

U.S. Supreme Court Articulates Standards For Pleading Scierter In Securities Fraud Cases

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In Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. ____ (2007), issued June 21, 2007, the Supreme Court clarified what plaintiffs must allege in securities fraud cases to adequately plead a “strong inference” of scierter under the Private Securities Litigation Reform Act (PSLRA). In an 8-1 decision written by Justice Ginsburg, the Court held that on a motion to dismiss, a district court must review not only the inferences urged by the plaintiff but also competing inferences rationally drawn from all of the facts alleged in the complaint and other sources cognizable on a motion to dismiss. The Court established a two-pronged test for pleading securities fraud: a complaint will survive dismissal, the Court ruled, only if a reasonable person would deem the inference of the defendant’s scierter – i.e., intention to deceive, manipulate, or defraud – to be both “cogent” and “at least as compelling as any opposing inference of nonfraudulent intent.”

The relevant portion of the PSLRA requires that a complaint alleging claims under § 10(b) and Rule 10b-5 must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” Since the enactment of the PSLRA, the Circuit courts have split as to how the term “strong inference” should be applied. In the decision below in Tellabs, the Seventh Circuit held that plaintiffs could satisfy their burden of pleading scierter if a “reasonable person” could have inferred from the alleged facts that the defendant acted with the required intent without examining competing inferences. The Sixth Circuit adopted a stricter standard, holding that plaintiffs would be entitled only to the *most* plausible of competing inferences. Other Circuits employed a more liberal test: for example, the Second and Third Circuits held that plaintiffs could establish a strong inference of scierter by pleading motive and opportunity.

The decision should make it more difficult for plaintiffs to plead a securities fraud claim that will survive dismissal. The Court stressed that a district court should not scrutinize each allegation of the complaint (e.g., of motive) in isolation, but rather, should assess all the allegations of the complaint “holistically.” The Court also explicitly sanctioned the practice of considering matters not in the complaint such as documents incorporated by reference and matters of which a court may take judicial notice. Looking at the alleged facts, a court must consider “plausible nonculpable explanations” for the

defendant's conduct and, when weighed against these nonculpable explanations, the inference urged by plaintiff cannot simply be "reasonable" but must be "cogent and compelling." Therefore, Tellabs should allow for more frequent resolutions of securities fraud suits at the pleading stage, if defendants can point to allegations or information incorporated by reference suggesting more plausible, nonculpable explanations for their conduct than the inferences of fraudulent intent urged by plaintiffs.

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