

Legal Updates & News

Bulletins

Supreme Court Endorses “Holistic” Approach to Evaluating Securities Fraud in *Tellabs*

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The Supreme Court has issued its much-anticipated decision in *Tellabs v. Makor Issues & Rights*, No. 06-484, 551 U.S. ____ (June 21, 2007). *Tellabs* holds that a court must consider competing inferences in determining whether the allegations in a securities fraud complaint give rise to a “strong inference” of scienter, as required by the heightened pleading standard set forth in the Private Securities Litigation Reform Act of 1995 (the “Reform Act”). Congress imposed the heightened pleading requirement as a check against abusive litigation in private securities fraud actions.

While *Tellabs* provides guidance about what constitutes a “strong inference” of scienter, it rejects any bright-line rules.

What Is a “Strong Inference” of Scienter?

The Court held that a “strong inference” is “more than merely plausible or reasonable — it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” The inference, however, “need not be irrefutable, *i.e.*, of the ‘smoking gun’ genre, or even the most plausible of competing inferences.”

How Courts Will Decide Whether Allegations Give Rise to a “Strong Inference” of Scienter

When ruling on a motion to dismiss, judges must consider all competing inferences and engage in a “comparative” evaluation of all allegations in a complaint. The question is “whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.” The Court provided three “prescriptions” to guide judges with this holistic evaluation:

- First, “a court must accept all factual allegations in the complaint as true.”
- Second, a “court must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.” Such documents often include SEC filings, press releases, and stock price and trading data.
- Third, “in determining whether the pleaded facts give rise to a ‘strong’ inference of scienter, the court must take into account plausible opposing inferences.” A court “must consider plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” A complaint can withstand dismissal only “if a reasonable person would deem the inference of scienter cogent and as at least as compelling as any opposing inference one could draw from the facts alleged.”

Possible Implications of the Decision

- **Case-By Case Determinations:** As *Tellabs* does not provide any concrete guidance as to what allegations would support a strong inference of scienter, judges will evaluate allegations and competing inferences in their totality, and case-by-case. No single allegation or factor is expected to be determinative in the abstract.
- **Standards of Proof:** *Tellabs* clarifies the differences between the pleading and proof standards in

securities cases. To survive dismissal, a plaintiff “must plead facts rendering an inference of scienter *at least as likely as* any plausible opposing inference.” To prove a case, a plaintiff’s burden is even higher: the plaintiff “must demonstrate that it is *more likely* than not that the defendant acted with scienter.” A plaintiff must meet this proof burden by a preponderance of the evidence.

- **No Uniform Standard for Recklessness:** The Court again expressly avoided deciding whether allegations showing recklessness establish scienter. The Court did, however, note that every Circuit Court of Appeals has so held, even if they “differ on the degree of recklessness required.” It is thus likely that there will continue to be divergent interpretations regarding allegations of recklessness.
- **Scienter for Each Defendant:** The Court elected not to “disturb” that part of the Seventh Circuit’s decision that requires a plaintiff to plead scienter as to each defendant. This should support defendants’ argument that plaintiffs should not be permitted to invoke the so-called “group pleading doctrine,” which plaintiffs often relied on to proceed against multiple officers and/or directors as a group.
- **Litigation Trends:** Although *Tellabs* is an important securities decision, it likely will not radically alter securities litigation trends as many had expected. It should not sound the death-knell to securities suits, nor should the new standard lead to a dramatic increase in private litigation.

Justice Ginsberg wrote for the majority, and was joined by Chief Justice Roberts, and Justices Breyer, Kennedy, Souter, and Thomas. Justices Scalia and Alito each filed concurring opinions. They both agreed that a complaint should not survive dismissal unless the inferences of scienter are “more plausible than the inference of innocence,” but noted that this distinction would likely have no practical effect. Justice Stevens filed a dissenting opinion. He suggested that a “probable cause” standard would be “easier to apply and more consistent” with the Reform Act.

The Court vacated the Seventh Circuit’s decision and remanded the case, so that the complaint could be reexamined in light of the Court’s ruling.