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'Tellabs': PSLRA Pleading Test Comparative, Not Absolute

To hear the defense bar and its advocates tell it, the U.S. Supreme Court's recent decision in *Tellabs v. Makor Issues & Rights Ltd.*[1] represents another chapter in the recent erosion of the right of private citizens to enforce the federal securities laws.

Court's Highly Crafted Opinion

After the June 21, 2007 decision, counsel for Tellabs quickly declared victory, while representatives of an association of high-technology businesses reported that "Silicon Valley can breathe a sigh of relief." However, a closer reading of the oral argument and Justice Ruth Bader Ginsburg's carefully crafted opinion reveals that these analyses stand the landmark ruling on its head, and are, in reality, mostly the spin of corporate CEOs and their advisers.

Driven by constitutional concerns about the usurpation of the jury's fact-finding role, the Supreme Court effectively dropped the bar as low as it could without eviscerating the language of the 1996 pleading standard for securities cases under the Private Securities Litigation Reform Act of 1995 (PSLRA).

Just as importantly, the Court's ruling emphasizes that the standard against which plaintiffs' pleadings will now be held is comparative, rather than absolute. Under the rule articulated by Justice Ginsburg, plaintiffs need only demonstrate that scienter is just as likely as any innocent explanation proffered by defendants, rather than that they have reached some high watermark of probability that exists only in the abstract.

This analysis tilts steeply in favor of plaintiffs who, as masters of their own complaints, can buttress their claims with as many documents and witnesses as they please. In contrast, *Tellabs* limits defendants to making their argument for exculpatory inferences based only on the complaint that plaintiffs have written and such public documents as have traditionally been relied upon by courts in determining motions to dismiss.

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The background of the case provides useful insight into long-simmering problems with the application of the PSLRA's pleading standard. In *Tellabs*, the plaintiffs alleged that top executives of a high-tech optical systems manufacturer mislead investors about the prospects for the company's flagship product, hiding evidence of order declines and cancellations and the effects of these changes on the company's future. In their complaint, plaintiffs provided the accounts of 27 confidential informants detailing the slide in demand for the company's products, and the contacts between Tellabs senior management and the company's major customers. Nevertheless, the *Tellabs* plaintiffs, like all private citizens pursuing fraud claims under the federal securities laws, faced a major hurdle imposed by Congress.

Congress passed the PSLRA as a statute that both recognized the important role that private actions serve in enforcing federal securities fraud laws and simultaneously stiffened the pleading requirements for these claims. Under the former regime established by the Federal Rules of Civil Procedure in 1938, plaintiffs alleging fraud were required to plead with specificity the "circumstances constituting fraud," but could plead the requisite state of mind on a simple notice basis. The PSLRA changed that standard by requiring that plaintiffs bringing fraud actions under the federal securities laws "state with particularity facts giving rise to a strong inference that defendant acted with the required state of mind."[2]

The Seventh Amendment

In the years following the enactment of the PSLRA, courts and commentators were quick to point out the potential mischief that the new heightened pleading requirement could wreak on the Seventh Amendment rights of plaintiffs.

The Seventh Amendment requires that "the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law."[3] These rights have long extended to plaintiffs seeking a jury trial on securities fraud claims. In considering competing inferences, juries are permitted to attribute a culpable state of mind to a defendant in a securities fraud case even when that is but one of many plausible conclusions that could be drawn from the facts presented. If the PSLRA requires that courts dismiss all cases but those in which plaintiffs show that scienter is the most plausible inference to be drawn, the statute impinges on the jury's traditional fact-finding role.

Attempting to navigate congressional intent on the one hand, and the requirements of the Seventh Amendment on the other, the U.S. Court of Appeals for the Seventh Circuit considered several possible interpretations of the PSLRA's pleading requirements in reviewing the district court's decision denying defendant's motion to dismiss in *Tellabs*. In the strictest view, adopted by the U.S. Court of Appeals for the Sixth Circuit and advocated by Tellabs, courts would permit plaintiffs to proceed only if scienter was the "most plausible" inference.

However, this approach implicated Seventh Amendment concerns in that it required courts to hold plaintiffs' allegations to a standard higher than that the jury would apply. The Seventh Circuit also considered the standard adopted by the U.S. Courts of Appeals for the Second and Third circuits, which would

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require that plaintiffs plead nothing more than "either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior."

The risk with this approach, however, was that such a reading sits uneasily with Congress' intent to heighten the requirements for pleading scienter under the securities fraud laws. The Seventh Circuit ultimately saw the threat to the Seventh Amendment as the greater concern, and adopted an analysis permitting plaintiffs to proceed on allegations that show that scienter is but one plausible inference to be drawn from the facts.

The difficulty of reconciling the Seventh Circuit's approach with congressional intent to make it more difficult to plead securities fraud animated the petition for writ of certiorari filed by Tellabs before the Supreme Court. In its argument, Tellabs urged that the Court set aside any concerns about the Seventh Amendment and conclude that courts should permit securities cases to proceed only after weighing conflicting inferences and concluding that scienter was the most likely inference to be drawn. Respondents, plaintiffs below, argued that the Court should adopt the more permissive views of the Second and Seventh circuits.

During oral argument, the Supreme Court expressed great misgivings about a rule permitting courts to choose the most plausible factual inferences before the jury had the opportunity to do so. Justice Anthony M. Kennedy asked counsel for Tellabs whether or not, in his view, "the pleading standard that the judge must follow is equivalent, [to]…the same instruction…that is given to the jury? Because if it isn't, then the Seventh Amendment argument may have some force." When counsel for Tellabs demurred that Congress is empowered to change standards for pleading without threat to the Seventh Amendment, Justice Ginsburg responded that "the question in 12(b)(6) is 'has the plaintiff stated a claim,' and at the end of the line it's 'has the plaintiff proved the claim.'" The Justice continued, "[i]s it fair to say at the pleading stage it's the equivalent of a clear and convincing standard, whereas at the end of the road it would only be more probable than not?"

Writing for the eight-Justice majority, Justice Ginsburg dealt firmly with the potential threat to jury trial posed both by the PSLRA and by the statutory interpretations of courts such as the Sixth Circuit. While acknowledging Congress' authority to impose pleading standards to guard against frivolous complaints, Justice Ginsburg wrote that

> 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 plead at trial. A plaintiff alleging fraud in a §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.

In so holding, the majority rejected the stricter standard advocated by Tellabs and the Sixth Circuit, declining even to require that a plaintiff demonstrate that an inference of scienter is any more likely than an exculpatory explanation. While this approach may, in a narrow sense, be marginally more stringent than the standard that had been adopted by the Second Circuit, it unmistakably cabined the authority of Congress to restrict the access of private securities fraud plaintiffs to the courts. Moreover, the standard's focus on comparative plausibility greatly relaxed the overly stringent application of the PSLRA pleading standard that defendants have enjoyed for years.

The U.S. Supreme Court's ruling 'Tellabs v. Makor' emphasizes that the standard against which plaintiffs' pleadings will now be held is comparative, rather than absolute.

A federal district court decision issued just a week after the Supreme Court's ruling illustrates the speed with which district courts have already begun to distance themselves from the defendant-friendly approach previously adopted by the Sixth Circuit and advocated by Tellabs. In a June 29, 2007 decision in *Elam v. Neidorff*, the U.S. District Court for the Eastern District of Missouri considered a defendant's motion to dismiss a federal securities case for failing to meet the PSLRA's "strong inference" standard. While ultimately granting the motion to dismiss, the court was quick to disavow the Sixth Circuit's test. Noting that although one previous Eighth Circuit case had apparently applied the stricter "most plausible of competing inferences" standard, it observed that "[t]he vast majority of the Eighth Circuit decisions might just as well have been decided under the 'at least as compelling' approach articulated by Justice Ginsburg."[4]

The *Tellabs* majority's rejection of the stricter view of the PSLRA's pleading standard is also likely to color the outcome of an important case now pending before the Ninth Circuit. In upholding the scienter allegations in the complaint in *South Ferry LP #2*, the U.S. District Court for the Western District of Washington relied in part on the presumption that top company executives were likely to have knowledge of problems going to the core of company operations. However, the court granted defendants' request to seek interlocutory review of this decision, noting that the viability of this "core operations" presumption may be in doubt given the PSRLA's "strong inference" standard.[5] In their papers before the Ninth Circuit, filed while *Tellabs* was still pending before the Supreme Court, the *South Ferry* defendants cited the amicus brief submitted by the SEC in support of Tellabs. The *South Ferry* defendants argued, quoting from the solicitor general's brief on behalf of the SEC, that the PSLRA's strong inference standard demands that plaintiffs show a "high likelihood" that defendants possessed a culpable mental state. Any presumption of scienter arising from an executive's knowledge of the core activities of a company, they maintained, could not meet the required showing.

The 'Tellabs' Standard

The standard ultimately adopted by the Supreme Court in *Tellabs* leaves the *South Ferry* defendants with a much harder argument. While plaintiffs might have difficulty proving that scienter inferred from a defendant's role and responsibilities in a company is more likely than innocence, under Justice Ginsburg's formulation, the *South Ferry* plaintiffs now need only show that scienter is as likely as culpability. To prevail, the *South Ferry* defendants will be obliged not only to show that an exculpatory explanation for their behavior is more likely, but they must base their theory on facts alleged by the plaintiffs.

While only time will reveal the repercussions of the *Tellabs* decision on cases brought under §10(b), it may be far too early for defendants in cases of investor fraud to "breath a sigh of relief."

1. *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007).
2. 15 U.S.C. §78u-4(b)(2)
3. U.S. Const., Amdt. 7.
4. 2007 WL 1880747 (E.D. Mo., June 29, 2007).
5. *South Ferry LP #2 v. Killinger*, No. C04-1599C, 2005 WL 3307533 (W.D. Wash. Dec. 6, 2005).