TELLABS, INC. V. MAKOR ISSUES & RIGHTS, LTD.—HOW THE RULING WILL AFFECT SECURITIES LITIGATION

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Abstract

Tellabs v. Makor Issues and Rights *is potentially the most significant securities litigation decision by the Supreme Court in years. It was hoped that the Supreme Court would clear up what it meant to give a "strong inference of the required state of mind" when pleading securities fraud under the Private Securities Litigation Reform Act ("PSLRA"). This Note suggests that the Supreme Court decision fell short of this hope.*

The standard the Supreme Court established in Tellabs *is significant because it is the language that every litigator must now use to establish a securities fraud claim. However, the Supreme Court took a neutral stance in declaring:*

"To qualify as "strong". . . we hold, 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."

This Note looks at how the securities community reacted to the Tellabs decision, noting that both potential plaintiffs and potential defendants believed that the ruling came down in their favor, and that many commentators acknowledged that the ruling left more to be desired.

I. INTRODUCTION

"In our view, public companies today must be more mature and sophisticated, have a more substantial administrative infrastructure and expend substantially more resources simply to comply with the increased securities regulatory burden."[1] This seems to be the issue of the hour in

[1] FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION (April 23, 2006), http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

American business. Are we over-regulating our corporations? Are we leaving our shareholders out to dry?

One way to affect the ease of litigation is to change the pleading requirements. Generally, in a complaint at the beginning of litigation, there only needs to be a "short and plain statement" alleging the wrongdoing.[2] For securities litigation, the standard has always been a little higher. As Christopher Keller and Michael Stocker explained, "[u]nder the former regime established by the Federal Rules of Civil Procedure in 1938, plaintiffs alleging fraud were required to plead with specificity the 'circumstances constituting fraud,' but could plead the requisite state of mind on a simple notice basis."[3] Securities pleadings standards have been a source of confusion among lawyers and judges.

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA").[4] In addition to adding several requirements, this Act placed one large hurdle at the start of any litigation for the plaintiffs. Plaintiffs in a securities fraud action cannot obtain discovery until the Court has first decided if it is going to dismiss the complaint.[5] This is just one example of the serious regulations that Congress placed on both sides of the recent securities litigation. The PSLRA left room for interpretation.

In June 2007, the Supreme Court attempted to define the level of scienter that a pleading must allege for a 10b-5 action to make it past the pleading stage. The case, *Tellabs v. Makor Issues & Rights*[6] sets a standard for what judges need to look for to determine if a fraud allegation will make it to the next level of litigation. As of March 17, 2008, more than one hundred decisions in the lower federal courts have referred to the *Tellabs* decision.[7] This case is an important part of the future of securities litigation and it will change the manner in which both the plaintiffs and the defendants approach a securities lawsuit.

This Note attempts to synthesize what has happened since the ruling, how the securities community has reacted, and what the fears for the future are from the eyes of potential litigants. *Tellabs* certainly changed the definition of "strong inference," but it left a lot to be desired. This Note first summarizes the reactions to *Tellabs,* and looks at whether the ruling helps or hurts corporations. This Note then attempts to illuminate some of the issues that remain despite *Tellabs.* Finally, this Note looks at Justice

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[2] FED. R. CIV. P. 8 (a) (2).

[3] Christopher J. Keller & Michael W. Stocker, *'Tellabs': PSLRA Pleading Test Comparative, Not Absolute,* N.Y.L.J., Oct. 3, 2007, at 4.

[4] Private Securities Litigation Reform Act of 1995, 48 Stat. 88 (codified at 15 U.S.C.§§ 77z-78u (2006)).

[5] James Spellman, *A 'Right' Move by US Supreme Court in Fraud Cases,* FINANCIAL ADVISER, Aug. 16, 2007, at 3.

[6] Tellabs, Inc. v. Makor Issues & Rights, Ltd, 127 S. Ct. 2499, 2508 (2007).

[7] John P. Stigi III & Martin White, *Courts Interpret 'Tellabs,* NAT'L. L. J., March 17, 2008 .

Stevens' dissent to the *Tellabs* opinion as a potentially more coherent alternative to the majority opinion.

II. BACKGROUND

There has been a constant debate about the ease with which shareholders can bring lawsuits against the company in which they own shares.[8] By the early 1990s Congress saw that the amount and cost of this type of securities litigation was getting out of control, and in 1995 Congress passed into law the PSLRA.[9] The purpose of the PSLRA was two-fold: Congress wanted "to curb frivolous lawyer driven litigation while preserving investor's ability to recover on meritorious claims."[10] Congress used the PSLRA as a vehicle to reduce the large quantity and ensuing expense of litigation while attempting to maintain shareholders' power to bring suit.

One of the ways the PSLRA made it more difficult for shareholders to file frivolous lawsuits was by tightening the requirements for pleadings in securities litigation.[11] Corporations faced with lawsuits from their shareholders regarding a 10b-5 violation can file a 12(b)(6) motion to dismiss.[12] These motions suggest that the plaintiff has not offered enough in the pleadings to meet the heightened requirements for a 10b-5 cause of action. The best outcome for corporations is to end the litigation with a 12(b)(6) decision.

Thus, for most securities lawsuits, judges are faced with determining whether or not the case should proceed to trial based solely on the plaintiffs' pleadings and the defendants' motion to dismiss. Prior to the 1995 PSLRA, this was an extremely contentious issue.[13] As Justice Ginsberg wrote in *Tellabs*, "Setting a uniform pleading standard for § 10(b) actions was among Congress' objectives when it enacted the PSLRA."[14] Today's PSLRA has made great strides in regulating the 10b-5 lawsuits.

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[8] *See generally* Marilyn F. Johnson, et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act,* 23 J.L. ECON & ORG. 627 (2007) and Mary Ann Frantz, Chair, *Annual Review of Federal Securities Regulation: The Subcommittee on Annual Review, Committee of Federal Regulation of Securities, ABA Section of Business Law,* 62 BUS. LAW. 1065 (2007).

[9] Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77z-78u (2006); *See also,* Marc H. Folladori, *Protecting Forward-Looking Statements: The Private Securities Litigation Reform Act of 1995 and Other Safeguards*, PRAC. L. INST., January 4-5, 2007.

[10] Mark D. Wood, *Liability for Securities Law Violations,* PRAC. L. INST. UNDERSTANDING THE SECURITIES LAWS 2007, Sept-Dec. 2007.

[11] *Tellabs,* 127 S. Ct. at 2504.

[12] FED. R. CIV. P. 12(b)(6).

[13] *Tellabs,* 127 S. Ct. at 2508.

[14] *Id.*

Under PSLRA, a plaintiff must clearly establish two points. First, the plaintiff must "specify each statement [made by the corporation] alleged to have been misleading [and] the reason or reasons why the statement is misleading."[15] Second, the plaintiffs must "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind" (emphasis added).[16] It is this second requirement for the pleading that has given courts across the nation so much trouble. Congress failed to indicate what they thought constituted a "strong inference." Thus, circuit courts across the nation have been making their own determinations.

The split among the circuits made a big impact on whether a corporation was going to win or lose their motion to dismiss.[17] The Second Circuit claims that in the 1995 PSLRA, Congress adopted language that the Second Circuit had used in *Shields v. Citytrust Bancorp, Inc.*[18] Believing that Congress intended to adopt their approach to "strong inference," the Second Circuit has stood strictly by their determination that a "strong inference" is shown if the plaintiff pleaded that the members of the defending corporation had "either a motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior."[19] However, this is the view of just one circuit.

The Second Circuit's view appears to be the "middle road" in pleading standards. The Sixth and Seventh Circuits created the polar ends of what is sufficient to prove a "strong inference" of scienter. The Sixth Circuit ruled that "plaintiffs are entitled only to the most plausible of competing inferences," when determining if the complaint is sufficient to impose scienter. The Sixth Circuit clarified that their definition does not mandate that the strong inference be "irrefutable."[20] This was a very strict and corporation friendly standard that suggested plaintiffs could prevail only after a defendant's motion to dismiss if the plaintiff's complaint suggested that the fact that the defendant acted with scienter was the *most convincing* reason that he so acted. For the Sixth Circuit, the allegations in the complaint had to be more convincing than any other possibility to get to the next stage of the litigation.

In *Makor Issues & Rights v. Tellabs*, the Seventh Circuit took the opposite approach. The Seventh Circuit ruled, "We will allow the complaint to survive if it alleges facts from which, if true, a reasonable

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[15] 15 U.S.C. § 78u-4(b)(1) (2006).

[16] 15 U.S.C. § 78u-4(b)(2) (2006). For 10b-5 violations, the "required state of mind" is scienter. *See generally* Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b), 17 C.F.R. § 240.10b-5.

[17] *See Tellabs*, 127 S. Ct. 2499 (2007).

[18] Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994).

[19] Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000) (Again, the required state of mind is "scienter," or "intent to deceive.").

[20] Helwig v. Vencor, Inc., 251 F.3d 540, 553 (6th Cir. 2001) (en banc).

person could infer that the defendant acted with the required intent."[21] This standard is low, and thus friendly to the shareholder. A plaintiff can allege facts, which have to be taken as true,[22] and if *any* reasonable person could believe that the defendant acted with scienter, the motion to dismiss would be denied. This juxtaposition, established by the Sixth and Seventh Circuits, is what sent *Tellabs* to the Supreme Court.[23] Securities litigation needed a pleading standard that was clearer as to how to establish that a member of the defending corporation acted with scienter. The *Tellabs* opinion from June 21, 2007 is the Supreme Court's most recent ruling that tries to carry out the congressionally imposed motives of the PSLRA.

A. *The* Tellabs *Decision*

The facts of *Tellabs* are fairly typical of 10b-5 litigation. Tellabs, Inc. is a "manufacturer of specialized equipment used in fiber optic cable networks."[24] The executives at Tellabs, Inc., specifically CEO Richard Notebaert, made statements between December 2000 and June 2001 that indicated the products and business were doing very well.[25] Notebaert stressed that the TITAN 5500 and the TITAN 6500 were thriving and in high demand.[26] For example, the plaintiffs allege, "[d]uring a conference call on March 8, 2001, in response to an analyst's inquiry whether Tellabs was experiencing 'any weakness there at all' as to the TITAN 5500, Notebaert stated: 'No, we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance.'"[27] Then, on June 19, 2001, Tellabs, Inc. announced a third reduction in their quarterly projections and said it was because the TITAN 5500 was not selling well.[28] Shareholders filed a class action suit alleging fraudulent conduct by the executives of Tellabs, Inc.[29] The District Court dismissed the plaintiff's complaint on Tellabs's motion to dismiss suggesting that "the complaint failed adequately to allege that the defendants met the scienter standard for securities fraud, which requires that they likely intended 'to

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[21] Makor Issues & Rights, Ltd, v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006).
[22] Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit, 507, U.S. 163, 164 (1993).
[23] *Tellabs,* 127 S. Ct. at 2506.
[24] *Makor,* 437 F.3d at 591.
[25] *Id.* at 593; *see also,* www.tellabs.com/about/ (last visited Apr. 8, 2008) (Tellabs claims that it "design[s], develop[s], deploy[s] and support[s] solutions for telecom services providers worldwide.").
[26] *Makor,* 437 F.3d at 593.
[27] Brief for Respondents at 7, *Tellabs, Inc. v. Makor Issues & Rights, Ltd,* 127 S. Ct. 2499, 2504, (2007).
[28] *Makor,* 437 F.3d at 593.
[29] *Id.* at 591-92.

deceive, manipulate, or defraud.'"[30] The Seventh Circuit reversed in part and ruled that a plaintiff's complaint will survive if "*any* reasonable person could believe that the defendant acted with scienter."[31] In light of the Seventh Circuit's ruling and the dichotomy between the Circuits on this issue, the Supreme Court granted writ of certiorari to determine "whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a 'strong inference' of scienter."[32]

The Court attempted to lay out a more uniform standard for judges to use in determining what is an adequate pleading of scienter. The Supreme Court took several of the circuit court decisions into consideration and ruled that, "[t]o qualify as 'strong' . . . we hold, 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."[33] The Supreme Court vacated the Seventh Circuit's ruling and stated that "neither the District Court nor the Court of Appeals had the opportunity to consider the matter in light of the prescriptions we announce today."[34] The Court remanded the case for further proceedings.[35]

This ruling was highly anticipated and was expected to clarify the pleading standards.[36] While it certainly garnered a lot of attention after the June 21, 2007 ruling, it would be a stretch to conclude that the scienter pleading standards have been "clarified."

III. IS THIS RULING CORPORATION-FRIENDLY OR WAS IT A VICTORY FOR THE SHAREHOLDERS?

The first indication that pleading standards were not clarified is that both sides thought they won. Some analysts and practitioners suggest that *Tellabs* was another example of the Roberts Court's kindness toward businesses.[37] The other side adamantly argues that, despite what Tellabs, Inc. claims, this was actually a decision making pleadings easier for shareholders.[38] It is possible the reason *Tellabs* was a successful decision is

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[30] *Id.* at 593.
[31] *Id.* at 602.
[32] *Tellabs,* 127 S. Ct. at 2506.
[33] *Id.* at 2505-06.
[34] *Id.* at 2513.
[35] *Id. See infra,* page 12 for an analysis of the *Tellabs* remand ruling.
[36] *See* Bruce Ericson, *Supreme Court to Clarify Securities Fraud Pleading Standards,* MONDAQ, Jan. 24, 2007, and Brad S. Karp & Christopher Hyde Giampapa, *Supreme Court to Decide PSLRA Pleading Standard,* N.Y.L.J. April 16, 2007 at 1-2.
[37] Michael Orey, *The Supreme Court: Open for Business-The Roberts Court is Showing a Willingness to Referee Corporate Concerns*, BUS. WK., Jul. 9, 2007, at 30; *see also,* Patti Waldmeir, *Investors Angry as Supreme Court Refuses Help*, FT.COM, July 1, 2007.
[38] *Shareholder Lawsuit Ruling A Boon?,* CFO MAG., Jun. 21, 2007, at 6. ("Plaintiff's attorney Barbara Hart of Labaton Sucharow & Rudoff, says that the Supreme Court

because neither side believes they lost. Thus, the Court may have reached its indirect goal to remain neutral in the perpetual clash between shareholders and corporations. However, in doing so, it appears that the Court may not have reached its intended goal of making the standard more uniform.

A. *A Ruling for the Plaintiffs*

Attorney Jeffrey Barrack suggests that several parts of the decision illuminate how the ruling is actually shareholder-friendly.[39] He points to the fact that Justice Ginsburg specifically wrote "that the standard adopted does not force a plaintiff 'to plead more than she would be required to prove at trial.'"[40] Barrack suggests that this is the court leaning toward helping shareholders get past the pleading stage. Also, Barrack suggests that this intent is furthered by the Court's ruling that there does not have to be an allegation of personal gain for the individuals who made the misstatements.[41] On its face, this makes it easier for the shareholders to get a claim past the pleading stages. To not have to prove officers' and directors' personal financial motive during alleged defrauding is one less hurdle for the shareholders.

Christopher Keller and Michael Stocker state, "the Supreme Court effectively dropped the bar as low as it could without eviscerating the language of the 1996 pleading standard for securities cases under the Private Securities Litigation Reform Act of 1995."[42] Keller and Stocker say that this decision is decidedly pro-plaintiff because the plaintiffs only have to show that their side is as likely as any other explanation.[43] Interestingly, they say that the defendants are at a marked disadvantage because they can only respond based on the facts alleged in the complaint and the documents available to the public. Keller and Stocker state that the ruling "unmistakably cabined the authority of Congress to restrict the access of private securities fraud plaintiffs to the courts."[44]

The Courts have also been divided as to whether or not the pleading standard should favor the plaintiffs or the corporations. An example of a case that resulted in a pro-plaintiff opinion is *In re Converium Holding AG*

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decision 'is a finding for investors because the court articulated what [investors] need to bring a case-a cogent set of facts that give rise to an inference of intent.'"); *see also* Patti Waldmeir, *Companies and Markets: Supreme Court Curbs Actions Against Companies*, FINANCIAL TIMES USA, Jun. 22, 2007, at 13.

[39] Jeffery A. Barrack, *U.S. Supreme Court Renders Investor-Friendly Decision in Tellabs*, 236 THE LEGAL INTELLIGENCER 41, 41 (2007).

[40] *Id.*

[41] *Id. See also, Tellabs,* 127 S.Ct. at 2503.

[42] Keller & Stocker, *supra* note 3.

[43] *Id.*

[44] *Id.*

Securities Litigation.[45] In this case, the plaintiffs sued Coverium in connection with its IPO. The plaintiffs argued that the company did not honestly indicate its financial situation going into the IPO.[46] The plaintiffs alleged fraud in their complaint. The defendants offered *several* pieces of information as a matter of defense to their alleged bad behavior.[47] However, this court did not find the several defenses sufficient to dismiss the case. The court wrote, "In light of *'all* of the facts alleged, taken collectively,' the inference of scienter raised by the Lead Plaintiffs' amended complaint is 'at least as compelling as any opposing inference one could draw from the facts alleged,' including the inferences suggested by Converium and the Officer Defendants in their motion to dismiss, as described above."[48]

Another example is *Belizan v. Hershon* from the District of Columbia's Circuit Court.[49] The circuit court vacated and remanded a decision to dismiss the case for inadequate pleadings. The court suggested that on remand, the district court should "consider whether plaintiffs' amended allegations . . . established an inference of recklessness 'at least as compelling as any opposing inference of nonfraudulent intent.'"[50] Thus, it is clear that at least some of the courts are reading the *Tellabs* opinion as one that is to favor the plaintiffs.

B. *A Ruling for the Corporations*

On the other side of the spectrum, many have thought that the *Tellabs* ruling was actually a victory for businesses. A headline in *Financial Times Asia* on the day of the decision sums up perfectly the immediate sentiment of many. The headline read, "*One More Big Win for Wall Street-Supreme Court does its Bit for US Competitiveness.*"[51] On August 16, 2007, the *Financial Advisor* ran a piece by James Spellman, who runs a strategic communications firm in Washington, D.C. Mr. Spellman stated that with *Tellabs,* "The Justices imposed higher demands

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[45] In re Converium Holding AG Securities Litigation , No. 04 Civ. 7897 (DLC), 2007 WL 2684069, *3 (S.D.N.Y. 2007).

[46] *Id.,* at *1.

[47] *Id.,* at *3.

[48] *Id.* (citing *Tellabs,* 127 S. Ct. at 2509-10).

[49] Richard D. Bernstein & Frank M Scaduto, *Lower Courts' Handling of 'Tellabs' 'Inference of Scienter,'* N.Y.L.J Dec. 11, 2007 at 4 citing Belizan v. Hershon, 495 F.3d 686, (D.C. Cir. 2007) (Bernstein & Scaduto call this "the *one* significant instance so far of an appellate court not affirming dismissal of securities claims under *Tellabs.*") (emphasis added).

[50] *Belizan,* 495 F.3d at 691.

[51] *One More Big Win for Wall Street-Supreme Court does its Bit for US Competitiveness,* 51 FINANCIAL TIMES ASIA, Jun. 21, 2007, at 8.

on investors seeking redress in securities fraud cases."[52] He continued by quoting a statement made by Goodwin Proctor, "The Supreme Court's opinion in *Tellabs* will become an argument in every [defense] lawyer's arsenal for seeking dismissal of a securities fraud class action case at the outset."[53] The Executive Vice-President of the National Chamber Litigation Center of the United States Chamber of Commerce, Robin Conrad, agreed with Goodwin Proctor. Conrad stated, "[b]y adopting a standard that weeds out baseless allegations of securities fraud, today's Supreme Court decision will go a long way in reducing abusive securities class actions, discouraging blackmail settlements and providing greater certainty for the financial industry and investors."[54] These practitioners clearly read the *Tellabs* decision as an asset to corporations and their defense.

Some of the legal discussion about how *Tellabs* has played out in the courts so far also indicates that people feel it is undoubtedly pro-corporation.[55] For example, one reporter wrote, "The lower courts seem to agree that *Tellabs* does indeed make it harder for plaintiffs to plead scienter."[56] The reporter then points to several cases that the lower courts dismissed in favor of the plaintiffs based on a *Tellabs* analysis.[57] However, this analysis is limited to cases in which the corporation reworked its accounting after the alleged fraud. The article argues, "it appears that when

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[52] Spellman, *supra* note 5, at 1.

[53] *Id.* at 2.

[54] Stephen Labaton, *Investors' Suits Face Higher Bar, Justices Rule,* N.Y. TIMES, Jun. 22, 2007, at 2.

[55] Steven Wolowitz & Joseph De Simone, *Did 'Tellabs' Raise PSLRA Scienter Bar?*, N.Y.L.J., Dec. 3, 2007, at S3. (These practitioners argue, "Unsurprisingly, many of [the post-*Tellabs* references] come in decisions dismissing complaints for not having met the PSLRA's pleading standard for scienter."); Wolowitz & De Simone cite *ATSI Communs., Inc. V Shaar Fund,*493 F.3d 87 (2d Cir. 2007) (holding "that a 'strong inference' of fraudulent intent could not be raised by a simple allegation that an otherwise legitimate investment vehicle 'creates an opportunity for profit through manipulation.'"), *Winer Family Trust v. Queen,* No. 05-3622, 2007 WL 2753734 (3rd Cir. Sept. 24, 2007) (concluding that the other possible explanations for the misstatements were enough to make the accusatory statements "neither 'cogent' nor 'compelling.'"), and *Higginbotham v. Baxter Int'l Inc.,* 495 F.3d 753 (7th Cir. 2007).

[56] Bernstein & Scaduto, *supra* note 49 at 4.

[57] Bernstein & Scaduto, *supra* note 49 at 4. Their article compiles a strong list of cases that have been dismissed for pleading defects in light of *Tellabs*. This list includes: Globis Captial Partners, L.P. v. Stonepath Group, Inc., 2007 WL 1977236, at *3 n.1 (3rd Cir. July 10, 2007), Higginbotham v. Baxter Int'l Inc., 495 F.3d 753 (7th Cir. 2007), WeinerFamily Trust v. Queen, 2007 WL 2753734 (3rd Cir. Sept. 24, 2007), Central Laborers'' Pension Fund v. Integrated Electrical Services Inc., 497 F.3d 546 (5th Cir. 2007), In re BearingPoint Inc. Securities Litigation, 2007 WL 2713906, (E.D. Va. Sept. 12, 2007), Caiafa v. Sea Containers Ltd., 2007 WL 2815633 (S.D.N.Y. Sept. 25, 2007), Roth v. OfficeMax, Inc. 2007 WL 2892634 (N.D. Ill. Sept 26, 2007), Mizzaro v. Home Depot, Inc., 2007 WL 2254693 (N.D. Ga. July 18, 2007), In re H&R Block Securities Litigation, 2007 WL 2908649 (W.D. Mo. Oct. 4, 2007).

a corporation investigates allegations of wrongdoing, it decreases the chances that scienter may be inferred."[58] Inherently, this reduces the implication of scienter. If the executives changed their statements on their own accord, they are more likely to have not been trying to cover something up. Therefore, it seems pretty obvious that these cases would naturally side with the defendants. Bernstein and Scaduto's point, though, is not solely that the cases came out in favor of the defendants, but rather, that it was because of *Tellabs'* heightened pleading standard that the alleged scienter could no longer be strong enough when the corporation had changed its announcements or prospectuses.

Bernstein and Scaduto paint a rosy picture of the real aftermath of *Tellabs*. However, looking at the big picture shows that the media and commentators were clearly split over the negative and positive impact of *Tellabs*.

C. Key Equity *and* Tellabs *on Remand*

One of the most convenient ways to see how the *Tellabs* ruling is actually playing out is to look carefully at a circuit court decision that has taken *Tellabs* into consideration. Even within the same courts, the judges do not agree whether *Tellabs* made the standard more or less difficult for the plaintiffs to meet at the pleading stage. Sarah Gold and Richard Spinogatti suggest that it is "likely that *Tellabs'* mandate—to consider all of the possible inferences the alleged facts suggest—may not ultimately produce as clear, uniform, and predictable a body of securities law as the Supreme Court might have hoped."[59] Gold and Spinogatti's article points to the *Key Equity Investors, Inc. v. Sel-Leb Marketing Inc.* case, decided on September 6, 2007, to make this point. They seem to hit the mark with this illustrative assessment of the confusion that came from *Tellabs*.

The Third Circuit, which probably would have aligned with the Second Circuit's pleading standards previous to the *Tellabs* ruling, changed its tune in light of *Tellabs*.[60] In *Key Equity* the Third Circuit granted the Sel-Leb's motion to dismiss, claiming that the shareholders had not met their pleading burden to show scienter.[61] In this case, the shareholders alleged "that Sel-Leb falsified its earnings to maintain its credit line," in addition to several other complaints.[62] The Third Circuit court, using *Tellabs,* explained that these were not strong enough allegations, and that they did not have sufficiently particular facts to make a "strong inference"

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[58] Bernstein & Scaduto, *supra* note 49.

[59] Sarah S. Gold & Richard L. Spinogatti, *Post-Tellabs: Inference of Scienter in Eye of the Beholder,* N.Y.L.J., Oct. 11, 2007 at 3 [hereinafter Gold &Spinogatti].

[60] *Id.*

[61] Key Equity Investors, Inc. v. Sel-Leb Marketing Inc, 2007 WL 2510385, 6 (3rd Cir. 2007) ; *see* Gold & Spinogatti, *supra* note 59.

[62] *Key Equity Investors,* 2007 WL 2510385 at 5.

in terms of what the *Tellabs* case established.[63] The court also says in a footnote, "With this allegation alone, an inference that defendant's renegotiated Sel-Leb's credit line in the ordinary course of business (when it was up for renewal) is more likely than an inference of *scienter.*"[64] This analysis is where the Third Circuit is really applying the new *Tellabs* standard.

Yet, the extremely potent dissent in *Key Equity* shows the nuances of *Tellabs.* In his dissent, Judge Garth makes it clear that he thought that Key Equity had met its pleading burden. Garth stated that because Key Equity alleged that Sel-Leb would have defaulted on its credit and that the directors hid that fact in their statement of "renewal," the plaintiffs had met the burden to show facts establishing a "motive and opportunity" to commit fraud.[65] Garth also points to a Sixth Circuit case, *PR Diamonds, Inc. v. Chandler*[66] that allowed a similar pleading to stand *before Tellabs.*[67] Garth suggests that because the strict and corporation-friendly Sixth Circuit had not dismissed that case before *Tellabs,* this indicates that these similar pleading facts really should be enough to support a cause for scienter. Either way, it is clear that *Tellabs* did not make the decision any easier for the Third Circuit court.

If Gold and Spinogatti are correct that *Key Equity* is a potent example of how courts across the nation are going to continue to interpret *Tellabs,* it would appear that those who argued that it was a pro-corporation ruling were correct. With seemingly adequate facts, the Third Circuit managed to rule in favor of the corporation despite a very compelling opposition.

However, this trend never actually materialized. On remand, the Seventh Circuit took another look at *Makor Issues & Rights, LTD v. Tellabs Inc.* bearing in mind the new standard established in *Tellabs.*[68] The Seventh Circuit ruled in favor of the plaintiffs and did not allow the case to be dismissed at the pleading stage. The court said, "The inference of corporate scienter is not only as likely as its opposite, but more likely . . . if there are only two possible inferences, and one is *much* more likely than the other, it must be cogent."[69] Thus, the plaintiffs have finally made it past the pleading stage and will continue on toward trial. Despite the supposedly critical opinion from the Supreme Court, the Seventh Circuit has not changed its tune in regards to the facts of *Makor.* The *Tellabs* ruling was neither strong enough nor different enough, to reverse the Seventh Circuit's

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[63] *Id.* at 6.
[64] *Id.* at 5.
[65] *Id.* at 10.
[66] PR Diamonds, Inc. v. Chandler, 364 F.3d 671 (6th Cir. 2004).
[67] *Key Equity Investors,* 2007 WL 2510385 at 11.
[68] *Makor Issues & Rights, LTD v. Tellabs Inc,* 513 F.3d 702 (7th Cir. 2008) ("*Makor II*").
[69] *Id.,* at 710.

ultimate opinion. It seems that despite the goal, the debates in the courts will remain contentious because of the *Tellabs* ruling.

IV. THE ISSUES THAT REMAIN

This Note has attempted to establish that it is still very difficult to rule whether securities pleadings are sufficient. However, this is not the only downside of the much anticipated ruling. In addition to the lack of clarity, several other issues remain open regarding securities scienter pleading.[70] These issues existed before the *Tellabs* ruling, but for the most part they seem to have been ignored. The ruling may have exacerbated them.

A. *Group Pleading*

One of the things that will become particularly interesting is how the juxtaposition between the group pleading issue and the courts instituting *Tellabs* will play out.[71] In *Makor*, the Seventh Circuit said that plaintiffs must plead the allegations of scienter to *all* the defendants. The Circuit Court ruled, "to proceed beyond the pleading stage, the plaintiff must allege as to each defendant facts sufficient to demonstrate a culpable state of mind regarding his or her violations."[72] The Seventh Circuit did not think it adequate to say that any misstatement applied to *all* defendants.[73] The Supreme Court expressly stated in *Tellabs* that they were not going to deal with this issue, as neither side brought it up.[74]

The idea behind the group pleading doctrine is that publications made by the corporation, can be assumed to be made by all the officers and directors.[75] This doctrine makes things easier on the plaintiffs because they

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[70] Previously cited authors have pointed out the issues that could arise. As with the previous part of the Note, this author is simply synthesizing the information. *See,* Wolowitz & De Simone, *supra* note 55, Bernstein & Scaduto *supra* 49, Keller & Stocker, *supra* note 3, and Sara S. Gold & Richard L. Spinogatti, *Group Pleading Suffers Another Blow*, N.Y.L.J, Dec. 12, 2007 at 3.

[71] *See generally* William O. Fisher, *Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the "Group Pleading" Protocol in 10b-5 Cases,* 56 BUS. LAW. 991 (2001); Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know,* 68 BUS. LAW. 1281, 1330 (2007); and Kevin M. O'Riordan, *Clear Support or Cause for Suspicion? A Critique of Collective Scienter in Securities Litigation,* 91 MINN. L. REV. 1596, 1609-14 (2007).

[72] *Makor,* 437 F.3d at 603.

[73] Note that the Seventh Circuit spent a large part of its opinion on remand discussing the group pleading or collective intent aspect of the case. *Makor II,* 513 F.3d at 707-08.

[74] *Tellabs*, 127 S. Ct. at 2511.

[75] *See* Wolowitz & De Simone, *supra* note 55, and Gold & Spinogatti, *supra* note 59. (Gold & Spinogatti's article reviews the splits among the circuits and suggests that eventually something is going to have to be done about the different applications. The authors acknowledge that many hoped the Court would address it in *Tellabs*. Gold &

do not have to plead with particularity against each defendant. Historically, different circuit courts have approached this question in their own respective manners.[76] *Tellabs* certainly did not make this an easier decision or even one that is moving toward uniform application among the different circuits.

Bernstein and Scaduto make an interesting suggestion about how some of the courts are dealing with the group pleading issue. They note that in *In re Openwave Systems Securities Litigation* the court allowed some of the plaintiffs' complaints to make it through to the next stage of litigation and denied others'.[77] They state, "The difference [about whether they make it through or not] appears to turn on the extent to which plaintiffs pleaded specific allegations of an individual's direct personal benefit versus generalized allegations based on an individual's title or office."[78] It seems that at least in this circuit, group pleading did not meet the new *Tellabs* standards for alleging scienter. The Supreme Court chose to ignore the opportunity to rule on this, and therefore created an even larger ambiguity.

B. *Outside Sources*

Another securities pleading issue arising from *Tellabs* is the debate over what outside sources may be used in determining whether the complaint survives a motion to dismiss.[79] The majority opinion in *Tellabs* stated that "the courts must consider the complaint in its entirety, *as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice*" (emphasis added).[80] As a general rule, the Supreme Court stressed that "*all* the facts alleged, taken collectively, give rise to a strong inference of scienter."[81] Given this express ability to analyze outside sources when determining if there is a strong inference of scienter, this was an important

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Spinogatti also acknowledge how the group pleading standard really affects securities litigation. They wrote, "By permitting plaintiffs to avoid having to identify each act or omission of a defendant with particularity . . . the group pleading doctrine . . . certainly appears inconsistent with Congress' intent to substantially heighten the pleading requirements in securities class action lawsuits.").

[76] *See* Wolowitz & De Simone, *supra* note 55 (noting that the Third, Fifth and the Seventh Circuits do not allow group pleading anymore, and that it appears that the Eleventh Circuit has also said in light of the PSLRA that there can be no group pleading; on the other hand, Wolowitz & De Simone state that the Second, Sixth and D.C. Circuits do still allow group pleading in light of the PSLRA.).

[77] Bernstein and Scaduto, *supra* note 49.

[78] *Id.*

[79] *See generally* Susan E. Hurd, *Tellabs Lesson*, DAILY DEAL, Aug. 7, 2007, at 2.

[80] *Tellabs*, 127 S. Ct. at 2509 .

[81] *Id.*

part of the decision.[82] Even Justice Alito, in his concurring opinion, suggested that the majority opinion actually gets rid of some level of the pleading particularity requirements by allowing the courts to look at each and every allegation including those not necessarily directly pleaded.[83]

One article, "Tellabs Lesson," notes how important this part of the *Tellabs* opinion is to the overall scheme of securities litigation. The article states, "A defendant's ability to rely on other source materials has proved very important in these cases for establishing competing inferences."[84] The article indicates the Court would have made a major misstep had it not allowed for the inclusion of outside documents. It argues, "The Reform Act [PSLRA] would be severely undercut if a plaintiff's claims could survive in the face of opposing inferences readily available from undisputed matter of public record."[85] One reporter believes the outside sources are necessary to reduce frivolous lawsuits.

In the Court's defense, they did suggest that ambiguity in the pleadings will hurt the plaintiff.[86] However, how is this really possible if they are allowed to include things that are specifically of public record? By definition it is impossible to plead with particularity something that is not actually in the complaint and simply relied on by common knowledge.

Keller and Stocker believe that even with the inclusion of outside sources in making an allegation for scienter, the defendants are at a disadvantage because they are still limited to these outside sources and to the facts alleged in the complaint.[87] However, this just reinforces the ambiguity of the *Tellabs* holding. Keller and Stocker are suggesting that because plaintiffs only have to make it "as likely as any other inference," the fact that the defendants hands are "tied" with what they can claim in defense makes it a decision that is pro-plaintiff.[88] Yet, from the other side, it seems as though the fact that the corporate defendants can include things that are common knowledge proves they are actually at an advantage when trying to find *something* that would be "at least as likely" to show their innocence as their guilt. It is simple statistics; the more opportunities you have, the better the chance that one will work.

This is especially interesting when you look at it in connection with smaller companies. It seems that smaller companies would have fewer outside sources for the courts to include in their evaluation to help absolve the smaller company of allegations of fraud or deceit.[89] If this is a true

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[82] Hurd, *supra* note 79.
[83] *Tellabs,* 127 S.Ct. at 2516, (Alito, J., concurring).
[84] Hurd, *supra* note 79.
[85] *Id.*
[86] *Tellabs,* 127 S.Ct. at 2511; Hurd, *supra* note 79 at 2.
[87] Keller & Stocker, *supra* note 3.
[88] *Id.*
[89] This is not necessarily a fact. However, if the company is smaller, it is going to file less paper and most likely will be covered less in the news.

issue it appears that smaller corporations do not benefit from this aspect of the *Tellabs* holding.

C. *Recklessness*

It should be noted that the court refused to acknowledge the "recklessness" question that has plagued securities litigation.[90] While delving into this area of the securities law is a topic for another note entirely, it would be unjust to not mention the "recklessness" issue as one of the things that *Tellabs* did not clear up but potentially could have.

V. DISSENT

Justice Stevens' dissent presents an interesting and important perspective that should not be overlooked. Justice Stevens agrees that the Court needed to create a judicial interpretation of "strong inference" in order to further the goal of protecting defendants' privacy, time and money by not allowing frivolous cases to make it past the pleading stage.[91] However, Justice Stevens argued that there is a more workable standard that should be applied in security cases.[92]

The majority opinion attempts to make a semi-absolving statement that they are not making the plaintiff do anything that they would not have to do at trial.[93] However, at trial the plaintiff would have the benefit of discovery in which they could get to the documents needed and be able to articulate exactly why they were defrauded. This is similar to saying that you cannot bring a claim unless you are *certain* that you will win it. The semantics of the *Tellabs* opinion are clearly causing a lot of issues. In light of this, it seems that Justice Stevens' suggestion might have been a better option.

Justice Stevens suggested that the 'probable cause' standard that is applied in criminal cases should be applied as the scienter pleading standard for "strong inference."[94] Justice Stevens supports his claim by saying, "It is most unlikely that Congress intended us to adopt a standard that makes it more difficult to commence a civil case than a criminal case."[95] In light of the semantic mush that comprises the majority opinion, this is a refreshing perspective. Justice Stevens points out just how unclear the standard of "strong inference" from the majority opinion is, when he points out that even the majority justices do not agree on the definition of the words that

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[90] *Tellabs,* 127 S.Ct. at 2507.
[91] *Id.* at 2517, (Stevens, J. dissenting).
[92] *Id.*
[93] *Id.* at 2513.
[94] *Id.* at 2517 (Stevens, J. dissenting); *see also,* 68 AM. JUR. 2d *Searches and Seizures* § 181 (2007) (providing background on probable cause).
[95] *Id.*

they used to create the definition of "strong inference."[96] Justice Stevens seems to be thinking outside the world of securities and more in the world of civil procedure. It is quite possible that Justice Stevens's suggested definition could have avoided some of the chaos that has ensued since the supposedly clarifying *Tellabs* decision.

Justice Stevens suggested that using his 'probable cause' standard would avoid the "unnecessary conclusion that 'in determining whether the pleaded facts give rise to a 'strong' inference of scienter, the court must take into account plausible opposing inferences.'"[97] Justice Stevens even went so far as to suggest that specifically, the *Tellabs* case should not be dismissed at the pleading stage. He states that when the Court uses his probable cause analysis, "the truth of the detailed factual allegations attributed to 27 different confidential informants described in the complaint . . . I think it clear that they establish probable cause to believe that Tellabs' chief executive officer 'acted with the required intent.'"[98] Speaking specifically of the allegations regarding "channel stuffing,"[99] Justice Stevens makes a very poignant point when he states, "If these allegations are actually taken as true and viewed in the collective, it is hard to imagine what competing inference could effectively counteract the inference that Notebaert and Tellabs 'acted with the require state of mind.'"[100] Given the issues that were not ironed out by the Tellabs ruling, it seems that Justice Stevens's definition could be beneficial or at least a guide for the lower courts.

The goal of this Note is to point out what we should be aware of in the future and issues that will probably surface in light of the *Tellabs* ruling. A standard that is more established and has a better foothold in the minds of today's judges would have been an easier ruling to apply.

VI. WHY IS THE *TELLABS* RULING IMPORTANT FOR SMALL BUSINESSES?

There are a few reasons why the ruling will be relevant to small businesses. First of all, the ruling affects all businesses that are subject to the Securities Acts, and that includes many small businesses. Whether or not corporations are going to be hurt by this ruling is probably not going to be completely evident for a couple of years, and therefore it will remain an important part of securities litigation.

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[96] *Tellabs,* 127 S.Ct. at 2517 (Stevens, J., dissenting) (Suggesting that Scalia's concurrence really is a different approach and not the same definition that the majority approved in its opinion.).

[97] *Id.*

[98] *Id.*

[99] In its *Tellabs* opinion, the Supreme Court described "Channel Stuffing" as a practice of "flood[ing] its customers. with unwanted products. *Tellabs,* 127 S.Ct. at 2505.

[100] *Id.* at 2517 (Stevens, J., dissenting).

In addition to the regular effects that *Tellabs* is going to have on every public company in America, it has the potential to strike small businesses in a different fashion. For example, one of the important points that came from Justice Ginsburg's majority ruling regarded how courts should interpret ambiguities and omissions in plaintiff's pleadings for 10b-5 cases. Justice Ginsburg wrote, "We agree that omissions and ambiguities count against inferring scienter, for plaintiffs must 'state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[101] By explicitly stating that omissions and ambiguities are a real mark against a plaintiff's pleading, the Court may have unintentionally disadvantaged small business shareholders.

It seems logical that smaller businesses have fewer public announcements. This makes it more difficult for shareholders of smaller businesses to gain the information that they need to make adequate pleadings. Therefore, when a shareholder of a small business goes to make their pleading it is potentially more difficult for that shareholder to plead with the required specificity to meet the *Tellabs'* heightened standard of ruling against pleadings with omissions and ambiguities.

This seems like a negative consequence toward the small business shareholders, but when you look at it in light of much of the rest of the securities regulation it probably is a positive consequence. Many of the smaller businesses are severely hampered by the new securities regulations because they require a lot of expensive disclosure to meet the requirements to remain a public company.[102] However, the manner in which omissions and ambiguities are now to be dealt with provides smaller businesses with a quasi-protection mechanism. By making it more difficult to meet the requirements, *Tellabs* is protecting small businesses.

However, there is one more facet to contemplate here. While the lack of information could help corporations by putting more pressure on the shareholders, it could hurt smaller corporations at the same time. There is less information that could be exonerating in light of the willingness for the courts to include anything that is incorporated by reference as well as pleaded.[103]

The third fashion in which the small public corporations are affected by this ruling is demonstrated partially by an article by Margaret Sachs.[104] Sachs argues in general that underclass investors, whom she classifies as "those trading in inefficient markets without an advisor,"[105] are

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[101] *Id.* at 2511.

[102] Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley,* 41 WILLAMETTE L. REV. 707, 719 (2005).

[103] *Tellabs,* 127 S. Ct. at 2509.

[104] Margaret V. Sachs, *Materiality and Social Change: The case for Replacing 'The Reasonable Investor' with the 'The Least Sophisticated Investor' in Inefficient Markets,* 81 TUL. L. REV. 473, 481 (2006).

[105] *Id.* at 476.

hurt by the current state of the materiality laws as established in *TSC Industries, Inc. v. Northway, Inc.*[106] and *Basic Inc. v. Levinson.*[107] These cases use the "reasonable investor" standard to determine if an omission or a misstatement is "material."[108] Sachs then argues for "an alternative materiality standard for inefficient markets."[109] She suggests that the alternative materiality standard should be based on the "least sophisticated investor."[110] However, Sachs says that the alternative standard should only be allowed "if the defendant acts with heightened scienter—that is, with actual knowledge of the fraud's likely deceptive effect."[111] Sachs wants to trade materiality for scienter on a sliding scale.

Sachs suggests that we need to heighten the scienter requirement if we lower the materiality requirement for "underclass investors," giving them an opportunity to bring their claim. Sachs, suggesting that scienter and materiality are linked, states, "The likelihood that the defendant was merely reckless declines as the absurdity of his misrepresentation increases."[112]

It seems possible that the *Tellabs* ruling has done just the opposite of what Sachs suggested for small businesses. As Sachs defines underclass investors as "those trading in an inefficient market"[113] and generally inefficient markets are composed of small businesses, this theory could therefore affect small businesses. Sachs wants to help underclass investors by lowering the materiality standard. She offsets this by suggesting a heightening of the scienter standard. However, *Tellabs, may* have lowered the scienter standard and therefore, hurt underclass investors. For example, the majority decision suggests that there does not need to be specific evidence of financial motive in order for a plaintiff to prevail on a 10b-5 pleading.[114] This makes it easier for shareholders to point out fraud and prevail on the immediate claim. In effect, not having to prove financial motive lowers the extent of scienter needed on that issue.[115] For small businesses this does not seem to make a difference at the outset, but if you look at how that is linked to materiality it becomes evident that it could affect the smaller companies.

This really is going to be an issue if it can ever definitively say that the pleading standards were raised or lowered with the *Tellabs* ruling.

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[106] TSC Industries, Inc. v. Northway, Inc 426 U.S. 438 (1976).
[107] Basic v. Levinson 485 U.S. 224 (1988)..
[108] *Id.*
[109] *See* Sachs, *supra* note 104, at 481.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *See* Sachs, *supra* note 104, at 476.
[114] *Tellabs,* 127 S.Ct. at 2511.
[115] The plaintiff still has to meet the requirements of *Tellabs.* This is not suggesting that the overall case made pleading scienter easier.

Thus, this third theory is probably not going to be an issue until the court speaks again. *Tellabs* was not clear enough to make it an imminent issue.

VII. CONCLUSION

It appears that *Tellabs* was an intelligent decision in that both corporations and shareholders think they won. However, it remains important to recognize that inconsistencies still exist and *Tellabs* failed to clear up some prevalent securities law issues. The Supreme Court may have achieved its objective of remaining neutral, but it has certainly failed to give a clear path for securities practitioners and federal judges.