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SECURITIES CLASS ACTION LITIGATION

'Tellabs' and SDNY: Plaintiff's Perspective

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Under the Private Securities Litigation Reform Act of 1995 (PSLRA), a plaintiff asserting violations of §10(b) of the Exchange Act must allege 'facts giving rise to a strong inference that the defendant acted with' scienter. [FN1]

On June 21, 2007, the U.S. Supreme Court issued an opinion in [Tellabs Inc. v. Makor Issues & Rights, Ltd.](#), [FN2] that resolved the split among the circuit courts about what constituted a 'strong' inference of scienter. Tellabs has been heralded by some as a tightening of the pleading standards that a plaintiff must comply with in order to survive a motion to dismiss. [FN3]

A review of the recent decisions from the U.S. District Court for the Southern District of New York, however, reveals that Tellabs is not likely to substantially alter motion to dismiss practice.

The 'Tellabs' Case

In Tellabs, the Supreme Court held that in order to plead a 'strong inference,' the inferences drawn from the plaintiff's allegations 'must be cogent and at least as compelling as any opposing inference of non-fraudulent intent.' [FN4]

Writing for the Court, Justice Ruth Bader Ginsburg set forth a three-part approach that lower courts must employ to determine whether a plaintiff sufficiently alleges a strong inference of scienter.

- Under Tellabs, courts must first 'accept all factual allegations in the complaint as true.' [FN5]
- Second, 'courts must consider the complaint in its entirety.' [FN6]
- Third, courts must 'take into account plausible opposing inferences.' [FN7]

The Court cautioned, however, that '[t]he inference that the defendant acted with scienter need not be irrefutable...or even the most plausible of competing inferences.' [FN8] Rather, a complaint must only show that the inference of scienter is 'at least as compelling as any opposing inference one could draw from the facts alleged.' [FN9] Accordingly, under the Tellabs standard, a tie between facts that gives rise to an inference of scienter and plausible opposing inferences is sufficient to avoid dismissal. The 'tie' factor significantly benefits plaintiffs by giving them the benefit of the doubt. In many cases, this will be a decisive factor as defendants are often adept at providing benign explanations for their conduct.

Notably, Tellabs did not reach the extreme positions that some had argued for. The Court expressly rejected Justice Antonin Scalia's argument for an increased burden on investors that would have required plaintiffs to show that an inference of scienter is more plausible than competing inferences. [FN10] The Court also rejected Justice

Samuel Alito's suggestion that the appropriate test for scienter at the pleading stage should be the same 'test that is used at the summary-judgment and judgment-as-a-matter-of-law stages.' [FN11]

Instead, the Court followed the much more lenient test of whether 'a reasonable person would deem the inference of scienter...at least as compelling as any opposing inference one could draw from the facts alleged.' [FN12]

Prior to *Tellabs*, in the U.S. Court of Appeals for the Second Circuit, plaintiffs could establish a strong inference of scienter by alleging facts that either (1) established 'strong circumstantial evidence of conscious misbehavior or recklessness,' or (2) showed that defendants had both 'motive and opportunity to commit fraud.' [FN13] Allegations of recklessness have been deemed sufficient where, for example, plaintiffs alleged that defendants knew or had access to information that contradicted their public statements or where defendants failed to review information they had a duty to monitor. [FN14] Although the Second Circuit did not specifically define strong inference, courts repeatedly emphasized that conclusory allegations that defendants knew or should have known certain facts were insufficient. [FN15] Similarly, the 'motive and opportunity' test also required a showing of strong inference of scienter and rejected conclusory allegations of fraudulent intent. [FN16]

Appearance of Status Quo

Following *Tellabs*, it appears that everything in the Southern District will remain the same. Even prior to *Tellabs*, district courts applied the first two requirements of the *Tellabs* three-part approach in deciding a motion to dismiss. [FN17] The Court itself acknowledged that 'as with any motion to dismiss ' courts must accept the plaintiffs' allegations as true and must examine a complaint in its totality. [FN18] Likewise, the third part of the *Tellabs* approach, the consideration of plausible opposing inferences, is not a new concept to courts. Courts regularly consider and weigh competing inferences. [FN19] *Tellabs*, however, made this already-established practice a requirement. While the Supreme Court requires lower courts to weigh inferences, it does not require that plaintiffs show that their inferences are the most plausible; rather, it merely requires that plaintiffs' inferences are at least as plausible as other inferences. Therefore, although courts in this district must now take into account plausible opposing inferences in deciding whether scienter has been sufficiently pleaded, the outcome of these cases will likely remain the same.

Moreover, *Tellabs* reaffirmed that allegations of recklessness remained sufficient to plead scienter. Although the issue of whether recklessness satisfies the scienter requirement was not directly before it, the Court noted that '[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly.' [FN20] Neither did *Tellabs* reject the Second Circuit's 'motive and opportunity' test. Indeed, the Court recognized that allegations of motive are but one factor that courts look at to determine scienter and that 'personal financial gain may weigh heavily in favor of a scienter inference.' [FN21] The Court recognized that 'the absence of motive is not fatal' and 'allegations must be considered collectively.' [FN22] That position is notable in that many cases have required correspondingly greater allegations of reckless conduct when the complaint lacks allegations of motive. [FN23]

Case Law

The post-*Tellabs* case law bears out the foregoing discussion. For example, in *In re Tommy Hilfiger Sec. Litig.*, the Court denied a motion to dismiss holding that the complaint sufficiently plead scienter under the 'conscious misbehavior or recklessness prong.' [FN24] Citing *Tellabs*, the Court noted that it considered the complaint 'as a whole' and found the requisite inference of scienter from allegations of a tax evasion scheme, restatement and confidential informants, among other factors. [FN25]

Similarly, in *In re Xethanol Corp. Sec. Litig.*, the Court denied a motion to dismiss holding that the scienter was sufficiently pleaded, based, in substantial part, on the statements of witnesses that 'show that Defendants were told, knew or should have known that their statements about the financial health and development of ethanol technology were false when made.' [FN26]

The Court noted that defendants provided explanations for these statements, characterizing them as 'whining' and 'sour grapes,' but that it is 'more plausible that these statements' raise a strong inference of fraud and 'defendants offer no alternate, more compelling inference to warrant dismissal.' [FN27] Finally, in *In re Scottish Re Group Sec. Litig.*, the Court found sufficient allegations that defendants had engaged in improper accounting practices and must have known or were reckless in not knowing about it because 'they applied and quoted the standard in the Company's financial statements ' and they later took a 'large \$112 million 'surprise' valuation that allegedly wiped out a year's worth of the Company's earnings.' [FN28] There have been numerous other Tellabs-related decisions from the Southern District of New York. [FN29]

Conclusion

On balance, it appears that Tellabs will not provide defendants with additional ammunition with which to get securities cases dismissed at an early stage.

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FN1. [15 U.S.C. §78u-4\(b\)\(2\)](#).

FN2. [Tellabs Inc. v. Makor Issues & Rights, Ltd., 127 S.Ct. 2499 \(2007\)](#).

FN3. See, e.g., Kaplan, 'UPDATE 3-Top court makes US securities fraud suits harder,' Reuters, June 21, 2007, available at <<http://www.reuters.com/article/sphereNews/idUSN2838072820070621?sp=true&view=sphere>> (last viewed March 12, 2008) (stating that the Tellabs decision made it 'harder for investors to pursue securities fraud lawsuits'); Labaton, 'Justices Tighten Rules on Shareholder Suits,' The New York Times, June 21, 2007 available at <http://www.nytimes.com/2007/06/21/washington/21cnd-bizcourt.html> (last viewed March 12, 2008) (claiming that the decision was a 'defeat for shareholders and a victory for the defendant companies. '); Barnes & Johnson, 'Pro-Business Decision Hews to Pattern of Roberts Court,' Washington Post, June 22, 2007, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/06/21/AR2007062100803.html> (last viewed March 12, 2008) (stating that Tellabs makes it more 'difficult for plaintiffs to sue corporations or win substantial damage awards.').

FN4. [Tellabs, 127 S.Ct. at 2510](#).

FN5. [Id. at 2509](#).

FN6. *Id.*

FN7. *Id.*

FN8. *Id.* at 2510.

FN9. Id. (emphasis added).

FN10. See id. at 2510 n.5.

FN11. Id.

FN12. Id. at 2510.

FN13. [Novak v. Kasaks](#), 216 F.3d 300, 307 (2d Cir. 2000).

FN14. [Id. at 308](#).

FN15. See, e.g. In re JPMorgan Chase Sec. Litig., 02 Civ. 1282 (SHS), 2007 U.S. Dist. LEXIS 22948, 37-39 (S.D.N.Y. March 29, 2007); [Jordan \(Berm.\) Inv. Co. v. Hunter Green Invs. Ltd.](#), 205 F.Supp. 2d 243, 253 (S.D.N.Y. 2002).

FN16. See [Kalnit v. Eichler](#), 85 F.Supp.2d 232, 243 (S.D.N.Y. 1999).

FN17. See, e.g., [In re Alstom SA Sec. Litig.](#), 454 F.Supp.2d 187, 196, 208 (S.D.N.Y. 2006) (noting that at the motion to dismiss stage the court must accept as true all factual allegations in the complaint, the court found a strong inference of scienter when weighing 'the totality of the facts'); [In re Mercator Software Inc. Sec. Litig.](#), 161 F.Supp.2d 143, 150 (D. Conn. 2001) (finding that 'when the allegations of the amended complaint, which [the court] accept[s] as true for purposes of this motion, are read in their totality, plaintiffs have alleged sufficient facts from which a reasonable jury could find reckless conduct on the part of the defendants. This is sufficient to meet the pleading standards for scienter in the Second Circuit').

FN18. [Tellabs](#), 127 S.Ct. at 2509.

FN19. See, e.g., Alstom, 454 F.Supp. at 207-208 (considering the weight of competing plausible inference in deciding whether plaintiffs sufficiently alleged scienter).

FN20. [Tellabs](#), 127 S.Ct. at 2507 n.3.

FN21. [Id. at 2511](#).

FN22. Id.

FN23. See, e.g., [Hart v. Internet Wire Inc.](#), 50 Fed.Appx. 464, 466 (2d Cir. 2002); [Kalnit v. Eichler](#), 264 F.3d 131, 142 (2d Cir. 2001) ('Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater. '); [In re Nokia Oyj Sec. Litig.](#), 423 F.Supp.2d 364, 403 (S.D.N.Y. 2006).

FN24. In re Tommy Hilfiger, Sec. Litig., 04-civ-7678, 2007 U.S. Dist. LEXIS 55088, at *10 (S.D.N.Y. July 20, 2007).

FN25. Id. at *10-*11.

FN26. *In re Xethanol Corp. Sec. Litig.*, 06 Civ. 10234 (HB), 2007 U.S. Dist. LEXIS 65935, at *9 (S.D.N.Y. Sept. 7, 2007).

FN27. *Id.* at *11.

FN28. [In re Scottish re Group Sec. Litig.](#), 524 F.Supp.2d 370, 393-394 (S.D.N.Y. 2007).

FN29. See, e.g., *In re Tower Auto. Secs. Litig.*, 05 Civ. 1926 (RWS), 2008 U.S. Dist. LEXIS 16056 (S.D.N.Y. March 3, 2008) (holding that 'an inference of fraudulent intent at least, as compelling as any opposing non-fraudulent inference' was established); [SEC v. Collins & Aikman Corp.](#), 524 F.Supp.2d 477 (S.D.N.Y. 2007) (denying motion to dismiss because the allegations in the complaint were 'more than adequate to plead scienter even under the heightened standards imposed by the Supreme Court in *Tellabs*); [In re Top Tankers Inc. Sec. Litig.](#), 528 F.Supp.2d 408 (S.D.N.Y. 2007) (denying the motion to dismiss the court stated that notwithstanding *Tellabs*, the court may 'not weigh the evidence that might be presented at trial' on a motion to dismiss); *In re Converium Holding AG Secs. Litig.*, 04 Civ. 7897 (DLC), 2007 U.S. Dist. LEXIS 67660 (S.D.N.Y. Sept. 14, 2007) (holding that the inference of scienter raised by plaintiffs was 'at least as compelling as any opposing inference one could draw from the facts alleged.').

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