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REPORT

Antifraud

Tellabs, Inc. v. Makor—The Problem of Pleading Fraudulent Intent

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Last month, the Supreme Court agreed to resolve a remarkably stark circuit split regarding the proper interpretation of a seemingly simple provision in the Private Securities Litigation Reform Act of 1995 (the "PSLRA" or the "Act"). The provision at issue requires a private plaintiff who asserts a securities fraud claim under the Securities and Exchange Act of 1934 (the "1934 Act") to "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind."[1] (emphasis supplied).

This provision dramatically raised the bar for pleading a securities fraud claim. First, it requires the complaint to plead facts concerning the defendant's state of mind "with particularity." This requirement supersedes Fed. R. Civ. P. 9(b), which, in common-law fraud claims, requires particularized pleading of "the circumstances constituting fraud"—such as the content of the fraudulent statement, the speaker, and the date—but expressly permits "malice, intent, knowledge, and other condition of mind of a person [to] be averred generally." Since it is difficult to plead facts concerning a defendant's state of mind before discovery, this particularity provision should deter weak securities fraud lawsuits even before consideration of the second italicized portion of this provision—the "strong inference" language.

Whether and to what extent the "strong inference" language further heightens the pleading standard has split the various courts of appeal. Four circuits have interpreted the PSLRA's "strong inference" standard as an additional requirement that changes the operation of inferences that is ordinarily applicable to a motion to dismiss under Fed. R. Civ. P. 12(b)(6). These four courts of appeal have held that instead of drawing all reasonable inferences in favor of the plaintiff, as courts are generally required to do on a motion to dismiss,[2] courts must require a securities fraud complaint to allege facts from which fraudulent intent is the "most plausible inference." This pro-defendant standard can eliminate even colorable claims at the pleading stage, without giving the plaintiff the benefit of discovery that might strengthen those claims.

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[3] the case under review, the Court of Appeals for the Seventh Circuit noted that depriving the plaintiff of the benefit of reasonable inferences in deciding a motion to dismiss "could potentially infringe the plaintiff's Seventh

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[1] 15 U.S.C. 78u-4(b)(2).

[2] *See, e.g., Markowitz v. Northeast Land Co.*, 906 F.2d 100, 103 (3d Cir. 1990); *Massey v. Merrill Lynch & Co., Inc.*, 464 F.3d 642, 645 (7th Cir. 2006).

[3] 437 F.3d 588 (7th Cir. 2006), *cert. granted* 127 S. Ct. 853, 75 U.S.L.W. 3207 (U.S. Jan. 5, 2007) (No. 06-484).

Amendment right'' to a trial by jury. The court was concerned that such an interpretation of the ''strong inference'' language could cause a district court to dismiss a securities fraud claim on the pleadings even though the same allegations, if supported by evidence, would be sufficient to survive summary judgment and go to a jury. To avoid this arguably perverse result, the Seventh Circuit held that the ''strong inference'' language does not require a court to weigh competing inferences when deciding a motion to dismiss. With minor variations, several other circuits have similarly held that the ''strong inference'' language does not require them to determine whether the plaintiff's inference of fraudulent intent is the ''most plausible'' inference. These interpretations of the statutory language are more favorable to plaintiffs, and arguably read the ''strong inference'' language out of the statute.

The Supreme Court has granted certiorari to resolve this obvious inconsistency among the circuits.[4] The question presented in the petition for certiorari is ''[w]hether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a 'strong inference' that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.''[5]

This issue is tremendously important. There is a world of difference between giving a plaintiff the benefit of every reasonable inference, on the one hand, and requiring the plaintiff to plead facts giving rise to the most plausible inference, on the other. Securities fraud cases require the plaintiff to plead the defendant's fraudulent intent, meaning either intentional wrongdoing or recklessness, the latter of which has been defined as ''an extreme departure from the standards of ordinary care . . . that is either known to the defendant or so obvious that the actor must have been aware of it.''[6] Since this fact-intensive issue requires the court to consider circumstantial evidence and the inferences from that circumstantial evidence, the process that courts use to decide this question may be outcome-determinative to many securities fraud claims.

The Purpose of the PSLRA. The PSLRA was designed to curb frivolous and abusive securities fraud lawsuits, especially class actions, which Congress believed had the potential to undermine confidence in the U.S. capital markets and increase the cost of capital.[7] Congress was concerned that it was too easy to plead fraud by hindsight whenever, for example, a corporation's stock dropped in price after its officers had made optimistic but ultimately incorrect public statements.[8] Moreover, discovery costs were so burdensome in these cases that even blameless defendants were forced to settle cases for large sums.[9] To combat these and other problems, the Act includes a number of important provisions concerning securities fraud lawsuits, such as mandating an automatic stay pending the court's decision on the motion to dismiss,[10] creating a ''safe harbor'' for certain forward-looking statements,[11] and providing for proportionate rather than joint and several liability for most violations.[12]

The Second and Third Circuits' Two-Pronged Approach. A crucial feature of the PSLRA is the provision stating that the plaintiff in any private action under the 1934 Act must plead ''with particularity'' facts that establish a ''strong inference'' that the defendant acted with scienter. Since the ''strong inference'' terminology in the PSLRA was derived from pre-PSLRA Second Circuit opinions requiring scienter allegations to ''give rise to a strong inference of fraudulent intent,''[13] the Court of Appeals for the Second Circuit has held that this provision requires it to use the same standard for determining scienter that it used before passage of the PSLRA.[14] Likewise, the Third Circuit has held ''that Congress's use of the Second Circuit's language compels the conclusion that the [PSLRA] establishes a pleading standard approximately equal in stringency to that of the Second Circuit'' prior to the PSLRA.[15] And since the Second Circuit's standard was considered the toughest before passage of the PSLRA, the use of that standard appears to accord with the pro-defendant purpose of the Act.

Even before the passage of the PSLRA, the Second Circuit was concerned that ''the relaxation of Rule 9(b)'s specificity requirement regarding condition of mind [could give plaintiffs] license to base claims of fraud on speculation and conclusory allegations.''[16] To prevent such a result, courts in the Second Circuit held that securities fraud ''plaintiffs must allege facts that give rise to a strong inference of fraudulent intent.''[17] The Second Circuit made it clear, however, that this ''strong inference'' standard was intended to compensate for the lack of a particularity requirement, not to supplement such a requirement: It stated that although fraudulent intent ''need not be plead with 'great specificity,' the facts alleged in the complaint must 'give rise to a ''strong inference'' of fraudulent intent.' ''[18] Before passage of the PSLRA, the Second Circuit did not specify the meaning of this ''strong inference'' standard.[19]

[4] Two federal circuits, the Fifth and the Eleventh, have not published opinions explaining their understanding of the ''strong inference'' requirement.

[5] Petition for a Writ of Certiorari, *Tellabs, Inc. v. Makor, Issues & Rights, Ltd., dated Oct. 3, 2006.*

[6] *Makor*, 437 F.3d at 600 (internal citation omitted).

[7] H.R. Rep. No. 104-369 (Nov. 28, 1995), at *31-32.

[8] *Id.* at *31.

[9] *Id.*

[10] 15 U.S.C. 78 u-4(b)(3)(B).

[11] 15 U.S.C. 78 u-5.

[12] 15 U.S.C. 78u-4(f)(2)(B)(i).

[13] H.R. Rep. No. 104-369 (Nov. 28, 1995), at *41 (''Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent'').

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

[15] *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

[16] *Acito v. IMCERA Group*, 47 F.3d 47, 52 (2nd Cir. 1995).

[17] *Id.*

[18] *Id* at 53.

[19] The Second Circuit further held that in determining whether the plaintiff's allegations met this standard, the court should sort the allegations into two categories—(1) allegations that the defendant had the ''motive and opportunity'' to commit fraud, and (2) allegations that constitute ''strong circumstantial evidence of conscious or reckless misbehavior'' by the defendant—either of which could satisfy the ''strong inference'' standard. *Kalnit v.* Eichler, 264 F.3d 131, 138 (2d Cir. 2001). Most courts have held, however, that it is artificial to

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In the PSLRA, however, Congress chose to include both an express particularity requirement and the "strong inference" language. Congress's use of both terms arguably suggests that it intended to set the bar even higher than the Second Circuit's pre-PSLRA standard. In post-PSLRA litigation, however, the Second and Third Circuits have adhered to the Second Circuit's earlier standard and declined to attach any independent significance to the "strong inference" language.[20] This reading can be criticized as a vestige of the Second Circuit's pre-PSLRA test, rather than a faithful reading of the statute as written.

The Eighth and Tenth Circuits' Interpretation. Like the Second and Third Circuits, the Eighth and Tenth Circuits have not interpreted the "strong inference" language to require the court to weigh inferences on a motion to dismiss differently from the ordinary operation of Fed. R. Civ. P. 12(b)(6). In these circuits, courts simply examine all the allegations in the complaint and decide whether they create a "strong" inference of scienter.

For example, in *Pirraglia v. Novell, Inc.*,[21] the Court of Appeals for the Tenth Circuit carefully considered whether the "strong inference" language required it to account for inferences in favor of the defendants and weigh those inferences to determine whether the inferences requested by the plaintiffs were the "most plausible." The Court of Appeals held that its "role at the 12(b)(6) stage is simply to determine whether the plaintiff raises a strong inference of scienter," a process that "does not involve a 'weighing of the plaintiff's suggested inferrence against other inferences." Thus, if the court is "[f]aced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail."[22] "If a plaintiff pleads facts with particularity that, in the overall context of the pleadings, including potentially negative inferences, give rise to a strong inference of scienter, the scienter requirement of the Reform Act is satisfied."[23]

Thus, the Tenth Circuit held that the "strong inference" requirement does not change the operation of inferences on a motion to dismiss, but instead modifies the "particularity" requirement itself. There is some logic to this reading. Although the meaning of Rule 9(b)'s particularity requirement is well-settled as applied to the other aspects of a fraud—the speaker, date, and place of the misrepresentations or omissions—there is no common law applying the particularity requirement to a defendant's "state of mind." And since "state of mind" is generally a matter of circumstantial rather than direct evidence, there is a danger in allowing plaintiffs too much leeway to infer fraudulent intent from circumstantial evidence.

To prevent this problem, the Court of Appeals read the "strong inference" requirement to preclude plaintiffs from relying only on weak circumstantial evidence of fraudulent intent, without working a wholesale deprivation of the inferences to which plaintiffs are ordinarily entitled on a motion to dismiss. This reading of the statute arguably gives meaning to all the words of the PSLRA's provision and furthers the congressional intent in legislating that provision in the first place.

As a practical matter, however, this decision gives the district courts scant guidance on how to determine whether a plaintiff's allegations are "strong." As a result, it is unclear whether the "strong inference" aspect of the statute has any real substance in these circuits.

The First, Fourth, Sixth, and Ninth Circuit's Interpretation. Four other circuits have construed the "strong inference" language to have far greater significance. The Court of Appeals for the Sixth Circuit, for example, has held that the provision changes the normal operation of inferences on a motion to dismiss. In particular, that Court held that the plaintiff must plead facts leading to inferences of scienter that are not "merely reasonable, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6) . . . [, but] are both reasonable and 'strong.' "[24]

The Sixth Circuit has gone on to define a "strong inference" by holding that under this standard, "plaintiffs are entitled to only the most plausible of competing inferences."[25] Thus, if the complaint contains facts relevant to scienter that are consistent with both an innocent explanation (the defendant made a genuine mistake in business judgment) and a damning one (the defendant intended to deceive shareholders), the plaintiff is entitled to the damning one only if it is more persuasive than any other inference. Notably, the Sixth Circuit has insisted that this standard does "not reverse the polarity of securities pleading" or deprive plaintiffs of inferences to which they are generally entitled under Rule 12(b)(6), but it seems to do just that.

The Sixth Circuit's test has been adopted in substance (though not verbatim) by courts of appeal for the First Circuit[26] ("[s]cienter 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"), the Fourth Circuit[27] (complaint fails to establish a strong inference of scienter where the defendants' actions are "more consistent with negligence than with recklessness or intent"), and the Ninth Circuit[28] (court must consider innocent and guilty inferences and deny a motion to dis-

separate "motive and opportunity" from the other factors evidencing fraudulent intent, and that the court should consider these factors in the totality of its inquiry on this question. *See, e.g., In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir. 2001). This issue does not appear to be embraced within the question presented for the Supreme Court's review.

[20] *Rombach v. Chang*, 355 F.3d 164, 176 (2d Cir. 2004); *but see In re Digital Island Secs. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004) (stating in dictum that "strong inference" provision "alters the normal operation of inferences" for a motion to dismiss under Rule 12(b)(6)).

[21] 339 F.3d 1182 (10th Cir. 2003).

[22] *Id.* at 1188.

[23] *Id.*; *see also In re K-tel Int'l Inc. Securities Litig.*, 300 F.3d 881, 889 n. 6 (8th Cir. 2002) (declining to adopt the view that plaintiffs are entitled only to "the most plausible of competing inferences").

[24] *Helwig*, 251 F.3d at 551 (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999)).

[25] *Id.* at 553.

[26] *In re Credit Suisse First Boston Corp,* 431 F.3d 36, 49 (1st Cir. 2005).

[27] *Ottman v, Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 349 (4th Cir. 2003).

[28] *Gompper v. VISX*, 298 F.3d 893, 897 (9th Cir. 2002).

miss if "it is equally if not more plausible" that defendants did not act with scienter).[29]

The Sixth Circuit's reading of the "strong inference" standard serves the Congressional intent to limit weak securities claims at the outset, and gives district courts meaningful guidance how to apply that standard. In fact, this approach makes the "strong inference" language even more important than the particularity requirement because it eliminates a whole class of securities fraud cases where the plaintiff cannot muster persuasive evidence of fraudulent intent without discovery.

The Case Under Review. In *Tellabs, Inc. v. Makor*, the case now before the Supreme Court, the Court of Appeals for the Seventh Circuit declined to follow the Sixth Circuit standard. The Seventh Circuit was concerned that the standard used by these other circuits "could potentially infringe upon plaintiffs' Seventh Amendment rights" to a trial by jury, and cited a different Sixth Circuit case which noted, "One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented." [30]

Although the Seventh Circuit in *Makor* did not find a Seventh Amendment violation or even analyze the Seventh Amendment issue, its cryptic statement refers to a paradox created by application of the Sixth Circuit's standard. Since the Sixth Circuit standard gives the plaintiff the benefit of only the "most plausible inference" at the motion to dismiss stage, but the plaintiff still has the benefit of any "reasonable inference" at the summary judgment stage,[31] a factual scenario that would be sufficient to survive summary judgment could nevertheless be dismissed on the pleadings. Thus, the Sixth Circuit standard requires plaintiffs to allege a stronger case at the motion to dismiss stage than they are required to prove after obtaining discovery.

To avoid this perverse result, the Seventh Circuit decided that it would be "wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role."[32] To this end, the Court of Appeals held that it "will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that that the defendant acted with the required intent."[33]

The problem with this holding is that it posits a standard of review that is essentially the same as the ordinary standard of review under Rule 12(b)(6). Thus, although the Seventh Circuit has acknowledged that the PSLRA provision "unequivocally raises the bar for pleading scienter" even beyond the particularity requirement of Rule 9(b),[34] the Seventh Circuit's holding drains the "strong inference" language of any substance, and renders the PSLRA provision indistinguishable from the typical particularity requirement.[35]

The Seventh Circuit's off-hand reference to the Seventh Amendment is also problematic. Although the Court of Appeals claimed that it was not deciding that constitutional issue, its toothless reading of the provision declared the Sixth Circuit's interpretation unconstitutional as a practical matter. This holding arguably constitutionalizes the standard of review applicable to motions to dismiss under Rule 12(b)(6), a proposition for which there is no authority. In fact, since it is well-settled that the resolution of a case prior to trial via summary judgment does not present a Seventh Amendment problem,[36] it would be difficult to argue that changing the standard of review on a motion to dismiss could work such a violation.

The Supreme Court's Choice. At the end of the day, the Supreme Court will be forced to choose between imperfect interpretations of the "strong inference" language. If the Supreme Court reads the "strong inference" language as mandating a requirement above and beyond the "particularity" requirement, then it will have the effect of changing the substantive standard for plaintiffs to establish liability, rather than changing just the pleading standard. This reading is inconsistent with the provision's facial application only to the complaint. On the other hand, if the Supreme Court reads the particularity requirement and the "strong inference" language together, as a single requirement, then the "strong inference" language would arguably be superfluous, violating a fundamental rule of statutory construction. Despite the apparent simplicity of the PSLRA provision at issue, no interpretation is perfectly faithful to its language.

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[29] The Ninth Circuit, alone among the courts of appeal, has held that the PSLRA altered the substantive law of scienter (in addition to the pleading standard) by requiring the plaintiff to allege intentional fraud or "deliberate recklessness" rather than ordinary recklessness. *In re Silicon Graphics Secs. Litig*., 183 F.3d 970, 977 (9th Cir. 1999). This question does not appear to be embraced within the grant of certiorari.

[30] *Makor*, 437 F.3d at 602, quoting *City of Monroe Employees Ret. Sys. v. Bridgestone Corp*., 399 F.3d 651, 683 n. 25 (6th Cir. 2005).

[31] *Atlantic Richfield Co. v. USA Petroleum Co.,* 495 U.S. 328, 332 n.2 (1990).

[32] *Makor*, 437 F.3d at 602.

[33] *Id*.

[34] *Id*. at 601.

[35] *Gompper*, 298 F.3d at 896-97 ("To accept plantiffs' argument that the court is required to consider only inferences favorable to their position would be to eviscerate the PSLRA's strong inference requirement . . . [and] thwart Congress' basic purpose in raising the bar in the first place").

[36] *Fid. & Deposit Co. v. United States*, 187 U.S. 315, 320 (1902).

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