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**For further information, please call David F. Graham at 312.853.7596 or Hille R. Sheppard at 312.853.7850 in Chicago or Richard Bernstein at 202.736.8027 in Washington, D.C., all of whom participated in the Tellabs case.**

**To receive future copies of Securities Litigation Updates via email, please send your name, company or firm name and email address to Katie Gnaster at [kgnaster@sidley.com](mailto:kgnaster@sidley.com)**

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Sidley achieved a major victory in the United States Supreme Court on June 21 on behalf of the securities industry and firm client Tellabs, Inc. In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, No. 06-484, 551 U.S. — (June 21, 2007), the Supreme Court adopted a stringent standard for pleading securities fraud cases, which the *New York Times* dubbed as “a blow to investors who want to sue companies and executives because of suspected fraud.”<sup>1</sup> At issue in *Tellabs* was the requirement in the Private Securities Litigation Reform Act of 1995 (“PSLRA”) that a complaint asserting securities fraud must allege facts sufficient to establish a “strong inference” that the defendant acted with fraudulent intent (scienter). In an 8-1 decision written by Justice Ginsburg, the Court held that, to qualify as “strong” within the meaning of 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 nonfraudulent intent.”

**A More Robust Pleading Standard**

*Tellabs* came to the Supreme Court from the Seventh Circuit, which had interpreted the PSLRA’s “strong inference” requirement in a particularly lax fashion. Driven in part by a concern that allowing courts at the pleading stage to weigh competing inferences might intrude upon the role reserved for the jury under the Seventh Amendment, the Seventh Circuit had held that a complaint should survive a motion to dismiss “if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent...” *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (2006) (emphasis supplied).

The Supreme Court rejected this approach, adopting a far higher standard that the *Chicago Tribune* predicted “will make it significantly harder for shareholders to file securities-fraud suits against corporations.”<sup>2</sup> The standard ultimately articulated by the Court places a far greater burden on a private securities fraud pleader than that which applies in other cases in federal court: “A complaint will survive, we hold, 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.” (Emphasis

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<sup>1</sup> Stephen Labaton, “Investors’ Suits Face Higher Bar, Justices Decide: 2nd Victory for Business,” *New York Times*, A1 (June 22, 2007).  
<sup>2</sup> James P. Miller, “Investors Have More to Prove in Fraud Suits,” *Chicago Tribune*, Section 3, page 1 (June 22, 2007).

supplied.) While Justices Scalia and Alito, separately concurring, advocated a standard that would have required that the inference of scienter be *more* compelling than any opposing inference, as Justice Alito observed, the difference between a 50% requirement (“at least as compelling”) and a 51% requirement (“more compelling”) is likely to have little practical effect.

The Court decisively rejected the notion that a court should construe all “reasonable” inferences in a plaintiff’s favor, and then determine whether those favorably drawn inferences constitute a “strong inference” of scienter. Some courts, in an effort to reconcile the PSLRA provisions with traditional motion to dismiss standards, have followed such an approach. The Supreme Court held, however, that it is not proper under the PSLRA simply to grant a plaintiff the benefit of “reasonable” inferences that “could” be drawn in her favor.

In addition to adopting a rigorous standard, the Supreme Court articulated a set of “prescriptions” to help guide the lower courts in applying the standard. These “prescriptions” largely followed a set of guidelines suggested by defendants.

*First*, the Court emphasized that in determining whether the pleaded facts give rise to a “strong” inference of scienter, a court “must consider the complaint in its entirety,” together with “documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.” Plaintiff-favorable facts or inferences cannot be “scrutinized in isolation.”

*Second*, and most importantly, “the court must take into account plausible opposing inferences,” including “plausible nonculpable explanations for the defendant’s conduct.” The Supreme Court thus expressly held that, in evaluating securities fraud complaints, courts must consider and directly *weigh* the relative strength of competing inferences, including any inferences that the defendant acted with an innocent mental state. This is because Congress expressly required the inference of scienter to be “strong,” and the “strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative....”

Unlike the Seventh Circuit, the Supreme Court thought “it plain” that a “comparative assessment of plausible inferences . . . does not impinge upon the Seventh Amendment right to a jury trial.” Indeed, in a statement of sweeping import, the Court held that the Seventh Amendment does not inhibit Congress “from establishing whatever pleading requirements it finds appropriate for federal statutory claims.”

While the Court chose not to apply its newly adopted standard and “prescriptions” to the facts alleged in the complaint in *Tellabs*, it did discuss how courts should evaluate certain frequently recurring categories of allegations. For example, the Court discussed how courts should consider allegations that are vague or ambiguous. That question was prompted by several allegations in *Tellabs*, including allegations of certain internal reports that allegedly contained information critical to establish the defendant’s knowledge at a given time, but the dates of which were ambiguously described (*i.e.*, “in or about early 2001”). The Court stated, “We agree that omissions and ambiguities count against inferring scienter....” The Court also addressed the role of motive (or lack thereof). The complaint in *Tellabs* had not alleged that Tellabs’ CEO, a named defendant in the case, or Tellabs itself had any pecuniary motive to commit fraud. Although the Court chose not to treat the absence of such motive allegations as itself dispositive, it nevertheless recognized that such circumstances may be significant in light of the entirety of the complaint. This guidance from the Court will prove important in future securities lawsuits, and should be carefully considered when moving to dismiss future securities lawsuits.

### Issues Not Decided

The *Tellabs* decision makes reference to several other legal issues without explicitly deciding them. The Court noted that it has, once again, “reserved the question whether reckless behavior is sufficient for civil liability under §10(b) and Rule 10b-5.” The Court observed, however, that while the Circuits “differ on the degree of recklessness required” – *e.g.*, the Ninth Circuit requires “deliberate or conscious recklessness” – they all agree that some form of recklessness can suffice.

The Court also noted the question “whether the group pleading doctrine survived the PSLRA,” claiming that there is disagreement among the Circuits on that issue. Because plaintiffs had not contested the Seventh Circuit’s determination that the “group pleading doctrine” does not survive the PSLRA, the Court elected not to decide the issue. Relatedly, the Court did not address, or even mention, the issue whether “collective scienter” can suffice in the case of a corporate entity defendant, with the different elements necessary for scienter drawn from different natural persons within the corporation. Plaintiffs in *Tellabs* had made such an argument both in the Seventh Circuit and before the Court. The Court’s decision also made no reference to an argument that was the subject both of briefing and questioning at oral argument: whether a standard of proof higher than the judicially adopted “preponderance of the evidence” standard for §10(b) actions may be appropriate, given the other changes wrought by the PSLRA, if necessary to avoid potential Seventh Amendment issues. Having otherwise disposed of the Seventh Amendment issues, the Court in passing reaffirmed without discussion that at trial a plaintiff must prove her case by a “preponderance of the evidence.”

### Effect on Lower Courts

The Supreme Court recognized that uniform application of a securities fraud pleading standard was one of the goals behind the PSLRA. Whether the decision in *Tellabs* will succeed in that respect remains to be seen. What is clear is that in addition to the Seventh Circuit, most other courts of appeals will have

to revise the standards they have heretofore adopted for purposes of applying the “strong inference” requirement. The Second and Third Circuits, for example, will have to abandon their bifurcated approach to the “strong inference” requirement, in which “motive and opportunity” allegations were analyzed separately and could alone suffice. The Tenth and Eighth Circuits, which have refused to “weigh” competing inferences against one another, will now have to engage in that comparative exercise. Conversely, the “most plausible of competing inferences” standard utilized by the Sixth Circuit and some others, and advocated by the concurrences in *Tellabs*, will need to be slightly modified to conform to the “at least as compelling” standard adopted by the *Tellabs* majority.

More important than any of these modifications in verbiage, however, is how the lower courts can be expected to react to the tenor of the decision, particularly in applying its “prescriptions.” In that regard, the clear and unmistakable message of the decision is that lower courts should approach allegations of scienter in a securities fraud complaint with a degree of close scrutiny that is virtually unparalleled at the pleading stage. Although substantial room for discretion in application still remains, especially given the largely unreviewable nature of decisions declining to grant a motion to dismiss, *Tellabs*’ emphasis on courts considering inferences pointing away from fraudulent intent, and engaging in comparative weighing of the likelihood of competing possibilities, should prove of considerable assistance to defendants faced with claims of dubious merit.