

Tellabs v. Makor Issues & Rights, Ltd.: The Weighing Game

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I. INTRODUCTION

Once-thriving securities-fraud lawsuits, hailed by shareholders and bashed by businesses, are facing an onslaught of legal challenges that could cripple the controversial class actions. The number of federal securities-fraud lawsuits is steadily falling. Businesses are stepping up their assault on what they call frivolous litigation. Government investigations are chilling plaintiff's attorneys.¹

This quote aptly characterizes the general hostility with which securities fraud lawsuits are viewed. Now the United States Supreme Court's decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* continues the attack.²

Much of this onslaught was brought about by the Private Securities Litigation Reform Act (the "PSLRA").³ In 1995, Congress enacted the PSLRA⁴ which altered the pleading,⁵ discovery,⁶ and liability⁷ rules for cases brought under the federal securities laws. One significant aspect

1. Edward Iwata, *Fewer Lawsuits Charge Securities Fraud*, USA TODAY, Oct. 10, 2007, available at http://www.usatoday.com/money/companies/2007-10-07-securities-fraud-lawsuits_N.htm.

2. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007) (requiring courts to determine whether a securities fraud complaint alleges a strong inference of scienter by considering nonculpable inferences, weighing them against the inference of scienter, and then finding that the culpable inference is at least as likely as the nonculpable inference at the pleading stage prior to discovery).

3. Traditionally, before the enactment of the PSLRA most circuits applied Rule 9(b) to securities fraud claims. See, e.g., *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994) (noting that Rule 9(b) has been recognized as applicable to securities fraud claims either explicitly or implicitly).

4. Private Securities Litigation Reform Act, 15 U.S.C. § 78u–4, et seq. (2000).

5. 15 U.S.C. § 78u–4(b)(1)–(2) (requiring a plaintiff to specify each statement alleged to have been misleading, the reasons why it is misleading, and how it gives rise to a strong inference that the defendant acted with scienter).

6. 15 U.S.C. § 78u–4(b)(3)(B) (staying discovery until after a court rules on a 12(b)(6) motion).

7. 15 U.S.C. § 78u–4(f) (changing the standard from joint and several liability to proportionate liability). Originally, the Act provided for joint and several liability, allowing a plaintiff to recover an entire judgment from any one defendant. However, to remedy this disproportionate bearing of liability, the PSLRA imposed a proportionate liability standard. S. REP. NO. 104–98, at 7 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 686. This also had the effect of indirectly dealing with large legal fees. But see DAVID J. BERSHAD ET AL., *SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES* 27 (Edward J. Yodowitz et al. eds., 1994) (dissenting introduction) (arguing a scheme of proportionate liability would penalize innocent victims where a culpable defendant simply cannot pay his share).

of the PSLRA is its heightened pleading requirement.⁸ The PSLRA requires plaintiffs to plead a *strong inference* of scienter in averments of fraud.⁹ However, as most of the circuits have lamented, the PSLRA fails to adequately define “strong inference.”¹⁰

Pleadings are considered the key to the courthouse door.¹¹ Absent a well-pled complaint, plaintiffs have no chance of relief.¹² Because securities litigation can amount to the recovery or loss of billions of dollars, clarity in securities pleadings is particularly important.¹³ In June of 2007, the U.S. Supreme Court clarified the meaning of “strong inference” in *Tellabs*.¹⁴ This Note argues that while the rule set forth by the Supreme Court in *Tellabs* clarifies the pleading standard, the

8. 15 U.S.C. § 78u-4(b)(2) (requiring a plaintiff to allege facts with particularity, with respect to each act or omission, that give rise to a strong inference that the defendant acted with the required state of mind). This Note will not discuss in depth the discovery and liability provisions of the Private Securities Litigation Reform Act.

9. 15 U.S.C. § 78u-4(b)(2).

10. Compare *Brown v. Credit Suisse First Boston Corp.*, 431 F.3d 36, 51 (1st Cir. 2005) (stating a court must consider nonculpable inferences) and *Ottmann v. Hanger Orthopedic Group Inc.*, 353 F.3d 338, 347 (4th Cir. 2003) (weighing both culpable and nonculpable inferences) and *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187–88 (10th Cir. 2003) (requiring a court to consider inferences but specifically refrain from weighing) with *Gompper v. VISX, Inc.*, 298 F.3d 893, 898 (9th Cir. 2002) (requiring a court to consider and weigh nonculpable inferences) and *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (limiting the plaintiff’s inferences to only the most plausible inferences).

11. See Marcia Coyle, *Prevailing Winds: In the First Full Term with Alito, Court Took Marked Conservative Turn*, NAT’L L.J., Aug. 1, 2007 (noting that Justices Roberts and Alito, as former Reagan lawyers, knew that doctrines like pleading, standing, and statutes of limitation provide keys to the courthouse door, and that a more stringent application of these doctrines dramatically narrows the amount of cases getting into court).

12. See FED. R. CIV. P. 12(b)(6) (stating a complaint which fails to state a claim shall be dismissed). But see Ryan G. Miest, Note, *Would the Real Scienter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud*, 82 MINN. L. REV. 1103, 1104 (1997–1998) (arguing pleadings are significant in the securities fraud context because plaintiffs who survive a 12(b)(6) motion are “virtually assured a settlement”).

13. See Miest, *supra* note 12, at 1104 n.6 (noting that the dominant plaintiff’s firm Milberg Weiss Bershad Hynes & Lerach, LLP won more than \$1 billion in settlements); see also Cornerstone Research, *Securities Class Action Case Filings: 2007 Mid-Year Assessment* (2007), available at http://cornerstone.com/pdf/practice_securities/CSRReleaseYIR2007.pdf [hereinafter Cornerstone Research] (noting that the maximum dollar losses in the first half of 2007 amounted to \$69 billion); Todd Foster et al., *Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But are these Trends Reversing?*, NERA Economic Consulting, 8–9 (Sept. 2007), http://www.nera.com/image/PUB_RecentTrends_Sep2007_2color_web-FINAL.pdf (finding that all top ten shareholder class action settlements as of June 30, 2007 topped \$1 billion for the first time ever with Enron weighing in at a \$7.2 billion settlement).

14. See *infra* Part IV.A (discussing the guidelines the *Tellabs* decision provides lower courts as well as ambiguities left by in its wake).

resulting definition relies on unsubstantiated fears of excessive litigation costs¹⁵ and unconstitutionally infringes on the Seventh Amendment.¹⁶

Part II of this Note provides a brief history of the regulation of the securities market.¹⁷ Knowledge of the circumstances giving rise to the enactment of both the securities laws and the PSLRA is vital to understanding the true intent behind these regulations. Next, this Note briefly highlights the circuit split that gave rise to the *Tellabs* issue.¹⁸ Part III discusses the Supreme Court's decision in *Tellabs*, providing an in-depth account of the factual history of the case and the lower court decisions.¹⁹ Part IV describes how the Supreme Court's decision resolves the split among the circuits,²⁰ and also illustrates how fears of excessive litigation, which are the center of the Court's rationale, are largely unsubstantiated.²¹ This Part argues that the *Tellabs* decision fails to achieve the balance inherent in the PSLRA and thus risks further dismissal of meritorious claims.²² Next, it asserts that the Court's rule unduly infringes on the Seventh Amendment right to a jury trial by requiring courts to resolve disputed questions of fact.²³ Last, Part IV argues that the Court should have adopted the probable cause standard set forth in the dissenting opinion.²⁴

Part V explores the impact of the *Tellabs* decision.²⁵ Specifically, this Part examines how the *Tellabs* rule has begun to evolve.²⁶ This

15. See *infra* Part IV.B (arguing that the Court's concern with excessive litigation is unsubstantiated, that the PSLRA contains other provisions to more appropriately deal with discovery concerns, and that the Court's adopted standard fails to achieve the balance called for by the PSLRA).

16. See *infra* Part IV.C (arguing that the Court requires judges to determine disputed issues of fact at the pleading stage and thus infringes on the Seventh Amendment jury trial right).

17. See *infra* Part II (tracing the development of the 1933 Act, 1934 Act, and the PSLRA).

18. See *infra* Part II.C (discussing the circuit division over whether competing inferences are to be weighed or considered on a 12(b)(6) motion).

19. See *infra* Part III (detailing the *Tellabs* litigation, the district court, Seventh Circuit, and Supreme Court opinions).

20. See *infra* Part IV.A (arguing that *Tellabs* crafts a rule whereby securities fraud plaintiffs get the benefit of a tie between competing inferences on a 12(b)(6) motion, but leaves questions over its application).

21. See *infra* Part IV.B (saying that the concern of rising litigation is unfounded, other PSLRA provisions are more suited to address this concern, and there is an inherent balance the PSLRA should achieve, namely preventing the filing of strike suits but preserving merited ones).

22. See *infra* Part IV.B.3 (saying that the *Tellabs* rule will cause meritorious securities fraud actions to be dismissed).

23. See *infra* Part IV.C (discussing *Tellabs* as it relates to the Seventh Amendment's right to a jury trial).

24. See *infra* Part IV.D (arguing that a probable cause approach achieves the required heightened standard but does not infringe on the Seventh Amendment).

25. See *infra* Part V (discussing recent interpretations of *Tellabs* and how a plaintiff now faces a harder time surviving a motion to dismiss).

Part also discusses the outcome of the *Tellabs* case on remand and thereby illustrates the difficulty a plaintiff now faces in surviving a 12(b)(6) motion to dismiss.²⁷ Part VI concludes that *Tellabs*, while setting forth a homogeneous standard, relies on erroneous concerns of strike suits and adopts an approach that violates the Seventh Amendment.²⁸ Ultimately, the *Tellabs* decision seriously impedes the ability of injured investors to bring suit.²⁹

II. BACKGROUND

The legislative history of securities regulation provides a crucial backdrop for understanding the *Tellabs* decision.³⁰ This Part describes the statutory predecessors of the PSLRA and the origins of securities fraud claims.³¹ It then explains the congressional enactment of the PSLRA.³² Last, this Part describes the resulting division among the circuits as to how to interpret the PSLRA's "strong inference" provision.³³

A. *The Initial Regulation of Securities and an Inference of Scienter*

The stock market crash of 1929 and the ensuing Great Depression caused immense economic turmoil.³⁴ Looking for a source of blame, President Franklin D. Roosevelt pointed the finger at the excesses of big

26. See *infra* Part V.A (examining recent circuit court decisions where application of *Tellabs* results in dismissal of claims).

27. See *infra* Part V.B (examining the *Tellabs* case on remand and what it means for plaintiffs).

28. See *infra* Part VI (concluding that the Supreme Court's decision rests on unsubstantiated fears of frivolous securities litigation and defines "strong inference" in a way which requires courts to sift through reasonable, competing inferences and thus usurps a jury function).

29. See *infra* Part VI (demonstrating a securities fraud plaintiff's difficulty in surviving a 12(b)(6) motion to dismiss by exploring the *Tellabs* case on remand and recent interpretations of *Tellabs* in the circuits).

30. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2508 (2007) (citing legislative history of the PSLRA to establish congressional intent).

31. See *infra* Part II.A (discussing the initial regulations of the securities market).

32. See *infra* Part II.B (discussing the PSLRA and its "strong inference" requirement).

33. See *infra* Part II.C (examining the division among the circuits on whether to consider and weigh both culpable and nonculpable inferences in assessing whether a strong inference has been pled).

34. See *Merrill Lynch v. Dabit*, 547 U.S. 71, 78 (2006) ("In response to the sudden and disastrous collapse in prices of stocks in 1929, and the Great Depression that followed, Congress enacted the Securities Act of 1933 . . . and the Securities Exchange Act of 1934 . . .").

business.³⁵ As part of his New Deal legislation, Roosevelt promulgated two statutes that would change the landscape of securities trading: the Securities Act of 1933³⁶ and the Securities Exchange Act of 1934.³⁷

First, Congress passed the Securities Act of 1933 (“the 1933 Act”).³⁸ The 1933 Act’s primary objectives were to provide investors with sufficient and significant information regarding securities that were offered for sale and to prohibit deceit and fraud by the offerors.³⁹ Also, to regulate secondary trading of securities, Congress passed the Securities Exchange Act of 1934 (“the 1934 Act”).⁴⁰ The primary aim of the 1934 Act was to protect investors against the manipulation of stock prices.⁴¹ To achieve this end, the 1934 Act gave shareholders the right to bring an action in federal court to recover damages for securities fraud.⁴² As a result, the majority of securities fraud claims are brought under Section 10(b) of the 1934 Act and the Security and Exchange Commission’s rule promulgated thereunder, Rule 10b–5.⁴³ Such claims, commonly referred to as 10b–5 actions, allow a private plaintiff to recover damages caused by an act or omission resulting in fraud or

35. 26 MICHAEL J. KAUFMAN, *The PSLRA, Enron and Laxity, in SECURITIES LITIGATION DAMAGES* § 4:4 (2007) (quoting Judge Abner J. Mikva discussing the history of FDR’s enacting the Securities Act of 1933). *But see* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L. J. 1843, 1849 (2007); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 457 (6th ed. 2003) (arguing that the market crash was not a result of fraud or other corporate abuses, rather, the market crash resulted from the expectation of the decline in economic activity; thus, asserting that one is entitled to be skeptical about aspects of securities regulation designed to prevent another market crash).

36. 15 U.S.C. § 77(a) (2000) et seq.

37. 15 U.S.C. § 78 (2000) et seq.

38. 15 U.S.C. § 77(a). The 1933 Act was the first federal regulation of securities laws.

39. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). *But see* POSNER, *supra* note 35, at 457–58 (noting that the SEC’s requirement that issues of stock were to be submitted by a prospectus in advance actually inhibits the flow of information as these prospectuses are written in legal and accounting jargon). Nevertheless, something is better than nothing.

40. 15 U.S.C. § 78(a) (2000) et seq. The Securities Exchange Act of 1934 also established the Securities and Exchange Commission which continues to this day.

41. *Ernst & Ernst*, 425 U.S. at 195.

42. Neither Section 10(b) of the Securities Exchange Act nor SEC Rule 10b–5 explicitly provides for a private cause of action. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729–30 (1975). Federal courts, however, recognize the rights of private litigants to seek relief under Rule 10b–5. *See, e.g., Ernst & Ernst*, 425 U.S. at 196; *Superintendent of Ins. of the State of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971). Rule 10b–5 actions grew in such popularity that Justice Rehnquist described them as “judicial oak[s] which [have] grown from little more than a legislative acorn.” *Blue Chip Stamps*, 421 U.S. at 737. *But see* POSNER, *supra* note 35, at 460 (arguing that private causes of action may result in over deterrence and unjust enrichment).

43. Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b–5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 BUS. LAW. 309, 310 (1996).

deceit in connection with the purchase or sale of any security.⁴⁴ The six elements that a plaintiff must allege and prove for a 10b–5 action are: (1) that the defendant made a material misrepresentation or omission; (2) that the defendant acted with scienter or a wrongful state of mind; (3) that the material misrepresentation or omission was made in connection with the purchase or sale of a security; (4) that the plaintiff relied on the material misrepresentation; (5) that the plaintiff suffered an economic loss as a result; and (6) that the material misrepresentation actually caused the loss.⁴⁵

Eventually, after the enactment of these regulations, “America’s financial markets became the envy of the world.”⁴⁶ Foreign capital flowed into the United States from foreign investors who felt assured that American markets were not being manipulated.⁴⁷ Investors received assurance because defrauded investors could bring a private action to recover damages upon a violation of the securities laws.⁴⁸ Yet in the 1990s, Wall Street and Congress began to perceive a threat to the stability of the American financial markets from frivolous investor suits⁴⁹ and strike suits.⁵⁰ In response, Congress passed the Private

44. 17 C.F.R. § 240.10b–5 (1997).

45. *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005) (citing the elements of a Rule 10b–5 claim). Scienter is a mental state embracing intent to deceive, manipulate, or defraud. *Ernst & Ernst*, 425 U.S. at 185 n.1.

46. See KAUFMAN, *supra* note 35 (quoting Judge Abner J. Mikva discussing the history of FDR’s enacting the Securities Act of 1933); see also S. REP. NO. 104–98, at 7 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 686; BERSHAD ET AL., *supra* note 7, at 11 (“Securities markets in Japan and Europe involve greater risk for investors because there is less vigilance against fraud and insider trading than in the U.S. markets, and because the standards for full and fair disclosure . . . are only now becoming established.”).

47. KAUFMAN, *supra* note 35 (discussing the history of the Securities Act of 1933).

48. S. REP. NO. 104–98, at 8 (1995) as reprinted in 1995 U.S.C.C.A.N. 679, 687; Herbert E. Milstein, *Some Effects of PSLRA: A Plaintiff Lawyer’s Perspective*, 1279 PLI/ CORP. 1251, 1253 (2001); see also BERSHAD ET AL., *supra* note 7, at 9 (dissenting introduction) (quoting the president of Bear Stearns, formerly one of the largest global investment banks and securities trading and brokerage firms, as saying “We think people are honest, but they’re more honest if you watch them like a hawk.”).

49. S. REP. NO. 104–98, at 4 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683; see also S. REP. NO. 104–98, at 5 (1995) as reprinted in 1995 U.S.C.C.A.N. 679, 684. Frivolous suit: a lawsuit having no legal basis, often filed to harass or extort money from the defendant. BLACK’S LAW DICTIONARY 1475 (8th ed. 2004). Throughout this Note, frivolous, nuisance, meritless, and strike suits are used interchangeably and likewise, nonfrivolous, nonnuisance, and meritorious are used interchangeably.

50. Congress noted:

The Committee heard substantial testimony that today certain lawyers file frivolous “strike” suits alleging violations of the Federal Securities laws in the hope that defendants will quickly settle to avoid the expense of litigation. These suits, which unnecessarily increase the cost of raising capital and chill corporate disclosure, are often based on nothing more than a company[’]s announcement of bad news, not

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Securities Litigation Reform Act of 1995.⁵¹ Initially, President Bill Clinton vetoed the Act, citing the heightened pleading requirement as his primary reason.⁵² However, Congress overrode Clinton's veto and made the PSLRA into law.⁵³

B. The Private Securities Litigation Reform Act and the Strong Inference of Scienter

Through the enactment of the PSLRA, Congress sought to accomplish three goals: first, to encourage voluntary disclosure of information by corporate issuers; second, to empower investors rather than their lawyers; and third, to encourage plaintiffs' lawyers to pursue valid claims and to encourage defendants to fight abusive ones.⁵⁴ Congress' third aim, to encourage the filing of valid claims, also had a

evidence of fraud.

S. REP. NO. 104-98, at 4 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683; see also S. REP. NO. 104-98, at 5 (1995) as reprinted in 1995 U.S.C.C.A.N. 679, 684 (noting that the system is being abused and misused); KAUFMAN, *supra* note 35 (discussing the history of the Securities Acts); H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 730 (explaining abusive practices, including (1) routine filing of lawsuits against issuers whenever there is a significant change in the stock price without regard to culpability, (2) targeting deep pocket defendants and individuals covered by insurance, (3) imposing burdensome discovery costs to push a settlement, and (4) class action manipulation). See generally BLACK'S LAW DICTIONARY 1475 (8th ed. 1999) (defining strike suit as a suit often based on no valid claim, brought either for nuisance value or as leverage to obtain a favorable or inflated settlement).

51. In 1994, when the Republicans won control of Congress, they passed the PSLRA as part of their Contract with America. 27 ALSTON & BYRD, LLP, *Private Securities Litigation Reform Act—Major developments and issues*, in SECURITIES LITIGATION FORMS AND ANALYSIS § 1:2 (2007).

52. President Clinton stated:

Specifically, I object to the following elements of this bill. First, I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.

141 CONG. REC. S19035 (daily ed. Dec. 21, 1995).

53. 141 CONG. REC. S19180 (daily ed. Dec. 22, 1995); 141 CONG. REC. H15214-24 (daily ed. Dec. 20, 1995).

54. S. REP. NO. 104-98, at 4 (1995) as reprinted in 1995 U.S.C.C.A.N. 679, 683; Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?* 23 J.L. ECON. & ORG. 598, 600 (2007). It is generally accepted that private causes of action further the integrity of American markets. See generally H.R. REP. NO. 105-803 (1998) (Conf. Rep.) (Congressional finding that securities regulation has a dual aim of protecting investors and promoting growth of financial markets); H.R. CONF. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 731 (stating that the overriding purpose of the nation's securities laws is to protect investors and maintain confidence in the market so national savings and investments may grow for the benefit of all).

flip side: to prevent *in terrorem* settlements.⁵⁵ In an effort to curb these perceived abuses of the 10b–5 action,⁵⁶ Congress imposed a variety of procedural barriers to securities fraud actions, including a heightened pleading requirement,⁵⁷ which states:

[I]n any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts *giving rise to a strong inference* that the defendant acted with the required state of mind.⁵⁸

55. S. REP. NO. 104–98, at 6 (1995) *as reprinted in* 1995 U.S.C.C.A.N. 679, 685 (“The dynamics of private securities litigation create powerful incentives to settle Many such actions are brought on the basis of their settlement value. The settlement value to defendants turns more on the expected costs of defense than the merits of the underlying claim.”). *In terrorem* settlements are settlements a defendant enters into for fear of costly litigation. *In terrorem* is Latin meaning “in order to frighten.” BLACK’S LAW DICTIONARY 839 (8th ed. 2004).

56. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2508 (2007); *see* 26 MICHAEL J. KAUFMAN, *The Private Securities Litigation Reform Act: Generally*, in SECURITIES LITIGATION DAMAGES § 3:1 (2007) (noting that the Private Securities Litigation Reform Act had parallel effects on both the Securities Act of 1934 and the Securities Act of 1933, impacting areas such as class action litigation, forward-looking statements, pleading requirements, RICO liability, and auditor disclosures); *see also* H.R. REP. NO. 104–369, at 37 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 736 (“The cost of discovery often forces innocent parties to settle frivolous securities class actions.”); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 914–15 (2003) (saying that the three goals of the PSLRA are: (1) to reduce the costs that securities actions impose on the capital markets by discouraging the filing of non-meritorious suits; (2) to reduce litigation risk for high technology issuers; and (3) to reduce the race to the courthouse door whereby class actions are filed soon after a significant stock price declines). *But see Tellabs*, 127 S. Ct. at 2515 (Scalia, J., concurring) (arguing that the report of a single committee of a single House does not express the will of Congress).

57. *See* Perino, *supra* note 56, at 925 (noting that the pleading requirement actually has three components: (1) a specificity requirement, (2) a particularity requirement for complaints pled on information and belief, and (3) the strong inference requirement).

58. 15 U.S.C. § 78u–4(b)(2) (emphasis added). Prior to the enactment of the PSLRA, the federal circuits uniformly held that intent and recklessness would suffice to plead scienter although they differed on the degree of specificity required. *See Miest, supra* note 12, at 1109–12 (discussing the state of pleading scienter in securities fraud claims prior to the enactment of the PSLRA). This “strong inference” language was seemingly adopted from the Second Circuit. *See Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (“The requisite ‘strong inference’ of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”). However, the legislative history suggests Congress did not intend to codify the Second Circuit’s strong inference standard and instead explicitly rejected the Second Circuit’s requirement that a plaintiff must allege motive and opportunity or reckless or conscious behavior. Congress aimed for a standard similar to Rule 9(b), but above the Second Circuit’s interpretation:

The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)’s notion of pleading with “particularity.” Regarded as the most stringent

Congress, however, failed to elaborate on what allegations would suffice to create such a strong inference of scienter, leaving the courts to flesh out an interpretation.⁵⁹

C. The Circuit Split: Weighing, Accepting, and Limiting Inferences at the Pleading Stage

Without legislative guidance on how to apply the scienter requirement, the federal courts embarked on the long road of discerning the congressional intent behind the nebulous language of “strong inference.”⁶⁰ The circuits invariably took different paths.⁶¹ Part III will describe how the Supreme Court in *Tellabs* set out to resolve the circuit dispute concerning whether nonculpable inferences⁶² should be considered in assessing whether a strong inference exists.⁶³

Before *Tellabs*, some circuits required courts to consider nonculpable or innocent inferences, as well as culpable inferences, in determining whether a strong inference of scienter had been alleged.⁶⁴ In *Brown v. Credit Suisse First Boston Corp.*, for example, a group of investors brought a securities fraud class action against a financial services firm

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. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.

H.R. REP. NO. 104–369, at 41 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 740. Congress specifically denied including motive, opportunity, or recklessness in the language of the statute. H.R. REP. NO. 104–369, at 49 n.23 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 748. *But see* Brief for Respondents at 26, *Tellabs v. Makor Issues & Rights*, 127 S. Ct. 2499 (2007) (No. 06–484) (arguing Congress did not intend to depart from the Second Circuit’s recognition that strong inference still requires a court to accept all allegations as true and to draw all reasonable inferences in favor of the plaintiff) [hereinafter Brief for Resp. (No. 06–484)].

59. *See infra* Part II.C (discussing the emergent circuit split regarding the determination of a “strong inference” of scienter).

60. *See infra* notes 65–86 and accompanying text (describing paths taken by the First, Fourth, Sixth, Ninth, and Tenth circuits in assessing a “strong inference” under the PSLRA).

61. *See infra* notes 65–86 and accompanying text (describing the different interpretations the circuits have taken in determining whether to consider and weigh competing nonculpable inferences on a 12(b)(6) motion).

62. Nonculpable inferences are inferences which would exonerate or “detract from the strength of the inference of scienter.” *Winters v. Stemberg*, No. 07–10193–WGY, 2008 WL 62465, at *4 (D. Mass. Jan. 4, 2008).

63. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2506 (2007); *see also* Perino, *supra* note 56, at 926 (noting that the PSLRA did not achieve its goal of resolving the circuit split of pleadings for securities fraud claims and noting specifically the sharp split among the circuits over the “strong inference” standard).

64. *Brown v. Credit Suisse First Boston Corp.*, 431 F.3d 36, 51 (1st Cir. 2005).

and its analysts.⁶⁵ The plaintiffs claimed that the defendant's analysts made misleading statements in the form of false investor ratings about the corporation's stock.⁶⁶ The First Circuit held that when assessing whether the plaintiff has pled a strong inference of scienter in a 12(b)(6) motion, a court should not delve into individualized assessments but rather consider *all* competing inferences, both culpable and nonculpable.⁶⁷ However, the court applied this standard to find that the plaintiff failed to allege a strong inference of scienter because the circumstances surrounding the assignment of the rating were susceptible to other nonculpable inferences.⁶⁸ The First Circuit found that the nonculpable, inherent subjectivity of the investor recommendations, when compared with the culpable inference of corruption, was not enough to allege a strong inference of scienter.⁶⁹

Similarly, in *Gompper v. VISX, Inc.*, the Ninth Circuit required that a court not only consider nonculpable inferences, but also *weigh* these inferences and find on balance that there is a strong inference of scienter.⁷⁰ The Ninth Circuit was primarily concerned with Congress' intent to eliminate abusive and opportunistic securities litigation.⁷¹ The court stated that the PSLRA "significantly altered pleading requirements"⁷² by requiring courts to consider inferences opposing the

65. *Id.* at 41–42.

66. *Id.* at 42. Specifically, the plaintiffs claimed that the analysts were issuing stock ratings, such as "buy," when in fact the analysts believed such stock was not of such a quality. *Id.* The plaintiffs claimed that the defendant's analysts issued "bullish reports . . . to curry favor with [another corporation] and thereby secure future investment banking business." *Id.* The plaintiffs alleged that the defendant issued a buy rating for the stock despite reservations the defendant had about the other corporation's growth. *Id.* at 44. This was evidenced by various emails sent between the defendant's employees and the other company's director of investor relations as well as some internal emails. *Id.*

67. *Brown*, 431 F.3d at 46, 51.

68. *Id.* at 47 ("Armed with the same background facts, two knowledgeable analysts, each acting in the utmost good faith, could well assign different ratings to the same stock."). The Fourth Circuit similarly requires courts to consider culpable and nonculpable inferences in determining whether the plaintiff adequately alleged scienter. *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 347 (4th Cir. 2003) (weighing both culpable and nonculpable inferences such as the inference that the defendant's understating of the number of post-acquisition departures was due to either fraud or the fact that the corporation was in the midst of a complex nationwide integration and the number of departures were simply undercounted).

69. *Brown*, 431 F.3d at 49–50.

70. *Gompper v. VISX, Inc.*, 298 F.3d 893, 898 (9th Cir. 2002).

71. *Id.* *But see* Shaun Mulreed, Comment, *Private Securities Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 From Achieving Its Goals*, 42 SAN DIEGO L. REV. 779, 817–18 (2005) (illustrating how the Ninth Circuit's standard, as articulated in *Gompper*, may actually lower the standard by allowing the standard to be applied in a lofty fashion).

72. *Gompper*, 298 F.3d at 895.

plaintiff, because a failure to do so would eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum.⁷³

Other circuits required courts to consider nonculpable inferences, but refrained from any weighing of these inferences.⁷⁴ For instance, the Tenth Circuit explicitly rejected a weighing of inferences in *Pirraglia v. Novell*.⁷⁵ In *Pirraglia*, a group of investors brought a securities fraud class action against the Novell Corporation alleging that individual officers made false statements and issued false financial reports.⁷⁶ In assessing whether the plaintiffs alleged a strong inference of scienter, the Tenth Circuit considered the Ninth Circuit's standard as expressed in *Gompper*.⁷⁷ The Tenth Circuit agreed that courts should consider all reasonable inferences, culpable and nonculpable.⁷⁸ However, the Tenth Circuit found that while the court must consider both types of inferences, it should not *weigh* them because to do so would invade the traditional role of the fact finder.⁷⁹ The Tenth Circuit ultimately settled on its own interpretation of the standard—if the plaintiff's complaint alleges facts which give rise to a strong inference of scienter holistically, the plaintiff has pled the requisite strong inference.⁸⁰ The court held that competing inferences are recognized in an evaluative, not preclusive, manner.⁸¹

In contrast to all other circuits, the Sixth Circuit does not consider other inferences at all, but rather limits its consideration to only the most plausible of inferences.⁸² In *Helwig v. Vencor*, the Sixth Circuit stated that inferences, even those adverse to a plaintiff, must be

73. *Id.* at 896.

74. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187–88 (10th Cir. 2003).

75. *Id.*

76. *Id.* at 1184. The plaintiffs alleged that the defendants falsely told analysts and investors that demand for Novell products was high even absent any special promotional tactics and that such forecasts were reflective of end-user demand and not the result of over-inventoried items. *Id.* at 1186.

77. *Id.* at 1187–88.

78. *Id.* at 1187. The Court stated, “Whether an inference is a strong one cannot be decided in a vacuum.” *Id.* This language would later be expressed by the Court in *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007) (“The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts?”).

79. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003).

80. *Id.* Ultimately, the Court would affirm in part and reverse in part finding sufficient allegations to establish scienter, but not particularity. *Id.*

81. *Id.* at 1187.

82. *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2000).

construed in the plaintiff's favor.⁸³ Similar to the Tenth Circuit, the Sixth Circuit reserves the weighing of inferences for the fact finder.⁸⁴ The court was concerned that the pleading standard would become a "choke-point for meritorious claims" and, therefore, sought to avoid premature dismissal of such claims.⁸⁵ Thus, the circuits ran the gamut of possibilities in determining whether inferences are to be weighed at the pleading stage—setting the scene for the Supreme Court to resolve the matter.⁸⁶

III. DISCUSSION

Despite the wide variety of interpretations proposed by the circuits, none of these views were adopted by the Supreme Court in *Tellabs*.⁸⁷ Instead, *Tellabs* requires that in determining whether a plaintiff's securities fraud complaint meets the requirements of the PSLRA and, therefore, gives rise to a "strong inference" of scienter, a court must consider competing inferences and weigh them.⁸⁸ The court then must determine that the pled facts have given rise to an inference of scienter *at least as likely* as any plausible opposing inference.⁸⁹ This Part will

83. *Id.*

84. *Id.*

85. *Id.* The Sixth Circuit noted that plaintiffs already face procedural hurdles imposed by the PSLRA such as the stay of discovery provisions. *Id.* Ironically, the Sixth Circuit's standard in effect is a rather vigorous standard, allowing the benefit of only the *most plausible* of competing inferences. *Id.*

86. *See supra* notes 64–85 and accompanying text (describing various approaches taken by the circuit courts in assessing whether a plaintiff has pled a "strong inference" of scienter). The circuits were likewise divided not only as to whether nonculpable inferences are to be considered in assessing a "strong inference" but also as to what kind of allegations qualified to allege a strong inference of scienter. First, some circuits applied the Second Circuit's standard that required plaintiffs to plead only mere motive and opportunity or to establish an inference of recklessness. *See, e.g.,* *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir. 2000). Second, some courts heightened the Second Circuit's standard by rejecting motive and opportunity as sufficient, but still allowing an inference of recklessness to suffice as a strong inference. *See, e.g.,* *In re Comshare, Inc. Secs. Litig.*, 183 F.3d 542, 549–51 (6th Cir. 1999) (holding that under the PSLRA, plaintiffs may plead scienter by alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that defendant had motive and opportunity to commit securities fraud). Third, the harshest standard, as set forth by the Ninth Circuit, would allow only an inference of conscious conduct to suffice to allege a strong inference. *See, e.g., In re Silicon Graphics Sec. Litig.*, 970 F. Supp. 746, 757 (N.D. Cal. 1997). The Ninth Circuit's approach is considered "extremely harsh." *See* 26 MICHAEL J. KAUFMAN, *Pleading State of Mind*, in *SECURITIES LITIGATION DAMAGES* §3:10 (2007) (characterizing the *Silicon* decision as implementing an extremely harsh standard for securities fraud claims).

87. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007).

88. *Id.*

89. *Id.*

begin with the factual background of the case.⁹⁰ It will then discuss the *Tellabs* decision, including the holdings of the district court⁹¹ and the Seventh Circuit.⁹² Finally, it will explain how the Supreme Court ultimately resolved the circuit divide.⁹³

A. *Factual Background: The Seeds of Fraud*

The investor-plaintiffs in *Tellabs* brought a securities fraud class action under §10(b)⁹⁴ and SEC Rule 10b-5⁹⁵ against Tellabs, Inc., Richard Notebaert, and Michael Birck, alleging that they engaged in a scheme to defraud investors of the true value of the company's stock during the class period.⁹⁶ Tellabs makes and markets specialized optical equipment and acts as a supplier of Internet networking solutions and services.⁹⁷ Michael Birck, one of the founders of Tellabs, was an officer and director during the class period.⁹⁸ Richard Notebaert, also a director, was the CEO and president during the class period.⁹⁹ The products at issue in the case were the Titan 5500 and the Titan 6500.¹⁰⁰ The Titan 5500 was the Tellabs flagship optical networking system.¹⁰¹ The Titan 6500 was a new multi-service transport switch, capable of simultaneously transporting a variety of

90. See *infra* Part III.A (detailing the facts surrounding the litigation as alleged in the plaintiff's complaint and as recounted by the courts).

91. See *infra* Part III.B (describing the district court's decision dismissing the complaint).

92. See *infra* Part III.C (examining the Seventh Circuit's ruling affirming the dismissal in part and reversing in part).

93. See *infra* Part III.D (exploring the Supreme Court's analysis and holding).

94. 15 U.S.C. § 78j(b) (2000).

95. SEC Rule 10b-5; 17 C.F.R. § 240.10b-5.

96. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2505 (2007). Tellabs' customers included exchange carriers, telephone companies, local telephone administrations, cellular and wireless service companies, cable operators, and internet service providers. *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 945 (N.D. Ill. 2004), *rev'd*, 437 F.3d 588 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007).

97. *Johnson*, 303 F. Supp. 2d at 945. Some of Tellabs' customers included SBC Communications, Inc., and Verizon Communications, Inc. Second Consol. Amended Class Action Complaint at ¶ 3, *Johnson v. Tellabs*, 303 F. Supp. 2d 941 (N.D. Ill. 2004) (No. 02-CV-4356) [hereinafter *Tellabs* Compl.]. Verizon Communications, Inc., accounted for approximately 19.1% of net sales in 2000. *Id.* at ¶ 33.

98. *Johnson*, 303 F. Supp. 2d at 945.

99. *Id.* at 945-46.

100. *Id.* at 946.

101. *Id.* The Titan 5500 directs different types of communications traffic across wired and wireless networks. *Tellabs* Compl., *supra* note 97, at ¶ 30. The Titan 5500 also includes access, transportation, and management capabilities for fiber optic networks, which are a critical part of voice and data communications infrastructures. *Id.*

wireless signals.¹⁰² The plaintiffs based their allegations on information provided by twenty-seven confidential sources.¹⁰³

The events upon which the claims were based unfolded in December of 2000, the start of the class period, with a press release issued by Tellabs announcing a \$100 million contract between Tellabs and Sprint for the purchase of the Titan 6500.¹⁰⁴ The press release stated that the Titan 6500 was “available now” and the Titan 5500 was experiencing continued growth.¹⁰⁵ Later, Notebaert told financial analysts that there would be “continuing growth of the Titan 5500.”¹⁰⁶

In January of 2001, Notebaert, on behalf of Tellabs, issued another press release stating that customers were buying more and more Tellabs equipment and that demand for the Titan 6500 was exceeding expectations.¹⁰⁷ When speaking with financial analysts, Notebaert said, “We feel very, very good about the robust growth we’re experiencing.”¹⁰⁸ The next month, a letter was sent to stockholders, signed by Notebaert and Birck, stating that Titan 5500 sales were soaring and that customers were embracing the Titan 6500 since its release from the lab.¹⁰⁹ The letter was accompanied by the company’s annual report, also signed by both Notebaert and Birck, which said growth for the Titan 5500 was still going strong.¹¹⁰

However, in March of 2001, despite these positive forecasts, Tellabs lowered its revenue and earnings expectations, noting that it recognized no revenue from the Titan 6500 shipments in the first quarter.¹¹¹ Despite these inconsistencies, Tellabs announced that it expected

102. *Johnson*, 303 F. Supp. 2d at 946.

103. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 591 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

104. *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 946 (N.D. Ill. 2004), *rev’d* 437 F.3d 588 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007). The press release stated, “Tellabs today announced a multiyear agreement with Sprint for the Titan 6500 multiservice transport switch The agreement is expected to be valued at more than \$100 million over the life of the contract. . . . *The TITAN 6500 is available now.*” (emphasis in original). *Tellabs Compl.*, *supra* note 97, at ¶ 73.

105. *Johnson*, 303 F. Supp. 2d at 947.

106. *Makor Issues & Rights*, 437 F.3d at 592.

107. *Id.*

108. *Id.*

109. *Id.* The annual report accompanied the letter signed by Birck and Notebaert, stating that they were not worried that the Titan 5500 had peaked because they were experiencing the highest revenues thus far and growth was still going strong. *Id.*

110. *Id.*

111. *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 948 (N.D. Ill. 2004), *rev’d sub nom. Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

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increased second quarter revenue shipments of the Titan 6500.¹¹² During this time, Notebaert was asked by securities analysts if Tellabs was experiencing any weakness in sales of the Titan 5500.¹¹³ Notebaert responded that the Titan 5500 was still experiencing strong acceptance in the market.¹¹⁴ Analysts then made recommendations to investors to buy Tellabs stock.¹¹⁵ Also, Birck and Notebaert signed a report indicating that the company achieved record level sales as a result of continued strong demand for the Titan 5500.¹¹⁶

In April of 2001, Notebaert told securities analysts that everything they heard from customers indicated strong demand for the Titan 6500.¹¹⁷ At the close of the class period in June of 2001, Tellabs issued a press release revising second quarter revenue expectations from about \$800 million to \$500 million, claiming customers were cautious about buying new technology and equipment.¹¹⁸ Tellabs stock fell from \$21.20 to \$15.87,¹¹⁹ representing a decline of more than 75% from the class period high of \$67.125.¹²⁰

The plaintiffs alleged that, throughout the class period, Tellabs, Notebaert, and Birck employed a scheme to defraud investors.¹²¹ For instance, the plaintiffs claimed that the \$100 million contract signed by Sprint was actually signed to satisfy an existing \$100 million commitment.¹²² In fact, Sprint had no intention of purchasing any of the Titan 6500 systems.¹²³ As evidence of financial motive, the plaintiffs also pointed out that, during the class period, Birck sold 80,000 shares of Tellabs stock for about \$5 million.¹²⁴ In addition, despite claims that the Titan 5500 was experiencing robust growth,

112. *Id.*

113. *Id.* at 956.

114. *Id.*

115. *Id.* In fact, the complaint calculated defendant Birck's proceeds from the sale to be \$5,183,150. *Tellabs* Compl., *supra* note 97, at ¶ 17.

116. *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 949 (N.D. Ill. 2004), *rev'd sub nom. Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

117. *Id.*

118. *Id.* at 949–50.

119. *Id.* at 948.

120. *Id.* at 950.

121. *Id.*

122. *Id.*

123. *Id.* at 946.

124. *Id.* at 950. Several other directors and/or officers were alleged to have sold Tellabs stock during the class period. *Id.*

demand for the product had actually dropped.¹²⁵ There were similar problems with the Titan 6500; contrary to Notebaert's statements, the Titan 6500 was unavailable to the public.¹²⁶

Additionally, the plaintiffs alleged that Tellabs over-inventoried customers with Titan 5500s, knowing that this would result in reduced sales and customer returns in early 2001.¹²⁷ The plaintiffs also claimed that Tellabs was engaging in channel stuffing.¹²⁸ Channel stuffing is a practice whereby a supplier induces its customers to substantially increase their purchases of particular products above what they would otherwise buy from the company in the normal course of business, thus giving the company the immediate appearance of rising revenue.¹²⁹ At all times, the plaintiffs claimed that Notebaert and Birck were hands-on managers and knew everything about the workings of the company.¹³⁰ The plaintiffs also alleged that Notebaert and Birck saw daily reports concerning Tellabs product bookings and revenues.¹³¹ The entirety of the plaintiffs' complaint rested on information from twenty-seven confidential sources.¹³²

The allegations against the individual defendants, Notebaert and Birck, consisted mainly of misstatements concerning the demand for the Titan 5500, misstatements concerning the availability of the Titan 6500, misstatements regarding Tellabs' fourth quarter financials as a result of

125. *Id.* at 946, 955. The plaintiffs alleged that tons of Titan 5500s were just sitting in warehouses. *Id.* at 946. According to a confidential source, orders from every single Titan 5500 customer declined. *Tellabs Compl.*, *supra* note 97, at ¶ 37.

126. *Johnson*, 303 F. Supp. 2d at 957. The Titan 6500 was failing customer and lab trials. *Id.* The Titan 6500 was not available for release in December. *Id.* at 957. In fact, the plaintiffs claimed that not a single Titan 6500 was shipped during the class period. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 604 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

127. *Johnson*, 303 F. Supp. 2d at 959. Orders were written for products customers did not want. *Id.* The defendants back-dated orders and offered excessive discounts which were hidden from the public, to offer incentives to entice the purchase of the products. *Id.*

128. *Id.*

129. *Id.* According to the plaintiffs, customers even called and complained about the channel stuffing and over inventorying. *Id.*

130. *Id.* at 962.

131. *Id.* at 963. The plaintiffs also claimed that an independent research firm hired by Tellabs to assess the demand for Titan's 5500 systems reported that demand would suffer a steep decline. *Id.* at 964.

132. *Tellabs Compl.*, *supra* note 97.

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over-inventorying customers (channel stuffing),¹³³ and a resulting overstatement of Tellabs' revenue projections.¹³⁴

B. The District Court Decision: Dismissing the Complaint

The District Court for the Northern District of Illinois dismissed the plaintiffs' second amended complaint for failure to state a claim upon which relief could be granted.¹³⁵ The district court assessed the complaint holistically and determined that a strong inference of scienter could not be implied from the pleadings.¹³⁶

First, the district court addressed the plaintiffs' attempt to plead scienter for the misleading statements concerning the Titan 5500 and the Titan 6500.¹³⁷ As for Tellabs, the district court dismissed the plaintiffs' allegation that the Tellabs executives, Notebaert and Birck, were "hands on and knew everything."¹³⁸ Such vague assertions, according to the court, were insufficient to establish knowledge on behalf of Notebaert and Birck and thereby impute it onto Tellabs.¹³⁹ The district court also rejected the plaintiffs' allegations that a strong inference of scienter was established by the fact that the quarterly status reports depicted a decline in customer demand, daily product bookings, and revenue statements.¹⁴⁰ The district court found that there was no indication of any information in the reports that supported an inference

133. Channel stuffing creates the short-term illusion that demand is rising between the time a company sends an extra product to distributors and the time when the distributors return it. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 598 (7th Cir. 2006), *vacated sub nom. Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007). One of the confidential sources for the plaintiffs claimed Tellabs at one point had to lease extra storage for all of the returned product. *Id.* At oral argument, Justice Ginsburg likened channel stuffing practices to good and bad cholesterol. Transcript of Oral Argument, at 37–38, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) (No. 06–484) (Ginsburg, J.) [hereinafter *Tellabs*, Tr. of Oral Argument]. Justice Ginsburg said it was not clear here whether the plaintiffs were alleging the good or the bad kind. *Id.* at 38.

134. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2505 (2007).

135. *Johnson*, 303 F. Supp. 2d at 944. Specifically, the district court rejected the Second Circuit's approach which required plaintiffs to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* at 961 (citing *Ottmann*, 353 F.3d at 345 (taking a holistic approach to determining scienter)). The district court did acknowledge that such facts can be used as *factors* in determining whether a strong inference of scienter had been pled. *Id.* at 961.

136. *Id.*

137. *Id.* at 962–64.

138. *Id.* at 962.

139. *Id.*

140. *Id.* at 962–63.

that the company knew that the statements in the press release were false.¹⁴¹

The district court also considered whether the plaintiffs had alleged sufficient facts to establish that the individual defendants, Notebaert and Birck, possessed the requisite scienter for these misstatements.¹⁴² The plaintiffs tried to establish the defendants' scienter based on the fact that defendant Birck sold Tellabs' stock during the class period.¹⁴³ The court reasoned that while such action may provide circumstantial evidence of scienter as indicative of financial motive, it must be dramatically out of line with prior trading practices, and hence actually suspicious, to establish a strong inference of scienter.¹⁴⁴ Because Birck's action did not contradict his prior trading practice, the district court dismissed this allegation.¹⁴⁵ Notebaert was not alleged to have sold stock during the class period.¹⁴⁶

The plaintiffs also claimed that Birck knew and disregarded the falsity of the statements because of his position within Tellabs, and that he had "his hands on the pulse of everything," attended town hall meetings, and heard sales personnel briefs concerning product status.¹⁴⁷ However, the district court held that the plaintiffs failed to establish scienter for Birck in this regard because they did not allege the kind of information to which Birck was privy.¹⁴⁸ The court dismissed Birck from the complaint, finding that the allegations against Birck amounted to no more than generalized imputations of knowledge.¹⁴⁹

For Notebaert, the district court similarly concluded that the general conclusions alleged by the plaintiff were insufficient to establish his scienter.¹⁵⁰ The plaintiffs alleged that he attended town hall meetings,

141. *Id.* at 963.

142. *Id.* With respect to Birck, the plaintiffs alleged that Birck had his "hands on the pulse of the company," attended town hall meetings, and heard sales personnel briefings concerning product status. *Id.* at 967.

143. *Id.* at 962.

144. *Id.*

145. *Id.* at 962. The court noted that while Birck sold 80,000 shares of common stock, he was the owner of over thirty-seven million shares of Tellabs' common stock. *Id.* The court also noted that the plaintiffs failed to allege any history of trading on the part of Birck that would indicate this sale was out of line with prior trading practices on his behalf. *Id.*

146. *Id.*

147. *Id.* at 967.

148. *Id.*

149. *Id.* ("In essence, Plaintiffs' scienter allegations amount to the argument that Birck knew or recklessly disregarded the falsity of the statements because of his position Given the mandates of the PSLRA, these allegations in their totality fall short of providing a strong inference of scienter.").

150. *Id.* at 968.

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discussed revenues with senior vice presidents of Tellabs, and knew whether Tellabs' products were selling.¹⁵¹ However, because no details regarding precisely what Notebaert learned during this period were alleged, there was no strong inference of scienter.¹⁵²

Next, the district court addressed whether the plaintiffs had alleged scienter for the channel stuffing allegation.¹⁵³ The district court considered only whether scienter for Notebaert and Tellabs was established, because it had already dismissed defendant Birck.¹⁵⁴ The plaintiffs claimed Notebaert worked directly with sales personnel to engage in channel stuffing.¹⁵⁵ Nevertheless, the district court found this allegation insufficient.¹⁵⁶ The district court reasoned that the absence of allegations specifying exactly what it was Notebaert engaged in left the court unable to conclude that what Notebaert was doing was inherently wrong.¹⁵⁷

In sum, because the district court failed to find scienter for the underlying allegations, it did not find scienter for the overstated revenue projections.¹⁵⁸

C. The Seventh Circuit Decision: Strong Inference According to a Reasonable Person and the Seventh Amendment Quandary

The plaintiffs appealed to the Court of Appeals for the Seventh Circuit.¹⁵⁹ The Seventh Circuit framed the issue as: “[H]ow much, in the way of factual detail in the pleadings, is sufficient to create this ‘strong inference’ of the requisite scienter?”¹⁶⁰ The Seventh Circuit reversed the district court’s holding, finding that the plaintiffs alleged facts sufficient to support a strong inference of scienter against Notebaert and Tellabs, but not against Birck.¹⁶¹ According to the Seventh Circuit, a plaintiff demonstrates a strong inference of scienter if

151. *Id.*

152. *Id.*

153. *Id.* at 968–69.

154. *Id.*

155. *Id.* (“Plaintiffs further allege that according to [confidential source 3], Notebaert knew about the channel stuffing activity relating to the Titan 5500 and he pushed and prodded the Company’s sales personnel.”) (internal quotes omitted).

156. *Id.*

157. *Id.*

158. *Id.* at 964.

159. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 591 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007).

160. *Id.* at 595.

161. *Id.* at 605.

a *reasonable person* could infer that the defendant acted with the required intent.¹⁶²

Initially, the Seventh Circuit tried to discern the congressional intent behind the passage of the PSLRA.¹⁶³ The court found that Congress did not change existing law with the enactment of the “strong inference” standard; it reasoned that if Congress had wanted to change existing law, it would have done so explicitly.¹⁶⁴ Therefore, the court applied the same standard that existed prior to the PSLRA’s enactment.¹⁶⁵ In applying this standard, the Seventh Circuit reasoned that although motive and opportunity may be useful factors, they do not make or break the sufficiency of the pleading.¹⁶⁶ Furthermore, the court rejected the idea that plaintiffs are only entitled to the most plausible inferences, as the Sixth Circuit found in *Helwig*,¹⁶⁷ because of the potential to infringe on a plaintiff’s Seventh Amendment right to a jury trial.¹⁶⁸ The Seventh Circuit held that scienter is a question of fact¹⁶⁹ and stated the standard as follows:

[W]e will allow the complaint to survive if it alleges facts from which . . . a *reasonable person could infer that the defendant acted with the required intent* Faced with two seemingly equally strong

162. *Id.* at 602.

163. *Id.* at 600 (“In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had not prevented abuse of the securities laws by private litigants. . . . To address this perceived abuse, the PSLRA changes the threshold pleading rules. . . .”) (internal citations omitted).

164. *Id.* See *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 168 (1993) (*expressio unius est exclusio alterius*); see also *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 513 (2002) (“Just as Rule 9(b) makes no mention of municipal liability . . . neither does it refer to employment discrimination. Thus complaints in these cases, as in most others, must satisfy only the simple requirements of Rule 8(a).”) (internal citations omitted); BLACK’S LAW DICTIONARY 620 (8th ed. 1999) (“*expressio unius est exclusio alterius*. A canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative”).

165. *Makor Issues & Rights, Ltd.*, 437 F.3d at 600. The court began by outlining the three main existing approaches to establishing a strong inference of scienter: (1) plaintiffs can state a claim by pleading either (a) motive and opportunity or (b) strong circumstantial evidence of recklessness or conscious misbehavior. *Id.* at 601 (citing *Novak v. Kasaks*, 216 F.3d 300, 309–10 (2d Cir. 2000)); (2) plaintiffs can state a claim by pleading facts showing (a) simple recklessness or (b) a motive to commit fraud and opportunity. *Id.* at 601 (citing *In Re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999)); or (3) plaintiffs can state a claim by pleading enough facts that establish altogether a strong inference of scienter. *Id.* at 601. See, e.g., *Ottmann v. Hangar Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550–52 (6th Cir. 2000) (taking a holistic approach to determining scienter).

166. *Makor Issues*, 437 F.3d at 601.

167. *Id.* at 602.

168. *Id.*

169. *Id.* A question of fact is an issue that has not been predetermined and authoritatively answered by the law. BLACK’S LAW DICTIONARY 1281 (8th ed. 1999).

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 fact finder.¹⁷⁰

The Seventh Circuit then examined whether the complaint stated facts giving rise to a strong inference against Notebaert, Birck, and Tellabs.¹⁷¹ Because Notebaert made all statements while acting within the scope of his position as CEO, these statements were imputed to the corporate entity, Tellabs.¹⁷²

First, the Seventh Circuit examined whether there was scienter for statements about the demand for the Titan 5500.¹⁷³ The Seventh Circuit held that Notebaert's statements that demand for the Titan 5500 was growing while reports indicated the contrary, coupled with the allegation that Notebaert "stayed on top of his company's financial health," were enough for a reasonable person to infer the requisite scienter.¹⁷⁴ As for Birck, evidence that he signed a letter stating that things were "still going strong," attended town hall meetings, knew the status of the product, and that he sold 80,000 Tellabs shares, came after the Titan 5500 had already begun to decline.¹⁷⁵ Because of this, the Seventh Circuit found the allegations insufficient to infer scienter against Birck.¹⁷⁶

Second, the Seventh Circuit examined the statements concerning the availability and demand for the Titan 6500.¹⁷⁷ The Seventh Circuit held that the plaintiffs succeeded in establishing a reasonable inference of scienter for Notebaert by claiming that he saw weekly sales reports and production projections, and that he therefore knew that the Titan 6500 was not yet available to customers.¹⁷⁸ The Seventh Circuit did not address any allegations in this regard against defendant Birck.¹⁷⁹

170. *Makor Issues & Rights, Ltd.*, 437 F.3d at 602 (emphasis added).

171. *Id.* at 603.

172. *Id.*

173. *Id.*

174. *Id.* ("While it is conceivable that Notebaert had yet to see the reports suggesting his company was in trouble . . . the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false.").

175. *Id.* at 603–04.

176. *Id.* at 604. The court rejected the evidence of the stock sale because the plaintiffs failed to allege that the sale of stock was substantially out of line with prior trading practices. *Id.*

177. *Id.*

178. *Id.* The plaintiffs alleged that not a single Titan 6500 was shipped. *Id.*

179. *Id.* at 603.

Third, the Seventh Circuit addressed the channel stuffing allegations.¹⁸⁰ The plaintiffs claimed that Notebaert worked directly with Tellabs' sales personnel and that a high-level sales executive admitted that purchase orders were fabricated.¹⁸¹ The Seventh Circuit imputed Notebaert's scienter for the channel stuffing allegation onto Tellabs.¹⁸² Thus, the Seventh Circuit found this was sufficient to establish a strong inference of scienter for both Tellabs and Notebaert.¹⁸³ The Seventh Circuit did not consider these allegations against Birck.¹⁸⁴

Finally, the Seventh Circuit held that the overstated revenue projections sufficiently established a strong inference of scienter because they were supported by the company's statements that its products were doing better than they actually were.¹⁸⁵ In sum, applying a reasonable person standard, the Seventh Circuit concluded that the complaint, as pleaded, alleged sufficient facts to infer scienter against Notebaert and Tellabs, but not Birck.¹⁸⁶

D. The Justices Weigh In

The Supreme Court granted certiorari in the *Tellabs* case "to prescribe a workable construction of the 'strong inference' standard, a reading geared toward the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."¹⁸⁷ However, the Court's true concern was whether the complaint alleged a claim that was "not trial worthy, but

180. *Id.* at 604-05.

181. *Id.* at 605.

182. *Id.*

183. *Id.* On the other hand, however, the Seventh Circuit said the plaintiffs failed to provide enough facts to support a strong inference of scienter against CEO Birck in this regard. *Id.* at 604 ("We do not believe that the mere fact that he sold one percent of his stock necessarily establishes a strong inference of scienter.").

184. *Id.*

185. *Id.* at 605 ("The scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here.").

186. *Id.* at 604.

187. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509 (2007). Justice Ginsburg delivered the opinion of the Court in an 8-1 decision, in which Chief Justice Roberts, Justice Kennedy, Justice Souter, Justice Thomas, and Justice Breyer joined. Justices Scalia and Alito concurred in the judgment. Justice Stevens dissented. *Id.* at 2503.

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rather discovery worthy.”¹⁸⁸ The decision has two main components.¹⁸⁹ First, the Court settled the discussion about weighing inferences.¹⁹⁰ Second, the Court quelled concerns about the possibility that the standard infringes on the Seventh Amendment right to a jury trial.¹⁹¹

1. Weighing Inferences and Finding Culpability at Least as Likely

First, the Court clarified the PSLRA’s pleading requirement.¹⁹² The Court emphasized that Congress’ purpose in passing the statute was to establish a uniform pleading standard designed to curb “nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers.”¹⁹³ With these aims in mind, the Supreme Court announced the pleading standard required by the PSLRA.¹⁹⁴ First, in ruling on a 12(b)(6) motion to dismiss a 10b–5 action, a court must accept all factual allegations in the complaint as true.¹⁹⁵ Second, a court must ask whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, rather than whether any individual allegation, scrutinized in isolation, meets that standard.¹⁹⁶ Third, a court must weigh opposing inferences and find

188. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 47 (as stated by Justice Stevens). Compare *Tellabs*, 127 S. Ct. at 2514 (Scalia, J., concurring) (noting that the pleading standard should effectively deter baseless actions) with *id.* at 2517 (Stevens, J., dissenting) (saying that the basic purpose of the pleading standard is to protect defendants from the costs of discovery and trial in unmeritorious cases); see also Coyle, *supra* note 11 (“‘We’re seeing a lot of cases where the justices don’t see real injured people bringing real claims. They see lawyers trying to extort The court acted similarly in the securities area in *Tellabs* . . . by raising the bar on pleading a claim under the Private Securities Litigation Reform Act.”).

189. See *Tellabs*, 127 S. Ct. at 2509–13.

190. See *infra* notes 192–215 and accompanying text (describing the new standard set forth by the Court in assessing a “strong inference” and the justifications for it).

191. See *infra* notes 232–242 and accompanying text (examining the Court’s analysis of the Seventh Amendment issue behind considering and weighing inferences on a motion to dismiss).

192. *Tellabs*, 127 S. Ct. at 2506 (2007) (noting the difference between the Sixth and Seventh Circuits).

193. *Id.* at 2508. The Supreme Court cited various examples of just such an objective by pointing out Congress’ newly prescribed lead plaintiff and lead counsel procedures, and Congress’ enactment of the ‘safe harbor’ provision. *Id.* But see Brief for Joseph A. Grundfest et al. as Amici Curiae Supporting Petitioners, at 12, *Tellabs v. Makor Issues & Rights*, 127 S. Ct. 2499 (2007) (No. 06–484) (arguing that no formal legislative intent can be discerned, but rather the Court should look to case law for history concerning 10b–5 claims for more adequate and accurate guidance).

194. *Tellabs*, 127 S. Ct. at 2509.

195. *Id.* The Court noted that, “[o]n this point, the parties agree.” *Id.*

196. *Id.* This step adopts the approach taken by the Ninth Circuit in *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) (requiring courts to consider and weigh inferences).

that a reasonable person would deem the inference of scienter *at least as likely* as any opposing inference.¹⁹⁷

The Court reasoned that plausible, opposing, nonculpable inferences must be considered because the inquiry of whether something is “strong” is inherently comparative.¹⁹⁸ However, the Court explicitly rejected the notion that the inference that the defendant acted with scienter needs to be irrefutable.¹⁹⁹ The Court clarified that the plaintiff does not need the “smoking gun” to prevail.²⁰⁰

The Supreme Court rejected the Seventh Circuit’s standard, however, primarily because it failed to screen out frivolous strike suits, one of Congress’ primary goals in enacting the PSLRA.²⁰¹ Thus, the Supreme Court held that the inference must be more than “reasonable”—it must be “cogent and compelling” when compared to other plausible inferences.²⁰²

i. The Jade Falcon Hypothetical

To best illustrate the new standard, the Court considered a scenario posed by Justice Scalia in his concurrence.²⁰³ Justice Scalia posed the following problem: “If a jade falcon were stolen from a room to which only A and B had access, could it *possibly* be said there was a “strong inference” that B was the thief?”²⁰⁴ The majority opinion relied on tort

197. *Tellabs*, 127 S. Ct. at 2509–10 (noting the failure of the Seventh Circuit to compare opposing inferences).

198. *Id.* at 2510 (“The strength of an inference cannot be decided in a vacuum.”). Justice Alito, at oral argument, demonstrated this point when he said:

You see somebody . . . walking in the direction of Capitol Hill You could draw an inference that the person is coming to the Supreme Court. If there are no other buildings in Washington, that would be a strong inference. But don’t you also have to consider the inference that the person is going to the Capitol, the person is going to the Library of Congress, the person is going to some other location up here? You have to consider all the inferences that you can draw from the facts.

Tellabs, Tr. of Oral Argument, *supra* note 133, at 36–37.

199. *Tellabs*, 127 S. Ct. at 2510 (“The inference that the defendant acted with scienter need not be irrefutable, i.e., of the “smoking-gun” genre, or even the ‘most plausible of competing inferences.’”).

200. *Id.*

201. *Id.* (“Recall in this regard that § 21D(b)’s pleading requirements are but one constraint among many . . . to screen out frivolous suits.”).

202. *Id.* Even at oral argument, the Justices seemed adamant that a reasonable inference did not capture Congress’ strong inference requirement. See *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 35–37.

203. *Tellabs*, 127 S. Ct. at 2510 n.5. See *infra* notes 204–05 and accompanying text (discussing the Court’s analysis of a stolen jade falcon with two equally likely suspects and how “strong inference” is determined in such a context).

204. *Tellabs*, 127 S. Ct. at 2513 (Scalia, J., concurring).

principles, stating, “law enforcement officials as well as the owner of the precious falcon would find the inference of guilt as to B quite strong—certainly strong enough to warrant further investigation. Indeed, an inference, at least as likely as competing inferences can, in some cases, warrant recovery.”²⁰⁵

ii. Competing Inferences Sometimes Warrant Recovery: *Summers v. Tice*

Interestingly, the Court relied on the classic tort case of *Summers v. Tice* to further justify its holding.²⁰⁶ In *Summers*, the plaintiff was hunting with the two defendants.²⁰⁷ The plaintiff was proceeding up a hill with the two defendants in the rear, placing them at the points of a triangle.²⁰⁸ When a quail was flushed, both defendants shot, and the plaintiff was injured.²⁰⁹ The trial court entered judgment against both defendants.²¹⁰ The California Supreme Court affirmed judgment against both defendants, despite the fact that the plaintiff could not prove which defendant actually caused the injury.²¹¹ The California Supreme Court justified holding both defendants liable because of the practical unfairness of denying the injured person redress simply because he could not prove how much damage each did while both of the parties were negligent.²¹²

In *Tellabs*, the Supreme Court relied on *Summers* to support its argument that the inference in pleading scienter need only be as strong as countervailing inferences.²¹³ If an inference that is at least as likely

205. *Id.* at 2510 n.5 (citing *Summers v. Tice*, 199 P.2d 1, 3–5 (Cal. 1948)). Yet, the concurring Justice Scalia replied that even a strong possibility is still merely a *possibility* and does not amount to the “strong inference” required by the PSLRA. *Id.* at 2513. (Scalia, J., concurring). Justice Scalia also said allowing someone to draw such an inference would contravene the wisdom of the old maxim, “no man ought to be a judge of his own cause.” *Id.* at 2513 n.* (2007). (Scalia, J., concurring). Justice Scalia further criticized the majority’s reliance on a single committee report of the House of Representatives and on *Summers v. Tice*. *Id.*

206. *Tellabs*, 127 S. Ct. at 2510 n.5. See *infra* notes 207–208 and accompanying text (discussing the Court’s reliance on *Summers v. Tice*).

207. *Summers v. Tice*, 199 P.2d 1, 1 (Cal. 1948); see also Benjamin C. Zipursky, *Evidence, Unfairness, and Market Share Liability: A Comment on Geistfeld*, 156 U. PA. L. REV. 126, 127 (2006) (discussing *Summers* as a justification for alternative market share liability).

208. *Summers*, 199 P.2d at 1 (“The view of defendants with reference to Plaintiff was unobstructed and they knew his location . . . [when defendants shot they] were seventy-five yards from plaintiff.”).

209. *Id.*

210. *Id.* The court noted that the plaintiff was not contributorily negligent. *Id.*

211. *Id.* at 5.

212. *Id.* at 3–4.

213. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 n.5 (2007) (citing *Summers*, 199 P.2d at 3–5).

as competing inferences can warrant recovery in some cases, then it should certainly satisfy a heightened pleading requirement.²¹⁴ Comparably then, the “strong inference” standard is not more demanding than the “preponderance of the evidence” standard used in negligence cases, such as *Summers*.²¹⁵

iii. Justice Scalia’s Concurrence: More Plausible

In Justice Scalia’s concurring opinion, on the other hand, he proposed an even more stringent standard.²¹⁶ He advocated that on the balance, the inference of scienter should be *more plausible* than the inference of innocence.²¹⁷ Justice Scalia’s concurrence criticized the majority by noting that the policy concerns present in *Summers*, such as practical unfairness, are not always present in securities fraud actions. He stated that:

[*Summers*] represented a “relaxation” of “such proof as is ordinarily required” to succeed in a negligence action There is no indication that the statute at issue here was meant to relax the ordinary rule under which a tie goes to the defendant. To the contrary, it explicitly strengthens that rule by extending it to the pleading stage of a case.²¹⁸

iv. Justice Alito’s Concurrence: Must Courts Consider Facts Not Alleged With Particularity?

Justice Alito concurred, aligning himself with Justice Scalia, arguing that the inference of scienter should be more likely than opposing inferences.²¹⁹ Alito argued that the strong inference standard should be more closely aligned with standards used at summary judgment and judgment as a matter of law stages.²²⁰ He reasoned that Congress most

214. *See id.* (allowing a complaint to survive if the alleged inference is at least as likely as opposing inferences); *Summers*, 199 P.2d at 1 (finding liability under a preponderance of the evidence standard because it is equally likely defendants were culpable).

215. *Compare Summers*, 199 P.2d at 1 (finding liability for both defendants on a preponderance of the evidence standard) with *Tellabs*, 127 S. Ct. at 2510 n.5 (at least as likely to prevail).

216. *Tellabs*, 127 S. Ct. at 2513 (Scalia, J., concurring).

217. *Id.* at 2513 (Scalia, J., concurring). Justice Scalia further noted that “[i]nference” connotes “belief” in what is inferred” and that a strong belief in the jade falcon hypothetical would be impossible. *Id.* at 2513 n*.

218. *Tellabs*, 127 S. Ct. at 2514 (Scalia, J., concurring) (internal citations omitted).

219. *Id.* at 2515–16 (Alito, J., concurring). It is interesting to note that Justice Alito voted twenty percent more often with Justice Scalia in this term of the Court than former Justice O’Connor ever did. Coyle, *supra* note 11.

220. *Tellabs*, 127 S. Ct. at 2516 (2007) (Alito, J., concurring). *See also Tellabs*, Tr. of Oral Argument, *supra* note 133, at 8–9 (Justice Alito suggesting the standard at the pleading stage should have to be the same as the standard at the summary judgment stage).

likely intended to adopt a known standard as opposed to an unknown standard; because the summary judgment and judgment as a matter of law standards are known standards, Congress most likely intended to adopt a pleading standard similar to those.²²¹ The majority responded to this argument by noting that those other standards are used in the context of discovery, which is not the case when ruling on the sufficiency of a pleading.²²²

Justice Alito addressed an issue largely ignored by the majority by arguing that only facts alleged with particularity can be considered when balancing inferences.²²³ He reasoned that because the statute requires facts to be stated with particularity,²²⁴ a strong inference must arise from those facts.²²⁵ According to Justice Alito, determining whether a strong inference exists without facts stated with particularity circumvents the entire purpose of the particularity requirement—to prevent plaintiffs from using vague or general allegations.²²⁶ The majority held that omissions and ambiguities can create inferences opposing the plaintiff’s allegations; Justice Alito argued that they should not enter the balance at all.²²⁷

v. Justice Stevens in Dissent: Advocating Probable Cause

Justice Stevens’ dissent conceded Justice Alito’s point that Congress likely intended to adopt a standard for determining “strong inference” grounded in a familiar legal concept.²²⁸ Unlike Justices Alito and Scalia, however, Justice Stevens argued that the standard should be similar to the probable cause standard in criminal proceedings.²²⁹

221. *Tellabs*, 127 S. Ct. at 2516 (Alito, J., concurring).

222. *Id.* at 2510 n.5 (Justice Ginsburg writing for the majority). “[T]he test at each stage is measured against a different backdrop.” *Id.*

223. *Id.* at 2515–16 (Alito, J., concurring); *see also* 15 U.S.C. § 78u–4(b)(1) (requiring plaintiffs in securities fraud actions to allege facts giving rise to information and belief with *particularity*).

224. 15 U.S.C. § 78u–4(b)(1) (“[I]f an allegation regarding the statement or omission is made on information or belief, the complaint shall state with particularity all facts on which that belief is formed.”).

225. *Tellabs*, 127 S. Ct. at 2516 (Alito, J., concurring).

226. *Id.* Justice Alito noted that “the particularity requirement is thus stripped of all meaning” under the majority’s opinion. *Id.*

227. *Id.* at 2511, 2516.

228. *See id.* at 2517 (Stevens, J., dissenting) (“[Congress] implicitly delegated significant lawmaking authority to the Judiciary in determining how [the] standard should operate in practice. . . . In addition to the benefit of its grounding in an already familiar legal concept, using a probable cause standard would avoid . . . [forcing a court to] ‘take into account plausible opposing inferences.’”) (citing *id.* at 2509).

229. *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting).

There are times when an inference can easily be deemed strong without any need to

Justice Stevens reasoned that just as citizens suspected of criminal activity can be subject to search only after a finding of probable cause, so too should defendants in a securities fraud action be forced to produce documents for discovery only after a finding of probable cause.²³⁰ Justice Stevens reasoned that the probable cause standard has the added benefit of being a concept familiar to judges and thus easier to administer.²³¹

2. The Majority Refutes Seventh Amendment Concerns

The second major issue that the Supreme Court's opinion addressed was the Seventh Circuit's concern that a comparative assessment of plausible inferences would infringe upon the Seventh Amendment right to a jury trial.²³² The Supreme Court dispensed with this concern by holding that a comparative assessment of plausible inferences, while constantly assuming the plaintiff's allegations to be true, does not infringe on the Seventh Amendment.²³³ The Court cited several gate-keeping functions of the judiciary that do not violate the Seventh Amendment, such as admitting expert testimony, judgment as a matter of law, and summary judgment.²³⁴ The Court further noted that Congress, as the creator of federal claims, has the power to determine pleading requirements.²³⁵ Justice Ginsburg, writing for the majority,

weigh competing inferences . . . if a known drug dealer exits a building . . . carrying a suspicious package, a judge could draw a strong inference that the individual was involved in the . . . drug transaction.

Id. Under Justice Stevens' standard he would have found scienter for the defendants. *Id.*; see also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 7, 44 (Stevens, J.) (questioning the percentage quantity of "strong inference"). *But see Tellabs*, Tr. of Oral Argument, *supra* note 133, at 8 (Scalia, J.) (saying that in a criminal case the person seeking the action is a government officer presumptively acting out of no selfish motives whereas, in a civil case as here, there is a serious concern of selfish motive).

230. *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting).

231. *Id.*

232. *Id.* at 2511 (majority opinion). Justice Stevens advocated his probable cause standard, thus avoiding the weighing of inferences altogether. *Id.* at 2517 (Stevens, J., dissenting).

233. *Id.* at 2511–12 (majority opinion).

234. *Id.* at 2512 n.8 (citing *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 589 (1993); *Neely v. Martin K. Eby Constr. Co.*, 386 U.S. 317, 321 (1967); *Pease v. Rathbun-Jones Eng'g Co.*, 243 U.S. 273, 278 (1917)).

235. *Tellabs*, 127 S. Ct. at 2512.

Congress, as creator of federal statutory claims, has power to prescribe what must be pleaded to state the claim, just as it has power to determine what must be proved to prevail on the merits. It is the federal lawmaker's prerogative, therefore, to allow, disallow, or shape the contours of—including the pleading and proof requirements for—§10(b) private actions. No decision of this Court questions that authority in general, or suggests, in particular, that the Seventh Amendment inhibits Congress from establishing whatever pleading requirements it finds appropriate for federal statutory

affirmed that after the judge makes a pleading determination, the case will still fall properly within the scope of “the jury’s authority to assess the credibility of witnesses, resolve genuine issues of fact, and make the ultimate determination” of, in this case, scienter.²³⁶

The Court pointed to its opinion in *Fidelity & Deposit Co. v. United States* to support its position.²³⁷ At issue in *Fidelity* was a rule adopted by the Supreme Court of the District of Columbia requiring a defendant in a contract action to file an affidavit specifically stating the grounds for his defense.²³⁸ The *Fidelity* Court said the purpose of the rule was to prevent vexatious delays where there is no defense.²³⁹ In *Fidelity*, the Court characterized the affidavit requirement as merely a “means of making an issue.”²⁴⁰ Once the issue is made, then the right of trial by jury attaches.²⁴¹ The Court analogized securities cases by saying that the plaintiff only need satisfy the “prescribed means of making an issue,” and only then will the jury trial right attach.²⁴² The concurring Justices and Justice Stevens in dissent did not address the Seventh Amendment issue.²⁴³

3. Vacated and Remanded

After announcing the new standard, the Supreme Court did not apply it. Instead, the Supreme Court vacated the Seventh Circuit’s decision, rejecting the reasonable person standard, and remanded the case so that the Seventh Circuit could consider it in accord with the Court’s new

claims.

Id. (citing *Swierkiewicz v. Sorema*, 534 U.S. 506, 512–13 (2002) and *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit*, 507 U.S. 163, 168 (1993)); *see also Tellabs*, Tr. of Oral Argument, *supra* note 133, at 30 (Scalia, J.) (discussing Congress’ enactment of entry qualifications for getting into court such as allegations of diversity for federal cases relying on diversity jurisdiction).

236. *Tellabs*, 127 S. Ct. at 2513.

237. *Id.*

238. *Fidelity & Deposit Co. v. United States*, 187 U.S. 315, 318 (1902). Specifically the contract action was an *ex contractu* action. *Id.* *Ex contractu* is Latin meaning “from a contract.” BLACK’S LAW DICTIONARY 608 (8th ed. 1999).

239. *Fidelity*, 187 U.S. at 320. This concern is comparable to the Court’s concern of preventing “vexatious discovery” in securities fraud cases. *Tellabs*, 127 S. Ct. at 2508 (quoting *Merrill Lynch v. Dabit*, 547 U.S. 71, 81 (2006)).

240. *Fidelity*, 187 U.S. at 320.

241. *Id.*

242. *Tellabs*, 127 S. Ct. at 2513 (quoting *Fidelity*, 187 U.S. at 320).

243. Justice Stevens argued that his approach did not require the weighing of inferences and thus avoided a Seventh Amendment problem altogether. *Id.* at 2517 (Stevens, J., dissenting); *see also supra* Part IV.D (discussing the constitutionality of Justice Stevens’ approach).

standard.²⁴⁴ The Supreme Court set out to reconcile the circuit differences as well as come up with a rule addressing the concerns of vexatious securities litigation.²⁴⁵ As Part IV will explore, the Court's decision resolves the circuit split,²⁴⁶ but is based on unsubstantiated concerns of excessive and abusive securities litigation²⁴⁷ and infringes on the Seventh Amendment right to a jury trial.²⁴⁸

IV. ANALYSIS

Undoubtedly, the Supreme Court's standard in *Tellabs* unifies the pleading standard under the PSLRA among the federal courts.²⁴⁹ However, the Court's preoccupation with frivolous securities litigation and exponential costs does not warrant the imposition of the heightened standard adopted by the Court.²⁵⁰ The Court's exacting pleading requirement may in fact perpetuate exponential costs of litigation rather than curb them.²⁵¹ Moreover, the Court's concern seems one-sided in that it focuses on preventing meritless litigation, but fails to consider the impact of the pleading requirement on merited litigation.²⁵² Lastly, the Court's standard is an infringement on the Seventh Amendment right to a jury trial.²⁵³

244. *Tellabs*, 127 S. Ct. at 2513; see *infra* Part V.B (exploring the remanded *Tellabs* case). The Seventh Circuit decided the *Tellabs* case on January 17, 2008, in favor of the plaintiffs. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 04-1687, 2008 WL 151180 (7th Cir. Jan. 17, 2008).

245. See *supra* notes 187-190, 193, 201 and accompanying text (discussing the Court's concern with frivolous and nuisance-driven securities litigation).

246. See *infra* Part IV.A (examining how the Court established a uniform rule and clarified the split among the circuits regarding whether nonculpable inferences are considered and weighed in a 12(b)(6) motion to dismiss).

247. See *infra* Part IV.B (detailing the drop in securities filings, discussing that discovery abuse is not as widespread as the misperception of it is, and asserting that a heightened standard may increase litigation costs).

248. See *infra* Part IV.C (arguing the Court's standard requires courts to resolve disputed questions of fact).

249. *Tellabs*, 127 S. Ct. at 2506; see *infra* Part IV.A (discussing the Supreme Court's newly announced standard).

250. See *infra* Part IV.B (saying that the rate of securities filings are declining, discovery abuse is not a cause of concern, and a heightened pleading standard may in fact increase litigation costs).

251. See *infra* Part IV.B.1.iii (explaining how a more rigid standard can exacerbate litigation expenses).

252. See *infra* Part IV.B.3 (arguing that the Court fails to preserve meritorious claims because a higher pleading standard will further result in the dismissal of merited claims).

253. See *infra* Part IV.C (demonstrating how the Court's rule violates the Seventh Amendment right to a jury trial).

A. A Strong Inference Strongly Defined

As this Part will demonstrate, the Court's rule elucidates a clear guideline for lower courts in determining scienter.²⁵⁴ The *Tellabs* ruling primarily sets a clear standard for courts in assessing the adequacy of an allegation of "strong inference,"²⁵⁵ and requires lower courts to weigh inferences of scienter against opposing nonculpable inferences.²⁵⁶ This Part will explore the questions left open by the Court's decision, namely, how courts should deal with an aggregate of inferences and how the particularity requirement fits in with the scienter determination.²⁵⁷

*1. The Tie Goes to the Runner*²⁵⁸

The decision sets forth a few clear guideposts on the question of what a court should consider when weighing competing inferences.²⁵⁹ First, the inferences need not be "of the smoking gun genre" or even the most

254. See *infra* Part IV.A.1 (saying that in the event of a tie over competing culpable and nonculpable inferences, the plaintiff prevails).

255. For recent cases employing the *Tellabs* rule, see, e.g., *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007); *In re Nat'l Century Fin. Enter., Inc. Fin. Inv. Litig.*, No. 2:03-md-1565, 2007 WL 2331929, at *5 (S.D. Ohio Aug. 13, 2007); *In re Loudeye Corp. Sec. Litig.*, No. C06-1442MJP, 2007 WL 2404626, at *5 (W.D. Wash. Aug. 17, 2007); see also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 41 (Scalia, J.) (searching for a clear established standard to guide courts in their analysis); Peter Lattman, *Tellabs: Securities Lawyers React*, WALL ST. J. ONLINE, June 21, 2007, <http://blogs.wsj.com/law/2007/06/21/tellabs-securities-lawyers-react/> (quoting David Kistenbroker, of the law firm Katten Muchin, as saying, "[The standard] really only serves to more clearly articulate the law as put on the books by Congress.").

256. See *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 551 (5th Cir. 2007) (saying *Tellabs* requires courts to engage in a weighing of allegations to determine scienter); *In re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, No. 2:03-md-1565, 2007 WL 2331929, at *8 (S.D. Ohio Aug. 13, 2007) (weighing an inference of scienter where the defendant improperly used incorrect accounting methods with the nonculpable inference that the defendant auditor did not know the company was selling securities to the public); see also Pete Yost, *Strict Standard Set on Investor Suits*, USA TODAY, June 22, 2007, http://www.usatoday.com/news/washington/2007-06-21-2376334548_x.htm (quoting Bruce Vanyo, an attorney who drafted the PSLRA, as saying that "a number of district courts have simply not engaged in a serious consideration of competing inferences").

257. See *infra* Part IV.A.2 (discussing questions remaining after *Tellabs* concerning the application of the rule).

258. See *Commc'ns Workers of Am. Plan for Employees' Pensions and Death Benefits v. CSK Auto Corp.*, No. CV06-1503-PHX-DGC, 2007 WL 2808652, at *2-*3 (D. Ariz. Sept. 27, 2007) ("a tie goes to the Plaintiff"); *Ross v. Abercrombie & Fitch Co.*, 501 F. Supp. 2d 1102, 1116-17 (S.D. Ohio 2007) (saying investors satisfied the scienter requirement because the inference of scienter was at least as compelling as the competing inference).

259. See 26 MICHAEL J. KAUFMAN, *Tellabs Decision, in SECURITIES LITIGATION DAMAGES* §3:11:80 (2007) (describing the likely impact of the *Tellabs* decision).

plausible of inferences.²⁶⁰ For instance, in *Tellabs*, the plaintiff did not need to produce a videotaped statement or a signed inter-office memorandum from Notebaert saying he knew of the channel stuffing practices and encouraged these practices to inflate revenue.²⁶¹ Second, omissions and ambiguities in the complaint weigh against finding an inference of scienter.²⁶² Even though a plaintiff is not required to have the “smoking gun,” a complaint that is too vague or ambiguous may not survive a 12(b)(6) motion.²⁶³ Third, evidence of motive, such as personal financial gain, weighs in favor of finding scienter, but the absence of such an allegation is not fatal.²⁶⁴ For instance, if the defendant sells all his stock immediately before the market gets wind of the bad news, this weighs in favor of a culpable scienter.²⁶⁵ However, the Court stated that the absence of motive will not automatically defeat an inference of scienter.²⁶⁶

Generally, the *Tellabs* decision is typecast by commentators as injurious to plaintiffs,²⁶⁷ as any heightened pleading standard will be considered an obstacle to plaintiffs. Thus, the issue centers on the

260. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007), *rejecting Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (allowing courts to consider only the most plausible inferences of the plaintiff).

261. *Tellabs*, 127 S. Ct. at 2510.

262. *Id.* at 2511.

263. *Id.*; *see Key Equity Investors, Inc. v. Sel-Leb Mktg. Inc.*, No. 06-1052, 2007 WL 2510385, at * 5 (3d Cir. Sept. 6, 2007) (dismissing the plaintiff's complaint in a securities fraud action where the plaintiff relied on conclusory allegations rather than specified allegations).

264. *Tellabs*, 127 S. Ct. at 2511; *see In re BearingPoint, Inc. Sec. Litig.*, No. 1:05-cv-454, 2007 WL 2713906, at *12 (E.D. Va. Sept. 12, 2007) (considering motive as a factor weighing against scienter).

265. *See Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 552-53 (5th Cir. 2007) (saying where a defendant CEO sells stock before disclosure of bad news to the market, this weighs in favor of finding scienter); *see also Ross v. Abercrombie & Fitch Co.*, 501 F. Supp. 2d 1102, 1116-17 (S.D. Ohio 2007) (stating an allegation that a defendant sold stock prior to a disclosure of a prior misrepresentation counts in favor of finding scienter).

266. *See Tellabs*, 127 S. Ct. at 2511 (“While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal.”).

267. *See Jonathan Eisenberg, Beyond the Basics: Seventy-five Defenses Securities Litigators Need to Know*, 62 BUS. LAW. 1281, 1362-63 (Aug. 2007) (listing the *Tellabs* rule as its own defensive device securities litigators can use to quash securities fraud actions before trial); Robert Barnes & Carrie Johnson, *Pro-Business Decision Hews to Pattern of Roberts Court*, WASH. POST, June 22, 2007, at D01, *available at* <http://www.washingtonpost.com/wp-dyn/content/article/2007/06/21/AR2007062100803.html> (“[The *Tellabs* decision] is part of a pattern by which the justices have made it more difficult for plaintiffs to sue corporations or win substantial damage awards.”); Stephen Labaton, *Investor's Suits Face Higher Bar, Justices Rule*, N.Y. TIMES, June 22, 2007, *available at* <http://www.nytimes.com/2007/06/22/washington/22bizcourt.html> (“[The new standard] makes it easier for companies and their executives to get shareholder complaints dismissed.”).

extent of the inhibitor. The *Tellabs* rule sets up a baseball scenario whereby “the tie goes to the runner.”²⁶⁸ The Court’s jade falcon hypothetical also illustrates this principle. In the hypothetical, a jade falcon is stolen from a room to which only *A* and *B* have access. According to the Court’s standard, we can draw a strong inference that either *A* or *B* took the jade falcon.²⁶⁹ The Court only requires that the inference be at least as compelling as opposing inferences.²⁷⁰

268. See Lattman, *supra* note 255 (quoting Joe Grundfest, Securities Law Professor at Stanford Law School, as saying, “[T]he opinion unfortunately leaves room for lower courts to reason “gee, the story in support of scienter seems as cogent as the story in opposition to scienter and that’s good enough.” The danger then is that the language devolves into the equivalent of baseball’s rule of “a tie goes to the runner.”); see also Roger Parloff, *Supreme Court Deals Blow to Securities Class Actions, 8-1*, FORTUNE, June 21, 2007, available at <http://legalpad.blogs.fortune.cnn.com/2007/06/21/supreme-court-deals-blow-to-securities-class-actions-8-1/> (quoting Sean Coffey, a plaintiffs’ class action lawyer of Bernstein Litowitz & Grossman, as saying, “[N]ow in the event of a tie, the plaintiff wins.”). But see Michael J. Kaufman, *Mission Implausible: The Supreme Court Replaces Federal Pleading Rules with Unfounded Economic Assumptions* (Spring 2008) (unpublished manuscript, on file with the author) (arguing that when *Tellabs* and *Bell Atlantic v. Twombly*, 127 S. Ct. 1955 (2007), are read together, they substantially raise the traditional pleading requirement, limiting irrational economic inferences at the pleading stage).

269. See *supra* notes 203–205 and accompanying text (describing the Court’s volley on the jade falcon hypothetical).

270. *Tellabs*, 127 S. Ct. at 2509–10. Had the Court adopted Justice Scalia’s approach, this would be insufficient. *Id.* at 2513 (Scalia, J., concurring) (advocating that the inference must be more plausible than an innocent inference). But see *In re Bayou Hedge Fund Litig.*, No. 06–MDL–1755, 2007 WL 2319127, at *8 (S.D.N.Y. July 31, 2007) (saying *Tellabs* did not change the Second Circuit’s requirement and that the Second Circuit now requires the allegations of recklessness to be greater than allegations of garden-variety fraud and the inference of recklessness must be at least as compelling as opposing nonculpable inferences). Moreover, the Court’s announced standard in *Tellabs* is difficult to reconcile with traditional conceptions of procedural motions. Kaufman, *supra* note 268 (arguing that *Tellabs* and *Bell Atlantic v. Twombly* have raised Rule 8(a)’s traditionally minimalist requirement by stripping plaintiffs of the benefit of perceived unreasonable economic assumptions at the pleading stage); see Coyle, *supra* note 11 (arguing a significant theme of this term of the Court was to use technical-procedural tools, such as standing, statutes of limitations, and pleading requirements, to narrow access to the courts); see also *Mizzaro v. Home Depot, Inc.*, No. Civ.A.1:06–CV–11510, 2007 WL 2254693, at *3 (N.D. Ga. July 18, 2007) (securities fraud class action saying the *Twombly* decision heightened the pleading standard for complaints attacked by a Rule 12(b)(6) motion). Rule 8(a) traditionally requires that a plaintiff’s complaint will be dismissed only if there is no set of facts entitling the plaintiff to relief. FED. R. CIV. P. 8; *Conley v. Gibson*, 355 U.S. 41, 46 (1957); see, e.g., *Chalmers v. Lane*, No. Civ.A.3:03CV1268–BH, 2003 WL 23109794, at *5 (N.D. Tex. Dec. 23, 2003) (“Thus the court should not dismiss the claim unless the plaintiff would not be entitled to relief under any set of facts or any possible theory that he could prove consistent with the allegations in the complaint.”); *McDonald v. Kinder-Morgan, Inc.*, 287 F.3d 992, 997 (10th Cir. 2002) (“We will affirm a dismissal pursuant to Fed. R. Civ. P. 12(b)(6) ‘only when it appears that the plaintiff can prove no set of facts in support of the claims that would entitle the plaintiff to relief.’”). This “no set of facts” language was the gold standard used to assess the adequacy of complaints:

The “notice pleading” theory espoused by the Court in *Conley* became the prevailing standard by which all federal complaints were to be gauged. In fact between 1957 and

To put this in the context of securities regulation, assume a plaintiff in a 10b-5 action alleges that the defendant CEO sold all of his shares in the defendant company during the class period immediately before the disclosure of an earnings restatement revealing earlier misrepresentations.²⁷¹ Assume also that the defendant CEO's stock sale came in lock-step with his resignation, which is common practice.²⁷² If the defendant files a 12(b)(6) motion to dismiss, should the complaint prevail?²⁷³ If the plausible inference of scienter arising from the CEO selling all his shares prior to the disclosure of an earnings restatement²⁷⁴ is weighed against the fact that the sale of a CEO's selling stock is common practice upon resignation,²⁷⁵ these two competing inferences

1994 *Conley* was cited more than 1700 times in opinions published by the courts of appeals, which is not to mention *Conley* citations by the district courts. It is not exaggerating to say that *Conley* is the most important federal decision on pleading of the twentieth century. By this writer's review it has never been directly challenged by a Supreme Court Justice.

Paul J. McArdle, *A Short and Plain Statement: The Significance of Leatherman v. Tarrant County*, 72 U. DET. MERCY L. REV. 19, 26 (1994). However, on a 12(b)(6) motion, the usual maxim that a plaintiff's complaint will prevail unless there is no set of facts entitling him to relief no longer seems to be the case as the *Twombly* decision effectively "retired" *Conley v. Gibson*:

[A]fter puzzling the profession for fifty years, [*Conley's*] famous observation has earned its retirement. The phrase ["no set of facts"] is best forgotten as an incomplete, negative gloss on an accepted pleading standard: once a claim has been stated adequately, it may be supported by a showing of any set of facts consistent with the allegations in the complaint.

Twombly, 127 S. Ct. at 1969. Thus, the two decisions, *Tellabs* and *Twombly*, serve to heighten Rule 8(a)'s short and plain statement requirement. Kaufman, *supra* note 268; see Kahn v. NYU Med. Ctr., No. 06 CIV 13455 LAP, 2007 WL 2000072, at *2 (S.D.N.Y. July 10, 2007) (interpreting *Tellabs* and *Twombly* as restating the proposition that a court must accept all factual allegations as true when faced with a Rule 12(b)(6) motion). It is important to note however that a majority of the recent lower federal court decisions, when citing both *Tellabs* and *Twombly*, do not interpret the two in conjunction with one another. See, e.g., Transit Rail, LLC v. Marsala, No. 05-CV-0564(C), 2007 WL 2089273, at *2 (W.D.N.Y. July 20, 2007); S.E.C. v. Boling, No. 06-1329(RMC), 2007 WL 2059744, at *3 (D.D.C. July 13, 2007); *In re Crude Oil Commodity Litig.*, No. 06 Civ. 6677(NRB), 2007 WL 1946553, at *3 (S.D.N.Y. June 28, 2007).

271. These facts are similar to the facts of *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 552-53 (5th Cir. 2007).

272. See *id.* at 553-54. It is important to note that the resignation could have come because the CEO knew the stock drop was coming. This illustrates the problem of courts weighing inferences absent any kind of facts disclosed from discovery. See *infra* notes 346-350 and accompanying text (arguing that discovery is necessary to allow plaintiffs and defendants to realistically assess the strength of their claims and defenses).

273. See FED. R. CIV. P. 12(b)(6).

274. See, e.g., *Ross v. Abercrombie & Fitch Co.*, 501 F. Supp. 2d 1102, 1116-17 (S.D. Ohio 2007) (noting that an allegation that a defendant sold stock prior to an unfavorable sales announcement weighs in favor of finding scienter).

275. *Cent. Laborers' Pension Fund*, 497 F.3d at 553 (saying that a CEO's stock sale coming in lock-step with his resignation weighs against scienter).

roughly should come out equal (a fifty-fifty ratio).²⁷⁶ Under the *Tellabs* decision, where one competing inference is at least as likely as the other, the plaintiff's complaint should survive.²⁷⁷ In sum, a tie goes to the plaintiff.²⁷⁸

2. Vagaries in the *Tellabs* Rule

Despite the seeming simplicity of the rule, there is still some concern that the Court's "at least as compelling as opposing inferences" standard provides little more clarity than Congress' language of "strong inference."²⁷⁹ For example, the rule may be difficult to apply where more than just one nonculpable inference competes with a culpable inference.²⁸⁰ Suppose the inference that the defendant acted with scienter is 40%, a nonculpable inference likewise is 40%, and a third alternative accounts for the remaining 20%.²⁸¹ Assuming the third alternative is a nonculpable inference as well, two possible interpretations emerge. First, the inference of scienter at 40% is at least as likely as the second nonculpable inference, thus it is cogent and compelling (a forty-forty ratio). The inference of 40% probability is more than likely than the third nonculpable inference, and therefore is also cogent and compelling (a forty-twenty ratio).²⁸² Yet the culpable inference is only 40% likely compared to nonculpable inferences aggregated at 60% (a forty-sixty ratio); thus, it is not cogent and

276. See *id.* (noting that a suspicious stock sale weighs in favor of scienter and that selling shares upon resignation weighs against).

277. See *Tellabs*, 127 S. Ct. 2499, 2509–10 (2007) ("A complaint will survive, we hold, only 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."); see also *Commc'ns Workers of Am. Plan for Employees' Pensions and Death Benefits v. CSK Auto Corp.*, No. CV06–1503–PHX–DGC, 2007 WL 2808652, at *3 (D. Ariz. Sept. 27, 2007) (requiring an inference of scienter to be only at least as likely as nonculpable inferences).

278. See *supra* notes 197, 204–204, 268–277 and accompanying text (describing how the plaintiff prevails when two inferences are equally likely).

279. See Lattman, *supra* note 255 (quoting William McGuinness as saying, "[I]t's not clear that the new 'cogent and at least as compelling as any other inference' standard will add any greater clarity."); see also *In re Faro Techs. Sec. Litig.*, No. 6:05–cv–1810–Orl–22DAB, 2007 WL 2744610, at *7 (M.D. Fla. Sept. 18, 2007) (interpreting *Tellabs* to weigh only nonculpable inferences offered by the defendants, not drawn by the court); *Key Equity Investors, Inc. v. Sel-Leb Mktg. Inc.*, No.06–1052, 2007 WL 2510385, at *6 (3d Cir. Sept. 6, 2007) (Garth, J., dissenting) (arguing that the facts, when taken together, do establish a strong inference).

280. See John C. Coffee, Jr., *Federal Pleading Standards After 'Tellabs,' 'Bell Atlantic,'* 238 N.Y.L.J. 5 (July 19, 2007) (discussing law professors' "tortured hypotheticals based on the *Tellabs* test").

281. *Id.*

282. *Id.*

compelling.²⁸³ This scenario encourages defendants to come up with a host of alternative explanations for the alleged fraudulent action, so that they might aggregate inferences greater than 50%.²⁸⁴

Further, Justice Alito's argument that only facts alleged with particularity must be weighed so as not to circumvent the particularity pleading requirement²⁸⁵ also points out a vagary in the Court's rule.²⁸⁶ Justice Alito compellingly argues that a court must only consider those facts alleged with particularity in order to give purpose to the statutory language.²⁸⁷ The majority briefly noted that vague allegations weigh against an inference of scienter.²⁸⁸ Yet Justice Alito's argument is more forceful than this; namely, he argues that vague allegations should not even enter into the balance because they fail the particularity

283. *Id.*; see also *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007) (requiring inferences of scienter to be at least as likely for a plaintiff to sufficiently state a claim in a securities fraud Rule 10b–5 action).

284. Beth Bar, *Raising the Bar: Attorneys Tailor Strategy To High Court Rulings*, 238 N.Y.L.J. 3 (July 12, 2007) (quoting Brad S. Karp as saying the nature of motion practice will change in securities litigation as defendants will now submit “a broad array of materials so that district courts can consider the entire record to determine whether it is more likely than not that scienter is present.”). See *supra* notes 280–283 and accompanying text (exploring possible interpretations a court may adopt when faced with multiple competing inferences).

285. *Tellabs*, 127 S. Ct. at 2515–16 (Alito, J., concurring). This point was also raised at oral argument. See *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 13–15 (Scalia, J. and Kennedy, J.) (questioning whether an allegation just asserting a CEO had knowledge would be sufficient). *But see* Charles W. Murdock, *Sarbanes-Oxley, Corporate Corruption, and the Complicity of Courts and Legislatures* 40 (2007) (unpublished manuscript, on file with the author) (disagreeing that while the particularity provision is on its face a reasonable one, its application is rather muddled because the question of “how much particularity need be pleaded without the benefit of discovery” is often litigated).

286. David Stras, *A Lingering Thought on Tellabs*, SUPREME COURT OF THE UNITED STATES BLOG, June 23, 2007, http://www.scotusblog.com/movabletype/archives/2007/06/a_lingering_tho.html (stating that the Court has left open the question of whether non-particularized allegations can be included in a court's assessment of whether a “strong inference” in fact exists).

287. *Compare Tellabs*, 127 S. Ct. at 2515–16 (Alito, J., concurring) and 15 U.S.C. § 78u–4(b) (2000) (requiring allegations of securities fraud based on information and belief to be alleged with particularity) with Murdock, *supra* note 285 (arguing that the PSLRA's particularity provision provides no clear guidance as to what suffices as a “particularized” allegation).

288. *Tellabs*, 127 S. Ct. at 2511.

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requirement.²⁸⁹ Nonetheless, the Court has not specifically resolved the issue, leaving the lower courts to grapple with the problem.²⁹⁰

B. The Court's Concern with Frivolous Litigation Does Not Warrant an Exacting Pleading Standard

Not only do questions persist about the application of the rule but the underlying justification for the standard—the desire to stop strike suits—does not warrant an exacting pleading requirement.²⁹¹ One of the primary problems with the *Tellabs* decision is its preoccupation with frivolous strike suits and excessive discovery costs.²⁹² First, this concern is largely unsubstantiated.²⁹³ Second, the PSLRA contains other provisions better suited to address this concern.²⁹⁴ Third, the PSLRA was enacted to stem frivolous strike suits as well as preserve meritorious claims.²⁹⁵ It is not designed solely to wipe out strike suits,

289. *See id.* at 2516 (stating that the Court's interpretation contradicts clear statutory language preventing a plaintiff from using vague or general allegations in order to get past a motion to dismiss).

290. *See* Richard H. Zelichov et al., *Tellabs: The Debate Over Competing Inferences Will Continue*, in *SECURITIES LITIGATION & ENFORCEMENT INSTITUTE* 508–11 (2007) (discussing issues left open from the *Tellabs* decision). A related issue left open by *Tellabs* is its impact on confidential informants. *Compare* *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (discounting allegations derived from information provided by confidential sources altogether saying such information is inherently too vague to be considered at all), *with* *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 552 (5th Cir. 2007) (acknowledging information derived from confidential sources where there is at least some specificity).

291. *See infra* Part IV.B (arguing that a heightened standard is not merited because the concern of rising securities litigation costs is unsubstantiated, other existing PSLRA provisions are more apt at dealing with concerns of strike suits, and a heightened pleading standard would disrupt the balance between preserving meritorious claims and dismissing frivolous ones).

292. For example, the Court's second line in the decision is that private securities fraud actions, if employed abusively, impose substantial costs on companies. *Tellabs*, 127 S. Ct. at 2504. The Court also discusses the PSLRA's heightened pleading requirement as designed to curb vexatious discovery and targeting deep-pocketed defendants. *Id.* at 2508. Justice Stevens likewise said the basic purpose of the heightened pleading requirement was to protect defendants from discovery costs and strike suits. *Id.* at 2517 (Stevens, J., dissenting). At oral argument, Justice Stevens said the real issue is not whether the complaint is trial worthy, but rather discovery worthy. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 47 (Stevens, J.)

293. *See infra* Part IV.B.1 (explaining how the concern with rising securities litigation costs is unsubstantiated because securities fraud action filings are declining, fewer securities issuers are being sued, and fears of discovery abuse are based on prevalent misperceptions rather than data).

294. *See infra* Part IV.B.2 (describing other existing PSLRA provisions, such as the stay of discovery provision or enhanced Rule 11 sanctions, as more capable of dealing with concerns of strike suits).

295. *See infra* Part IV.B.3 (describing the delicate balance between dismissing nuisance filings and preserving meritorious claims).

but rather to achieve this equilibrium.²⁹⁶ The Court has failed to establish a pleading rule that strikes a similar balance.²⁹⁷

1. The Court's Concern with Rising Securities Litigation Costs is Unsubstantiated

There are several reasons why the Court's concern over frivolous securities fraud class actions is unfounded.²⁹⁸ First, securities filings in general are on the decline.²⁹⁹ Second, the general fear of excessive and abusive discovery tactics is based on common misperceptions rather than hard evidence.³⁰⁰ Lastly, a heightened pleading standard is not tailored to address the Court's concerns.³⁰¹ In fact, a higher standard may result in a circuitous problem whereby litigation costs actually rise.³⁰²

i. The Rate of Securities Filings is on the Decline

Overall, securities fraud claims are being filed less and less frequently.³⁰³ The first half of 2007 marked the fourth consecutive six-month period where securities class actions were below average.³⁰⁴ There were only fifty-nine filings in the first half of 2007 compared

296. *See infra* Part IV.B.3 (discussing the PSLRA's twin aims of preventing nuisance filings while preserving investors' meritorious claims).

297. *See infra* Part IV.B.3 (arguing that a heightened pleading standard results in the dismissal of claims based on hyper-technical pleading rules rather than the merits).

298. *See infra* Part IV.B.1.i–IV.B.1.iii (discussing the problems with the *Tellabs* decision).

299. *See infra* Part IV.B.1.i (discussing the declining rate of securities fraud action filings after the PSLRA).

300. *See infra* Part IV.B.1.ii (arguing that the prevalence of discovery abuse is not based on actual data, but common misperceptions that the discovery process is abused).

301. *See infra* Part IV.B.1.iii (stating that an exacting pleading standard will increase litigation costs as plaintiffs will compensate for the increased risk of dismissal by bringing suits with higher damages).

302. *See infra* Part IV.B.1.iii (illustrating how an exacting pleading standard may result in higher litigation costs).

303. *See infra* notes 304–308 and accompanying text (describing the statistical drop in the number of securities class action filings since the enactment of the PSLRA and concluding that there is a trend of less securities fraud actions being filed).

304. Cornerstone Research, *supra* note 13, at 2; *see also* Patrick E. Higginbotham, *Judge Robert A. Ainsworth, Jr. Memorial Lecture, Loyola University School of Law: So Why do We Call Them Trial Courts?*, 55 S.M.U. L. REV. 1405, 1407 (2002) (discussing the general decline in all trials across the country as a syndrome characterized by a surge in private dispute resolution). Cornerstone Research reported that filings increased from 116 in 2006 to 166 in 2007. Cornerstone Research, *Securities Class Action Case Filings: 2007: A Year in Review 2* (2007), available at <http://securities.cornerstone.com/pdfs/YIR2007.pdf> (noting that the maximum dollar losses in the first half of 2007 amounted \$69 billion) [hereinafter Cornerstone, *2007: Year in Review*]. This rise was due in large part to the subprime mortgage crisis and increased stock volatility. *Id.* Moreover, this rise in 2007 still is 14% below the average for the prior ten years. *Id.*

with the average semi-annual filing rate of 101 as measured between 1996 and 2005.³⁰⁵ Furthermore, there has been a general decline in securities fraud class action filings since the second half of 2005,³⁰⁶ with the rate decreasing by approximately 40% compared to statistics from 1996.³⁰⁷ Even though one research institute predicts filings for the second half of 2007 may rise, this slight rise still makes it unlikely that the suits will pick up enough to reverse the general trend of declining filings.³⁰⁸ Thus, with a general trend of fewer securities fraud actions filed, the threat of *in terrorem* settlement is not as prevalent.³⁰⁹

Not only are actual securities filings decreasing but the overall rate of securities issuers (corporate defendants) who are being sued has decreased as well.³¹⁰ For example, from 1996 to 2005, on average, 2.3% of the companies listed on the NYSE, NASDAQ, and Amex were defendants in class action lawsuits.³¹¹ However, at the start of 2006 and at the end of the first half of 2007, only 1.6% of these companies were named as defendants.³¹² In fact, the annual likelihood of suit has dropped by 27% since the pre-PSLRA period.³¹³ A study by the National Economic Research Associates (“NERA”) also found that, on

305. Cornerstone Research, *supra* note 13, at 2. The sharp increase in 2001 and 2002 reflects the suits surrounding the initial public offering (“IPO”) litigation where virtually every issuer that went public at the end of the Internet boom was being sued. Perino, *supra* note 56, at 932. These suits are different from traditional securities claims because the IPO claims contain allegations specific to the IPO process itself and not misrepresentation or omission with respect to the issuer. *Id.* However, Perino goes on to find that the average number of filings even adjusted for the IPO cases was still on average higher than pre-PSLRA filings. *Id.* Nonetheless, as Perino acknowledges later, the acquisition of more complete data may better explain this increase instead of an actual increase in filings. *Id.* at 933.

306. Cornerstone Research, *supra* note 13, at 5.

307. *Id.*

308. Foster et al., *supra* note 13, at 3. NERA predicts at the close of 2007 there will be a total of 152 filings, up from the 2006 total of 136. *Id.* However, this is still below the average amount of filings between 1995 and 2005, which was 284 filings. *Id.* At the end of 2007, NERA reported a total of 198 filings, a growth. Stephanie Plancich, et al., *2007 Year End Update: Recent Trends in Shareholder Class Actions: Filings Return to 2005 Levels as Subprime Cases Take Off; Average Settlements Hit New High*, NERA Economic Consulting, 1 (Dec. 2007), available at www.nera.com. This increase in filings is due in large part because of the subprime mortgage crisis. *Id.* at 15.

309. See *supra* notes 304–308 and accompanying text (discussing the statistical drop of securities class action case filings).

310. Cornerstone Research, *supra* note 13, at 6.

311. *Id.* But see Perino, *supra* note 56, at 930 (concluding that data as of 2002 was insufficient to determine whether the PSLRA had affected the total number of issuers sued per year).

312. Cornerstone Research, *supra* note 13, at 6.

313. Foster et al., *supra* note 13, at 7.

average, a public corporation faces a lower probability of being sued.³¹⁴ Thus, both the rate of securities claims being filed and the rate of corporate defendants being sued is on the decline.³¹⁵

ii. Fears of Abusive Discovery are Based on General Misperceptions³¹⁶

Congress passed the PSLRA in response to concerns that high litigation and discovery costs forced parties into settling claims, even when the claims lacked merit.³¹⁷ In *Tellabs*, the Court echoed these concerns of strike suits.³¹⁸ Specifically, Congress was concerned that plaintiffs file frivolous lawsuits in an effort to find a sustainable claim, not yet alleged in the complaint, through the discovery process.³¹⁹

314. *See id.* (noting that the average public corporation faces a 6.4% probability that it will face at least one shareholder class action lawsuit over a five-year period). At the end of 2007, NERA reported that the rate of issuers rose to 2.19%. Cornerstone, *2007: Year in Review*, *supra* note 304, at 7. Nevertheless, this is still lower than the all time high of 2.91% or the national ten-year average of 2.27%. *Id.*

315. *See supra* notes 304–308, 309–313 and accompanying text (describing the statistical drop in securities class action filings as well as the statistical drop in the rate of securities issuers being sued).

316. *See generally* Linda S. Mullenix, *Discovery in Disarray: The Pervasive Myth of Pervasive Discovery Abuse and the Consequences for Unfounded Rulemaking*, 46 STAN. L. REV. 1393 (1994) (discussing the myth of discovery abuse).

317. *See, e.g.*, H.R. REP. NO. 104–369, at 37 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 736 (“According to the general counsel of an investment bank, ‘discovery costs account for roughly 80% of total litigation costs in securities fraud cases’” (citing the testimony of former SEC Commissioner J. Carter Beese, Jr., Chairman of the Capital Markets Regulatory Reform Project Center for Strategic and International Studies, before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs on March 2, 1995)); *see also supra* notes 51, 55–56 and accompanying text (discussing Congress’ concern that securities lawyers were filings strike suits in hopes that corporate defendants would settle rather than risk other adverse costs).

318. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2508 (stating that the PSLRA was designed to stem nuisance suits and targeting of deep-pocketed defendants). Coercive or *in terrorem* settlements are driven by the time that employees must spend responding to discovery requests and providing testimony. S. REP. NO. 104–98, at 8 (1995) *as reprinted in* 1995 U.S.C.C.A.N. 679, 687. Discovery abuses fall into two categories: (1) excessive discovery requests used to impose excessive costs (usually utilized by plaintiffs) and (2) resisting legitimate discovery requests to avoid disclosure or buy time (usually utilized by defendants). Peggy E. Bruggman, *Reducing the Costs of Civil Litigation: Discovery Reform*, Public Law Research Institute 1 (2004), *available at* <http://w3.uchastings.edu/plri/fal95tex/discov.htm>; *see also* Judith A. McKenna & Elizabeth C. Wiggins, *Empirical Research on Civil Discovery*, 39 B.C. L. REV. 785, 799–804 (1998) (discussing the various types of discovery abuses).

319. Congress stated:

The Securities Subcommittee heard testimony that discovery in securities class actions resembles a fishing expedition. . . . [O]nce suit is filed, the plaintiff’s law firm proceeds to search through all of the company’s documents and take endless depositions for the slightest positive comment which they can claim induced the plaintiff to invest and any shred of evidence that the company knew a downturn was coming.

However, the concern about abusive discovery practices rests on prevailing sentiments that discovery is excessive and abusive rather than on actual hard data.³²⁰ Plainly put, discovery abuse in general is not as prevalent as is widely perceived.³²¹ First, it is important to note that the actual costs of discovery have been sparsely quantified in empirical studies.³²² Most studies measuring the incidence of discovery survey only opinions, impressions, or billable hours.³²³ What is widespread however, is the *misperception* that discovery is excessive and abused.³²⁴ In fact, relatively little discovery occurs in the course of an ordinary lawsuit.³²⁵ The first major study into the actual effects of discovery practice generally found there was no widespread failing in the scope or availability of discovery.³²⁶ Likewise, a study by the Federal Judicial

S. REP. NO. 104–98, at 14 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 693.

320. See generally McKenna & Wiggins, *supra* note 318 (tracing discovery studies).

321. For instance:

Frequently the assertions of the extent of discovery abuse do not rest on evidence, but only cite to another writer making a similar claim or simply make a conclusory statement that drives [sic] its strength from the fact that it has been repeated so frequently. Indeed, taking on lives of their own, many of the claims that discovery abuse is the major cause of delay and expense in the federal system are these kinds of conclusory assertions.

Bruggman, *supra* note 318, at 12.

322. McKenna & Wiggins, *supra* note 318, at 797. Moreover, the actual quantification of such costs is extremely difficult. *Id.* at 797; see also Charles W. Sorenson, Jr., *Disclosure Under Federal Rule of Civil Procedure 26(a)—Much Ado About Nothing*, 46 HASTINGS L.J. 679, 703 (1995) (stating that claims of discovery rest on non-evidence and may be exaggerated).

323. Sorenson, *supra* note 322, at 681 (referencing “[t]he widespread public and professional perception of a ‘litigation explosion’” (citing WALTER K. OLSON, *THE LITIGATION EXPLOSION: WHAT HAPPENED WHEN AMERICA UNLEASHED THE LAWSUIT* (1991))). One such study found that, in terms of time, discovery is what lawyers statistically spend most of their time on in the course of ordinary litigation. David M. Trubek et al., *The Costs of Ordinary Litigation*, 31 UCLA L. REV. 72, 91 (1983) (surveying a random sample of cases and lawyers finding lawyers spend about 16.7% of their time on discovery matters).

324. Bruggman, *supra* note 318, at 12 (“Most of the information about the discovery process and its problems is based on opinions and perceptions of those in the legal profession.”); see also McKenna & Wiggins, *supra* note 318, at 788 (noting that early research was based on surveys and interviews, which are not the most reliable indicators); Seymour Moskowitz, *Rediscovering Discovery: State Procedural Rules and the Level Playing Field*, 54 RUTGERS L. REV. 595, 610 (2002) (noting that in fewer than 5% of cases studied were more than ten discovery requests filed).

325. Trubek et al., *supra* note 323, at 90. In a study covering 1649 civil lawsuits, evenly divided between federal and state cases, interviews with 1812 attorneys, and questionnaires from 1387 attorneys, no evidence of discovery in over half of the cases was found. *Id.* at 80–82. “Pretrial activity is much more common than trials, but modest nonetheless. . . . We found no evidence of discovery in over half the cases. Rarely did the records reveal more than five separate discovery events.” *Id.* at 89–90.

326. McKenna & Wiggins, *supra* note 318, at 786–87 (citing the Columbia Project field survey).

Center conducted in 1978 examined 3000 cases in six United States district courts and found that in 53% of cases no discovery was requested at all, and fewer than 5% of these cases had more than ten discovery requests.³²⁷ In 72% of the cases, there were no more than two discovery requests.³²⁸ The National Center for State Courts likewise conducted a study in state courts and found that only 42% of the cases in the sample group conducted discovery.³²⁹ Thus, the total volume of discovery in the course of ordinary cases is generally less than perceived.³³⁰

Concededly, while discovery in ordinary litigation is not as rampant as perceived, discovery is more frequent in complex litigation.³³¹ One study found that securities suits utilized discovery more than typical litigation scenarios.³³² Nevertheless, securities litigation alone does not suffer from this increased usage of discovery; among other claims found to have a higher than normal volume for discovery are trade regulation claims, tort claims, intellectual property claims, admiralty claims, contract cases, and antitrust cases.³³³ Hence, the concern of excessive and abusive discovery is not unique to securities fraud claims.³³⁴

In fact, the idea that discovery has run amok pervades all litigation scenarios, not just securities litigation.³³⁵ Problems of discovery abuse were on the Advisory Committee on Civil Rules' docket well before the

327. Bruggman, *supra* note 318, at 12.

328. McKenna & Wiggins, *supra* note 318, at 790.

329. Bruggman, *supra* note 318, at 13.

330. *See supra* notes 320–329 and accompanying text (discussing the studies indicating discovery is not abused as often as perceived). Part of the explanation for this misperception is that interested parties, such as politicians, lawyers, judges, and insurance companies have manipulated the media to foster the idea that discovery abuse is real to further their own agendas. Bruggman, *supra* note 318, at 10–12.

331. McKenna & Wiggins, *supra* note 318, at 791–92.

332. *Id.* *But see* BERSHAD ET AL., *supra* note 7, at 8 (arguing that the only reform necessary is a system promoting “earlier disclosure of documents and other pertinent evidence”).

333. McKenna & Wiggins, *supra* note 318, at 791–92.

334. *See* Sorenson, *supra* note 322, at 697–702 (discussing the misperceptions of discovery abuse for litigation in general); *see also* Suja. A. Thomas, *The PSLRA's Seventh Amendment Problem* (Univ. of Cincinnati Coll. of Law Pub. Law & Legal Theory Research Paper Series, Working Paper No. 07–03, 2007), available at <http://ssrn.com/abstract=968893> (proposing an alternative remedy to stem discovery costs based on the nature of class actions in general and not specified to securities fraud claims); *supra* notes 316–330 (discussing the pervasive myth of discovery abuse).

335. Moskowitz, *supra* note 324, at 596; *see also* Higginbotham, *supra* note 304, at 1416 (stating that the most costly feature of litigation is discovery but acknowledging that the actual costs of discovery have rarely been quantified in empirical studies).

passage of the PSLRA.³³⁶ In fact, even before the Federal Rules of Civil Procedure (“FRCP”) were enacted, many feared that excessive discovery would allow plaintiffs to blackmail corporate defendants.³³⁷ The fear of *in terrorem* settlements has been around since at least the 1930s.³³⁸

Nor are securities regulations unique in their effort to curb perceived abusive discovery practices.³³⁹ Since 1970, there has been a general trend toward containing the scope of discovery.³⁴⁰ A variety of procedural remedies found in the FRCP have been crafted to constrain discovery.³⁴¹ For instance, a discovery conference intends to narrow the discovery issues in dispute.³⁴² Also, FRCP 26(a) no longer provides for unlimited discovery but instead includes a provision allowing courts to limit discovery.³⁴³ In addition, Rule 26(g) encourages judges to impose sanctions for discovery abuse.³⁴⁴ As recently as 1993, automatic disclosure was introduced.³⁴⁵

Furthermore, despite the potential for abuse during discovery, discovery serves a vital function in the litigation process.³⁴⁶ Discovery is usually necessary in securities fraud actions, where many facts are

336. McKenna & Wiggins, *supra* note 318, at 787; *see also* Sorenson, *supra* note 322, at 680–90 (providing a brief history of discovery abuse).

337. Moskowitz, *supra* note at 324, at 607 (noting that Representative Robert Dodge and Senator Claude Pepper were fearful that plaintiff’s lawyers would use the threat of discovery to blackmail corporations even before the rules were completed).

338. *See id.* (stating that “the rules gave so many tools to the person asserting a claim ‘that it would be cheaper and more to the self-interest of the defendant to settle for less than the cost to resist’” (quoting Hon. Edward R. Finch, *Some Fundamental and Practical Objections to the Preliminary Draft of Rules of Civil Procedure for the District Courts of the United States*, 22 A.B.A. J. 809, 809 (1936))).

339. *See* McKenna & Wiggins, *supra* note 318, at 786 (tracing the development of the discovery rules under the Federal Rules of Civil Procedure and noting the rising criticism of the discovery rules in general).

340. Moskowitz, *supra* note at 324, at 611.

341. *See infra* notes 342–344 and accompanying text (describing various procedural devices available in the course of discovery to curb its use).

342. FED. R. CIV. P. 26(f).

343. FED. R. CIV. P. 26 cmt. 3; *see also In re Top Tankers Inc.*, No. 06 Civ. 13761(CM) 2007 WL 4563930, at *11 (S.D.N.Y. Dec. 18, 2007) (acknowledging that Congress wanted to protect corporations from strike suits but nonetheless allowing quick and targeted discovery as the most efficient means to dispose of the case).

344. FED. R. CIV. P. 26 advisory committee notes to the 1993 amendments.

345. FED. R. CIV. P. 26(d).

346. *Hickman v. Taylor*, 320 U.S. 495, 507 (1947); *see also* Christine L. Childers, *Keep on Pleading: The Co-Existence of Notice Pleading and the New Scope of Discovery Standard Federal Rule of Civil Procedure 26(b)(1)*, 36 VAL. U. L. REV. 677, 687 (Summer 2002) (discussing the history of the enactment of the FRCP’s discovery provisions).

exclusively in the possession of the defendant.³⁴⁷ Discovery is designed to promote resolution of cases on the merits.³⁴⁸ Neither defendants nor plaintiffs could adequately assess the strength of their own claim or their opponent's claim absent discovery requests.³⁴⁹ By allowing claims to proceed to the discovery stage, settlements on the merits are more easily facilitated because both parties can adequately assess the adequacy of their claims.³⁵⁰ Similarly, the practical reality is that the majority of cases, not just securities claims, settle in the course of ordinary litigation.³⁵¹ In a typical litigation scenario, the courts merely serve as a background for the bargaining between parties to reach a settlement.³⁵² Thus, to single out settlements in securities litigation as nuisance-driven ignores the fact that most litigation is aimed at achieving settlement.³⁵³

In sum, available hard data suggests that discovery abuse is not rampant, but the misperception of it is.³⁵⁴ Neither is the perceived threat of *in terrorem* settlements any novel development peculiar to securities fraud class actions alone.³⁵⁵ These concerns have been around since the birth of the discovery process.³⁵⁶ The Court's fear of allowing fishing expeditions in securities fraud actions further misperceives the problem of discovery abuse, rather than recognizing discovery as an important litigation tool which is not overused.³⁵⁷

347. See Brief for Respondents (No. 06-484), *supra* note 58, at 34 (noting that "information . . . in a securities fraud action . . . typically is within the exclusive possession of defendants prior to discovery").

348. See Moskowitz, *supra* note 324, at 598 ("The core function of discovery is to seek the truth so disputes may be settled by what the facts reveal rather than what facts are concealed.").

349. Moskowitz, *supra* note 324, at 600.

350. D. Theodore Rave, Note, *Questioning the Efficiency of Summary Judgment*, 81 N.Y.U. L. REV. 875, 894 (2006) (noting that when enough facts are presented it gives the parties a chance to weigh in on the merits of the case before trial and thus helps parties reach settlement based on fuller information).

351. Trubek et al., *supra* note 323, at 89; see also Higginbotham, *supra* note 304, at 1408 (noting that trials declined from 12% in 1970 to 3% in 1999).

352. Trubek et al., *supra* note 323, at 89; see also Higginbotham, *supra* note 304, at 1416 (noting one of the ambitions of the Federal Rules was to promote full and early disclosure of facts to facilitate settlement).

353. See *supra* notes 346-352 and accompanying text (stating that the majority of litigation, not just securities class actions, results in settlement rather than trial).

354. See *supra* notes 320-330 and accompanying text (arguing that while discovery abuse is perceived as rampant, it is not).

355. See *supra* notes 335-338 and accompanying text (describing how concerns of excessive discovery are a persistent dilemma rather than a new development).

356. See *supra* notes 335-338 and accompanying text.

357. See *supra* notes 320-352 and accompanying text (demonstrating that it is the misperception that discovery is abused that is rampant rather than actual discovery abuse and that concerns of excessive discovery are a recurring theme built into the Federal Rules).

iii. A Heightened Pleading Standard Will Not Decrease Securities Litigation Costs

Litigation, not only for securities fraud class actions, is an interactive investment process,³⁵⁸ influenced by the other party's actual or anticipated expenditures.³⁵⁹ The high costs of securities litigation and settlement are not due to frivolous litigation, nuisance suits, or abusive discovery practices, but rather result from this symbiotic relationship.³⁶⁰

Despite the lower filing rate, settlement costs on average have been rising.³⁶¹ The top ten recent shareholder class action settlements exceeded \$1 billion.³⁶² In 2007, Enron settled a class action suit for \$7.2 billion.³⁶³ Tyco International announced an agreement to pay \$2.975 billion as a settlement, making it the largest amount ever paid by a single settling defendant.³⁶⁴ Even excluding the Enron settlement and other mega-settlements, one study finds that the total value of cases that are settled continues to exceed previous averages from 1996 to 2005.³⁶⁵ These giant settlements seem to support the Court's concern that the threat of exorbitant costs pressure defendants into settling claims with little or no merit.³⁶⁶ However, as the NERA Economic Consulting Study indicates, these giant settlements correspond to giant *investor losses*.³⁶⁷ In fact, NERA finds investor losses are the single most

358. Trubek et al., *supra* note 323, at 76–77 (discussing the idea that litigation is an investment of scarce resources to achieve a future result); *see also* Higginbotham, *supra* note 304, at 1412 (stating that decisions on whether to go to trial are based on cost concerns).

359. Trubek et al., *supra* note 323, at 77.

360. *See infra* notes 360–375 and accompanying text (arguing that higher settlement costs are proportional to increasing investor losses and increasing numbers of injured plaintiffs, and that higher litigation costs are proportional to the higher amounts in controversy).

361. Foster et al., *supra* note 13, at 9. The median settlement amount hit a new high in 2007 as well, increasing from an average of \$7 million to \$9 million. *Id.* at 11. NERA reported that at the end of 2007, the median settlement value was \$9.6 million. Plancich, *supra* note 308, at 13.

362. Foster et al., *supra* note 13, at 9.

363. *Id.* Also in 2007, McKesson HBOC Inc. settled for \$1.033 billion. *Id.* at 8; *see also* Laure E. Simmons & Ellen M. Ryan, *Securities Class Action Settlements: 2006 Review and Analysis*, at 1 (2006), <http://www.cornerstone.com>.

364. Foster et al., *supra* note 13, at 9.

365. Cornerstone Research, *Securities Class Action Case Filings: 2006: A Year in Review*, at 1 (2006), <http://www.cornerstone.com> [hereinafter Cornerstone Research, 2006]; *see also* Plancich, *supra* note 308, at 1, 9–13 (stating that average settlements have increased to reach a peak of \$33.2 million in 2007).

366. *See supra* notes 187, 193, 201 and accompanying text (discussing the Court's concern that high litigation costs will pressure defendants into settlement); *see also supra* notes 360–365 and accompanying text (discussing statistics detailing the rising settlement costs).

367. Foster et al., *supra* note 13, at 9. Investor losses are defined as an estimate of what investors lost over a class period relative to an investment in the S&P 500. *Id.*

powerful predictor of settlement size.³⁶⁸ Thus, higher settlements result from higher *losses suffered by plaintiffs*, not because of an increase in strike suits.³⁶⁹ Congress did not intend to prevent injured plaintiffs from recovering for their losses.³⁷⁰ These huge settlements indicate more damage done to investors, not more strike suits filed by plaintiffs.³⁷¹

Furthermore, investor losses are actually stabilizing despite higher settlement values.³⁷² When considered in conjunction with the median amount of estimated damages, the percentage of the median settlement amount³⁷³ has been lower than in previous years.³⁷⁴ Thus, high settlements are proportional to the higher losses suffered by plaintiffs.³⁷⁵

Another factor to consider in assessing costs in securities cases is the overall status of the market. Market conditions strongly affect the rate of filings.³⁷⁶ The PSLRA has been shown to have no impact on the rate of filings in months following market declines and/or market increases.³⁷⁷ By the same token, the average annual share volume on the NASDAQ grew from 60.8 billion shares in the pre-PSLRA study

368. *Id.* NERA lists a host of other factors that may affect the amount of settlement, including the existence of accounting violations, an announced investigation by a public body, whether the company is an IPO, whether an institutional investor is the lead plaintiff, and whether the class consists of members other than common stock shareholders. *Id.* at 12–13. NERA does not list a heightened pleading requirement as indicative of settlement value.

369. *Id.* at 9.

370. See H.R. REP. NO. 104–369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 730 (“Private securities litigation . . . help[s] deter wrongdoing . . . [and] is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.”).

371. See also *supra* Part IV.B.1.i (illustrating the trend of declining securities filings).

372. Foster et al., *supra* note 13, at 12. At the close of 2007, NERA reported the median ratio of settlements to investor losses was 2.4%. Plancich, *supra* note 308, at 14.

373. Compare Median: located in or related to the precise midpoint in a range of values or quantities, such that half of them fall above the midpoint and half below, BLACK’S LAW DICTIONARY 1002 (8th ed. 1999), with Mean: of or relating to an intermediate point between two points or extremes. BLACK’S LAW DICTIONARY 1001 (8th ed. 1999)

374. Simmons & Ryan, *supra* note 363, at 6. The median settlement as a percentage of estimated damages was only 2.4 percent in 2006. *Id.* at 6. However, this may be because the Supreme Court’s *Dura* decision in 2005 led to lower proportionate settlements. *Id.* at 5–6; see also *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 343 (2005) (holding that an investor claiming securities fraud cannot establish economic loss by simply alleging, and later establishing, that the price of the security on the date of purchase was inflated because of misrepresentation).

375. Plancich, *supra* note 308, at 14 (saying that as investor losses increase, settlements increase, but at a lower rate); see *supra* notes 367–371 and accompanying text (arguing that the average settlement value of securities class actions is rising because the average losses suffered by investor-plaintiffs is larger).

376. Perino, *supra* note 56, at 934.

377. *Id.* at 934–35.

period to 281.7 billion shares after the passage of the PSLRA.³⁷⁸ Simply put, there is more money at stake in securities class actions now than there was prior to the enactment of the PSLRA because there is more money in the market now than there was before.³⁷⁹ Also, the greater the number of shares traded during a class period at a particular affected price, the more plaintiffs affected, and, in turn, the more damages claimed.³⁸⁰

Moreover, securities claims deal with higher dollar amounts than typical lawsuits,³⁸¹ further accounting for the existence of higher discovery and litigation costs. For example, one study indicates that the volume of discovery is directly related to the amount in controversy.³⁸² Therefore, it is only logical that in securities claims, with millions (and sometimes even billions) of dollars at stake,³⁸³ the volume of discovery will be higher than in normal litigation.³⁸⁴ Thus, similar to the relationship between investor losses and settlements, discovery costs are not exorbitant, but are instead proportional to the massive size of securities claims.³⁸⁵

The concerns of the Supreme Court and Congress about increased discovery and settlement costs for *in terrorem* settlements are not groundless, however.³⁸⁶ One of the reasons why Congress enacted the PSLRA was to reduce *in terrorem* settlements whereby defendants settle based on the fear of extraordinary discovery or litigation costs.³⁸⁷ There is a risk that some meritless cases will be settled because a large

378. *Id.* at 938.

379. *Id.* at 939.

380. *Id.*

381. Compare Foster et al., *supra* note 13, at 8 (listing top ten shareholder class actions in securities as all exceeding \$1 billion) with Trubek et al., *supra* note 323, at 92 (detailing findings of allocation of legal fees in ordinary litigation scenarios).

382. McKenna & Wiggins, *supra* note 318, at 793.

383. See Foster et al., *supra* note 13, at 8 (listing top ten shareholder class actions in securities as all exceeding \$1 billion).

384. McKenna & Wiggins, *supra* note 318, at 797.

385. See *supra* notes 381–384 and accompanying text (arguing that discovery costs in securities litigation are perceived as high because the amount at stake in an average securities class action is typically higher than an average lawsuit).

386. See *infra* notes 387–388 and accompanying text (discussing how defendants may feel pressure in some instances to settle cases without merit).

387. S. REP. NO. 104–98, at 9 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 688; H.R. REP. NO. 104–369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 730.

corporate defendant believes it is cheaper to settle, wants to avoid reputational losses, or is simply risk averse.³⁸⁸

Yet raising the bar on pleading requirements too high will invariably undercut the aim of reducing expected litigation and settlement costs, because plaintiffs are likely to compensate by bringing higher stakes suits.³⁸⁹ To begin, the PSLRA has resulted in litigation delays.³⁹⁰ Settlements are becoming more costly since the enactment of the PSLRA, not because of strike suits, but rather because the PSLRA has made litigation for plaintiffs more costly; thus plaintiffs only bring cases that are likely to have larger damages overall.³⁹¹ In fact, data collected from the first half of 2007 shows that, while the rate of securities class action filings are down, the amount of claimed losses suffered has actually risen since 2006.³⁹² If this trend continues, one can see the danger in raising the pleading standard: by raising pleading requirements, litigation risks increase and plaintiffs cover this additional

388. See Perino, *supra* note 56, at 921 (discussing reasons why a large corporate defendant might settle lawsuits filed immediately after a significant decline in stock price). The fact that defendants are sometimes pressured into settlement rather than risk adverse disclosures is a criticism common to the entire discovery system, not just securities claims. See McKenna & Wiggins, *supra* note 318, at 792–93 (pointing out that discovery itself is commonly criticized as leading to unjust results because of increased information availability).

389. See *infra* notes 390–395 and accompanying text (demonstrating how a higher pleading standard may create a cyclical problem rather than a solution to increasing litigation costs).

390. Milstein, *supra* note 48, at 1254 (“[The] PSLRA has created endless hurdles for injured plaintiffs and their attorneys and delayed outcomes of the litigation.”); see also Perino, *supra* note 56, at 970 (concluding that a higher gate-keeping function may increase costs because of resulting increased usage of pretrial motions).

391. See Perino, *supra* note 56, at 957 (stating that because of the increased risk in suing under the PSLRA, plaintiffs are bringing suits with larger potential damages); see also Cornerstone Research, *supra* note 13, at 10 (noting that the filing of “mega” filings has risen and that other provisions of the PSLRA, like the Act’s lead plaintiff provision, may create rising costs in suit and settlement); Simmons & Ryan, *supra* note 363, at 10 (noting that the presence of an institutional investor is associated with a statistically significant increase in settlement size).

392. Cornerstone Research, *supra* note 13, at 7. One study concludes that over the last decade, average investor losses have increased dramatically. Plancich, *supra* note 308, at 14. At the end of 2007, NERA reported that median investor losses for cases settled in 2007 were \$310 million and the median investor losses for cases filed were \$355 million, the highest in the three-year period. *Id.* at 15. This is a signal that the settlements associated with these new filings might remain high. *Id.*

risk by bringing cases with greater alleged damages.³⁹³ Thus, by raising the pleading standard,³⁹⁴ one might see the overall damages involved in a claim actually rise,³⁹⁵ subverting the intent to decrease costs to corporate defendants and the market overall.

For example, consider the following concept: (1) Congress enacted the PSLRA and its strong inference requirement in response to perceived abuses of discovery in securities litigation;³⁹⁶ (2) plaintiffs compensate for the higher risk of litigation, i.e., increased risk of dismissal as a result of the higher pleading standard, by bringing cases with larger damages;³⁹⁷ (3) thus, the cost of litigation, including discovery, as it is proportional to the size of the claim, rises;³⁹⁸ (4) then, these higher litigation costs are misperceived as abuses.³⁹⁹ Thus, the Court should be particularly wary of applying any heightened standard

393. See Perino, *supra* note 56, at 941 (“[I]f case values increase enough, then attorneys will still have incentives to undertake the risk of litigation under the PSLRA.”). This is further evidenced by a 2006 study finding the rate of filings was lower but settlement amounts are increasing. Cornerstone Research, 2006, *supra* note 365, at 1. Thus, plaintiffs are bringing fewer claims, but the ones they are bringing are commanding a much higher price. However, Perino also argues that plaintiffs may be able to bring more suits with smaller capital investments because of the stay of discovery provision. Perino, *supra* note 56, at 936. Nevertheless, this argument rests on the fact that such a strategy would make sense only if more actions were brought for smaller claims. *Id.* Therefore, this argument must fail as more recent data has shown filings are decreasing and claim amounts are increasing. See *supra* Part IV.B.1.iii (demonstrating how securities class actions are being filed less and less frequently, but settlement amounts are at all-time highs). In sum, it is reasonable to conclude the stay of discovery provision is not making it cheaper for plaintiffs to bring suit.

394. See *Tellabs, Inc. v. Makor Rights & Issues, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007) (requiring courts to find an inference of scienter at least as likely as nonculpable inferences at the pleading stage).

395. Choi, *supra* note 54, at 604.

396. H.R. REP. NO. 104–369, at 37 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 736 (justifying the PSLRA which imposes a heightened pleading standard because of perceived abuses in securities fraud litigation); see also *Tellabs*, 127 S. Ct. at 2509 (justifying a heightened pleading standard because of the threat of discovery abuses).

397. See Choi, *supra* note 54, at 606–09 (describing statistics whereby plaintiffs compensate for the higher risks of litigation by bringing suits with higher damages); Perino, *supra* note 56, at 941 (stating that large settlements and fee awards since the enactment of the PSLRA indicate continued incentive for attorneys to file securities class actions).

398. See McKenna & Wiggins, *supra* note 318, at 793 (noting that the costs of litigation are proportional to the size of the claim); see also *supra* notes 381–385 and accompanying text (demonstrating that high discovery costs in securities fraud class actions are proportional to the higher than average amount in controversy).

399. See Bruggman, *supra* note 318, at 12 (arguing that data indicates discovery abuse is not as widespread as the actual misperception of it is); see also *supra* notes 325–330 and accompanying text (describing data indicating that in actuality, relatively little discovery occurs in the course of an ordinary lawsuit).

as exacting pleading requirements may actually raise the securities litigation costs it seeks to prevent.⁴⁰⁰

In addition, empirical evidence does not indicate that a tougher pleading standard is even necessary to reduce the rate of frivolous filings.⁴⁰¹ The PSLRA's heightened pleading standard is not among the reasons posited to explain the continual decline in securities filings.⁴⁰²

Data tracking the number of securities filings among the circuits finds that in 2006, before *Tellabs*, the Second Circuit and the Ninth Circuit had among the highest rates of securities class action filings.⁴⁰³ Thus, despite the fact that the Second Circuit's interpretation of "strong inference" is drastically different than the arguably more stringent standard of the Ninth Circuit, filings in both Circuits remained high.⁴⁰⁴ The Ninth Circuit, which has adopted arguably the harshest standard,⁴⁰⁵ was dominated in 2006 by four filings which contributed to a maximum dollar loss of \$98 billion.⁴⁰⁶ The inference to be drawn from this data is that pleading standards have little direct effect on a plaintiffs' attorney's ability to file a claim.⁴⁰⁷

400. See *supra* notes 390–395 and accompanying text (illustrating how a heightened pleading standard in response to perceived abuse leads plaintiff attorneys to compensate for the increased risk of dismissal by bringing claims with larger damages; as a result, the cost of litigation as a whole rises and is itself misperceived as an abuse of the system).

401. Brief of Council of Institutional Investors as Amicus Curiae in Support of Respondents at 6, *Tellabs v. Makor Issues & Rights*, 127 S. Ct. 2499 (2007) (No. 06–484).

402. Cornerstone Research, *supra* note 13, at 3 (offering two hypotheses why securities fraud filings are down, including (1) that there is simply less fraud due to aggressive enforcement and oversight by the SEC and (2) the strong stock market containing low volatility is tied with class action filings); see also, Simmons & Ryan, *supra* note 363, at 18 (listing important determinants of settlement amounts such as assets of the defendant firm, whether an accountant is named co-defendant, and even whether the claim was filed in the Second Circuit; but not listing anything concerning a pleading standard).

403. Foster et al., *supra* note 13, at 3.

404. Cornerstone Research, 2006, *supra* note 365, at 15. The Second Circuit had thirty-one filings in 2006 and the Ninth Circuit had twenty-five filings in 2006. *Id.* Historically, the Ninth and Second Circuits have had the highest number of class action filings. See *id.* at Exhibit 12 (charting class action filings by circuit since 1996). But see Perino, *supra* note 56, at 945 (suggesting that a decrease in the overall percentage of defendants sued in the Ninth Circuit is a result of the stringent pleading standard). Also, Perino's findings indicate that a less stringent standard does not result in a significant increase in litigation. *Id.* at 946.

405. See Perino, *supra* note 56, at 926 (characterizing the Ninth Circuit's standard as "the most rigorous version of the pleading standard").

406. Cornerstone Research, 2006, *supra* note 365, at 16.

407. See Andrew Longstreth, *Starving for (Class) Action*, AM. LAW., Aug. 1, 2007, at 13 (discussing defense lawyers' reaction to the statistical drop in filings and noting the feigned indifference of a partner at Paul, Hastings, Janofsky & Walker who expressed abiding faith in the creativity of the plaintiff's bar to overcome legal obstacles).

In short, there is an interesting dynamic at work in securities class action litigation: filings overall are declining while settlements are rising.⁴⁰⁸ These mega settlements are misperceived as the byproduct of abusive and excessive litigation.⁴⁰⁹ However, the data rather shows that plaintiffs are suffering increasingly greater losses.⁴¹⁰ Settlement sizes in relation to plaintiff's losses are actually stabilizing and appear to be declining.⁴¹¹ These higher settlements and costs are more rationally explained by the general increase of value and volume in the market as well.⁴¹² The Court's standard should have acknowledged this dynamic so that roundabout misperceptions of costs do not further damage plaintiffs' ability to bring merited suits.⁴¹³ Unfortunately the Court failed to acknowledge this phenomenon, instead falling into the seductive misperception that discovery has run roughshod over the system victimizing corporate defendants.⁴¹⁴

408. See *supra* Part IV.B.1.i (discussing the statistical drop in securities fraud class action filings and the statistical drop in the rate of corporate securities issuers likely subject to suit).

409. See *supra* Part IV.B.1.ii (demonstrating how discovery is misperceived as an abused procedural tool, but that actual data has not quantified it as such).

410. See *supra* Part IV.B.1.iii (arguing the rise in average settlement amount results from a corresponding rise in investor losses, rather than from a rise in nuisance filings).

411. See *supra* notes 372–375 and accompanying text (showing how the median settlement amount is leveling off).

412. See *supra* notes 376–380 (discussing how the general increase in value of the financial markets and in the number of investors in these markets creates a larger plaintiff pool and higher damages).

413. See Bruggman, *supra* note 318, at 12 (discussing how the theory of discovery as abused is based on misperceptions rather than hard data and evidence).

414. See *Tellabs, Inc. v. Makor Rights & Issues, Ltd.*, 127 S. Ct. 2499, 2508 (2007) (discussing how the risk of abusive discovery may pressure defendants into settlement).

2. Other PSLRA Provisions Address Discovery Concerns⁴¹⁵

The Court could have appropriately addressed concerns of abusive discovery practices by issuing an opinion advocating better use of the PSLRA's stay of discovery and FRCP Rule 11 provisions.⁴¹⁶ The 1933 Act and the 1934 Act were both aimed at protecting investors against fraud.⁴¹⁷ These acts and the PSLRA, considered together, take a holistic approach to protecting the integrity of our financial markets.⁴¹⁸ Thus, the acts should be interpreted holistically.⁴¹⁹ The Court should

415. If the court is so concerned with excessive discovery, more appropriate remedies are other pretrial procedures already in place, such as motions for a more definite statement, FED. R. CIV. P. 12(e), court sanctions for abusive discovery tactics, FED. R. CIV. P. 11, taking judicial notice of certain facts, FED. R. EVID. 201, and strict enforcement of automatic disclosure provisions. FED. R. CIV. P. 26. There is no reason to infer these traditional pretrial motions are not available in securities fraud class actions. The Court's new rule ignores other pretrial procedures that may be more appropriate to deal with concerns raised by the Court. See McArdle, *supra* note 270, at 46 (saying that frivolous, groundless, or fraudulent claims can be dealt with through pretrial procedures like motions for summary judgment); see also Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation Under the Federal Securities Laws*, 2 N.Y.U. J. L. & BUS. 1, 22 (2005) (noting that the Private Securities Litigation Act invites defendants to test the merit of pleadings through motions to dismiss and by asking the court to stay discovery). Indeed, concerns of excessive discovery have been addressed before by Justice Thomas in *Swierkiewicz*:

If a pleading fails to specify the allegations in a manner that provides sufficient notice, a defendant can move for a more definite statement under FED. R. CIV. P. 12(e) before responding. Moreover, claims lacking merit may be dealt with through summary judgment under FED. R. CIV. P. 56. The liberal notice pleading of FED. R. CIV. P. 8(a) is the starting point of a simplified pleading system, which was adopted to focus litigation on the merits of a claim.

Swierkiewicz v. Sorema N.A., 534 U.S. 506, 513 (2002). Previously, Justice Black addressed these concerns in *Conley* as well. *Conley v. Gibson*, 355 U.S. 41, 47–48 (1957) (citing FED. R. CIV. P. 12(e) (motion for a more definite statement); FED. R. CIV. P. 12(f) (motion to strike); FED. R. CIV. P. 12(c) (motion for judgment on the pleadings); FED. R. CIV. P. 16 (pre-trial procedure and formulation of issue); FED. R. CIV. P. 26–37 (depositions and discovery); FED. R. CIV. P. 56 (motion for summary judgment); and FED. R. CIV. P. 15 (right to amend)), *abrogated by* *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007). Likewise, Justice Stevens said the Court's concern with costly discovery "is no reason to throw the baby out with the bathwater" and that such concerns are appropriately addressed with procedural remedies already in place. *Twombly*, 127 S. Ct. at 1988 n.13 (Stevens, J., dissenting).

416. See *infra* Part IV.B.2.i (describing the PSLRA's stay of discovery provision and enhanced Rule 11 sanctions).

417. *Ernst & Ernst v. Hochfelder*, 96 S. Ct. 1375, 1382 (1976) (noting that the 1933 Act "was designed to provide investors with full disclosure of material information concerning public offerings . . . and to protect them against fraud" while "the 1934 Act was intended principally to protect investors").

418. *Id.* at 1387 ("[T]he interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen.") (quoting *SEC v. Nat'l Sec. Inc.*, 393 U.S. 453, 466 (1969)).

419. See *id.* at 1388–89 (refusing to adopt an interpretation of §10(b) applying a negligence standard for accountants alleged to have violated §10(b) that would seem to subvert procedural restrictions applicable under § 11 and § 12(2)).

strive to achieve harmony among the securities laws.⁴²⁰ In so doing, the Court should not single out the heightened pleading standard as the sole device to effectuate legislative aims or to curb excessive discovery.⁴²¹ As this Part explores, there are primarily two provisions in the PSLRA, the stay of discovery and the Rule 11 provisions, which are more apt to deal with legislative concerns than the pleading standard.⁴²²

i. The PSLRA's Stay of Discovery Provision⁴²³

Congress passed the PSLRA in response to concerns over excessive discovery costs and fishing expeditions by plaintiffs in securities claims.⁴²⁴ Congress' answer to these concerns was to enact a stay of discovery provision in the PSLRA.⁴²⁵ This provision provides that

420. *Id.*

421. The Court does acknowledge these other provisions of the PSLRA, but does nothing more. *Tellabs, Inc. v. Makor Rights & Issues, Ltd.* 127 S. Ct. 2499, 2508 (2007). In essence, the PSLRA's strong inference provision was aimed at unifying the pleading standard. *See id.* at 2507–08 (discussing the circuit split on the application of Rule 9(b) to securities cases). Even Senators more concerned with the abusive nature of securities litigation and advocating strengthened standards recommended more stringent liability provisions, tougher sanctions for abusive practices, strengthening safe harbor provisions, and delineating a clearer standard for liability, but not for a stricter pleading standard. S. REP. NO. 104–98, at 33–35 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 711–13. Particularly, the heightened pleading standard was not designed to keep claims out of court, but it was aimed at giving full effect to concerns which 9(b) was originally designed to address, such as protecting defendant's reputations from hostile claims of fraud. Congress said:

Naming a party in a civil suit for fraud is a serious matter. Unwarranted fraud claims can lead to serious injury to reputation for which our legal system effectively offers no redress. For this reason, among others, Rule 9(b) of the Federal Rules of Civil Procedure requires that plaintiffs plead allegations of fraud with "particularity." The Rule has not prevented abuse of the securities laws by private litigants The House and Senate hearings on securities litigation reform included testimony on the need to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits.

H.R. REP. NO. 104–369, at 41 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740.

422. *See generally* BERSHAD ET AL, *supra* note 7, at 31–51 (discussing proposals for securities fraud litigation reform).

423. *See generally* Milstein, *supra* note 48, at 1288–94 (describing the PSLRA's overall impact on the discovery process).

424. S. REP. NO. 104–98, at 14 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 693; H.R. REP. NO. 104–369, at 37 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 736 (discussing testimony from general counsel of an investment bank that discovery costs account for roughly 80% of total securities litigation costs).

425. 15 U.S.C. § 78u–4(b)(3)(B); S. REP. NO. 104–98, at 14 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 693; *see also* H.R. REP. NO. 104–369, at 32 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 731. However, the perception of discovery abuse is present in ordinary litigation as well and, likewise, judges are loathe to enforce or impose sanctions for violating discovery rules. Bruggman, *supra* note 318, at 2.

courts must stay discovery pending a 12(b)(6) motion to dismiss.⁴²⁶ Discovery is put on hold unless there is a particularized showing that absent discovery, a party will suffer undue prejudice.⁴²⁷ The provision stays even mandatory disclosures.⁴²⁸ Thus, discovery does not commence until after a court rules on a 12(b)(6) motion.⁴²⁹

ii. The PSLRA's Enhanced Rule 11 Sanctions Provision

To address the concern that lawyers may file factually baseless claims and subsequently use discovery as a fishing expedition to find a sustainable claim,⁴³⁰ Congress also enacted a provision related to FRCP 11.⁴³¹ This provision requires courts to issue findings that the attorneys and parties have complied with Rule 11's requirement that there be no improper purpose for pleadings and that the allegations contain existing evidentiary support.⁴³² The goal of reducing meritless suits without hindering the ability of victims of fraud to pursue legitimate claims could be dealt with by strengthening the application of Rule 11.⁴³³

However, this provision is not currently utilized to its full capacity.⁴³⁴ A 2002 study suggests that procedural barriers do not affect the filing of nonmeritorious suits.⁴³⁵ To actually effectuate change, courts should not only engage in a sanctions review but also impose sanctions or fee

426. 15 U.S.C. § 78u-4(b)(3)(B). However, there is an exception if a court finds upon motion of any party that a particularized discovery request is necessary to preserve evidence or to prevent undue prejudice to that party. See 26 MICHAEL J. KAUFMAN, *Limits on Abusive Discovery, in SECURITIES LITIGATION DAMAGES* § 3:8 n.6 (2007) ("An example of a situation involving the necessity to preserve evidence may be terminal illness of an important witness.")

427. 15 U.S.C. § 78u-4(b)(3)(C). Courts recognize an additional exception to the stay of discovery when there is a risk that evidence will be destroyed if discovery does not commence. *Med. Imaging Ctr. of Am., Inc. v. Lichtenstein*, 917 F. Supp. 717, 720 (S.D. Cal. 1995) (stating two exceptions: (1) to preserve the evidence and (2) to prevent undue prejudice); see also Perino, *supra* note 56, at 929 (noting that Congress likely anticipated the discovery stay would slow the race to the courthouse door as plaintiffs would be forced to do more extensive pre-filing investigations).

428. *Medhekar v. U.S. Dist. Court*, 99 F.3d 325, 328 (9th Cir. 1996).

429. 15 U.S.C. § 78u-4(b)(3)(B) (2000).

430. S. REP. NO. 104-98, at 14 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 693.

431. 15 U.S.C. § 78u-4(c)(1)-(2) (sanctions for abusive litigation).

432. S. REP. NO. 104-98, at 7 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 686.

433. H.R. REP. NO. 104-369, at 39 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 738.

434. Perino, *supra* note 56, at 938 (finding that small sanctions are imposed in only a handful of cases).

435. *Id.*

shifting if the action is dismissed.⁴³⁶ Plaintiffs' attorneys would thus have less of an economic incentive to initiate strike suits.⁴³⁷ Consequently, Rule 11 can work to impose direct costs on attorneys themselves.⁴³⁸

3. The Court Failed to Balance Concerns of Frivolous Litigation with the Need to Preserve Meritorious Claims

Had the Court in *Tellabs* focused to a greater extent on other PSLRA provisions and the actual rate of filing of securities fraud actions, it may have been able to strike the desired balance.⁴³⁹ In enacting the PSLRA, Congress was addressing the concern that defendants were being forced into settlements.⁴⁴⁰ However, the PSLRA is not aimed at furthering only the agendas of corporate defendants.⁴⁴¹ The statute aims to strike an optimal balance between protecting investors by preserving meritorious suits and protecting corporate defendants from frivolous claims, which thereby promotes strong financial markets.⁴⁴² In *Tellabs*, the Court neglected part of this balance: protecting investors' meritorious suits.⁴⁴³ The PSLRA should be a tool to deter wrongdoing, not to facilitate corporate fraud.⁴⁴⁴ When discussing the possibility of

436. *Id.* at 971. Perino also argues Congress should alter current damage calculation methods and attorney fee models. *Id.* at 973–74.

437. *Id.* at 971.

438. *Id.*

439. *See infra* notes 440–446 and accompanying text (demonstrating how the PSLRA has already resulted in the dismissal of meritorious claims and that now, the *Tellabs* rule, which further heightens the standard, will result in the dismissal of more meritorious securities fraud claims, thus subverting the true intention of the PSLRA: to protect meritorious claims as well as prevent nuisance filings).

440. H.R. REP. NO. 105–803, at 13 (1998) (Conf. Rep.).

441. *Id.*

442. H.R. REP. NO. 105–803, at 1 (1998) (Conf. Rep.). *But see* Mulreed, *supra* note 71, at 792–805 (arguing that the core provisions of the PSLRA are hostile toward the plaintiff and greatly disadvantage him in litigation); *see also* Miest, *supra* note 12, at 1132–34 (arguing that the Securities Acts are aimed at full and fair disclosure). The Court should be particularly careful when dealing with the balance involved with procedural rules because procedural rules allocate power between litigants and thus affect substantive rights. Moskowitz, *supra* note at 324, at 596.

443. *See infra* notes 447–451 and accompanying text (arguing that the PSLRA, which imposes a heightened pleading standard, negatively impacted a plaintiff's ability to survive a 12(b)(6) motion to dismiss; and that the *Tellabs* decision, which imposes a more heightened pleading standard, will further impact a plaintiff's ability to survive a 12(b)(6) motion).

444. H.R. REP. NO. 104–369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730 (“Private securities litigation . . . help[s] to deter wrongdoing . . . [and] is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action.”).

strike suits, it is easy to list a parade of horrors.⁴⁴⁵ However, the risk posed by a standard resulting in the dismissal of meritorious suits is likewise paramount.⁴⁴⁶

The PSLRA had already affected the dismissal rates of securities fraud claims, even prior to the *Tellabs* decision.⁴⁴⁷ Before the PSLRA was adopted, dismissals accounted for only 19.4% of dispositions of securities class actions.⁴⁴⁸ After the statute, dismissals have accounted for 39.1% of dispositions.⁴⁴⁹ Even in the past year, dismissal rates have increased.⁴⁵⁰ Because *Tellabs* further heightens the pleading standard for plaintiffs, it may further increase dismissal rates.⁴⁵¹

Even if a heightened pleading standard produces a pool of less frivolous claims at the pleading stage, a key portion of the inquiry is missing: are nonnuisance suits also less prevalent; are meritorious claims going by the wayside?⁴⁵² Some legal practitioners argue that the decision took an evenhanded approach, balancing the need to curb frivolous litigation as well as permitting meritorious claims to

445. See Miest, *supra* note 12, at 1133–34 (listing various effects threats of “strike suits” have on “targeted” corporations, including the costs and time spent defending lawsuits and millions of dollars spent on settlement, which may not be proportionate to the merits of the suit).

446. KAUFMAN, *supra* note 35 (“As the legislative juggernaut rolled on there were critics of the product . . . By inhibiting the rights of individuals to seek damages, we lowered the risks for securities fraud, eliminated deterrence, and fostered a culture of laxity.”).

447. See Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung too Far in Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL’Y & ETHICS J. 943, 974 (2006) (concluding that the PSLRA’s heightened pleading standard has severely limited a plaintiff’s ability to survive at the motion to dismiss stage); see also Foster et al., *supra* note 13, at 7 (noting that dismissal rates have increased substantially since the passage of the PSLRA); Perino, *supra* note 56, at 937 (quoting studies finding an increase in securities fraud action dismissal rates).

448. Foster et al., *supra* note 13, at 7.

449. *Id.*

450. *Id.* The dismissal rates for 2004–2006 were 38.2%. *Id.* From 2005 to 2007, the dismissal rate was 39.1%. *Id.* According to NERA, a possibility for some of this decline may be the Supreme Court’s *Dura* decision in 2005. *Id.* *Dura* held that investors could no longer allege loss causation by merely alleging a price drop after a disclosure of a misrepresentation. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 346 (2005).

451. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007); see *supra* notes 446–451 (arguing that since the PSLRA’s heightened pleading standard adversely impacted plaintiffs, so too will the *Tellabs* decision as it likewise imposes a heightened pleading standard).

452. Choi, *supra* note 54, at 603.

proceed.⁴⁵³ However, data indicates that meritorious suits are actually being dismissed.⁴⁵⁴ A pleading standard that casts a wide net at the expense of meritorious claims fails to achieve the desired balance of the statute and denies injured investors a remedy.⁴⁵⁵

Data from 2007 demonstrates that nonnuisance claims face a higher risk of dismissal and a lower probability of suit since the enactment of the PSLRA.⁴⁵⁶ Specifically, nonnuisance claims, claims which lack pre-filing hard evidence of fraud⁴⁵⁷ and where the amount involved is typically only between \$2 million and \$4 million, are less likely to be filed, and, even if filed, still less likely to succeed.⁴⁵⁸ Securities issuers that faced meritorious suits without pre-filing hard evidence in the pre-PSLRA period are much less likely to face such a lawsuit in the post-PSLRA period.⁴⁵⁹ That is, since the PSLRA, corporate defendants that would have been sued are not being sued.⁴⁶⁰ Similarly, there is a general decline in plaintiffs' attorneys even pursuing nonnuisance litigation absent pre-filing hard evidence in the post-PSLRA period.⁴⁶¹ Since the adoption of the PSLRA, companies engaging in fraud where there is no hard evidence to prove it are significantly less likely to face a

453. See Lattman, *supra* note 255 (quoting Stan Bernstein, of Bernstein Leibhard, as saying, "By rejecting the extreme positions advocated by defendants and their amici that would have required plaintiffs to essentially prove their entire case at the pleading stage, the Court struck a reasonable balance between preserving investors' ability to recover on meritorious claims and curbing frivolous litigation."); see also Thomas O. Gorman, *Tellabs: The Supreme Court Strikes a Balance Regarding Requirements in Securities Damage Actions*, June 21, 2007, <http://www.secactions.com/?p=202> (saying that the decision is not a clear victory for either side and represents a balance between competing interests); Kevin M. LaCroix, *The Supreme Court Issues Tellabs Opinion*, June 22, 2007, <http://dandodiary.com/2007/06/articles/securities-litigation/supreme-court-issues-tellabs-opinion/> (characterizing the decision as a "draw at best").

454. See *infra* notes 456–464 and accompanying text (demonstrating the recent rise in dismissals of securities fraud claims previously judged to be with merit).

455. See *infra* notes 456–464 and accompanying text (illustrating how meritorious claims are being dismissed). It is important to note that it is wholly agreed that strike suits are in no way beneficial to defendants or investors. See Mulreed, *supra* note 71, at 791 (noting that strike suits resulting in large settlements are inefficient allocations of corporate assets).

456. Choi, *supra* note 54, at 598.

457. Pre-filing hard evidence is defined as either an allegation of an accounting restatement of revenue or earnings or a SEC action. *Id.* at 601.

458. *Id.* at 623.

459. *Id.* at 601.

460. *Id.* at 615. Choi found that the incidence of nonnuisance suits filed pre-PSLRA is 3.5%. *Id.* However, those same suits, Choi predicts, would only have been filed at a rate of 1.7% in the post-PSLRA period. *Id.* Thus, the difference, Choi concludes, is significant. *Id.* Choi also notes that the difference in means of incidences of suit is not statistically significant. *Id.*

461. *Id.* at 617.

private securities class action.⁴⁶² Plaintiffs' attorneys are shifting their attention to fraud cases where there is better evidence, in order to meet the pleading standard under the PSLRA (and now under *Tellabs*), without information gained during discovery.⁴⁶³ This pursuit will ultimately lead to plaintiffs' attorneys seeking (and possibly recovering) a larger amount of damages to offset increased risks.⁴⁶⁴

*C. The Constitutionality of Weighing Inferences at the Pleading Stage*⁴⁶⁵

Along with the Court's desire to curb excessive discovery in securities litigation, the Court also sought to assuage concerns about the pleading standard's impact on the Seventh Amendment.⁴⁶⁶ The Seventh Amendment has been a jealously guarded right of the American people since our nation's inception.⁴⁶⁷ It provides:

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.⁴⁶⁸

462. *Id.* at 622. See 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, 648–50 (2007) (finding the PSLRA increased the incidence of hard-evidence cases of fraud, but not examining the impact of the PSLRA on other potentially meritorious claims).

463. Choi, *supra* note 54, at 622.

464. *Id.* at 622–23; see also *supra* Part IV.B.1.iii (illustrating how a heightened pleading standard may inadvertently increase litigation costs).

465. See Thomas, *supra* note 334 (discussing the constitutional infirmity of the PSLRA as it relates to the Seventh Amendment); Suja. A. Thomas, *Why a Motion to Dismiss is Now Unconstitutional* (UNIV. OF CINCINNATI PUB. LAW, Working Paper No. 07–15, 2007), available at <http://ssrn.com/abstract=1010062> (arguing that the *Tellabs* and *Twombly* decisions now make a motion to dismiss unconstitutional) [hereinafter Thomas, *Motion to Dismiss*]. See generally RITA J. SIMON, *THE JURY: ITS ROLE IN AMERICAN SOCIETY* 11–25 (1980) (concluding that juries are generally depicted negatively in the media).

466. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2511–12 (2007).

467. See generally LLOYD E. MOORE, *THE JURY: TOOL OF KINGS, PALLADIUM OF LIBERTY* (Anderson Publishing Co. 1988) (1973) (tracing the development of the Seventh Amendment); see also, JOHN GUNTHER, *THE JURY IN AMERICA* xiii (1988) (commenting on the absolute absurdity of having twelve strangers forced to sit and listen to a case in which they have no personal interest and then render an effectual decision, but acknowledging that the juries are nonetheless the conscience of our community). But see ELLEN E. SWARD, *THE DECLINE OF THE CIVIL JURY* 12 (2001) (noting the statistical drop in cases ending in jury trials since 1938 when the Federal Rules were enacted).

468. U.S. CONST. amend. VII. Originally, the proposed Constitution contained no right for a jury trial in civil cases, only criminal cases. U.S. CONST. art. III, § 2, cl. 3 (“[T]he Trial of all crimes, except in Cases of Impeachment, shall be by Jury”); Ellen E. Sward, *The Seventh Amendment and the Alchemy of Fact and Law*, 33 SETON HALL L. REV. 573, 582 (2003). The Seventh Amendment was ratified in 1791. *Id.* at 581.

The Amendment's language invokes the historical distinction between the common law and equity, and between law and fact.⁴⁶⁹ The jury is seen as the "last element of republicanism designed to offset the monarchical tendencies of the federal judiciary."⁴⁷⁰ Over time, the jury trial has had its share of redundant criticisms⁴⁷¹ and textbook defenses.⁴⁷² Despite this ongoing debate, some vestige of the jury trial right still remains in effect.⁴⁷³ Nevertheless, the right to a jury trial is not absolute.⁴⁷⁴ Current Supreme Court jurisprudence concerning the Seventh Amendment requires only the preservation of the *substance* of

469. Sward, *supra* note 468, at 583. The Supreme Court has held that the Seventh Amendment does not prohibit Congress from providing for only an administrative determination of newly created statutory rights. *Atlas Roofing Co. v. OSHA*, 430 U.S. 442, 455 (1977). However, a statute governing private rights historically triable by a jury still falls under Seventh Amendment protection. *Curtis v. Loether*, 415 U.S. 189, 193–94 (1974). See generally RICHARDSON R. LYNN, *JURY TRIAL LAW AND PRACTICE* (1986) (detailing the scope of the Seventh Amendment right to a trial by jury).

470. Originally, the right to a jury trial was seen as so fundamental that the absence of it helped spur the American Revolution. GUNTHER, *supra* note 467, at 30 (noting that after Parliament passed the Stamp Act of 1764, it proved difficult to enforce because colonial juries were reluctant to enforce British laws, and thus to enforce it, Parliament moved prosecutions from the Common Pleas to the admiralty courts where juries were not allowed); see also SWARD, *supra* note 467, at 90–91 (describing England's process of moving controversial cases favorable to the crown out of the hands of American jurors during the colonial period). Eventually, the First Continental Congress would assert this qualm against England in the Declaration of Independence. GUNTHER, *supra* note 467, at 31.

471. See Paul D. Carrington, *The Seventh Amendment: Some Bicentennial Reflections*, 1990 U. CHI. LEGAL. F. 33, 39–41 (1990) (arguing that jury trials preclude evidence from entering trial to protect lay jurors, force a trial into a compact event, impose unfettered moral judgment in tort law that is ultimately detrimental to victims, and turns lawyers into flamboyant actors).

472. See SWARD, *supra* note 467, at 23–65 (noting that the jury generally serves four functions: (1) a dispute settling role, in which it serves as an equalizer among citizens leveling inappropriate influence; (2) a law-making role, through jury nullification and achieving an indirect regulatory effect; (3) a political role, as it protects the individual against the tyranny of the government; and (4) a socializing role, in that it encourages diverse involvement); see also Carrington, *supra* note 471, at 37–39 (listing similar jury roles).

473. With the enactment of the Federal Rules of Civil Procedure in 1938, the law and equity distinction was merged into a single set of procedures. Sward, *supra* note 468, at 589. Specifically, Rule 38(a) preserves the right to trial by jury, although it is limited by requiring parties to demand a jury trial in advance. FED. R. CIV. P. 38(a) ("The right of trial by jury as declared by the Seventh Amendment to the Constitution—or as provided by a federal statute—is preserved to the parties inviolate."). The enactment of the Federal Rules has been characterized as a hostile act committed against the jury trial right by creating a presumption in favor of a bench trial. SWARD, *supra* note 467, at 108–09.

474. The Seventh Amendment does not create a right, but rather preserves the right to a trial by jury as it existed under the common law in 1791. Suja A. Thomas, *Why Summary Judgment is Unconstitutional*, 93 VA. L. REV. 139, 146 (2007). Traditionally, equity matters were not resolved by a jury trial, but legal matters were. *Parsons v. Bedford*, 28 U.S. 433 (1830). For a general background of the law and equity distinction see LYNN, *supra* note 469, at 10–12; see also *Chevron v. Oubre*, 93 F.R.D. 622, 623 (M.D. La. 1982) (holding that an action to cancel mineral lease is equitable and not subject to trial by jury).

the English common law jury trial as it existed in 1791.⁴⁷⁵ In the English common law, juries decided only questions of fact and not questions of law.⁴⁷⁶ Thus, questions of fact are reserved for the jury, and the court should not assume that function, directly or indirectly.⁴⁷⁷

In *Tellabs*, the Court dispenses with Seventh Amendment concerns raised by the Sixth and Seventh Circuits.⁴⁷⁸ Recall that the Court in *Tellabs* held that weighing competing inferences, while constantly assuming the truth of the plaintiff's allegations, does not infringe on the Seventh Amendment.⁴⁷⁹ Notwithstanding the Court's assurances, this weighing of inferences on a motion to dismiss does infringe on the Seventh Amendment right to a jury trial because judges usurp the jury's function of determining facts in a manner inconsistent with common law procedures.⁴⁸⁰

Furthermore, there are three aspects of a 12(b)(6) motion which tend to complicate Seventh Amendment implications.⁴⁸¹ First, a 12(b)(6) motion is a procedural mechanism regulating pleadings; thus, there is a tendency to view it as immune from Seventh Amendment challenges.⁴⁸²

475. Suja A. Thomas, *The Seventh Amendment, Modern Procedure, and the English Common Law*, 82 WASH. U. L. Q. 687, 700 (2004).

476. Thomas, *supra* note 474, at 158.

477. *In re Peterson*, 253 U.S. 300, 310 (1920) (“[U]ltimate determination of issues of fact by the jury [should] not [be] interfered with.”); *Walker v. New Mexico*, 165 U.S. 593, 596 (1897) (stating that issues of fact in common law actions are to be settled by the jury).

478. See *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2511–12 (2007) (“A court’s comparative assessment of plausible inferences, while constantly assuming the plaintiff’s allegations to be true, we think it plain, does not impinge upon the Seventh Amendment right to jury trial.”); see also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 30 (Roberts, J.) (stating that congressional articulation of a standard to be applied as a matter of law does not interfere with the Seventh Amendment).

479. *Tellabs*, 127 S. Ct. at 2511–12. The Court also said that Congress unquestionably has the power to shape litigation through pleading requirements. *Id.* Such absolutist language is dangerous because if the judge can make factual determinations or weigh competing inferences on a motion to dismiss, pleading motions may serve as an avenue for evading and eroding Seventh Amendment protections. Brief for Respondent (No. 06–484), *supra* note 58, at 45.

480. See *infra* notes 487–496 and accompanying text (discussing how the *Tellabs* rule, which requires a resolution of a mixed question of fact and law and a resolution of the reasonableness of inferences on a dispositive motion infringes on the right to a jury trial).

481. Allan Horwich & Sean Siekkinen, *Pleading Reform or Unconstitutional Encroachment? An Analysis of the Seventh Amendment Implications of the Private Securities Litigation Reform Act*, 35 SEC. REG. L. J. 4, 7 (spring 2007), available at http://schiffhardin.com/binary/horwich_spring07.pdf (Spring 2007).

482. *Walker v. New Mexico*, 165 U.S. at 596 (“The Seventh Amendment . . . does not attempt to regulate matters of pleading or practice. . . .”); Horwich & Siekkinen, *supra* note 481, at 7. In fact, the Court says just that. *Tellabs*, 127 S. Ct. at 2512 (“No decision of this Court questions that authority in general, or suggests, in particular, that the Seventh Amendment inhibits Congress from establishing whatever pleading requirements it finds appropriate for federal statutory claims.”).

Second, the Court has never addressed Seventh Amendment implications in the context of a motion to dismiss.⁴⁸³ Third, historically no factual determinations were to be made at the pleading stage because all factual allegations were presumed true.⁴⁸⁴ Nevertheless, the Court's standard infringes on the Seventh Amendment for two reasons: first, it assumes the jury's role of determining facts,⁴⁸⁵ and second, it is inconsistent with common law procedures.⁴⁸⁶

First, in support of its heightened pleading standard, the Court cites several cases affirming the constitutionality of summary judgment and judgment as a matter of law.⁴⁸⁷ However, summary judgment and judgment as a matter of law bypass the jury in a constitutionally permissible manner because their implementation is strictly predicated on the absence of any disputed questions in the jury's domain.⁴⁸⁸ The court may review the *reasonableness* of an inference drawn by a jury, but the court does not select from among conflicting inferences.⁴⁸⁹ Here, since the Court requires judges to weigh and resolve *rationality*

483. Horwich & Siekkinen, *supra* note 481, at 7. This point was also raised at oral argument. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 5.

484. Horwich & Siekkinen, *supra* note 481, at 7; *see also* Conley v. Gibson, 355 U.S. 41, 45 (1957) (a plaintiff's complaint should prevail unless there are "no set of facts" entitling him to relief). *But see* Kaufman, *supra* note 268 (arguing that *Twombly* abrogates *Conley* and restricts irrational economic inferences from being drawn in the plaintiff's favor without an allegation of grounds which makes the claim plausible).

485. Horwich & Siekkinen, *supra* note 481, at 9–10 (arguing that balancing all competing reasonable inferences at the pleading stage, as opposed to assessing the reasonableness of inferences, violates the Seventh Amendment right to a jury trial); *see also* *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 33 (Miller, Resp.'s Atty.) (noting that procedural devices are proper as long as they do not call for a resolution of fact issues).

486. *See supra* notes 465-479 and accompanying text (arguing that the common law procedures reserve all questions of fact for the jury, including questions regarding the reasonableness of inferences, and that the *Tellabs* rule is at odds with traditional common law procedure).

487. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2512 n.8 (2007) (citing *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 589 (1993)) (allowing expert testimony to be excluded based on a judicial determination of reliability); *Neely v. Martin K. Eby Constr. Co.*, 386 U.S. 317, 321 (1967) (holding a judgment notwithstanding the verdict is constitutional); *Pease v. Rathburn-Jones Engineering Co.*, 243 U.S. 273, 278 (1917) (holding summary judgment constitutional).

488. Horwich & Siekkinen, *supra* note 481, at 5.

489. Brief for Respondent (No. 06-484), *supra* note 58, at 48–49 (quoting *Tennant v. Peoria & Pekin Union Railway Co.*, 321 U.S. 29, 35 (1944)). This rationale is precisely what makes summary judgment motions constitutional. *But see* Thomas, *supra* note 474, at 159 (arguing summary judgment is unconstitutional); *see also* Sward, *supra* note 468, at 638 (noting that the reasonable jury standard was not announced in England until 1853, after the date of the enactment of the Seventh Amendment).

competing inferences, a role that properly belongs to the jury,⁴⁹⁰ the Court is applying the statute in a constitutionally impermissible manner.⁴⁹¹

After *Tellabs*, a Court must weigh these inferences and must make a determination between them.⁴⁹² One may argue that the Court's weighing does not ultimately resolve factual issues because the Court requires the plaintiff's claim to be only as likely as competing inferences. However, it is the weighing itself that is inappropriate; it is the proper role of the jury to select among competing inferences.⁴⁹³

Furthermore, scienter is traditionally considered a mixed question of fact and law—not solely a question of law—which is determined by inferences drawn from the allegations.⁴⁹⁴ Questions of fact require inductive inferences about transactions or occurrences.⁴⁹⁵ When the Court determines scienter at the pleading stage, it reaches a dispositive conclusion about a mixed question of fact and law, which invades the province of the jury, thereby jeopardizing the Seventh Amendment right to a jury trial.⁴⁹⁶

490. *Tellabs*, 127 S. Ct. at 2504 (“[A] court . . . must engage in a comparative evaluation; it must consider not only inferences urged by the plaintiff . . . but also competing inference rationally drawn from the facts alleged.”).

491. Horwich & Siekkinen, *supra* note 481, at 9–10. For instance, in *Pirraglia*, the Tenth Circuit said when a court is faced with two equally strong inferences, it is inappropriate for the court to determine which inference will prevail. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003).

492. *Tellabs*, 127 S. Ct. at 2510.

493. Horwich & Siekkinen, *supra* note 481, at 8–9.

494. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007); *see, e.g., In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1084–85 (8th Cir. 2005) (saying scienter is a factual question, but a complaint must provide a factual basis for scienter allegations); *In re Zonagen, Inc. Sec. Litig.*, 322 F. Supp. 2d 764, 774 (S.D. Tex. 2003) (“Scienter is an inherently fact-specific issue that should ordinarily be left to the trier of fact.”); *RMED Int’l, Inc. v. Sloan’s Supermarkets, Inc.*, 185 F. Supp. 2d 389, 403 (S.D.N.Y. 2002) (“[S]cienter is a question of fact, and therefore appropriate for resolution by the trier of fact.”); *Gabellini v. Rega*, 724 F.2d 579, 581 (7th Cir. 1984) (saying questions of scienter are questions of fact). The question of scienter is largely compared to negligence in tort. Horwich & Siekkinen, *supra* note 481, at 8–9. Negligence generally must be decided by the jury because even when facts are undisputed, reasonable men could reach different results from the facts. *Id.*

495. Horwich & Siekkinen, *supra* note 481, at 7 (“An inference is an answer to the question, ‘What does this fact mean (in the context of the case)?’”). Compare Arthur R. Miller, *The Pretrial Rush to Judgment: Are the “Litigation Explosion,” “Liability Crisis,” and Efficiency Clichés Eroding Our Day in Court and Jury Trial Commitments?*, 78 N.Y.U. L. REV. 982, 1083 (2003) (defining questions of law as questions involving the resolution of principles generally applicable to a class of cases) with Paul F. Kirgis, *The Right to a Jury Decision on Questions of Fact Under the Seventh Amendment*, 64 OHIO ST. L.J. 1125, 1159 (2003) (defining questions of fact as those requiring inductive inferences about transactions or occurrences in dispute).

496. *See Walker v. New Mexico*, 165 U.S. 593, 596 (1897) (saying questions of fact are reserved for the jury).

Second, even a court considering only the reasonableness of inferences drawn from the record (or the complaint as in *Tellabs*) contravenes common law procedures, which require the judge to accept *all* allegations of the party as true, regardless of the improbability of those allegations.⁴⁹⁷ Scholars who reject the traditional fact/law distinction as a tool to determine the scope of the jury trial⁴⁹⁸ make a compelling argument for the unconstitutionality of summary judgment.⁴⁹⁹ This argument is equally applicable to the *Tellabs* rule.⁵⁰⁰ According to these scholars, the framework for determining the constitutionality of procedural devices in lieu of Seventh Amendment concerns is as follows: (1) under the common law, only the jury or the parties determine the facts; (2) a court determines the sufficiency of the evidence only after a jury trial, and even then, if evidence is believed to be insufficient, the court orders a new trial; and (3) a jury decides a case with any evidence, however improbable.⁵⁰¹ Thus, on a motion for summary judgment, the moving party argues that no reasonable jury could find for the nonmoving party, and the nonmoving party argues the opposite.⁵⁰² The parties dispute what the evidence demonstrates and a court resolves that dispute.⁵⁰³ For instance, on a motion for judgment notwithstanding the verdict, even reasonable persons, such as Supreme

497. Thomas, *supra* note 474, at 159. This stricter approach would hold even the Seventh Circuit's standard unconstitutional. See *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007) (advocating a reasonableness standard).

498. Sward, *supra* note 468, at 573–74 (noting that rarely do questions neatly divide into questions of fact and law); Thomas, *supra* note 475, at 578–80. One problem with the fact/law distinction is that at common law, some forms of pleading allowed juries to make *de facto* determinations of law, such as where a party used a general issue plea, as well as determinations of fact. Sward, *supra* note 468, at 578. Also, it was not easy historically to distinguish fact and law. *Id.* at 578–79. Furthermore, sometimes fact and law were classified rather arbitrarily, *i.e.*, characterizing the interpretation of written documents as a question of law. *Id.* at 579–80. In addition, over the course of history, fact has slowly become law, and thus removed more and more cases from the province of the jury. *Id.* at 638–39.

499. Thomas, *supra* note 474, at 140.

500. In fact, such an argument is in the works. See Thomas, *Motion to Dismiss*, *supra* note 465, and Thomas, *supra* note 334 (discussing the constitutionality of the PSLRA). See also Thomas, *supra* note 474, at 140 (discussing the constitutionality of summary judgment). Thomas does not extend her argument so far as to attack the constitutionality of directed verdicts and judgments notwithstanding the verdict because they occur after trial. *Id.* at 176–77.

501. Thomas, *supra* note 474, at 180. (“Third, a jury would decide a case that had any evidence, however improbable that evidence was, unless the moving party admitted the facts and conclusions . . .”).

502. *Id.* at 161–62.

503. *Id.* at 162; see also *Key Equity Inv. v. Sel-Leb Mktg Inc.*, No. 06-1052, 2007 WL 2510385, at * 6 (3d Cir. Sept. 6, 2007) (dissent) (dissenting judge disagreeing with the majority on whether the facts give rise to a strong inference).

Court justices, may disagree as to the sufficiency of the evidence as a matter of law.⁵⁰⁴

After *Tellabs*, in a securities fraud claim, when a defendant moves to dismiss, the parties will argue that the inference of scienter drawn from the facts of the plaintiff's complaint is or is not as likely as competing inferences.⁵⁰⁵ The court then resolves this dispute.⁵⁰⁶ The common law only allowed a judge to consider the sufficiency of the evidence *after* a jury trial and verdict.⁵⁰⁷ Even then, where a judge found insufficient evidence, another jury would decide the second case, not the judge.⁵⁰⁸

Moreover, the Court's support for its holding does not justify the constitutionality of its announced rule.⁵⁰⁹ The rule set forth in *Fidelity* is far different from an actual summary judgment ruling.⁵¹⁰ Under modern summary judgment, the court does not ultimately accept as true the plaintiff's allegations; instead, the court reviews the allegations and determines whether a reasonable jury could find for the non-movant.⁵¹¹ The issue in *Fidelity* was that the court did not review the evidence, but rather accepted as true the facts alleged by the nonmoving party.⁵¹² Consequently, the rule in *Fidelity* more closely resembles a motion to dismiss, rather than today's summary judgment procedure.⁵¹³ The Court in *Tellabs* created the same problem with a motion to dismiss as it has with summary judgment—the Court is assessing the evidence, not accepting all allegations as true, and making a dispositive

504. See *Neely v. Martin K. Eby Constr. Co.*, 386 U.S. 317, 330 (1967) (Douglas, J., dissenting) (disagreeing with the majority on the grounds that the evidence is sufficient to go to the jury).

505. See Thomas, *supra* note 474, at 161–62; see also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 36 (“You read [the complaint] in the light favorable to the pleader. You do not weigh. That is a jury function.”).

506. *Tellabs, Inc., v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007).

507. Thomas, *supra* note 474, at 161.

508. *Id.*

509. See *id.* at 164–66 (arguing that the *Fidelity* decision does not support the constitutionality of modern day usage of summary judgment); see also *Tellabs*, 127 S. Ct. at 2512 (citing *Fidelity & Deposit Co. v. U.S.*, 187 U.S. 315 (1902)).

510. Compare *Fidelity*, 187 U.S. at 320 (accepting all facts as true) with *Tellabs*, 127 S. Ct. at 2509–10 (accepting only allegations which are at least as likely).

511. Thomas, *supra* note 474, at 166; see also *Valenti v. Qualex*, 970 F.2d. 363, 365 (1992) (noting that summary judgment is not appropriate if the evidence is such that a reasonable jury could return a verdict for the nonmoving party).

512. *Id.*; see also *Fidelity*, 187 U.S. at 320 (“And the facts stated in the affidavit of defense will be accepted as true.”).

513. Thomas, *supra* note 474, at 166.

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determination.⁵¹⁴ Thus, because the Court's rule requires courts to determine mixed questions of fact and law at the pleading stage and creates a rule inconsistent with common law procedures, it violates the Seventh Amendment.⁵¹⁵

*D. The Supreme Court Should Have Adopted a Probable Cause Approach*⁵¹⁶

The Court's standard should achieve three aims: (1) balance the threat of strike suits with the interests in preserving injured investors' right to sue; (2) adopt a known and thus workable standard; and (3) maintain the integrity of the Seventh Amendment by refraining from weighing inferences.⁵¹⁷ Justice Stevens' probable cause approach, articulated in his dissenting opinion in *Tellabs*, achieves these three aims.⁵¹⁸

First, Justice Stevens' approach achieves the appropriate balance between preventing frivolous suits and preserving investors' right to sue.⁵¹⁹ He compares corporate defendants to citizens suspected of engaging in criminal activity.⁵²⁰ Under his approach, only when there is probable cause can private plaintiffs initiate discovery, thus heightening the standard.⁵²¹ Justice Scalia argues that such a standard does not make sense in this scenario because probable cause is involved in a criminal proceeding.⁵²² Presumably, in criminal proceedings government officials are not prompted by selfish motives like private litigants.⁵²³ In contrast, in a securities fraud class action, plaintiffs and

514. See *Tellabs*, 127 S. Ct. at 2509–10 (requiring courts to weigh inferences); see also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 31 (“[T]he motion to dismiss operates as a dispositive motion. It cuts off the ability to proceed at all.”).

515. See *supra* notes 465–514 and accompanying text.

516. See generally Murdock, *supra* note 285, at 53 (“Justice Stevens’ analysis [in *Tellabs*] and insight are a refreshing contrast to the wordsmithing in which so many federal courts engage in order to let culpable management off the hook.”).

517. See *supra* Part IV.A–C (describing the problems with the *Tellabs* decision).

518. *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting) (highlighting his probable cause approach). See also *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 7, 44 (Stevens, J.). But see *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 8 (Scalia, J.) (saying that in a criminal case the person seeking the action is a government officer presumptively acting out of no selfish motives whereas here, in a civil case as here, there is a serious concern of selfish motive).

519. See *infra* notes 488–499 (depicting how the probable cause approach achieves a heightened standard but requires no weighing of inferences).

520. *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting).

521. *Id.*

522. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 8 (Scalia, J.) (saying that criminal prosecutors presumptively act out of no selfish motives whereas in civil litigants are highly self-interested).

523. *Id.*

plaintiffs' attorneys are highly self-interested litigants aimed at extracting money from the defendant.⁵²⁴ Justice Scalia's suggestion ignores the reality that it is not uncommon for prosecutors to also serve as self-interested litigants.⁵²⁵ For example, in a recent high-profile rape case the prosecutor was found to have withheld exculpatory evidence believing a conviction would help further his political career.⁵²⁶

Second, a reading of the statute should strive to fit the statute's language within current existing legal constructs.⁵²⁷ The statute only requires a *strong* inference, not a *conclusive* one.⁵²⁸ The statute is bereft of any language requiring judges to weigh inferences at the

524. *Id.*

525. See, e.g., Duff Wilson & John Holusha, *Duke Case Prosecutor Says He Will Resign*, N.Y. TIMES, June 15, 2007, available at http://www.nytimes.com/2007/06/15/us/15cnd-duke.html?_r=3&hp=&adxnnl=1&oref=slogin&adxnnlx=1203305349-GlmJ/xPb94N7JlrHcL/fZQ (discussing the prosecutor who brought rape charges against three persons but withheld DNA and alibi evidence in order to secure a conviction to further his political career); Richard M. Pious, *Impeaching the President: the Intersection of Constitutional and Popular Law*, 43 ST. LOUIS U. L.J. 859, 896–97 (Summer 1999) (quoting Hillary Clinton describing Kenneth Starr's investigation of former President Bill Clinton's illicit affair with a White House intern, "We get a politically motivated prosecutor who is allied with the right-wing opponents of my husband who has literally spent four years looking at every telephone call we've made, every check we've written, scratching for dirt, intimidating witnesses, doing everything possible to try to make some accusation."); *United States v. Nixon Oral Argument, Editors Note*, 9 SETON HALL CONST. L.J. 1, 59–60 (Fall 1998) (quoting Justice Powell on oral argument acknowledging the danger of politically motivated prosecutors); Eva M. Fromm, *Commanding Respect: Criminal Sanctions for Environmental Crimes*, 21 ST. MARY'S L.J. 821, 823–24 (1990) (arguing that zealous and politically motivated prosecutors seeking to advance their own careers bring criminal suits "when administrative or civil actions were previously deemed sufficient in similar situations").

526. Wilson & Holusha, *supra* note 525 (discussing the prosecutor who brought rape charges but withheld exculpatory evidence); see also Lara Setrakian & Chris Francesciani, *Former Duke Prosecutor Nifong Disbarred*, (June 16, 2007), available at <http://abcnews.go.com/TheLaw/story?id=3285862> (discussing the prosecutor's subsequent disbarment and saying, "[The prosecutor] was driven to prosecute the Duke LaCrosse case out of self-interest and self-deception.") (internal quotes omitted).

527. See *Tellabs*, 127 S. Ct. at 2516–17 (Justices Stevens and Scalia arguing Congress intended courts to apply a known standard).

528. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 40.

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pleading stage.⁵²⁹ Justice Stevens' approach adopts a familiar standard: probable cause.⁵³⁰

Third, the Court should not adopt an approach whereby courts disregard facts because of the mere possibility of inferences.⁵³¹ Justice Stevens' approach does not run afoul of the Seventh Amendment as it involves no weighing of competing inferences.⁵³²

V. IMPACT

Despite the more balanced approach advocated by Justice Stevens in his dissent, the majority set forth a different standard.⁵³³ Thus, attention must now turn to how the majority's rule will affect securities fraud plaintiffs. This Part first explores recent circuit court decisions in the wake of *Tellabs*.⁵³⁴ This Part then examines the outcome of *Tellabs* on remand in the Seventh Circuit.⁵³⁵ As this Part demonstrates, both the recent circuit decisions and the evolving rule set forth in *Tellabs* on

529. Brief for Resp. (No. 06-484), *supra* note 58, at 18. *But see* Reply Brief of Petitioners at 3, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) (No. 06-484) ("It is hard to imagine what more Congress might say in the Reform Act to make it clear that a departure from such traditional rules is required."). Congress could have said something to the effect of, "Federal Rules of Civil Procedure 8(a) does not apply to Securities Fraud Actions," or "A plaintiff's complaint is to be judged by the standards set forth in this statute and not the Federal Rules' liberal notice requirement," or "Federal Rule of Civil Procedure 8 does not apply." Presumably, Congress is more than capable of including such direction in a federal statute had it desired to do so. *Makor Issues & Rights v. Tellabs, Inc.*, 437 F.3d 588, 600 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007) ("If Congress had wanted to impose a more stringent scienter standard, we believe that it would have done so explicitly . . .").

530. *See Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting) ("[Congress] implicitly delegated significant lawmaking authority to the Judiciary in determining how [the] standard should operate in practice. . . . In addition to the benefit of its grounding in an already familiar legal concept, using a probable cause standard would avoid . . . [forcing a court to] take into account plausible opposing inferences.") (citation omitted) (footnote omitted).

531. *See Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (telling courts not to consider any allegations from confidential informants because "perhaps they have axes to grind").

532. *Tellabs*, 127 S. Ct. at 2517 (Stevens, J., dissenting). Justice Stevens illustrated the constitutionality of his concept:

There are times when an inference can easily be deemed strong without any need to weigh competing inferences. For example, if a known drug dealer exits a building immediately after a confirmed drug transaction, carrying a suspicious looking package, a judge could draw a strong inference that the individual was involved in the aforementioned drug transaction without debating whether the suspect might have been leaving the building at that exact time for another unrelated reason.

Id.

533. *Tellabs*, 127 S. Ct. at 2509-10.

534. *See infra* Part V.A (examining two recent circuit court decisions applying *Tellabs*).

535. *See infra* Part V.B (discussing the *Tellabs* result on remand in the Seventh Circuit).

remand have made it harder for a securities fraud plaintiff to survive a motion to dismiss.⁵³⁶

A. *Recent Circuit Court Decisions and the Evolution of the Tellabs Rule*

Since *Tellabs*, courts have engaged in weighing competing inferences.⁵³⁷ The lower courts, however, are applying *Tellabs* in a way that makes it much harder for a plaintiff's case to survive dismissal.⁵³⁸ One recent decision characterized the *Tellabs* rule as a "mini-trial on the merits of the case based only on the complaint."⁵³⁹ Two recent circuit court decisions have taken *Tellabs* to mean that only allegations pled with sufficient specificity suffice to create a strong inference.⁵⁴⁰ As a result, plaintiffs may no longer be able to rely on confidential informants in a majority of cases.⁵⁴¹

In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*, the Fifth Circuit used the *Tellabs* decision to dismiss a complaint, finding that allegations of GAAP violations,⁵⁴² confidential source statements, and allegations of insider trading did not collectively give rise to a strong inference of scienter.⁵⁴³

According to the plaintiff, the defendant corporation IES made statements expressing confidence in the company's financial health, and

536. See *infra* Part V.A & Part V.B (illustrating how it is unclear whether a plaintiff may continue to rely on confidential sources in securities fraud litigation).

537. *ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99 (2d Cir. 2007); *In Re Nat'l Century Fin. Enters., Inc. Fin. Inv. Litig.*, No. 2:03-md-1565, 2007 WL 2331929, at *5 (S.D. Ohio, Aug. 13, 2007); *In re Loudeye Corp. Sec. Litig.*, No. C06-1442MJP, 2007 WL 2404626, at *5 (W.D. Wash. 2007).

538. Richard D. Bernstein & Frank M. Scaduto, *Lower Courts' Handling of 'Tellabs' Inference of Scienter*, 238 N.Y.L.J. 4 (Dec. 11, 2007) (surveying lower court decisions since *Tellabs* and concluding that plaintiffs now have a lesser chance of surviving dismissal); see also *In re ProQuest Sec. Litig.*, 527 F. Supp. 2d 728, 747 (E.D. Mich. 2007) (saying *Tellabs* requires a "mini-trial on the merits of the case based only on the complaint").

539. *In re ProQuest Sec. Litig.*, 527 F. Supp. 2d at 747.

540. See *infra* notes 542-561 and accompanying text (looking at a recent Fifth Circuit and Seventh Circuit opinion using *Tellabs* to dismiss a complaint for failing to allege scienter).

541. See, e.g., *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (rejecting allegations supported by information from confidential informants). For a full discussion of the use of confidential sources see generally, Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure* XII *FORDHAM J. CORP. & FIN. L.* 551, 556 (2007) (arguing for the use of confidential sources in securities fraud litigation at the pleading stage).

542. Allegations of violations of Generally Accepted Accounting Principles ("GAAP") alone without corresponding fraudulent intent are not sufficient to state a securities fraud claim. *Chill v. Gen. Elec.*, 101 F.3d 263, 270 (2d Cir. 1996).

543. *Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 553 (5th Cir. 2007).

subsequently, the stock price increased.⁵⁴⁴ Later, IES publicly stated that it could not release quarterly earnings on time and that it would have to restate its prior financial figures due to material weaknesses.⁵⁴⁵ The plaintiff alleged GAAP violations, failure to fix a known internal accounting error, and insider trading.⁵⁴⁶ The plaintiff relied on confidential sources to attribute knowledge of the accounting error to the defendants.⁵⁴⁷ The Fifth Circuit invoked *Tellabs*, finding that the court must weigh the allegations to determine whether there is a strong inference of scienter.⁵⁴⁸

The Fifth Circuit reasoned that violations of GAAP weigh in favor of establishing scienter where they are alleged in detail because “books do not cook themselves.”⁵⁴⁹ However, the court found that, absent a lack of specific job details, such as the particular job descriptions, individual responsibilities, and specific employment dates for the confidential sources, confidential source statements do not establish a strong inference of scienter.⁵⁵⁰ The court weighed both culpable and nonculpable inferences for one of the defendant CEOs.⁵⁵¹ It balanced his one-time suspicious stock sale with the fact that he retained much of his stock after the class period, and weighed the balance against scienter.⁵⁵² Regarding the company’s former CEO, the court balanced his suspicious sale with the fact that the sale came in lockstep with his resignation and obligations incurred under a divorce decree, and found there was no strong inference of scienter.⁵⁵³ Ultimately, the court, in reading the complaint holistically, found that there was no strong inference as a matter of law.⁵⁵⁴

544. *Id.* at 552.

545. *Id.* at 549.

546. *Id.* at 552. See generally 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *GAAP Violation with Fraud—After the Reform Act*, in BROMBERG & LOWENFELS ON SECURITIES FRAUD §6:54:140 (2d ed. 2007) (listing the types of GAAP violations that usually survive a 12(b)(6) motion).

547. *Cent. Laborers'*, 497 F.3d at 552.

548. *Id.* at 553.

549. *Id.* at 552.

550. *Id.* In addition, the court rejected the insider trading allegations. *Id.* at 552–53. For a more complete explanation of insider trading see generally, Thomas Lee Hazen, *Insider Trading and Rule 10b-5*, in 3 LAW OF SECURITIES REGULATION § 12:17 (5th ed. 2007).

551. *Cent. Laborers'*, 497 F.3d at 552–54.

552. *Id.* at 553.

553. *Id.* at 553–54. The court said his stock sale was suspicious because of the sheer volume of stock that was sold. *Id.* See also *supra* notes 254–257 (discussing the issue remaining after the *Tellabs* decision concerning the proper weight for aggregated inferences).

554. *Cent. Laborers'*, 497 F.3d at 555.

In one case, the Seventh Circuit has since rejected the use of confidential sources altogether.⁵⁵⁵ In *Higginbotham v. Baxter*, the defendant company announced it would restate the earnings from the three preceding years to correct fraudulent statements by its subsidiary.⁵⁵⁶ The Seventh Circuit, like *Tellabs*, echoed the concerns of frivolous litigation and abusive discovery.⁵⁵⁷ The Seventh Circuit repeated the *Tellabs* mandate requiring courts to weigh culpable and nonculpable inferences.⁵⁵⁸ However, the Seventh Circuit held that all allegations attributable to confidential witnesses must be discounted because there is no way to consider opposing inferences.⁵⁵⁹ The Seventh Circuit reasoned that “[p]erhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don’t exist. . . . *Tellabs* requires judges to weigh the strength of plaintiffs’ favored inference in comparison to other possible inferences; anonymity frustrates that process.”⁵⁶⁰ Thus, no allegations stemming from confidential informants were considered.⁵⁶¹

B. *The Tellabs Case on Remand*

The Supreme Court did not reverse the Seventh Circuit’s holding, but vacated the decision and remanded it for the Seventh Circuit to apply the Supreme Court’s rule.⁵⁶² In January 2008, the Seventh Circuit resolved the *Tellabs* case on remand in favor of the plaintiffs.⁵⁶³ Because the Seventh Circuit’s standard was a lower standard than the one set forth by the Supreme Court, and because allegations against defendant Birck were dismissed based on that lower standard, logically, the Seventh Circuit did not find an inference of scienter as to Birck

555. *Higginbotham v. Baxter Int’l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007).

556. *Id.* at 755–56. The Brazilian subsidiary reported sales made earlier than their actual dates to accelerate revenue. *Id.* When revenue could no longer be accelerated, they simply made up sales data. *Id.*

557. *Id.* at 756 (“Any restatement of a public company’s financial results is likely to be followed by litigation.”). The court stated, “A complaint is not a discovery device.” *Id.* at 757. *But see supra* Part IV.B (detailing the necessities of discovery and how discovery facilitates resolution of cases on the merits).

558. *Higginbotham*, 495 F.3d at 756.

559. *Id.* at 757.

560. *Id.*

561. *Id.*

562. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2513 (2007).

563. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 712 (7th Cir. 2008).

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under the higher standard.⁵⁶⁴ Only the allegations concerning Notebaert and Tellabs were considered.⁵⁶⁵

Rather than address the issue of scienter from Notebaert's standpoint as the court had in its earlier decision,⁵⁶⁶ the Seventh Circuit addressed the issue of scienter from the company's standpoint.⁵⁶⁷ The court began by lumping together the two allegations of false statements about the demand for the Titan 5500 and Titan 6500.⁵⁶⁸ To review, the allegations were that Notebaert made statements that demand for the Titan 5500 was continuing to grow despite a report from Tellabs' marketing strategy department that revenue from the Titan 5500 would decline by about \$400 million and an internal report from a Tellabs market analyst that said demand for the Titan 5500 was "drying up."⁵⁶⁹ The plaintiffs also alleged that Notebaert made statements to financial analysts that "everything we hear from the customers indicates that our in-user demand for services continues to grow."⁵⁷⁰ The plaintiffs also alleged that Notebaert made a number of false statements concerning the availability of the Titan 6500.⁵⁷¹ The plaintiffs alleged that Tellabs did not ship a single Titan 6500 during the class period and that the Titan 6500 was not available.⁵⁷² The plaintiffs also put forth evidence from a Tellabs sales director that Notebaert saw weekly sales and production reports.⁵⁷³ Notebaert made statements saying the 6500 was "available now" and was "being shipped."⁵⁷⁴

After the *Tellabs* decision, weighing the possibility that these statements were simple, honest mistakes against an inference that the

564. *See Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 605 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007) (dismissing *Birck* under the reasonableness approach); *see also* Supplemental Br. of Def.-Appellees at 3 n.2, *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 04-1687, 2008 WL 151180 (7th Cir. Jan. 17, 2008) [hereinafter *Tellabs Remand, Br. of Def.-Appellees*].

565. *Makor*, 513 F.3d at 707-08.

566. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 603 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007).

567. *Makor*, 513 F.3d at 707-08.

568. *Id.*

569. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 603 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007).

570. *Id.*

571. *Id.* at 604.

572. *Id.*

573. *Id.*

574. *Id.* Under the Seventh Circuit standard, the court found that the plaintiffs had sufficiently pled scienter. *Id.*

CEO knowingly lied,⁵⁷⁵ there appears to be a fifty-fifty balance, and thus the tie should go to the plaintiff.⁵⁷⁶ In fact, the Seventh Circuit found just this situation.⁵⁷⁷ The court stated, “There are two competing inferences One is that the company knew . . . that the statements were false, and material to investors. The other is that although the statements were false . . . their falsity was the result of . . . careless[] mistakes at the executive level.”⁵⁷⁸ The Seventh Circuit said nonculpable inferences could be drawn that perhaps lower level employees accidentally overstated the company’s earnings and the mistake was never caught.⁵⁷⁹ Also, a nonculpable inference to be drawn in favor of the defendant company is that perhaps lower level employees were embezzling and concealing funds.⁵⁸⁰ The Seventh Circuit said that these inferences amount to one inference: an inference of mistake at the management level.⁵⁸¹ Nevertheless, these inferences were not as likely as the inference that these statements were made with intent to deceive.⁵⁸² Specifically, the Seventh Circuit noted that the sheer importance of the products and the fact that no plausible story was offered by the defendants makes the inference of a culpable scienter more likely than any nonculpable inference to be drawn.⁵⁸³

The third allegation was that Tellabs engaged in channel stuffing to falsely inflate its projected financial health.⁵⁸⁴ The plaintiffs provided evidence that a former business manager at Tellabs said Notebaert worked directly with Tellabs’ sales personnel to affect the channel stuffing.⁵⁸⁵ The plaintiffs also put forth another confidential source, a

575. *See* *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2509–10 (2007) (requiring courts to consider and weigh both culpable and nonculpable inferences).

576. *Id.*

577. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 709 (7th Cir. 2008).

578. *Id.* at 707-08.

579. *Id.*

580. *Id.* at 708-09 (“Suppose the false communication by the lower-level employee to his superiors had been deliberate. Suppose he was embezzling tens of millions of dollars, and by concealing the embezzlement greatly exaggerated his corporation’s assets.”).

581. *Id.*

582. *Id.*

583. *Id.* (“The 5500 was described by the company as its ‘flagship’ product and the 6500 was the 5500’s heralded successor. They were to Tellabs as Windows XP and Vista are to Microsoft.”); *see also* Supplemental Br. of Plaintiff-Appellants at 3, *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 04–1687, 513 F.3d 702 (7th Cir. 2008) [hereinafter *Tellabs* Remand, Br. for PL-Appellants] (distinguishing the facts in *Higginbotham* and the facts in *Tellabs*). Similarly, because the Titan 5500 is Tellabs’ “flagship product,” it would be difficult to infer that the CEO was unaware of its market status. *Tellabs*, 513 F.3d at 707-08.

584. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 604–05 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007).

585. *Id.*

high-level sales executive, who admitted that he and his staff fabricated purchase orders for products and claimed Notebaert knew about this.⁵⁸⁶ However, there are two kinds of channel stuffing: good and bad.⁵⁸⁷ Thus, the balance consists of an inference that they engaged in bad channel stuffing that Notebaert knew about, weighing against an inference that they engaged in good channel stuffing, along with another inference that Notebaert had no idea the channel stuffing took place.⁵⁸⁸ This is not a clear fifty-fifty divide.⁵⁸⁹ Whether the channel stuffing allegation will establish a strong inference on remand depends on how the court weighs the variety of inferences, namely that Notebaert knowingly engaged in bad channel stuffing, verses two nonculpable inferences, one being that he knowingly engaged in good channel stuffing, and the other being that he unknowingly engaged in bad channel stuffing.⁵⁹⁰ In this case, the Seventh Circuit found more culpable than nonculpable inferences for the channel stuffing allegation.⁵⁹¹ The Seventh Circuit noted that in this case, there were such a large number of returns such that an inference of ignorance on behalf of management would be hard to deduce.⁵⁹² Therefore, the Seventh Circuit found the claim of channel stuffing established a strong inference of scienter.⁵⁹³

The Seventh Circuit then turned its attention to whether these allegations were sufficient to establish a strong inference of scienter for the individual

586. *Id.* at 605.

587. *Tellabs*, Tr. of Oral Argument, *supra* note 133, at 37–38. Good channel stuffing would be where a distributor discounts and offers other incentives for persons to buy. *Id.* Bad channel stuffing would be where a distributor floods customers with unwanted products and fabricates orders for purposes of inflating revenue projections. *Id.*

588. *See Makor*, 437 F.3d at 604–05 (discussing the allegation of channel stuffing and the inferences to be drawn from it).

589. *See supra* Part IV.A.2 (discussing the ambiguities in the *Tellabs* decision, including how exactly inferences are to be weighed).

590. The inferences could weigh in at (1) 30:30:30, (2) 30:60, or (3) 30:30, 30:30. Coffee, *supra* note 280. *Tellabs* provides no indication of how this is to be resolved. Previously, the Seventh Circuit indicated the complaint alleged sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle. *Makor Issues & Rights*, 437 F.3d at 598. Similarly, Justice Stevens believed that the channel stuffing allegations were particularly persuasive. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2517 n.2 (2007) (Stevens, J., dissenting).

591. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 709–10 (7th Cir. 2008).

592. *Id.* (“The huge number of returns of 5500 systems is evidence that the purpose of the stuffing was to conceal the disappointing demand for the product rather than to prod distributors to work harder to attract new customers . . .”).

593. *Id.*

CEO, Notebaert.⁵⁹⁴ The court found a strong inference of scienter against Notebaert in his individual capacity because the false statements emanated directly from him.⁵⁹⁵

Lastly, the Seventh Circuit addressed the fact that the plaintiffs alleged fraudulent conduct through twenty-six confidential informants.⁵⁹⁶ The complaint noted the position each held and the dates of their employment.⁵⁹⁷ Subsequent to *Tellabs*, the Seventh Circuit has held that allegations from confidential informants will not be considered because the court cannot possibly weigh them.⁵⁹⁸ Under the *Higginbotham* approach, one would expect the claim to be dismissed right away.⁵⁹⁹ However, the Seventh Circuit backed away from its approach in *Higginbotham* requiring the steep discountenance of confidential sources, and instead listed a number of factors which made the use of confidential sources sufficient in this case.⁶⁰⁰ The plaintiffs had twenty-six confidential sources.⁶⁰¹ All of these sources were in key positions sufficient to establish a high likelihood that they had the information alleged.⁶⁰² The Seventh Circuit said the *Tellabs* sources were also prepared to testify.⁶⁰³ And lastly, since the sources'

594. *Id.* ("Suppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.")

595. *Id.* at 711–12.

596. *Id.*; see also *Tellabs Compl.*, *supra* note 97, at 2–4 (listing all twenty-seven confidential sources and their occupations).

597. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 596–97 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007).

598. *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007).

599. However, other Circuits seem to imply that where the confidential informants are so designated with sufficient information like particular job descriptions, individual responsibilities, and specific employment dates, a court may weigh such allegations. *Cent. Laborers' Pension Fund v. Integrated Elec. Serv. Inc.*, 497 F.3d 546, 552 (5th Cir. 2007). Even still, the descriptions of the confidential sources contained only the position held and the dates of employment vaguely described as "substantially prior to the Class Period," or "from prior to the Class Period through most of the Class Period." *Tellabs Compl.*, *supra* note 97, at 2–4. Nevertheless, the Seventh Circuit may distinguish this case from *Higginbotham* because in *Tellabs* there were some twenty-seven confidential sources, while in *Higginbotham* there were only five. Supplemental Brief of Pl.-Appellants at 2, *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, No. 04–1687, 2008 WL 151180, (7th Cir. Jan. 17, 2008) [hereinafter *Tellabs Remand, Br. of Pl.-Appellants*]. However, only four of the twenty-seven anonymous sources discuss Notebaert. *Tellabs Remand, Br. of Def.-Appellees*, *supra* note 564, at 3–4.

600. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 711–12 (7th Cir. 2008).

601. *Id.* The twenty-seventh confidential source was dropped on remand because the twenty-seventh source had allegations that did not pertain to either Notebaert, the Titan 5500, or the Titan 6500. *Tellabs Remand, Br. of Pl.-Appellants*, *supra* note 583, at 3 n.3.

602. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 711–12 (7th Cir. 2008).

603. *Id.*

allegations were corroborated by multiple sources, they were sufficient.⁶⁰⁴ Because these factors all weighed in favor of the plaintiff, the Seventh Circuit concluded that the absence of proper names does not invalidate the drawing of a strong inference from the informants' assertions.⁶⁰⁵

However, no solace should be taken from *Tellabs* on remand.⁶⁰⁶ For one thing, confidential sources still must meet a rather vigorous set of factors.⁶⁰⁷ These factors include: the numerosity of the sources, whether they are in a position to know the information first-hand, whether they are prepared to testify, whether the allegations are described with such specificity as to make them convincing, and whether the information is corroborated with multiple sources.⁶⁰⁸ Moreover, in *Tellabs* the lynchpin on remand was that the statements all involved the company's flagship products.⁶⁰⁹ Thus, there was a compelling culpable inference to be drawn in favor of the plaintiffs.⁶¹⁰

In sum, at the outset, the plaintiff will have difficulty surviving a 12(b)(6) motion where the allegations in the complaint rely on confidential informants.⁶¹¹ Plaintiffs now have the additional burden of either securing witnesses willing to disclose identities or find sufficient facts in some other way.

VI. CONCLUSION

The *Tellabs* decision resolves an important question concerning the sufficiency of scienter allegations in securities fraud actions. The Court requires plaintiffs to plead facts that establish a strong inference of

604. *Id.*

605. *Id.*

606. *See infra* notes 607–610 and accompanying text (discussing the vigorous factors a confidential source must meet if confidential sources are allowed at all).

607. *See Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 757 (7th Cir. 2007) (describing treatment of confidential sources); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 711–12 (7th Cir. 2008) (describing treatment of confidential sources).

608. *Makor*, 513 F.3d at 711–12 (“The confidential sources listed in the complaint . . . are numerous and consist of persons who from the description of their jobs were in a position to know at first hand the facts to which they are prepared to testify The information that the confidential informants are reported to have obtained is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources.”).

609. *Id.* at 708–09, 711–12. The Seventh Circuit analogized the importance of the products at issue to *Tellabs* as Windows XP and Vista are to Microsoft. *Id.* at 708–09.

610. *Id.* at 708–09.

611. Now in the Seventh Circuit, it is unclear whether allegations resting on confidential informants will be considered at all and therefore there is a high likelihood that such claims will be dismissed from the start. *Higginbotham*, 495 F.3d at 757. Now the runner might not even get a chance at bat, let alone a chance to tie on a base run.

scienter, such that when culpable inferences are weighed against nonculpable inferences, the inference of culpability or scienter is at least as likely as opposing inferences. The Court also establishes that Congress' pleading schemas do not violate the Seventh Amendment as they merely provide for plaintiffs to make an issue.

While the Court's standard undoubtedly resolves the circuit split concerning the weighing of inferences in securities fraud litigation, it has many negative ramifications. First, the Court fashions the rule by resting on concerns of frivolous strike suits and nuisance settlements. This concern is largely unfounded because it is based on common misperceptions concerning abusive securities class action litigation, rather than on existing data. In crafting this standard, the Court neglects other PSLRA provisions as well as a key side of the policy balance: preserving investors' right to sue. In addition, the rule infringes on the Seventh Amendment right to a jury trial. Scienter, as a question of fact, must be left for the jury to determine. The Court should have adopted Justice Stevens' probable cause approach because it achieves the desired aims of both Congress and the Court and does not run afoul of the Seventh Amendment. The *Tellabs* standard and recent interpretations of it make it harder for plaintiffs alleging securities fraud to survive a 12(b)(6) motion. Now, a *Tellabs*-required mini-trial on the merits at the pleading stage may result in the dismissal of more meritorious claims.