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TELLABS INC. V. MAKOR ISSUES & RIGHTS, LTD.: PLEADING A STRONG INFERENCE OF SCIENTER

By
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I. INTRODUCTION

A. The decision: On June 21, 2007 the Supreme Court handed down its decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd., No. 06-484, 2007 WL 1773208 (June 21, 2007) ("Tellabs"). The decision defined a key element of a securities fraud claim for damages under the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Specifically, the case defined what a securities law plaintiff must allege in a complaint to establish a "strong inference" of scienter under Section 21D(b)(2) of the Act, 15 U.S.C.§ 78u-4(b)(2), holding that the inference from the facts pled "must be cogent and at least as compelling as any opposing inference of nonfraudulent intent" when viewed in the context of all the allegations in the complaint. Id. at *4.

B. What as resolved: The decision resolved a split in the circuits concerning the meaning of Section 21D(b)(2) and how courts should consider conflicting inferences which may be raised by the facts pled in the complaint.

C. What was not resolved: As in the past, the Court declined to define scienter, although it may be argued that the decision effectively overruled Ninth Circuit decisions which employ a definition of scienter that is more stringent than the one used by other circuits. The Court also did not decide whether the "group pleading" doctrine can be used under the Reform Act. Its treatment of the issue, however, at least suggests that the doctrine cannot be used in pleading cases under the PSLRA.

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II. THE ORIGINS OF TELLABS.

A. The Reform Act: In 1995 Congress passes the Private Securities Litigation Reform Act in response to what was perceived to be growing abuse in bringing securities class actions.

B. Pleading Standards before the Reform Act. The pleading standards in effect at the time the Reform Act was passed were deemed ineffective at curbing what Congress perceived as abuses in bringing securities class actions.

1. Fed. R. Civ. P. 9(b). Prior to the Reform Act, the only heightened pleading requirements for securities fraud suits were contained in Federal Rule 9(b) which provides:

> In all averments of fraud or mistake, the circumstances constituting the fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of a person may be averred generally.

Under this rule, courts required that plaintiffs plead allegations of securities fraud with particularity. The plain language of the rule, however, specifies that its heightened pleading requirements do not apply to allegations regarding state of mind.

2. Nevertheless, prior to the Reform Act there was a split in the circuits over what had to be pled in a securities fraud action regarding state of mind.

a. The Second Circuit, followed by a number of other circuits, developed what was regarded as the most stringent pleading standards regarding state of mind. The Second Circuit rule required that a securities plaintiff plead facts giving rise to a "strong inference" of fraudulent intent. Plaintiff could satisfy this test in two ways:

> By alleging facts establishing motive and opportunity to commit fraud, or by alleging facts constituting circumstantial evidence of either reckless or conscious behavior.

In re Time Warner, Inc. Sec. Litig., 9 F.3d 259 (2nd Cir. 1993); *accord*, IUE AFL-CIO Pension Fund v. Herrmann, 9 F.3d 1049, (2nd Cir. 1993); *see generally*, 5A Wright & Miller, Federal Practice and Procedure, § 1301.1 at 300.

b. Some courts followed the Ninth Circuit's much more permissive approach. In In re GlenFed, Inc. Sec. Litig., 42 F.3d 1541 (9th Cir. 1994), that court held, in an *en banc* decision, that fraud had to be

pled with particularity, in securities fraud cases. Facts concerning the requisite state of mind of the defendant could be alleged generally, without regard to the specificity requirement of Rule 9(b). *See also* In re Stac Elec. Sec. Litig., 89 F.3d 1399 (9th Cir. 1996).

c. The Seventh Circuit developed an intermediate approach followed by some courts. Under that approach, the plaintiff is required to plead a basis for believing that the requisite scienter existed. *See, e.g.*, In re HealthCare Compare Corp., Sec. Litig., 75 F.3d 276 (7th Cir. 1996).

C. Origin of the Reform Act pleading requirements: During the hearings which led to the passage of the Reform Act, Congress repeatedly heard testimony concerning frivolous private securities fraud suits brought by plaintiff lawyers, largely for the attorney fees. Those hearings highlighted the negative impact such suits had on corporate America, primarily high tech companies. Thus, the Conference Report notes that the Act was prompted by

> The routine filing of lawsuits against issuers of securities ... whenever there is a significant change in the issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action.

H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). The legislative history to the Act noted in this regard that a "complaint alleging violation of the Federal securities laws is easy to craft and can be filed with little or no due diligence." S. Rep. No. 98, 104th Cong., 1st Sess. 8 (1995). Congress believed that the settlement value of those actions was disproportionate to the merits of the actions. Id. at 6.

1. To curb these abuses, Congress imposed a number of limitations and restraints on private securities actions. Those included requirements concerning the appointment of lead counsel which favor the selection of institutional investors, limits on damages and attorney fees, a safe harbor for forward looking statements, and a stay of discovery pending the resolution of a motion to dismiss the complaint.

2. The Reform Act also imposed specific pleading requirements on private securities fraud actions, since Rule 9(b) was seen as insufficient.

   a. For each alleged untrue statement or omission of a material fact, the "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with

particularity all facts on which that belief is formed." PSLRA, Section 21D(b)(1).

b. To plead the required state of mind, the Act requires that "the complaint shall, with respect to each act or omission ... state with particularity facts giving rise *to a strong inference* that the defendant acted with the required state of mind." 15 U.S. § 78u-4(b)(2) (emphasis added). In actions under Section 10(b) of the Exchange Act, the "required state of mind" is scienter. Ernst & Ernst. v. Hochfelder, 425 U.S. 185 (1976).

3. The Reform Act borrowed the "strong inference" from the Second Circuit. The statute, however, did not incorporate the two-prong test used by that Circuit. Likewise, the statute did not specifically define the phrase. The legislative history of the section is less than illuminating.

a. The House Conference Report suggests that Congress intended to create a uniform pleading standard. At the same time, the Report indicates that Congress wanted to raise the pleading standards to eliminate abuse. H.R. Conf. Rep. 104-369 at 31, 41.

i. During the floor debates which led to the passage of the Act, the Senate at one point tentatively adopted an amendment crafted by Senator Specter. That amendment sought to codify the then-existing case law on the issue of pleading state of mind from the Second Circuit Court of Appeals, which was viewed as the most stringent test. *See* 141 Cong. Rec. S9,170 (daily ed. June 27, 1995).

ii. The Joint House Senate Conference Committee rejected the Specter Amendment. *See* H.R. Conf. Rep. 104-369, at 41.

iii. The Specter Amendment was rejected, according to Senator Dodd, because it was "an incomplete and inaccurate codification" of the Second Circuit case law. 141 Cong. Rep. S 19067 (daily ed. Dec. 21 1995) (Sen. Dodd quoting a memorandum prepared by Stanford Professor Joseph Grundfest); 141 Cong. Rec. S 19068 (daily ed. Dec. 21, 1995) ("The Specter amendment ... did not really follow the guidance of the Second Circuit. So that is the reason that amendment was taken out).

b. The "Statement of Managers" noted that the purpose of the Act was to create uniformity among the circuits and "establish ... more stringent pleading requirements to curtail the filing of meritless lawsuits." H.R. Conf. Rep. No. 104-369, at 37 (1995).

c. The statement went on to discuss the pleading standard in the Act:

> The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading "with particularity. Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that those facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

Id. at 41.

d. A footnote to the passage quoted above notes: "For this reason, the Conference Report chose not to include in the pleading standard, certain language relating to motive, opportunity, or recklessness." Id. n. 23. Later, the report notes that "[t]he Committee does not intend to codify the Second Circuit's caselaw interpreting [the] pleading standard, although courts may find this body of law instructive." Id. at 15.

e. Subsequently, President Clinton vetoed the bill, expressing concern about the pleading standard:

> I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims ... I am prepared to support the high pleading standards of the U.S. Court of Appeals for the Second Circuit – the highest pleading standard of any Federal Circuit Court. But the Conferees make crystal clear in the Statement of the Managers, their intent to raise the standard even beyond that level. I am not prepared to accept that.

141 Cong. Rec. H15,214 (daily ed. Dec. 10, 1995).

f. Congress overrode the President's veto. During the floor debates which led to passage of the Act, its sponsors disagreed with President Clinton's reading of the Act, noting that in fact it did incorporate the pleading standard of the Second Circuit. For example, Senator Dodd noted that the bill was "faithful to the

Second Circuit's test." 141 Cong. Rec. S19067 (daily ed. Dec. 21, 1995).

g. Some courts have read this history suggesting that the standard incorporated in the Act is that of the Second Circuit. Ganino v Citizens Utils. Co., 228 F.3d 154 (2d Cir. 2000). Others have rejected this notion. In re Silicon Graphics Inc., Sec. Litig., 183 F.3d 970 (9th Cir. 1999). Still others have viewed the history as equivocal. Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338 (4th Cir. 2003).

III. THE REFORM ACT PLEADING STANDARDS IN THE CIRCUIT COURTS

A. Key Issues: Following the passage of the Reform Act, the courts struggled with its interpretation. Four key issues discussed in the opinions construing Section 21D(b)(2) are:

1. The applicable state of mind – that is, whether reckless conduct is sufficient;

2. what constitutes a "strong inference" of the required state of mind, a question which revolved largely around the application of the prior Second Circuit test;

3. the application of the "group pleading doctrine; and

4. whether, and to what extent, to consider competing inferences in assessing whether there is a "strong inference" of scienter on a Rule 12(b)(6) motion.

B. Definition of Scienter: Section 21D(b)(2) does not define the requisite mental state necessary to bring a fraud action under the securities laws. Rather, the section simply refers to the "applicable mental state," thus leaving its definition for resolution by the courts.

1. At the time the Reform Act was passed, the Supreme Court had held in Ernst & Ernst, 425 U.S. at 194, n. 12 that fraud actions under Section 10(b) and Rule 10b-5 must be based on intentional conduct, that is scienter which it defined as "a mental state embracing intent to deceive, manipulate, or defraud." The Court reserved the question of whether recklessness will satisfy this standard.

2. At the time the Act was passed, every Court of Appeals which had considered the issue had held that scienter included the concept of recklessness.

a. Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (*en banc*);

b. Hudson v. Phillips Petroleum Co., 881 F.2d 1236, 1244 (3rd Cir. 1989);

c. Van Dyke v. Coburn Enters., Inc., 873 F.2d 1094, 1100 (8th Cir. 1989);

d. McDonald v. Alan Bush Brokerage Co., 863 F.2d 809, 814 (11th Cir. 1989);

e. Hackbart v. Holmes, 675 F.2d 1114, 1117-1118 (10th Cir. 1982);

f. Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961-62 (5th Cir. 1981) (*en banc*);

g. Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-25 (6th Cir. 1979);

h. Sundstrand Corp. v. Sun Chem. Corp. 553 F.2d 1033, 1044-45 (7th Cir. 1977); and

i. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir. 1978).

3. While the language used by each court varies to some extent, most Circuits use a formulation similar to the one adopted by the Seventh Circuit in Sundstrand, which provides that recklessness is conduct which is "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Sundstrand, 553 F.2d at 1045.

4. Following the passage of the Reform Act, most circuits reiterated their pre-Act holdings on the inclusion of recklessness within scienter. *See, e.g.*, Ottmann, 353 F.3d at 343 n. 3 (collecting cases).

5. The Ninth Circuit, however, took a different approach. In Silicon Graphics, 183 F.3d 970, the court concluded that following the Reform Act, a securities plaintiff must plead a "strong inference of, at a minimum, 'deliberate recklessness.'" Id. at 977. Previously, the court had adopted the Sunstrand definition of recklessness. Id. at 976. Following the passage of the PSLRA, however, the court concluded that although recklessness is a form of intentional conduct, the § 21D(b)(2) proscription to plead facts giving rise to a "strong inference" means that now a securities plaintiff must plead "deliberate recklessness." This standard, the court noted, requires the securities law plaintiff to plead facts which "strongly suggests actual intent." Id. at 979. No other circuit has adopted this standard.

C. What Constitutes a "Strong Inference:" The PSLRA did not define this key phrase, leaving it to the courts to develop a workable standard. While the legislative history suggests that the case law of the Second Circuit be considered for guidance, Congress specifically chose to leave the definition of the phrase open and declined to codify the two prong test used by the circuit to define the concept. The Circuit Courts are split over whether the pre-PSLRA Second Circuit test was sufficient to establish the required "strong inference."

1. The Pre-Act Second Circuit Test Applies– the Second and Third Circuits: These circuits have held that a plaintiff can establish a "strong inference"

of scienter by pleading either motive and opportunity, or strong circumstantial evidence of recklessness or conscious misbehavior.

a. In Press v. Chem. Inv. Serv. Corp., 166 F.3d 529 (2nd Cir. 1999), the court held that the Reform Act "heightened the requirement for pleading scienter to the level used by the Second Circuit ... As a pleading requirement, a plaintiff must either (a) allege facts to show that 'defendants had both motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.' Id. at 538. The court went on to state that it "has been lenient in allowing scienter issues to withstand summary judgment based on fairly tenuous inferences." Id. The court concluded that where plaintiff claimed fraud because the defendant held his treasury bills a few days past maturity and the promised date of return, that motive, and thus a strong inference of scienter, had been pled based on the claim that a motive of retaining use of the funds was sufficient. The court cautioned, however, that general allegations of motive and opportunity to defraud were not sufficient. The court found the allegations by the plaintiff were "barely" adequate. While the question of motive and opportunity is one for the trier of fact, at the pleading stage the court expressed concern about making the standard so high that it would be impossible to plead the case.

b. The Third Circuit adopted a similar position in In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999).

2. The Reform Act Creates A Heightened Standard -- The Ninth Circuit: The Ninth Circuit, which prior to the Reform Act had the most liberal pleading standard regarding scienter, adopted the most stringent test following passage of the PSLRA. Silicon Graphics, 183 F.3d 970.

a. After carefully reviewing the legislative history of the Act, the Court determined "[i]n sum, the legislative history supports our conclusion that the PSLRA pleading standard is higher than the standard of the Second Circuit." The Court based this conclusion largely on its determination that Congress sought to promulgate a higher pleading standard and that its refusal to codify the Second Circuit case law, along with the veto by President Clinton, supported the conclusion that the Act was intended to incorporate a pleading standard which is higher then the pre-Act Second Circuit standard. Thus the court noted: "Had Congress merely sought to adopt the Second Circuit standard, it easily could have done so. It did not do so. Instead, Congress adopted a standard more stringent than the Second Circuit standard." Silicon Graphics, 183 F.3d at 979.

b. Based on this theory, the Court held that "a private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct. ... We hold that although facts showing mere recklessness or a motive to commit fraud and opportunity to do so, may provide some reasonable inference of intent, they are not sufficient to establish a *strong* inference of deliberate recklessness. In order to show a strong inference of deliberate recklessness, plaintiffs must cite facts that come closer to demonstrating intent, as opposed to mere motive and opportunity. Accordingly, we hold that particular facts giving rise to a strong inference of deliberate recklessness, at a minimum, is required to satisfy the heightened pleading standard under the PSLRA." Id. at 974.

3. Intermediate positions – the First, Fourth, Sixth, Eight, Tenth and Eleventh Circuits: These circuits have adopted various positions which fall between those adopted by the Second and Ninth Circuits. For example:

a. The First Circuit: In Greebel v. FTP Software, Inc., 194 F.3d 185 (1st Cir. 1999), the First Circuit held that its pre-PSLRA case law, which contained heightened pleading standards, was not disturbed. First, the court concluded that the Act did not change the previous case law on scienter. Second, after reviewing the arguments of plaintiffs and the SEC that the Second Circuit "motive and opportunity" test be employed noted: "indeed, the debate about adoption or rejection of prior Second Circuit standards strikes us as somewhat beside the point. The categorization of patterns of facts as acceptable or unacceptable to prove scienter or to prove fraud has never been the approach this circuit has taken to securities fraud. ... Instead, we have analyzed the particular facts alleged in each individual case to determine whether the allegations were sufficient to support scienter." Id. at 196.

b. The Eleventh Circuit: In Bryant v. Avado Brands, Inc., 187 F.3d 1271 (11th Cir. 1999), the court held that while motive and opportunity may constitute evidence of recklessness, standing alone, they are insufficient to establish a strong inference of scienter. The Circuit Court reversed a determination by the District Court finding a securities fraud complaint sufficient based on the Second Circuit "motive and opportunity" test.

i. First, the Court concluded that Congress did not intend to change the pre-Reform Act case law on scienter since it incorporated the phrase "requisite state of mind" in the statute. Thus, scienter is a concept which includes recklessness. Accordingly, the court concluded that a

securities fraud complaint must plead with particularity "that a defendant acted with a severely reckless state of mind ... ." Id. at 1283. While this formulation of the recklessness standard seems to vary from that of other circuits and appears to emulate that of Silicon Graphics, it was intended to put the court in line with all other circuits, except the Ninth on this issue.

ii. The court then went on to define what must be pled to satisfy the statutory requirement of "strong inference" of scienter: "We interpret this language to mean that a plaintiff must plead with particularity facts which give rise to a strong inference that the defendant acted in a severely reckless fashion – the required state of mind in our Circuit for many years. ... While allegations of motive and opportunity may be relevant to a showing of severe recklessness, we hold that such allegations, without more, are not sufficient. ... Motive and opportunity ... do not constitute a substantive standard; rather, motive and opportunity are specific kinds of evidence, which along with other evidence might contribute to an inference of recklessness or willfulness." Id. at 1285-86.

iii. The SEC filed an amicus brief in this case urging the adoption of the Second Circuit standard: "the Second and Third Circuits reached the same conclusion as the district court below that Plaintiffs and the SEC, as *amicus curiae,* urge us to affirm on appeal – i.e., that a strong inference of scienter can be alleged by showing a motive and opportunity to commit fraud or by showing circumstantial evidence denoting either recklessness or conscious misbehavior." Id. at 1283.

c. The Sixth Circuit: Sitting *en banc*, the court in Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001) adopted a quantum of the evidence approach which varies slightly from that of other circuits.

i. First, the Court agreed with other circuits that the PSLRA did not alter the fact that in a Section 10(b) case, the concept of scienter includes recklessness.

ii. Second, if a strong inference of scienter has been plead is a fact-intensive, case-by-case undertaking according to the court. "Whether the fact can be said to establish motive, opportunity, or neither, we are directed only to consider whether they produce a strong inference that the defendant acted at least recklessly. ... Accordingly, facts presenting

motive and opportunity may be of enough weight to state a claim under the PSLRA, whereas pleading conclusory labels of motive and opportunity will not suffice." Id. at 551. The court went on to hold that the key question is not the type of evidence – motive, opportunity or otherwise – but the quantum: "In enacting the PSLRA, Congress was concerned with the quantum, not type, of proof. Id. Although the decision in this case was by a seven to six vote, none of the judges expressed disagreement with the views of the majority on the PSLRA.

d. The Tenth Circuit: In City of Philadelphia v. Fleming Co., Inc., 264 F.3d 1245 (10th Cir. 2001) the Court adopted a position similar to that of the Sixth Circuit in interpreting "strong inference" of scienter.

i. Initially the Court agreed with the conclusion of five other Circuits (First, Second, Third, Sixth and Eleventh) that scienter still embraces the concept of recklessness. The court did not agree with the position of the Ninth Circuit in Silicon Graphics.

ii. Second, the court concluded that the "legislative history suggests that Congress specifically intended a pleading standard stricter than the standard then prevailing in the Second Circuit. After reviewing decisions from other circuits, the court concluded that evidence of motive and opportunity can be considered, but is not dispositive of the question of whether plaintiff has pled a "strong inference" of scienter: "We believe the most reasonable reading of the PSLRA in regard to motive and opportunity ... [is that] allegations of motive and opportunity, with nothing more, could allow potentially frivolous lawsuits to go forward with only minimal allegations of scienter. But evidence of motive and opportunity may be relevant to finding of scienter, and thus may be considered as part of the mix of information that can come together to create the 'strong inference' of scienter required by the PSLRA. When reviewing a plaintiff's allegations of scienter under the PSLRA, a court should therefore examine the plaintiffs' allegations in their entirety, without regard to whether those allegations fall into defined, formalistic categories such as 'motive and opportunity,' and determine whether the plaintiff's allegations, taken as a whole, give rise to a strong inference of scienter." Id. at 1263.

iii. While the court cited the decision of the Sixth Circuit in Helwig (251 F.3d 540) with approval, its holding does not admit the possibility acknowledged by that decision that evidence of motive and opportunity might suffice.

e. The Eighth Circuit: In Florida State Board of Admin. v. Green Tree Fin. Corp., 270 F.3d, 645 (8th Cir. 2001), the court made an extensive review of Second Circuit jurisprudence on "motive and opportunity", as well as the decisions by other Circuit Courts on the construction of the Reform Act pleading requirements. Based on this review, the court adopted an intermediate position similar to most other circuits. In doing so, the court noted: "Putting aside the Ninth Circuit standard, which gives the deletion of the Specter amendment a more pointed reading than it will bear, the split in the other Circuits is more apparent than real ... the Second Circuit has dramatically constricted the types of 'motive and opportunity' that it will recognize as sufficient to plead scienter. It will not allow plaintiffs to proceed based on widely held motives such as '(1) the desire to maintain a high corporate credit rating or otherwise sustain 'the appearance of corporate profitability, or of the success of an investment, [or] (2) the desire to maintain a high stock price. The court then went on to explain that "[t]he search in the Second Circuit line of cases, as well as in the other circuits, is for facts that give a strong reason to believe that there was reckless or intentional wrongdoing. ... Taken as a whole, the cases simply do not substantiate the fear that courts applying the motive and opportunity formulation will permit pleadings to go forward without facts strongly suggesting wrongdoing." Id. at 659. *See also* In re: K-Tel Int'l, Inc., Sec. Litig., 300 F.3d 881 (8th Cir. 2002).

f. The Fourth Circuit: In Ottmann, 353 F.3d 338, the court also adopted a middle ground approach to evaluating whether a "strong inference of scienter" had been pled, directing district courts to consider whether all of the evidence pled established such an inference. The District Court dismissed the amended complaint for failure to plead a "strong inference" of scienter. The Circuit Court affirmed.

i. The court began by discussing the relationship of the PSLRA pleading standards to Rule 9(b). In this regard, the court noted that "[t]he heightened pleading requirements of the PSLRA supersede the requirements of Federal Rule of Civil Procedure 9(b) in securities fraud cases, at least with respect to scienter."

ii. On the question of whether scienter embraces reckless conduct, the court held that "We therefore agree with our sister circuits that a securities fraud plaintiff may allege scienter by pleading not only intentional misconduct, but also recklessness." Ottmann at 344.

iii. In considering whether motive and opportunity is sufficient to plead a strong inference of scienter, the court first turned to the legislative history of the PSLRA which it found unclear. After reviewing decisions from other circuits, the court adopted a totality of the evidence approach: "We agree that a flexible, case-specific analysis is appropriate in examining scienter pleadings. ... We therefore conclude that courts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter. And, while particular facts demonstrating a motive and opportunity to commit fraud (or a lack of such facts) may be relevant to the scienter inquiry, the weight accorded to those facts should depend on the circumstances of each case." Id. at 345-346.

D. The Group Pleading Doctrine:

1. Prior to the PSLRA, some Circuit Courts had permitted fraudulent written statements by corporations in documents such as periodic filings and registration statements to be attributed to directors and officers. Thus, for example, the Ninth Circuit held in Wool v. Tanden Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987) that "[i]n cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual report, press releases, or other 'group-published information,' it is reasonable to presume that those are the collective actions of the officers." *See also* Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 367-68 (1st Cir. 1994).

2. In view of the provisions of Section 21D(b)(2) requiring that a "strong inference" of scienter be pled demonstrating "that the defendant acted with the required state of mind," some courts have held that the doctrine can no longer be used. *See, e.g.,* Southland Secs. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353 (5th Cir. 2004); Gurfein v. Ameritrade, Inc., 411 F. Supp. 2d 416 (S.D.N.Y. 2006); In re Cable & Wireless, PLC, 321 F. Supp. 2d 749 (E.D. Va. 2004); Allison v. Brooktree Corp., 999 F. Supp. 1342 (S.D. Cal. 1998).

3. Other courts, however, have concluded that application of the doctrine is not inconsistent with the Reform Act pleading requirements. *See, e.g.,* Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246 (10th Cir. 1997) (employing doctrine regarding periodic filings).

E. Competing inferences. When moving to dismiss a complaint under Fed. R. Civ. P. 12(b)(6), it has long been held that the facts pled in the complaint are assumed to be true and all reasonable inferences must be drawn in favor of plaintiff. As the Supreme Court stated in Conley v. Gibson, 355 U.S. 41, 45-46 (1957), "In appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." While this passage is frequently cited in post-Reform Act securities cases, at least four different approaches have emerged to considering the allegations in the complaint and determining whether a "strong inference" of scienter has been pled: 1) One view is that the PSLRA does not change traditional Rule 12(b)(6) procedure; 2) a second holds that there is a "tension" between the Rule and the Act and that now all reasonable inferences must be considered; 3) a variation of this "all reasonable inferences" rule holds that only inferences from facts pled with particularity may be considered; and 4) another view holds that only the most plausible of competing inferences may be considered, thus significantly changing Rule 12(b)(6) practice. A related question is a concern that weighting inferences may impermissibly impinge on the province of the fact finder and ultimately on the Seventh Amendment right to a jury trial.

1. No change: The First Circuit addressed the relationship between the standards under Rule 12(b)(6) and the pleading requirements of the Reform Act in Aldridge v. A.T. Cross Corp., 284 F.3d 72 (1st Cir. 2002).

   a. In reviewing the dismissal of securities law complaint brought under the PSLRA, the court held: "Although the pleading requirements under the PSLRA are strict ... they do not change the standard of review for a motion to dismiss. Even under the PSLRA, the district court, on a motion to dismiss, must draw all reasonable inferences from the particular allegations in the plaintiff's favor, while at the same time requiring the plaintiff to show a strong inference of scienter." Id., at 78.

   b. In assessing whether plaintiffs had pled a strong inference of scienter, the court applied this standard by carefully reviewing all the facts in the complaint: "In evaluating whether the inferences of scienter are strong, we agree with the Sixth Circuit's language that: 'Inferences must be reasonable and strong – but not irrefutable ... Plaintiffs need not foreclose all other characterizations of fact as the task of weighing contrary accounts is reserved for the fact finder.' Helwig, 251 F.3d at 553. The plaintiff must show that his

characterization of the events and circumstances as showing scienter is highly likely." Aldridge, 284 F.3d 82.

c. However, in an earlier decision the First Circuit stated its position somewhat differently. In Greebel v. FTP Software, Inc., 194 F.3d 185, the court noted that "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6). ... (internal citations omitted) Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and '*strong' inferences.*'" Id. at 195-196 (emphasis original).

2. Tension – all facts: The Ninth Circuit adopted a similar approach to that of the First, but concluded that there was a "tension" between the Rule and the PSLRA and that the latter required the court to consider all facts in the complaint. Subsequently, the Fifth Circuit adopted essentially the same approach but without commenting on the impact of the PSLRA on Rule 12(b)(6).

a. In Gompper v. VISX, Inc., 298 F.3d 893 (9th Cir. 2002), the court affirmed the dismissal of a securities complaint on a motion to dismiss. After acknowledging the standard procedure used in evaluating inferences under Rule 12(b)(6) and the requirements of the PSLRA, the court noted: "As plaintiffs point out, an inevitable tension arises between the customary latitude granted the plaintiff on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), and the heightened pleading standard set forth under the PSLRA." Id. at 896

i. The court went on to note that all inferences must be considered in evaluating a complaint under the PSLRA, those favorable and unfavorable to the plaintiff: "On appeal, plaintiffs argue the district court erred by considering inferences unfavorable to their case ... we cannot accept this position in light of Congress's more forceful mandate that a complaint in a securities fraud action must simply state more in order to prevail on a motion to dismiss. To accept plaintiffs' argument ... would be to eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum... . Such a result would allow all plaintiffs who engage in careful, measured pleading to demonstrate a strong inference of scienter, because district courts would only be allowed to

consider reasonably drawn inferences that favor the plaintiffs. Such an analysis would thwart Congress's basic purpose in raising the bar in the first place: namely, to eliminate abusive and opportunistic securities litigation and to put an end to the practice of pleading fraud by hindsight." Id. at 896-97.

ii. Based on this analysis, the court stressed that all reasonable inferences must be considered "when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences." Id. at 897 (emphasis original). *See also* Pirraglia v. Novell, Inc., 339 F.3d 1182 (10th Cir. 2003) (acknowledging "tension" but adopting a rule requiring that inferences from facts pled with particularity be considered).

b. The Fifth Circuit adopted a similar position in In Re Credit Suisse First Boston Corp., 431 F.3d 36 (1st Cir. 2005). In this case the court affirmed the dismissal of a securities complaint that was based on allegedly misleading statements made to analysts. The court began by noting that "[i]n considering a motion to dismiss, the district court is bound to 'assume the truth of all well-pleaded facts and indulge all reasonable inferences that fit the plaintiff's stated theory of liability.' Id. at 45. The court then when on to note that on such motions when determining whether a strong inference of scienter has been pled, "we have instructed district courts to make an individualized assessment that sweeps before it the totality of the facts in a given case." Id. at 46. *See also* Ottmann, 353 F.3d at 345 (courts should "examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter.").

3. All inferences from facts pled with particularity: In Pirraglia, supra., the court adopted a rule which is similar to that crafted by the Ninth Circuit in Gompper.

a. After discussing Gompper the court noted that "[w]hether an inference is a strong one cannot be decided in a vacuum. In evaluating the strength of a plaintiff's inference of scienter, we may recognize the possibility of negative inferences that may be drawn against plaintiff. We do so, not in a preclusive manner, but in an evaluative manner. That is to say, we consider the inference suggested by the plaintiff while acknowledging other possible inferences, and determine whether plaintiff's suggested inference is 'strong' in light of its overall context. ...We emphasize that this process does not involve a 'weighing' of the plaintiff's suggested inferences against other inferences. Faced with two seemingly

equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the fact-finder." Id. at 1187-1188. The court then rejected the rule adopted by the Sixth Circuit in Helwig.

b. However, the court appears to have limited its consideration to facts which have been pled with particularity: " If a plaintiff *pleads facts with particularity* that, in the overall context of the pleading, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the Reform Act is satisfied." Pirraglia at 1188 (emphasis added).

4. Most plausible: The Sixth Circuit, sitting *en banc*, adopted a rule which varied from standard Rule 12(b)(6) practice and the approaches to evaluating the allegations in a securities complaint under the PSLRA used by other courts.

a. In Helwig, 251 F.3d 540, the court reviewed the dismissal of a securities law complaint.

i. In conducting that review, the court initially rejected contentions that Rule 12(b)(6) had been dramatically altered by the Reform Act: "Contrary to defendant's contention, the Reform Act did not reverse the polarity of securities pleading. As always under Rule 12(b)(6), we will indulge plaintiff's inferences of fraud –provided, of course, those inferences leave little room for doubt as to misconduct." Id. at 553.

ii. The court went on to note that "Inferences must be reasonable and strong – but not irrefutable ... strength depends on how closely a conclusion of misconduct follows from a plaintiff's proposition of fact. Plaintiffs need not foreclose altogether characterizations of fact, as the task of weighting contrary accounts is reserved for the fact finder. Rather, the 'strong inference' requirement means that plaintiffs are entitled only to the most plausible of competing inferences. *See* Black's Law Dictionary 1423 (6th ed. 1990) (defining 'strong' as 'cogent, powerful, forcible, forceful'). This represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff 'the benefit of all reasonable inferences.' (emphasis original), and contemplated dismissal 'only if it is clear that no relief

could be granted under any set of facts that could be proved' (citation omitted)." Id.

b. The Eighth Circuit adopted a variation of the Sixth Circuit rule in Green Tree Fin. Corp., 270 F.3d 645. There the court followed the rule of Helwig. However, in doing so the court noted that "whereas under Rule 12(b)(6), we must assume all factual allegations in the complaint are true ... under the Reform Act, we disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the statute." Id. at 660.

IV. THE SUPREME COURT DECISION IN TELLABS.

A. Background to the case: Tellabs reviewed a decision of the Seventh Circuit Court of Appeals, Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588 (7th Cir. 2006). In that decision the court affirmed in part and reversed in part the decision of the District Court which had granted a motion to dismiss plaintiff's securities fraud complaint.

1. The claims: Plaintiffs brought a securities class action against Tellabs, Inc. and several of its officers based on a claimed accounting fraud. The initial complaint claimed that Tellabs and its CEO and other officers knowingly misled the public in press releases, periodic filings and other statements. The amended complaint, bolstered by 27 confidential sources, claimed that investors were misled by:

   a. claims that sales for their key product were stable or continuing to grow when in fact demand was waning;

   b. allegations that the market was informed that the next generation product was available and that demand was strong when in fact the product was not ready for delivery and demand was weak;

   c. misrepresentation regarding the financial results for the fourth quarter of 2000, primarily as a result of channel stuffing; and

   d. statements that exaggerated Tellabs' earnings and revenue projections.

2. The District Court: Dismissed the shareholders' initial and amended complaints concluding that the facts has been pled in accord with the standards of the PSLRA, but that it insufficiently alleged scienter.

3. The Seventh Circuit: The Circuit Court affirmed in part and reversed in part.

   a. First, the court concluded that the PSLRA did not alter the definition of scienter. Prior to the Reform Act the Circuit Courts had uniformly held that the concept embraced recklessness. After reviewing the post-PSLRA decisions of the various Circuit Courts on this issue, the court rejected the position of the Ninth Circuit and held that the Act did not change the required state of mind: "[i]t seems more likely to us that Congress did not object to the substance of the state of mind standard found in the law before the passage of the Act. If Congress had wanted to impose a more stringent scienter standard, we believe that it would have done so explicitly, just as it expressly changed the pleading requirements." Id. at 600.

b. Second, the court noted that the Reform Act "unequivocally raised the bar for pleading scienter." Id. at 601. After reviewing the positions of various Circuit Courts on what constitutes proof of a "strong inference" of scienter the court adopted what it called a "middle ground." Accordingly, the court held that "[w]ithout more detailed instruction, we conclude that the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient." Id.

c. In construing inferences drawn from the complaint, the court rejected the position of the Sixth Circuit as potentially raising Seventh Amendment concerns. Rather, the court concluded that "[i]nstead 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." If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal; the complaint would fail as a matter of law to meet the requirements of Section 21D(b)(2). Id. at 602.

d. Finally, as to the group pleading doctrine, the court noted that there is "much debate" in the courts. The court found the language mandating a strong inference as to "the defendant" controlling. Accordingly, the court concluded: "While we will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant in multiple defendant cases." Id. at 603.

B. The question presented: The Supreme Court granted certiorari to resolve a split among the circuits as to what must be pled under Section 21D(b)(2) of the Reform Act. As the Court stated: " We granted certiorari to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a 'strong inference' of scienter." Tellabs, 2007 WL 1773208 at *6 .

C. Brief overview of the arguments of the parties:

1. The Petitioners (defendants): Petitioners claimed that the "Seventh Circuit chose to give the respondents the benefit of the doubt created by their ambiguous allegations, and refused to place the allegations in their full context." Brief of Petitioners at 41. Petitioners began by arguing that the Reform Act replaced the notice pleading regime of the federal rules.

Based on this supposition, the text of the statute, and the harm that unchecked securities litigation can cause as evidenced by the legislative history of the PSLRA, Petitioners argued that regardless of the precise verbal formulation of the interpretation of "strong inference," it should encompass three key principles.

a. First, the allegations in the complaint should not be evaluated in "isolation but in the overall context created by the complaint." Id. at 34.

b. The second key principle is that "[t]he presence or absence of allegations of a defendant's motive to engage in fraud should also play a role in evaluating the strength of the inference of scienter." Id. at 36.

c. Finally, Petitioners argued that strategic ambiguities and as well as those "associated with innocence ..." should also be considered in evaluating whether the requisite strong inference of scienter is present. Id. at 40.

2. The Respondents (plaintiffs): Respondents begin by arguing that the PSLRA does not abolish the long standing principles regarding pleading. Rather "[n]othing in the PSLRA abolishes those principles, amends Rule 12(b)(6), or terminates the canons that a plaintiff need not plead detailed evidence." Brief of Respondents at 20. In addition, the overriding purpose of the securities laws is to protect investors and maintain confidence in the securities markets. Read in this context, Respondents argued that "[an]inference would be 'strong' if the particularized allegations support a reasonable conclusion that the defendant probably – i.e., more likely than not – had scienter." Id. at 25. This test is consistent with the language of the Act and the Second Circuit case law which the PSLRA adopted. Indeed, the SEC, according to Respondents, has repeatedly argued this position. Moreover, most courts do not weigh inferences drawn from the complaint. Finally, Respondents argued that the Seventh Circuit standard is correct because it considered all of the allegations in the complaint and properly construed the Reform Act. In contrast, the test proposed by Petitioners raises serious Seventh Amendment concerns.

3. Amici Curiae: Twenty friend of the court briefs were filed. One key brief was filed by the United States and the SEC. After reviewing pre-PSLRA case law noting that the Second Circuit had, at one time, the highest pleading standard, the SEC argued that there must be a "high likelihood that the conclusion that the [defendant] possessed scienter followed from particular the facts alleged in respondent's complaint" Brief for the United States as Amicus Curiae Supporting Petitioners at 15, Tellabs, Inc. v. Makor Issues & Rights, Ltd., No. 06-484 (Feb. 2007). In creating the

"strong inference" standard, Congress rejected the then existing Ninth Circuit standard and, according to the SEC, "built upon the Second Circuit's strong inference" terminology and added various other pleading requirements, resulting in a statute that was intend[ed] to *strengthen* existing pleading requirements. (Quoting H.R. Conf. Rep. No. 369 at 41) (emphasis added in brief). After stating in a footnote that the question of motive and opportunity were not at issue in this case, the SEC went on to argue that the Seventh Circuit standard "appears to be equivalent to the standard that it (and some other courts of appeals) had applied *before* the enactment of the Reform Act," which is an inappropriate standard. Id. at 23. Finally, in determining whether there is a "strong inference" the agency argued that the court "must consider other possible explanations for the defendant's conduct." Id. at 24. Thus, when the facts "alleged in the complaint give rise to a substantial possibility that the defendant acted without scienter, the necessary 'strong inference'" is absent. Id. at 25.

D. The Decision by The Supreme Court: The Supreme Court reversed the decision of the Seventh Circuit in an 8 to 1 decision and remanded the case for reconsideration in view of its decision. Tellabs, 2007 WL 1773208 at *3. Specifically, the Court held: "A plaintiff alleging fraud in a Section 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely* as any plausible opposing inference. At trial, she must then prove her case by a 'preponderance of the evidence.' Stated otherwise, she must demonstrate that it is *more likely* than not that the defendant acted with scienter." Id. at *12. The Court did not apply this standard to the facts before it.

1. The majority opinion:

a. Justice Ginsburg, in writing the majority opinion, began by noting that the Court has "long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement ... to government enforcement actions. Id. at *4. At the same time, however, the Court noted that if not "adequately contained," those suits can be abusive.

b. The PSLRA was designed as a "check" on meritless suits. Accordingly, the Act contains both procedural and substantive requirements which must be complied with by plaintiffs in bringing securities damage actions. Key sections of the Act impose strict pleading requirements. One requirement contained in Section 21D(B)(2) is that plaintiff must plead a "strong inference" of scienter. "To qualify as "strong" within the intendment of Section 21D(B)(2), we hold, 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 nonfradulent intent." Id. at *4.

c. The Court noted that in an ordinary civil action Fed. R. Civ. P. 8(a) only requires a "short and plain statement of the claim showing that the pleader is entitled to relief." Prior to the PSLRA, the sufficiency of a securities fraud complaint was governed by Rule 9(b), requiring that fraud be pled with particularity. The Courts of Appeals diverged, however, on precisely what must be pled under that Rule. The Second Circuit formulated the most stringent test, requiring that a "strong inference" of scienter be pled.

d. Congress, in the PSLRA sought to craft a uniform standard for pleading." Congress imposed substantive and procedural limits to make sure that only proper actions were brought. Id. at *8, Fn4. In doing so, however, nothing in the Act "casts doubt" on the conclusion that private securities litigation is an "indispensable tool" which is "crucial to the integrity of domestic capital markets

e. The "strong inference" standard raised the bar for pleading scienter. While Congress did not specifically define the standard, it is clear that it adopted the language of the Second Circuit while not codifying its case law defining that language. Thus, the Court concluded "[o]ur task is to prescribe a workable construction of the 'strong inference' standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer driven litigation, while preserving investor's ability to recover on meritorious claims." Id. at *1.

f. The Court then established what it called three "prescriptions": First, under Rule 12(b)(6) the factual allegations in the complaint must be accepted as true. Second, the complaint in its entirety must be considered, which is the traditional Rule 12(b)(6) standard. Third, "in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences." While the Seventh Circuit declined to engage in such a comparative process, the Court concluded that this is essential because Congress was not requiring merely that plaintiff have a basis for alleging scienter but rather, facts must be set forth which give rise to a "strong" inference. Id. at *2.

g. Citing standard dictionary definitions the court held that "strong" means "powerful or cogent." Alternate definitions include "'[p]owerful to demonstrate or convince'" (quoting the Oxford English Dictionary 949 (2d ed. 1989). Id. at *10. The strength of that inference can not be tested in a vacuum. Rather it must be considered in the context of the entire complaint. Thus "[a] complaint will survive, we hold, only if 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." Id.

In this regard, the Court cited in a footnote, an example drawn from the dissent of Justice Scalia in which a jade falcon is stolen from a room to which only two people have access. Under some circumstances, the Court notes, an inference that one or the other can be drawn which would be sufficient to sustain recovery. The court went on to note that motive can be a relevant consideration, but its absence is not necessarily fatal. On the other hand, omissions and ambiguities "count against inferring scienter." Id. at *11. "In sum, the reviewing court must 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?" Id.

h. This standard does not run afoul of the Seventh Amendment because Congress has the right to establish pleading standards. Establishing such standards does not impinge on the right of the jury.

i. The Court concluded by noting: "We emphasize, as well, that under our construction of the 'strong inference' standard, a plaintiff is not forced to plead more than she would be required to prove at trial. A plaintiff alleging fraud in a Section 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely* as any plausible opposing inference. At trial, she must prove her case by a 'preponderance of the evidence.' Stated otherwise, she must demonstrate that it is *more likely* than not that the defendant acted with scienter." Id. at *12 (emphasis original).

2. Justice Scalia, concurring:

a. Justice Scalia concurred in the result and much of the opinion. However in his view "the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence." Id. at *13. In a footnote, the Justice noted that the comment in the majority opinion on his "stolen statue" example demonstrates that any inference drawn about either person only raises a "possibility" and not a "strong" inference.

b. The Justice argued that the majority has abandoned the text of the statute "in favor of unexpressed purpose" in crafting its test because "it is inconceivable that Congress's enactment of stringent pleading requirements ... [in the PSLRA] somehow manifests the purpose of giving plaintiffs the edge in close cases." Id. at *13. At the same time Justice Scalia noted that in practice his test will probably give the same result as that of the majority.

3. Justice Alito, concurring:

c. While he concurred in the result, Justice Alito agreed with the test proposed by Justice Scalia and took issue with the repeated command of the majority that all facts in the complaint be considered.

d. Justice Alito noted that "[i]n two respects, however, I disagree with the opinion of the Court. First, the best interpretation of the statute is that only those facts that are alleged 'with particularity' may properly be considered in determining whether the allegations of scienter are sufficient. Second, I agree with Justice Scalia that a 'strong inference' of scienter, in the present context, means an inference that is more likely than not correct." Id. at *15. The opinion argues that the test adopted by the majority essentially undermines the notion of a "strong" inference and the particularity requirements of the Act. However, in practice Justice Alito, like Justice Scalia, noted that the differences in the tests would probably not make any real difference.

4. The Dissent by Justice Stevens:

e. Justice Stevens begins by essentially agreeing with each other Justice that the phrase "strong inference" was left to the courts to define and that its purpose, along with the other heightened pleading requirements is to "protect defendants from the costs of discovery and trial in unmeritorious cases." Id. at *17. He then goes on to argue, however, that the standard should be one of "probable" cause which is a notion that is familiar to the courts.

f. In addition, Justice Stevens argues that it is unnecessary to require that the inference be evaluated in view of all the facts in every instance because at times there may not be any need to weigh competing inferences.

V. ANALYSIS

A. The key themes and points in the decision:

1. Balance: The opinion is noteworthy for its effort to present a balanced approach although this may ultimately increase the pleading burden on plaintiffs.

a. The majority is written by Justice Ginsburg, noted as one of the Court's more liberal justices.

b. The opening passage in the majority opinion cites the salutary purpose of securities litigation in policing the markets. This point is reiterated at other points in the opinion and balances the legislative history of the PSLRA which is replete with tales of abuse in bringing such suits. Indeed, this is a theme more typically developed by the SEC in its briefs.

c. The Court specifically states that it is reaching for balance noting: "Our task is to prescribe a workable construction of the 'strong inference' standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims." Id. at *9.

d. This balance is reflected in the Court's construction of the "strong inference" language of the statute and its test on inferences. While the Court reiterates its holding at several points, two passages perhaps best illustrate the balance the Court sought.

e. The Court specifically declined to adopt the suggestions of Justices Scalia and Alito that plaintiffs be required to plead inferences which predominate over opposing inferences in some fashion. This standard had been suggested by some Circuit Courts.

2. In note 5, commenting on the "jade falcon" example of Justice Scalia, the Court states that "I suspect, however, that law enforcement officials as well as the owner of the precious falcon would find the inference of guilt as to B quite strong—certainly strong enough to warrant further investigation. Indeed, an inference at least as likely as competing inferences can, in some cases, warrant recovery." Id. at *10 Fn. 5. Based on the facts in the example the inferences of guilt as to A and B are equally strong and might best be described as being in equipoise. The example suggests that the balanced inferences are sufficient for pleading.

3. This point is reiterated at the end of the majority opinion which notes that "A plaintiff alleging fraud in a Section 10(b) action, we hold today, must plead facts rendering an inference of scienter *at least as likely* as any plausible opposing inference." Id. at *12 (emphasis original).

a. In crafting this balance, the Court rejected arguments advanced by the Petitioners and the SEC suggesting that a more stringent standard was required.

4. Discretion in the District Court: The standard gives the District Court significant discretion in construing the allegations contained in a plaintiff's securities law complaint.

a. The Court gave the District Courts little specific guidance as to what constitutes a "strong inference," other than its equipoise test. Indeed, the Court did not apply its test to the facts before it which might have yielded a concrete example of its application.

b. The Court did establish three "prescriptions:"

i. The facts must be accepted as true. This is basic Rule 12(b)(6) theory. It is noteworthy, however, that in stating this proposition the Court did not incorporate the balance of the Cooley formula which strongly tips in favor of plaintiffs. At the same time, it did not adopt the argument of Petitioners suggesting that the PSLRA rewrote Rule 12.

ii. Courts were directed to consider the complaint in its entirety. Three points are noteworthy here.

(a) The entirety of the complaint includes documents incorporated into the complaint by reference and "matters of which a court may take judicial notice." Tellabs at 2007 WL 1773208 at *9. While the first part of this directive is standard Rule 12 procedure, the second part has been somewhat controversial. Some courts have permitted consideration of materials outside the complaint on a motion to dismiss while some have been more restrictive.

(1) This is an important point because it should assure that decisions are made on the merits.

(2) At the same time, it highlights the focus of the court because neither the Seventh Circuit or the parties argued it.

(b) The Court rejected the test of the Seventh Circuit that only some inferences be considered. It thus implicitly rejected the position of the Sixth Circuit.

(c) The Court declined to adopt the position argued by Justice Alito that only inferences from facts pled

with particularity be considered. This theory had been advanced by some Circuit Courts.

iii. The Court directed that "plausible" opposing inferences be considered. Id. at *10. The directive that only "plausible" rather than "every" inference be considered is noteworthy and again reflects the balance of the Court's approach. This directive is consistent with the Court's statement that '[t]he strength of an inference cannot be decided in a vacuum." Id.

c. No specific evidence required: The Court did not dictate any specific evidentiary test or require that plaintiffs include certain kinds of allegations in a securities fraud complaint. Rather, the Court repeatedly noted "that the court's job is not to scrutinize each allegation in isolation, but to assess all the allegations holistically." Id. at *11.

i. Although the Court did not comment on the question of whether "motive and opportunity" are sufficient to establish a strong inference of scienter, it did note that "the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint." Id. Thus the absence of allegations of "motive" is not fatal.

ii. However, the Court noted that "omissions and ambiguities count against inferring scienter." Id.. This point, along with the directive to carefully consider all of the allegations in the complaint and related materials, may increase the burden on plaintiffs. Now a plaintiff will have to carefully consider what is pled, what is missing and what defendants may offer through judicial notice in crafting their allegations.

B. What the Court did not decide:

1. Recklessness: As in the past, the Court reserved decision on the question of whether recklessness is included within scienter. The Court did not discuss the heightened formulation of recklessness used by the Ninth Circuit in Silicon Graphics. However, the Court's construction of the "strong inference" tests at least cast doubt on the validity of this position.

2. The Group Pleading Doctrine: The Court declined to rule on this issue simply noting that the issue was not presented and that it would not "disturb" the decision in the Seventh Circuit. Although the Court did not rule on the issue, some might take this comment as tacit approval of the Circuit Court's holding.

C. Winners and losers

1. The Ninth Circuit: The Court did not endorse the Silicon Graphics approach. Arguably the burden of pleading a securities law complaint in that Circuit may have been eased by the Court's decision. In addition, its holding on scienter may arguably have been over ruled.

2. The Second and Third Circuits: The Court did not adopt the much discussed "motive and opportunity" test. To the extent the Second Circuit test is viewed as less demanding than the approach adopted by the Court, it may now be slightly more difficult to plead a securities fraud complaint in these Circuits.

3. Other Circuits: The various formulations adopted by other Circuits may not necessarily yield a different result when the specific facts of each case are applied. Thus it is at best unclear whether it will be more or less difficult to plead a securities fraud complaint in other circuits. However, the directive that omissions be held against plaintiffs and that the court may take judicial notice of documents, places a burden on plaintiffs to carefully consider not only what the complaint says, but also what it does not say and what might be brought in on judicial notice. This may increase the pleading burden on plaintiffs.