

By John M. Orr

In June 2007, the Supreme Court issued its decision in the *Tellabs* securities litigation.¹ In the 12 year history of the Private Securities Litigation Reform Act (PSLRA), no other case had reached the high court to resolve lower court conflicts in the standard necessary to plead “scienter,” the mental state required to establish liability under Section 10(b) of Securities Exchange Act of 1934. As a result, scholars, shareholder groups, corporations, securities litigation attorneys, and the brokers and underwriters of Directors & Officers (D&O) liability insurance—the line of insurance responsive to securities litigation—awaited the decision with great anticipation. Would the Court hold plaintiffs to a higher pleading standard, forcing lower courts to dismiss cases with greater frequency? Or would the Court make the pleading of securities litigation easier for plaintiffs, likely resulting in increased filings and reduced dismissal rates?

The Court specifically was asked to articulate a standard for pleading what the PSLRA calls a “strong inference” of scienter. When it issued its decision in June, it held that, in determining whether pleaded facts gave rise to a “strong” inference of scienter, courts “must take into account plausible opposing inferences,” and that “the inference of scienter must be more than merely ‘reasonable’ or ‘permissible’—it must be cogent and compelling, thus strong in light of other explanations.”²

Reaction of Commentators: A Tie

In a paper issued by Integro shortly after the Court’s ruling³, we opined that, in establishing a “cogent and compelling inference” standard, the Court gave neither plaintiffs nor defendants a clear win. Rather, the Court found the middle ground, striking a balance between the less rigid standard advocated by plaintiffs and the more rigid standard advocated by corporate defendants and the SEC.

Legal commentators largely have agreed with this analysis. Stanford Securities Law Professor and former SEC Commissioner Joseph Grundfest observed that there likely would be little or no effect on the dismissal rates of securities litigation. Specifically, Grundfest stated:

[T]he opinion unfortunately leaves room for lower courts to reason “gee, the story in support of scienter seems as cogent as the story in opposition to scienter, and that’s good enough.” ... It is therefore unfortunately predictable that we will have a new series of lower court splits over the proper interpretation of *Tellabs*’ pleading standard.... So, the battle continues.⁴

Los Angeles attorney Bruce G. Vanyo of Katten Muchin Rosenman LLP, a co-drafter of the PSLRA, viewed the ruling in a positive light: “This decision ends any uncertainty about whether a court must engage in a genuine analysis of competing inferences from an alleged set of facts. ... It is also important that the court specified that a judge must look not only at the complaint, but any other sources that can be examined in ruling on a motion to dismiss.”⁵

Reaction of the Courts: Motion to Dismiss Rulings Mixed

In the weeks and months following the Court’s opinion, a number of decisions have emerged from district and appellate courts across the country applying the *Tellabs* holding. True to Grundfest’s prediction, the decisions have cut both ways, although more in our sample have resulted in dismissals. Examples of decisions to date include the following:

- *In re The Cooper Companies, Inc. Securities Litigation, Case No. CV-06-169 CJC (C.D. Cal. July 13, 2007), motion to dismiss granted*: “Considering the allegations collectively and in their totality, the Court ... concludes that Plaintiffs’ complaint fails to raise the requisite inference of scienter. Most significant is Plaintiffs’ failure to adequately plead that any of the alleged false statements were known to be false when they were made.”

- *Bucks County Retirement Board v. The Home Depot, Inc.*, 2007 WL 2254693 (N.D.Ga., July 18, 2007), *motion to dismiss granted*: The court stated that the inference of scienter urged by the plaintiffs was not cogent or compelling and that, while the Amended Complaint could be read to allege that a "large, longstanding and pervasive scheme" of chargeback fraud existed at Home Depot, "the Amended Complaint does no more than infer that 'someone' in the 'management' of Home Depot had to know about the scheme."
- *Higginbotham v. Baxter Intern., Inc.*, 2007 WL 2142298 (7th Cir., Jul 27, 2007), *granting of motion to dismiss affirmed*: The appellate court affirmed a lower court's dismissal of the action, holding that the plaintiff's allegations attributed to confidential witnesses must be "discounted" because it cannot be weighed in competing inferences, and thus are not sufficiently "compelling" to support a "strong inference" of scienter.
- *Ross v. Abercrombie & Fitch Company*, 2007 WL 2284477 (S.D.Ohio, Aug. 9, 2007), *motion to dismiss denied*: "In the Court's view, a strong inference of scienter is shown through Plaintiffs' allegations that Defendants knew about Abercrombie's declining gross margins and storewide markdowns throughout the class period, yet failed to disclose the information."
- *Schleicher, et al. v. Wendt, et al. (Consenco, Inc.)*, 2007 WL 2705584 (S.D. Ind., Sept. 12, 2007), *motion to dismiss denied*: "The combination of the nature, duration, scope, and financial magnitude of the alleged misstatements and omissions provides a sufficient foundation for the required strong inference of fraudulent intent or scienter."

Courts also have applied *Tellabs* to certain of the options backdating lawsuits to the extent the lawsuits allege violations of Section 10(b). Examples of these decisions include the following:

- *In re VeriSign, Inc. Derivative Litigation*, 2007 WL 2705221 (N.D.Cal., Sept. 17, 2007), *motion to dismiss granted*: "[The] allegations do not satisfy the pleading requirements of the PSLRA because plaintiffs neither specify the roles that Evan and each of the director defendants played in the alleged backdating scheme or in the alleged scheme to issue false financial reports, nor allege facts giving rise to a strong inference of scienter as to each defendant. ... The assertions of scienter are entirely conclusory."
- *Nathan Weiss et al. v. Amkor Technology, Inc., et al.*, Case No. CV 07-0278-PHX-PGR (D.Ariz., Sept. 25, 2007), *motion to dismiss granted*: Applying *Tellabs* with little analysis, the court noted, "Other than general assertions about the Individual Defendants' roles and responsibilities and motivations, the Plaintiffs do not plead specific facts to support their allegations of scienter."

Will Corporations' D&O Insurance Renewals Be Affected?

Early indications suggest that the D&O insurers have not reacted much at all to the decision, at least with respect to premium pricing or the negotiation of policy terms and conditions. This is not surprising since the decision made no apparent shift in the securities litigation landscape. It is fair to say the insurers are taking a "wait and see" approach, more closely evaluating trends that develop, if any at all, in post-*Tellabs* filings and dismissal rates, and perhaps most importantly, in settlement values and actual claim payments.

For now, factors unrelated to the *Tellabs* decision still appear to be driving an increasingly competitive D&O market. Such factors include continuing increases in global D&O capacity, favorable midyear reinsurance renewals, sustained reductions in annual securities litigation filings, and relatively healthy investment income for insurers.

Two other notable issues with potential D&O market implications include the possible long-term impact of the 2005 Supreme Court decision involving *Dura Pharmaceuticals*^{vi} and a pending Supreme Court decision due this session in the case of *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*^{vii}. In *Dura*, the Court's decision restricted plaintiffs' ability to plead and prove damages in securities litigation, which may serve ultimately to reduce insurer payouts in the future. However, in *Stoneridge*, the Court will be ruling on the viability of "scheme liability" claims against secondary actors, such as investment banks and auditors, in securities litigation.

Stoneridge is a factor to watch, as any court decision expanding liability in securities litigation could heighten settlement values and increase potential payouts not only under D&O policies, but also E&O policies, as well as other lines of insurance. Also, D&O premiums could rise to the extent an insured's exposure may encompass not just the wrongful acts of its own officials, but also those of third party vendors. A high court rejection of scheme liability, on the other hand, would help to sustain reduced losses and improved market conditions.

We will continue to provide relevant updates on these and other important issues affecting D&O insurance. We believe companies that better understand their securities exposures and the forces driving the insurance markets are best positioned to secure favorable D&O terms and conditions at renewal and to make more educated insurance purchasing decisions.

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About Integro

Integro is an insurance brokerage and risk management firm dedicated to serving the insurance and risk management needs complex institutional risks. Integro has offices across North America, as well as, in Bermuda, London, and Stockholm. Its headquarter office is located at 3 Times Square, 9th Floor, New York, New York, 10036. 1-877-688-8701. www.integrogroup.com

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1. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, 127 S.Ct. 2499 (U.S. 2007)
 2. *Id.* at 2510.
 3. Caracciolo, Vincent G., "Tellabs: The Supreme Court and Pleading Scienter in Securities Fraud," http://www.integrogroup.com/portal/server.pt/gateway/PTARGS_0_0_341_207_209_43/http%3B/publisher.integrogroup.com%3B7087/publishedcontent/publish/integro_internet/newsroom_content/white_papers/tellabs_supreme_court_final_2.pdf.
 4. Quoted by Lattman, Peter, "Tellabs Securities Lawyers React," *The Wall Street Journal Law Blog*, June 21, 2007, <http://blogs.wsj.com/law/2007/06/21/tellabs-securities-lawyers-react/>.
 5. Quoted by Hylkema, Joe, "Supreme Court Clarifies Standards for Stock-Fraud Plaintiffs," *Andrews Online*, June 27, 2007, <http://www.andrewsonline.com/prevStory11.html>.
 6. *Dura Pharmaceuticals, Inc. v. Broudo*, No. 03-932, 544 U.S. 336 (2005).
 7. Docket No. 06-43, Term 2007-2008, appealed from Eighth Circuit Court of Appeals