Tellabs: The Supreme Court Decision: How High a Hurdle?

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The securities class action arena is disruptive, distressing, and expensive. Now, in light of a new Supreme Court ruling, there may be some good news for directors, officers and corporations – at least in certain venues. Plaintiffs in some jurisdictions may have to work a bit harder to maintain a securities fraud case.

On June 21, 2007 the United States Supreme Court issued its ruling in *Tellabs, Inc. v. Makor.* The much anticipated decision addresses the requisite "state of mind" pleading standard. In effect, *Tellabs* considered the limitations on entry "tickets" to the litigation dance.

Federal courts have uniformly recognized that Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) to include exacting pleading requirements. Heightened pleading hurdles have been viewed as a check against abusive litigation in private securities fraud actions. The PSLRA requires that plaintiffs must state with particularity facts giving rise to a "strong inference" that the defendant acted with the required state of mind. Unfortunately, Congress left the key term "strong inference" undefined, and some courts have arguably set the hurdle very low for plaintiffs to maintain lawsuits against defendants.

Lower courts tried to breathe life into the term "strong inference," but as is common in many statutory interpretations, conflicts among the federal circuits developed. The Supreme Court in *Tellabs* tries to resolve these conflicts in the spirit of achieving the PSLRA's dual goals of curbing frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims.

In what might be considered a "holistic" approach, and without establishing a "bright-line rule," the Supreme Court attempts to prescribe a workable construction of "strong inference." *Tellabs* holds that to qualify as "strong" under the PSLRA, "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 non-fraudulent intent."

The three step framework established in *Tellabs* requires courts to:

1. accept all factual allegations in the complaint as true;
2. consider whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter; not whether any individual allegation, scrutinized in isolation, meets that standard; (courts can consider facts in documents incorporated by reference to the complaint, as well as facts to which "judicial notice" is appropriate—including *inter alia* filings with the SEC, share prices and trading data and company press releases); and
3. take into account plausible opposing inferences.

Tellabs rejects both a purely pro-investor "lenient" pleading standard and also the more conservative pleading standard in place in certain circuits. The decision tries to resolve circuit court conflict on the scienter pleading issue; however, it is likely that the import of *Tellabs* will be a function of the lower court venue in which the litigation is brought and maintained.

Relatively speaking, the high court's decision raises the bar in some judicial circuits, while arguably lowering the bar for plaintiffs to keep defendants in other circuits. Based on the Supreme Court's "new" framework, it may be:

- easier than pre-*Tellabs* for defendants to prevail on a motion to dismiss in the Seventh Circuit (IL,IN, WI) inasmuch as the prior standard was viewed as "pro- investor;"

- more difficult than pre-*Tellabs* for defendants to prevail in the, First, Fourth, Sixth, and Ninth Circuits (ME, MA, NH, PR, RI – MD, NC, SC, VA, WV – KY, MI, OH, TN – CA and most of the western states) as the prior standard employed in those Circuits was viewed as more conservative;
- possibly more difficult than pre-*Tellabs* for defendants to prevail in the Second and Third Circuits (NY, VT, CT – PA, NJ, DE and Virgin Islands). The "motive and opportunity" standard used in those Circuits was not adopted by the Supreme Court in its *Tellabs* framework, but rather suggested "motive" could be a relevant consideration although the absence of pleading "motive" would not be fatal; and
- about the same as pre-*Tellabs* in the Eighth and Tenth Circuits (ND, SD, NE, MN, IA, MO, AR- UT, WY, CO, NM, KS, OK) as the *Tellabs* framework seems to track the middle ground previously employed in those Circuits.

Interestingly, both plaintiff lawyers and defense lawyers are claiming victory. Perhaps this is because geographic perspectives may be at play; perhaps it is a natural way of reading *Tellabs* – it could have proven much worse for both sides.

Members of the plaintiffs bar suggest that *Tellabs* will have no impact on the way they prosecute a securities lawsuit, nor will it impact the number of lawsuits brought and maintained against directors and officers. Members of the defense bar suggest that Tellabs is a defeat for the plaintiffs and victory for business. While *Tellabs* might be touted as having a pro-business approach, significant discretion is left in the hands of the lower courts to execute on a framework that leaves wide latitude to keep defendants tied up in litigation.

Although many had hoped that the Supreme Court would provide a bright-line test that would substantially impact a plaintiff's ability to maintain a securities fraud case, *Tellabs* does not appear to have the stringent dictates necessary to sound the death-knell to private securities suits. Indeed, it may make it a bit easier in certain jurisdictions for a plaintiff to survive motions to dismiss. The Supreme Court decision provides enough wiggle room for lower court judges continue to do what they would have prior to the *Tellabs* framework. Forum shopping may continue in search of traditionally more lenient judges. For now, many director and officer defendants will likely be subject to the same disruption, distress, and expense when part of a securities fraud class action; albeit under a different framework.

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