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.

ON REMAND FROM THE SUPREME COURT OF THE UNITED STATES
CASE NO. 06-484

SUPPLEMENTAL BRIEF OF PLAINTIFFS-APPELLANTS

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Plaintiffs-Appellants respectfully submit this supplemental brief, pursuant to the Court's Order dated August 30, 2007. As detailed below, the allegations of the Second Consolidated Amended Class Action Complaint (the "SAC") meet the standard the Supreme Court set forth in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), and thus give rise to a "strong inference" that defendants Tellabs, Inc. ("Tellabs" or the "Company") and Richard C. Notebaert, Tellabs' Chief Executive Officer and President, acted with scienter, as § 21D(b)(2) of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") requires.

In its previous opinion, *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F3d 588 (7th Cir. 2006), *vacated*, 127 S. Ct. 2499 (2007), this Court held plaintiffs' allegations that defendants Tellabs and Notebaert acted with scienter satisfied the PSLRA's strong-inference standard. The Supreme Court's decision does not warrant a different result. The SAC meets -- indeed, exceeds -- the standard as articulated by the Supreme Court. Taking the facts alleged as true and considering them collectively, the inference of scienter is far more than merely reasonable or permissible; rather, it is cogent and compelling, even in light of the purported innocent explanations defendants have offered. The District Court's decision dismissing the SAC should again be reversed.

ARGUMENT

PLAINTIFFS' ALLEGATIONS AMPLY SUPPORT A "COGENT AND COMPELLING" INFERENCE OF SCIENTER

In *Tellabs*, 127 S. Ct. 2499, the Supreme Court, for the first time, articulated the proper analysis for evaluating whether a complaint alleges a "strong inference" of scienter. The Supreme Court began by reaffirming "that meritorious private actions to enforce the federal antifraud securities laws are an essential supplement to criminal prosecution and civil enforcement actions. . . ." *Id.* at 2504 (*citing Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345

(2005); *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)) *See also id.* at 2508 & n.4 ("Nothing in the [PSLRA] . . . casts doubt on the conclusion 'that private securities litigation [i]s an indispensable tool with which defrauded investors can recover their losses' -- a matter crucial to the integrity of domestic capital markets.") (*quoting Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 81 (2006))

The Supreme Court ruled that, while a court must weigh competing inferences when evaluating the sufficiency of plaintiffs' allegations, defendants are entitled to the benefit only of "***plausible***" inferences "***rationally drawn from the facts alleged***." *Id.* at 2504, 2509, 2510 (emphasis added). Thus, a defendant may not place before the court additional facts beyond those the court normally may consider on a motion to dismiss. The Supreme Court confirmed that "courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true." *Id.* at 2509.

Of particular significance, the Supreme Court explained that, while the inference of scienter must be "cogent," it need only be "***at least as*** compelling" as any opposing, non-culpable inference, and decidedly need not be "the most plausible of competing inferences." *Id.* at 2505, 2513-14 (emphasis added) (citations omitted). *See also id.* at 2510 n.5 ("an inference at least as likely as competing inferences can, in some cases, warrant recovery").

Moreover, the Supreme Court affirmed the well-established precept that the sufficiency of a complaint turns on whether "***all*** of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." *Id.* at 2509 (emphasis in original). *See also id.* at 2511 ("the court's job is not to

scrutinize each allegation in isolation but to assess all the allegations holistically").[1] "In sum, the reviewing court must ask: ***When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?***" *Id.* (emphasis added).

The SAC identifies, by detailed description,[2] 26 persons,[3] including 25 former Tellabs employees, with specific knowledge and information concerning the allegations of wrongdoing relevant to the core products at issue -- the TITAN 5500 ("5500") and the TITAN 6500 ("6500"). The SAC specifies the position each source held and the period of his or her employment with the Company.[4] The sources' independent accounts corroborate one another

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[1] To that end, although "motive can be a relevant consideration, and personal financial gain may weigh ***heavily in favor*** of a scienter inference," the absence of any allegation of motive "is not fatal." *Tellabs*, 127 S. Ct. at 2511 (emphasis added). Rather, "the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint." *Id.*

[2] Consistent with other Circuits, this Court has recognized: "A bright line rule obliging the plaintiffs to reveal their sources has the potential to deter informants from exposing malfeasance. Such a rule might also invite retaliation." *Makor*, 437 F.3d at 596.

Nonetheless, in their initial disclosures, pursuant to Fed. R. Civ. P. 26(a)(1), plaintiffs provided defendants with the name and last known contact information (telephone number) for individuals believed likely to have discoverable information, and that list included all the sources to whom the SAC refers. *See* Plaintiffs' Amended Initial Disclosure Statement Pursuant to Federal Rule of Civil Procedure 26(a)(1), at 4-6. *Compare Higginbotham v. Baxter Int'l, Inc.*, No. 06-1312, 2007 WL 2142298, at *2 (7th Cir. July 27, 2007) (noting that, when asked at oral argument when the identity of the "confidential witnesses" would be revealed, plaintiffs' counsel replied that "the sources' identity would never be revealed," which meant "that their stories can't be checked"). That plaintiffs, in this case, have disclosed the names of all the sources negates the *Baxter* Court's concern that "[p]erhaps they [the confidential sources] don't even exist." *Id.*

[3] A twenty-seventh source provided information only with respect to Tellabs' SALIX product, which is no longer at issue.

[4] The many confidential sources include: two "Tellabs marketing manager[s]," a "Tellabs executive account manager and regional manager," three "high-level Tellabs sales executive[s]," (*continued*)

and accord with other particularized facts in the SAC, creating a powerful inference that defendants knew of, or at the very least recklessly disregarded,[5] the severe problems affecting the 5500 and 6500, which jeopardized the Company's overall performance and prospects. This Court previously observed:

> The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

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a "Tellabs shipping supervisor," a "mid-level Tellabs employee involved in distribution," a "Tellabs senior business manager," two "Tellabs sales director[s]," a "Tellabs project manager," a "Tellabs customer accounts representative," a "Tellabs regional sales director," a "Tellabs installations supervisor"," a "Tellabs sales manager," a "Tellabs materials manager," a "Tellabs manager in the business development area," a "Tellabs marketing strategy executive," a "Tellabs market analyst," a "Tellabs operations manager," a "Tellabs engineer who held a variety of management positions at Tellabs," a "Tellabs senior designer," a "Tellabs customer manager," a "Tellabs team project manager," and a "Tellabs consultant who worked for value added resellers [*i.e.*, "third parties that work along with Tellabs to handle customer services, including engineering site surveys, installations, and testing services" and "also act as distributors of Tellabs' products"]." Twenty-five of the twenty-six sources were at Tellabs during the Class Period. (One high-level sales executive who worked at the Company for many years left just prior to the Class Period.) (JA103-05)

By contrast, the complaint in *Baxter* relied on only five sources, whose roles within the company were described with far less detail: "a former Baxter executive employed throughout the Class Period and knowledgeable regarding the Brazil situation," "a confidential witness who was retained by Baxter as a consultant on the issue of financial controls," "a former Brazilian Baxter executive," a witness "who had been responsible for training Baxter's financial executives," and "a former Baxter executive who worked in Deerfield, Illinois, and who was employed throughout most of the Class Period." Second Amended Class Action Complaint ¶¶38, 40, 55, 73, 99, *Higginbotham v. Baxter Int'l, Inc.*, No. 04 C 4909 (N.D. Ill. Sept. 28, 2005) ("*Baxter* Complt.").

[5] *See Makor*, 437 F.3d at 600 ("we will apply the same scienter standard now as we did prior to the passage of the PSLRA"). The Supreme Court did not disturb the principle, which every Court of Appeals to consider the issue has adopted, that a showing of recklessness satisfies the § 10(b) scienter standard. *Tellabs,* 127 S. Ct. at 2507 n.3.

Makor, 437 F.3d at 596.[6]

The sheer number of sources, the detail with which they are described, the degree to which they corroborate each other and are corroborated by other facts in the SAC, and plaintiffs' willingness to disclose their identity all clearly distinguish this case from *Higginbotham v. Baxter Int'l Inc.*, No. 06-1312, 2007 WL 2142298 (7th Cir. July 27, 2007). In addition, the allegations of fraud in *Baxter* all centered around activities at the Brazil subsidiary of Baxter International, Inc. ("Baxter International"). *Id*. at *1. The *Baxter* plaintiffs did not proffer evidence that managers in Baxter International's corporate headquarters in the United States participated in the alleged misconduct at the distant Brazil subsidiary (Baxter International has operations on four continents, *Baxter* Complt. ¶29) and did not contend that the knowledge of the senior managers in Brazil should be imputed either to Baxter or any of its managers in the United States. *Id.* at *3.

A. The SAC's Account of Falling Demand for the "Flagship" 5500 Supports an Inference of Scienter

Plaintiffs' 5500 allegations easily satisfy the Supreme Court standard. In 2000, optical networking systems accounted for approximately 64% of Tellabs' sales. (JA 113, ¶30) 5500 -- Tellabs' principal seller in this category -- was the Company's "flagship," according to Tellabs'

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[6] Where, as here, the sources are described "with sufficient particularity 'to support the probability that a person in the position occupied by the source would possess the information alleged'" and the complaint provides "other evidence to support their allegations" (*Makor*, 437 F.3d at 596-97), there is no reason to require plaintiffs to disclose the sources' identity. Indeed, any attempt to challenge the credibility of the sources would contravene the Supreme Court's direction that, even in a PSLRA case, all factual allegations must be accepted as true. *Tellabs*, 127 S. Ct. at 2509. *Compare Baxter*, 2007 WL 2142298, at *2 ("Perhaps these confidential sources have axes to grind."). Moreover, defendants are entitled to the benefit only of inferences to be drawn "from the facts alleged" in the complaint and may not present additional facts not ordinarily considered on a motion to dismiss in an effort to discredit a source. *See Tellabs*, 127 S. Ct. at 2504.

2000 10-K. (*Id.*) The central importance of 5500, and 6500, to Tellabs' success, alone, compels a powerful inference that Tellabs and Notebaert, who, as CEO and President throughout the Class Period, ran the Company day-to-day at the highest level, knew about serious problems affecting those products.

By mid-2000, well before the Class Period (December 11, 2000 through June 19, 2001), Tellabs' customers were experiencing severe business deterioration and consolidation. (JA 106, ¶¶3, 4) With full knowledge of the dramatic slowdown in the telecommunications and internet sectors, defendants falsely, and without qualification, reassured investors that Tellabs' key products were continuing to enjoy strong demand. Yet, demand for 5500 -- Tellabs' "best seller" -- was, in fact, slowing substantially. (JA 114-17, ¶¶34-45) A number of confidential sources confirmed the drop in demand for 5500, identifying specific customers that significantly reduced their orders, including Verizon Communications, Inc. ("Verizon"); SBC Communications, Inc. ("SBC"); Lexcom; and Telcobuy.com -- the Company's major customers and distributors. (JA 114-16, 122-24, ¶¶35, 37, 43, 67-71) The importance of Tellabs' relationships with such key customers as Verizon and SBC compels a strong inference that defendants were well aware of significant decreases in those customers' orders and improper sales practices affecting them.

Moreover, the richly particularized SAC demonstrates:

- According to a Tellabs installations supervisor, ***in late 2000***, there was a roughly 25% reduction in 5500 orders from Verizon, Tellabs' largest customer. (JA 114-15, ¶35) A Tellabs operations manager reported that, ***in January 2001***, Verizon orders declined by about 50%. (*Id.*) According to a Tellabs executive account manager and regional manager, ***during the fourth quarter 2000*** and throughout 2001, Verizon failed to execute millions of dollars of projected 5500 orders. (JA 116, ¶43)

- According to a Tellabs customer manager, ***as early as November 2000*** (before the Class Period), Tellabs' customers were not buying 5500s: "it got slower and slower." (JA 116, ¶41)

- According to a Tellabs business development manager, by early 2001, sales of Tellabs' products were declining. (JA 115, ¶38) A Tellabs sales director also recounted that 5500 sales declined noticeably by then. (JA 122, ¶65) Additionally, a mid-level Tellabs distribution employee reported that, ***by the beginning of the first quarter of 2001***, Tellabs had no orders and distribution personnel were told to go home early. (JA 124, ¶72)

- According to a team project manager for a product distributor, Tellabs stopped taking parts used to manufacture its products ***by the beginning of 2001***. (JA 116, ¶44)

- According to a Tellabs marketing manager, Tellabs had excess 5500s on hand ***in late 2000/early 2001*** and had "tons" of excess 5500s, and other products, on hundreds of racks in a warehouse; some systems sat on the shelves for six months to a year. (JA 116-17, ¶¶42, 45)

- According to a Tellabs engineer who held various managerial positions and who viewed the reports in question, Tellabs' finance department's internal quarterly reports showed declining demand ***in the third and fourth quarters of 2000*** for 5500 and other Tellabs products. (JA 116, ¶40)

- According to a Tellabs market analyst, quarterly reports concerning the profitability of Tellabs' products -- reports accessible on Tellabs' database system -- showed a decline in 5500 demand ***by March 2001***.[7] (JA 116, 159, ¶¶40, 153(d))

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[7] Tellabs executives also were provided daily computer reports concerning product bookings and revenue, which, a high-level Tellabs sales executive confirmed, they regularly reviewed. (JA 159, ¶153(e)) Tellabs sales personnel produced weekly sales projections. (JA 159, ¶153(f)) (*continued*)

All the foregoing allegations strongly confirm defendants were aware of serious problems with 5500 by late 2000/early 2001 -- well before their Class Period statements falsely assuring the market 5500 demand remained strong.[8] In addition:

- According to a Tellabs marketing strategy executive, a $100,000 study performed for Tellabs by Probe Research, an independent firm, completed in or about early 2001, confirmed a steep drop in the number of T1 circuits, the main source of demand for 5500 systems.[9] (JA 115, ¶39) That study is consistent with Tellabs' finance department's internal quarterly reports, and other alleged facts, which reflected a decline in 5500 demand as early as the second half of 2000. (JA 116, 159, ¶¶40, 153(d))

- An internal report prepared by Tellabs' marketing strategy department accurately concluded that, because of the T1 decline, 5500 revenue would fall by about $400 million (a huge and extremely significant decline given that Tellabs had no other products to compensate

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In addition, Tellabs management was apprised of customer purchases and buying plans to ensure compliance with federal regulations and FCC supplier diversity requirements. (JA 163, ¶168) Notebaert had daily calls with fellow executives to stay on top of everything, and had weekly revenue calls concerning how Tellabs would "make its numbers." (JA 160, ¶153(g)) Notebaert also communicated with employees at town hall meetings, worked closely with the sales teams, and received sales personnel briefings on product status. (JA 121, 158, 160, ¶¶60, 153(a), 154)

[8] The Court previously observed -- specifically in addressing the adequacy of the scienter allegations relating to defendant Michael J. Birck, Chairman of Tellabs' Board of Directors -- that "it was not until March 2001 that the TITAN 5500's declining status was obvious." *Makor*, 437 F.3d at 604. *See also* Circuit Rule 54 Statement of Defendants-Appellees ("Defts.' Rule 54 Statement") at 10 n.5. That 5500 problems might not have been "obvious" to the Company's Chairman until March 2001 does not mean Notebaert was not well aware of those problems much earlier. As Tellabs' CEO and President, and therefore its most senior insider, Notebaert clearly had far more direct, day-to-day involvement with its business and operations than Birck, who was not an officer of the Company during the Class Period.

[9] In light of all the other evidence of defendants' early knowledge of 5500 problems, their persistent focus on the Probe Research report as if it were the only fact on which plaintiffs rely is entirely unwarranted, and misleading.

for the shortfall). That report was discussed at marketing strategy meetings and was widely circulated to at least 10 executives, including individuals who reported directly to senior management (*e.g.*, the head of marketing strategy, who reported directly to Tellabs' Chairman). (JA 115, ¶39) Tellabs' mergers and acquisitions group also gathered market data and provided it to Tellabs' senior executives. (JA 163, ¶169)

- Tellabs senior management was in direct contact with the Company's customers. For example, according to a business development manager, Tellabs' Senior Vice President of Business Operations attended quarterly meetings with senior persons at Verizon, AT&T, and other important Tellabs customers. Tellabs' management therefore knew how much customers were buying and planning to buy. (JA 162, ¶164)

- According to a Tellabs materials manager, orders from every 5500 customer declined throughout the Class Period. (JA 115, ¶37)

- According to a Tellabs sales manager, customers in Latin America were not buying 5500. (JA 115, ¶36)

Despite their manifest awareness of serious problems with 5500 by late 2000/early 2001, defendants, including Notebaert, falsely assured the market that 5500 demand remained strong, and thereby artificially inflated Tellabs' stock price. This Court previously found the following statements actionable (*Makor*, 437 F.3d at 597, 603):

- In Tellabs' 2000 Annual Report (issued February 14, 2001), Notebaert responded to the "frequently asked question" "Your core business is built on the TITAN 5500 -- are you worried that this product has peaked?": "No . . . it's still going strong." (JA 135, ¶91)

- During a conference call on March 8, 2001, in response to an analyst's inquiry whether Tellabs was experiencing "any weakness there at all" as to 5500, Notebaert stated: "No,

we're not. We're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (JA 140, ¶102)

- During an April 6, 2001 conference call, Notebaert told analysts: "[E]verything we hear from the customers indicates that our [end] user demand for services continues to grow."[10] (JA 144, ¶114)

In its earlier opinion, the Court effectively found the allegations of Notebaert's awareness of 5500 problems to be cogent, not merely reasonable or permissible (*see Tellabs*, 127 S. Ct. at 2510):

> ***Given the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information suggesting that his statements were false***. *See Green Tree*, 270 F.3d at 665 ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

Makor, 437 F.3d at 603 (emphasis added). The inference that defendants acted with scienter in falsely assuring the public that 5500 demand remained strong is a powerful one, and far outweighs any nonculpable inference defendants have posited.

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[10] Defendants' assertion (Defts.' Rule 54 Statement at 11 n.7) that Notebaert's statement clearly refers to customers of Tellabs' customers, whose demand was continuing to grow, is entirely unsupported by the record and is an improper attempt to present for resolution at the pleading stage factual issues regarding the market for Tellabs' products that go well beyond what is alleged in the complaint. *See Tellabs*, 127 S. Ct. at 2504 (court may consider nonculpable inferences "rationally drawn from the facts alleged"); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir. 2001) ("The strong-inference pleading standard does not license us to resolve disputed facts at this [motion to dismiss] stage of the case.").

B. The SAC's Particularized Account of Development Problems with 6500 Likewise Compels an Inference of Scienter

With respect to the 6500, this Court also judged the allegations of scienter to be compelling:

> According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN 6500 during the class period. ***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***. According to a Tellabs sales director, Notebaert saw weekly sales reports and production projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a strong inference," 15 U.S.C. § 78u-4(b)(2), that Notebaert ***knowingly lied*** when he informed investors that the 6500 was "available now" and was "being shipped."

Makor, 437 F.3d at 604 (emphasis added) (alterations in original). Defendants have yet to offer any plausible nonculpable explanation to counter the compelling inference of wrongdoing.

Thus, in contrast to defendants' public statements, which portrayed the product as launched and being sold, 6500 -- according to Tellabs' 2000 Annual Report, one of a small handful of "major new products" Tellabs "began selling" in 2000 (JA 136, ¶93) -- was far behind schedule, failing lab tests, and not ready for release. According to confidential sources, senior management knew 6500 was not ready and was failing evaluations, and, in fact, visited customers in connection with those failures. (JA 118-19, 122-23, 161, 164; ¶¶50, 53, 67, 159,

171) A high-level Tellabs sales executive confirmed that Notebaert, and other senior executives, knew about 6500 problems.[11] (JA 119, 164, ¶¶53, 171-72)

- The high-level Tellabs sales executive also related that 6500 was almost two years late to market; its slow development was evident from 1998 through 2001. Customers that evaluated 6500 in their labs realized it "was not even close to being ready." Due to the delay, Tellabs lost approximately $50 million to $60 million of sales, and lost business to Alcatel. (JA 119, 164, ¶¶52-53, 171)

- A Tellabs marketing manager confirmed that 6500 was failing customer evaluations. Tellabs' Senior Vice President of Product Development made numerous visits to customers regarding failed evaluations. (JA 118, ¶50)

- According to another high-level Tellabs sales executive, by October 2001, four months after the Class Period, there had been very few trials of 6500. (JA 117-18, ¶48) That is corroborated by a Tellabs distribution employee, who related that Tellabs did not make actual sales of 6500 or even have the product in its warehouse until after mid-September 2001. (*Id.*)

- According to a Tellabs project manager, even two months after the Class Period ended, 6500 still was not released. A Tellabs consultant also confirmed that 6500 was not approved by the Regional Bell Operating Companies. (JA 117-18, ¶48)

- According to a Tellabs senior business manager, at least since September 2000, Sprint network traffic (and hence demand for 6500) was dropping. (JA 118, ¶49)

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[11] Although the sales executive left Tellabs shortly before the Class Period, he had worked at the Company for many years while 6500 was being developed (JA 91) and therefore clearly was in a position to know about 6500 development problems and what Notebaert knew about them.

- According to a Tellabs executive account manager, Tellabs was having difficulties testing 6500 and, in fourth quarter 2000 and first quarter 2001, Tellabs product managers were working to fix its defects and hoped to release the product in first quarter 2002, many months after the Class Period ended. (JA 118, ¶51)

- According to a former Tellabs marketing strategy executive, customers thought 6500 took too much space in comparison to its bandwidth capacity. Customers explained that competitor Ciena's product provided more bandwidth. Tellabs repeatedly attempted, without success, to sell its 6500 to major customers Verizon, BellSouth, and SBC. (JA 117, ¶47)

- Tellabs management received weekly and monthly reports concerning product development status. Tellabs sales personnel wrote weekly reports concerning sales projections and field trials, as well as customer maintenance reports, which updated trial status. (JA 159, ¶153(f))

Despite their awareness of serious problems with 6500, beginning well before and continuing during the Class Period, defendants made a series of materially false and misleading statements that inaccurately represented the 6500 was ready. This Court found the following actionable (*Makor*, 437 F.3d at 598):

- Tellabs' December 11, 2000 press release: "The TITAN 6500 system is available now." (JA 125, ¶73)

- Notebaert also represented during the March 8, 2001 analyst conference call: "Interest in and demand for the 6500 continues to grow. . . . We continue to ship . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand." (JA 139, ¶100)

- During the April 6, 2001 conference call, responding to a question whether Tellabs was still on track to recognize 6500 revenue in the second quarter, Notebaert again claimed: "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong. . . ." (JA 145, ¶117)

In light of the stark contradiction between what defendants were telling the investing public and what they knew to be the truth, the inference of fraud is not only cogent but incontrovertible.

C. Defendants' Unfounded Representations Concerning Tellabs' 2001 Performance Further Evidence Their Misconduct

In addition to their misrepresentations regarding 5500 and 6500, defendants made projections for 2001 that had no conceivable reasonable basis given what defendants knew about problems with those products. This Court previously recognized that "since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here." *Makor*, 437 F.3d at 605.

Through at least March 2001, defendants repeatedly falsely assured the market the Company expected 30% growth in revenues and earnings for 2001.[12] (JA 126-28, ¶¶76-77; JA 131-32, ¶85; JA 138-39, ¶99; JA 139, ¶100) Even after Tellabs modified its guidance in March and April 2001, in the face of disappointing first quarter results, defendants continued to make

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[12] Tellabs' 2000 10-K, filed March 29, 2001, which Notebaert signed, represented the Company was "on track to meet its objective of $6 billion in annual revenues by the year 2003." (JA 141-42, ¶107)

overstated revenue projections and to reassure the public about the Company's prospects notwithstanding what defendants knew about collapsing demand.

Thus, on March 7, 2001, Tellabs reduced first quarter guidance slightly, but simultaneously continued to assure investors, without a reasonable basis for doing so, that "[g]rowth in Tellabs' core optical networking business [*i.e.*, the 5500] remains strong" and that it "expects to recognize TITAN 6500 system revenues in the second quarter." Notebaert stated: "Given the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year." (JA 138-39, ¶99; *see also* JA 139-40, ¶¶100-03) When an analyst inquired about Tellabs' reaction to certain competitors' lowered expectations during a March 8, 2001 conference call, Notebaert, with considerable contrary knowledge, responded: "we haven't gotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in." (JA 140, ¶103)

On April 6, 2001, with the release of actual first quarter 2001 results imminent, Tellabs further reduced its projection for the quarter, but did not modify its guidance for the full year. (JA 144-45, ¶¶113-18) At the same time, defendants again falsely represented that demand "continues to grow" (JA 144, ¶114) and that "the 6500 is showing strength . . . . The demand is very strong."[13] (JA 145, ¶117)

Then, on April 18, 2001, the Company again lowered its guidance but, notwithstanding what defendants knew about falling demand for the Company's core products, still projected

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[13] Notebaert also gave false assurances that there was only a temporary deferral of 5500 orders: "The good news there is that the orders weren't cancelled. It was just do it after the end of the quarter." (JA 144-46, ¶¶116, 119(b))

full-year 2001 revenues within the range of $3.6 billion to $3.7 billion, a very substantial increase over 2000.[14] (JA 147, 152-53, ¶¶121, 142)

Thus, far from negating any inference of wrongdoing, defendants continued to misrepresent Tellabs' prospects, as the SAC alleges with particularity. (JA 140, 145-46, 147, ¶¶104 [March 7, 2001], 119 [April 6, 2001], 122 [April 18, 2001])

Defendants' assertion (Defts.' Rule 54 Statement at 13) that Tellabs' first quarter 2001 reported revenues increased by 21% over the previous year, thus purportedly evidencing continued growth, is misleading.[15] Tellabs' 2000 10-K states 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." *See* Defts.' App. of Materials Cited in the Mem. in Support of Defts.' Mot. to Dismiss (Doc. No. 74), Tab 7, at 122-23. Accordingly, a decline in demand would affect revenues on a delayed basis.[16] Therefore, it is apparent that the dramatic drop in sales for the second quarter 2001 was the result of earlier reductions in orders, which is consistent with the SAC.

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[14] For 2001, Tellabs ultimately reported net sales of less than $2.2 billion and a net loss of $182 million -- a decline from 2000 of more than 35% in net sales and about 125% in net earnings. (JA 152-53, ¶142)

[15] In fact, first quarter 2001 net earnings were about $123 million. First quarter 2000 earnings before the cumulative effect of a change in accounting principle were virtually the same -- about $121 million. (Defts.' App. of Materials Cited in the Mem. in Support of Defts.' Mot. to Dismiss (Doc. No. 74), Tab 18) [Tellabs' April 18, 2001 Press Release] Revenues fell by more than 24% from fourth quarter 2000 to first quarter 2001. (JA 129-30, 147, ¶¶81, 123(a))

[16] On March 8, 2001, Notebaert explained with regard to 5500: "We're in the process of installing … a large number of frames that we shipped in the fourth quarter…" (JA 140, ¶102)

D. Defendants Employed Channel Stuffing and Other Deceptive Devices to Hide Falling Demand

To bolster the false picture of robust demand, defendants engaged in numerous covert deceptive practices, including channel stuffing (JA 121-24, ¶¶62-71); jamming distributors with unsellable product (JA 122-124, ¶¶66-69, 71); writing phony purchase orders and delivering products customers had not ordered (JA 122-23, ¶¶63, 68); and backdating sales (JA 124, ¶70). Such practices artificially inflated Tellabs' fourth quarter 2000 results.[17] (JA 132, ¶86(a)) A senior Tellabs business manager reported that management approved channel stuffing, and that Notebaert had direct involvement with and knew about the channel stuffing, which a high-level sales executive confirmed.[18] (JA 122-23, 160-61, ¶¶67, 156)

- According to the same high-level sales executive, Tellabs employees fabricated purchase orders and Tellabs' Verizon team used channel stuffing as a strategy. (JA 122, ¶63) Defendants' channel-stuffing sales practices were so egregious Verizon's Chairman complained to Tellabs. (JA 124, ¶71)

- The senior business manager related that the magnitude of Tellabs' channel stuffing of 5500 in late December 2000 was "extraordinary" (JA 122, ¶64); that channel stuffing in December 2000 involving SBC alone amounted to roughly $20 million; that Telcobuy.com

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[17] That Tellabs has not restated its fourth quarter 2000 results does not support a nonculpable inference. It merely indicates that defendants and their auditors do not wish to admit wrongdoing, which is hardly surprising.

[18] The Class Period begins December 11, 2000 -- well into the fourth quarter 2000, which began September 30, 2000 (*see* JA 136, ¶94). Accordingly, although the sales executive left Tellabs shortly before the Class Period, he clearly was in a position to know about sales practices during fourth quarter 2000 and Notebaert's awareness of them.

and Verizon also were victimized by the channel stuffing; that Tellabs paid VARs[19], including Telcobuy.com, a certain percentage (5% or 10%) to hold inventory, an abnormal practice in the industry; that Telcobuy.com wanted to return the product because it realized it could not sell it to SBC and that Tellabs had jammed Telcobuy.com with inventory; and that approximately $10 million to $15 million of inventory came back in 2001 (JA 122-23, ¶67).

- A Tellabs customer service accounts representative recounted that Tellabs sent customers unwanted product (especially 5500); that customers returned 5500 merchandise as soon as it showed up; that, although customer sites often were not ready, Tellabs delivered product anyway to make its revenue numbers; that he processed millions of dollars of returns, mostly 5500s; that returns were so heavy during early 2001 extra storage space had to be leased; that returns in the first three months of 2001 were in the millions of dollars; and that Verizon and Telcobuy.com were heavily returning product. (JA 123, ¶68)

- A Tellabs marketing manager related that Tellabs definitely channel stuffed and loaded up distributors "big and fat" at the end of fourth quarter 2000 (especially in December), and that distributors were upset and later returned the product. (JA 122, ¶66)

- Another Tellabs marketing manager related that Tellabs got "creative" to meet fourth quarter 2000 and early 2001 investor expectations, including offering discounts and other incentives (not disclosed to the investing public), and shipping to distributors (including shipping 5500s to Lexcom in early 2001) without the ultimate customer's agreement to purchase, as is customary, which resulted in returns during the subsequent quarter. (JA 123-24, ¶69)

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[19] VARs -- value added resellers -- are third parties that work with Tellabs to handle customer services, including engineering site surveys, installations, and testing services, and also distribute Tellabs' products. (JA 105)

- According to the same marketing manager, to meet earnings expectations, Tellabs backdated sales for the 5500, pulling sales to larger customers from first quarter 2001 into fourth quarter 2000. (JA 124, ¶70)

The deliberate nature of channel stuffing, sales backdating, and other deceptive practices also creates a powerful inference of defendants' knowledge. Tellabs' undisclosed efforts to accelerate sales by channel stuffing hardly can be viewed as innocent in light of the SAC's allegations that employees fabricated purchase orders (JA 122, ¶63); that Tellabs sent customers unwanted 5500s (JA 123, ¶68); that Tellabs backdated sales (JA 124, ¶70); and that Verizon's Chairman even called Tellabs to complain about channel stuffing (JA 124, ¶71). Indeed, such blatantly improper practices compel an inference of wrongdoing that is not only cogent, but undeniable. In his separate opinion in *Tellabs*, Justice Stevens observed:

> ***The "channel stuffing" allegations . . . are particularly persuasive***. Contrary to petitioners' arguments that respondents' allegations of channel stuffing "are too vague or ambiguous to contribute to a strong inference of scienter," . . . ***this portion of the complaint clearly alleges that Notebaert himself had specific knowledge of illegitimate channel stuffing during the relevant time period***. . . . If these allegations are actually taken as true and viewed in the collective, ***it is hard to imagine what competing inference could effectively counteract the inference that Notebaert and Tellabs "'acted with the required state of mind***.'"

Tellabs, 127 S. Ct. at 2517 n.2 (emphasis added).[20]

Likewise, in its prior opinion, this Court explained:

> While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them. The

[20] The majority opinion does not address the persuasiveness of these or any other facts alleged in the SAC.

> complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Makor, 437 F.3d at 598. *See also Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1262 (11th Cir. 2006) ("We agree with the Seventh Circuit that channel stuffing may amount to fraudulent conduct when it is done to mislead investors . . . .").[21] With respect to Notebaert's awareness of such deceptive practices, this Court noted:

> Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert "worked directly with Tellabs'[s] sales personnel" to effect the channel stuffing. Another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered. He claimed that Notebaert "unquestionably knew" about the channel stuffing. As with the TITAN 5500 and 6500, we find that the complaint contains enough detail to establish a strong inference that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues.

Makor, 437 F.3d at 604-05.

Defendants' self-serving speculation (Defts.' Rule 54 Statement at 18) that Notebaert's participation in channel stuffing might only have involved fashioning incentives for customers to

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[21] In *Garfield*, the Eleventh Circuit concluded that allegations of channel stuffing had not been pled with sufficient detail to satisfy the PSLRA's strong-inference requirement. 466 F.3d at 1262-67. Thus, the Eleventh Circuit explained: "A general allegation that Individual Defendants promoted channel stuffing at a series of meetings does not establish scienter." *Id.* at 1265. The *Garfield* court also deemed insufficient a conclusion regarding the defendants' purported awareness of improper revenue recognition and the need to increase actual sales because it was "based on multiple inferences and drawn from somewhat baffling language." *Id.* Nor did the defendants' mere signing of the required Sarbanes-Oxley certifications support a strong inference of scienter. *Id*. at 1266. In this case, as detailed herein, far more is alleged.

buy Tellabs products[22] is unavailing. Innocent or not, such undisclosed incentives, and other deliberate practices intended to inflate sales, corroborate the information numerous Tellabs employees provided and further confirm demand was weakening by fourth quarter 2000 and defendants knew it.

Defendants' suggestion they had no plausible motive to misrepresent Tellabs' performance and prospects (Defts.' Rule 54 Statement at 19) defies common sense. The public revelation that Tellabs' most important product, 5500, was not selling and that one of its most important new products, 6500, was not ready, surely would have jeopardized the Company's standing in a highly competitive and troubled market. That Notebaert, whose livelihood and business reputation depended on his Company's success, desired to protect Tellabs and himself from the adverse effects of publicizing those problems makes complete sense.[23] Moreover, the Supreme Court has made clear: "the absence of a motive allegation is not fatal." *Tellabs,* 127 S. Ct. at 2511.

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[22] The SAC alleges the incentives Tellabs offered, which were not disclosed to the investing public, were excessive, unusual, and departed from ordinary business practices. (JA 121-22, ¶62; *see also* JA 122-23, 124, ¶¶67, 71)

[23] It also is relevant that the Company's Chairman and five other insiders personally profited from the artificial inflation of Tellabs stock by selling almost 150,000 shares for proceeds of over $8 million during the Class Period. (JA 153-56, ¶¶144-45) None of the insiders ***purchased*** any Tellabs stock during the Class Period (other than certain options exercised at substantially below-market prices, which were then immediately sold for a substantial profit). (JA 153-56, ¶¶144-45) The Court should draw no inference adverse to plaintiffs from the fact that Notebaert did not risk his reputation, property, or liberty by not engaging in illegal selling of Tellabs stock. (Moreover, discovery might well reveal that Notebaert had a financial motive that is not yet publicly known.)

E. Defendants' Sudden June 19, 2001 Announcement of Severe Problems Further Shows Their Scienter

After trading closed on June 19, 2001, the Class Period's last day, Tellabs, having known the truth for months, issued a press release dramatically revising its second quarter guidance, reducing projected revenues, by approximately $300 million, to $500 million and projecting earnings per share from $.29 to breakeven (before restructuring and other charges). Contrary to previous assurances that the telecommunications industry slowdown was not affecting Tellabs, the Company acknowledged: "The dramatic changes affecting the landscape of the telecommunications marketplace ***have continued*** to impact Tellabs" (emphasis added). (JA 150, ¶131)

During a subsequent analyst conference call, defendants attributed the severe revenue shortfall to a massive reduction in 5500 sales. (JA 150, ¶132) Further confirming the severity of Tellabs' problems, Notebaert admitted the revenue collapse affected Tellabs' business "across the board." (JA 150, ¶133)

A June 19, 2001 article titled "Tellabs Plays Mini-Nortel with Steep Shortfall" appearing in TheStreet.com noted: "While it was not a total surprise on Wall Street that Tellabs was having a bad quarter, the size of its shortfall came as a big shock. 'Mind-numbing,' as one New York hedge fund manager put it." (JA 151, ¶136)

The next day, June 20, the trading price of Tellabs common stock fell $5.16 per share, or more than 24% (the greatest percentage decline in the history of Tellabs stock), on extraordinary volume of almost 36 million shares (five times the average daily volume during the Class Period). (JA 151, ¶¶135, 137) In the following months, the price of Tellabs stock did not recover. (JA 152, ¶139)

Notwithstanding their unqualified assurances to investors as late as March 2001 that 5500 was "continu[ing] to maintain its growth rate" and was "still experiencing strong acceptance," and that Tellabs continued to expect 30% growth in revenues and earnings for 2001, defendants ultimately admitted they had been well aware, by at least "early … 2001," that demand was falling dramatically. Corroborating other facts pleaded in the SAC showing early declining demand, Notebaert's post-Class Period letter to shareholders in the 2001 Annual Report admitted: "***Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination***" (emphasis added). (JA 152, 164; ¶¶141, 172)

The Annual Report also revealed that, in April 2001, Tellabs had begun a series of layoffs, ultimately reducing its workforce by about 27%. Tellabs closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically. (JA 152, 163, ¶¶141, 170) It is a strong inference that the admitted-to "self-examination" that led to these moves and the planning of such dramatic cuts began at least earlier in 2001.

Diametrically opposed to all of Tellabs' Class Period public assurances of substantial, continued growth, Tellabs ultimately reported net sales attributable to products of only $407,701,000 and a net loss of $174,702,000 for second quarter 2001 -- a drop from second quarter 2000 of more than 43% in net sales and more than 211% in net earnings. For full year 2001, Tellabs reported net sales of $2,199,700,000 and a net loss of $182,000,000 as compared to net sales of $3,387,400,000 and net earnings of $730,800,000 for 2000 -- a decline of more than 35% in net sales and about 125% in net earnings. Further confirming the severity of

Tellabs' problems, the Company reported a net loss of $313,100,000 for 2002. (JA 152-53, ¶142)

The sheer magnitude of the Company's problems, and all the other particularized facts in the SAC, judged in their totality, as they must be, create an inference of Tellabs' and Notebaert's scienter that is cogent and at least as compelling as any nonculpable inference that might conceivably be drawn from the facts alleged.[24] *See Tellabs*, 127 S. Ct. at 2510. Indeed, the inference of wrongdoing is far more compelling than any purported innocent inference defendants have proffered. The SAC more than meets the pleading standard the Supreme Court articulated in *Tellabs.*

CONCLUSION

For all the foregoing reasons, the Court should again reverse the District Court's dismissal of the SAC and deny defendants' motion to dismiss.

Dated: September 19, 2007

Respectfully submitted,

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[24] Even without regard to Notebaert's scienter, the SAC clearly alleges knowledge on the part of many other members of Tellabs senior management, whose state of mind would be imputed to Tellabs for § 10(b) purposes. With respect to Tellabs' scienter, there is no requirement that the person with culpable knowledge be a named defendant. *See, e.g., City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468, 508 & n.35 (6th Cir. 2004).

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VERIFICATION OF DISKETTE

I, Luisa M. Walker, hereby certify that the diskette, filed herewith, containing the electronic version of Appellant's Brief, has been scanned for, and does not contain, any computer viruses.

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Luisa M. Walker