<u>Tellabs</u>
Pleading a "Strong Inference" of Scienter Under the PSLRA

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INTRODUCTION

The Decision

- On June 21, 2007 the Supreme Court decided Tellabs v. Makor Issues & Rights, Ltd.
- The decision is significant: it redefines a key pleading requirement for securities damage cases
- The Opinion: A Balanced Approach
  - Eliminate abuses
  - Levels playing field
  - May increase plaintiff pleading burden

INTRODUCTION

Overview

1. The key Reform Act provision – Section 21D(b)(2)
2. Origins of the Reform Act – scienter pleading standards
3. The Reform Act in the Circuit Courts – key issues
4. <u>Tellabs</u>: The decision
5. Analysis
6. Conclusions

KEY REFORM ACT SECTIONS

Overview of Act

- In 1995 Congress passed PSLRA or Reform Act
- Response to perceived abuses regarding class actions
- Existing pleading standards were ineffective
- Act includes substantive and procedural limitations on class actions, e.g.
  - Provisions governing appointment of lead counsel
  - Specific pleading requirements

KEY REFORM ACT SECTIONS

Overview (cont)

- Section 21D(b)(2) governs pleading scienter:

  "In any private action ... the complaint shall ... state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

ORIGINS OF 21D(2)(b)

Pre-Reform Act Pleading Standards

- Fed. R. Civ. P. 9(b) was key standard:

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

ORIGINS OF 21D(2)(b)

Pre-Reform Act Pleading Standards (cont)

- Under Rule 9(b) plaintiffs required to plead fraud with particularity
- Rule does not apply to allegations of state of mind
- Pleading state of mind governed by Rule 8(a)

ORIGINS OF 21D(2)(b)

Pre-Reform Act Pleading Standards (cont)

- Two issues:
  1. The required state of mind
  2. What facts must be pled

THE ORIGINS OF 21D(b)(2)

Pre-Reform Act Pleading Standards (cont)

- The required state of mind
  - In Ernst & Ernst, 425 U.S. 185 (1976): scienter is required; Court reserved on whether recklessness is sufficient
  - Subsequently, all Circuits agreed that recklessness is sufficient. See, e.g., Sundstrand Corp, 553 F.2d 1033 (7th Cir. 1977)

THE ORIGINS OF 21D(b)(2)

Pre-Reform Act Pleading Standards (cont)

- The pleading standard regarding scienter: a three way split in the circuits

Pre-Reform Act Pleading Standards (cont)

1. The strict standard
   - Adopted by 2nd Circuit and others
   - Must plead facts giving rise to a "strong inference" of scienter
   - Strong inference of scienter plead by either
     a. Motive and opportunity
     b. Facts constituting circumstantial evidence of either reckless or conscious behavior. See, e.g., Time Warner Sec. Lit., 9 F.3d 259 (2nd Cir. 1993)

ORIGINS OF 21D(b)(2)

Pre-Reform Act (cont)

2. Liberal standard
   - o notice pleading
   - o See, e.g., GlenFed Sec. Lit, 42 F.3d 1541 (9th Cir. 1994)
3. Middle view
   - o Plead a basis for belief that requisite scienter existed
     - – See, e.g., HealthCare Compare Sec. Lit., 75 F.3d 276 (7th Cir. 1996)

ORIGINS OF 21D(b)(2)

Reform Act: Legislative history

- Congress heard repeated testimony of abuses
  - suits were lawyer-driven
  - frequently frivolous with few facts
  - settlements resulting from risk rather than merits

ORIGINS OF 21D(b)(2)

Reform Act: Legislative History (cont)

- A key Congressional finding:

  "complaint alleging violations 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)

- Rule 9(b) was viewed as ineffective

ORIGINS OF 21D(b)(2)

Reform Act: Legislative History (cont)

- Section 21D(b)(2) borrowed "strong inference" from Second Circuit case law
- Purpose: to create a uniform pleading standard. H.R. Conf. Rep. 104-369 at 31, 41.
- The Second Circuit case law on proof of strong inference was not adopted

ORIGINS OF 21D(b)(2)

Reform Act: Legislative History: 2nd Cir. case law (cont)

- Prior to passage, Senator Specter offered amendment to bill
  - Sought to incorporate 2nd Cir. case law
  - Amendment defeated
  - Senator Dodd: rejected because incomplete codification of 2nd Cir. cases. 141 Cong. Rec. S 19067 (daily ed. Dec. 21 1995).

ORIGINS OF 21D(b)(2)

Reform Act: Legislative History (cont)

- Joint Conference Committee Report
  - Standard based on 2nd Cir.
  - Written to conform to particularity requirement of Rule 9(b)

ORIGINS OF SECTION 21D(b)(2)

Reform Act: Legislative History: Joint Conf. Rpt. (cont)

- Because bill sought to strengthen pleading requirements

  "it does not intend to codify Second Circuit's case law interpreting standard." H.R. Conf. Rep. 104-369, at 41.

- Later the report notes the "courts may find this [2nd Cir.] body of law instructive." Id. at 15.

ORIGINS OF 21D(b)(2)

Reform Act: Legislative History (cont)

- President Clinton vetoed the bill arguing that the standard exceeded the 2nd Cir. Level 141 Cong. Rec. H 15,214 (daily ed. Dec. 10, 1995)
- Congress overrode the veto. During the floor debates supporters of the bill noted that it incorporated the 2nd Cir. standard. See, e.g., 141 Cong. Rec. S 19067 (daily ed. Dec. 21 1995)

INTERPRETING 21D(b)(2)

Circuit Courts

- The circuit courts struggled with the interpretation of the section
- Four key issues emerged

  1. The applicable state of mind
  2. What is a "strong inference"
  3. Use of the "group pleading" doctrine
  4. How to consider competing inferences

INTERPRETING 21D(b)(2)

Circuit Courts

1. State of Mind
   - The Section does not define state of mind referring to "the applicable state of mind"
   - At the time of passage, every circuit court had concluded that scienter included recklessness
   - Post Reform Act, most circuits reiterated their earlier holdings. See, e.g., Ottmann, 353 F.3d 338, 343 n. 3 (4th Cir. 2003)(collecting cases)

INTERPRETING 21D(b)(2)

Circuit Courts: State of Mind (cont)

- The Ninth Circuit: plaintiff must plead "deliberate recklessness"
  - Holding based on theory that the legislative history mandated a standard above the second circuit. Silicon Graphics Sec. Lit., 183 F.3d 970 (9th Cir. 1999)

INTERPRETING 21D(b)(2)

Circuit Courts (cont)

2. "Strong inference": courts split
   - One view: Re-adoption of the 2nd Cir. Test
     - Followed by 2nd and 3rd Cir.
     - Leading case: Press, 166 F.3d 529 (2nd Cir. 1999):
     - The Reform Act "heightened the requirement for pleading scienter to the level used by the Second Circuit"
     - The test: "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"
     - General allegations of motive and opportunity are not sufficient
     - What constitutes motive and opportunity is a question for the trier of fact
     - Care must be taken not to raise the pleading standard too high

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference (cont)

- Second View: a heightened standard
  - the 9th Cir. rejected the pre-Reform Act 2nd Cir. standard
  - the legislative history: Congress sought a higher standard

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference: A higher standard (cont)

- Silicon Graphics, 183 F.3d at 974:

  "[A]lthough 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 ... Plaintiffs must cite facts that come closer to demonstrating intent ... we hold that particular facts giving rise to a strong inference of deliberate recklessness, at a minimum, is required ..."

INTERPRETING 21D(b)(2)

Circuit Courts – Strong Inference: (cont)

- Third view: most adopted an intermediate position, focused on the specific facts of the case. See, e.g.,
  - o 1st Cir.- Greebel, 194 F.3d 185, 196 (1st Cir.1999):
    - Act did not change the standard from its pre-Act decisions
    - Court analyzed "the particular facts in each individual case to determine whether the allegations were sufficient to support scienter."

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference: Intermediate position (cont)

- 11th Cir. - Bryant, 187 F.3d 1271, 1283, 1285-86 (11th Cir. 1999)
  - While motive and opportunity may be relevant, standing alone they are insufficient
  - Plaintiff must plead particularized facts.
  - The SEC filed an amicus brief arguing for the 2nd Cir. test

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference: Intermediate position (cont)

- 6th Cir. - Helwig, 251 F.3d 540 (6th Cir. 2001)(*en banc*)
  - Motive and opportunity may be sufficient
  - "In enacting the PSLRA, Congress was concerned with the quantum, not type of proof."

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference: Intermediate position (cont)

- 10th, 8th & 4th Cir: All adopted similar positions to that of the 11th, e.g:
  - City of Philadelphia, 264 F.3d 1245 (10th Cir. 2001)(examine all allegations; motive and opportunity evidence alone "could allow potentially frivolous lawsuits to go forward")

INTERPRETING 21D(b)(2)

Circuit Courts -- Strong Inference: Intermediate Position (cont)

- Green Tree Options Lit., 270 F.3d 645 (8th Cir. 2001)(after extensive review of motive/opportunity cases notes 2nd Cir. has constricted the test and will not allow motives such as corporate profitability or high stock price)
- Ottmann, 353 F.3d 338 (4th Cir. 2003)(flexible case specific approach; motive/opportunity may be sufficient depending on case)

INTERPRETING 21D(b)(2)

Circuit Courts (cont)

3. The group pleading doctrine
   - Pre-Reform Act cases presumed that misrepresentations in filings were the collective action of officers. See, e.g., Wool, 818 F.2d 1433 (9th Cir. 1987)
   - Post Reform Act, the courts are split based on the language of the section; compare Southland, 365 F.3d 353 (5th Cir. 2004) (doctrine no longer applicable) with Schwartz, 124 F.3d 1246 (10th Cir. 1997)(not inconsistent with Act).

INTERPRETING 21D(b)(2)

Circuit Courts (cont)

4. Competing inferences:
   - o Traditional Rule 12(b)(6) standard
     - – facts are presumed true
     - – all inferences favor plaintiff. Conley, 355 U.S. 41 (1957)

INTERPRETING 21D(b)(2)

Circuit Courts: Inferences

- Under the Reform Act four views emerged regarding inferences and Rule 12(b)(6) motions:
  1. Essentially no change
  2. A "tension" between Rule and Act
  3. Only inferences from facts pled with particularity considered
  4. Only the most plausible of competing inferences considered

INTERPRETING 21D(b)(2)

Circuit Courts: Inferences (cont)

1. No change: Aldridge, 284 F.3d 72 (1st Cir. 2002):
   - Act does "not change the standard of review for a ... motion to dismiss."
   - But in Greebel, 194 F.3d 185 (1st Cir. 1999) the same circuit held:

     "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss ... inferences do not survive on dismissal," (citations omitted)

INTERPRETING 21D(b)(2)

Circuit Courts: Inferences (cont)

2. Tension: Gompper, 298 F.3d 893 (9th Cir. 2002):
   - tension between Rule 12(b)(6) and the Act
   - rejects plaintiffs' claim that can not consider inferences contrary to position of plaintiff – not to do so would "eviscerate the PSLRA's strong inference requirement ..." See also Credit Suisse, 431 F.3d 36 (1st Cir. 2003)

INTERPRETING 21D(b)(2)

Circuit Courts: Inferences (cont)

3. Facts pled with particularity: Pirraglia, 339 F.3d 1182 (10th Cir. 2003):
   - All inferences must be considered
   - Cautioned against weighing which is for trier of fact
   - "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." (emphasis added).

INTERPRETING 21D(b)(2)

Circuit Courts: Inferences (cont)

4. Most plausible: Helwig, 251 F.3d 540 (6th Cir. 2001):
   - On Rule 12 motion court will "indulge" plaintiff's inferences – provided ... [they] leave little room for doubt ..."
   - "Strong inference" means plaintiffs are entitled "only to the most plausible of competing inferences."
   - See also Green Tree Options, 270 F.3d 645 (8th Cir. 2001) (follows Helwig but disregard those that "do not live up to the particularity requirements").

THE DECISION IN TELLABS

The Seventh Circuit Decision

- The claims: Securities class action alleging investors misled by
  1. Claims regarding sales for key product were stable when they were not
  2. Statements that next generation of product was available and demand good when neither was true
  3. False quarterly financial results from channel stuffing
  4. Exaggerated earnings and revenue projections

- The District Court dismissed the initial and amended complaints

THE DECISION IN <u>TELLABS</u>

The Seventh Circuit Decision (cont)

- The circuit court affirmed in part and reversed in part
  - The Reform Act did not alter the definition of scienter; recklessness is sufficient
  - The Act "raised the bar for pleading scienter"

THE DECISION IN <u>TELLABS</u>

The Seventh Circuit decision (cont)

- The best approach:

  "is for courts to examine all the allegations in the complaint and then to decide whether collectively they establish ... [a strong] inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient."

THE DECISION IN <u>TELLABS</u>

The Seventh Circuit Decision (cont)

- Rejected 6th Cir. position on inferences:

  "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 ..."

THE DECISION IN <u>TELLABS</u>

The Seventh Circuit Decision (cont)

- On the group pleading doctrine, the court noted there is much debate but

  "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 ..."

THE DECISION IN <u>TELLABS</u>

The Issue Before the Supreme Court

- The Supreme Court granted certiorari:

  "We granted certiorari to resolve the disagreement among the Circuits on whether, and to what extent, a court must consider competing inference in determining whether a securities fraud complaint gives rise to a 'strong inference' of scienter."

THE DECISION IN <u>TELLABS</u>

Brief Overview of the Arguments

- Petitioners (defendants):
  - The Reform Act essentially replaces Rule 12(b)(6)
  - Strong inference includes three key principles
    1. All allegations evaluated
    2. Presence or absence of motive/opportunity plays a role
    3. Ambiguities should be considered

THE DECISION IN <u>TELLABS</u>

Overview of the Arguments (cont)

- Respondents (plaintiffs)
  - Reform Act does not abolish standard pleading principles
  - Purpose of securities laws is to protect investors
  - Allegation is strong if particularized claim supports reasonable inference
  - Courts should not weigh inferences

THE DECISION IN TELLABS

Overview of the Arguments (cont)

- Twenty amici curiae filed briefs. The SEC argued:
  - Congress "built" on Second Circuit standard
  - Seventh Circuit standard appears to be pre-Reform Act standard
  - In evaluating inferences court should consider other explanations
  - If facts raise "substantial possibility" that defendant acted w/o scienter, no strong inference

THE DECISION IN <u>TELLABS</u>

Supreme Court

- The Court reversed and remanded
- The holding:

  "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." (emphasis original)

THE DECISION IN <u>TELLABS</u>

Supreme Court

- The majority opinion: by Justice Ginsburg, joined by seven other justices
- Begins with a discussion of private securities litigation
  - The court has long recognized their importance in enforcing the law
  - PSLRA ws designed as a "check" on meritless suits

THE DECISION IN <u>TELLABS</u>

Supreme Court: Majority Opinion (cont)

- To qualify as a "strong inference":

  "we hold, an inference must be more than plausible or reasonable - it must be cogent and at least as compelling as any opposing inference of nonfradulent intent."

THE DECISION IN <u>TELLABS</u>

Supreme Court: Majority Opinion (cont)

- Prior to the Reform Act
  - Pleading governed by Rule 9(b)
  - Courts diverged with Second Circuit having most stringent test
- Reform Act sought a uniform standard.
- Court's task here:

  "prescribe a workable construction of the 'strong inference' standard geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investor's ability to recover on meritorious claims."