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Litigation

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SEVENTH CIRCUIT UPHOLDS SCIENTER ALLEGATIONS FOLLOWING *TELLABS* DECISION

By C. Neil Gray

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Supreme Court reversed and remanded to the United States Court of Appeals for the Seventh Circuit a case with instructions to dismiss the complaint unless the court found it adequately alleged a “strong inference” of scienter, using the standard that “a reasonable person would deem the inference of scienter to be cogent and at least as compelling as any opposing inference one could draw from the facts alleged.” *Id.* at 2510. On January 17, 2008, the Seventh Circuit held that plaintiffs’ complaint met this standard and adhered to its original decision to reverse the judgment of the district court dismissing the complaint. See *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, --- F.3d ---, No. 04-1687, 2008 WL 151180 (7th Cir. Jan. 17, 2008). The Seventh Circuit’s decision on remand is important not only because it is among the first decisions by Circuit Courts

of Appeal interpreting the Supreme Court’s *Tellabs* decision, but also because it may portend a shift in the way motions to dismiss securities fraud claims are briefed and argued.

Background

Beginning in June 2002, plaintiffs filed numerous securities class actions against Tellabs, Inc. and Tellabs’ Chief Executive Officer, Richard Notebaert, for securities fraud. Plaintiff Makor Issues & Rights was named Lead Plaintiff. Makor alleged that Tellabs (a manufacturer of switching equipment used by telephone companies) and Notebaert violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by issuing a series of false and misleading statements about the continued success of Tellabs’ principal product (the TITAN 5500) and the demand for TITAN 5500’s intended successor product (the TITAN 6500) between December 2000 and June 2001. In June 2001, Tellabs announced a critical drop in revenues and its share price plunged.

Tellabs moved to dismiss for failure to state a claim upon which relief could be granted. Specifically, Tellabs argued that Makor had not pleaded its case with the particularity required by the Private Securities Litigation Reform Act of 1995 (the “PSLRA”). The United States District Court for the Northern District of Illinois granted Tellabs’ motion without prejudice and subsequently dismissed an amended complaint with prejudice. The District Court held that Makor had sufficiently alleged that Notebaert’s statements were misleading but had not adequately alleged scienter.

The Seventh Circuit agreed that Makor adequately alleged the misleading nature of Notebaert’s statements but reversed the District Court and held that Makor had sufficiently alleged a “strong inference” of scienter, as contemplated by the PSLRA, because a reasonable person could infer from all of the allegations of the complaint that the defendants had acted with the required state of mind. See *Makor Issues &*

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Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588 (7th Cir. July 10, 2006).

The Supreme Court's *Tellabs* Decision

The Supreme Court granted certiorari to resolve a disagreement among Circuit Courts of Appeal as to “whether, and to what extent, a court must consider competing inferences in determining whether a securities fraud complaint gives rise to a ‘strong inference’ of scienter.” The Supreme Court held that a court evaluating scienter allegations must engage in a comparative evaluation of not only any inferences urged by a plaintiff in the complaint (accepting all factual allegations in the complaint as true), but of any competing inferences rationally drawn from the facts alleged. “[T]he inference of scienter must be more than merely ‘reasonable’ or ‘permissible’ — it must be cogent and compelling, thus strong in light of other explanations. A complaint will survive ... 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.” *Tellabs*, 127 S. Ct. at 2510. The Supreme Court did not itself evaluate the complaint under this standard but remanded the case to the Seventh Circuit to reconsider the complaint under this clarified standard.

The Seventh Circuit's Decision

At the outset, the Seventh Circuit reviewed Makor's allegations, which the court previously held adequately alleged that defendants had made materially false statements. The court concluded that this aspect of its prior ruling was not disturbed by the Supreme Court; thus, the court had to decide anew only whether Makor's complaint alleged a strong inference of scienter.

The court separated its analysis with respect to Tellabs and Notebaert and began with the former. The court reviewed the possible means by

which the misleading statements could have been imparted to management and thereafter communicated to the public and concluded that, in light of the importance of the TITAN 5500 and 6500 to Tellabs, it was “exceedingly unlikely” “that the allegedly false statements ... were the result of merely careless mistakes at the management level based on false information fed to it from below, rather than of an intent to deceive or a reckless indifference to whether the statements were misleading,” nor had any “plausible story [] yet been told by the defendants that might dispel [the court's] incredulity.” The court held that scienter at the corporate level was far more likely than “either a cascade of innocent mistakes, or acts of subordinate employees, either or both resulting in a series of false statements,” and thus that the inference of scienter had to be considered “cogent.”

The court then held that it was likewise “exceedingly unlikely” that Notebaert, the chief executive of the company and the individual who made most of the allegedly false statements, “was unaware of the problems of his company's two major products and merely repeat[ed] lies fed to him by other executives of the company.”

Finally, the court addressed the defendants' objection to the use of confidential informants by Makor. The court held that despite a recent decision by the Seventh Circuit suggesting that allegations based on confidential informants “must be steeply discounted” (*Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756-57 (7th Cir. 2007)) and the difficulty of assessing allegations based on anonymous informants, the allegations about Tellabs and Notebaert were sufficiently detailed and the informants and their bases of knowledge were adequately described such that “the absence of proper names does not invalidate the drawing of a strong inference from informants' assertions.”

Conclusion

The Supreme Court's *Tellabs* opinion offered ways for defendants to demonstrate that plaintiffs have not pleaded a strong inference of scienter as required by the PSLRA. It has been unclear how far courts would go in considering, or even conjuring up themselves, competing inferences to be drawn from the facts alleged in a complaint, and then comparing them with the inference urged by the plaintiff. The Seventh Circuit's recent decision in *Tellabs* reflects the court's discomfort with the Supreme Court's test. The Seventh Circuit noted that “[t]o judges raised on notice pleading, the idea of drawing a ‘strong inference’ from factual allegations is mysterious.” 2008 WL 151180, at *2. And when presented with the same complaint on remand, the Seventh Circuit held that it passed muster under the Supreme Court's test, in the process giving renewed acceptance to the use of confidential witnesses to satisfy the pleadings standards of the PSLRA. Thus, although the general formulation in the Supreme Court's decision in *Tellabs* was positive for defendants in securities fraud actions, the full impact of the Supreme Court's standard for pleading scienter likely will remain unclear for some time.

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