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Pleading After *Tellabs*

Geoffrey P. Miller

Abstract: In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court held that a securities fraud complaint will survive a motion to dismiss “only if a reasonable person would deem the inference of [culpable state of mind] cogent and at least as compelling as any opposing inference one could draw from the facts alleged.” This paper analyzes how the *Tellabs* test may be applied, identifies questions left open under the decision, and discusses broader implications of the opinion and the PSLRA. Among other things, the paper suggests that the PSLRA’s heightened pleading rules have deformed the motion to dismiss to the point where it now operates in securities fraud cases as a hybrid falling somewhere in between the traditional Rule 12(b)(6) and Rule 56 summary judgment procedures.

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Among the many tasks bequeathed to the courts in the Private Securities Litigation Reform Act of 1995 (PSLRA), few have proved as vexed as that of interpreting the special pleading standard for allegations of scienter (state of mind). In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court attempted to resolve a longstanding confusion in

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1  Stuyvesant P. Comfort Professor, New York University Law School. For helpful comments I thank Stephen Burbank, Salvatore Graziano, Linda Silberman, Irwin Warren, and participants at a University of Wisconsin/Institute for Law & Economic Policy Conference on “The Continuing Evolution of Securities Class Actions.”

2  See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976) (scienter is a “mental state embracing intent to deceive, manipulate, or defraud.”). All circuit courts that have considered the issue agree that in addition to intent to defraud, scienter encompasses conduct that displays recklessness (variously defined) as to truth or falsity.

the federal courts as to what is required of scienter allegations in order to defeat a motion to dismiss under Rule 12(b)(6). This paper analyzes the PSLRA’s scienter pleading rule in light of the *Tellabs* decision.

The PSLRA provides that “[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.” The purpose of this rule is clear: Congress sought to deter “frivolous, lawyer-driven” securities class action litigation by requiring the plaintiff to demonstrate at the outset that the action is likely to be meritorious and not a mere device for extracting unwarranted settlements.

The PSLRA’s scienter pleading rules are in tension with the pleading standards otherwise applied in federal courts. Rule 8(a)(2) generally requires only that the plaintiff set forth a “short and plain statement of the claim showing that the pleader is entitled to relief.” Although Rule 9(b) requires that the circumstances of fraud be alleged with particularity, allegations of “[m]alice, intent, knowledge, and other condition of mind” may still be averred generally. The rule for testing the adequacy of pleadings under the 12(b)(6) motion to dismiss is not at all demanding: the complaint merely needs to set forth

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4. 15 U.S.C. § 74u-4(b)(2). A related requirement provides that “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” 15 U.S.C. § 74u-4(b)(1).
6. Rule 8(a)(2) repudiates centuries of arcane rules that too often, in the view of the rule-makers, resulted in bona fide claims failing because of a lawyer’s mistake. The purpose of pleading was henceforth to be that of providing notice: the complaint only had to say enough to allow the defendant to formulate a defense. See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 346 (2005).
7. Various reasons have been proposed for the heightened pleading requirement for fraud cases – protecting settled transactions, safeguarding reputations, providing notice of ambiguous claims, weeding out
a “plausible entitlement” to relief.8 Courts applying this standard take as true all the factual allegations in the complaint,9 and sometimes require that all reasonable inferences are drawn in the plaintiff’s favor.10

The pleading requirements for scienter in securities fraud cases are at odds with these rules.11 Under the PSLRA, the complaint must contain particularized allegations of scienter – general averments are not enough. The plaintiff cannot defeat a motion to dismiss merely by establishing a plausible entitlement to relief, nor does the court draw all (or even most) inferences in plaintiff’s favor. The plaintiff’s burden, instead, is to establish a “strong inference” of scienter.

While it is thus clear that the PSLRA significantly heightens pleading requirements for scienter, the amount of the step-up is not nearly so clear. When, in particular, can it be said that the complaint has established a “strong” inference? The word “strong” is not defined in the statute, and in ordinary speech has many connotations. It seems clear that Congress demanded something more than a simple inference: it is not enough that a court could infer scienter from the pleaded facts; instead, the inference must be “strong.” It also seems clear that the inference need not be so powerful as to be, say, “conclusive.” Congress could have used an adjective like this but didn’t do so. However, excluding these end points leaves a lot of middle ground uncharted. Between a simple inference and a conclusive one there are many gradations, and where the line is to be drawn is far from certain based on the statute’s words alone.

frivolous suits – but none is very convincing. See Christopher M. Fairman, An Invitation to the Rulemakers -- Strike Rule 9(b), 38 U.C. Davis L. Rev. 281 (2004).
9 E.g., Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit, 507 U.S. 164, 164 (1993).
10 E.g., ACA Financial Guaranty Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. 2008).
In the face of this uncertainty, the federal circuits adopted different standards. One approach, championed in the Sixth Circuit, held that an allegation of scienter survives a motion to dismiss only if it is the “most plausible” of competing inferences. The Seventh Circuit, in contrast, determined that the complaint would survive a motion to dismiss if “it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.” The First Circuit adopted yet a different rule under which, if the alternative inferences were equally likely, the court would dismiss the case.

In *Tellabs*, the Supreme Court, in an opinion by Justice Ginsburg, attempted to resolve the confusion by setting forth a nationwide standard for pleading scienter in private securities litigation: a complaint will survive a motion to dismiss “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.”

The operative language of the opinion is obviously chosen with considerable care, and therefore warrants careful analysis. First, the Court indicated that the applicable perspective is that of a “reasonable person.” The rule thus requires that the trial court’s inferences should be based on ordinary assumptions about the world rather than on implausible, biased, or unusual ones. What is perhaps less clear is whether the trial court must evaluate the allegations from the perspective of a person unsophisticated in business or finance, or rather should bring to bear whatever background knowledge the court may have about these topics. The better view – and certainly the one implicit in the cases – is

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11 See Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 705 (7th Cir. 2008) (“To judges raised on notice pleading, the idea of drawing a ‘strong inference’ from factual allegations is mysterious.”).
12 Fidel v. Farley, 392 F.3d 220, 227 (6th Cir. 2004).
13 Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006).
14 In re Credit Suisse First Boston Corp., 431 F.3d 36 (1st Cir. 2005).
15 127 S.Ct. at 2510 (emphasis supplied).
that the court should not exclude sophisticated knowledge about these topics when evaluating a motion to dismiss. To exclude such information, even if a court were capable of the necessary psychological contortions, would simply be to impair the accuracy of the court’s evaluation. The Court’s standard, however, requires only that the evaluation be from the perspective of a reasonable person, not an unsophisticated one.

A second observation goes to the Court’s requirement that a reasonable person “would” – not “could” – deem the inference of scienter to be cogent and at least as compelling as the alternatives. The difference between “would” and “could” seems deliberate. Although it is possible to make too much of this distinction, Justice Ginsberg’s use of “would” carries some suggestion that even if a reasonable person could conclude that the inference of scienter is sufficient, the complaint still fails if a reasonable person could also reach the opposite conclusion.

Third, what of that troublesome adjective “strong”? Justice Ginsburg declined to follow the Seventh Circuit’s approach – under which a complaint survived if it gave rise to a reasonable inference of scienter – on the ground that it failed to account for the “inherently comparative” nature of the inquiry. To decide whether the inference of scienter is “strong,” the majority opinion said, it is necessary to evaluate other, alternative inferences that might be drawn from the same factual allegations. The majority opinion also rejected the “tie goes to the defendant” approach of the First Circuit (endorsed by Justice Scalia in his opinion concurring in the judgment), as well as Justice Alito’s suggestion that the appropriate test is the same as that used at the summary-judgment and

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16  127 S.Ct. at 2510 n.5.
judgment-as-a-matter-of-law stages. The proper test, in the majority’s view, is that the plaintiff wins in the event the competing inferences on scienter are equally strong.

I. Applying the Tellabs Standard

A. One Test or Two?

How should we interpret the Court’s carefully crafted, but not entirely pellucid language? At the outset we may note an ambiguity implicit in the statement that the inference of scienter must be “cogent and at least as compelling as any opposing inference.” Is this one standard or two? The word “and” suggests a bifurcated approach: to defeat of motion to dismiss, the inference of scienter drawn from the complaint must be both cogent and at least as compelling as any opposing inference. On the other hand it seems odd that the single word “strong” would require two separate tests. The issue, although technical, is important: if a dual standard is implied, defense counsel will certainly suggest interpretations of the two requirements the joint effect of which is to screen out many class action complaints.

Judge Posner, on remand in Tellabs, seemed to side with the two-test approach; he separately analyzed the complaint with respect to its cogency and its comparative inferential strength, and further suggested that the requirement of cogency is more demanding than the comparative inference test. The plaintiff, in other words, must demonstrate that the inference of scienter is stronger than competing, non-fraudulent inferences, and then must meet an even more demanding requirement by showing that the

17 Id.
18 Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 711 (7th Cir. 2008) (“Because the alternative hypotheses—either a cascade of innocent mistakes, or acts of subordinate employees, either or both resulting in a series of false statements—are far less likely than the hypothesis of scienter at the corporate level at which the statements were approved, the latter hypothesis must be considered cogent”) (emphasis added).
inference is a lot stronger than the alternatives. This interpretation is unconvincing.\textsuperscript{19} Justice Ginsburg’s opinion in \textit{Tellabs} was adamant that the comparative test was the important one. It would have been strange if she had thrown in a \textit{more} demanding cogency requirement without flagging this fact. Moreover, under this interpretation the majority opinion in \textit{Tellabs} would appear even more demanding than the views advanced by other Justices – Scalia and Alito – who disagreed with the majority for placing an insufficient burden on investors.

I believe a better interpretation of the Supreme Court’s language is the following. The standard articulated by the Court is a unitary standard: the only operative requirement is that of comparative inferential strength.\textsuperscript{20} However, the Court suggested a phased approach for courts to use in applying that standard. First, the trial court should consider whether the allegations in the complaint give rise to a plausible inference of scienter. If the court concludes that the allegations do not even rise to this level, then it is unnecessary to proceed further because the inference of scienter cannot be considered cogent. The complaint can be dismissed without further analysis because it is obvious that there must be at least one competing, innocent explanation which is stronger than the inference of scienter. Second, if the inference of scienter is found to be plausible, the reviewing court proceeds to the more challenging and difficult task of comparing the inference of scienter with other inferences that might be drawn from the complaint. Under this interpretation the requirement of cogency is similar to the analysis on motion for summary judgment: when the burden of proof is on the plaintiff, the plaintiff must at least make out the elements of

\textsuperscript{19} In fairness, it should be noted that this is only one interpretation of Judge Posner’s opinion, which need not be read as firmly endorsing a two-test approach.

\textsuperscript{20} Thanks to Stephen Burbank for convincing me that the standard is unitary rather than dual.
the claim before the defendant is required to come forward with a countervailing showing.  

B. Inferences of Scienter

Let’s now consider what must be pleaded to establish an inference of scienter. As with any mental state, scienter cannot be established by direct evidence, but only circumstantially. The process of circumstantial inference takes the following form: an objective fact is established and then is evaluated in light of general background information with the view to assessing the probability that, given the established fact, the unobserved but forensically meaningful fact exists. This process of assessment of conditional probabilities is what the Supreme Court in Tellabs meant by “inference.” The analytical process requires that general background information widely accepted in the community be the basis for probability judgments and that the probabilities assigned be consistent with what most people in the community would consider reasonable. As discussed above, the Tellabs Court coded this requirement in a “reasonable person” standard: the inference of scienter is to be assessed from the standpoint of a reasonable person, not someone with unusual, unique or distorted ideas about the world and how it operates.

The application of this process of circumstantial inference is somewhat different in the context of a motion to dismiss than when facts are proven at trial. This is so because on motion to dismiss the predicate facts are not established through forensic proof but rather are merely alleged. Thus the adjudicator looks only at information supplied by the plaintiff. He or she does not have access (except by indirect methods such as taking

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judicial notice) to information that the defendant could supply. In other respects, however, the analytical process is similar in both the motion to dismiss context and at trial.

Inferences pertinent to scienter commonly found in securities fraud complaints include the following:

1. Several predicate facts bearing on scienter must be established in the pleadings relevant to elements of a securities fraud claim other than scienter. For example, the plaintiff must plead with particularity that the defendant made a statement to the market. This pleading, while relevant to another element of the cause of action, is also significant from the vantage point of scienter. Analyzed from the perspective of conditional probability, its effect is to create a low baseline of probability. The reason is that when a corporate officer makes a statement to the market, that person can be expected to be as accurate as possible, knowing the business and legal consequences that can follow from error. In other words, we apply to the predicate fact – a statement to the market – the background information that people in positions of authority at large companies usually make true statements when speaking to the market. Thus, conditional on a statement being made to the market, we can infer that there is a high probability – in default of other information – that the statement is not made recklessly or with intent to mislead.

2. Rule 10b-5 also requires, however, that the statement to the market be false or misleading. Particularized pleadings of falsity strengthen the inference of scienter. This is so because we apply the background assumption that corporate officers who make statements to the market are aware of the consequences of error, and thus are careful to check the truth of their statements before they make them. With that assumption in place, the conditional probability that the person acted wrongfully is greatly increased given that
the statement was false. People who make false statements to the market do not always intend to mislead, but if it is important that they speak truthfully, the fact that their statement turned out to be false creates a suspicion that they were lying.

3. Allegations of materiality further increase the probability that a defendant acted with scienter, even though they are still not sufficient in themselves to defeat a motion to dismiss. Our background information here is that sophisticated businesspeople understand that when information is material – when it is important to market actors in deciding whether to buy, sell or hold the company’s shares – they need to be especially careful to verify the truth of what they are saying, both for legal reasons (materiality being a predicate for liability under Rule 10b-5) and also for business purposes (the market will lose faith in the company if its officers make false statements about important facts). Because people will usually be especially careful when the information is material, as compared when it is not, the fact that a material statement turns out to be false enhances the suspicion that the person making the statement knew it was false (or was reckless with respect to its truth).

4. Many securities fraud complaints allege that bad news about the company came out soon after the defendant made optimistic statements to the market. This allegation increases the conditional probability of scienter. The background information here is that the operations of big companies are not usually so volatile that normal or good performance deteriorates into poor performance in a short period of time. Given this background information we assess as reasonably high the conditional probability that the defendant knew the bad news at the time the defendant provided the market with the overly optimistic information. At one time in the history of securities fraud litigation, optimistic
statements by insiders followed shortly thereafter by material bad news were nearly enough in themselves to satisfy the pleading requirements: given that a company’s performance does not usually change in a short period of time, and given that the market does not react unless the news is considered to be significant, the conditional probabilities of falsity, materiality, and scienter were increased to the point where any complaint which made these allegations stood a chance of withstanding a motion to dismiss. The PSLRA put the kibosh on this practice. Business interests complained that a raft of lawsuits followed every time a company’s shares suddenly lost value in the wake of bad news, and argued that these suits almost always settled even when the cause of the share price decline had nothing to do with any deception by corporate insiders. In response to these complaints, Congress made it clear that courts should police against the practice of extracting settlements in the wake of every share price plunge.23 It is thus clear in the wake of the PSLRA that allegations of false, material statements followed by bad news and sudden losses in market value are not, in themselves, sufficient predicates for a strong inference of scienter: “fraud by hindsight” is not allowed.24 Although sudden disclosure of unanticipated bad news is certainly one reason to increase our assessment of the conditional probability of scienter, it is not in itself sufficient.

5. Another common allegation is that the defendant occupied a leadership position at the company. The plaintiff typically will provide not only the defendant’s title, but also a description of the responsibilities that the defendant carried out in the firm. For these

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22 Notice that this background information is not necessarily true: there is no a priori reason why corporate performance should not be very volatile. So in making this background assumption we are importing information we generally know about the business world.


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allegations to carry through to an enhanced conditional probability of scienter, the court needs to apply a variety of pieces of background information – that corporate officers tasked with responsibilities generally do their jobs; that they understand what they are doing; that they demand and receive from subordinates the key information necessary for them to do their jobs, and so on. If these assumptions are valid, it becomes more probable, given that the officer would ordinarily receive information about the true condition of the company, that the person did in fact have that information at the time he made the overly optimistic statements in question. Still, however, the mere fact that someone was in a high position at a company is not enough, in itself, to create a strong inference that the person knew that his or her statements were false.

6. Another typical allegation is the claim that a defendant sold shares in the company at the same time he was issuing unfounded optimistic statements about the company’s prospects or performance. Here, the relevant background information is the fact that people who own shares in a company which is facing bad news can avoid a financial loss by selling before the news hits. Since – another background assumption, although not a controversial one – people prefer making money to losing it, ownership of stock provides a motivation to condition the market upward at the time of sale. Thus allegations that a defendant sold the company’s stock during the period after the defendant’s optimistic statement, but before the bad news came out, increase the

25 See, e.g., Smajlaj v. Brocade Communications Systems, Inc., 2007 WL 2457534 (N.D. Cal. 2007) (inferring scienter, inter alia, from fact that defendants had given CEO exclusive authority for stock option program).
26 See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226, 1228-29 (9th Cir. 2004) (at the time excessively optimistic statements about the company were made, CEO and CFO sold very large share blocks for significant profits).
conditional probability that the defendant knew or was reckless with respect to the falsity of
the information.

7. Accounting errors are sometimes alleged as predicate facts giving rise to an
inference of scienter. The scenario is this: at the time the defendant made optimistic
statements to the market, the issuer’s financial statements were overly positive due to
improper accounting (or the optimistic statements were the financial statements
themselves).27 The background information that creates the inference of scienter is that
corporate accounts are usually accurate in broad brush, even if errors of detail are common.
Thus technical or minor accounting errors will not be sufficient to raise an inference of
scienter.28 But serious accounting errors, being uncommon, raise different inferences. If
such a violation occurred, it is possible that either (a) the company’s accountants were
given falsified information to use as a basis for the financial reports, or (b) the accountants
conspired with company insiders to present a deceptively rosy picture of the company’s
financial posture. The strength of the inference of scienter, with respect to a particular
defendant, will depend on his role in the company: did he exercise control over the
information flow; was he in a sufficiently high-level position so as to influence or conspire
with the accountants to falsify the books; did he certify the accuracy of the financial
statements, thus exposing himself to potential liability for errors; and so on.

8. Plaintiffs sometimes allege that reports circulated within a company – including
distribution to people without immediate authority for the contents – should be considered

27 See, e.g., In re Daou Sys., Inc., Sec. Litig., 411 F.3d 1006, 1016 (9th Cir. 2005), cert. denied sub
28 See, e.g., In re Hansen Natural Corp. Sec. Litig., 2007 WL 3244646 (C.D. Cal. 2007) (mere
allegation of GAAP violations, with more, did not give rise to strong inference of scienter); In re Worlds of
Wonder Securities Litigation, 35 F.3d 1407, 1426 (9th Cir. 1994) (“Plaintiff must prove that the accounting
practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the
to have been read, digested, understood and endorsed by everyone on the circulation list. The purpose of these allegations is to sweep within the complaint individual defendants as to whom scienter cannot otherwise be alleged. The “group pleading doctrine” held that in such cases a false or misleading statement could be imputed to everyone who had responsibility for the preparation of the document. A similar theory could support the scienter of individual defendants not otherwise tied to the fraud: if they are part of an in-group who regularly communicate about key issues facing the company, everyone within the control group – and not only those with immediate line responsibility – might be deemed to know of the falsity of the statements being published. These arguments depend on background information about the functioning of organizations: they assume that top insiders in companies share important information and that everyone who participates in the drafting of a document is aware of all statements in the document. These assumptions, however, are not consistent with an ordinary understanding about how companies work. Most people familiar with corporate operations would probably agree that sensitive information is not widely shared among all senior managers, that documents such as SEC filings, although they may be widely circulated, do not reflect the consensus of views of everyone on the circulation list, and that decisions made by some individuals cannot necessarily be attributed to all. Decisions that expand the scope of liability based on these obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts.

29 See Wool v. Tandem Computers, Inc., 818 F.2d 1433, 1440 (9th Cir. 1987) (“In cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other ‘group-published information,’ it is reasonable to presume that these are the collective actions of the officers.”).

30 See Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 707 (7th Cir. 2008) (“The problem with inferring a collective intent to deceive behind the act of a corporation is that the hierarchical and differentiated corporate structure makes it quite plausible that a fraud, though ordinarily a deliberate act, could be the result of a series of acts none of which was both done with scienter and imputable to the company by the doctrine of respondeat superior. Someone low in the corporate hierarchy might make a mistake that
theories are based more on ideas of social policy than on legitimate inferences from background information – concerns similar to those that motivated the now-rejected theory of enterprise liability for secondary actors.\textsuperscript{31} Perhaps not surprisingly, these group pleading ideas have fallen into disfavor in the wake of the PSLRA’s enhanced pleading rules.\textsuperscript{32} The inference of scienter must rather be established with pleadings specific to each defendant.

9. Plaintiffs may allege that the defendants had a motivation to mislead the market because, as corporate officers, they wanted the company to show good rather than bad results. Courts have generally rejected these allegations on the ground that they do not create a sufficient inference of reliance.\textsuperscript{33} The basis for the court’s rejection of these allegations, properly analyzed, is not a denial that corporate officers wish to show good performance by their firms. Clearly, some senior officers display loyalty to their companies that would be quite commendable if it were not a motivation for fraud. Nor is the rejection of this pleading based on the premise that an officer’s identification with the interests of the company has no relevance to whether the officer is likely to engage in deception. An overly intense identification with a company’s performance might be misguided, in the sense that it may not correlate with behavior that serves the firm’s long-range interest; but few would deny that such conduct does sometimes occur. These allegations do not have force with judges because they are not really contentions of

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\textsuperscript{32} The Supreme Court declined to decide this issue in \textit{Tellabs} on the ground that the question was not before it. See 127 S.Ct. at 2511 n.6. But no court of appeals has affirmed the group pleading doctrine in the wake of the PSLRA. See Fin. Acquisition Partners L.P. v. Blackwell, 440 F.3d 278, 287 (5th Cir. 2006); Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602-03 (7th Cir. 2006), rev’d on other grounds, 127 S.Ct. 2499 (2007); Winer Family Trust v. Queen, 503 F.3d 319 (3d Cir. 2007).

\textsuperscript{33} See Lipton v. Pathogenesis Corp., 284 F.3d 1027, 1038 (9th Cir.2002); GSC Partners CDO Fund v. Washington, 368 F.3d 228, 237 (3d Cir. 2004) (“Motives that are generally possessed by most corporate officers...”:
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predicate facts. They are statements of background conditions. In every case it is possible that senior officers will over-identify with the company’s short term performance and thus be induced to commit fraud; but because this is a general background condition in all cases, the courts already take it into account when evaluating conditional probabilities, and therefore to give it explicit credit as a predicate allegation would be a form of double-counting.

10. Securities fraud complaints often point to the fact that prior to the disclosure of bad news to the market, a company’s creditors may become nervous and begin to demand enhanced security or threaten to exercise rights under the loan agreement. This predicate allegation – a defendant’s knowledge that creditors are becoming restless – enhances the conditional probability of scienter because creditors usually do not act up unless they have some reason to be concerned about the security of their loans. Even if the plaintiff can’t make a factually-grounded allegation that a defendant directly knew of a company’s deteriorating financial condition, allegations that he knew creditors were getting antsy enhances the probability that he was lying when he assured the market that all was well. On the other hand, creditors may become obstreperous for reasons other than the company’s perilous finances, and not all creditor questions rise to the level of concern. The court must evaluate all the relevant information in order to assess whether it gives rise to a strong inference that the defendant knew of the company’s bad financial condition.

11. Securities fraud complaints sometimes allege that the defendants manipulated relationships with customers or suppliers in order to show order flow that was not justified by business fundamentals. In Tellabs, for example, the complaint alleged that the company

directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from this fraud.”}
had engaged in “channel stuffing” – shipping unwanted product to customers. The natural inference from this allegation is that the defendant’s motive for shipping excess product, given the customer irritation and costs involved, must have been to affect the company’s accounting – increased sales means increased profits. Manipulation of the accounting, in turn, is evidence that the defendants were aware of the company’s true financial condition and thus attempted to mislead the market when they made optimistic statements. The plaintiff’s problem here is that the conduct alleged is qualitatively the same as behavior that is perfectly appropriate. The mere shipping of product, taken alone, is innocuous and gives rise to no inference of scienter at all. The inference of scienter arises only if the company shipped too much product. The plaintiff can of course allege that the company shipped too much, but such an allegation, without more, is likely to be viewed as insufficiently specific. Given the background information that companies ship product to customers and that product shipments often vary year to year, the plaintiff’s challenge is to supply sufficiently particularized allegations that the volume of product shipped was greatly in excess of that observed in the past, and that no changes in general industry conditions can explain the change.34

12. In the wake of the PSLRA, plaintiffs’ securities lawyers, lacking information through civil discovery, turned increasingly to private investigators to scope out misconduct. This has led to the common practice of reporting statements of confidential sources – internal auditors, staff accountants, clerks, personal assistants, and others who

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34 The Seventh Circuit, on remand, concluded that given the volume of returns, the allegations of channel stuffing did contribute to a strong inference of scienter. Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008).
have access to knowledge bearing on the defendant’s scienter.35 Paraphrases of statements from these sources can support inferences of scienter because these informants are sometimes witnesses to events within the “black box” of the corporation.36 Nevertheless, if the source is not identified, the defendant can argue that the court requires more specific information if it is to carry out its responsibilities under *Tellabs*. Courts have divided on this question, some concluding that information from confidential sources must be discounted because it is impossible to evaluate competing inferences without more specific information,37 others recognizing that confidential sources can be evaluated for what they are worth.38 The latter view is preferable. It is a *non sequitur* to say that because *Tellabs* mandates a rigorous analysis, confidential sources should be excluded entirely: rather, a statement in the complaint that a confidential source has provided certain information is a predicate allegation like any other that, evaluated in light of general information, can be used to draw forensically relevant inferences. Thus, it appears clear under *Tellabs* as well as the PSLRA itself that a plaintiff must disclose that the allegation comes from a source.39

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36 See, e.g., In re Syncor International Corp. Sec. Litig., 239 Fed.Appx. 318 (9th Cir. 2007) (finding strong inference of scienter from statements by confidential informants that defendants had acknowledged illegal payments).
37 See Higginbotham v. Baxter International, Inc., 495 F.3d 753, 756-57 (7th Cir.2007) (“One upshot of the approach that Tellabs announced is that we must discount allegations that the complaint attributes to five confidential witnesses information from anonymous sources could be deemed ‘compelling’ or how we could take account of plausible opposing inferences.”)
38 See Central Laborers’ Pension Fund v. Integrated Electrical Services Inc., 497 F.3d 546, 552 (5th Cir. 2007) (“[c]onfidential source statements are a permissible basis on which to make an inference of scienter.”).
39 In a non-securities law case, it would be appropriate for a plaintiff not to even mention the existence of such informants, but rather to simply to allege the contents of the informants’ statements. But naked “information and belief” allegations are disfavored under PSLRA’s heightened pleading rules. Such allegations are insufficient to withstand a motion to dismiss on the false statement element of the securities fraud action, see 15 U.S.C. § 74u-4(b)(1) (“if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”). The pleading rule on scienter does not contain a similar restriction on “information and belief” allegations, but
The plaintiff should also provide all information pertinent to the source’s credibility consistent with the need to maintain confidentiality, including information setting forth the basis for the confidential source’s knowledge – his or her position at the defendant, his expertise in the subject matter, his access to information, and so on. In evaluating the conditional probability of scienter, the court should then apply ordinary background assumptions – for example, the fact that people who have no reason to lie are probably more likely to speak truthfully than are people whose interests is affected by their statements.

C. Competing Inferences

Let’s turn to the comparative analysis in which the court compares the strength of competing inferences. The difficulty here is that while the complaint will set forth the plaintiff’s allegations of scienter in elaborate detail, the court will not have ready access to the alternative inferences. The defendant’s answer need not contain an affirmative explanation for the conduct in question. In fact, because several innocent explanations depend on facts that the defendant would rather not admit – for example, that he was incompetent, lazy or duped – defendants will often find it preferable to leave to the courts the task of teasing out competing inferences. The trial court must therefore engage in the comparative exercise mandated by Tellabs equipped with only minimal guidance from the defendant and such information as is provided by the allegations in the complaint, any supporting documentation, and information (such as public filings or government documents) as to which the court may take judicial notice. How can the court responsibly perform this analysis?

the practice appears to be that all such allegations, even those pertaining to scienter, require factual supplementation.
It turns out that the task is simplified by the fact that only a limited number of alternative inferences are possible. The following inferences are most likely to be pertinent:

1. Ignorance: the court may consider whether the defendant lacked access to information about what was really going on in the company. The defendant may have been naïve, even a fool, but not a scoundrel; any false statements to the market were made in good faith without knowledge of their questionable factual basis. The defendant can suggest this to the court by raising questions as to whether the company’s true financial condition would have naturally reached him in the course of the company’s business.

2. Incompetence: predicate allegations of scienter might be explained on the theory that the defendant or his colleagues were simply incompetent. Misstatements about the company’s finances may have been due to error rather than intent. The defendants may have been so bad at their jobs that they did not understand the company’s situation, even though, given their positions in the firm, they should have done so. The defendant’s problem here is two-fold. First, the normal background assumption about corporate managers is that they are competent – informed and able to carry out their responsibilities. To rebut that background assumption a defendant needs to present grounds for believing that managers may not have been competent. This information may not be easy to tease out of the record presented to the court. Moreover, to suggest his or his codefendants’ incompetence, even by way of hypothetical questions, is to acknowledge culpable behavior that might bias the court against him. But sometimes the materials of record may admit only two possibilities, incompetence or intent, and in such cases defense counsel can safely suggest that the defendant goofed (for example, if the company over-reported earnings at
some periods but under-reported them at others, the inference of scienter is weakened because then the misstatements look more like mistakes than a deliberate plan).

3. Lack of expertise: perhaps the information available to the defendant, even if it would have spoken volumes to a person trained in the art, meant nothing to him because he lacked expertise in the subject matter. Commonly, these arguments will relate to accounting concepts. The court may infer that the defendant, not being trained in the fine points of financial reporting, may well not have understood that a disaster lurked beneath the sophisticated jargon of the financial statements.

4. Lack of motive: The defendant may have had no reason to lie to the market, notwithstanding facts that might suggest otherwise. Suppose, for example, that the plaintiff alleges that the defendant sold large quantities of the company’s stock at a time when he was making overly optimistic comments about its performance or prospects. As we have seen, this allegation creates an inference of scienter: people naturally want to make money and not lose it, and someone holding a company’s stock will make more money if they sell into a rising market. But the inference of scienter will be weakened if the securities sales in question were not unusual, were consummated under a long-established trading plan, or were justified by unusual liquidity needs on the part of the defendant (if these can be shown on the available record). Or the court may consider the fact that the sales occurred soon after the expiration of stock options in which the defendant significantly increased his share ownership; here the inference of scienter is countered by the background knowledge that people have a legitimate reason to rebalance their portfolios after selling a large illiquid asset.
5. Exogenous shocks: the court may infer that the problems that occurred at the firm were due to exogenous shocks that could not be predicted at the time the defendant made the false statement, or that, being unexpected, were not thoroughly digested and understood until later. This argument is sure to be heard in the sub-prime cases now being filed. Managers of firms that lost huge amounts in sub-prime investments may claim that the collapse in American credit markets was a virtually unprecedented event which they could not anticipate and whose magnitude they could not accurately assess at the time they provided overly optimistic statements to the market.

C. Amendments

An important practical question concerning the application of the Tellabs standard is the availability of amendment. Does Tellabs alter the general approach of Rule 15(a) that leave to amend should be freely granted when justice so requires? Since Congress intended to save defendants the costs of having to respond to frivolous litigation, perhaps the PSLRA’s heightened pleading standards also imply that the courts should look with a gimlet eye on motions to amend. On the other hand, since the PSLRA is silent about amendments, one might infer that the statute leaves the existing rule on amendments intact. Which is the better view?

We have here a tradeoff between competing costs. Denying leave to amend after a 12(b)(6) dismissal creates two risks for securities class actions. There is the danger that good cases will be lost merely because the lawyers failed to supply sufficient information – raising the specter of the old system of forms of action and the forfeiture of substantive rights because of attorney default. There is also the risk that plaintiffs’ counsel, fearing a

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40 See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp., 380 F.3d 1226, 1232 (9th Cir. 2004); In re Apple Computer Sec. Litig., 886 F.2d 1109, 1117 (9th Cir. 1989), cert. denied sub nom.
dismissal without leave to amend, will expend excessive resources in working up a complaint that is sure to pass muster, even though the information in question could more efficiently be obtained, post-filing, by the normal process of civil discovery. Granting leave to amend too readily, however, creates the risk that plaintiffs’ counsel will file a patently inadequate complaint, knowing that leave to amend will be granted, and then supply progressively more detailed versions until one finally meets with the court’s approval. This practice would be costly for the courts and would impose unnecessary burdens on defendants who would be forced to make repeated motions to dismiss.

Given this tradeoff, the better view is that courts should liberally grant leave to amend but should also retain the discretion to say “enough is enough.” Nothing in Tellabs conflicts with this approach. In practice, district courts do regularly grant leave to amend when they believe there is a chance to salvage the complaint. On the other hand they also have wide discretion deny leave to amend (denials of leave are reviewed on an abuse-of-discretion standard), and thus have the power to put a hopeless case out of its misery in a humane and efficient manner.

D. Open Questions

Tellabs leaves open a number of subtle questions:

1. How should the court deal with the fact that the complaint typically contains numerous predicate allegations that give rise to inferences of scienter of varying degrees of


41 The decisions agree that the PSLRA did not affect the rules on amendment. See ACA Financial Guaranty Corp. v. Advest, Inc., 512 F.3d 46 (1st Cir. 2008); Belizan v. Hershon, 434 F.3d 579, 584 (D.C. Cir. 2006).

42 See, e.g., Intr-Plex Techs., Inc. v. Crest Group, Inc., 499 F.3d 1048, 1056 (9th Cir. 2007) (“[d]ismissal without leave to amend is improper unless it is clear, upon de novo review, that the complaint could not be saved by any amendment”); In re Alpharma, Inc. Sec. Litig., 372 F.3d 137, 153 (3d Cir. 2004) (leave to amend need not be granted if further amendments would be futile).

strength? Quite possibly, no single predicate allegation, taken alone, would be sufficient to raise the complaint past the bar. But obviously the inference to be drawn from numerous allegations may be stronger than what can be inferred from only one. The Tellabs Court addressed this problem, observing that the reviewing court must analyze the matter “holistically,” viewing the allegations collectively as well as individually. This requirement was clearly correct given that multiple allegations can have a cumulative effect. Left unaddressed, however, was how a reviewing court should engage in this holistic assessment.

The key consideration here should be the degree of correlation between the predicate acts. If the predicate acts are perfectly correlated, so that one necessarily implies the other, a holistic analysis taking both into account would not strengthen the inference of scienter. For example, an allegation that the defendant had the right to exercise an option adds little, if anything, to the allegation that the defendant actually exercised it (unless the exercise is alleged to be improper). The inference of scienter drawn from the fact that the defendant exercised the option is not strengthened by the allegation that he had the right to do so. Other alleged predicate acts are less perfectly correlated. For example, the allegation that the defendant, who was on the distribution list, reviewed a financial report for April adds something, although not much, to the allegation that the defendant reviewed the report for March. The additional allegation therefore only slightly strengthens the inference of scienter. More powerful inferences of scienter are generated when the predicate acts are uncorrelated. Suppose the compensation committee is recorded as approving an option grant at a time when the stock price was low relative to the time of expiration. In itself this might not give rise to a strong inference of backdating because
stock prices naturally rise and fall. But if the compensation committee is recorded as awarding many options at many different times, and each time the award was dated at a time when the stock price happened to be depressed, the inference of scienter is stronger because each of the option grants is a separate event. It is as if one is flipping a coin: the chance of getting a head on the first flip is 50%, on two flips is 25%, on three flips is 12.5%, and so on. The more often independent events give rise to consistent results, the more likely it is that those results are not due to chance (if the flip came up heads fifty times in a row we might wonder whether there was something wrong with the coin).

2. Another issue is whether comparative analysis is required when the competing inference goes not to scienter but to some other element of the cause of action. Suppose that based on the particularized allegations in the complaint the court concludes that the probabilities are these: 75% chance that the defendant is innocent of any misconduct because he did not make the fraudulent statement, 25% chance that the defendant did make the statement and did so knowing that it was false. Here, the analysis conclusively shows that the inference of non-liability outweighs the inference of liability. But the inference of non-liability does not go to scienter; if inferences of scienter alone are considered, it would be obvious that the plaintiff has established a strong inference of the requisite state of mind. The answer to this question seems clear: under *Tellabs* it is improper to weigh inferences of scienter against inferences pertaining to other elements of the cause of action. But it is important that the courts make this distinction because it is a point easily confused. There will often, moreover, be cases where a predicate allegation bears both on scienter and on some other element of the claim; here, presumably, the court should try to sort out the

44 See Middlesex Retirement System v. Quest Software Inc., 527 F.Supp.2d 1164 (C.D.Cal. 2007) (inferring scienter, inter alia, from multiple, extremely beneficial option grant dates).
scienter inference from the inference pertaining to the other element and only use the one pertaining to scienter in the analysis under *Tellabs*.

3. Given that a reviewing court looks at the complaint as a whole when assessing the strength of the inference of scienter, should it also look at the possible competing inferences as a whole or rather take them one by one? Suppose that the court concludes that the probability of scienter given the predicate allegations is 40%. This is probably enough to make the inference cogent, but does it satisfy the comparative test? To clarify that question, suppose further that the alternative explanations are these: 25% chance that the defendant was duped by unfaithful subordinates, 25% chance that the defendant didn’t understand the accounting principles on which the fraud was based, and 10% chance that the defendant was not duped but still had insufficient information to establish that his misstatement was deliberate. If we compare the 40% probability of scienter against the 60% probability that scienter is absent, it would seem that the comparative analysis would require dismissal of the complaint. But if we compare the 40% probability of scienter against the probability of any of the alternative explanations taken alone, then the complaint should withstand a motion to dismiss. The *Tellabs* opinion suggests the latter rule: “the complaint will survive . . . if a reasonable person would deem the inference of scienter . . . at least as compelling as any opposing inference one could draw from the facts.”

Perhaps a way to understand this point is to ask whether the competing inferences are based on inconsistent theories. If only one of the alternative inferences is possible, then it makes sense for the reviewing court to pick only the most probable of the alternatives as the basis for comparison and ignore the others. But if the alternative inferences are each
jointly possible, although different, then the analysis would presumably be more complex. The court should then inquire into the joint probability that each of these inferences could occur together. Perhaps, for example, the defendant sold a lot of stock at the time of the misrepresentation in order to cover big losses in other investments; was hospitalized during much of the class period and therefore unable to participate in the alleged misconduct; and was considered to be a potential whistleblower by other participants in the fraud and therefore was shielded from knowledge of the misconduct. All of these are possible, all could logically occur together, and all tend to undermine the inference of scienter. But the chance that all these events would occur to the same person at the same time is much lower than the chance that one of them would occur. Thus the court should not simply add up the probabilities of the inferences, but rather should consider the (presumably lower) probability that all of them would occur together. On the other hand, if there is a plausible link between the inferences – if the defendant’s hospitalization made it more likely that he would be left out of the loop by colleagues who did not want to overstress him, for example – then the likelihood that they could be simultaneously valid is increased, and thus is more appropriate for the reviewing court to consider them together when engaging in comparative analysis.

4. What should the court make of the PSLRA’s safe harbor for forward-looking statements? This provision immunizes statements about future performance if they are accompanied by “meaningful cautionary statements” identifying factors that could cause actual results to differ. The problem is that, taken literally, this language would appear to immunize even statements made with intent to deceive. Under this interpretation, no form

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45 127 S.Ct. at 2510 (emphasis supplied).
of pleading, even one that raises the strongest possible inference of scienter, would survive a motion to dismiss. Some courts have resisted this interpretation for the obvious reason that it would appear inconsistent with the overall tenor and purpose of the securities laws, which is to provide accurate information to the investing public.\footnote{See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp., 320 F.3d 920, 936, 937 n.15 (9th Cir. 2003) (dictum); Glenbrook Capital Ltd. Partnership v. Kuo, 525 F.Supp.2d 1130 (N.D. Cal. 2007).} Others have viewed the plain language of the statute as dispositive and have refused to allow inquiry into scienter as long as the requisite cautionary language is present.\footnote{See In re See Beyond Techs. Corp. Sec. Litig., 266 F.Supp.2d 1150, 1164 (C.D.Cal. 2003); In re Portal Software, Inc. Sec. Litig., 2006 WL 2385250 (N.D.Cal. 2006).} The better view is that cautionary language is not “meaningful” if the warning is part of a pattern of deception. We would doubt that a worker holding a road sign saying “caution” gives meaningful information if the bridge ahead is about to collapse; in fact we might conclude that the word “caution” was itself deceptive because it implied that it was safe to proceed as long as one took proper care, when in fact proceeding could be disastrous regardless of our level of care. By like reasoning, because a cautionary comment attached to a forward-looking statement is not “meaningful” if the defendant is engaged in a deliberate fraud, the presence of such a statement should not conclusively establish the lack of a strong inference of scienter.

II. Broader Implications

I turn now to a brief discussion of some of the broader implications of \textit{Tellabs} and the PSLRA’s heightened pleading rules.

1. As others have observed,\footnote{See Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard On ‘33 And ‘34 Act Claims, 76 Wash. U. L.Q. 537, 538 (1998).} the pleading rules under the PSLRA interact powerfully with the statute’s postponing of discovery until after the conclusion of a motion...
to dismiss.\textsuperscript{50} The intersection of these rules puts a plaintiff in a vise: the pleading rules require particularized allegations and a strong inference of scienter while the discovery stay deprives the attorney of the conventional means to develop this information.\textsuperscript{51} Given the discovery stay and the unavailability of information from formal discovery, a plaintiff hoping to survive the motion to dismiss is well advised to conduct a private investigation. These investigations are costly, especially if the plaintiff’s attorney hires an outside firm to conduct them rather than doing them in-house. The consequence is that the established firms, which have long occupied privileged positions in the pecking order of the plaintiffs’ securities bar, have an even greater advantage over new entrants. Together with the lead plaintiff provisions, which also favor established firms, the discovery stay and enhanced pleading provisions arguably decrease competition, reduce the supply of legal services, and deprive investors and the public of some of the benefit that a robust market for representation by plaintiffs attorneys would provide.

2. Another potential consequence of the enhanced pleading requirement relates to the problem of ensuring competent management. This task is formally assigned to state rather than federal law.\textsuperscript{52} Yet securities law class actions can have a role. Well-performing companies do not get sued for securities fraud. Since inadequate managers tend (we assume) to work at poorly-performing companies, the threat of a securities fraud lawsuit


\textsuperscript{51} One consequence of the combination of a discovery stay and heightened pleading is that the PSLRA may weed out cases where the evidence of fraud is highly inferential. There is some evidence that the rules have screened out cases which would otherwise have been brought. See T.S. Foster, D.N. Martin, V.M. Juneja, and F.C. Dunbar, Trends in Securities Litigation and the Impact of the PSLRA (NERA 2000) (finding that a higher percentage of securities fraud have been screened out at the pleading stage post-PSLRA). It also appears, however, that the rules may have eliminated meritorious cases as well as frivolous ones. See Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act?, 23 J.L. Econ. & Org. ___ (forthcoming) (meritorious as well as frivolous suits appear to have been dismissed at the pleading stage).
provides an additional incentive for managers to perform well. Moreover, the process of
discovery tends to reveal the dirty linen inside a company, imposing possible reputational
sanctions on managers as well as exposing them to potential derivative lawsuits.

The PSLRA’s heightened pleading standards arguably reduce the role of securities
class actions at encouraging competent performance by managers. If a complaint is thrown
out for insufficient pleading, the plaintiff will have no opportunity to investigate facts
which also bear on corporate mismanagement. Even if a defendant’s extrajudicial
admissions of mismanagement come to the court’s attention at the motion to dismiss stage,
these will not save a defective securities fraud complaint and may actually enhance the
probability that the complaint will be dismissed since they tend to rebut scienter. 53

Moreover, the defendant need not make any admissions of mismanagement in order to
rebut the inference of scienter; he can rely on his lawyer to suggest hypothetical
possibilities to the court. If the PSLRA reduces a de facto role for securities fraud litigation
as a monitor of corporate management, the development did not occur at a propitious time
given contemporaneous cutbacks in the efficacy of state fiduciary duty principles at
policing the duty of care. 54

3. A final observation about Tellabs pertains to the nature of the motion to dismiss
in securities law cases. The traditional concept of the 12(b)(6) motion is that it operated as
a rather minimal screen to eliminate cases that patently had no chance of success. The

52 See Santa Fe Indus. Inc. v. Green, 430 U.S. 462 (1977) (refusing to expand the reach of federal
securities laws to cover allegations of breach of fiduciary duty).
certainly admit mistakes, but this is a fraud case, not a mismanagement case. They fall well short of
evidencing a ‘strong inference’ of the necessary intent . . . .”)
54 Section §102(b)(7) of the Delaware General Corporation Law and its counterparts in other states
now allow companies to exempt directors from liability for money damages for breaches of the duty of care,
even if the conduct involves gross negligence. The Delaware Supreme court’s Disney decision, moreover,
focus of the federal rules was on discovery, which, it was thought, would inform the parties about the nature of the claims once the complaint was filed. The key pretrial event, in the traditional framework of the rules, was not the motion to dismiss but rather the motion for summary judgment under Rule 56. Here evidence that might be presented to a jury, either produced through discovery or through affidavits, could be tested prior to trial, and the case could be adjudicated if the court concluded that the relevant materials established that “there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.”

Tellabs is an interpretation of the standards governing a motion to dismiss under Rule 12(b)(6). But when one examines how that motion is actually adjudicated in securities fraud cases, it becomes evident that the hydraulic pressures of the PSLRA’s pleading rules have deformed the 12(b)(6) motion and converted it into something different – a sort of hybrid between the motion to dismiss and the motion for summary judgment. For example, the requirement of particularized pleading demands that the plaintiff have a much better-developed factual basis for the claim before the case is filed. The information available to the average plaintiffs’ attorney at the time the complaint is filed is, in many cases, nearly equivalent to the knowledge that a party would have at the time of a motion for summary judgment. Consider also the information set that is available to the court when ruling on a 12(b)(6) motion in a securities fraud case. In an ordinary civil case, the court sees only a complaint with such information as the plaintiff’s counsel has elected to provide, subject to the minimal baseline that the complaint must comply with Rule 8(a)(2). In the securities class action under the PSLRA, in contrast, the court typically confronts an

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provides little hope that claims of mismanagement can succeed even if the §102(b)(7) bar is overcome. See In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (en banc).
awesomely detailed, lengthy set of allegations outlining a virtual roadmap of the issues to be dealt with at trial.56 Given the particularized pleading requirement of the PSLRA and the danger of dismissal if the complaint is found to be insufficiently detailed, plaintiff’s counsel has an incentive to throw every available bit of favorable information into the complaint, in hopes that at the least the judge will be induced by the sheer number of paragraphs to conclude that the complaint has alleged fraud with specificity.57 The information set available to the judge from the complaint is thus typically far greater in a securities fraud case than in an ordinary civil case.

In addition, the judge in securities cases has much greater access to information outside the complaint. It is true that courts, in general civil practice, may take such information into account when ruling on motions to dismiss – documents referenced in the complaint and other information, documentary or otherwise, as to which the court may take judicial notice.58 In ordinary cases, however, information from outside the complaint will be of little value: the court will usually have enough material in the complaint itself to rule on the motion to dismiss. In securities fraud cases under Tellabs, in contrast, the courts must investigate all sources of competing inferences of scienter (assuming the complaint is

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55 FRCP 56(c).
57 At the very least the complaint must contain the essential information that one would expect in a competent newspaper story. See In re Alpharma Inc. Securities Litigation, 372 F.3d 137, 148 (3d Cir. 2004), quoting DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (securities fraud complaint must set out the “who, what, when, where and how” of the events at issue).
58 Courts can examine a broad range of public documents under a theory of judicial notice. See, e.g., Dreiling v. Am. Exp. Co., 458 F.3d 942, 946 n.2 (9th Cir. 2006) (SEC filings). They may also consider any document which forms a basis for the litigation (such as any document containing an alleged misrepresentation), see In Re Pac. Gateway Exch., Inc., 169 F.Supp.2d 1160, 1164 (N.D. Cal. 2001), as well as and any document (even if supplied by the defendant) whose contents are referenced in the complaint. Tellabs, 127 S.Ct. at 2509.
found to create a cogent inference). Courts in PSLRA cases therefore have a much greater reason to investigate information outside the four corners of the complaint.\footnote{See, e.g., MJ Implants, Inc. v. Aetna, Inc., 498 F.3d 1175, 1180 (10th Cir. 2007) (on motion to dismiss in PSLRA cases courts may consider documents incorporated into the complaint by reference).}

Consider, moreover, the rigor with which the court examines the pleadings. In ordinary litigation, the court takes as true the material allegations in the complaint and draws inferences favorably to the plaintiff. Under the PSLRA’s scienter rule, however, while the court in theory is still required to accept as true the allegations in the complaint, there is no deference accorded to inferences of scienter aside from the stipulation that a tie goes to the plaintiff. The rigor of judicial review of scienter pleadings under the PSLRA is significantly greater than the scrutiny applied in other contexts.

There are, of course, significant differences between PSLRA motions to dismiss and motions for summary judgment. The defendant at the 12(b)(6) stage is not permitted to supply the court with information not reasonably encompassed within or referenced by the complaint; and the court, instead of evaluating the defendant’s explanation of the events in question, must exercise its own imagination to evaluate competing inferences (guided, of course, by whatever suggestions the defendant might make in connection with the motion to dismiss). Nevertheless, the line between the PSLRA motion to dismiss and a motion for summary judgment is thinner than what we observe in ordinary cases – so much so that if a securities fraud survives a motion to dismiss is it also likely to survive any subsequent motion for summary judgment. While the PSLRA’s pleading rules do not “covert the motion [to dismiss] into one for summary judgment,”\footnote{In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1426 (3d Cir. 1997).} as a practical matter they come awfully close.
What we observe, therefore, is a blurring of basic procedural distinctions established by the Federal Rules. But the pressure to blur these distinctions – to convert the motion to dismiss into a quasi-motion for summary judgment, and therefore to give the trial court a degree of discretion to reject cases deemed unsuitable for litigation – is not limited to securities fraud cases. It remains to be seen whether the procedural innovations implicit in the PSLRA will carry over into other substantive areas of law.

Conclusion

The *Tellabs* decision drew a reasonable line for identifying when a plaintiff has pleaded facts giving rise to a strong inference of scienter. This paper has (1) analyzed how the *Tellabs* test may be applied, (2) identified questions left open under the decision, and (3) discussed broader implications of the opinion and the PSLRA. Among other things, the paper has suggested that the PSLRA’s heightened pleading rules have deformed the motion to dismiss to the point where it now operates in securities fraud cases as a hybrid falling somewhere in between the traditional Rule 12(b)(6) and Rule 56 procedures.