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CRS Report for Congress

Securities Fraud: *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*

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Summary

The United States Supreme Court granted the petition for certiorari in the case *Tellabs, Inc. v. Makor Issues & Rights, Ltd*. The case was appealed from a decision by the Court of Appeals for the Seventh Circuit. It presents the question whether and to what extent a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required by the Private Securities Litigation Reform Act of 1995. This report will be updated.

On January 5, 2007, the United States Supreme Court granted the petition for certiorari in the case *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[1] The case was appealed from a decision by the Court of Appeals for the Seventh Circuit[2] and presents the question of whether and to what extent a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter,[3] as required by the Private Securities Litigation Reform Act of 1995 (PSLRA).[4] Oral argument occurred on March 28, 2007.

The case is a class action against Tellabs, Inc., which is a manufacturer of specialized equipment used in fiber optic cable networks. The plaintiffs in the case, a class of Tellabs shareholders, allege that Tellabs's fraudulent conduct began with the issuing of a press release which stated that Tellabs had signed a multi-year, $100,000,000 contract for one of Tellabs's next-generation products, the Titan 6500. Tellabs's chief executive officer (CEO), Richard Notebaert, predicted to financial analysts that, in addition to the Sprint

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[1] No. 06-484.

[2] 437 F.3d 588 (7th Cir. 2006).

[3] "Latin term for a person's guilty knowledge; i.e., knowing that a person's actions are wrong." MODERN DICTIONARY FOR THE LEGAL PROFESSION (3d ed. 2001).

[4] 15 U.S.C. § 78u-4.

contract, there would be continuing growth of the Titan 5500, the 6500's predecessor. Based in part on these representations, market analysts recommended that investors buy Tellabs stock. In addition, further optimistic statements signed by Notebaert and Richard Birck, Tellabs's chairman and former CEO, included "Tellabs's growth is robust," "Our markets hold significant potential for sustained growth," and "Our core business is performing well." As time passed, Notebaert continued to issue upbeat statements. Within two years of the first optimistic statement issued by Notebaert, Tellabs significantly reduced its projected earnings and its stock price plunged.

Plaintiffs then filed a class action suit against Tellabs and ten of its executives, alleging that the executives knowingly lied to the public in specific ways, such as that they knew that the Titan 6500 was not available and that they knew that the demand for the Titan 5500 was waning, instead of growing. Plaintiffs also alleged that Birck engaged in illegal insider trading. The district court twice dismissed the shareholders' suit on the basis that the shareholders had failed to prove scienter under the PSLRA.[5] The plaintiffs appealed to the Seventh Circuit, arguing that 1. Some of the statements that the court dismissed as "mere puffery" were legally actionable; 2. The complaint provided enough detail to support a strong inference of scienter for each of the defendants; and 3.The disclaimer which accompanied Tellabs's forecasts was insufficient and that therefore Tellabs could not rely upon the PSLRA's safe harbor provision.[6]

The Court of Appeals for the Seventh Circuit first listed three distinct statutory violations that plaintiffs' complaint alleged. First, the plaintiffs contended that Tellabs, as a company, and that Notebaert and Birck, as individuals, violated section 10(b),[7] the general antifraud provision, of the Securities Exchange Act of 1934,[8] and Securities and Exchange Commission (SEC) Rule 10b-5,[9] the SEC rule which implements the general antifraud provision. Second, the complaint alleged that Notebaert, Birck, and certain other Tellabs executives were "control persons" and therefore liable under section 20(a)[10] of the Securities Exchange Act for the corporation's fraudulent acts. Third, the plaintiffs alleged that Birck committed insider trading violations.[11]

In analyzing the issues of the case, the Seventh Circuit noted that the PSLRA, which governs class actions brought for securities law violations, sets out particularity for fact pleading that exceeds the requirements under Rule 9(b) of the Federal Rules of Civil Procedure.[12] Under the PSLRA, a securities fraud (section 10(b) "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement

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[5] *Johnson v. Tellabs, Inc*., 303 F. Supp. 2d 941 (N.D. Ill. 2004).

[6] The safe harbor provision for forward-looking statements under the PSLRA may be found at 15 U.S.C. section 78u-5.

[7] 15 U.S.C. § 78j(b).

[8] 15 U.S.C. §§ 78a *et seq*.

[9] 17 C.F.R. § 240.10b-5.

[10] 15 U.S.C. § 78(t).

[11] 15 U.S.C. § 78t-1.

[12] *See, e.g., In re Rockefeller Center Properties, Inc. Securities Litigation*, 311 F. 3d 198 (3d Cir. 2002).

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"[13] and "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[14]

There has been debate within the courts of appeals as to how much factual detail in the pleadings is enough to satisfy the "strong inference" of scienter required by the PSLRA. For example, the Ninth Circuit has stated that, in enacting the strong inference requirement, Congress raised the bar under the PSLRA for the substantive state of mind requirement for securities fraud allegations.[15] The Seventh Circuit decision stated that it was not convinced that Congress intended to raise the bar under the PSLRA because, prior to the enactment of the PSLRA, every circuit considering the substantive standard had held that a showing of recklessness was sufficient to allege scienter.[16] The Seventh Circuit stated that, because the PSLRA refers to the "required state of mind," it seemed likely that Congress approved of the state of mind standard used before passage of the PSLRA and that, if Congress wanted a stricter scienter standard to be used, Congress would have placed a new standard in the law.

The Seventh Circuit went on to discuss that, although it believed that the PSLRA did not impose a stricter substantive scienter standard, the act did raise the bar for pleading scienter. In addition to having to meet a particularity requirement, plaintiffs must meet a substantive requirement by pleading sufficient facts to create a "strong inference" of scienter. The Seventh Circuit could not find congressional intent as to what facts will create such an inference. Further, according to the Seventh Circuit, there is conflict in the circuits as to how to demonstrate the required "strong inference." The Second and Third Circuits follow the reasoning that the PSLRA adopted the Second Circuit's pre-PSLRA pleading standard for scienter.[17] The Ninth and Eleventh Circuits, however, believe that Congress considered but rejected the Second Circuit's approach and instead chose a more

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[13] 15 U.S.C. § 78u-4(b)(1).

[14] 15 U.S.C. § 78u-4(b)(2).

[15] *In re Silicon Graphics Securities Litigation*, 183 F.3d 970, 979 (9th Cir. 1999): A plaintiff must allege facts that create a strong inference of "deliberate or conscious recklessness" or a "degree of recklessness that strongly suggests actual intent."

[16] *See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990); *In re Philips Petroleum Securities Litigation*, 881 F.2d 1236, 1244 (3d Cir. 1989); *Van Dyke v. Coburn Enter, Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Broad v. Rockwell International Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2nd Cir. 1978); and *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977).

[17] "[P]laintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence or recklessness or conscious misbehavior." *Novak v. Kasaks*, 216 F.3d 300, 309-10 (2d Cir. 2000); *In re Advanta Corporation Securities Litigation*, 180 F.3d 525, 530-35 (3d Cir. 1999).

onerous burden.[18] The remaining six circuits, according to the Seventh Circuit, have taken a middle ground and have reasoned that "Congress chose neither to adopt nor reject particular methods of pleading scienter–such as alleging facts showing motive and opportunity–but instead only required plaintiffs to plead facts that together establish a strong inference of scienter."[19] The Seventh Circuit in this case decided to follow this middle ground.

Having decided the line of reasoning that it would take concerning the threshold of what constitutes a strong inference of scienter, the Seventh Circuit held that plaintiffs' complaint against Notebaert met the threshold but that the complaint against Birck did not meet the threshold. Notebaert's guilt derived, according to the court, from the evidence that he likely knew that the optimistic statements which he made concerning Tellabs's Titan 5500 and Titan 6500 were false. Birck, on the other hand, made optimistic projections only up until the time that he likely knew of the Titan 5500's market weakness. The federal securities laws impose liability not only on the person who actually commits the securities law violation but also on the persons who "directly or indirectly"[20]control the violator. Therefore, the plaintiffs' claims against Notebaert, Birck, and the other Tellabs executives for controlling person liability survived. The executives, according to the court, may later have an opportunity to prove that they acted in good faith. Further, since Notebaert acted within the scope of his position as CEO of Tellabs, his knowledge of the falsity of his statements could be imputed to the corporate entity Tellabs. Finally, the charge against Birck for insider trading survived because of his possibly being found to be a control person.

In its brief, the petitioner (Tellabs) states:

> The Seventh Circuit in this case interpreted and applied the "strong inference" standard in a way that is inconsistent with its text and purpose. The court of appeals adopted an approach to a securities fraud complaint that rewards ambiguous pleading by reading such allegations exclusively in the plaintiff's favor, and one-sidedly considers the strength of claimed inferences of scienter by themselves, without placing the allegations putatively supporting such an inference in the context provided by the complaint and and other materials properly before the court.
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> Contrary to the Seventh Circuit's approach, the Reform Act requires a plaintiff to plead specific facts that, considered in the overall context created by the complaint

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[18] "Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so." *In re Silicon Graphics Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999). "Because the clear purpose of the [PSLRA] was to curb abusive securities litigation, and because we believe that the motive and opportunity analysis is inconsistent with that purpose, we decline to adopt it." *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999).

[19] *Ottoman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir. 2003); accord *Florida State Board of Administration v. Green Tree Financial Corp.*, 270 F.3d 645, 659-60 (8th Cir. 2001); *Nathansen v. Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-52 (6th Cir. 2001); *Greebel v. FTP Software Inc.*,194 F.3d 185, 195-97 (1st Cir. 1999).

[20] 15 U.S.C. § 78t(a).

> as a whole and other materials properly before the court, demonstrate that the plaintiff's claim that the defendant acted with scienter has substantial merit.[21]

Respondents (shareholders), on the other hand, argue that:

> Petitioners ask the Court to ignore the PSLRA's actual language and fabricate an impossible-to-meet heightened pleading burden that obliges a plaintiff to provide sufficient evidentiary detail to foreclose any possibility that the defendant's intent was not fraudulent. Such a requirement has no basis in more than a decade of applying the PSLRA, and it is at odds with the established principle that a plaintiff is not required to provide detailed evidence or to prove the merits of its case in the complaint. The variant super-heightened pleading standards conjured up by petitioners and supporting *amici* are very likely to throw out the meritorious wheat along with the chaff. The PSLRA was never intended to leave the securities marketplace so vulnerable to malfeasance.[22]

The issue of what should constitute a "strong inference" that a person acted with scienter in committing a securities fraud violation for purposes of bringing a class action seems to be at the heart of the PSLRA. In the act's legislative history there are statements which the Court may look to if it does not believe that the meaning of the statute is plain on its face. For example, in the conference report for the legislation the following was stated concerning the "heightened pleading standard":

> Naming a party in a civil suit for fraud is a serious matter. Unwarranted fraud claims can lead to serious injury to reputation for which our legal system effectively offers no redress. For this reason, among others, Rule 9(b) of the Federal Rules of Civil Procedure requires that plaintiffs plead allegations of fraud with 'particularity.' The Rule has not prevented abuse of the securities laws by private litigants [footnote omitted]. Moreover, the courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits [footnote omitted]. The House and Senate hearings on securities litigation reform included testimony on the need to establish uniform and more stringent pleading requirements to curtail the filing of meritless lawsuits.
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> The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard also is specifically written to conform the language to Rule 9(b)'s notion of pleading with 'particularity.'
>
> Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a 'strong inference' of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard [footnote omitted]. The plaintiff must also specifically plead with particularity each statement alleged to have been misleading. The reason or reasons why the statement is misleading must also be set forth in the complaint in detail. If an allegation is made

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[21] [http://www.abanet.org/publiced/preview/briefs/pdfs/06-07/06-484_Petitioner.pdf], at 2.

[22] [http://www.abanet.org/publiced/preview/briefs/pdfs/06-07/06-484_Respondent.pdf], at 16.

> on information and belief, the plaintiff must state with particularity all facts in the plaintiff's possession on which the belief is formed.[23]

It is interesting to note that, just as a conflict in the circuits existed in the interpretation of Rule 9(b) of the Rules of Civil Procedure, so a conflict now exists in the interpretation of the pleading standard under the PSLRA. Although it is not possible to predict how the Supreme Court will rule in this case, a look at the legislative history suggests that Congress intended a quite stringent pleading standard.

[23] H.Rept. 104-369 at 41 (1995).