

Diluting the Strong Inference Standard

MORE THAN A decade after the law was enacted, application of the Private Securities Litigation Reform Act (PSLRA) continues to challenge the judiciary. The U.S. Supreme Court's recent interest in cases considering the implications of the PSLRA is evidence of that challenge.¹ In *Tellabs Inc. v. Makor Issues & Rights Ltd.*, the Supreme Court addressed a circuit split regarding the PSLRA's

scienter pleading requirement. Prescribing a "workable construction of the 'strong inference' standard," the Court held that plaintiffs alleging securities fraud must raise an inference of scienter "at least as compelling as any opposing inference one could draw from the facts alleged."² The standard adopted by the Court's majority, however, may have stopped short of accomplishing Congress's objectives in enacting the PSLRA.

Enacted in 1995 over a presidential veto, the PSLRA was the first comprehensive revision of the national securities laws since they were enacted more than 60 years earlier.³ Prompted by the routine filing of lawsuits whenever there was a significant change in an issuer's stock, the targeting of defendants with deep pockets, and coercive settlement tactics by class action lawyers, Congress decided to impose substantial limitations on the filing and maintenance of securities fraud claims.⁴ Foremost among Congress' objectives was maintaining the integrity of the nation's securities markets by protecting issuers of securities. To achieve that end, Congress adopted exacting pleading requirements and imposed an automatic stay of discovery upon the filing of a motion to dismiss, rendering the failure to overcome the initial pleading burden to be the end of many securities actions.⁵

In drafting the PSLRA's pleading standards, Congress looked to the various standards that circuit courts had adopted. In particular, Congress focused on the strictest standard articulated before the PSLRA was passed: the Second Circuit's pleading standard.⁶ Before the PSLRA was enacted, the Second Circuit had required plaintiffs to plead a "strong inference of fraudulent intent."⁷ Congress, however, set out to "strengthen existing pleading requirements"⁸; therefore, the legislature built upon the Second Circuit's standard and required plaintiffs to "state with par-

ticularity facts giving rise to a strong inference that the defendant acted with the required state of mind [scienter]."⁹ The key term, "strong inference," however, was left undefined.

It is not surprising that the legislature's silence on this issue caused a split among the circuits. For example, in the Sixth Circuit, the strong inference requirement meant that plaintiffs were entitled to only the "most plausible of competing inferences."¹⁰ In the Seventh Circuit, plaintiffs merely had to allege facts sufficient for a "reasonable person [to] infer that the defendant acted with the required intent."¹¹ Therefore, it was left to the Supreme Court to articulate a uniform pleading standard.

In *Tellabs*, the Court attempted to clarify for the circuits how to determine whether a plaintiff has alleged a "strong inference" of scienter. Respondents (shareholders of the petitioner, Tellabs Inc.) filed a class action lawsuit against Tellabs, a manufacturer of specialized equipment used in fiber optic networks, as well as certain executives of Tellabs. The shareholders alleged, among other points, that Tellabs and its high-level executives had engaged in securities fraud in violation of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5. Tellabs moved to dismiss the complaint, claiming its failure to plead with sufficient particularity, as the PSLRA requires. The District Court dismissed the shareholders' complaint without prejudice, and the shareholders filed an amended complaint. The District Court agreed with Tellabs, this time dismissing the shareholders' complaint with prejudice because of failure to plead scienter. The shareholders then appealed to the Seventh Circuit, which reversed the ruling and held that "if [the complaint] alleges facts from which, if true, a reasonable person could infer that the defendant acted with the requisite intent," then the plaintiffs' complaint should survive.¹² Tellabs petitioned the Supreme Court for certiorari.

The Supreme Court vacated and remanded the case. In an opinion by Justice Ginsburg, the majority rejected the Seventh Circuit's pleading standard and found that courts must "consider plausible nonculpable explanations for the defendant's conduct," and, in light of those competing inferences, an inference of scienter "must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." In other words, if there is a "tie" between culpable and nonculpable strong inferences, then

plaintiffs “win” and a defendant’s motion to dismiss should be denied.

Concurring in the judgment, Justice Scalia wrote a separate opinion in which he urged the Court to adopt a more stringent standard.¹³ Specifically, Justice Scalia argued that “the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence,” that is, a tie should go to the defendant and the plaintiff’s complaint should be dismissed. But the majority refused to adopt the stronger standard. The Court reasoned that such a “possibility” is “certainly strong enough to warrant further investigation” and declined to require the plaintiff “to plead more than she would be required to prove at trial.”

Of course, Congress should not require more from plaintiffs at the pleading stage than is required at trial. Justice Scalia’s standard is more consistent with the goals of the PSLRA, one of which was to strengthen pre-PSLRA pleading standards, which also included Federal Rule 9(b)’s exacting pleading requirements for fraud.¹⁴ Heightening these already stringent pleading standards, Congress required plaintiffs to plead not more than they would have to prove at trial but exactly what they would have to prove at trial, that is, fraud by a preponderance of evidence. As Justice Scalia explained, the standard that he proposed was more in keeping with Congress’ intent to preclude plaintiffs from filing suit in hopes that discovery will produce a viable claim, rather than to encourage them to do so.

The majority admitted that Congress “has power to prescribe what must be pleaded to state [a securities fraud claim], just as it has power to determine what must be proved to prevail on the merits.” Congress’ inclusion of the adjective “strong” is a clear indicator that previous pleading standards were insufficient and that much more should be required of plaintiffs. The majority in *Tellabs* should have presented lower courts with a more stringent standard in order to remove any question as to what is required of plaintiffs under the PSLRA.

In the months since the Supreme Court’s decision, it has become evident that lower court opinions remain unclear as to the pleading burden that the PSLRA places on plaintiffs. For example, in *Frank v. Dana Corp.*, the Northern District of Ohio denied the defendants’ motion to dismiss for failure to plead scienter; however, the court’s decision confused the *Tellabs* standard several times.¹⁵ Initially, the court (incorrectly) found that *Tellabs* requires that “plaintiff must establish an inference of scienter that is *more plausible* and powerful than competing inferences of defendants’ state of mind.”¹⁶ Then, as part of its scienter analysis, the court declared (again, incorrectly) that it is “required to accept plaintiff’s inferences of scienter only if those inferences are the *most plausible* of competing inferences.”¹⁷ After twice misreading the standard announced in *Tellabs*, the court, quoting *Tellabs*, ruled that the plaintiff had

failed to plead scienter because the plaintiff’s inferences of scienter were not “as strong as any opposing inference.”

Other courts have disagreed about how *Tellabs* affects specific pleading practices of plaintiffs, including the use of allegations based on confidential sources. Ironically, the Seventh Circuit, whose pleading standard was expressly strengthened by *Tellabs*, suggested that its frustration with the *Tellabs* standard was that it was too weak. However, the court used *Tellabs* to find other ways to impose strict requirements on the plaintiffs, for example, finding that the plaintiffs’ allegations based on confidential sources should be “discounted.”¹⁸ In contrast, after the *Tellabs* decision, district courts within the Second Circuit continue to allow plaintiffs to rely on allegations based on confidential sources.¹⁹

Undoubtedly, the majority in *Tellabs* recognized that the PSLRA is an impediment to plaintiffs’ attempts to allege securities fraud; however, the Supreme Court’s standard (and lack of application of that standard) is not sufficient under the PSLRA. Application of the scienter pleading standard is highly fact-sensitive.²⁰ Courts must assess the allegations of each plaintiff’s complaint to determine whether the facts as pled raise a strong inference of scienter. Thus, courts necessarily exercise significant discretion. The PSLRA sought to rein in that discretion by imposing a demanding scienter pleading standard. By its refusal to require more of the courts (and of plaintiffs), the majority weakened the exacting pleading standard that Congress intended.

Notwithstanding its shortcomings, *Tellabs* is a significant decision that has altered the landscape of securities law. Whether the bench will use *Tellabs* as a scapegoat for its leniency when denying defendants’ motions to dismiss or as a shield to protect defendants from meritless lawsuits, remains to be seen. The probability of such dueling interpretations of *Tellabs* illustrates the greatest disappointment of *Tellabs*—its failure to establish a uniform pleading standard under the Private Securities Litigation Reform Act. **TFL**

Erin E. Rhinehart received her J.D. from the University of Dayton School of Law and is an attorney with the firm of Faruki Ireland & Cox P.L.L. in Dayton, Ohio.

Endnotes

¹*Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 125 S. Ct. 1627 (2005); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 126 S. Ct. 1503 (2006) (focusing on the implications of the Securities Litigation Uniform Standards Act (SLUSA)); *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007).

²*Tellabs*, 127 S. Ct. at 2510.

INFERENCE *continued on page 22*

³15 U.S.C. § 78a et seq. (referred to as the Securities Exchange Act of 1934).

⁴H.R. Conf. Rep. No. 104-369, at 31 (1995).

⁵15 U.S.C. § 78u-4(b)(3)(B).

⁶The weakest pre-PSLRA pleading standard was articulated by the Ninth Circuit, which required plaintiffs to “aver scienter generally ... simply by saying that scienter existed.” *Decker v. Glenfed Inc.*, 42 F.3d 1541, 1545, 1547 (9th Cir. 1994).

⁷*Shields v. Citytrust Bancorp. Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

⁸H.R. Conf. Rep. No. 104-369, at 41 (1995) (emphasis added).

⁹15 U.S.C. § 78u-4(b)(2).

¹⁰*PR Diamonds Inc. v. Chandler*, 364 F.3d 671, 682 (6th Cir. 2004).

¹¹*Makor Issues & Rights Ltd. v. Tellabs Inc.*, 437 F.3d 588, 602 (7th Cir. 2006), *vacated and remanded*, *Tellabs Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499.

¹²*Tellabs*, 127 S. Ct. at 2506.

¹³*Tellabs*, 127 S. Ct. at 2513-2515 (Scalia, J., concurring).

¹⁴H.R. Conf. Rep. No. 104-369, at 41; Fed. R. Civ. P. 9(b).

¹⁵*Frank v. Dana Corp.*, No. 3:05cv7393, 2007 U.S. Dist. LEXIS 61307, at *3 (N.D. Ohio Aug. 21, 2007).

¹⁶*Id.* at *11 (emphasis added).

¹⁷*Id.* at *17 (citing *Tellabs*) (emphasis added).

¹⁸*Higgenbotham v. Baxter*, 495 F.3d 753, 756 (7th Cir. 2007) (“One upshot of the approach that *Tellabs* announced is that we must discount allegations [from confidential witnesses].”).

¹⁹For example, *In re Xethanol Corp. Secs. Litig.*, No. 06 Civ. 10234, 2007 U.S. Dist. LEXIS 65935, at *9-10, n.3 (S.D.N.Y. Sept. 7, 2007) (finding that allegations based on confidential witnesses, who were identified by job title and dates of employment, were sufficient to allege that the defendants had actual knowledge that their statements were false when made).

²⁰For example, *In re United Am. Healthcare Corp. Sec. Litig.*, No. 2:05-CV-72112, 2007 U.S. Dist. LEXIS 6362, at *48-49 (E.D. Mich. Jan. 30, 2007) (“The determination of whether Plaintiffs have sufficiently alleged the requisite state of mind as to each of the Defendants, therefore, requires a *fact sensitive analysis* of the Complaint’s allegations to determine whether the facts as pled produce a strong inference that [each of the particular defendants] acted at least recklessly.”) (internal quotation marks and citations omitted; emphasis added; alteration in original).



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