

SECURITIES LAW

'Strong Inference'

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THIS PAST month, the U.S. Supreme Court granted a petition for writ of certiorari in *Tellabs Inc. v. Makor Issues & Rights Ltd.*, No. 06-484 (2007), which presents the question of how courts should weigh competing inferences in deciding whether a securities fraud complaint under Section 10(b) of the Securities Exchange Act of 1934 gives rise to the "strong" inference of scienter required by the Private Securities Litigation Reform Act (PSLRA), 15 U.S.C. 78u-4(b)(2).

In the decision on appeal, *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 437 F.3d 588, 600-03 (7th Cir. 2006), reversing the dismissal of securities fraud claims against Tellabs Inc. and one of its executives, the 7th U.S. Circuit Court of Appeals held that the "best approach" to the PSLRA requirement is "to examine all of the allegations in the complaint and then to decide whether collectively they establish" the required strong inference of scienter.

A controversial passage on 'degree of imagination'

In a controversial passage, the 7th Circuit commented on the "degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" *Id.* at 601. The court observed that the 6th

Circuit, which allows plaintiffs only the most plausible of competing inferences, has "hinted" that the standard might implicate 7th Amendment rights. *Id.* at 602 (citing *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005)). Without reaching the constitutional question, the 7th Circuit wrote that it would be "wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role":

"Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. 'Faced 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, lest we invade the traditional role of the factfinder.'" *Id.* at 601-02 (*Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003)).

In their certiorari petition, the defendants framed the appellate question as whether and to what extent courts must consider or weigh competing inferences in

evaluating whether plaintiffs have satisfied the PSLRA's "strong inference" requirement. Petition for Writ of Certiorari at i, *Tellabs Inc. v. Makor Issues & Rights Ltd.*, No. 06-484 (2006).

The petitioners characterized the circuits as split into several camps, with some courts accepting only the "most plausible" of competing inferences and others declining to weigh inferences. *Id.* at 3-5. In opposition, the respondent argued that the differences among the circuits are mostly "semantics, not substance" and that the allegations do not give rise to competing inferences and satisfy even the most stringent standard. Brief in Opposition at 1, *Tellabs Inc. v. Makor Issues & Rights Ltd.*, No. 06-484 (2006).

The appeal presents an opportunity for the Supreme Court to resolve circuit court disagreements on several related issues, including whether the PSLRA altered the Rule 12(b)(6) standard under which courts draw all reasonable inferences in favor of plaintiffs, whether courts should consider inferences that favor defendants, and how to handle situations where the same facts give rise to competing inferences, one favoring plaintiffs and another favoring defendants.

The 3d and 8th circuits, for example, have concluded that the PSLRA "alters the normal operation of inferences under [Rule 12(b)(6)]." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); see *In re Alpha Pharma Inc. Sec. Litig.*, 372 F.3d 137, 150 (3d Cir. 2004) ("under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor," but under the PSLRA inferences survive "only if they are both reasonable and 'strong inferences'"); *In re Rockefeller Ctr. Props. Inc. Sec. Litig.*, 311 F.3d 198, 224 (3d Cir. 2002) (securities fraud plaintiffs "may not benefit from

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inferences flowing from vague or unspecific allegations—inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis”); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 660 (8th Cir. 2001) (under Rule 12(b)(6) plaintiffs are afforded “all reasonable inferences,” but under the PSLRA a court must “disregard ‘blanket’ assertions” and dismiss a complaint unless “its allegations collectively add up to a strong inference of the required state of mind”).

On the other hand, the 1st and 6th circuits have suggested that the PSLRA does not alter the Rule 12(b)(6) standard. See *Alldridge v. A.T. Cross Corp.*, 284 F.3d 72, 78 (1st Cir. 2002) (“Although the pleading requirements under the PSLRA are strict...they do not change the standard of review for a motion to dismiss. Even under the PSLRA, the district court, on a motion to dismiss, must draw all reasonable inferences from the particular allegations in the plaintiff’s favor, while at the same time requiring the plaintiff to show a strong inference of scienter”); *Helwig v. Vencor Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (“‘When an allegation is capable of more than one inference, it must be construed in the plaintiff’s favor.’ Our willingness to draw inferences in favor of the plaintiff remains unchanged by the PSLRA”) (citation omitted); see *Pirraglia*, 339 F.3d at 1187 n.9. Still, only inferences that are “both reasonable and ‘strong’” survive. *Greebel v. FTP Software Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999); *Helwig*, 251 F.3d at 551.

The 9th Circuit has most directly confronted the problem of competing, equally weighted inferences. In *Gompper v. VISX Inc.*, 298 F.3d 893, 896 (9th Cir. 2002), the 9th Circuit recognized that “inevitable tension arises between the customary latitude granted the plaintiff on a motion to dismiss under Fed. R. Civ. P. 12(b)(6), and the heightened pleading standard set forth under the PSLRA.” The plaintiffs had argued that “if the facts as pled give rise to a reasonable and warranted inference of scienter, then the court must accept this inference entirely, without consideration of competing negative inferences, even where, under the circumstances, those competing inferences may be equally or more plausible.” Id. The court rejected this argument on the ground that it would “eviscerate” the

PSLRA requirement by allowing plaintiffs to plead “in a vacuum.” Id. Rather, “the court must consider all reasonable inferences to be drawn from the allegations, including inferences unfavorable to plaintiffs.” Id. at 897. While plaintiffs argued that VISX’s aggressive litigation pattern suggested that the company knew its patents were invalid, an “equally if not more plausible” inference that could be drawn from the same allegations was that VISX “believed the patents were valid.” Id. In such circumstances, the court held, plaintiffs cannot succeed.

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The 4th and 6th circuits have followed a similar approach to competing inferences. In *Ottmann v. Hanger Orthopedic Group Inc.*, 353 F.3d 338, 349-50 (4th Cir. 2003), the 4th Circuit held that the required strong inference does not arise where the allegations are “more consistent with negligence than with recklessness or intent,” or “just as likely the result of an overgeneralization as...the product of intentional deception or recklessness.” In *Helwig*, 251 F.3d at 544, 553, the 6th Circuit held that while “the task of weighing contrary accounts is reserved for the fact finder,” the PSLRA’s “‘strong inference’ requirement means that plaintiffs are entitled only to the most plausible of competing inferences.”

‘Tension’ noted between Rule 12(b)(6) and PSLRA

The 10th Circuit has also recognized a “tension” between Rule 12(b)(6) and the PSLRA, but reached a different conclusion.

Pirraglia, 339 F.3d at 1187. In *Pirraglia*, which presented the question whether, under the “strong inference” requirement, the court “should take into account reasonable inferences other than those urged by the plaintiffs.” Id.

Like the 9th Circuit, the 10th Circuit held that a court cannot determine whether an inference is strong “in a vacuum,” but must “recognize the possibility of negative inferences that may be drawn against the plaintiff.” Id. Breaking from the 9th Circuit’s analysis, however, the 10th Circuit cautioned that “this process does not involve a ‘weighing’ of the plaintiff’s suggested inference against other inferences.” Id. at 1188. “Faced 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, lest we invade the traditional role of the factfinder.” Id.

An opinion from the Supreme Court could also resolve another division. In *Makor*, the 7th Circuit joined several other circuits in rejecting the 2d Circuit’s “motive and opportunity” test. 437 F.3d at 601; see, e.g., *Ottmann*, 353 F.3d at 345-46. The 2d and 3d circuits persist in applying pre-PSLRA standards permitting plaintiffs to plead scienter by alleging either facts showing that the defendants had motive and opportunity to commit fraud or facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Kalnit v. Eichler*, 264 F.3d 131, 138-39 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999). **NLJ**