No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITIONERS' REPLY BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES Page

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Respondents have all but conceded that there is a deep split of authority concerning both the standard for pleading scienter under the PSLRA, and the ability of a court to take into account at the pleading stage inferences unfavorable to the plaintiff. Respondents have devoted but a single sentence to the split. In that sentence, respondents assert that "much" of what petitioners have said about the disparate approaches prevailing in the courts of appeals amounts to "differences in semantics, not substance." Opp. 1. But despite the availability of ample space in their brief, respondents make no effort to reconcile the different legal tests described in the petition. Pet. 3-5, 19-26.

The reason is simple: the different tests are substantive, not merely semantic. That is why the lower courts, including the Seventh Circuit here, have acknowledged that different courts

have interpreted the strong inference requirement differently, and have explicitly disagreed among themselves as to the appropriate legal standard and the role of unfavorable inferences. Pet. App. 20a-21a. As shown in the Petition, those differences are outcome determinative, which is why two well respected industry groups have recognized that the split is real and meaningful. Amicus Br. of SIFMA & Chamber of Commerce at 3-4. Only this Court can provide a uniform standard for determining whether a complaint has alleged a "strong inference of scienter."

Respondents ignore the pressing need for this Court to adopt a uniform interpretation of the "strong inference" standard, and rest their Opposition on the proposition that this is an inappropriate case for this Court to clarify the law because the facts of this case "satisf[y] any formulation of the PSLRA pleading requirements." Opp. 1. In fact, respondents' own discussion of why their allegations satisfy the "strong inference" standard merely mimics that of the Seventh Circuit, and suffers from the same defect. Both respondents and the Seventh Circuit refuse even to consider the innocent inferences that may be drawn from the record. Whether a court should consider such innocent inferences at all, and, if so, whether a complaint survives only if the inference of scienter is the most plausible is precisely the question that demands this Court's attention. Respondents' refusal even to acknowledge that important question cannot disguise the fact that this case presents an excellent vehicle for addressing it.

1. There is a mature circuit split regarding whether and to what extent inferences of a defendant's innocent mental state should be considered under the PSLRA's "strong inference of scienter" standard. Respondents nowhere dispute that the circuits have articulated different formulations for how district courts should evaluate whether a complaint adequately alleges facts that give rise to a "strong inference" that a defendant acted with scienter. The First, Fourth, Sixth and Ninth

Circuits have stated not only that innocent inferences should be considered, but that the inference of scienter must be the "most plausible," *i.e.*, more plausible than any innocent inference, for a complaint to survive. Pet. 19-20, *citing In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005), *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003), *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002), *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001). By contrast, the Tenth and Eighth Circuits forbid direct comparison of the strength of competing innocent and culpable inferences, and have expressly rejected the "most plausible" standard. Instead, these courts have instructed that the strength of innocent inferences should be considered only as a factor in determining whether an inference of scienter meets some threshold standard of strength. Pet. 20-21, *citing Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003), *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 665-67 (8th Cir. 2001). By further contrast, the Seventh Circuit, in the case under review, watered down the Tenth Circuit's standard, holding that a complaint should survive "if it alleges facts from which … a reasonable person *could* infer that the defendant acted with the required intent," Pet. App. 20a (emphasis added), and refused even to consider the innocent inferences that emerged from the record.[1]

Respondents treat these different approaches as non-substantive, semantic differences. Opp. 1. The courts of appeals disagree. The Ninth Circuit, when considering what role innocent inferences should play in evaluating a complaint, chose expressly to align itself with the Sixth

[1] The Seventh Circuit's standard is also noticeably weaker than that employed by the Second and Third Circuits, which have not permitted complaints to survive based on the kind of ambiguous allegations of scienter that the Seventh Circuit accepted. Pet. 23-24, *citing Novak* v. *Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000), *GSC Partners CDO Fund* v. *Washington*, 368 F.3d 228, 239-45 (3d Cir. 2004).

Circuit's "'most plausible of competing inferences'" test. *Gompper*, 298 F.3d at 897, *citing Helwig*, 251 F.3d at 553. The Eighth Circuit, on the other hand, has specifically chosen to back away from any suggestion that it had adopted that standard. *In re K-Tel Int'l Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). The Tenth Circuit expressly considered whether to adopt the "'most plausible of competing inferences'" standard, and chose to "reject the position of the Sixth Circuit." *Pirraglia*, 339 F.3d at 1188, *citing Helwig*, 251 F.3d at 553. At the same time, the Tenth Circuit agreed with the Ninth Circuit's view expressed in *Gompper* that a court must consider innocent inferences when evaluating whether a complaint adequately alleges a strong inference of scienter. *Pirraglia*, 339 F.3d at 1187-88. Respondents provide no basis for their view that the courts of appeals have been confronting, sometimes rejecting and other times accepting, each other's views for no substantive reason. As the Second Circuit has rightly observed, the role of innocent inferences "raises serious concerns." *Press* v. *Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000).

Moreover, the courts of appeals have made clear the substantive reasons that animated their choice of a particular standard. The Tenth Circuit, rejecting the "most plausible of competing inferences" standard, explained that its decision was driven by concern that weighing competing inferences is the province of the factfinder. *Pirraglia*, 339 F.3d at 1188. The Seventh Circuit went even further and argued that to avoid the need to inquire into a potential Seventh Amendment violation, courts should be precluded from considering innocent inferences altogether. Pet. App. 20a-21a. According to the Seventh Circuit, if a "reasonable person *could* infer that the defendant acted with the required intent," then the complaint should survive. *Id.* at 20a (emphasis added). The Seventh Circuit's test is materially weaker even than of the Tenth Circuit's, which requires a plaintiff to plead facts that "*would convince* a reasonable person that the defendant knew

a statement was false or misleading." *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003) (emphasis added).

The difference between whether an inference could possibly be drawn (the Seventh Circuit's test) and whether that same inference would be reasonably convincing (the Tenth Circuit test) or the most plausible (the Sixth Circuit test) goes to the substantive core of the PSLRA's "strong inference" standard. Merely requiring, as the Seventh Circuit does, that the inference of scienter be possible amounts to the traditional pleading rule that all inferences from the facts alleged should be drawn in favor of the plaintiffs. As the Ninth and Tenth Circuits have expressly recognized, to take that approach under the PSLRA's strong inference standard would all but eviscerate Congress's effort to raise the pleading standard. *Gompper*, 298 F.3d at 896; *Pirraglia*, 339 F.3d at 1187-88. This case, in which alternative innocent inferences were simply ignored by the court of appeals, goes to the heart of whether the "strong inference" standard will be interpreted in a way that advances or frustrates its purpose.

2. Respondents' discussion of the Seventh Circuit standard begs the question. Respondents argue that the Seventh Circuit acknowledged the PSLRA's "strong inference" requirement and recognized that a "heightened pleading standard" was intended. Opp. 1-4. This effort to characterize the Seventh Circuit's opinion as uncontroversial attempts to skirt the issue presented by the Petition. Respondents conclude that the Seventh Circuit correctly applied the "strong inference" standard merely because it repeatedly used the phrase "strong inference" in its opinion. *Id.* at 4 (counting usage of the phrase "strong inference"). But use of the language of the statute only begs the question of what standard is required by those words. Nobody can doubt that the PSLRA uses the phrase "strong inference." The dispute of authority that has arisen is, of course, not over what the words *are*, but rather over what they *mean*. The phrase is not self-interpreting; it

requires judicial exposition. And Congress clearly intended a uniform national standard, not the varying interpretations prevailing today.

Even though respondents ignore the dispute among the circuits over the interpretation of the "strong inference" standard, the Seventh Circuit did not. The Seventh Circuit expressly rejected the "most plausible of competing inferences" test adopted by the First, Fourth, Sixth and Ninth Circuits. Pet. App. 20a-21a. It did so for the specific reason that it thought that test raised concerns under the Seventh Amendment. *Id.* at 20a. The Seventh Circuit's discussion of what "strong inference" has meant to other courts, along with its own contribution to that debate, belies respondents' suggestion that merely uttering the phrase is enough.

How the Seventh Circuit actually evaluated the record in this case reveals clearly its lenient version of the "strong inference" standard. As explained in the Petition, the Seventh Circuit refused to evaluate the complaint in light of the innocent inferences that were apparent from the record, and instead held that a "complaint [should] survive if it alleges facts from which … a reasonable person could infer that the defendant acted with the required intent." Pet. App. 20a; Pet. 13-15. That is a more lax standard than that adopted by any other circuit. But even if it were not a uniquely weak standard, even if it were, for example, a faithful application of the Tenth Circuit standard (which it is not), there would still remain a deep split of authority requiring this Court's attention. Respondents simply ignore this fact.

3. This is an excellent vehicle for this Court to provide a uniform "strong inference" standard. Respondents devote the bulk of their Opposition to explaining why their complaint would survive under any interpretation of "strong inference." Their explanations simply ignore the question presented by the split of authority: whether and how a court should consider innocent inferences that may be drawn from the facts in a federal securities fraud complaint. When one focuses on that

issue, it becomes clear that this case sharply presents the question presented in the Petition.

Respondents emphasize their allegations that certain of Notebaert's public statements were false. Opp. 4-8. But this entirely misses the mark. For present purposes, petitioners do not dispute that the complaint adequately alleges that certain statements, *e.g.*, about the strength of demand for the Titan 5500, turned out to be false. *Id.* at 5-7. But alleging that statements were uttered which turned out to be false is not enough to establish Notebaert's liability under the federal securities laws. The statements must have been known by him to be false when made, or made with reckless indifference to the truth at the time. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976). The element of scienter, which is the focus of the Petition, is critical to ensure that our capital markets do not become bogged down in vexatious litigation, and that corporate executives are encouraged to provide information freely to the public concerning their companies. Amicus Br. of SIFMA & Chamber of Commerce 7-9. That is why courts recognize that allegations in a complaint that statements by defendants turned out to be false tell us nothing about whether a given defendant acted with scienter. Pet. App. 16a (stating that the allegations of actionable false statements "will not affect the ultimate outcome of this case" unless the complaint also adequately pleads scienter). Indeed, the fact that this Court may assume that certain statements within the class period were false only properly focuses attention on the actual issue presented: whether the complaint alleges facts giving rise to a "strong inference" that any alleged false statement by Notebaert was made by him with scienter.

Respondents do not turn to that question until page 9 of their 15 page brief. Yet even when (finally) devoting attention to the "strong inference" standard, respondents fail to engage meaningfully the central issue: whether and how a court should consider inferences that the defendant acted with an innocent mental state that may be drawn from the record.

Respondents' "analysis" consists largely of block quotations from the Seventh Circuit's decision. Opp. 9-12. But the problem emphasized by the Petition is that the Seventh Circuit chose not to consider inferences of an innocent mental state that could be drawn from the facts. Pet. 13-15, 26-28. Repeating what the Seventh Circuit said is simply non-responsive. What matters is whether the Seventh Circuit properly chose to look only to the inferences that "could" be drawin in respondents' favor in determining whether a "strong inference" of scienter had been alleged.

Respondents claim that "fairly construed, there are no competing innocent inferences to be weighed against the powerful inferences of culpability in this case." Opp. 12. Respondents' meager effort to support that assertion ignores the substantial basis for inferring innocence on this record.

For example, respondents' effort to deny that the April 6 and April 18 downward guidance revisions provide a basis for an innocent inference reflects their refusal (like the Seventh Circuit) even to engage innocent possibilities. Respondents argue that those revisions were "forced" by "the release of disappointing first quarter 2001 results." *Id.* at 14. But the heart of respondent's complaint is that needed revisions to guidance were deliberately not made until June 19, 2001. Respondents do not even try to explain why Notebaert, in the middle of an alleged seven-month fraud, would be "forced" to speak truthfully (even in part) about guidance revisions for the remainder of the year (lowering revenue projections by about 20%) by supposedly disappointing financial results in the first quarter of 2001. Much less do respondents attempt to explain what kind of facts could point to an innocent mental state if truthful statements modifying projections downward in response to truthful reports of financial results do not qualify.

The complete absence of any plausible motive for Notebaert to commit the alleged fraud is another significant "competing innocent inference," and respondents' response is similarly

weak.[2] The allegations of the complaint concern a circumscribed, seven-month period, ending when the company itself announced revisions to its guidance. There is no allegation that Notebaert sold stock during that period, and no allegation that the company benefited financially during that period. Yet respondents insist there was a motive because Notebaert would have wanted to protect his company from "the adverse effects of publicizing that" its products were not selling "in a highly competitive and troubled market." Opp. 12-13. But respondents never explain why Notebaert's supposed desire to protect his company from the adverse effects of the truth would suddenly evaporate a mere seven months after it formed, or why the "truth" after seven months would be any less harmful than the "truth" disclosed earlier. The innocent inference is powerful, even if respondents (and the Seventh Circuit) refuse to acknowledge it.

Respondents' claim that there are no innocent inferences to be drawn from this record is, in fact, a disguised assertion that courts should not engage innocent inferences at all. Only by refusing even to consider innocent inferences could respondents (following the Seventh Circuit) adopt an approach that rewards their ambiguous pleading with respect to both the Probe Research report and the alleged channel stuffing. See Pet. 27-28. Respondents emphasize their allegation that channel stuffing occurred, including illegitimate channel stuffing. Opp. 14. But, as below, respondents ignore the fact that they defined channel stuffing to include innocent conduct as well, and never alleged that Notebaert knew of or participated in any *illegitimate* channel stuffing. And, conspicuously, the paragraph in the Opposition describing

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[2] Respondent's assertion that the lack of motive allegations is unimportant because motive is not an essential element of a § 10(b) claim misses the point. Opp. 13. While motive is not an essential element of the claim, the presence or absence of allegations of motive are useful indications of the presence or absence of scienter. Pet. 24 *citing Kalnit* v. *Eichler*, 264 F.3d 131, 142 (2d Cir. 2001); *GSC Partners*, 368 F.3d at 238.

respondents' allegations of illegitimate channel stuffing makes no mention of Notebaert at all. It is respondents' own ambiguous pleading that raises the inference that Notebaert was unaware of any illegitimate channel stuffing, whether respondents acknowledge it or not.

In the end, pretending that, regardless of the legal standard, the record provides no basis for inferring that Notebaert acted with an innocent mental state does not make it so. To the contrary, the legal standard applied is dispositive here. The question of whether and how to consider innocent inferences that may be drawn from the record when determining whether a complaint adequately pleads facts giving rise to a "strong inference" of scienter is well presented by this case. That question has widely divided the courts of appeals. Granting the Petition will enable this Court to provide the uniform answer that Congressional policy and the proper functioning of our capital markets demand.

CONCLUSION

For the foregoing reasons, and those stated in the Petition, a writ of certiorari should be granted.

Respectfully submitted,

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