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*499 Tellabs: The Debate Over Competing Inferences Will Continue

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The views expressed herein are solely those of the author and do not necessarily reflect Katten's views.

*501 Introduction

Many members of the securities litigation bar likely spent the morning of June 21, 2007 carefully reading *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* - the Supreme Court's first decision to interpret the enhanced pleading standards of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). The Reform Act changed the standards applicable to motions to dismiss private securities fraud class actions specifically stating, among other provisions, that a complaint shall "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

This heightened standard created inevitable tension between the Reform Act and the Federal Rules of Civil Procedure. In a typical Rule 12(b)(6) motion, courts only require plaintiffs to plead "a short and plain statement of the claim showing that the pleader is entitled to relief" and only consider inferences that support a claim for relief. The Reform Act, however, requires "particularity" and there was a question as to how courts could determine whether a complaint pled a "strong inference" of scienter without weighing inferences and considering inferences unfavorable to plaintiffs.

The Supreme Court's *Tellabs* decision conclusively resolved at least some of the tension between Rule 12(b)(6) and the Reform Act as the Court clearly held that courts "must consider, not only inferences urged by the plaintiff, . . . but also competing inferences rationally drawn from the facts alleged." *Tellabs,* slip op. at 2. The Court also ruled that a "strong inference" of scienter "must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, slip op. at 2.

The Court, however, did not likely end the argument that occurs in almost every private securities case as to whether a complaint adequately alleges a "strong inference" of scienter. The "strength of inferences" is in the eye of the beholder, and the Court did not apply its new *__502__ standard to the allegations in the *Tellabs* complaint even though it could have done so as the case presented a pure issue of law. *Tellabs*, slip op. at 17-18. Furthermore, though the Court ruled almost unanimously that courts must consider competing inferences, the justices did not speak with a single voice. Justice Ginsburg wrote for the Court in an 18-page opinion, Justice Scalia wrote a separate five-page concurrence, Justice Alito wrote a second separate three-page concurrence, and Justice Stevens wrote a three-page dissent. Thus, the debate between the securities plaintiffs bar and the securities defense bar will likely continue as courts determine how *Tellabs* applies in particular cases and sort through the implications of the Court's (and other justices') holdings, dicta, and language.

This article briefly describes the issue presented in Tellabs and the Court's holding. It then analyzes the status of the pre-Tellabs cases concerning competing inferences in each of the Courts of Appeal after Tellabs. Lastly, it discusses some of the likely disagreements between the plaintiff and defense bars in the near future and discusses certain of the Court's footnotes.

Tellabs Decision

The Court granted certiorari in *Tellabs* to decide whether a court must consider or weigh competing inferences in determining whether a complaint has alleged a strong inference of scienter. *Tellabs*, slip op. at 6. The text of the Reform Act states that a complaint shall "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," and a split had developed between the Courts of Appeals as to whether this language required courts to consider inferences unfavorable to the plaintiff in determining whether the requisite "strong inference" had been alleged. While the exact contours of the split were and are potentially subject to debate, it was clear that courts in the First, Fourth, Sixth, and Ninth Circuits were required to consider innocent inferences while the Seventh Circuit in *Tellabs****503** had held that courts did not need to consider innocent inferences and only needed to decide if the complaint "allege[d] facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." *Compare In re Credit Suisse First Boston Corp.*, 431 F.3d 36 (1st Cir. 2005); *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338 (4th Cir. 2003); *Helwig v. Vencor, Inc.*, 251 F.3d 540 (6th Cir. 2001); *Gompper v. VISX, Inc.*, 298 F.3d 893 (9th Cir. 2002)*with Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006).

The Supreme Court's *Tellabs* decision issued on June 21, 2007 rejected the Seventh Circuit's approach to pleading scienter and vacated the Seventh Circuit's decision. *Tellabs,* slip op. at 17-18. The Court reasoned that the Seventh Circuit's standard did not "capture the stricter demand Congress sought to convey" in enacting the Reform Act (*Tellabs*, slip op. at 2), and held that a court seeking to determining whether a complaint alleged the requisite "strong inference" of scienter "must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged." *Id.* The Court further held that courts "must engage in a comparative evaluation" of the competing inferences and that "[t]o qualify as strong . . . an inference of scienter must be more than merely plausible or reasonable - it must be [powerful or] cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Tellabs*, slip op. at 2.

Disagreements Amongst the Court

Though the decision of the Court adopted the Petitioner's primary claim that the Reform Act requires courts to consider non-culpable inferences as well as the inferences urged by plaintiff(s), it did not go as far in establishing a higher standard for alleging scienter as Petitioner or some of its amici urged. Instead, these higher standards were expressed in the concurring opinions of Justices Scalia and Alito. Thus, while Justice Scalia concurred in the judgment of ***504** the Court, he wrote separately to express his view that the "test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence." *Tellabs*, slip op. at 1 (Scalia, J., concurring) (emphasis in original). Justice Scalia reasoned that "it is inconceivable that Congress's enactment of stringent pleading requirements [in the Reform Act] somehow manifests the purpose of giving plaintiffs the edge in close cases" and viewed his standard as giving the Reform Act "its normal meaning." *Tellabs*, slip op. at 2-3 (Scalia, J., concurring). While Justice Scalia acknowledged that his test will not often "produce results much different from the Court's," he nonetheless argued that the Court should "read the language for what it says." *Tellabs*, slip op. at 3 (Scalia, J., concurring).

Justice Alito also wrote separately noting that he concurred in the judgment of the Court but believed that Justice Scalia's articulation of the test was correct. *Tellabs*, slip op. at 1 (Alito, J., concurring). He also wrote that he believed the Court was wrong to state that "'omissions and ambiguities' merely 'count against' inferring scienter" as he believed that facts not stated with particularity "cannot be considered [at all] in determining whether the strong-inference test is met." *Tellabs*, slip op. at 2 (Alito, J., concurring). Justice Alito reasoned that the Court's decision to consider non-particularized allegations violated the Reform Act's requirement that the "complaint shall . . . state

with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Tellabs, slip op. at 2 (Alito, J., concurring).

Justice Stevens was the lone dissenter believing that the "probable cause" standard best served the purposes of the heightened pleading requirements of the Reform Act.

Tellabs Impact on Scienter Standard in the Courts of Appeals

The Court obviously rejected the Seventh Circuit standard that a complaint only needed to "allege facts from which, if true, a reasonable person could infer that the defendant acted with *__505__ the required intent" as the Court expressly vacated the Seventh Circuit's *Tellabs* decision as inconsistent with Congressional intent to raise a plaintiff's burden to plead scienter. The Court also, however, expressly disagreed with the Sixth Circuit's formulation that a court only considers the "most plausible of competing inferences." *See Tellabs*, slip. op. at 12 (holding that "the inference that the defendant acted with scienter need not be . . . the 'most plausible of competing inferences") (quoting *Fidel v. Farley*, 392 F.3d 220 (6th Cir. 2004)).[1]

The *Tellabs* decision's impact on the standards for alleging scienter in the other Circuits is less clear. Thus, though Petitioners characterized the standard applicable in the First Circuit as equivalent to requiring that scienter be the "most plausible of competing inferences" in their Petition for Writ of Certiorari, the First Circuit itself never expressly so held. Rather, the First Circuit Court of Appeals had simply stated that "scienter allegations do not pass the 'strong inference' test when, viewed in light of the complaint as a whole, there are legitimate explanations for the behavior that are equally convincing." *Credit Suisse*, 431 F.3d at 49. This standard might conflict with the Supreme Court's opinion in the unusual situation where all the culpable and innocent inferences are "precisely in equipose" (*Tellabs*, slip op. at 3 (Scalia, J., concurring), but the First Circuit standard is otherwise consistent with the Court's decision. Similarly, the pre-*Tellabs* law in the Fourth and Ninth Circuits is essentially consistent with the Court's decision in Tellabs as courts in both these jurisdictions were (and are) required to "accept all factual allegations in the complaint as true"; "review[] the complaint in its entirety"; and "consider all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." See *Gompper*, 298 F.3d at 896-97; *Ottman*, 353 F.3d at 350.

*__506__ The prior law in the Tenth Circuit presents a slightly different problem vis-a-vis the Court's *Tellabs* opinion. The United States Court of Appeals for the Tenth Circuit held in *Pirraglia v. Novell, Inc.*, 339 F.3d 1182 (10th Cir. 2003) that courts must consider "negative inferences that may be drawn against the plaintiff." This holding is consistent with *Tellabs*. The Tenth Circuit, however, went on to hold that after considering these "negative inferences," the court must not "weigh" the "plaintiff's suggested inference against other inferences" but must rather engage in an "evaluative" process to determine if the facts pled give rise to a strong inference of scienter. *Pirraglia*, 339 F.3d at 1188-1189. This holding seems inconsistent with *Tellabs* which seems to endorse "weighing" inferences. Though the opinion of the Court, as opposed to the concurrences by Justices Scalia and Alito, never uses the word "weigh," the Court expressly holds that courts must engage in a "comparative evaluation" of inferences and a "comparative inquiry," notes that "the inquiry is inherently comparative," and it is hard to fathom how a court can comply with these directives without "weighing" the competing inferences. *Tellabs*, slip op. at 2, 11, 12.

The prior law in the Second and Third Circuits also seems inconsistent with the Tellabs decision, but for very different reasons. In contrast to most of the other circuits who consider all allegations together, the Second and Third Circuits divided their consideration of a complaint's allegations into two distinct categories defined as "motive and opportunity" and "strong circumstantial evidence of conscious misbehavior or recklessness." See *Kalnit v. Eichler*, 264 F.3d 131 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999). This "categorical" approach appears to conflict with the Court's holding in *Tellabs* that "courts must consider the complaint in its

1. The Sixth Circuit standard is arguably even stronger than the standard set forth by Justice Scalia who wrote that "the test should be whether the inference of scienter (if any) is more plausible than the inference of innocence." Tellabs, slip op. at 1 (Scalia, J., concurring) (emphasis in original).

entirety" and "assess all the allegations holistically," as presumably courts in the Second and Third Circuits that find "sufficient" allegations of motive and *__507__ opportunity do not consider the allegations of "conscious misbehavior or recklessness," including possibly the nonculpable inferences that can be drawn from such allegations.[2] *Tellabs*, slip op. at 11, 14.

Issues Raised By *Tellabs*

The next few years will likely see some interesting debates in the district courts and Courts of Appeals between the plaintiff and defense sides of the securities bar as to the proper interpretation of *Tellabs*. Indeed, the "spin" on the decision began almost before the ink had dried on the opinion. Plaintiff's lawyers emphasized the Court's statement in footnote 4 that "'private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses'" and defense lawyers focused on the fact that the Court held that courts must consider competing inferences. This article does not purport to attempt to cover all those debates and will rather discuss just two: the 50/50 situation and its cousin the ambiguous allegation.

*__508__ As discussed above, there was a disagreement amongst the justices joining in the judgment as to whether a complaint satisfies the requisite "strong inference" requirement when the inference of scienter and the opposing inference "are precisely in equipose." This is the situation that this article refers to above as the 50/50 situation. Justices Ginsberg, Breyer, Kennedy, Souter and Thomas and Chief Justice Roberts believed that the standard was satisfied in this situation while Justices Scalia and Alito believed that it was not. Justice Scalia noted in his concurrence that that this situation where the inference of scienter and the non-culpable inference are equally "compelling" would likely be rare.

The situation is rare, however, only when courts engage in the Supreme Court majority's "comparative evaluation" properly. Indeed, there is potential for great mischief where courts do not engage in careful analysis as there will often be cases where there are both culpable and nonculpable inferences. For example, a plaintiff may argue that allegations of non-unusual insider trading give rise to a strong inference of scienter by providing a motive for fraud while defendants will claim that normal trading is consistent with ordinary executive behavior. A court that does not engage in careful analysis of these inferences could wrongly conclude that such a situation warrants a finding that the "inference of scienter is . . . at least as compelling as [the] opposing inference" because both inferences exist. This type of "analysis," however, would be inconsistent with the Court's holding in *Tellabs* as it would essentially institute the Seventh Circuit's rejected standard as the law of the land - and possibly actually even a lower standard as discussed in Note 2 above. Every well-crafted complaint (and even most poorly crafted complaints) will contain at least some allegations that are consistent with an inference of scienter. If such a complaint can survive a motion to dismiss based on the theory that complaints containing both inferences of scienter and non-culpable inferences meet the "at least as *__509__ compelling" standard then the consideration of competing inferences - the primary holding of the *Tellabs* Court -- becomes irrelevant. The *Tellabs* Court certainly did not grant certiorari and reverse the Seventh Circuit's decision to issue an irrelevant interpretation of the Reform Act.

There is similar potential for misapplication with respect to ambiguous allegations. The Court wrote that "omissions and ambiguities count against inferring scienter," but suggested that such allegations must nonetheless be considered as courts must "assess all the allegations holistically." This consideration of ambiguity in conjunction

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2. This difference in approach between the Second and Third Circuits on the one hand and the Supreme Court on the other hand also raises the interesting (and related) question as to whether *Tellabs* impacts the applicable case law in the various Courts of Appeals as to whether allegations of motive and opportunity are sufficient by themselves to give rise to a strong inference of scienter. *Compare Advanta*, 180 F.3d at 534 n.8 *with In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 979, 988 (9th Cir. 1999). On this issue, the Court reasoned that "personal financial gain may weigh heavily in favor of a scienter inference," but also explicitly noted that "the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint." The Court's decision therefore suggests that motive alone is not sufficient because the court must consider the entire complaint. The Court also held, however, that "the absence of a motive allegation is not fatal." Of course, the Court's decision does not change existing case law that allegations of insider trading alone are not sufficient to give rise to a strong inference of scienter. Even the Seventh Circuit's Tellabs decision applying a scienter standard that the Supreme Court deemed too low held that "the sale of stock [that is not] 'dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information'" does not give rise to a strong inference of scienter. Makor Issues, 437 F.3d at 604.

with the Court's ruling that a complaint adequately alleges scienter in the 50/50 situation could turn *Tellabs* into an illusory victory for the securities defense bar if courts do not engage in the "comparative evaluation" carefully. For example, assume that a complaint's only scienter allegation with respect to a company's CEO is that the an internal company report from May 2007 exists that directly contradicts a statement the CEO made in June 2007. Assume as well that the complaint adequately details the contents of the report, but contains no allegation that the CEO was actually sent or read the report.[3] I assume that everybody would agree that this complaint is potentially ambiguous with respect to the CEO's knowledge of the facts contained in the report as there is no allegation that the CEO read the report. There is an inference of scienter, however, that can be drawn from these facts as one can infer that the CEO has knowledge of internal reports generated by the organization in advance of making statements on a particular topic. There is a competing inference too. Company CEOs tend to be busy and cannot read every internal company report.

*__510__ What should happen in this situation? If a court were to hold that such a complaint sufficiently alleged scienter based on its analysis that the inference of scienter is "at least as strong as any opposing inference," *Tellabs* would potentially open a floodgate of cases that survive motions to dismiss. The Court, however, likely did not intend such a result. Though the Court did not decide whether the *Tellabs* complaint adequately alleged scienter and remanded to the Seventh Circuit for further proceedings, it raised the scienter standard above the standard applied by the Seventh Circuit and specifically held that "omissions and ambiguities count against inferring scienter." A determination that the facts in the hypothetical are sufficient does not give proper force to each of these holdings. First, the Seventh Circuit itself (even applying its lower standard) rejected similar allegations with respect to Tellabs chairman and former CEO, Richard Birck. Thus, the Seventh Circuit held that plaintiffs had not alleged Mr. Birck's scienter with respect to his February 2001 statements concerning the market for the Tellabs product in question, even though plaintiffs had alleged that a Probe Research Report to which Mr. Brick had access revealed "in or about early 2001" that "the market for the product had faded." Second, if the Court's statement that "omissions and ambiguities count against inferring scienter" has meaning then the ambiguities of the allegation in the hypothetical must do more than merely make it a closer case as to whether scienter is alleged and must be sufficient (at least in certain situations) to result in a finding that a strong inference of scienter has not been alleged.[4]

*511The Footnotes

As mentioned in the introduction, the Court's footnotes are worthy of discussion as well. The Court once again (as it has since 1976) "reserved the question whether reckless behavior is sufficient for civil liability under 10(b) and Rule 10b-5." *Tellabs*, slip op. at 7 n.3. And more interestingly, the Court noted that it did not "disturb" the Seventh Circuit's holding that the "group pleading doctrine" did not survive the Reform Act. *Tellabs*, slip op. at 14-15 n.6. This question - whether the group pleading doctrine has continued validity since enactment of the Reform Act -- has divided courts throughout the country though the only Courts of Appeals to have addressed the issue have held that it does not. *See Southland Securities Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004); *Makor Issues*, 437 F.3d at 603.

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3. I recognize that this specific hypothetical is somewhat contrived (and also contrary to the Courts' holding that courts must consider a complaint in its entirety), but it serves to illustrate the point discussed in the text.

4. This reading does not go as far as Justice Alito's view that plaintiff cannot derive any benefit from ambiguous allegations. Rather, it merely gives effect to the fact that ambiguous allegations cannot be given the same weight as particularized allegations.

   The *Tellabs* Court also provides no indication that it intends to overturn essentially established law that a plaintiff cannot allege scienter merely by alleging that a defendant must have know of the alleged fraud based on his or her high level position with the company. *See, e.g.*, *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir. 2002); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001). A court holding that the facts from the example in the text gives rise to a strong inference of scienter would be so holding.

It is not clear whether the Court intended to endorse the Seventh Circuit's holding on this issue by explicitly stating that it did not "disturb" "the Seventh Circuit's determination," but this unusual choice of words (especially in contrast to the explicit indication that in Footnote 3 that it was not deciding the question of whether reckless behavior suffices to establish civil liability under Section 10(b)) and the Court's citation only of cases that have rejected the group pleading doctrine certainly suggests that the Court believes that the group pleading doctrine is inconsistent with the Reform Act.

Lastly, there is an interesting debate in the footnotes between the majority and Justice Scalia concerning the 50/50 situation discussed above centered around whether a court can find a strong inference of scienter as to "B" where a "jade falcon is stolen from a room to which only A and B had access." *Compare Tellabs*, slip op. at 13 n.5 *with Tellabs*, slip op. at 1 n.* (Scalia, J., *512 concurring). The majority reasoned that "law enforcement officials as well as the owner of the precious falcon" would find such facts sufficient to warrant further investigation (i.e., allowing the plaintiff to proceed with discovery as discovery is stayed under the Reform Act while a motion to dismiss is pending) and notes that this is consistent with the ruling in *Summers v. Tice*, 33 Cal. 2d 80 (1948). Justice Scalia, in contrast, believed that the majority's argument merely demonstrated why "no man ought to be a judge of his own cause" and reasoned that *Summers* is "famous" because it "relax[es]" the ordinary rules of proof and Congress did not intend to "relax" ordinary rules in enacting the Reform Act. *Tellabs*, slip op. at 1 n.*, 2 (Scalia, J., concurring). While Justice Scalia's point that no man should judge his own cause is somewhat disingenuous because it ignores the majority's argument that "law enforcement officials" would want to proceed with further investigation, his argument that Congress did not intend to "relax" ordinary rules in enacting the Reform Act has force and is essentially ignored by the majority.

Conclusion

Tellabs, like the Supreme Court's 2005 decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), has changed the terms of the debate between the plaintiff's and defense bar but will likely do little to end the fight.

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- Defense of an electric utility and its officers and directors in securities class action litigation arising from its investigation by the Federal Energy Regulatory Commission.
- Defense of public restaurant company and its officers and directors in connection with an investigation and litigation relating to its past practices relating to option grants.
- Defense of a Santa Barbara-based high technology company and its officers and directors in securities class action and derivative litigation arising out of the company's failure to meet its public projections.
- Defense of director and major shareholder in securities class action and bondholder lawsuit arising out of failure and bankruptcy of a telecommunications company.
- Defense of U.S. steel company in securities fraud lawsuits brought in state and federal courts by investors who purchased high yield bonds issued by a failed steel manufacturing plant in Thailand.
- Defense of former director of public company in various civil securities matters and SEC investigation related to the company's past practices relating to option grants.
- Defense of former officers of a software networking company in securities class actions arising from the company's financial restatement and subsequent bankruptcy.
- Representation of high technology company as amicus curiae in securities class action before the United States Supreme Court.

He has also handled other business tort and contract disputes including:

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