the state of mind requirement to require a showing of “deliberate or conscious recklessness.” The Seventh Circuit then considered the other Circuits’ various standards for determining whether a complaint’s allegation raised a “strong inference” that the defendant acted with scienter. Among other things, the Seventh Circuit considered whether a Court must weigh alternative inferences that might be drawn from the plaintiffs’ allegations, in order to determine whether the inference urged by the plaintiff is “strong.”

This article reviews the case’s background, takes a look at what the case is about, and discusses why the outcome of the case will matter.

The Sights

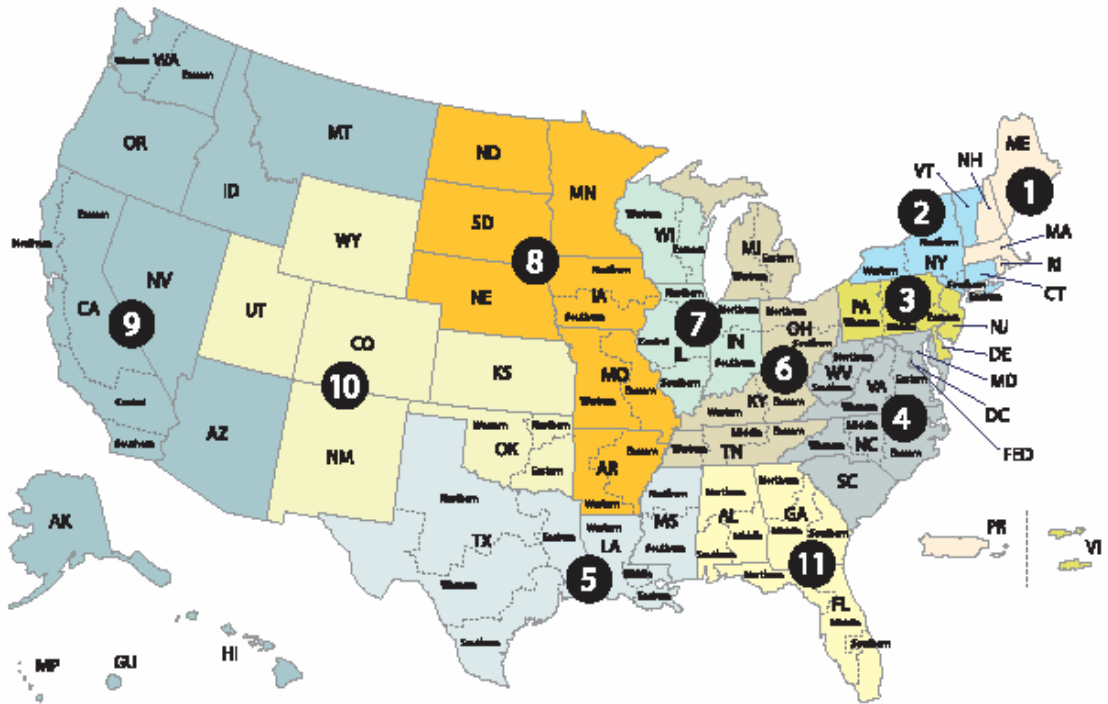
Inside:

U.S. Circuit Courts Map
Page 2

Why The Case Will
Matter
Page 3

Contact:

Lisa McNamara Hughes
Phone: 860-906-0103
lhughes@oakbridgeins.com
www.oakbridgeins.com



Geographic Boundaries of United States Courts of Appeals and United States District Courts (Courtesy www.usCourts.gov)

Alternative inferences might suggest an innocent explanation for the facts on which plaintiffs’ allegations of fraud are based.

The Seventh Circuit concluded that instead of weighing inferences and accepting only the most plausible inference (which the Seventh Circuit was concerned might intrude on the jury’s functions), it would accept all inferences that a reasonable person would draw in favor of a plaintiff based on the allegation of the complaint. The Seventh Circuit said:

We think it is wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury’s role. Instead of accepting only the most plausible of competing inferences 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 reasonable intent.

In response to the Seventh Circuit’s ruling, the defendants petitioned the Supreme Court to hear the case and review the Seventh Circuit’s ruling.

The Supreme Court agreed to take the case on the question “whether and to what extent a Court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a ‘strong inference’ that the defendant acted with scienter.”

The parties briefing is to be completed by March 20, 2007 and the case is to be argued on March 28, 2007. The Court is likely to rule before the end of the current term, in June.

Why the Case Will Matter

The Supreme Court agreed to hear the case because of the current “split in the circuits” over the PSLRA’s heightened pleading standard. It hardly serves the principles of uniform application of the laws to have different standards applying in different parts of the country. The existence of different interpretations of the pleading standard may sound esoteric, but the existence of different interpretations of the pleading standard has very real practical consequences. For example, the much lower level of civil securities fraud litigation in the Ninth Circuit (which includes California) is directly attributable to the very high standard applicable there – as noted above, the Ninth Circuit alone concluded that the PSLRA raised the substantive requirements to establish scienter, and not just the pleading requirements. The relatively more relaxed standard applicable in the Second Circuit (which includes New York) explains the higher level of litigation activity there.

But while the outcome of the Supreme Court’s consideration of the Tellabs case unquestionably will be the elimination of the split between the circuits, the practical consequences of a uniform standard will depend on what uniform standard the Court devises and how the standard compares with the prior practice in each of the various Circuits.

For example, the Supreme Court could follow the Ninth Circuit, concluding that the PSLRA requires a showing of “deliberate or conscious recklessness.” This higher scienter standard has meant more dismissals and the filing of fewer cases in the Ninth Circuit. Other Circuits, including the Seventh Circuit, have concluded that Congress did not intend to change what constitutes scienter. There is a possibility that the Supreme Court might address not just the pleading requirements under the PSLRA but might also address the substantive requirement for establishing scienter (an issue the Court has never previously addressed directly). Any changes to the substantive standard of scienter could significantly affect the securities litigation exposure for officers and directors.

The Supreme Court agreed to hear the case because of the current “split in the circuits” over the PSLRA’s heightened pleading standard.

There is a possibility that the Supreme Court might address not just the pleading requirements under the PSLRA but might also address the substantive requirement for establishing scienter.

more liberal members of the Court, often takes positions friendly to business; by way of illustration, he wrote the majority opinion in the recent case overturning a punitive damages verdict.

Conclusion

After more than ten years of case law under the PSLRA, the various Circuits have each evolved their own separate standards for the sufficiency of pleading under the PSLRA. The existing standards have significantly affected the dismissal rates and securities lawsuit filing levels in each Circuit.

The pleading standard that the Supreme Court adopts could significantly alter the rate of dismissals of securities fraud lawsuits, and ultimately could affect the number of securities lawsuits that get filed. This potential impact could be the greatest in the Ninth and Second Circuits, simply because they, respectively, have the most restrictive and most relatively liberal interpretations of the pleading standard. A “liberal” pleading standard is easier to satisfy, and less likely to result in a dismissal; a “conservative” pleading standard is harder to satisfy and more likely to result in a dismissal. If the Supreme Court adopts the standard urged by the SEC, the number of securities fraud lawsuit filings could potentially be significantly diminished.

About the Author

This article was prepared by Kevin M. LaCroix, Esq. of OakBridge Insurance Services. Kevin has been advising clients concerning directors' and officers' liability issues for nearly 25 years. Prior to becoming a director at OakBridge, Kevin was President of Genesis Professional Liability Managers, a D & O liability insurance underwriter. Kevin previously was a partner in the Washington, D.C. law firm of Ross Dixon & Bell. Most recently, he served as a Co-Chair of the 2007 Professional Liability Underwriting Society (PLUS) D & O Symposium in New York. Kevin is based in OakBridge's Beachwood, Ohio office. His direct dial phone number is (216) 378-7817, and his email address is klacroix@oakbridgeins.com.

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.

About OakBridge Insurance Services

OakBridge Insurance Services is one of the nation's leading Executive Liability insurance intermediaries. The firm provides its services through CoBrokerage alliances with strong, regional insurance brokers across the country. Please inquire whether your broker works with OakBridge or visit www.oakbridgeins.com.

Disclaimer

This article is provided for informational purposes only and is not intended to provide legal advice. The issues and suggestions presented in this article should be reviewed with outside counsel. Any change in board processes or practices should be discussed with outside counsel before implementation.