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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | [customerservice@portfoliomedia.com](mailto:customerservice@portfoliomedia.com)

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## Some Insights Into The Effects Of Tellabs

*Law360, New York (May 20, 2009)* -- Two years ago, in *Tellabs v. Makor Issues & Rights Ltd.*, the Supreme Court set out a “workable construction” of the statutory requirement that plaintiffs in Section 10(b) cases plead a “strong inference of scienter.”[1]

In addition to announcing the “cogent inference” requirement, *Tellabs* instructed courts to analyze all of available facts and to consider all plausible inferences from those facts, not only inferences favorable to the plaintiffs.[2]

These instructions give a court considerable leeway to decide which possible inferences about a defendant’s state of mind “cogently” account for all of the available facts. This includes deciding whether a proposed inference passes a test of economic reality.

This approach is illustrated by *Bateman Litwin NV v. Swain*, a decision from the U.S. District Court for the Eastern District of Virginia. In that case, the complaint alleged that a defendant who sold stock to the plaintiffs had known but withheld material information.[3]

The court accepted this allegation as true, but still refused to accept the plaintiff’s inference that the defendant had acted with scienter.

Rather, based on other facts available to it, the court concluded that the plaintiffs’ inference of scienter “ma[d]e little sense” in light of the defendant’s “economic self-interest.” It was not “cogent.”[4]

### **The *Tellabs* “Prescriptions” for Deciding Whether a Complaint Pleads a “Strong Inference of Scienter”**

In *Tellabs*, the Supreme Court gave several “prescriptions” for applying the “strong inference” requirement.[5]

It instructed courts that their review should cover a relatively broad set of facts, encompassing the complaint “in its entirety” as well “other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.”[6]

The court also instructed courts not to look at individual allegations “in isolation,” but to consider, in a “holistic” way, “all of the facts alleged, taken collectively.”[7] The court then held that the reviewing court “must consider plausible nonculpable explanations for the defendants’ conduct.”[8]

The court explained that this inquiry is “inherently comparative,” so that a plaintiff’s proposed inference must be judged in comparison with other possible inferences.[9] This was a significant change, because some courts had previously limited their inquiry to inferences favoring the plaintiff.[10]

The court next addressed the “strong inference” requirement itself. It first ruled out some of the lower thresholds that courts had used, holding that “the inference of scienter must be more than merely “reasonable” or “permissible.”[11]

It then held that the required inference “must be cogent and compelling, thus strong in light of other explanations.”[12] To pass muster, the inference must be “at least as compelling as any opposing inference.”[13]

## **Bateman Litwin NV v. Swain**

Bateman Litwin illustrates the effect of several of the Tellabs “prescriptions.” Plaintiff Bateman Litwin had purchased all of the stock of a closely held ethanol company from the two defendants.[14]

Bateman Litwin sued the sellers for securities fraud, alleging that they had misrepresented the ethanol company’s financial condition.[15] The defendants moved to dismiss, arguing among other things that the complaint did not plead a “strong inference” of scienter.

Although the complaint made extensive allegations of fraud, the court held that it pleaded only one allegation with the required particularity.[16]

According to that allegation, days before the closing of the sale, an executive of the ethanol company had told one of the sellers, Swain, that a third-party contractor had demanded that the ethanol company pay it \$18 million.[17]

The complaint alleged that Swain had kept quiet about this new information and gone through with the sale.[18]

A court that read these allegations, and limited its review to inferences favorable to the plaintiffs, might well conclude that the complaint sufficiently supported an inference of scienter. This court, however, disagreed, based on its review of other available facts.

The court began its analysis by quoting Tellabs at length.[19] It then turned to the alleged facts surrounding the closing.[20] In particular, the court emphasized an allegation in the complaint that the wrongfully withheld information was known to “numerous personnel” at the ethanol company.[21]

This fact, the court explained, “undermined” an inference of scienter.[22] This was because, the court reasoned, it was “unlikely” that the sellers would have “intentionally concealed that information from Bateman Litwin while knowing that within a matter of days” Bateman Litwin “would control” the company, “direct its employees, and inevitably discover the truth.”[23]

The court went on to explain that, in its view, hiding the liability until after closing would have made no economic sense. This was because the sales agreement, signed in August of 2007, contained a formula that retroactively reduced the price paid to the sellers if the ethanol company’s profit for the entire year 2007 fell short of a specified target.[24]

According to that formula, for every \$1 of shortfall from a target profit of \$22 million, the price paid to the sellers would be retroactively reduced \$1.50; if the company lost money for the year, the purchase price would be reduced an additional \$2 for every \$1 of loss.[25]

Because of this purchase-price formula, the court reasoned, it would have been irrational for the sellers to hide an \$18 million liability and go through with the transaction.[26]

As the court explained, by hiding the liability until after the closing, the sellers “would not avoid paying” it themselves because the amount would reduce the company’s 2007 income and come out of their pockets anyway.[27]

By going through with the closing, the sellers would only have increased the cost of the liability to themselves.[28] Applying the multiplier in the formula, an \$18 million liability likely would have cost the sellers at least \$27 million and, if it led to a loss, up to \$36 million.

Moreover, the court reasoned, by trying to hide a liability that so quickly would be discovered, the sellers would have invited fraud charges against themselves.[29] “[I]t makes little sense,” the court concluded, “to suppose that [one of the sellers] would act so assuredly against his own self-interest.”[30]

For all of these reasons, the court concluded that an inference that the sellers acted with scienter was not “cogent.”

The court concluded that the “stronger inference” from the facts alleged was that, at the time that the seller was allegedly told about a demand, the ethanol company “was still in the process of substantiating and qualifying” the “claim[],” apparently concluding that defendant Swain had not thought this was the kind of information that needed to be disclosed.[31]

This conclusion, the court indicated, reconciled facts including that the seller was not provided a claim in writing and that he had a disincentive to hide an actual claim.[32]

Bateman tried to save its complaint by arguing that the sellers had an economic incentive to go through with the closing despite knowing about an \$18 million demand because the company was in fact losing so much money that the sellers wanted to unload it anyway.[33]

The court brushed this argument aside because the complaint pleaded no fact indicating that, before the sale, the sellers expected the company to lose money in 2007.[34]

## **Applying Tellabs to Challenge the Validity of an Inference of Scierter**

Bateman Litwin shows how Tellabs changed the structure and substance, as well as the tone, of decisions on motions to dismiss. It illustrates defendants' improved opportunity to challenge a plaintiff's theory of scierter at the outset of a case — even where the plaintiff has pleaded facts that on their face may seem to point to scierter.

It is true that, before Tellabs, a court was free to evaluate a complaint and judge the force of the plaintiff's theory of scierter, but before Tellabs courts had less reason to do so.

By fixing the pleading standard at the relatively demanding level of a “cogent” inference, Tellabs made it worthwhile for courts to test complaints against the standard. The other Tellabs prescriptions further stiffened the pleading requirement.

In effect, these prescriptions required that plaintiffs show that all facts available to the court fit together to support an inference of scierter that meets the “cogent” standard.

This change reflect the combined effect of several Tellabs elements. First, Tellabs emphasized that the court should be aware of the entire stock of facts available on a motion to dismiss.

This stock of facts is relatively rich to begin with in a Section 10(b) case because of the requirement, re-emphasized in Tellabs, that the plaintiff plead facts with particularity.[35]

Tellabs also reminded courts to consider any additional facts available through judicial notice, further increasing the stock of facts while reducing the plaintiff's ability to limit the set of facts that its scierter theory must fit.[36]

Then, the Tellabs court gave the critical instruction to evaluate all inferences that are plausible in light of those facts.[37] The result is that a plaintiff's theory of scienter now must account for a relatively broad set of facts.

Bateman Litwin illustrates how these pieces can work together to defeat a proposed inference that fits some of the available facts, but not all of them.

Bateman Litwin suggests that, even on motions to dismiss, defendants should employ their skills at fact-based argument, taking advantage of all of the materials available to the court.

It also indicates that defendants should look for opportunities to argue, at the outset of a case, that the plaintiff's theory of scienter fails a test of financial or economic rationality as applied to all of the available facts.

## **Conclusion**

Because Section 10(b) cases that survive motions to dismiss almost always settle, any increase in defendants' ability to challenge a complaint is important. As Bateman Litwin shows, Tellabs does tend to strengthen the defendant's position on motions to dismiss.

This further supports the view that Tellabs is the latest of several steps in the direction of increasing the significance of motions to dismiss in securities fraud cases.

--By Andrew J. Morris, Carr Maloney PC

*Andrew Morris is a partner with Carr Maloney in the firm's Washington, D.C., office.*

*The opinions expressed are those of the author and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*

[1] Tellabs v. Makor Issues & Rights Ltd., 127 S. Ct. 2499 (2007). For the "strong inference" requirement, see 15 U.S.C. § 78u-4(b)(2) (requiring that the complaint "state with particularity ... facts giving rise to a strong inference" of scienter).

[2] Id. at 2509-10.

[3] See C.A. No. 4:07cv138, Memorandum Opinion and Order (Mar. 18, 2009) at 3-4 (adopting and incorporating the portion of the Report and Recommendation of United States Magistrate Judge ("Report") dismissing the Section 10(b) claim).

[4] Report at 15.

[5] 127 S. Ct. at 2509.

[6] Id.

[7] Id. at 2509, 2511.

[8] Id. at 2510.

[9] Id.

[10] Id. at 2509.

[11] Id. at 2510.

[12] Id.

[13] Id.

[14] Report at 2.

[15] Id. at 3-4, 8-11.

[16] Id. at 8-11.

[17] Id. at 3, 11-12.

[18] Id.

[19] See Report at 7 (quoting Tellabs, 127 S. Ct. at 2504-05); see also id. at 13 (citing Tellabs, 127 S. Ct. at 2504-05).

[20] Id. at 12-13.

[21] Id. at 14.

[22] Id.

[23] Id.

[24] Id. at 2. (The plaintiff attached the agreement to the complaint. Because the complaint quoted from the agreement, the defendants could have relied on it in their motion to dismiss even if it were not attached.)

[25] Id. at 2, 14.

[26] Id. at 12-15.

[27] Id. at 14-15.

[28] Id.

[29] *Id.* at 15.

[30] *Id.* at 14.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] 127 S. Ct. at 2511; see also *id.* at 2515–16 (Alito, J., concurring).

[36] *Id.* at 2509.

[37] *Id.* at 2509-2510.