No. 04-1687

United States Court of Appeals
for the Seventh Circuit

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.

Remand from the United States Supreme Court, No. 06-484

SUPPLEMENTAL BRIEF OF DEFENDANTS-APPELLEES

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Pursuant to the Court's August 30, 2007 order, Defendants-Appellees respectfully submit this supplemental brief addressed to the question whether, under the standard adopted by the United States Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the allegations in Plaintiffs' Second Consolidated Amended Class Action Complaint ("Complaint") "warrant a strong inference that Notebaert and Tellabs acted with the required state of mind, 15 U.S.C. § 78u-4(b)(2)." As explained below, the allegations do not meet that new standard. In particular, the Complaint fails to create an inference of Notebaert's scienter that is more than merely "reasonable," but "cogent and compelling," and "at least as compelling as any opposing inference of nonfraudulent intent." *Id.* at 2504-05. And, in the absence of Notebaert's scienter, the derivative claim of scienter against Tellabs also fails, together with the rest of the remaining claims.

INTRODUCTION

The Supreme Court's decision in *Tellabs* significantly alters this Court's prior approach to determining whether a complaint gives rise to a "strong inference" of scienter, as required by the Private Securities Litigation Reform Act ("PSLRA"). Most importantly, the Supreme Court explained:

> The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite "strong inference" of scienter, a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff.

Tellabs, 127 S. Ct. at 2510. Thus, the central difference between this Court's present task and this Court's prior review of the adequacy of the Complaint is the need to consider and weigh plausible inferences of a nonculpable mental state that emerge from the record.[1]

In their Supplemental Brief, Plaintiffs make no effort to grapple with the opposing inferences of innocence. Plaintiffs provide but a partial analysis of the record – only attempting to draw inferences in their favor – because when the record is considered as a whole in light of the plausible competing inferences, any inference that Tellabs' then-CEO, Richard Notebaert, acted with scienter is not compelling.

Whether the Complaint alleges facts giving rise to a "strong inference" that Notebaert acted with scienter is the sole issue for this Court at this stage of the proceedings.[2] Yet much of Plaintiffs' Supplemental Brief is little more than a wholesale

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[1] This Court previously viewed itself as potentially constrained by the Seventh Amendment in undertaking such an exercise. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006). The Supreme Court concluded that the Seventh Amendment provides no obstacle to a "comparative assessment of plausible inferences." *Tellabs*, 127 S. Ct. at 2511-12.

[2] In the initial appeal, Plaintiffs abandoned their Rule 10b-5 claims against all defendants other than Notebaert, Tellabs and Birck (Tellabs' Board Chairman). This Court, in turn, dismissed the Rule 10b-5 claims against Birck, finding that the allegations of scienter against him were insufficient. *Makor*, 437 F.3d at 604. Because the Supreme Court adopted a more rigorous scienter standard than that used by this Court in its prior opinion, the previous ruling as to Birck's scienter is unaffected. Plaintiffs have not suggested otherwise. This Court also previously predicated Tellabs' potential Rule 10b-5 liability on the adequacy of the scienter claim against Notebaert. *Id.* at 605. Accordingly, the sufficiency of the allegations with respect to Notebaert's scienter is the key with respect to all of the remaining Rule 10b-5 claims.

(continued)

repetition of allegations from various anonymous sources without regard to whether such sources or allegations concern Notebaert at all, much less his mental state. Indeed, various of Plaintiffs' allegations concern matters that either clearly pre-date Notebaert's tenure – he did not even become Chief Executive Officer of the Company until September 2000 (JA 110, ¶ 20) – or are at best ambiguous as to their timing. Yet rather than focus on those matters this Court previous relied upon in finding certain allegations of the Complaint adequate as to Notebaert, Plaintiffs now take a kitchen-sink approach, in an apparent effort to dissuade close analysis. As discussed below, however, a rigorous examination of the allegations reveals how little they say at all about Notebaert's mental state and how far they fall short of creating a "compelling inference" of scienter.

Indeed, while Plaintiffs emphasize the sheer number of their alleged anonymous sources, strikingly few of those anonymous sources purport to have anything at all to say about Notebaert. In fact, there are only four confidential sources that speak about Notebaert at all, other than with respect to the SALIX product line (which Plaintiffs acknowledge is no longer at issue, Pls.' Supp. Br., p. 3, n.3). Those four anonymous sources are CS-3, CS-6, CS-15 and CS-21. Two of those, CS-15 and CS-21, offer nothing

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Defendants-Appellees have previously informed the Court that there are certain other grounds for dismissal, apart from scienter, that have been raised and were pending in the District Court at the time of the Supreme Court's decision in this case, including loss causation grounds with respect to various allegations. *(See* Circuit Rule 54 Statement of Defendants-Appellees, pp. 4-6.) Because this Court has requested supplemental briefing only as to the issue of scienter, Defendants-Appellees have not addressed these other issues here.

more than the general and unparticularized assertion that Notebaert stayed on top of the Company's business and financial condition – a generic allegation that could routinely be made with respect to any senior executive. Numerous cases have recognized that such allegations do not support an inference of scienter, much less a strong one. *E.g., In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999); *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir. 2002). That leaves only two sources, CS-3 and CS-6, and these sources *are not even alleged to have had any personal knowledge* of what Notebaert was told, or did, or knew. As discussed more fully below, none of the sources, either individually or taken together, provide enough about Notebaert's mental state to give rise to a "strong inference" of scienter.

Moreover, it bears emphasizing that Plaintiffs' allegations supposedly supporting Notebaert's scienter are based *solely* on information purportedly from these anonymous sources. This Court recently held that *Tellabs* requires courts to "discount allegations that the complaint attributes to [] 'confidential sources.'" *Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 756 (7th Cir. 2007). As in *Higginbotham*, the anonymous sources in this case do not "corroborate or disambiguate evidence from disclosed sources." *Higginbotham*, 495 F.3d at 757 (emphasis added). Nor are their key assertions allegedly bearing on Notebaert's scienter corroborated by any documents, matters of public record or other such facts. (While Plaintiffs assert that the sources' claims are "corroborated by other facts in the SAC" (Pls.' Supp. Br., p. 5), there are no such other "facts"). As in *Higginbotham*, the Complaint here does not offer any "concrete evidence"

to support even the weak allegations regarding Notebaert's alleged scienter attributed to the various anonymous sources. *Id*.

In any event, the Complaint's claim of Notebaert's scienter fails whether one "discounts" allegations from confidential sources or not. Under the standard it previously employed, this Court found that the Complaint adequately alleged facts supporting a claim of Notebaert's scienter with respect to three categories of statements: (1) March 7 and April 6, 2001 statements regarding continued demand for the TITAN 5500; (2) the fourth quarter 2000 Tellabs financial statements, which allegedly included revenue from the shipment of unordered products; and (3) certain statements regarding the "availability" and shipment of the TITAN 6500.[3] As discussed in detail in Sections II, III, and IV below, when *all* potential inferences (not just those favorable to Plaintiffs) are now considered with respect to each of these matters, and when pleading ambiguities count against Plaintiffs, rather than in their favor, the claim that Notebaert knowingly participated in some short-lived fraud having no potential benefit at all for him – and which he himself is alleged to have brought to an end in a matter of months by disclosing "the truth" (*i.e.*, reduced projections) – is far from "compelling."

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[3] This Court had found that Tellabs' revenue projections during the Class Period were also potentially actionable. *See Makor*, 437 F.3d at 598-99. As this Court previously observed, and as Plaintiffs acknowledge, the same scienter allegations that apply to the statements regarding the TITAN 5500 apply to Plaintiffs' claim that Tellabs' revenue projections during the Class Period were overstated. (*See* Pls.' Supp. Br., p. 14, citing *Makor*, 437 F.3d at 605.) However, with respect to the projections, Plaintiffs must allege facts showing that Notebaert had actual knowledge that the projections were false; allegations of recklessness do not suffice. *See* 15 U.S.C. § 78u-5(c)(1)(B)(i).

ARGUMENT

I. The Standard For Pleading A "Strong Inference" Of Scienter Under *Tellabs.*

The Supreme Court has now made clear that to determine whether a complaint alleges facts which give rise to a "strong inference" that a defendant acted with scienter, as required by the PSLRA, 15 U.S.C. § 78u-4(b)(2), a court must consider not only any plaintiff-friendly inferences of scienter, but also any plausible nonfraudulent explanations that emerge from the record. It is therefore not sufficient for a court only to examine what reasonable inferences may be drawn in favor of the plaintiff, and then ask whether those favorable inferences could, when added up, support a finding of the requisite state of mind. Rather, the question whether an inference is "strong," the Court has explained, is "inherently comparative," *Tellabs*, 127 S. Ct. at 2510, and, as a result, "a court … must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged." *Id.* at 2504. In the end, to qualify as "strong," the Court explained, "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Id.* at 2504-05; *see also id.* at 2510.

The Supreme Court also provided guidance with respect to determining whether an inference of scienter is ultimately sufficiently "cogent and compelling" to survive. As Plaintiffs correctly note, courts should consider the allegations in the full context supplied by the complaint and other documents properly considered on a motion to dismiss. *Id.* at 2509. But Plaintiffs ignore the fact that the Court also emphasized that "omissions and ambiguities" with respect to the matters alleged to establish scienter

"count against inferring scienter." *Id* at 2511. Thus, for example, if significant interstitial details are omitted – as is the case here, for example, with respect to the issue of the timing of certain reports, where timing is of critical importance – it is no longer appropriate to fill that gap with the presumption of plaintiff-friendly inferences. Nor if a plaintiff employs ambiguity in his allegations is an inference favorably resolving the ambiguity to be assumed. Further, while the Supreme Court noted that the absence of any apparent motive to engage in fraud is not necessarily fatal, it is clear that motive – or lack thereof – remains a relevant consideration in assessing the strength of scienter allegations as compared to plausible inferences of innocence. *Id*.; *cf. Higginbotham*, 495 F.3d at 759.

This Court has further elaborated on the substance of the "cogent and compelling" standard of *Tellabs*. In *Higginbotham*, this Court explained that "[i]t is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences," because "anonymity conceals information that is essential to the sort of comparative evaluation required by *Tellabs*." 495 F.3d at 757.[4] Thus, in assessing the strength of scienter allegations, allegations from

[4] Plaintiffs attempt to distinguish *Higginbotham* on the ground that the complaint there supposedly described the roles of the five confidential sources with less detail than the Complaint here. (Pls.' Supp. Br., p. 4, n.4.) Not only did this play no role in the *Higginbotham* opinion, there is, in fact, no meaningful distinction in the level of description provided. According to Plaintiffs, the *Baxter* complaint described each of its confidential sources, in several instances characterizing the putative source as a "former Baxter executive," and describing when and where the individual allegedly worked. Plaintiffs typically provide no more information here. For example, CS-3 is described only as a former "high-level Tellabs sales executive" and CS-6 as a former "Tellabs

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confidential sources should not be ignored, but must be "discounted," and "[u]sually that discount will be steep." *Id.* at 757.

These background legal principles provide the framework for considering whether the allegations of the Complaint, in light of all the properly considered material before the Court, give rise to a strong inference of scienter. As discussed below, they do not.

II. Statements Regarding Demand For The TITAN 5500.

A. The allegations on which this Court previously relied in finding a strong inference of scienter are not sufficient under *Tellabs.*

This Court previously found that the Complaint's allegations were sufficient to support a claim that Notebaert acted with scienter in making statements on March 7

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senior business manager." (*See* JA 122, ¶¶ 63, 67.)

Plaintiffs also attempt to distinguish *Higginbotham* on the basis of Plaintiffs' supposed "willingness to disclose the[] identity" of their confidential sources. (*See* Pls.' Supp. Br., p. 5.) But the holding in *Higginbotham* does not rest on whether a plaintiff is willing, when pressed by the defendant, to represent that it may *eventually* reveal the identity of its confidential sources – once it has gotten past a motion to dismiss. Rather, as this Court explained, *if* a plaintiff elects to use anonymous sources at the motion to dismiss stage, it deprives the court and defendant of critical information potentially important for a meaningful weighing of inferences: "[t]o determine whether a 'strong' inference of scienter has been established, the judiciary must evaluate what *the complaint* reveals and disregard what it conceals." *Id* (emphasis added). A plaintiff's willingness to disclose such information only *after* concealing it has served the purpose of surviving a motion to dismiss only underscores the potentially tactical use of anonymity. In any event, Plaintiffs' extra-record representation that they have indicated a willingness to disclose the identity of their confidential sources is misleading. (*See* Pls.' Supp. Br., p. 3, n.2.) After this Court issued its opinion reversing the dismissal by the District Court, the parties began limited discovery, including initial disclosures. Although the confidential sources may be among the 81 witnesses listed in Plaintiffs' initial disclosures, in their response to defendants' interrogatories Plaintiffs flatly refused to identify within this haystack which witness is which confidential source.

and April 6, 2001 regarding continued demand for the TITAN 5500. *See Makor,* 437 F.3d at 603.[5] In reaching that determination, this Court relied upon allegations that a report commissioned from Probe Research revealed, "'in or about early 2001,' that the market for the TITAN 5500 had faded," and that, in reaction to this news, "Tellabs' marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million." *Id.* This Court also pointed to an allegation that "internal reports revealed by March 2001 that the market for the 5500 was drying up." *Id.* The Court acknowledged the vagueness in the allegations regarding the timing of both the Probe Research report and the internal reports. *See id.*; *see also* JA 115, ¶ 39 (alleging that the Probe Research report was completed "in or about early 2001"); JA 116, ¶ 40 (not specifying when in March 2001 the internal reports were generated). The Court also acknowledged that it was "conceivable" that Notebaert had yet to see these reports when he made the statements at issue. *Makor*, 437 F.3d at 603. (In fact, the Complaint contains no allegation that he had seen the reports at the time of either of his statements

[5] This Court also found that a February 2001 statement in Tellabs' 2000 Annual Report that the TITAN 5500 was "still going strong" was factual in nature and therefore could be actionable. *Makor*, 437 F.3d at 597. However, when it later evaluated the claims of scienter, this Court concluded that "it was not until March 2001 that the TITAN 5500's declining status was obvious." *Id.* at 603. Plaintiffs assert that this holding is limited to Birck, and does not apply to Notebaert. *See* Pls.' Supp. Br., p. 8, n.8. But this Court observed that "it was not until March 2001 that the TITAN 5500's declining status was obvious" only after assessing the strength of the Complaint's scienter allegations as to *Notebaert*. *See Makor*, 437 F.3d at 603. In that assessment, this Court focused on allegations regarding internal reports that allegedly revealed "by March 2001" that the market for the TITAN 5500 was declining, which reports it determined Notebaert could be inferred to have seen. *Id.*

in early March or early April.) Nonetheless, in light of the significance of the TITAN 5500 and Notebaert's alleged practice of staying on top of the Company's financial health, the Court found that there was "enough for a reasonable person" potentially to infer that Notebaert "knew that his statements were false." For this Court, then, it was "sufficiently probable" that Notebaert acted with scienter. *Makor*, 437 F.3d at 603.

In light of the new approach for evaluating the allegations of a securities fraud complaint set forth in *Tellabs*, these allegations can no longer be said to meet the PSLRA's "strong inference" standard. That a reasonable person could potentially draw certain plaintiff-friendly inferences is not enough; a court must consider the plausible innocent inferences, and compare the two. *Tellabs*, 127 S. Ct. at 2504, 2509-10. Under the new approach, there are at least five fundamental reasons why the Complaint fails to give rise to a "compelling inference" that Notebaert acted with scienter with regard to his statements concerning customer demand for the TITAN 5500 on March 7 and April 6, 2001.

1. Under *Tellabs*, "omissions and ambiguities count against inferring scienter." *Tellabs*, 127 S. Ct. at 2511. This Court could previously push past the critical ambiguity with respect to the timing of the reports upon which it was relying. *See Makor*, 437 F.3d at 603. Refusing to penalize the plaintiff for such ambiguity found support in the general rule that all reasonable potential inferences in a pleading should be drawn in favor of the plaintiff. But the PSLRA creates a different rule. *Tellabs*, 127 S. Ct. at 2511. Plaintiffs can no longer rely on favorable speculation that the conclusions in the Probe Research report and internal March reports were known to Notebaert at the time he

made the statements in dispute. That is particularly evident with respect to Notebaert's March 7, 2001 statement. As noted above, neither the Probe Research report nor the March 2001 internal reports are even alleged to have been in existence at the time of this March 7 statement. The Complaint seeks to skirt this critical issue of timing by using the ambiguous phrase – "in or about early 2001," and a reference to an unspecified time in March 2001. Now that such ambiguity counts against Plaintiffs, not in their favor, such phrases do not suffice to create a compelling inference of Notebaert's knowledge of these matters as of March 7 (or even as of April 6).

2. The sequence of events, considered in totality, supports the opposing inference that Notebaert was processing information regarding demand for the TITAN 5500 as he became aware of it and truthfully disclosing it to the market in a timely fashion. Indeed, it is undisputed that by mid-April 2001, Notebaert himself publicly disclosed to the market information capturing all of what allegedly was contained in the Probe Research report and March 2001 internal reports. This gives rise to an opposing inference that Plaintiffs all but ignore in their Supplemental Brief – and which this Court never considered because of its prior non-comparative mode of analysis. Yet the notion that Notebaert would fraudulently hide new downward estimates of demand in two of his statements regarding the TITAN 5500, but then himself reveal the new information *within a matter of days*, is far less plausible than an inference of nonfraudulent intent. The sequence of events is telling.

Starting on March 7, 2001, and continuing through the end of the class period (June 19, 2001), Tellabs revised its projections downward several times. Tellabs initially

revised downward its projections for the first quarter of 2001 on March 7, 2001, primarily citing below-trend growth in its CABLESPAN business (a separate business line that is not the subject of any allegations here). (R.49, Tab 1.)[6] While these revisions were unrelated to demand for the TITAN 5500, they show that Tellabs was delivering to the public information regarding declining performance during the class period. And, there is no reason to believe (nor any allegation) that Notebaert had seen *any* reports concerning declining demand for the TITAN 5500 by so early in March 2001. As noted above, the ambiguity of the dates alleged regarding the reports at issue counts against Plaintiffs here.

On April 6, 2001, Tellabs announced a more significant reduction in its first quarter guidance, projecting sales for that quarter of about $772 million, compared with prior guidance in the range of $830 million to $865 million. (*See* R.49, Tab 17.) In its April 6 press release, the Company stated that "[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." *Id.* During a call with analysts that same day, Notebaert provided additional details. He explained that in the last two and a half weeks of the quarter, *i.e.*, a period following March 7, certain customers had pushed some TITAN 5500 orders into the next quarter. (R.49, Tab. 2, p. 3.) He further stated that, "[c]learly, the environment has resulted in

[6] Tellabs also noted an inability to recognize revenue in the quarter from shipments of its new TITAN 6500 system.

near term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent." *Id.*

In light of the ambiguity regarding the timing of the reports of declining customer demand, it is significant that on April 6 Notebaert was discussing information that he received "late in the quarter," and specifically the last two and a half weeks of the quarter, concerning customers. That timeframe corresponds to late March, which is shortly before the April 6 disclosure, and which fits comfortably with the allegation that internal marketing reports were showing declining demand in "March 2001." (JA 116, ¶ 40.) It is also significant that the April 6, 2001 reduction of first quarter guidance, and accompanying cautionary notes, were volunteered by Notebaert and Tellabs, instead of waiting to release finalized results twelve days later, even though there is, in general, no obligation under the securities law to update projections. *See Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331-32 (7th Cir. 1995). It is difficult to understand why Notebaert would have do so, instead of simply remaining quiet, if he were attempting to hide difficulties from the market and deceive the public.

Less than two weeks later, on April 18, 2001, Tellabs announced its first quarter financial results. (R.49, Tab 18.) Although below original guidance, the results showed that the Company was still experiencing significant growth, with an increase in sales for the quarter of 21% over the same quarter from the prior year. (*Id.*) Still, the Company reduced its full-year revenue projections from approximately $4.4 billion to a range of $3.6 to $3.7 billion. (*Id.*) Significantly, *this reduction is twice as large as the $400 million reduction that this Court previously noted is alleged to have been forecast by Tellabs' marketing*

department sometime in March. Makor, 437 F.3d at 603. The Company explicitly attributed the revised projections to "reduced and deferred spending by the major communications carriers." (R.49, Tab 18.) Later that day, Notebaert once again indicated that he was responding to new information coming to him only recently, telling analysts:

> Declining business trends we experienced late in the quarter indicate[] that we are operating in a very different environment than we were just a few short months ago. In fact, a very different environment than it was just a few weeks ago. Our customers are reviewing, and in some cases, reducing capital spending plans ….

(R.49, Tab 19, pp. 1-2.)

Again, it is difficult to understand why Notebaert would (1) voluntarily, publicly reduce annual guidance on April 18, (2) by twice as much as the reductions Plaintiffs claim had recently been internally estimated, and (3) inform the market of declining business trends and reduced customer spending, if he were in the midst of some fraud designed to disguise and withhold such adverse information and had allegedly been perpetrating the fraud just days before.

Finally, on June 19, 2001, about a month before the scheduled release of its second quarter earnings, Tellabs announced substantial reductions in its guidance for the second quarter and also withdrew its prior guidance for the remainder of 2001.[7] (JA 150, ¶ 131.) (The Complaint alleges that the "truth" became known by virtue of this

[7] According to the Complaint, the revenue shortfall was "due almost entirely" to a reduction in sales of the TITAN 5500. (JA 150, ¶ 132.)

June 19, 2001 announcement; Plaintiffs do not allege any false or misleading statements between April 18 and June 19, 2001.) Again, this was not an instance of Notebaert and the Company waiting to report the Company's financial results, as they could have done. Instead, once again adverse estimates were voluntarily brought to the market's attention in advance of any legal requirement to do so.

In sum, four times within a span of approximately three and a half months (March 7-June 19, 2001), and three times in a span of six weeks (March 7-April 18, 2001), Notebaert voluntarily reported setbacks and reduced estimates to the market. This record makes an inference of his nonfraudulent intent far more compelling than any inference that he acted with scienter in his statements on March 7 and April 6, or any theory that he was attempting to lie about a known downturn at those times. Indeed, in this respect the record here is similar to that recently evaluated by the Third Circuit in *Winer Family Trust v. Queen*, ___ F.3d ___, No. 05-3622, 2007 WL 2753734 (3d Cir. Sept. 24, 2007). In *Winer*, the plaintiff alleged that a February 2002 press release fraudulently failed to disclose the full extent of projected renovation costs. *Id.* at *6. But the record revealed that the defendant publicly revised those cost projections upward in April 2002 and again in May 2002. *Id.* at *7. Given the fact that the defendant had reported the information in question, that such reporting had occurred not very long after the time plaintiff claimed it should have been made, and that defendant had revised projections on more than one occasion, the Court concluded that a nonculpable inference – *i.e.*, that defendant was disclosing information as he gradually became aware of it – was more

compelling than an inference that the February 2002 statement had been knowingly false. So too here.

3. The Complaint (JA 144, ¶114) plucks out an excerpt of a statement by Notebaert made during Tellabs' April 6, 2001 analysts' conference call: "everything we hear from the customers indicates that our in-user demand for services continues to grow." In its prior opinion, this Court likewise pointed to this excerpt as a statement from which Notebaert's scienter could potentially be inferred. *Makor*, 437 F.3d at 603. But when the statement is read in full context, and competing inferences considered, the purported inference of Notebaert's scienter is far from "compelling." At most, Plaintiffs have manufactured an ambiguity, but that does not suffice to give rise to a "strong inference" of scienter.

The persons whose growing demand for services was being referred to by Notebaert were *not* Tellabs' customers, but rather those using the services provided *by* Tellabs' customers, *i.e.*, internet users. (Tellabs occupied a product niche, and a focal point of its products was providing switching equipment for internet service providers. (*See* R.74, Tab 4, p. 3.)) Thus, the statement in question does not say that customer demand is growing; it explicitly states that it is "end-user"[8] demand that continues to

[8] As Plaintiffs acknowledge in their Supplemental Brief, the Complaint misquotes "end-user" as "in-user," as the transcript shows. (Pls.' Supp. Br., p. 10; *see also* R.74, Tab 3, p.2.) The full transcript is properly considered in connection with the motion to dismiss. *See Venture Assocs. Corp. v. Zenith Data Sys. Corp.*, 987 F.2d 429, 431 (7th Cir. 1993); *see also Tellabs*, 127 S. Ct. at 2509. In any event, whether the phrase is "end-user" or "in-user" the meaning is the same.

grow. Nor does the statement refer to products, which is what Tellabs sold to its customers; it refers to "services," which was precisely what Tellabs' customers provided to *their* internet-user customers. Indeed, the very next sentence in the transcript – which the Complaint neglected to quote – makes clear that Notebaert was referring to the demand faced *by* Tellabs' customers: "Fortunately for Tellabs, our TITAN family of products helps *our carrier customers meet this demand* in a cost effective way…." (R.74, Tab 3, p.2.)

What prompted these comments by Notebaert about the underlying demand faced by Tellabs' customers was, as the transcript makes clear, precisely the fact that Notebaert had disclosed that Tellabs had recently "experienced a more controlled order flow from our larger customers than we had originally anticipated. " (R.74, Tab 3, p. 1.) And Notebaert cautioned that Tellabs' customers were "exercising a high degree of prudence over every dollar spent." (R.74, Tab 3, p. 2.)

In sum, read in context, what Notebaert was saying was that while Tellabs' own customers had recently deferred orders, and were exercising a new-found caution in purchasing equipment from Tellabs, there was a potential silver lining in this cloud because Tellabs' customers themselves continued to face growing demand (*i.e.*, burgeoning internet usage) which they would have to meet. At a minimum, this innocent inference better accords with both the language used by Notebaert and the context than the inference of fraud suggested by Plaintiffs.

Plaintiffs oddly argue that there is no support in the record for the suggestion that Notebaert's statement refers to the customers of Tellabs' customers. (*See* Pls.' Supp.

Br., p. 10, n.10.) But the support is the statement itself, read in the full context of the transcript, which is properly before the Court. *See* p. 16, n.8, *supra*. Nor is this a matter of seeking to resolve factual issues at the pleading stage, as Plaintiffs assert. (Pls.' Supp. Br., p. 10, n.10.) Instead, it is a matter of acknowledging and weighing the relative strength of competing, potential inferences – precisely the task that the Supreme Court has held is required at the pleading stage when evaluating allegations of scienter.

Finally, if Notebaert were attempting to deceive the market regarding demand for the TITAN 5500 in his statements on April 6, 2001, one has to ask why would he be informing the market that Tellabs had recently "experienced a more controlled order flow from our larger customers than we had originally anticipated," informing it that the environment was resulting in customers exercising new caution in purchasing, and informing it of reduced guidance for the first quarter of 2001 due to these developments. These actions do not easily comport with a theory that a fraudulent attempt to hide known problems was underfoot. Weighing these competing inferences too against any inferences of fraud, once again the inferences of fraud are not at least equally "compelling."

4. At the time of Notebaert's April 6 statement, the Company was still projecting first quarter revenues of 21% over the same period in the prior year. (*See* R.74, Tab 3, p. 2.) The Company ultimately reported that level of growth for the quarter. (R.49, Tab 18.) While this increase was less than the 30% that Tellabs had originally projected, it still reflected robust growth. And, significantly, the Complaint nowhere alleges that this level of growth was inaccurate. Unlike the uncorroborated allegations attributed to

Plaintiffs' anonymous sources, this is "concrete" evidence. Accordingly, even if Notebaert's April 6 statement were construed as involving the growth of customer demand – which it was not – the fact that demand was continuing to grow is supported by these results. Moreover, the record also contains much that supports the inference that Notebaert honestly believed that Tellabs was positioned differently in the marketplace from other suppliers to major telecommunications carriers – because of its focus on internet traffic, which was indisputably growing – and thus would not experience a decline in demand notwithstanding the telecommunications sector's widely known problems at the time. On March 7, Notebaert specifically explained that Tellabs was in a "product niche" within the telecommunications sector, and that he had not seen any "indication from any [of Tellabs'] major customers of a downturn in this segment we are in and in our niche." (R.49, Tab 16, p. 5.)

In their supplemental brief, Plaintiffs attempt to argue that Tellabs' first quarter financials would not reflect the decline in demand because, they claim, under Tellabs' standard for revenue recognition, "a decline in demand would affect revenues on a delayed basis." (Pls.' Supp. Br., p. 16.)[9] This assertion is pure speculation, however, and finds no support in the Complaint. It also is contradicted by the record. On April 6, Tellabs announced that a fall off in demand in the last two and a half weeks of the first

[9] Plaintiffs also confuse matters in seeking to downplay the undisputed fact that Tellabs' revenues increased by 21% in the first quarter of 2001 over the same quarter in the previous year by presenting data for the same periods with respect to net earnings, not revenue. (Pls.' Br., p. 16, n.15.)

quarter of 2001 had an immediate impact, reducing revenue for that quarter. (*See* R.49, Tab 17, p. 1.)

5. The alternative nonfraudulent inferences available here are further significantly strengthened by the Complaint's utter failure to identify any plausible motive for Notebaert to have been lying to the market for some brief period of time regarding demand for the TITAN 5500. The period of the fraud posited by Plaintiffs is approximately six months, *i.e.*, from December 11, 2000 to June 19, 2001. On the matter of demand for the TITAN 5500, however, the period in question may be six weeks (*i.e.*, March 7 – April 18, 2001) or less, given that the Court previously concluded that it was not until March 2001 that the reduction in demand may have been "obvious" and on April 18, 2001 Notebaert informed the market of severely reduced demand and a very large reduction in estimated annual sales.

Regardless of the period analyzed, though, the Complaint does not allege that Notebaert personally benefited financially in any way, through stock sales or otherwise, during the period that the stock price allegedly was artificially inflated. While the absence of any such allegation of motive, standing alone, is not fatal, it also cannot be ignored. *See Tellabs*, 127 S. Ct. at 2511; *see also Higginbotham*, 495 F.3d at 759 ("One possible inference is that the *absence* of sales by … managers who would have been in the know … implies that nothing was thought to be out of the ordinary …"). Nor does the Complaint allege that Tellabs benefited in any way. Plaintiffs do not allege that there were any Company activities during this limited period of time – such as

offerings, mergers, or exchanges – that would somehow have been facilitated by an artificially inflated stock price.

What is left is a theory of a short-lived scheme producing no interim benefits and having no apparent purpose, and brought to an end through disclosures by the very person claimed to be its engineer. All of this strongly supports a nonfraudulent inference, and renders any competing inference of fraud not only less than compelling but irrational. *Cf. DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990).

Plaintiffs' attempts to counter this complete lack of any motive as to Notebaert are telling. First, they state that "discovery might well reveal that Notebaert had a financial motive that is not yet publicly known." (Pls.' Supp. Br., p. 21, n.23.) But the PSLRA was designed to prevent plaintiffs from getting past the pleading stage based on the mere possibility that discovery might yield evidence of fraudulent intent. *See* 15 U.S.C. § 78u-4(b)(3)(B); *see also* S. Rep. No. 104-98, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693. Second, they assert – with no factual basis – that Notebaert's "livelihood and business reputation depended on the Company's success." (Pls.' Supp. Br., p. 21.) But these are exactly the sort of generic allegations, which could be asserted in every case, that have long been rejected. *See, e.g., Novak v. Kasaks*, 216 F.3d 300, 307-08 (2d Cir. 2000). And more fundamentally, the generic assertion makes no sense where, as here, there is only a short period of delay before the bad news arrives. Plaintiffs do not, because they cannot, for example, explain why Notebaert's "livelihood and business reputation" were somehow better off by revealing an $800 million reduction in annual

estimates on April 18, 2001 rather than on March 7 or April 6, 2001, if he had had the information at those earlier times.

Finally, Plaintiffs point to the fact that *other* Tellabs executives profited from the alleged artificial inflation of Tellabs' stock. (Pls.' Supp. Br., p. 21, n.23.) But the District Court already found that the stock sales by these insiders during the Class Period were *not* unusual and did not give rise to a strong inference of scienter. *See Johnson v. Tellabs*, 303 F. Supp. 2d 941, 962 (N.D. Ill. Feb. 19, 2004). Plaintiffs never appealed that ruling. In any event, stock sales by other Tellabs' executives make no sense as a motive for Notebaert – particularly given the admitted absence of any of his own. Fraud is not usually a charitable exercise for the benefit of others but not oneself, and an inference to the contrary is far the more plausible here.

* * *

Considering the record as a whole, these factors all contribute to a powerful innocent inference that, far from attempting to perpetrate some fraudulent masking of a decline in demand for the TITAN 5500, Notebaert was processing information as it became available to him and honestly believed his statements on March 7 and April 6, 2001. Plaintiffs' competing claimed inferences of fraud are neither "cogent and compelling," nor "at least as compelling" as the opposing inference of innocence to be drawn from the facts alleged. *Tellabs*, 127 S. Ct. at 2510.

B. The other allegations upon which Plaintiffs rely in their Supplemental Brief do not give rise to a strong inference of scienter.

Notwithstanding this Court's previous reliance on the Probe Research report and the internal reports from March 2001 allegedly showing declining demand for the TITAN 5500, Plaintiffs now seek to downplay those reports, going so far as to criticize the Defendants for their "persistent focus" on them. (Pls.' Supp. Br., p. 8 n.9.) Plaintiffs instead focus on two other categories of allegations in their Complaint which they claim give rise to a "strong inference" of scienter.

1. **Anecdotal allegations.** The first category of allegations Plaintiffs rely on are anecdotal observations by various anonymous sources, and isolated accounts regarding individual customers. These allegations say little about what matters: whether Notebaert was told of an *aggregate* decline in demand for the TITAN 5500 prior to his March and April statements, or provided with analyses to that effect. This Court's prior focus on the Probe Research and March 2001 internal marketing reports was not accidental; rather, the significance of these alleged reports was precisely that they, unlike anecdotal allegations, purported to get at whether Notebaert had available to him systematically gathered information concerning an overall decline in demand.

In now focusing on anecdotal allegations, Plaintiffs are asking the Court to make a speculative leap that these piecemeal assertions support an aggregate conclusion. In fact, these anecdotal allegations – virtually none of which is claimed to have been brought to Notebaert's attention – say nothing at all about what Notebaert was being told concerning aggregate demand. Significantly, there is no allegation that in late 2000

and early 2001 Notebaert was not receiving projections of demand that were entirely consistent with what he shared with the market.

Moreover, a careful review of some of these anecdotal allegations underscores the weakness of any inference of Notebaert's scienter.

Plaintiffs first point to allegations regarding a purported drop-off in Verizon orders. According to an anonymous Tellabs "installations supervisor," whose position, responsibilities and sources of knowledge are not further described, "in late 2000" (again, the time is not further specified) there was a roughly 25% reduction in 5500 orders from Verizon." (Pls.' Supp. Br., p. 6; JA 114, ¶ 35). Similarly, an anonymous source identified only as a "Tellabs operations manager" alleges that "in January 2001, Verizon orders declined by about 50%." (*Id.*) But even if a single customer had temporarily decreased orders for the TITAN 5500, Plaintiffs have alleged no facts demonstrating the impact this decrease would have had on overall projected sales for the TITAN 5500. Indeed, these allegations do not even say anything regarding expectations for orders from the same customer for later in 2001, *i.e.*, whether any drop-off was anticipated to be temporary in nature. Moreover, although the allegations purport to describe the size of these alleged drop-offs ("roughly 25%" and "roughly 50%"), those figures are essentially meaningless absent particularized facts to place them in context. For example, the Complaint does not indicate whether the alleged January 2001 drop off of 50% represented the percentage reduction from the prior year's orders, the prior quarter's orders, or the prior month's orders. It would hardly be surprising if Verizon's orders declined from the fourth quarter, when many companies

are trying to exhaust their capital budgets for the year, to the first month of the new year. In any event, the Complaint does not say the decline (whatever it was from) was unexpected or not fully taken into account in the Company's projections, much less say anything about what Notebaert was told or knew in that regard.[10]

Plaintiffs next point to a conclusory allegation attributed to an anonymous former Tellabs customer manager (*i.e.*, a lower level position), that "Tellabs' customers were not buying as early as November 2000." (JA 116, ¶41; *see also* Pls.' Supp. Br., p. 7.) But this, of course, leaves out all critical details: *how many* such customers were not buying, and *how much*, and what was the overall effect? Plaintiffs also do not allege that these declines were unanticipated, or were not factored into the Company's projections.[11] The same is true with respect to the allegation that, according to an

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[10] Similarly, Plaintiffs point to their allegation that, according to an anonymous Tellabs sales manager, customers in Latin America and Central America "did not want" the TITAN 5500. (*See* JA 115, ¶ 36.) In Plaintiffs' Supplemental Brief at page 9, this becomes transformed to these customers "were not buying" the 5500. The Complaint does not say, however, *when* these customers "did not want" the 5500s, or when this allegedly occurred, if it was some new development. And again, Plaintiffs also do not say what impact a fall-off in Latin American orders would have had on Tellabs' aggregate projections, or allege that this fact was not factored into Tellabs' projections.

[11] Plaintiffs also attribute to CS-25 the statement that "it got slower and slower" during the Class Period, *i.e.*, until June 19, 2001. But this begs the question of what was known when and simply reflects a reality that Tellabs itself disclosed to the market beginning in April 2001, as it reduced projections. The same ambiguity exists in numerous other allegations cited by Plaintiffs in their Supplemental Brief. For example, the hindsight claim that "orders from every 5500 customer declined throughout the Class Period" (JA 115, ¶37, cited in Pls.' Supp. Br., p. 9), says nothing about what was known when, and by whom, and is entirely consistent with Tellabs' own announcements of significantly reduced guidance on, *inter alia*, April 18 and June 19, 2001. And, CS-15's allegation (JA 115, ¶38, cited in Pls.' Supp. Br., p. 7) that "sales of Tellabs' products were declining by

(continued)

anonymous "engineer" (who is not alleged to have had any responsibility or played any role at all in formulating projections) internal quarterly reports allegedly showed declining demand in the third and fourth quarters of 2000. (*Id.* at 7; *see also id.* at 8 (internal quarterly reports "reflected a decline in 5500 demand as early as the second half of 2000").)[12] Again, the comparator used for the purported "decline" is critically omitted, *e.g.*, was it the rate of growth that was declining or was the decline absolute (and, even then, compared to what)?[13] *See San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 812-13 (2d Cir. 1996) (rejecting "a general claim of the existence of confidential company sales reports that revealed [a] larger decline in sales."); *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1087-88 (9th Cir. 2002). All of this is left to mere speculation; no specifics are provided. And, even more fundamentally, there is no allegation that whatever results are being referred to were

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early 2001" is entirely consistent with Tellabs' own announcements in April 2001, including the announcement on April 6 of a drop-off in sales during the last two and a half weeks of March and the announcement on April 18 of significantly reduced annual projections.

[12] Relying on paragraph 164 of the Complaint, Plaintiffs assert that "Tellabs senior management was in direct contact with the Company's customers" and "therefore knew how much customers were buying and planning to buy." (Pls.' Supp. Br., p. 9.) However, paragraph 164 says nothing about what specifically was allegedly learned through such contacts, and when, and whether or not it was incorporated in the projections delivered to the market. And, contrary to Plaintiffs' implicit suggestion, the cited paragraph says nothing about Notebaert; rather, it says that defendant Kohler (as to whom all §10(b) claims have been dismissed) "frequently attended quarterly meetings with … Tellabs' customers." (*See* JA 162, ¶ 164.)

[13] The ambiguity is particularly noteworthy given that Tellabs reported record fourth quarter 2000 sales. (*See* R.74, Tab 1.)

not fully taken into account by the executives formulating 2001 projections – much less that Notebaert ever had reason to believe of some deficiency in that regard.[14]

Nor do these allegations – none of which even refers to Notebaert and what he was told or knew – somehow surmount their individual glaring weaknesses by being taken collectively. The point remains that, even viewed together, these allegations do nothing to create a "compelling" inference that the aggregate assessments of demand portrayed by Notebaert at various times were at odds with aggregate assessments being supplied to him, or were otherwise known by him to be false.

2. **Post-Class Period statements.** The second set of allegations on which Plaintiffs rely are allegations regarding Tellabs' announcements after the Class Period ended. Plaintiffs cite Tellabs' June 19, 2001 press release revising downward its second quarter guidance and withdrawing its already revised guidance for the full year. (*See* Pls.' Supp. Br., p. 22.) But these developments do nothing to indicate that any prior statements by Notebaert were made with scienter. They simply reflect a continued worsening of the market after April 18, 2001, when Tellabs previously reduced its guidance. Plaintiffs' attempt to suggest anything else is merely an exercise in 20/20 hindsight.

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[14] Plaintiffs also allege that a product distributor reported that "Tellabs stopped taking parts used to manufacture its products by the beginning of 2001." (Pls.' Supp. Br., p. 7.) This allegation says nothing about overall existing or projected demand for the TITAN 5500. The Complaint does not even allege which parts Tellabs stopped taking, say anything about Tellabs' inventory for such parts, or say whether Tellabs obtained the parts from one of the distributor's competitors. Similarly, the vague allegation that Tellabs had "excess" TITAN 5500s on hand "in late 2000/early 2001" (*id.*) says nothing about declining demand for the product, especially, once again, in light of the Company's actual sales during that period.

Plaintiffs also point to certain statements in Tellabs' 2001 Annual Report, published in March 2002, contending Tellabs "admitted" that its prior statements were false. To the contrary, the statements in the Annual Report mirror the statements Notebaert made in April 2001. First, Plaintiffs point to the statement that, "[e]arly in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination." (Pls.' Supp. Br., p. 23.) This tracks Notebaert's statements on April 6, 2001: "Clearly, the environment has resulted in near term caution in the pace at which customers are deploying equipment. Our customers are exercising a high degree of prudence over every dollar spent." (R.49, Tab 2, p. 2.) Notebaert reiterated this on April 18: "Our customers are reviewing, and in some cases, reducing their capital spending plans so we have factored that in when forecasting our business trends through 2001." (R.49, Tab 18, p. 2.) Next, Plaintiffs contend that the Annual Report "revealed" that "in April 2001," Tellabs had begun a series of layoffs, closed manufacturing plants in Ireland and Texas, consolidated facilities, and cut expenses. (Pls.' Supp. Br., p. 23.) But, again, this was not news: Notebaert announced on April 18, 2001 that Tellabs was "acting decisively to align [its] cost structure," eliminating jobs, and consolidating excess facilities. (R.49, Tab 18, pp. 2-3.)

Lastly, Plaintiffs contend that the "sheer magnitude of the Company's problems" creates an inference of scienter. This Court has long held, however, even prior to the passage of the PSLRA, that the "sheer magnitude" of an alleged fraud does not give rise to an inference of fraudulent intent. *See, e.g., DiLeo*, 901 F.2d at 627 ("Four billion dollars

is a big number, but even a large column of big numbers need not add up to fraud."). That is particularly true here, where the alleged "magnitude" is not misstated financial statements, but rather the Company's ultimate poor performance in a year in which it repeatedly downgraded its projections amidst the implosion of an entire industry.

III. The Alleged Overstatement Of Tellabs' Fourth Quarter 2000 Financial Results.

Plaintiffs have alleged that Tellabs' fourth quarter financial statements were artificially inflated due to alleged "channel stuffing." The Complaint defines "channel stuffing" broadly to include legitimate conduct (such as offering customers discounts of 10% or 20%) as well as potentially illegitimate conduct (such as writing orders for products customers had not requested). (JA 110, 112, ¶¶ 62-63, 69.)

In its prior opinion, this Court found that "the only allegation that the plaintiffs pleaded with sufficient particularity" with respect to the claim that Tellabs' fourth quarter of 2000 financial statements were inaccurate, "is the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s." 437 F.3d at 598. This Court affirmed the dismissal of any other claims regarding the fourth quarter of 2000 financial statements, including the allegations regarding fictitious sales, back-dated orders, and creative incentives, which the lower court had found either insufficiently particularized or otherwise not actionable. *Id.* Nothing in the Supreme Court's decision provides any reason to reconsider that ruling.

In their Supplemental Brief, however, Plaintiffs do not take this Court's prior ruling into account and try to drag back in their allegations regarding fictitious sales, back-dated orders, and "creative" incentives. (*See* Pls.' Supp. Br., pp. 17-19.) But the sole

issue here is whether the Complaint alleges facts sufficient to give rise to a strong inference that Notebaert knew that Tellabs was sending customers unordered product so as to improperly record revenue from those shipments in the fourth quarter of 2000.

As to that issue, there are two allegations that this Court previously relied upon as potentially supporting an inference of Notebaert's knowledge of the alleged shipping of unordered product. *See Makor*, 437 F.3d at 604-05. Those two allegations are based on alleged information from two confidential sources: CS-6, allegedly a former Tellabs senior business manager, and CS-3, allegedly a former high-level Tellabs sales executive who admittedly left the company at some unspecified time prior to the beginning of the class period. (JA 103, 123, 160, ¶¶67, 156.) Notably, the Complaint does not allege that either confidential source ever had any personal interaction with Notebaert regarding the shipping of unordered product. Nor does the Complaint allege any facts that would support a finding that either confidential source had any other personal knowledge of what Notebaert was told or knew or did in that regard. Moreover, the information supplied by these confidential sources is entirely uncorroborated by any documents or other concrete evidence – indeed, it is contradicted by the objective evidence that is available.[15] *Higginbotham* teaches that in circumstances such as this, allegations from confidential sources must be steeply discounted. *Higginbotham*, 495 F.3d at 757.

[15] The weakness of Plaintiffs' proposed inference in light of the absence of any concrete evidence is underscored by the fact that Tellabs has never restated its fourth quarter 2000 financial statements. Given that the lawsuit has been pending for years, and that the allegations of improper revenue recognition in the fourth quarter of 2000 have been a substantial part of the claims, one might reasonably infer that Tellabs' auditors have (continued)

In any event, a careful examination of what the two confidential sources allegedly do, and do not, say about Notebaert reveals that, at best, Plaintiffs have sought to exploit an ambiguity inherent in the phrase "channel stuffing." In fact, the confidential sources carefully avoid saying anything unambiguously about Notebaert's alleged involvement in the shipping of unordered products. While this type of ambiguity may have sufficed to permit a plaintiff-friendly inference prior to the Supreme Court's decision in *Tellabs,* it is no longer adequate.

CS-6. CS-6 allegedly claims that "Notebaert worked directly with Tellabs' sales personnel to channel stuff SBC." But while using the phrase "channel stuffing," CS-6 is not alleged to have said anything specifically regarding *the shipping of unordered product* (with respect to Notebaert or otherwise).

The ambiguity in the allegation regarding the type of "channel stuffing" in which Notebaert allegedly participated is critical to evaluating the strength of Plaintiffs' claimed inference as to Notebaert's scienter. Indeed, even before the Supreme Court issued its opinion in this case, the Eleventh Circuit, applying a standard no more

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considered whether a restatement is necessary and determined that it is not. Plaintiffs' attempt to brush aside this fact only underscores how far the speculation must stretch to reach the conclusion that Notebaert acted with scienter. Plaintiffs assert that the lack of a restatement "merely indicates that defendants *and their auditors* do not wish to admit to wrongdoing." (Pls.' Supp. Br., p. 17, n.17 (emphasis added).) Plaintiffs apparently believe that it is more plausible that Tellabs' outside auditors are in on the fraud than that the Company's auditors have found no reason to doubt the accuracy of the reported fourth quarter results. This is bald, unsupported assertion. Such cavalier, *ad hoc* allegations of unprofessional conduct by outside auditors reflect the weakness of any inference of scienter.

stringent than that ultimately adopted by the Supreme Court, found substantially similar allegations insufficient to satisfy the "strong inference" standard. *See Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006). Plaintiffs weakly attempt to distinguish *Garfield*, saying that "far more is alleged" in this case (*see* Pls.' Supp. Br., p. 20, n.21), but the Complaint here in fact suffers from the same defect as the complaint in that case. In *Garfield*, the plaintiffs alleged that the defendants had attended monthly meetings where "aggressive channel stuffing" was discussed. *Id.* at 1264. Recognizing that channel stuffing is a vague phrase that might refer to either legitimate or illegitimate conduct, the Eleventh Circuit expressly found that "a general allegation that Individual Defendants promoted channel stuffing at a series of meetings does not establish scienter." *Id*. at 1265. It was possible to "surmise" that the individual defendants in *Garfield* might have been aware of improper revenue recognition. But the inference of scienter was not strong because the plaintiff failed to allege what was actually said at the meetings. *Id*. So too here: CS-6 does not specify what sort of "channel stuffing" activities Notebaert allegedly engaged in or knew about.

Not only has CS-6 failed specifically to assert that Notebaert worked directly with sales personnel *to send unordered product* to SBC (rather than engaging in some other, innocuous form of "channel stuffing"), but a closer look at his allegations reveals that CS-6 has in fact described a very different kind of channel stuffing, and one that this Court has already determined is not actionable. (JA 122-23, ¶ 67.) Specifically, the allegation attributed to CS-6 discusses payments by Tellabs to Telcobuy.com – a "VARS," defined in the Complaint as a reseller (JA 105), that "distributed to SBC" – to

induce Telcobuy.com not to return inventory it had purchased. (JA 122-23, ¶ 67.) The allegation never says that Telcobuy.com (much less SBC) was sent unordered products. Instead, the Complaint says that at some point Telcobuy.com found itself with more product than it wanted and so was seeking to return the product. (JA 122-23, ¶¶ 67-68.) Providing incentives for Telcobuy.com not to do so is a far cry from sending a customer product that had not been ordered in the first place.[16]

CS-3. CS-3 allegedly has vaguely stated that "Notebaert unquestionably knew about the channel stuffing activity relating to the TITAN 5500." (JA 161, ¶ 156.) As noted above, the Complaint contains no allegations regarding the basis for CS-3's knowledge of what Notebaert allegedly knew. The Complaint does not allege, for example, that CS-3 personally told Notebaert about the shipment of unordered product, attended a meeting with Notebaert where shipping unordered product was discussed, or otherwise has personal knowledge as to what Notebaert knew about the shipment of unordered product. (Indeed, the Complaint does not even allege that CS-3, who admittedly left the Company prior to the beginning of the Class Period (December 2000), even overlapped with Notebaert's tenure as CEO, which only began in September 2000. (*See* JA 103, 110, ¶ 20.)) Given this utter lack of specific facts, CS-3's

[16] Significantly, Plaintiffs have not alleged that Telcobuy.com had a *right* of return. Earlier in the litigation, Plaintiffs abandoned claims – made in their first amended complaint – that seemed to suggest consignment sales. *See Johnson v. Tellabs*, 262 F. Supp. 2d 937, 950 (7th Cir. 2003) (discussing allegations of consignment sales in first amended complaint); *compare Johnson v. Tellabs, Inc.*, 303 F. Supp. 2d 941, 959-60 (N.D. Ill. 2004) (discussing allegations of channel stuffing in second amended complaint).

statement that Notebaert "unquestionably" knew about "channel stuffing" appears to be nothing more than unfounded speculation or rumor, and does not give rise to a *cogent* inference of scienter.

Moreover, the allegation attributed to CS-3 also is ambiguous regarding *what* "channel stuffing" Notebaert allegedly knew about. Although the Complaint alleges that CS-3 has reported that "Tellabs employees actually wrote purchase orders for customers for products that the customers had not ordered," this allegation is ambiguous regarding *when* such purchase orders were written and, further, says nothing at all about Notebaert or his involvement in such activities. (JA 122, ¶ 63.) In fact, this allegation does not even say *in what year* this alleged channel stuffing took place, or whether it occurred prior to Notebaert's tenure. These omissions and ambiguities further undermine whatever weak inference of scienter can be drawn from CS-3's purported statement. *Tellabs*, 127 S.Ct. at 2511.

Indeed, Plaintiffs' other allegations regarding CS-3 show how they are trying to employ ambiguity in their favor. Although CS-3 is ambiguous regarding what "channel stuffing" Notebaert allegedly knew about, he is shown to be quite capable of unambiguously asserting that the shipping of unordered products has taken place when he wants to be clear. CS-3 allegedly stated that "Tellabs employees actually wrote purchase orders for customers for products that the customers had not ordered." (JA 122, ¶ 63.) But when it comes to talking about what Notebaert knew about, all CS-3 has to say is conspicuously generic – referring to "channel stuffing," not specifying

knowledge of the shipment of unordered products – and therefore does not establish scienter. *See Garfield,* 466 F.3d at 1265.

Nor is this critical ambiguity a matter of inadvertence. The District Court had, in its ruling dismissing the first amended complaint, told Plaintiffs that their allegations of scienter regarding "channel stuffing" inappropriately encompassed conduct that was innocent. *See Johnson*, 262 F. Supp. 2d at 948-50, 957. Plaintiffs' obfuscation in this regard can no longer be resolved in their favor. Indeed, even under the more liberal Federal Rule of Civil Procedure ("Rule") 12(b)(6) standard, this Court has expressed skepticism for such tactics. *See E.E.O.C. v. Concentra Health Servs., Inc.*, 496 F.3d 773, 780 (7th Cir. 2007). *Tellabs* deprives the Plaintiffs of the benefit of any such ambiguity. 127 S. Ct. at 2511.[17]

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[17] Plaintiffs also point to Justice Stevens' dissenting opinion in an attempt to buttress their claim. (*See* Pls.' Supp. Br., p. 19, quoting *Tellabs*, 127 S.Ct. at 2517, n.2 (Stevens, J. dissenting).) However, with the exception of the allegation that Notebaert "worked directly with Tellabs' sales personnel to channel stuff SBC," which gives rise to only a weak inference of scienter for the reasons set forth above, Justice Stevens points to allegations that in no way tie Notebaert to the shipment of unordered products. Justice Stevens points to allegations regarding incentives to hold inventory (*see* JA 122, ¶ 67) and backdating sales (JA 121, ¶ 62); however, as noted above, this Court has previously determined that the District Court correctly held that the Complaint does not state a claim with respect to those activities. Justice Stevens also points to allegations that Verizon's Chairman allegedly called Tellabs to complain. (*See* JA 124, ¶ 71.) But there are no allegations that Verizon's chairman called *Notebaert*, that Notebaert was ever made aware of the call, or that the returns or the call pertained to unordered products (as opposed to products that Verizon had ordered but later determined, for whatever reason, it did not want). In fact, the Complaint does not even allege *when* Verizon's Chairman allegedly called to complain, and whether he even called during Notebaert's tenure with the Company.

Considering the record as a whole, the culpable inference is dependent upon the statements of two anonymous sources, neither of whom is alleged to have personal knowledge pertaining to Notebaert and, in any event, neither of whom explicitly says anything regarding Notebaert's knowledge of any shipping of unordered product. These allegations do not suffice to give rise to a strong inference of scienter, once Plaintiffs are stripped of their claimed favorable inferences generated by their own pleading ambiguity. Moreover, given the absence of any motive for Notebaert to artificially inflate Tellabs' fourth quarter financial statements (again, Plaintiffs do not allege that Notebaert or Tellabs had anything to gain from such inflation, *see* pp. 20-21, *supra*), and the complete absence of any concrete, corroborating evidence linking Notebaert to the shipping of unordered product – the inference of innocence is more powerful and compelling than any inference of scienter.

IV. Statements Regarding The Availability And Shipment Of The TITAN 6500 Product.

The TITAN 6500 was a new Tellabs product that was expected to contribute minimally to the Company's revenues for 2001.[18] In December 2000, Tellabs announced that Sprint had entered into a contract to purchase 6500s and further announced that the product was "available now." (JA 125, ¶ 73.) On March 8 and April 6, 2001, during conference calls with analysts, Notebaert stated that 6500s had been shipped to certain

[18] A March 8, 2001 Robert W. Baird analyst report (referenced in the Complaint at ¶ 105(d) (JA 141)), for example, projected 2001 revenues of just $75 million for the TITAN 6500, compared with total projected revenues for the Company of approximately $4.3 billion, *i.e.*, less than 2%. (*See* R.74, Tab 8, p. 2.)

customers and were undergoing acceptance testing by those customers. (*See* R.49, Tab 16, p. 2-3; R.49, Tab 2, p. 3.) On April 6, 2001, Notebaert specifically disclosed to the market that no revenue from the sale of 6500s could be recognized during the first quarter of 2001 because on-site customer testing had not yet been completed. (R.49, Tab 2, p. 3.)

On June 19, 2001, the date Plaintiffs allege the "truth" was revealed, Tellabs announced it was recognizing revenue from the sale of TITAN 6500. (R.49, Tab 4, p. 4.) That same day, Notebaert also disclosed that while the conditions for revenue recognition had thus far been met at only one customer, the product continued to be shipped to other customers. (R.49, Tab 4, p. 4, 6.) Plaintiffs have never alleged that any of Notebaert's June 19 statements regarding the 6500 were false or misleading; to the contary, as noted above they have alleged that the June 19 pronouncements constituted the "truth."

Out of this sequence of events, this Court previously found that Notebaert's statement in December 2000 that the 6500 was "available now," together with the statements in March and April that the product was being "shipped," were adequately alleged to have been made with scienter. This Court relied on certain assertions attributed to anonymous sources, and, in the course of drawing all inferences in Plaintiffs' favor, concluded that, "If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes." *Makor*, 437 F.3d at 604. But in light of the new approach to evaluating the record – the requirement that this Court weigh the plausibility of

competing inferences to determine whether the inference of scienter is at least as compelling as the inference of innocence – that conclusion should change.

To begin, there are several factors that support the innocent inference that Notebaert did not act with scienter when he said that the TITAN 6500 was available and being shipped to customers.

First, it is undisputed that Tellabs *in fact* booked revenue from the sale of the TITAN 6500 in the second quarter of 2001. The fact that the Company booked revenue from the product is consistent only with the product having been available and shipped. And, as mentioned above, Plaintiffs have never contended that the second quarter financial statements, or the June 19, 2001 announcement of such revenue booking, were inaccurate. To the contrary, Plaintiffs do not and cannot explain how an inference that Notebaert falsely stated, with scienter, that the product was available and shipping remains compelling in light of the fact that the Company accurately booked revenue from the product during the second quarter of 2001.

Second, other facts that emerge from the allegations of Plaintiffs' own Complaint are inconsistent with Plaintiffs' own allegations, and consistent only with Notebaert's statements that the product was available to customers and had been shipped to them. The Complaint alleges that individual defendants were "visiting customers" to deal with problems with the TITAN 6500. (JA 117, ¶ 46.) It alleges that the product failed customer evaluations, and that "Pullen made numerous visits to TITAN 6500 customers in connection with failed evaluation problems." (JA 118, ¶ 50.) Simply put, Tellabs' personnel could not have been visiting customers to deal with the product's alleged

problems if the TITAN 6500 was merely an imaginary figment that was not "available" and had not been shipped. Again, even under the liberal standards of Rule 12(b)(6), Plaintiffs' contradictory allegations must be resolved against them. *See* 71 C.J.S. Pleading § 88.

Third, there is simply no reason why Notebaert would knowingly mislead the public regarding the availability of the TITAN 6500 for a period of a few months. The product was projected to have little impact on Tellabs' bottom-line for year 2001. (*See* p. 36, n.18, *supra*.) And Notebaert even informed the market during the relevant period that Tellabs was *not* booking revenue from the TITAN 6500 because the product continued to undergo "acceptance testing" at customer sites. (*See* R.49, Tab 2, p. 3.)

Against all this, Plaintiffs can point to little that supports the culpable inference of scienter they ask the Court to draw. What they have falls far short of what would be sufficient to create a "cogent and compelling" inference of scienter in light of the competing inference of innocence. *Tellabs*, 127 S. Ct. at 2502.

First, this Court's prior opinion relied on the allegations from confidential sources that "Notebaert saw weekly sales reports and production projections" and that senior managers allegedly knew that "the TITAN 6500 was not ready for deployment despite Tellabs's public announcements" in finding that the Complaint adequately alleged scienter. *Makor*, 437 F.3d at 604. The allegation that senior management reviewed weekly sales reports is too general to support a strong inference of scienter. Plaintiffs do not allege anywhere that these sales reports contradicted Notebaert's

statements regarding the TITAN 6500. Indeed, these reports presumably reflected the sales that Tellabs eventually booked in the second quarter of 2001.

Second, the Complaint alleges that "the TITAN 6500 was not ready for deployment despite Tellabs's public announcements" (JA 119, ¶ 53), and that the TITAN 6500 had "defects" (although Plaintiffs do not describe what those alleged defects were). (*See id.* at 12-13, citing JA 118, 164, ¶¶ 50, 51, 171; *see also id.* at 13, citing JA 117, ¶ 46.) But these allegations maneuver around and avoid the issue. These allegations concern whether the TITAN 6500 was in good condition or is the sort of product that, perhaps, *should* not have been shipping.

But the question here is whether Notebaert knew or consciously disregarded information that the TITAN 6500 actually was *not* available and had *not* been shipped. Whether or not the product allegedly had problems at customer sites that needed to be ironed out is an entirely separate matter. Indeed, on March 7, 2001, Notebaert even publicly acknowledged that problems with a new product were to be expected: "I can't remember ever turning on a system in my prior life that for the first few years you didn't have a patch or something." (R.49, Tab 16, p. 4.)[19] In short, allegations that the

[19] The Complaint specifies individual defendants Jackson and Pullen as those who "knew that the TITAN 6500 was not ready for disbursement." (JA 119, ¶ 53.) It nowhere alleges that *Notebaert* knew that the product was "not ready for disbursement." Instead, it alleges that "Notebaert also knew about the TITAN 6500 problems." *Id.* The confidential source is entirely unclear what "problems" Notebaert allegedly knew about or when he knew about them. Moreover, and importantly, the confidential source who allegedly reported this was no longer with the Company at the time that *any* of the allegedly false statements with respect to the TITAN 6500 were made. (*See* JA 103.) The Complaint does not explain how this confidential source could have known what

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TITAN 6500 had "defects" and was not "ready for deployment" do nothing to point back toward a culpable inference that Notebaert knew that the product was not even available and had not actually been shipped to any customers.

Finally, Plaintiffs rely on vague allegations that the TITAN 6500 was not "released" or "ready." (*See* Pls.' Supp. Br., pp. 12-13, citing JA 115, ¶48, 51 (according to CS-9,"6500 was still not a released, saleable product even two months after the end of the Class Period"); (Tellabs product managers "hoped to release the product in the first quarter of 2002").) In light of the context set forth above – including the allegations in Plaintiffs' own Complaint indicating that the product was present at customer sites – it is apparent that Plaintiffs' repeated assertion that the TITAN 6500 was not "released" is a semantic game. Take, for example, Plaintiffs' allegation that "in the fourth quarter of 2000 and first quarter 2001, Tellabs product managers were working to fix [the TITAN 6500's] defects and hoped to release the product in the first quarter of 2002." (JA 118, ¶ 51.) The word "release" in that context must have a special meaning that is difficult to discern in light of the undisputed fact that in the second quarter of 2001 Tellabs recognized revenue from TITAN 6500 sales. Such ambiguities count against an inference of scienter. *Tellabs*, 127 S. Ct. at 2511. In any event, the Complaint does not allege that Notebaert was ever made aware of the expectations of these product managers with respect to the product's readiness. Likewise, Plaintiffs point to the allegation from a "distribution employee" – as to whom no other information is

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information was available to or known by Notebaert in the spring of 2001.

provided – that "Tellabs did not make actual sales of 6500 or even have the product in its warehouse until after mid-September 2001." (Pls.' Supp. Br., p. 12, citing JA 117-18, ¶ 48.) A warehouse worker (which is what a "distribution employee" is) should not, however, be presumed to be in a position to know whether the TITAN 6500 was being sold at all. And in fact we know that it *was* sold because Tellabs recognized revenue from sales in the second quarter of 2001. *Higginbotham*'s skeptical approach toward confidential sources seems particularly apt here. *See Higginbotham*, 495 F.3d at 757 ("It is hard to see how information from anonymous sources could be deemed 'compelling'….").

Simply put, the inference posited by Plaintiffs, that Notebaert's statements regarding the availability of and demand for the TITAN 6500 were knowingly false, is not as compelling as the opposing inference that Notebaert believed the TITAN 6500 was being shipped with the bugs being worked out at customer sites. The innocent inference is consistent with a careful reading of what the Complaint itself reveals to have been the case. The culpable inference is, by contrast, inconsistent with the undisputed fact that the Company recognized revenue from the TITAN 6500 during the second quarter, (R.49, Tab 4, p. 4), and with the numerous allegations in Plaintiffs' own Complaint that customers were evaluating the product and reporting problems they encountered on-site.[20]

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[20] Plaintiffs also assert that the December 11, 2000 projections were unreasonable when made because of the alleged problems with the TITAN 6500. (*See* Pls.' Supp. Br., p. 14.) But the Complaint fails to allege facts sufficient to give rise to a strong inference that

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V. The Remaining Claims Cannot Survive If The Claims Against Notebaert Fail.

As a last resort, Plaintiffs assert in a footnote that even if the Complaint fails adequately to allege scienter as to Notebaert, its claim of primary liability against Tellabs may still survive if the Complaint adequately alleges that some other member of Tellabs's senior management had the requisite scienter. (Pls.' Supp. Br., p. 24, n.24.) This Court previously found, however, that "the complaint adequately alleges *only* that Notebaert acted with scienter," and specifically predicated Tellabs's liability on the liability of Notebaert. *Makor*, 437 F.3d at 603, 605 (emphasis added). Plaintiffs did not seek a writ of certiorari as to this Court's ruling that the Complaint does not adequately allege scienter as to Birck, and did not appeal the District Court's dismissal of its §10(b) claims against defendants Joan Ryan (the Company's CFO), Brian Jackman, Robert Pullen and John Kohler. Nor have Plaintiffs ever argued that Tellabs's liability should be predicated on the alleged scienter of some other (unspecified) member of senior management not named as a defendant. Nothing in the Supreme Court's opinion would warrant reopening that issue now.

Notebaert had *actual knowledge* that whatever small portion of the projections pertained to expected full year sales for the TITAN 6500 was incorrect. Indeed, Plaintiffs do not allege what portion, if any, of the Company's December 11, 2000 revenue projections were attributable to the TITAN 6500. As noted above, the market expected the contribution from the TITAN 6500 to be immaterial. *See* p. 36, n.18, *supra*. Nor do Plaintiffs draw any link between the TITAN 6500 and the eventual revenue shortfall announced by the Company on June 19, 2001, when Plaintiffs claim the "truth" emerged. Instead, Plaintiffs allege that the shortfall was due to a massive decrease in demand for the TITAN 5500. (*See* JA 150, ¶ 132.)

Finally, since the remaining claims pleaded by Plaintiffs against defendants are all predicated on some underlying primary violation, the absence of scienter required for a primary violation is fatal to all of the remaining claims as well.[21]

CONCLUSION

For the foregoing reasons, defendants-appellees respectfully request that the judgment of the District Court be affirmed.

Respectfully submitted,

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[21] This includes the §20A claim against Birck, 15 U.S.C §78t-1(a). Following a petition for rehearing, this Court modified its original opinion and remanded to the District Court the question whether a §20A claim can be supported by a "controlling person" violation under §20(a), 15 U.S.C. §78t(a). *See Makor*, 437 F.3d at 605. However, since a §20(a) claim requires an underlying primary violation, the absence of any such underlying primary violation is fatal even if, *arguendo*, a §20(a) violation could support a §20A claim.

CERTIFICATE OF COMPLIANCE

In accordance with Federal Rule of Appellate Procedure 32(a)(7), counsel for Defendants-Appellees certifies that this brief complies with the type-volume limitations set forth in Rule 32(a)(7)(B)(i). The word processing system used to prepare this brief, upon which counsel relies in making the certification, indicates that this brief contains 13,546 words, exclusive of the items listed in Rule 32(a)(7)(B)(iii).

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CERTIFICATE OF SERVICE

Melanie E. Walker, an attorney, certifies that she caused copies of the foregoing Supplemental Brief of Defendants-Appelles to be served on the counsel listed in the manner specified on October 9, 2007.

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