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## TELLABS REDUX: SEVENTH CIRCUIT REINSTATES PLAINTIFFS' COMPLAINT ON REMAND FROM THE UNITED STATES SUPREME COURT

By: *Richard J. Bortnick, Esq. and Emilio G. Boehringer, Esq.*  
rbortnick@cozen.com • eboehringer@cozen.com

In a much anticipated ruling, the Seventh Circuit Court of Appeals, following on the heels of the United States Supreme Court's heralded decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. \_\_\_, 127 S. Ct. 2499 (2007) ("*Tellabs I*"), has again ruled that the complaint at issue sufficiently plead the elements of securities fraud required under the Securities and Exchange Act of 1934 and SEC Rule 10b-5 and thereby permitted a class of plaintiffs to proceed with their claims against Tellabs and its Chief Executive Officer. See *Makor Issues and Rights, Ltd., et al. v. Tellabs Inc., et al.* \_\_\_ F.3d \_\_\_, (7th Cir. 2008) ("*Tellabs II*"). While the decision may have been unexpected in some peoples' estimations, it is in line with the Supreme Court's edicts and past precedent, and unsurprising to those who closely track securities fraud litigation.

In *Tellabs I*, the Supreme Court articulated the standard to be applied by courts evaluating whether a complaint alleging securities fraud under Section 10(b) and Rule 10b-5 adequately pleads a "strong inference" of *scienter* - *i.e.*, an intent to deceive, manipulate or defraud - in light of the mandates of the Private Securities Litigation Reform Act (the "PSLRA"), which was enacted in 1995. To support the element of intent to deceive, a plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In accordance with the Supreme Court's decision in *Tellabs I*, federal courts evaluating *scienter* are required to weigh the competing inferences derived from a securities fraud complaint and must dismiss the complaint "*unless* 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." (emphasis added). Because the Seventh Circuit did not utilize this balancing test in ruling on defendants' motion to dismiss, the Supreme Court remanded the case back to the Seventh Circuit so that it could evaluate the *Tellabs* plaintiffs' allegations using the correct standard.

Briefly, the *Tellabs* plaintiffs' complaint alleged that Tellabs and its Chief Executive Officer engaged in securities fraud by falsely representing to the investing public

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the market demand, revenues, and growth projections for a product which accounted for more than half of Tellabs' sales as well as for its successor product, which had just been introduced into the marketplace. In fact, the *Tellabs* plaintiffs claimed, Tellabs was experiencing a major drop in sales and revenues with respect to its original product, and had failed to sell or ship any of the successor products. During the relevant class period, Tellabs' share price fell from a high of \$67 to under \$16.

On these facts, the District Court for the Northern District of Illinois dismissed plaintiffs' suit on the grounds that plaintiffs had failed to sufficiently plead *scienter*, notwithstanding the testimony of 27 confidential sources. On appeal, the Seventh Circuit reversed the District Court, ruling that the *Tellabs* plaintiffs satisfied the "strong inference" of *scienter* requirement of the PSLRA because their complaint alleged facts from which a reasonable person could infer that the defendants acted with the necessary intent. In so holding, the Seventh Circuit rejected alternative, more stringent, tests set forth by other federal Circuit Courts of Appeal.

On appeal, the Supreme Court in *Tellabs I* reversed the Seventh Circuit's decision and remanded for further proceedings, with the clear direction that the Circuit Court dismiss the complaint unless, after weighing the competing interests drawn from the facts and allegations in plaintiffs' complaint, "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 Supreme Court further observed that plaintiffs' complaint must plead facts "rendering an inference of *scienter* at least as likely as any plausible opposing inference. . ." in order to survive.

On remand, Chief Judge Posner, writing for the Seventh Circuit, interpreted the Supreme Court to say in *Tellabs I* that a complaint satisfactorily pleads a "strong inference of *scienter*" under the PSLRA where the inference of *scienter* is both (1) cogent and (2) at least as compelling or likely as any opposing inference to be drawn from the facts alleged in the complaint.

Turning the Supreme Court's analysis upside down, Chief Judge Posner first addressed the second question of whether the inference of *scienter* in plaintiffs' complaint was "at least as likely as any plausible opposing inference." Here, the parties advanced two competing inferences based on defendants' misstatements: the plaintiffs alleged that Tellabs knew, or was reckless in failing to realize, that the statements its directors and officers made were false and material to investors. In turn, the defendants advanced the proposition that while the statements at issue may have been false, "their falsity was the result of innocent, or at worst, careless mistakes at the executive level." In light of these assertions, the Seventh Circuit tested the defendants' theorem by examining the probability that the allegedly false statements were the result of mere errors premised upon erroneous information provided by lower-level employees, rather than as the result of deliberate or reckless deception by management.

Upon a detailed review, the Seventh Circuit concluded that the plaintiffs had met their burden of pleading a "strong inference of *scienter*." The court noted that it was *exceedingly* unlikely that

Tellabs' management's false statements resulted from careless mistakes or were based on misinformation, particularly since the products at issue were the company's major assets and its biggest revenue sources. Indeed, while the defendants proffered no explanation lending credence to the argument that they were unaware of the statement's falsity, the Seventh Circuit dispelled the possible inference that there could have been an innocent misunderstanding, reasoning that defendants had gambled that the company's sales volumes and profits would increase with the advent of its new product, but lost that bet. The court likened this "gamble" to embezzling money in the hope "that winning at the track will enable the embezzled funds to be replaced before they are discovered to be missing."

At the same time, the court declined to discount the complaint's allegations, even though they were in large part based on information provided by confidential sources. The court acknowledged that while it might not credit confidential information in certain situations, "the information that the confidential informants are reported to have obtained [here] is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources." In short, the Seventh Circuit concluded that the inference of *scienter* was not only as likely as the opposing inference of lack of *scienter*, it was, in fact, more likely.

Reverting back to the first issue of whether the inference of *scienter* presented in plaintiffs' complaint was "cogent," the court found that if the inference of *scienter* was more likely than not based on the facts presented, it of necessity also had to be cogent. Chief Judge Posner reiterated that while it was conceivable that Tellabs' management was unaware of the problems involving the company's key products and only were repeating false information given to them by lower level employees, such a scenario was exceedingly unlikely under the circumstances. In other words, the court found that the inference of *scienter* was persuasive, believable and valid on the facts presented. As such, it concluded that the class action plaintiffs' complaint adequately plead *scienter* in conformity with the PSLRA and adhered to its prior decision reversing the trial court's dismissal. It therefore remanded the case back to the lower court for further proceedings and, if appropriate, trial.

The Seventh Circuit's decision in *Tellabs II* is not surprising in light of the facts plead and the manner in which they were interpreted by the court. When the Supreme Court decided *Tellabs I* in June 2007, many analysts opined that the decision was a victory for the defense bar and corporate America because the Court endorsed the process of a judge weighing competing inferences permitted by a plaintiffs' complaint in order to determine whether the complaint adequately set forth allegations of *scienter*. It appeared that the Supreme Court in *Tellabs I* was instructing lower courts to use the facts alleged in the complaint to conduct a mini-trial before discovery even opened. The first wave of lower court decisions interpreting *Tellabs I* led to favorable rulings on defendants' motions to dismiss, suggesting to some observers that there would be a significant change in how lower courts would address *scienter* issues in future securities fraud cases.

Conversely, other commentators opined that the Supreme Court's decision in *Tellabs I* did not materially shift the law in favor of defendants, but, at best, was a draw in the never-ending battle between securities fraud plaintiffs' counsel and corporate America. To these observers, the Supreme Court did nothing more than resolve a dispute amongst the Circuit Courts and clarify the standards plaintiffs' counsel must meet in order to overcome a motion to dismiss, with little or no residual impact on the number of securities lawsuits filed or dismissed.

In turn, the possibility that *Tellabs I* could discourage the filing of frivolous lawsuits was viewed by some to be of little material consequence, as they suggested that such lawsuits likely would not have passed muster under the standards which prevailed before *Tellabs I* was decided, even in the more plaintiff-friendly Circuits. Judge Posner's approach on remand in *Tellabs II* portends the likelihood that some courts will continue to parse through the facts presented in securities fraud cases to achieve a pre-determined result, irrespective of whether they use the Supreme Court's new balancing test, or a different, perhaps pre-*Tellabs I*, methodology.

In short, many view the Supreme Court's middle of the road decision in *Tellabs I* to have done nothing more than preserve the status quo. Viewed in that light, Judge Posner's decision in *Tellabs II* is not surprising, as it achieves the balance that the Supreme Court sought in *Tellabs I* - the dismissal of frivolous lawsuits and the continued prosecution of potentially meritorious claims. At bottom, the facts in *Tellabs* were particularly one sided, and the allegations concerning *scienter*, as interpreted by the Seventh Circuit, clearly favored the plaintiffs. The real test of *Tellabs I* will be seen in those cases where the plaintiffs' allegations lead to an inference of *scienter* that is only as strong as the opposing inference of no *scienter*.

*Please contact Richard J. Bortnick (rbortnick@cozen.com) in our West Conshohocken office (800.379.0695) or Emilio G. Boehringer (eboehringer@cozen.com) in our New York office (800.437.7040) if you have any questions regarding this Alert.*