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A Balanced Decision in *Tellabs*? The Supreme Court Sets the Pleading Standard for Securities Fraud

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On June 21, 2007, the United States Supreme Court issued a decision in *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, which is not nearly as harmful to investor rights as early media reports have portrayed. In *Tellabs*, the Supreme Court interpreted the pleading standard that plaintiffs in securities fraud cases must satisfy under the Private Securities Litigation Reform Act of 1995 ("PSLRA") with respect to scienter, that is, defendants' fraudulent state of mind. Bernstein Litowitz Berger & Grossmann LLP filed a friend of the court brief on behalf of a number of our public pension fund clients in this case. The U.S. Chamber of Commerce and other corporate interest groups filed numerous friend of the court briefs urging the Court to set the pleading standard so high that many meritorious cases would be dismissed. The majority of the Justices declined to do so and instead preserved investors' right to bring meritorious cases.

In an opinion written by Justice Ruth Bader Ginsburg and joined by Chief Justice Roberts and Justices Kennedy, Souter, Thomas, and Breyer, the Court carefully balanced "the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims." We believe that the Court's decision is favorable for investor rights in three important respects.

First, the Court adopted a reasonable interpretation of the PSLRA, which requires the complaint in every securities fraud case to "state with particularity facts giving rise to a strong inference that defendants acted with the required state of mind." The Court rejected the invitation by the *Tellabs* defendants and corpo-

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rate interest groups, which asked the Court to rule that a securities fraud complaint must allege facts so strong that the inference of defendants' guilty state of mind is stronger than any competing inference that defendants acted innocently, or even that the alleged facts must be so strong that the inference of fraudulent intent is the strongest or most plausible inference. If the Court had accepted the defendants' and corporate interest groups' arguments, many meritorious securities fraud cases would have been vulnerable to dismissal.

Instead, the Court held that a complaint should not be dismissed "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 added). In other words, if "the inference of scienter [is] *at least as strong* as any opposing inference," the complaint should not be dismissed (emphasis added). We believe that this standard will permit meritorious

cases to survive motions to dismiss, while allowing dismissal of meritless cases.

Second, the Court's decision in *Tellabs* repeatedly recognizes that private securities litigation vindicates investors' rights and provides an important supplement to governmental enforcement of the securities laws by the Securities and Exchange Commission and the Justice Department. The Court wrote that "private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses — a matter crucial to the integrity of domestic capital markets." None of the Justices — not even Justices Scalia and Alito, who wrote separate opinions favoring a more pro-defendant pleading standard than the majority — echoed the anti-investor rhetoric of the business groups' briefs that portrayed private securities fraud litigation as harmful to the economy and ineffective in maintaining fair and efficient capital markets. The Court's recognition that meritorious investor lawsuits serve the legitimate purposes of deterring fraud and compensating victims of fraud is a significant check to the anti-investor campaign that special interests are currently waging.

Finally, the Court recognized that the PSLRA "aimed to increase the likelihood that institutional investors — parties more likely to balance the interests of the class with the long-term interests of the company — would serve as lead

plaintiffs." The Supreme Court's recognition of the vital role of institutional investors in securities litigation should encourage the trend among institutions to seek leadership of securities class actions, and among the district courts to appoint responsible institutions as lead plaintiffs to protect investors' interests.

Some media reports about the *Tellabs* decision have portrayed it as a blow to investor rights, because the Supreme Court reversed a lower federal appeals court ruling in favor of the plaintiffs and held that plaintiffs must plead "cogent" and "compelling" facts supporting the inference that defendants acted with scienter. However, the Supreme Court did not dismiss the case, but rather sent it back to the lower courts to determine whether the complaint satisfies the Supreme Court's interpretation of the PSLRA's pleading standard. Furthermore, the Supreme Court expressly rejected one federal appeals court's pro-defendant interpretation of the PSLRA, which held that the inference of scienter from the facts alleged in the complaint must be the "most plausible" of all possible inferences. The Supreme Court's own interpretation of the PSLRA is more balanced and fair to both plaintiffs and defendants. The lower courts will be applying the *Tellabs* standard in every federal securities fraud case from now on, and it remains to be seen what impact it will have. On the whole, we believe that *Tellabs* could have been better for investors but, it also could

have been much worse. Fortunately, for investors, the decision does not raise the barrier for securities fraud cases unreasonably high, and meritorious cases should continue to survive motions to dismiss and preserve the rights of investors to seek redress in the courts.

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