

## **The Supreme Court Clarifies Plaintiffs' Burden for Pleading State of Mind in Securities Fraud Cases**

**June 26, 2007**

On June 21, 2007, the Supreme Court of the United States issued an opinion about securities fraud claims under the Private Securities Litigation Reform Act of 1995 (PSLRA) that potentially affects all public companies. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, --- U.S. ---, 2007 WL 1773208 (2007). *Tellabs* clarifies a plaintiff's burden to plead that the defendant had the necessary state of mind (scienter) to commit securities fraud and therefore affects a plaintiff's ability to bring a claim for securities fraud that will withstand a motion to dismiss. The Supreme Court holds in *Tellabs* that (1) courts must consider competing inferences in determining whether a complaint gives rise to the necessary strong inference of scienter, and (2) that the resulting inference must be at least as compelling as any opposing one. Whether the *Tellabs* decision improves the litigation climate for a defendant depends upon where that defendant has been sued. In the U.S. Court of Appeals for the Seventh Circuit, where this case originated, the Supreme Court's decision was a mild victory for defendants.

Shareholders alleged that Tellabs, Inc. and its CEO, Richard Notebaert, engaged in a scheme to deceive the investing public about the true value of Tellabs stock. The shareholders brought a class action in the U.S. District Court for the Northern District of Illinois alleging, among other things, the defendants had committed securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, and that, as a "controlling person" under Section 20(a) of the 1934 Act, Notebaert was derivatively liable for Tellabs' conduct. The district court dismissed the case, holding that although the complaint adequately pleaded that Notebaert's statements were misleading, the shareholders insufficiently alleged that Notebaert acted with scienter. The U.S. Court of Appeals for the Seventh Circuit reversed. While recognizing that the PSLRA "unequivocally raise[d] the bar for pleading scienter" by requiring "sufficient facts to create a *strong inference* of scienter," the Seventh Circuit held that a complaint could survive if it alleged facts from which "a reasonable person could infer that the defendant acted with the required intent."

The resulting eight-to-one Supreme Court decision has different implications for defendants depending on where they are located. The Court rejected the bar set by the Seventh Circuit for "strong inference," explaining that the inference of scienter must be more than merely "reasonable" or "permissible." The Court held that a complaint will survive "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." The Court noted that the strength of an inference is inherently comparative

and cannot be decided in a vacuum. Thus, a court must consider plausible nonculpable explanations for the alleged conduct. On the other hand, the Court stated that the inference need not be “irrefutable,” “of the ‘smoking-gun’ genre,” or “even the ‘most plausible of competing inferences.’” Indeed, the Court left open the possibility that a plaintiff could pass the “strong inference” bar by pleading facts whereby the inference was only as strong as, not stronger than, the opposing inference.

Thus, the opinion helps defendants in jurisdictions that only required a reasonable inference, such as the Seventh Circuit, but it may ultimately prove to lower slightly the standard followed in other jurisdictions, such as the Sixth Circuit, where courts had held that “plaintiffs are entitled only to the *most* plausible of competing inferences.” The *Tellabs* decision does make it clear that defendants should be permitted to argue alternative inferences based upon plaintiffs’ factual allegations as well as documents referenced in the complaint and “matters of which a court may take judicial notice.” Accordingly, defendants are not limited to plaintiffs’ version of events and can use the motion to dismiss to make competing factual arguments.

Finally, the *Tellabs* decision leaves unresolved other prominent issues over which the appellate courts have differed, such as whether the PSLRA heightened the substantive state-of-mind requirement for securities fraud allegations to require something more than a showing of recklessness. The effects of *Tellabs* on the lower courts’ analysis of these issues, as well as of the inference of scienter, will be determined as courts apply this recent decision to pending and future cases.

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1. The allowance of pleading scienter when the inference is only *as strong* as the opposing inference was a sticking point for Justice Scalia, who believes that the inference of scienter should be *more plausible* than the inference of innocence. He acknowledges in his concurring opinion that this distinction is insignificant, for it is not often “that inferences are precisely in equipoise.”

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If you have any questions regarding the issues raised in this Morgan Lewis LawFlash, please contact either of the following Morgan Lewis attorneys:

**Philadelphia**

Karen Pieslak Pohlmann 215.963.5740

[kpohlmann@morganlewis.com](mailto:kpohlmann@morganlewis.com)

Mark J. Sonnenfeld 215.963.5572

[msonnenfeld@morganlewis.com](mailto:msonnenfeld@morganlewis.com)

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