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

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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 presented 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 (PSLRA). On June 21, 2007, the Supreme Court held that the pleading standard (what is in fact necessary to establish the strong inference of scienter) required by the PSLRA must be more than merely “plausible” or “reasonable.” It must be “cogent,” and at least as compelling as any opposing inference of nonfraudulent intent. This report will not 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 Circuit² and presented 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 Supreme Court issued its decision on June 21, 2007.

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.

The case was 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, alleged that Tellabs's fraudulent conduct began with the issuing of a press release which stated that Tellabs had signed a multi-year, \$100 million 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 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 10 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

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.

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 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, according to the Seventh Circuit, had to 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

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

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).

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 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.

Conflict among the circuit courts as to how to demonstrate the required “strong inference” was the reason for the Supreme Court’s granting of certiorari in the *Tellabs* case.²¹ In its decision the Supreme Court held that, to qualify as a strong inference of scienter under the PSLRA, the inference must be more than merely plausible or

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).

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).

²¹ Slip op., at 6.

reasonable. It must be “cogent,” and at least as compelling as any opposing inference of nonfraudulent intent.

The Court in its analysis stated that Congress has the authority to provide the standard for pleading a claim.

Congress, as creator of federal statutory claims, has power to prescribe what must be pleaded to state the claim, just as it has power to determine what must be proved to prevail on the merits. It is the federal lawmaker’s prerogative, therefore, to allow, disallow, or shape the contours of — including the pleading and proof requirements for — §10(b) private actions. No decision of this Court questions that authority in general....²²

Finding no clear guide from Congress in the statute or in the legislative history on what would satisfy the requirements for a strong inference, the Court established three prescriptions for satisfying the standard: 1. Faced with a motion to dismiss a section 10(b) action under the Rules of Civil Procedure, courts must accept all factual allegations in the complaint as true; 2. Courts must consider the complaint in its entirety, as well as other sources, such as documents incorporated into the complaint by reference and matters of which a court may take judicial notice; and 3. In determining whether the pleaded facts give rise to a “strong” inference of scienter, a court must take into account plausible opposing inferences.²³

The Court ended its opinion by stating that it would not decide whether, under the three prescriptions for the standard it described as necessary for a strong inference of scienter, the shareholders’ allegations warranted a strong inference that Notebaert and Tellabs acted with the required state of mind. The lower courts did not have the opportunity to consider the matter in the light of these prescriptions. Therefore, the Court vacated the Seventh Circuit’s judgment and remanded the case for further proceedings consistent with its opinion.

²² Slip op., at 15-16.

²³ Slip op., at 11.