

## May a Court Consider Competing Inferences of a Defendant's State of Mind in Determining Whether the Complaint Pleads a "Strong Inference" of Scienter?

by John P. Stigi III

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### ISSUE

"Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a securities fraud complaint has 'state[d] with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,' as required by the Private Securities Litigation Reform Act of 1995 (the Reform Act)."

### FACTS

Defendant-petitioner Tellabs, Inc., is a manufacturer of specialized optical networks and broadband access equipment. Its primary customers are telecommunications carriers and Internet service providers. Defendant-petitioner Richard

Notebaert was the CEO of Tellabs. During 2001, Tellabs experienced a decrease in demand for its products when the telecommunications and technology sectors suffered a severe contraction. As a result, the price of Tellabs stock declined.

Plaintiffs-respondents are a putative class of Tellabs investors who lost money when the company's stock price declined. In this action, plaintiffs alleged that defendants engaged in a scheme to inflate Tellabs' stock price during the "class period" between Dec. 11, 2000 (the date when Tellabs first issued projections for 2001 revenue), and June 19, 2001 (the date Tellabs withdrew its previous guidance for 2001 revenue and revised its projection of revenue for the second quarter of 2001), by making false or misleading public statements regarding the company's financial condition and future financial prospects.

More specifically, the plaintiffs allege that CEO Notebaert, on behalf of Tellabs, made four cate-

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TELLABS, INC., ET AL. V. MAKOR  
ISSUES & RIGHTS LTD. ET AL.  
DOCKET NO. 06-484

ARGUMENT DATE:  
MARCH 28, 2007  
FROM: THE SEVENTH CIRCUIT

# Case at a Glance

Tellabs, Inc., is being sued under federal securities laws following a sharp decline in its share price in 2001. A trial judge dismissed the suit for failing to sufficiently allege a "strong inference" that the company acted with the requisite scienter, or intent. The Seventh Circuit reinstated the suit, using a standard different from other circuits that places a lower burden on plaintiffs to meet the pleading standard.



gories of false or misleading statements during the class period. First, Notebaert allegedly made statements indicating that demand for the TITAN 5500, Tellabs' flagship networking device, was continuing to grow when in fact demand for that product was allegedly flagging. Second, Notebaert allegedly made statements indicating that the TITAN 6500, Tellabs' next-generation networking device, was available for delivery, and that demand for that product was strong and growing when in fact that product allegedly was not yet available for delivery and demand allegedly was weak. Third, Notebaert allegedly misrepresented Tellabs' financial results for the fourth quarter of 2000, which allegedly reflected revenues from "channel stuffing"—a term that refers generally to the practice of selling products to customers or resellers despite the absence of real demand for the products. In a typical "channel stuffing" case, the customer or reseller has a right to return the products at a later date, disqualifying revenues from recognition on the company's books and records. Fourth, Notebaert allegedly made a series of overstated revenue projections, when demand for the TITAN 5500 was drying up and production of the TITAN 6500 was behind schedule.

In March 2001, Tellabs began making more cautious statements about its projected sales. On June 19, 2001, Tellabs disclosed that demand for the TITAN 5500 had significantly dropped, and the company considerably lowered its revenue projections for the second quarter of 2001. The following day, the price of Tellabs stock, which had reached a high of \$67.125 during the class period, dropped to a low of \$15.87.

In the class action securities lawsuit filed shortly thereafter, the plaintiffs

asserted claims against Tellabs, Notebaert, and other officers and directors of Tellabs under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated under the Exchange Act, as well as Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a). Before any discovery, the Tellabs defendants moved to dismiss plaintiffs' complaint for failure to meet certain heightened pleading requirements applicable to securities fraud cases.

The U.S. District Court for the Northern District of Illinois dismissed plaintiffs' first amended complaint, granting the plaintiffs leave to file a second amended complaint. See *Johnson v. Tellabs, Inc.*, 262 F. Supp. 2d 937 (N.D. Ill. 2003). The defendants moved to dismiss this second amended complaint. The district court dismissed that complaint, too, but this time without leave to amend. See *Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004). The district court held that the allegations contained in the second amended complaint were too vague to support a "strong inference" of defendants' scienter. For example, with regard to the "channel stuffing" allegations, the district court held that the complaint failed to provide details of precisely what "channel stuffing" activities Notebaert had allegedly engaged in. The district court noted that the absence of detail in the allegations was critical because the complaint had defined "channel stuffing" so broadly that it included innocent business conduct, such as offering price discounts to customers to encourage sales.

The plaintiffs appealed the final dismissal to the Seventh Circuit Court of Appeals, which affirmed the dismissal as to certain defendants, but reversed the dismissal as to Tellabs

and Notebaert. See *Makor Issues & Rights Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006). Whereas the district court criticized the plaintiffs for their vague allegations of defendants' alleged wrongdoing, the Seventh Circuit was willing to credit the plaintiffs' theories that filled in the factual gaps to support an inference of defendants' scienter based upon the premise that, at this early stage of the litigation, the plaintiff is entitled to the benefit of all reasonable inferences that flow from the pleaded facts in order to preserve his "day in court."

The Seventh Circuit's reasoning on this point is in direct conflict with that of other circuits. For this reason, the Supreme Court granted a writ of certiorari to resolve the split in the circuits on this important area of federal law.

## CASE ANALYSIS

For years, courts and legislators have struggled with finding the right balance that will deter both securities fraud and unmeritorious securities fraud lawsuits. The primary tool used to strike that balance on a case-by-case basis is the standard for pleading a securities fraud claim. Prior to 1995, Rule 9(b) of the Federal Rules of Civil Procedure provided the standard for pleading a securities fraud claim. Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

Notwithstanding Rule 9(b)'s directive that "condition of mind ... may be averred generally," many courts, including the First, Second, and Fifth Circuits, required that a securities fraud plaintiff plead facts giving rise to a "strong inference" that



the defendant's "condition of mind" rose to the level of "scienter." See, e.g., *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1176 (2d Cir. 1993). Those courts viewed this enhanced pleading requirement as necessary to ensure that securities fraud complaints were not based upon mere conjecture. See, e.g., *O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991). Other courts, such as the Third and Ninth Circuits, declined to impose this "strong inference of scienter" requirement as inconsistent with the language of Rule 9(b). See, e.g., *In re GlenFed Inc. Sec. Litig.*, 42 F.3d 1541, 1546-47 (9th Cir. 1994) (en banc).

By the 1990s, technology companies in Silicon Valley with notoriously volatile stock prices became routine targets of securities fraud litigation. The comparatively lenient approach to Rule 9(b) applied by the Ninth Circuit was perceived to be at least partially responsible for a flood of securities litigation. This "problem" received the attention of Congress, which in December 1995 enacted the Reform Act (overriding President Clinton's veto). Among other things, the Reform Act requires a plaintiff to plead with particularity each statement alleged to be misleading and set forth in detail the "reasons why the statement is misleading." To the extent that the plaintiff is required to prove that a defendant acted with a "particular state of mind," the Reform Act requires the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In a securities fraud case, the "required state of mind" is an intent to commit fraud or, at a minimum, recklessness as to whether the statements at issue were false or misleading. Mere negligence will not support a claim for securities fraud. A complaint which fails to meet

these standards "shall be dismissed," the statute provides.

As Tellabs noted in its petition for certiorari, there are at present as many as four different circuit court formulations of the "strong inference" analysis: (1) The First, Fourth, Sixth, and Ninth Circuits require a direct comparison of the plausibility of competing inferences. Unless the culpable inference is the most plausible, the inference is not "strong." These circuits essentially apply a "preponderance of the inferences" analysis. (2) The Tenth Circuit, like the First, Fourth, Sixth, and Ninth, considers all inferences, but does not "weigh" the inference to determine whether one or another is "most plausible." (3) The Second and Third Circuits apply their heightened, pre-Reform Act analyses that do not evaluate inferences in the manner of the other Circuits. (4) The Seventh Circuit determines whether a "reasonable" person "could" infer from the pleaded facts that the defendant acted with scienter, without taking into account contrary inferences of innocence.

Tellabs argues in its merit brief to the Supreme Court that the "plain language of the Reform Act makes clear that Congress intended to change the pleading paradigm with respect to allegations of scienter in securities fraud cases. By requiring plaintiffs to 'state with particularity facts giving rise to a strong inference' ... Congress signaled a clear break from the general notice-pleading rule embodied in Fed. R. Civ. P. 8(a) and the permissive rule regarding general averments of intent in Fed. R. Civ. P. 9(b)."

Congress "has heightened the pleading burden with respect to allegations of scienter for a private plaintiff asserting a claim of securities fraud under the 1934 act in two

critical respects," Tellabs notes. "First, the 'particularity' requirement requires a plaintiff to plead specific facts from which an inference that the defendant acted with scienter may be drawn. Rule 9(b), which on its face permits general averments of a defendant's mental state, is thus superseded in federal securities fraud cases. Second, and of central concern in this case, the specifically pled facts must create a 'strong' inference of scienter.

"Determining the strength of the inference of scienter requires a court to consider the plausibility of the assertion that the defendant acted with scienter in light of the specific facts pled—including facts that serve to undermine any such claimed inference. This requirement is a fundamental shift away from the familiar role of a modern complaint, which, in the typical case, need only provide notice of the basic nature and circumstances of the claim. By contrast, the Reform Act imposes a burden on the plaintiff to plead specific facts that, if proven to be true, cogently demonstrate a substantial claim as to scienter that meaningfully tends to exclude innocent possibilities. Thus, if a plaintiff is able to do no more than allege facts that are, at most, equally consistent on their face with either innocence or culpability—despite the benefit of having all well-pleaded facts treated as true, and being the master of what to include in the complaint—a 'strong inference' of scienter does not exist and the complaint should be dismissed."

According to Tellabs, the "requirement that a federal securities fraud pleading paint a cogent picture of the substantial merit of the plaintiff's claim of scienter is critical to advancing the fundamental purpose of the Reform Act. Through the Reform Act, Congress sought to

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deter and defeat the abusive practice of securities fraud strike suits. Congress perceived that the typical roadblocks against insubstantial claims, discovery and summary judgment, were not effectively weeding out meritless securities fraud claims. Congress concluded that the high costs of discovery, and the potential bet-the-company nature of securities fraud suits, too often forced companies to settle even meritless claims for substantial sums whenever a complaint survived a motion to dismiss on the pleadings. The result was a legal regime that undermined the goals that the securities laws are supposed to advance, in particular encouraging a free-flow of information delivered to the market regarding publicly traded companies. An omnipresent threat of litigation discourages public statements about a company's future prospects. By requiring plaintiffs to plead facts sufficient to show a substantially meritorious scienter claim, Congress changed this perverse legal environment."

Under the Reform Act's "language and purpose," Tellabs argues, "certain principles emerge for evaluating whether a securities fraud complaint's allegations give rise to a 'strong inference' of scienter. First, a court should consider and weigh all the allegations of the complaint, along with all other materials properly before it, including facts that support an inference of innocence. Even if a well pled fact might support some inference of scienter in isolation, the inference may not be 'strong' in light of the overall context, including other facts properly before the court. Any rule that permits courts to ignore the facts that suggest an innocent mental state would allow precisely the kinds of doubtful, speculative claims to proceed that Congress clearly intended to deter and prevent."

Second, Tellabs asserts, "the absence of certain allegations from a complaint is also relevant. In particular, both before and after the Reform Act, courts have appropriately recognized that the presence or absence of allegations of motive to engage in fraud is particularly important for determining whether the complaint creates a 'strong inference' of scienter. The absence of a cogent economic motive to engage in unlawful conduct substantially weakens any inference of scienter, because courts do not lightly assume that individuals behave illegally for no reason. Once again, allowing such claims to proceed would reintroduce the harms of weakly grounded claims that Congress intended to eliminate."

Third, according to Tellabs, "the language and purpose of the Reform Act require that certain commonly employed, ambiguous pleading strategies not count in a plaintiff's favor. Allegations that are as consistent with innocence as with culpability do not satisfy the 'strong inference' requirement and should not suffice to survive a motion to dismiss; rather, the facts alleged must meaningfully tend to exclude the possibility of innocence. There are at least two different types of such ambiguous allegations. What might be called 'strategic ambiguity' leaves out significant details that would clarify whether the identified conduct was either innocent or culpable. Other ambiguous allegations include facts that one might expect to be true in the event the defendant acted illegally, but one would also expect to see even if the defendant were acting innocently. Both types of ambiguous allegations do no more than raise the possibility of scienter, without meaningfully tending to exclude innocent explanations. Allowing claims based on such allegations to proceed would effectively reinstate the pre-existing regime

that Congress rejected for securities fraud claims. Congress did not wish to wait until later in the litigation to allow the plaintiff to uncover facts that tend to exclude an innocent explanation."

In this case, Tellabs argues, "the Seventh Circuit erred in ordering the case to proceed. The Seventh Circuit repeatedly credited ambiguities in respondents' favor and ignored all facts that undercut the scienter charge." The complaint should have been dismissed, the company asserts because the plaintiffs "did not even come close to meeting their burden."

The plaintiffs-respondents, in contrast, argue that the Seventh Circuit properly interpreted the heightened pleading standard in the Reform Act. In their brief opposing certiorari, they contend that the complaint "passes muster even under the most restrictive formulation of the [Reform Act] pleading requirements."

The complaint "is unusually detailed in that, among other things, it identifies confidential sources—all closely connected with Tellabs—with knowledge and information concerning the Company's serious problems and Petitioners' awareness thereof," the plaintiffs assert. "The Complaint specifies the position held by each source and the dates of his or her employment with the Company."

The Seventh Circuit, according to the plaintiffs, "correctly found that the Complaint provides detailed facts to support the allegation that, by January 2001, demand for Tellabs' 'best seller'—the TITAN 5500—was declining, including that Verizon, Tellabs' largest customer, reduced its orders for the TITAN 5500 by roughly 25 percent in late 2000 and by roughly 50 percent in



January 2001; that customers in Latin America and Central America were no longer buying the product; that, by late 2000, according to a couple of confidential sources, Tellabs had excess TITAN 5500s on hand because of a lack of demand; that one confidential source revealed that Tellabs paid Probe Research, an outside company, \$100,000 to forecast demand for the TITAN 5500; that the report, which was completed ‘in or about early 2001,’ showed that the market need for the TITAN 5500 was evaporating; and that, based on that research, Tellabs’ marketing strategy department distributed an internal memorandum concluding that revenue from the TITAN 5500 could decline by about \$400 million.”

The plaintiffs note that Tellabs tries “to make much of the Seventh Circuit’s failure to take account of purported ‘competing innocent inferences’ to be drawn from facts alleged in the Complaint. ... Yet, fairly considered, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case. Accordingly, whether or not inferences of an innocent mental state are considered and balanced against the inferences of scienter would not affect the outcome of this case. The inferences of culpability are not only the most plausible or the stronger inferences to be drawn here, they are the only inferences.”

According to the plaintiffs, “considered individually and cumulatively, the facts alleged compel a powerful inference of scienter that would satisfy even the most stringent reading of the [Reform Act]. The Complaint supports an inescapable inference that Petitioner Notebaert, who was responsible for managing the Company at the very highest level, was fully aware that the very serious problems affecting sales of Tellabs’

core products jeopardized the Company’s overall performance and prospects.”

### SIGNIFICANCE

For securities defendants, the most important tool for disposing of securities cases before expensive and protracted discovery is the initial motion to dismiss. Indeed, the Reform Act’s heightened pleading standard, and especially the “strong inference” requirement, was designed to provide a vehicle for district courts to distinguish between real cases of financial fraud where a “strong inference” of defendants’ misconduct is plain on the face of the complaint and mere strike suits based upon little more than a lawyer’s opportunistic suspicion and conjecture. By requiring a plaintiff to plead particularized facts giving rise to a “strong inference” that the defendants acted with an intent to commit fraud, instead of merely pleading general facts giving rise to a reasonable, even if highly unlikely, inference of defendants’ intent, the Reform Act is seen by corporate defendants as deterring many cases that would otherwise have been filed for what defendants regard as their “in terrorem” effect.

If the Supreme Court were to affirm *Tellabs* and allow securities fraud complaints to proceed to discovery and trial based merely upon what a reasonable person could potentially infer from the facts alleged in the complaint, there would likely be material increases in the number of cases filed and the number of cases that settle with payments to investors and their lawyers.

Finally, the Seventh Circuit’s decision briefly addressed a constitutional issue that had been raised in a footnote by a prior Sixth Circuit ruling, *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.* In that footnote, the court

suggested that the heightened pleading requirement might violate the Seventh Amendment. While that issue is intriguing, the Supreme Court can interpret the Reform Act in such a way to preserve the statute and avoid the constitutional question.

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