



TELLABS, INC. v. MAKOR

WILL IT MAKE A DIFFERENCE?

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Congress passed the Private Securities Litigation Reform Act over eleven years ago to curb abuses in securities fraud class actions. The Act requires a plaintiff to state with particularity facts giving rise to a “strong inference” of scienter or fraudulent intent on the part of each defendant to survive a motion to dismiss. 15 U.S.C. § 78u-4(b)(2). On June 21, 2007, the Supreme Court issued its first decision on this pleading requirement: *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

The Tellabs Holding. In *Tellabs*, the Supreme Court resolved an existing split among the Circuits on whether inferences favorable to a defendant must be considered in ruling on a motion to dismiss. The Court held that “a [district] court must consider [all] plausible nonculpable explanations for the defendant’s conduct, as well as inferences favoring the plaintiff.” *Id.* at 2510. To qualify as “strong” under the Reform Act, “an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” *Id.* at 2504-05. In the wake of this ruling, commentators speculated on how *Tellabs* might affect motions to dismiss in securities cases. As discussed below, several recent cases applying *Tellabs* have given us insight on what we can expect going forward. These cases demonstrate that defendants have already begun to derive significant benefits from the *Tellabs* decision.

A Weapon to Fight Conclusory Allegations and Speculation. *Tellabs* presents defendants with another weapon aimed at the dismissal of cases premised on generalized speculation. *Tellabs* directs that “omissions and ambiguities [in the plaintiffs’ allegations] count against inferring scienter,” because the Reform Act requires claims to be pled with particularity. *Id.* at 2511. Relying on *Tellabs*, courts have rejected vague and conclusory allegations of purported knowledge by the defendants and, in particular, have demonstrated an increased willingness to scrutinize claims pending against the individual defendants.¹

For example, in *Jaffee v. The Home Depot, Inc.*, No. 1:06-CV-1617-ODE, slip op. (N.D. Ga. July 18, 2007), claims against all defendants were dismissed for failure to plead scienter under *Tellabs*. The complaint “d[id] no more than infer that ‘someone’ in the ‘management’ of [the company] had to know about the scheme.” *Id.* at 17. There were no allegations that the supposed misconduct was “communicated up the corporate chain of command to the individually-named [d]efendants or any other members of senior management who were responsible for preparing the public statements [p]laintiffs have alleged contained false and misleading information.” *Id.* at 8. Dismissal was required because, even under the most liberal

¹This trend is beneficial to all defendants in the case. The Reform Act requires that scienter be pled as to each defendant and each alleged misstatement separately. *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1016-18 (11th Cir. 2004). If the plaintiffs are unable to plead scienter as to any of the individual defendants (*i.e.*, the officers and directors of the company at issue), then the entire case should be dismissed. A corporation can only act through its employees and, under this scenario, there is no scienter that could be imputed to the corporate defendant. See, *e.g.*, *In re Hutchinson Tech. Inc. Sec. Litig.*, No. 05-CV-2095 (PJS/JJG), 2007 U.S. Dist. LEXIS 40622, at *44-*45 (D. Minn. June 4, 2007).

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reading of the complaint, plaintiffs had not alleged facts demonstrating scienter with respect to each defendant in the action. *Id.* at 17-18. *Tellabs* directs courts to perform precisely this type of analysis in determining whether scienter has been pled.

Relying on Inferences from Other Source Materials Outside of the Complaint. *Tellabs* also made clear that courts should consider, not only those inferences from the complaint favorable to defendants, but also inferences available from other sources ordinarily examined when ruling on motions to dismiss, such as documents incorporated by reference into the complaint, SEC filings, and other matters of public record that are susceptible to judicial notice. *Tellabs*, 127 S. Ct. at 2509. A defendant's ability to rely on other source materials has proven to be very important in securities cases, particularly for the purpose of establishing the competing inferences that must be considered.

Tellabs makes clear that defendants will not be limited to the four corners of the complaint – an important safeguard in these cases. Plaintiffs have every incentive to omit those public record facts that undercut an inference of scienter. Under *Tellabs*, plaintiffs will not be allowed to prevail simply because they have attempted to plead around facts contrary to their cause.

Use of Confidential Informants Rejected Under Tellabs. For scienter purposes, plaintiffs often rely on information allegedly received from “confidential informants,” who purport to be former employees of the company at issue. The Seventh Circuit found that *Tellabs* calls into question this common practice. *See Higginbotham v. Baxter Intern., Inc.*, No. 06-1312, 2007 WL 2142298, at *2-*3 (7th Cir. July 27, 2007). *Tellabs* requires a court to “discount” allegations purportedly derived from informants and this discount will usually be “steep.” *Id.* at *3. It is “hard to see how information from anonymous sources could be deemed ‘compelling’ or how [a court] could take account of plausible opposing inferences” as required under *Tellabs*. *Id.* at *2. Confidential sources could have axes to grind, be lying, or perhaps do not even exist. *Id.* *Tellabs* provides defendants with another means to attack this highly suspect, but nevertheless common, pleading tactic. *See id.* at *2-*3; *see also Jaffee*, slip op. at 17-18.

Facilitating Greater Scrutiny of Stock Sales Allegations. Plaintiffs often attempt to plead scienter through a defendant's stock sales during the alleged class period. They argue that the sales were motivated by a defendant's alleged desire to “cash out” of the stock before adverse facts about the company were revealed to investors. Where other benign inferences are available regarding these sales (or the lack of sales), *Tellabs* requires that they must be considered in ruling on a motion to dismiss.

For example, a court recently held that plaintiffs failed to plead scienter under *Tellabs* by relying on stock sales made pursuant to SEC Rule 10b5-1. *See Elam v. Neidorff*, No. 4:06CV1142 CDP, 2007 WL 1880747, at *4-*5 (E.D. Mo. June 29, 2007). Rule 10b5-1 was adopted by the SEC to allow executives to trade in company stock via a pre-determined plan and thereby avoid second-guessing as to what possibly motivated their sales. The court held that merely pointing to stock sales made pursuant to Rule 10b5-1 is insufficient to plead scienter, particularly where plaintiffs fail to allege facts that would show these pre-arranged sales were unusual in any respect. *Id.* at *5. In *Elam*, as is often true in securities cases, the plaintiffs omitted any information on the defendants' prior sales history or even the total number of shares held by each, which precludes a strong inference. *Id.* *Tellabs* directs that the omitted information about overall trading practices must be considered and defendants are entitled to bring this information to the court's attention through the appropriate SEC filings. *Id.*; *see also Tellabs*, 127 S. Ct. at 2509. In this respect, *Tellabs* prevents plaintiffs from pleading scienter based solely on the fact that some stock sales took place during the proposed class period.

Conclusion. *Tellabs* preserves both the letter and the spirit of the reforms instituted by Congress in 1995. The Supreme Court properly rejected the more liberal view that any reasonable or rationale inference should suffice, which would have read the word “strong” out of the statute and returned litigants to pre-Reform Act standards. Courts have begun to embrace the *Tellabs* standard and are using that decision to perform the type of exacting analysis of securities fraud allegations that Congress originally intended.