United States Court of Appeals

for the

Seventh Circuit

Case No. 04-1687

MAKOR ISSUES & RIGHTS, LTD.,
CHRIS BROHOLM, RICHARD LEBRUN, *et al.*,

Plaintiffs-Appellants,

– v. –

TELLABS INCORPORATED,
MICHAEL J. BIRCK, RICHARD C. NOTEBAERT, *et al.*,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS

REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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INTRODUCTION

This case involves classic fraud: Although Defendants[1] knew that demand for the Company's flagship TITAN 5500 product was plummeting and that its most important new product, the TITAN 6500, was plagued with problems, they falsely assured the investing public that demand for the 5500 "remains strong" and that the 6500 was "available now." To further conceal the Company's collapsing fortunes, Defendants engaged in channel stuffing and other deceptive practices. Defendants also falsely represented that the downturn in the telecommunications industry was not affecting the Company.

ARGUMENT

I. THE DISTRICT COURT FAILED TO APPLY THE CORRECT STANDARDS

Defendants erroneously insist that the District Court properly applied the correct pleading standards. In fact, although the District Court appeared to acknowledge the correct standards, it "did not 'give plaintiff[] the benefit of all reasonable inferences' as it should have on a motion to dismiss, but appears to have drawn its inferences in the defendants' favor";[2] did not go "[b]eyond each individual allegation . . . [to] consider whether the total plaintiffs' allegations, even

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[1] The same defined terms used in Plaintiffs' Opening Brief are used herein. In addition, these documents will be cited as follows: Plaintiffs' Second Amended Complaint ("SAC") (¶__); Plaintiffs/Appellants' Opening Brief (Opening Br. __); Brief of Defendants/Appellees (Def. Br. __).

[2] Aldridge v. A.T. Cross Corp., 284 F.3d 72, 79 (1st Cir. 2002).

though individually lacking, are sufficient" (emphasis in original);[3] and improperly "require[d] the pleading of detailed evidentiary matter. . . ."[4] For example:

- The District Court should have drawn the fair inference that the "deep process of self-examination" which Defendants Birck and Notebaert admitted occurred "[e]arly in 2001, as our customers reduced capital spending and expressed caution about the future" (JA152:¶141), was already underway when Notebaert was assuring analysts that "demand for our core optical products . . . remains strong." (JA139:¶100) According to Defendants' own announcement, by April 2001, Tellabs had begun a series of layoffs, plant closures, and significant spending reductions. (JA152, 163:¶¶141, 170) Other facts pleaded in the SAC confirm demand was declining by late 2000. (JA114-17:¶¶34-45)

- Although Plaintiffs allege that Tellabs' marketing strategy department's report that accurately concluded TITAN 5500 revenue would fall by $400 million was prepared "in or about early 2001" (JA115:¶39), and it is logical to assume the report was interrelated with the "deep process of self-examination" that also occurred in early 2001, the District Court erroneously found that the SAC "does

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[3] Broudo v. Dura Pharms., Inc., 339 F.3d 933, 940 (9th Cir. 2003), cert. granted on other grounds, 124 S. Ct. 2904 (2004); In re MicroStrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620, 631 (E.D. Va. 2000) ("otherwise-unremarkable facts may take on added significance when combined with each other, having what might be termed a synergistic effect on probative value").

[4] In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 72 (2d Cir. 2001).

not state when the marketing strategy department completed and disseminated its report." (BA80)[5]

- Another fair inference the District Court should have drawn is that Tellabs' CEO (Notebaert) and Chairman (Birck) were well aware of the conclusions of the marketing strategy report, especially as those executives made public statements regarding the products involved.

- The District Court also should have employed the reasonable inference that the head of the Company's mergers and acquisitions group, which gathered market research, kept Birck, to whom the head of that group directly reported, informed of adverse market conditions. (BA86; JA163:¶169)

- The District Court erroneously failed to infer that Defendants, who were responsible for managing the Company at the highest levels, were fully aware of serious problems affecting the Company's core products, the TITAN 5500 and 6500. See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 943, n.21 (9th Cir.), cert. denied, 124 S. Ct. 433 (2003):

> This argument is patently incredible. It is absurd to suggest that the Board of Directors would not discuss either the repurchasing authorization for millions of

[5] The District Court also noted that Plaintiffs failed to allege "who, other than the 'finance department,'" prepared the marketing reports (BA78), a seemingly irrelevant evidentiary detail.

> dollars worth of stock or the FAA investigations or negotiations, ...

(Citation omitted). See also numerous cases cited in Opening Br. at 34 & n.25, 37-38 & nn.27-28. In fact, the District Court affirmatively found that Plaintiffs' "allegations support that Notebaert was active in Tellabs' business" (BA88), but refused to draw an inference of scienter therefrom.

- Instead of assessing the cumulative weight of Plaintiffs' well-pleaded allegations, among others, that Defendants received daily, weekly, and monthly reports, that Defendants engaged in channel stuffing to conceal the Company's difficulties, and that the Company's own internal study showed a $400 million decline in demand for the TITAN 5500, the District Court considered and dismissed each of these evidentiary details in isolation. (See, e.g., BA78, 80, 85) For instance, logic compels the inference that senior executives who regularly were receiving so many reports were well informed about the problems that threatened the Company's financial health.

- Because of a purported lack of evidentiary detail (of the type that is virtually impossible for Plaintiffs to obtain without discovery), the District Court gave no weight to Plaintiffs' allegations that, during the Class Period, Defendants received

frequent reports concerning the Company's performance.[6] (BA77-79) (JA116, 158-59, 163:¶¶40, 153-54, 168)

- The SAC alleges that "a former Tellabs engineer who held a variety of management positions at Tellabs [a fact the District Court ignored], from well prior to the Class Period through well after the Class Period"[7] (JA105, SAC at 4)

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[6] Inasmuch as numerous sources cited in the SAC related that demand for the TITAN 5500 was collapsing, there is an overwhelming inference that the Company's extensive internal reporting system reflected the same adverse information, as at least two confidential sources confirmed. (JA116:¶40)

[7] This confidential source was thus "described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged," Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000). See also In re Cabletron Sys., 311 F.3d 11, 24 n.6 & 28-31 (1st Cir. 2002) (reference "to . . . anonymous sources as 'former employees with personal knowledge of the relevant facts' or some similar phrase" held sufficient); ABC Arbitrage v. Tchuruk, 291 F.3d 336, 353 (5th Cir. 2002) (sources only need to be "identified through general descriptions in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source . . . would possess the information pleaded") (emphasis added); In re Theragenics Corp. Sec. Litig., 137 F. Supp. 2d 1339, 1346-47 (N.D. Ga. 2001) (sustaining complaint that identified as its "source," "numerous medical doctors in the field"; "[t]he additional information may be obtained through discovery, but is not required to be included in the Complaint"); Fitzer v. Sec. Dynamics Techs., Inc., 119 F. Supp. 2d 12, 21-22 (D. Mass. 2000) (PSLRA's particularity requirements were met by relying upon unnamed "generally identified former employees" described as: "(1) a former employee who handled returns; (2) a former employee in the technical support department; (3) a former employee . . . who was responsible for strategic planning; (4) a former employee who was a sales representative for the company's western territory; and (5) a former employee who was a sales representative"; "persons in those positions are likely to have knowledge of the facts described, including product demand and sales practices"). Moreover, as noted in Plaintiffs' Opening Brief (at 31), questions regarding the credibility of a source are not properly resolved on a pleading motion.

(emphasis added) actually "viewed" the internal quarterly reports generated by Tellabs' finance department, and that those reports showed "declining demand in third and fourth quarters" for the TITAN 5500, among other products. (JA116:¶40) Yet, the District Court inexplicably noted:

> The source of this information is also unclear. Although Plaintiffs allege that CS-23 'viewed' the quarterly reports, it is unclear that CS-23 provided this information. Moreover, CS-23 is a former Tellabs' engineer, thus it is unclear when or how he had access to the reports."

(BA79) The information provided by CS-23 was corroborated by a former Tellabs market analyst, who confirmed that the quarterly reports, which were accessible on Tellabs' database system, "showed a decline in customer demand for the TITAN 5500 in March 2001." (JA116:¶40)

- The District Court improperly disregarded allegations regarding Defendants' practices of writing fictitious sales orders (BA72; JA122:¶63) and providing customer incentives that "were excessive, unusual, and out of line with ordinary business practices" (BA72-73; JA121-22:¶62) even though these allegations corroborated, and were corroborated by, similar over-inventorying and backdating allegations, which the District Court held were sufficiently alleged.
- The District Court should have considered that the very willfullness of the over-inventorying and backdating, and other deliberate practices detailed in the SAC, evidenced Defendants' awareness of the undisclosed demand problems these

practices were intended to mask. See authorities cited in Opening Br. at 41-42 & n.34. It is difficult to imagine that Tellabs employees engaged in an illicit strategy of channel stuffing involving the Company's most significant customers and tens of millions of dollars of products[8] (see Opening Br. at 16-18, 41) unless Defendants approved. In fact, the SAC alleges that, according to a former Tellabs senior business manager, Tellabs executives actually approved channel stuffing and Notebaert was personally involved with Tellabs sales personnel in channel stuffing SBC, one of Tellabs' most important customers. (JA114, 122-23:¶¶33, 67)

- The District Court improperly discredited information provided by confidential source "CS-3," whom the SAC describes as "a former high-level Tellabs sales executive, from many years prior to the Class Period through shortly prior to the Class Period." (JA103) It is entirely reasonable to infer that this source had knowledge of channel stuffing and related activities, which were ongoing during the fourth quarter 2000, when CS-3 was still at the Company (the Class Period began near the end of the quarter).

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[8] Charles Lee, the Chairman of Verizon, Tellabs' largest customer, even called Tellabs to complain about channel stuffing. (JA114, 124:¶¶33, 71) It certainly is reasonable to infer that Verizon's Chairman either spoke directly with his counterparts at Tellabs, i.e., Notebaert and Birck, or, at a minimum, that they were aware of the complaining call.

- The District Court failed to address the manifest contradiction between the Company's internal information, showing declining demand for the TITAN 5500 by March 2001 and even earlier, and Notebaert's unequivocal assurances, during the March 8, 2001 analyst conference call, that demand for the TITAN 5500 "remains strong" (JA139:¶100) and that "[w]e're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (JA140:¶102) The drop in demand was so dramatic that it clearly did not occur overnight. Instead of connecting the information about declining demand with Notebaert's representations of continuing strong demand, the District Court noted that "[t]his information in March of 2001 . . . does not have any effect on the allegedly fraudulent fourth quarter 2000 financials . . . ." (BA79)

II. PLAINTIFFS ADEQUATELY PLEADED SCIENTER AS TO EACH DEFENDANT

As demonstrated at length in Plaintiffs' Opening Brief (at 30-47), the SAC clearly alleges facts giving rise to "a strong inference"[9] that each Defendant knew of the Company's severe problems. Committing the same errors as the District Court, Defendants not only disregard much of the SAC's evidentiary detail but never address the cumulative weight of all the alleged facts applicable to each Defendant. Defendants also improperly seek to disregard well-pleaded facts that

[9] The plain language of the PSLRA requires only "a strong inference" (emphasis added) not "the stronger inference," "the strongest inference," or "the only strong inference." 15 U.S.C. §78u-4(b)(2) (2004).

reflect on all Defendants' scienter simply because the SAC uses the term "Defendants," when appropriate. See authorities cited in Opening Brief at p. 32 n.23.

Defendants' arguments attacking the sufficiency of Plaintiffs' scienter allegations are wrong:

- Defendants assert that Plaintiffs' claims "def[y] common sense" because Notebaert -- whose livelihood depended on the Company and who no doubt was extremely concerned with its well-being -- had absolutely no "concrete motive" to engage in deception.[10] (Def. Br. at 17) Defendants' argument itself defies common sense.

Clearly, the public revelation of significant problems affecting the Company's key products would jeopardize its performance and prospects in a highly competitive and troubled market. Notebaert's (or Birck's) natural desire to protect his Company from the adverse effects of publicizing that the products on which its fortunes depended were not selling and did not work makes complete sense. See Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 656

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[10] DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990), cited by Defendants (Def. Br. at 9, 17, 34), is entirely distinguishable. Unlike the instant case, in which Defendants are all insiders, DiLeo involved claims against an outside auditor. In DiLeo, the Court declined to infer that the accounting firm would "have joined cause with [a client company]" because the audit fees from the client "could not approach the losses [the accounting firm] would suffer from a perception that it would muffle a client's fraud." Id. at 629.

(8th Cir. 2001) ("common sense would suggest that [defendant's desire to maintain company's profitability or credit rating] may be the very motives that prompt many cases of deceptive misstatements").

- Moreover, motive is not an essential element of a Rule 10b-5 claim; nor is there any requirement that a motive be alleged.[11] See Novak v. Kasaks, 216 F.3d 300, 306, 311 (2d Cir. 2000). The District Court, and a number of Courts of Appeal, have correctly recognized that reckless disregard for the truth still constitutes scienter under §10(b). (BA30) See cases cited in Opening Br. at 25. Further, as insider trading is unlawful, no inference adverse to Plaintiffs should be drawn from the fact that certain insiders may have refrained from selling their shares.

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[11] In addition, because Plaintiffs have had no discovery it would be unfair to require Plaintiffs to know or speculate as to what is in Defendants' minds. Nevertheless, it is obvious that Notebaert, as CEO, President, and a Director of Tellabs, and Birck, as a founder, CEO and President for 25 years, and Chairman of Tellabs (JA109-10:¶¶17, 20), had a powerful interest in concealing information that might prove damaging to the Company. See Morse v. Abbott Labs., 756 F. Supp. 1108, 1110 (N.D. Ill. 1991) ("[U]nlike DiLeo, the individual defendants, all directors and/or senior officers, have incentive to withhold disclosure of material information which would have an adverse effect on [the company]. These facts, expressly missing in DiLeo, 'afford a basis for believing that plaintiffs could prove scienter.'") (quoting DiLeo, 901 F.2d at 629).

- That Tellabs' first quarter 2001 reported revenues increased by 21% over the previous year (Def. Br. at 24) proves nothing.[12] This litigation arises out of Defendants' efforts to conceal, among other things, collapsing demand (i.e., orders) for the Company's products. According to Tellabs' 2001 Form 10-K, product revenue is recognized only "when all significant contractual obligations have been met, including the terms of the shipment, and collection of the resulting receivable is reasonably assured." Accordingly, a decline in demand would affect revenues on a delayed basis.[13] Therefore it is apparent that the dramatic reduction in sales for the second quarter 2001 was the result of earlier reductions in orders,[14] which is consistent with the SAC. Furthermore, discovery may well reveal that Defendants continued to engage in the channel stuffing and other manipulative practices they had employed to inflate fourth quarter 2000 results.

- Defendants note that the Company's April 6, 2001 press release attributed lowered first quarter 2001 revenue guidance to certain customers deferring orders

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[12] According to Tellabs' Form 10-Q for the quarter ended March 30, 2001, net earnings before the cumulative effect of a change in accounting principle for the first quarter 2001 were about $123 million, virtually the same as the previous year (about $121 million). Revenues fell by more than 24% from the fourth quarter 2000 to the first quarter 2001. (JA129, JA147:¶¶81, 123(a))

[13] On March 8, 2001, Notebaert explained with regard to the TITAN 5500: "We're in the process of installing . . . a large number of frames that we shipped in the fourth quarter. . . ." (JA140:¶102)

[14] For the second quarter 2002, Tellabs reported net sales attributable to products of only about $408 million, a drop of more than 43% from the previous year. (JA152:¶142)

"late in the quarter." (Def. Br. at 3, 4) It is improper, however, on a pleading motion to accept as true Defendants' self-serving explanations. See Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1278 (11th Cir. 1999) ("a court, when considering a motion to dismiss in a securities fraud case, may take judicial notice (for the purpose of determining what statements the documents contain and not to prove the truth of the documents' contents) of relevant public documents required to be filed with the SEC, and actually filed") (emphasis added; footnote omitted).

- Defendants' assertion that the $100 million contract with Sprint for the TITAN 6500, announced in December 2000, shows that the TITAN 6500 was in fact available (Def. Br. at 30-31) overlooks Plaintiffs' detailed allegations that Sprint made this deal only to fulfill a pre-existing financial obligation concerning a different product. (JA119-20:¶¶54-55) In any event, entering into a contract, especially one of the first contracts, to purchase a product does not necessarily signify that the product is functional.

- No adverse inferences should be drawn from Plaintiffs' determination not to pursue their §10(b) claims against certain Defendants at this time. See Def. Br. at 18-19. (Plaintiffs are continuing to pursue their §20(a) control person claims against Tellabs' CFO, Joan E. Ryan, and Brian J. Jackman.) There is no requirement that Plaintiffs prosecute every possible claim against every possible Defendant. Furthermore, as Defendants well know, under Central Bank, N.A. v. First Interstate Bank, 511 U.S. 164, 191 (1994), "a private plaintiff may not

maintain an aiding and abetting suit under §10(b)." Moreover, merely because, at present, Plaintiffs are not pursuing claims against certain individuals does not mean that those individuals did not assist the current Defendants in perpetrating the complained of fraud.

- Defendants' arguments notwithstanding, the fact remains: six highly placed insiders, including Birck, sold almost 150,000 shares of Tellabs stock for proceeds of over $8 million, an impressive amount by any standard.[15] "Amount" or "timing" frequently indicate suspiciousness; percentage of holdings sold is not the only indicia. See, e.g., In re 3COM Sec. Litig., 761 F. Supp. 1411, 1417 (N.D. Cal. 1990) ($2 million; no mention of percentage).

- The SAC details many facts that clearly indicate corporate awareness, including channel stuffing, back-dating sales, frequent reports to executives, research studies, and customer contacts. The Company's fortunes depended on the

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[15] Defendants' vague reference to trading restrictions sometimes imposed by public companies (Def. Br. at 34 n.14) to try to explain away the suspicious timing of the insider trading does not make clear whether Defendants claim any such restrictions were, in fact, present here and, in any event, improperly seeks to introduce facts that go well beyond the SAC.

Plaintiffs are unable to determine from Birck's SEC filings how much he paid to acquire his Tellabs shares. Discovery may well reveal that he acquired the shares for little, or even no, consideration. The $5.2 million he received from selling 80,000 shares during the Class Period (JA154:¶144) might far outweigh what he paid for all his shares. See In re Oxford Health Plans, Inc. Sec. Litig., 187 F.R.D. 133, 140 (S.D.N.Y. 1999). Birck is a founder of Tellabs and was President and CEO from 1975 to 2000. (JA109:¶17)

products and customers at issue. The decline in revenues was dramatic, necessitating layoffs, plant closures, and huge expense cuts. (JA152, 163:¶141, 170) There can be no question senior management was well aware of these serious problems threatening Tellabs' performance and prospects. To require Plaintiffs, before any discovery, to identify, by name, those individuals with knowledge who also prepared, reviewed, approved, or otherwise participated in issuing Tellabs' public statements[16] imposes an unreasonable burden. Moreover, as demonstrated in Plaintiffs' Opening Brief (at 45-47), scienter may be found against a corporation even when it is not shown against any one individual.[17] Among other things, the

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[16] Southland Sec. Corp v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004), cited by Defendants, makes clear this encompasses many individuals: "We believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or its issuance, or who furnish information or language for inclusion therein, or the like) . . . ." See also In re Warner Communications Sec. Litig., 618 F. Supp. 735, 752 (S.D.N.Y. 1985), aff'd, 798 F.2d 35 (2d Cir. 1986) ("As to Warner, plaintiffs arguably need only show that one or more members of top management knew of material information indicating an earnings decline, but failed to stop the issuance of misleading statements or to correct prior statements that had become misleading . . . .").

[17] Defendants misread Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435 (9th Cir. 1995) ("Theoretically, collective scienter could be a basis for liability. 'In litigation involving Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, even though a corporation is incapable of acting except through individual directors and officers, the cumulative knowledge of its directors and officers is imputed to it . . . . [A] corporation's knowledge need not be possessed by a single officer or agent; the cumulative knowledge of all its agents will be imputed to the corporation.' Knepper & Bailey, supra § 1.02, Supp. at 4; see also William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 790, at 16 (perm. ed.) ('The knowledge necessary to adversely affect the

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corporation's scienter may be established where "management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace." Warner, 618 F. Supp. at 752.

III. THE DISTRICT COURT ERRED IN HOLDING DEFENDANTS' UNFOUNDED FORECASTS WERE PROTECTED BY THE PSLRA'S SAFE HARBOR

As shown in Plaintiffs' Opening Brief (at 48-51), the PSLRA's safe harbor does not protect Defendants' repeated forecasts during January through April 2001, of 30% growth for 2001, because they lacked any reasonable basis, were contradicted by adverse facts known to Defendants, and were not accompanied by any "meaningful cautionary statements." 15 U.S.C. § 78u-5(c)(1)(A)(i).

Defendants' boilerplate disclosure, repeated unchanged with each projection,[18] referred only to a number of generic "[f]actors that might cause" actual results to differ from Defendants' projection. BA28-29 (emphasis added). Tellingly, the Defendants' belief carefully omits the "lead-in" phrase, "[f]actors

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corporation does not have to be possessed by a single corporate agent; the cumulative knowledge of several agents can be imputed to the corporation.')."). In Nordstrom, an insurance coverage case, the Ninth Circuit held only that there was "no evidence in this case to support 'collective scienter' without a concurrent finding that a defendant director or officer also had the requisite intent." 54 F.3d at 1435 (emphasis added).

[18] See Asher v. Baxter Int'l Inc., No. 03-3189, slip op. at 14 (7th Cir. July 29, 2004) (noting that "the cautionary language remained fixed even as the risks changed"; reversing dismissal on safe harbor grounds).

that might cause . . . ," which qualified the disclosures as only hypothetical possibilities. See Def. Br. at 47. Warning only of potential risks when serious problems have actually materialized does not constitute meaningful disclosure. See numerous pre- and post-PSLRA authorities cited in Opening Br. at 49-50 & n.43. See also In re Nortel Networks Corp. Secs. Litig., 238 F. Supp. 2d 613, 629 (S.D.N.Y. 2003). For instance, cautioning there "might" be (unspecified) risks associated "with introducing new products" does not even hint that TITAN 6500 was far behind in development, failing lab evaluations, and plagued with other problems.[19]

Defendants' contention that a statement accompanied by "sufficient cautionary language" is protected "whether or not defendants were allegedly aware that 'problems' existed" (Def. Br. at 48) is wrong. Purported cautionary disclosures that fail to discuss known problems are not "meaningful" as the PSLRA requires. Clearly, Congress did not intend to give public corporations a license to lie. In a just-rendered decision, this Court explained:

> For its part, Baxter says that mentioning these business segments demonstrates that the caution is sufficient; but this also is wrong, because then any issuer could list its lines of business, say "we could have problems in any of these," and avoid liability for statements implying that no

[19] It is disingenuous for Defendants to point to language purporting to warn of a possible downturn in the telecommunications industry, when Notebaert assured analysts: "I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in. . . ." (JA140:¶103)

> such problems were on the horizon even if the management well knew that a precipice was in sight.

Baxter, slip op. at 11 (emphasis added). See also In re SeeBeyond Techs. Corp. Sec. Litig., 266 F. Supp. 2d 1150, 1165-66 n.8 (C.D. Cal. 2003)[20]; In re Scientific Atlanta, Inc., 239 F. Supp. 2d 1351, 1362 (N.D. Ga. 2002), aff'd, [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,846 (11th Cir. June 22, 2004) (no safe harbor protection because "[d]efendants did offer cautionary language pointing out generalized risks but did not caution against the more specific risks known to them at the time the statements were made"); In re World Access, Inc. Sec. Litig., 119 F. Supp. 2d 1348, 1357-58 (N.D. Ga. 2000) (safe harbor not applicable "when Defendants are aware . . . of the facts that render their statements untrue when made").

Misstating Plaintiffs' claim, Defendants assert Plaintiffs are contending "the projections should somehow have been known to be false at the time they were made" (Def. Br. at 48). What Plaintiffs are really contending is that Defendants

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[20] As the SeeBeyond court explained:

> If the forward-looking statement is made with actual knowledge that it is false or misleading, the accompanying cautionary language can only be meaningful if it either states the belief of the speaker that it is false or misleading, or, at the very least, clearly articulates the reasons why it is false or misleading.

Id.

knew, but failed to disclose, serious problems that rendered the projections misleading and lacking in any reasonable basis.

Moreover, as this Court made clear in Baxter, a safe harbor defense raises issues of fact, which "cannot be determined on the pleadings." Slip op. at 15. The Court stated:

> Yet Baxter's chosen language may fall short. There is no reason to think -- at least, no reason that a court can accept at the pleading stage, before plaintiffs have access to discovery -- that the items mentioned in Baxter's cautionary language were those thought at the time to be the (or any of the) "important" sources of variance.

Id. at 13 (emphasis added).[21]

This Court also stated:

> [That cautionary language remained fixed even as risks changed] raises the possibility -- no greater confidence is possible before discovery -- that Baxter knew of important variables that would affect its forecasts, but omitted them from the cautionary language. . . . Thus this complaint could not be dismissed under the safe harbor. . . .

Id. at 14 (emphasis added).[22] The PSLRA's instruction that "on any motion to

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[21] See also Nursing Home Pension Fund v. Oracle Corp., 242 F. Supp. 2d 671, 679 (N.D. Cal. 2002) (whether risk warnings were meaningful "present[ed] factual issues beyond the purview of motion to dismiss"); Fidel v. Farley, Civ. No. 1:00-CV-48-M, 2001 U.S. Dist. LEXIS 9461, at *20 (W.D. Ky. June 22, 2001) (application of safe harbor is "factually complex question," "more appropriate for summary judgment").

[22] This Court further observed in Baxter that, if the market were fully informed of the pertinent risks, "it is hard to understand the sharp drop in the price of

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dismiss . . . the court shall consider . . . cautionary statement accompanying the forward-looking statement . . .” (15 U.S.C. §78u-5(e)) (emphasis added) does not require that the issue be decided in every case at the pleading stage.

Defendants also argue their projections are protected by the safe harbor because Plaintiffs purportedly fail to allege facts sufficient to establish Notebaert had “actual knowledge” the projections were false. (Def. Br. at 49-50) Yet, as demonstrated at length in Plaintiffs’ Opening Brief and herein, the SAC sets forth facts supporting a strong inference that each Defendant knew the adverse facts that rendered Defendants’ projections deceptive.

IV. THE DISTRICT COURT ERRED IN DISMISSING REPRESENTATIONS OF STRONG DEMAND FOR TELLABS’ CORE PRODUCTS AS IMMATERIAL PUFFERY

Defendants’ Class Period assurances that demand for TITAN 5500 was “still going strong” (JA135:¶91) and “remains strong” (JA139:¶99) and that demand for TITAN 6500 “is huge” (JA131:¶84) were clear and definite representations of current facts that were critical to any investor’s evaluation of Tellabs. Defendants’ assertion that “no reasonable investor” would rely on such management representations concerning the Company’s core products (Def. Br. at 50) is preposterous. Similar statements, including statements using the word “strong,”

(continued)
[defendant’s] stock.” Id. at 14. Here, upon the adverse disclosures at the end of the Class Period, the trading price of Tellabs stock fell, in one day, by more than 24% on unprecedented volume. (JA151-52:¶¶135, 137-39).

have been held actionable in other cases. See authorities cited in Opening Br. at 53 & n.45. See also Serabian v. Amoskeag Bank Shares, Inc., 24 F.3d 357, 364 (1st Cir. 1994) ("[o]ur loan review capabilities are strong"); In re Anicom Inc. Sec. Litig., [2000 Transfer Binder], Fed. Sec. L. Rep. (CCH), ¶ 91,458, at 96,739-96,741 (N.D. Ill. May 15, 2001) ("record growth"); Market St. Sec. v. Racing Champions Corp., [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,295, at 95,664 (N.D. Ill. Nov. 20, 2000) ("business expansion . . . will continue," "sales remain at an all time high," "orders . . . 'have been excellent,'" and "company should be able to 'again produce a year of strong growth'"); Evergreen Fund, Ltd. v. McCoy, Case No. 00C0767, 2000 U.S. Dist. LEXIS 16876, at *5, *19-20 (N.D. Ill. Nov. 1, 2000) ("enormous growth"); Danis v. USN Communications, Inc., 73 F. Supp. 2d 923, 933 (N.D. Ill. 1999) (description of company as "one of the fastest growing" actionable).[23]

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[23] Defendants' mistakenly rely on cases involving optimistic, forward-looking statements and ignore the representations of current fact in this case. See, e.g., Stransky v. Cummins Engine Co., 51 F.3d 1329 (7th Cir. 1995) ("While it often may be the case that predictions of growth are not material, we hesitate to impose a *per se* rule to this effect.") (emphasis added); Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993) (distinguishing false predictions of growth from "expressions of belief or opinion concerning current facts" which may be material under Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991)). Other cases cited by Defendants involved statements far less concrete than those complained of here. See Searls v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995) (statement that company was "recession-resistant"); Rosenzweig v. Azurix Corp., 332 F.3d 854, 860 (5th Cir. 2003) ("Our fundamentals are strong."); In re Allaire Corp. Sec. Litig., 224 F. Supp. 2d 319, 331 (D. Mass. 2002) (statement that software program (continued)

V. THE DISTRICT COURT PROPERLY UPHELD THE ACTIONABILITY OF DEFENDANTS' MISSTATEMENTS AND DECEPTIVE PRACTICES

A. The District Court Properly Upheld The Actionability Of Plaintiffs' Allegations Of Over-Inventorying And Back-Dating

The District Court correctly refused to dismiss Plaintiffs' allegations that "Tellabs over-inventoried its customers to falsely portray growing revenues and demand, and failed to disclose these facts to investors." (BA71; see also JA121-24:¶¶62-72) The District Court found:

- The allegations were supported by "at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want";
- The sources corroborated one another and were reliable;
- "Plaintiffs identify specific customers when Tellabs allegedly over-inventoried, namely Telcobuy and Verizon";
- Plaintiffs "even allege that Verizon's Chairman called Tellabs to complain about the channel stuffing";
- Plaintiffs "also identify the specific time periods of the over-inventorying";
- "Plaintiffs further allege that the channel stuffing of the TITAN 5500 was of an 'extraordinary' magnitude";
- "Plaintiffs allege that Notebaert worked directly with Tellabs sales personnel to effectuate the channel stuffing";
- "Tellabs engaged in these channel stuffing activities when they did not even have an agreement with the ultimate purchaser" of the product; and

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(continued)
"exceeded our expectations" held vague, but separate statement that software program was "fueling growth" held actionable).

- "Although customers did not need the products, Tellabs shipped them anyway."

(BA71) In short, the District Court determined that the allegations of over-inventorying were "more than general conclusions." (BA72)

Defendants' effort to dismiss the highly particularized allegations of over-inventorying as conclusory, innocuous, and insufficiently detailed falls flat. Defendants seek to dismiss as "innocuous" (Def. Br. at 42) allegations concerning such activities as shipping out "a tremendous amount of product during the last 6 weeks of the fourth quarter" (JA124:¶72) and "offering customers discounts" (JA123:¶69), ignoring that these activities were part of an overall scheme to conceal falling demand particularized in the SAC. See Cabletron, 311 F.3d at 24 (finding it reasonable to infer "that the timing of [a] disproportionate surge in returns [in the beginning of each quarter] was no coincidence, but was caused by attempts to inflate revenue in one quarter, albeit at the expense of the next one").

Defendants disregard other factual allegations corroborating their willful scheme to mask the Company's mounting difficulties, such as:

- The report of a former Tellabs operations manager, that, in January 2001, orders from Verizon significantly declined by roughly 50% because Verizon had been overloaded with TITAN 5500 products (JA114-15:¶35);
- The report of a former Tellabs marketing manager that Tellabs had excess TITAN 5500s on hand, and "tons" of excess TITAN 5500s in its Bollington warehouse in late 2000/early 2001 due to lack of customer demand because Tellabs had overloaded its customers (JA116-17:¶¶42, 45);
- Reports by a former Tellabs marketing manager, a former Tellabs senior business manager, and a former Tellabs customer service accounts

representative, of massive returns by Tellabs' major distributors and customers (JA122-23:¶¶66-68); and

- Reports of former Tellabs personnel involved in distribution and shipping that during the final weeks of the fourth quarter 2000 Tellabs distribution personnel worked around the clock to ship an extraordinary amount of product, and that as soon as the first quarter 2001 began, Tellabs had no orders and employees were told to go home early (JA124:¶72).

Defendants' demand for further evidentiary proof goes well beyond what the PSLRA requires.[24]

The District Court also correctly found that Plaintiffs' allegations that Defendants disguised declining demand by backdating sales were sufficiently "particularized . . . with support from a confidential source [a former Tellabs marketing manager] as well as examples" (BA72), "including pulling sales to larger customers such as SBC and Sprint from the first quarter 2001 into fourth quarter 2002 to make the numbers" (id.) (quoting JA124:¶70). In the face of allegations identifying specific major customers and the fiscal quarters affected, Defendants' contention that the backdating allegations lack "any factual details" (Def. Br. at 43) is unfounded.

In sum, the District Court concluded: "Plaintiffs have sufficiently

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[24] Defendants' attempt to dismiss as immaterial "millions of dollars of returns" (Def. Br. at 43 n.19; JA123:¶68) ignores allegations that "[c]hannel stuffing in December 2000 involving SBC alone amounted to roughly $20 million" (JA122:¶67), of which approximately $10 to $15 million was returned in 2001 (JA123:¶68). Moreover, as courts have widely recognized, questions of materiality involve issues of fact that are most appropriately left for the jury. Ganino v. Citizens Utils. Co., 228 F.3d 154, 162 (2d Cir. 2000).

particularized their allegations that Defendants engaged in channel stuffing in order to falsely portray Tellabs' [fourth quarter 2000] financials." (BA73) Tellabs' 2000 Form 10-K, which contained the deceptive financial statements, was signed by Birck and Notebaert, among others. (JA141:¶107)

B. The District Court Properly Upheld The Actionability Of Misstatements Regarding TITAN 5500

In response to a question at a March 8, 2001 analysts' conference whether Tellabs was experiencing "any weaknesses" with regard to the TITAN 5500, Notebaert stated: [25]

> No, we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance. . . [;] business continues to grow as usual.

(JA140:¶102) The District Court correctly declined to dismiss Notebaert's unqualified assurances as mere puffery. (BA64-65) The SAC details numerous facts evidencing that, when Notebaert made these assurances, demand for the TITAN 5500 already was declining. See Opening Br. at 8-10. These allegations

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[25] Defendants' passing reference to group pleading (Def. Br. at 10 n.4) is beside the point inasmuch as Notebaert and Birck made direct statements for which they are unquestionably responsible. In any event, numerous courts, including courts in this Circuit, continue to recognize the viability of the group pleading doctrine. See, e.g., In re Spiegel, Inc. Secs. Litig., No. 02 8946, 2004 U.S. Dist. LEXIS 12648 (N.D. Ill. July 9, 2004); In re NeoPharm, Inc. Sec. Litig., No. 02 C 2976, 2003 U.S. Dist. LEXIS 1862 (N.D. Ill. Feb. 7, 2003); Sutton v. Bernard, [2001 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶91,519, at 97,249 n.5 (N.D. Ill. Aug. 6, 2001) ("many courts continue to rely on group pleading doctrine") (citing cases); Lindelow v. Hill, No. 00 C 3727, 2001 U.S. Dist. LEXIS 10301, at *7-8 (N.D. Ill. July 20, 2001).

include information from at least twelve independent sources, and details concerning a widely circulated and discussed Tellabs marketing strategy report that concluded TITAN 5500 revenue would fall by about $400 million. Id.

C. The District Court Properly Upheld The Actionability Of Misstatements Regarding TITAN 6500

The District Court also appropriately upheld the actionability of Defendants' statements that the "TITAN 6500 system is available now" (December 11, 2000 press release) (JA125:¶73), that "[i]nterest in and demand for the 6500 continues to grow . . . . We are satisfying very strong demand and growing customer demand." (Notebaert, March 8, 2001 analyst conference call) (JA139:¶100), and that "[t]he demand [for TITAN 6500] is very strong" (Notebaert, April 6, 2001 analysts' conference call) (JA145:¶117). See Opening Br. at 14-15. As the District Court observed:

> Plaintiffs have provided particularized allegations that contradict Defendants' affirmative representations regarding the demand, acceptance, and development of the TITAN 6500.

(BA67). See Opening Br. at 10-12.

By any reasonable definition, TITAN 6500 was not "available now"[26]

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[26] "Available" is variously defined as "present or ready for immediate use" (Merriam Webster on-line dictionary); "present and ready for use" (The American Heritage Dictionary of the English Language, 4th Edition 2000); and "suitable or ready for use" (Random House Unabridged Dictionary, unabridged ed. 1987). At (continued)

(December 2000) given that (i) according to a former high level Tellabs sales executive, by October 2001, there had only been a couple of trials of TITAN 6500 (JA117:¶48); (ii) according to a former Tellabs distribution employee, the Company did not even have the product in its warehouse until after mid-September 2001 (JA118:¶48); (iii) according to a former Tellabs project manager, TITAN 6500 was not a released, saleable product until two months after the Class Period (id.); (iv) according to a former Tellabs executive account manager, in the fourth quarter 2000 and first quarter 2001, Tellabs product managers were working to fix TITAN 6500's defects and hoped to release it in first quarter 2002 (JA118:¶51); and (v) according to a former high-level Tellabs sales executive, TITAN 6500 "was not even close to being ready" (JA119:¶53). See Opening Br. at 10-12.

A strained, "specialized" reading of "available" is inappropriate. See Aldridge, 284 F.3d at 80 (although defendants possibly "used the term 'price protection' in some specialized narrow sense[,] it is just as likely, if not more likely, that [plaintiff's] more common definition of price protection is what was meant").

Defendants attempt to spin a defense out of a distorted reading of Plaintiffs' allegation that "Pullen [then Senior Vice President of Product Development] made

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(continued)
most, as the District Court recognized: "[T]he meaning of 'available now' is a factual issue. . . ." (BA66)

numerous visits to TITAN 6500 customers in connection with failed evaluation problems." (JA118:¶50) The SAC makes clear the allegation refers to "numerous visits," not "numerous customers," as Defendants try to construe it. The allegation confirms that TITAN 6500 was not working, not that there was strong demand for it.

VI. THE DISTRICT COURT ERRED IN DISMISSING THE CONTROL PERSON AND INSIDER TRADING CLAIMS

Plaintiffs and Defendants apparently agree that the viability of Plaintiffs' control person and insider trading claims depends on whether the Court upholds predicate violations. Plaintiffs have adequately alleged such violations.

CONCLUSION

For the reasons stated herein and in Plaintiffs/Appellants' Opening Brief, the District Court's dismissal of the SAC should be reversed and Defendants' motion to dismiss denied.

Dated: July 30, 2004

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 6,934 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2002 in 14-Point Times New Roman.

Dated: July 30, 2004

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Attorney for Plaintiffs-Appellants

CERTIFICATE OF COMPLIANCE WITH CIRCUIT RULE 31(e)

Pursuant to Rule 31(e) of the Circuit Rules of the United States Court of Appeals for the Seventh Circuit, the undersigned, an attorney associated with the firm of Milberg Weiss Bershad & Schulman LLP, hereby certifies that the Brief Table of Contents, Table of Authorities, Brief, and Certificates of Compliance have been provided in electronic format.

Dated: July 30, 2004

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Attorney for Plaintiffs-Appellants