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A primer on pleading securities fraud under PLSRA: the Seventh Circuit's decision in *Tellabs*

By Charles W. Murdock

In *Makor Issues & Rights, LTD v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006), the Seventh Circuit, in an eminently reasonable opinion, examined (1) the requirement of pleading with particularity under PLSRA, (2) the requisite specificity for the "bespeaks caution" safe harbor for forward-looking statements, (3) the pleading requirements for a strong inference of scienter, and (4) the establishment of control person liability. The breath and clarity of the opinion provide a clinic on the effect of PLSRA from the perspective of the requirements to plead securities fraud.

The case essentially involved a series of positive and specific statements by Notebaert, the CEO of Tellabs, and Birck, the chairman of the board, with respect to two of Tellabs key products, the Titan 5500 and the Titan 6500. They reported the continuing growth of the 5500 and that the 6500 was ready to ship. In point of fact, according to the complaint, demand for the 5500 was precipitously declining and the 6500 was not yet being produced.

With respect to particularity, the Seventh Circuit declined to require plaintiffs to identify the names of their confidential sources, stating that it would be too much to require plaintiffs to provide "name, rank, and serial number" for each confidential source. Id at 596. Rather the standard was that plaintiffs must describe their sources with sufficient particularity "to support the probability that a person in the position occupied by the source would possess the information alleged." This standard protects the privacy of the sources, while giving the court sufficient information to assess the soundness of the allegations. Otherwise, sources might be deterred from exposing malfeasance and might be subject to retaliation. The confidential sources in this case included former managers and high-level executives, who were thus in a position to provide reliable information about whether management's statements were false and material and whether management knew this to be the case.

The court then addressed whether the allegations in the complaint were sufficiently particularized and held that statements such as "we feel very, very good about the robust growth we're experiencing" and "demand for our core optical products ... remains strong" were too vague, did not specifically identify the 5500, and were "unlikely to induce an investor to purchase Tellabs stock." Id at 597. However, in response to a question from an analyst about whether Tellabs was experiencing any weakness in the 5500 sales, the CEO responded "we're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." According to the court this statement went well beyond puffery; it was a direct response to an analyst's inquiry about a possible decline in the 5500 sales, and it would be reasonable for an analyst or investor to believe the CEO; it would clearly be misleading to describe an alleged decline as equivalent to continued growth.

Moreover, in the frequently asked questions section of the 2000 annual report, the CEO and the Chairman responded to the question "are you worried that the [5500] has peaked" by stating flatly "No... Although we introduced the product nearly 10 years ago, it's still going strong."

With respect to the 6500, statements such as the "product is exceeding our expectations" are meaningless and, according to the court, are discounted by the market as pure hype. However, statements such as that the 6500 system is available now

[December 11, 2000], and that it was shipped through the first quarter, were particular, specific, and, according to the complaint, completely false. According to the court, the foregoing allegations of misleading statements met the particularity standard.

The court then addressed whether Tellabs's financial results for the fourth quarter of 2000 were also misleading. The court found that an allegation that Tellabs "flooded its downstream customers with unordered Titan 5500s," a practice known as channel stuffing, and that Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns, met the particularity hurdle.

The next issue was whether Tellabs's overstated revenue projections, which included disclaimers, met the PLSRA "bespeaks caution" safe harbor for forward-looking statements. Each projection was accompanied by the following statement:

Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The Company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. Id. at 599.

According to the Seventh Circuit, the appropriate standard to apply in determining whether cautionary statements are meaningful is whether the disclaimer mentions "those sources of variance that (at the time of the projection) were the principal or important risks," a test it enunciated in *Asher v. Baxter International*, 377 F.3d 727, 734 (7th Cir. 2004). While the foregoing disclaimer did encompass Tellabs's troubles, the court observed that it also "encompass[ed] a whole world of other possible contingencies." Id. The court concluded that the "breath of these warnings makes it impossible for us to conclude that they meaningful described 'the principal or important risks' facing Tellabs at the time it made the projections. Indeed, this level of generality exemplifies the useless caveat emptor boilerplate we criticized in Asher."

Plaintiffs, having overcome the hurdles of particularity and bespeaks caution, additionally had to meet what was, according to the court, an even more arduous hurdle, namely, adequately alleging scienter. PLSRA requires that the complaints must allege with respect to each act or omission "facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78 u-4(b)(2). The Seventh Circuit rejected the position of the Ninth Circuit that PLSRA raised the substantive state of mind requirement for securities fraud allegations on the basis that, if Congress had wanted to impose a more stringent scienter standard than that which prevailed at the time of the legislation, it would have done so explicitly, just as it expressly changed the pleading requirements to require particularity. Id. at 600. The court adopted the following scienter standard that was in effect prior to PLSRA, namely, "an extreme departure from the standards of ordinary care, [] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

While PLSRA did not impose a more stringent substantive scienter standard, it did raise the bar for pleading by requiring the plaintiff to plead sufficient facts to create "a strong inference" of scienter. In determining what is necessary to plead a strong inference, the Seventh Circuit rejected both the position of the Second and Third Circuits, which have held that PLSRA adopted the Second Circuit's pre-PLSRA standard of "pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious behavior," and the position taken by the Ninth and Eleventh Circuits that have opted for a more onerous pleading burden. Instead, it agreed with the other circuits that "the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient." Id. at 601.

The court then addressed the "degree of imagination" that courts can use in divining whether or not a complaint creates a "strong inference." The Sixth Circuit had indicated that a plaintiff is entitled "only to the most plausible of competing inferences," but that the inference does not need to be "irrefutable." *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004). Since the Sixth Circuit recognized that its approach might infringe upon a plaintiff's Seventh Amendment right to a jury trial, the Seventh Circuit decided that it was wiser to adopt an approach that could not be viewed as an usurpation of the jury's role. Accordingly, it required that the plaintiff must allege facts that, if true, "a reasonable person could infer that the defendant acted with the required intent". Id. at 602.

The final issue relating to scienter was whether scienter allegations made against one defendant could be imputed to the other defendants, in other words, whether the "group pleading presumption," which presumes that "group-based information," such as that conveyed in prospectuses, registration statements, annual reports and press releases, is the collective work product of the officers as a group. Since PLSRA spoke of defendant in the singular, the Seventh Circuit determined that plaintiffs must create a strong inference of scienter with respect to each individual defendant.

Applying the foregoing principles to the facts at hand, the court first reviewed the allegations against the CEO, Notebaert. According to one confidential source for allegations in the complaint, a market analyst, internal reports revealed that the market for the 5500 was drying up by March 2001. Yet in April 2001, the CEO told financial analysts that demand continued to grow. According to the court, while it was conceivable that the CEO had not yet seen these reports, nevertheless plaintiffs had provided sufficient facts for a reasonable person to infer that the CEO knew that his statements were false. According to another confidential source, the CEO stayed on top of the company's financial health through weekly conversations with his fellow executives. The Seventh Circuit concluded that "[g]iven the significance of the Titan 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information indicating that his statements were false." Id. at 603. In so doing, the court quoted with approval the statement in *Florida State Board of Administrators v. Green Tree Financial Corp.*, 270 F.3d 645, 665 (8th Cir. 2001):

One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.

The CEO also made a number of false statements regarding the 6500, suggesting that it was available and being shipped, whereas Tellabs did not ship a single Titan 6500 during the class period. According to a confidential source who was a sales director, the CEO saw weekly sales reports and production projections and knew that the 6500 was not ready to ship. Accordingly, plaintiffs established a strong inference of scienter in that the CEO lied when he informed investors that the 6500 was available and being shipped.

Plaintiffs also sufficiently alleged scienter with respect to the CEOs execution of the 10-K report containing the projections that the court previously found were not protected by the disclaimers. One source stated that the CEO worked directly with sales personnel to effect the channel stuffing. Moreover, since the revenue projections rested on the company statements that it was doing better than it actually was, the CEO's scienter for those alleged misrepresentations also served as circumstantial evidence of his scienter for the misleading projections.

Plaintiffs were not as successful in their allegations against Birck, the chairman of Tellabs. While plaintiffs alleged generally that he had regular meetings with the CEO and that both he and his CEO had their hands on the pulse of the organization, the chairman's last public comment was in February, prior to the time that the decline in interest for the Titan 5500 was obvious. Moreover, the chairman made no actionable statements with respect to the 6500. With respect to the projections in the 10–K reports that both the chairman and CEO signed, the chairman's possibly unreasonable trust in the CEO does not rise to the level of recklessness required by the statute.

The court also determined that the fact that the chairman sold 80,000 shares of Tellabs the first week of February 2001 do not create a strong inference of scienter. 80,000 shares was only 1 percent of the chairman's holdings and the complaint provided no information as to his previous pattern of sales. Id. at 604.

However, the good news for the chairman in the previous paragraph was short-lived since the court held that the chairman was liable as a control person under section 20 of the 1934 Act, 15 USC §78t (a). Under section 20, a person who controls a primary violator is also liable, unless such control person can prove that he acted in "good faith." Thus, since the chairman was one of a group that controlled Tellabs, a primary violator, they will also be liable unless they can establish their good faith. The court acknowledged that this was something of a "backdoor" to liability since the court had previously determined that the Chairman's scienter had not been adequately alleged. Id. at 605. Nonetheless, the complaint's allegations with respect to control person liability were sufficient, and the Chairman will later have the opportunity to prove whether or not he acted in good faith.

Finally, plaintiffs' claim against the Chairman for insider trading under section 20A of the 1934 Act survived. In order for plaintiffs to succeed on this claim, they must establish that his sale involved a violation of the Act. While the securities law

fraud claims against the chairman were dismissed for lack of scienter, he still may be liable as a control person. According to the court, "whether §20 (a) control–person liability standing alone can serve as the 'separate underlying violation' required by §20A for insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum." Id.

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