No. 06-

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

PETITION FOR A WRIT OF CERTIORARI

DAVID F. GRAHAM
ROBERT N. HOCHMAN
KEVIN C. PECORARO
SIDLEY AUSTIN LLP
One South Dearborn
Chicago, Illinois 60603
(312) 853-7000

CARTER G. PHILLIPS*
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Counsel for Petitioner

* Counsel of Record

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QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

PARTIES TO THE PROCEEDING

Petitioners, defendants-appellees below, are Tellabs, Inc., and Richard C. Notebaert. Additional defendants-appellees below are Michael J. Birck, Joan E. Ryan, Brian J. Jackman, Robert W. Pullen and John C. Kohler, all of whom are former officers or directors of Tellabs, Inc. Petitioner Tellabs, Inc. has no parent company, and no publicly held company owns 10 percent or more of Tellabs' shares.

Respondents are Makor Issues & Rights, Ltd, a corporation appointed as lead plaintiff-appellant below, and the individuals Chris Broholm, Richard LeBrun, David Leehey and Patricia Morris, all of whom purport to act on behalf of themselves and a class of all persons similarly situated.

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Petitioners Tellabs, Inc. and Richard C. Notebaert respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit was entered on January 25, 2006. That opinion was modified (on an issue that is not the subject of this petition) by an order entered on July 10, 2006. That Order is included in the Appendix at 118a-119a. The modified opinion is included in the Appendix ("App.") at 1a-27a. It has been officially reported and can be found at *Makor Issues & Rights, Ltd.* v. *Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006). The opinion and order of the United States District Court for the Northern District of Illinois dismissing

respondents' Second Consolidated Amended Class Action Complaint ("Second Amended Complaint") was entered on February 19, 2004, and is included in the Appendix at 28a-79a. That opinion has been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004). The opinion and order of the United States District Court for the Northern District of Illinois dismissing respondents' Consolidated Amended Class Action Complaint was entered on May 19, 2003, and is included in the Appendix at 80a-117a. That opinion has also been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 262 F. Supp. 2d 937 (N.D. Ill. 2003).

JURISDICTION

The court of appeals issued its original opinion on January 25, 2006. Petitioner timely sought rehearing, which resulted in an order modifying the original opinion dated July 10, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISION INVOLVED

Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747. Section 21D provides, in pertinent part, as follows:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

STATEMENT OF THE CASE

This case presents a deep split of authority with respect to what is perhaps the most important provision of a frequently invoked federal statute. The Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 ("Reform Act" or "PSLRA"), was passed by Congress to provide a strict, nationally uniform standard by which complaints alleging securities fraud under federal law would be judged. Congress deliberately chose to require that such complaints plead particularized facts creating a "strong inference" that the defendant acted with the culpable mental state required for liability. 15 U.S.C. § 78u-4(b)(2). Absent compliance with this requirement, litigation is not permitted to proceed past a motion to dismiss, thereby preventing the substantial litigation costs that too often forced defendants in such suits to settle even non-meritorious claims.

More than 10 years later, there is not the clear, uniform standard that Congress envisioned. Scienter is, of course, the culpable mental state required for a claim under Section 10(b) of the Securities Exchange Act of 1934, and is generally proved by inference rather than with direct evidence. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 391 n.30 (1983). The various courts of appeals have adopted four meaningfully different interpretations of the "strong inference" standard as applied to claims of scienter. There is now a 4-2-2-1 split of authority regarding whether and how a court applying the "strong inference" standard should consider the inferences of an innocent mental state that could be drawn from the complaint's allegations. Only this Court can resolve this important conflict.

The Seventh Circuit, in the case at hand, has determined that in ascertaining whether a "strong inference" of scienter has been adequately pleaded, it will not consider competing inferences of an innocent mental state that may also be drawn from the alleged facts. To consider the strength of innocent inferences as against any potentially culpable inferences at the

pleading stage, the Seventh Circuit reasoned, might "be misunderstood as a usurpation of the jury's role" in potential violation of the Seventh Amendment. Pet. App. 20a. To avoid this possibility, the Seventh Circuit held that a securities fraud complaint should survive "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." *Id.* (emphasis added).

Six other circuits allow innocent inferences to play a significant role in evaluating whether a complaint alleges facts from which a "strong inference" that the defendant acted with scienter may be drawn. All of these circuits reject the "could infer" standard of the court below, even as those six circuits disagree on what role reasonable innocent inferences should play in the analysis.

Four circuits—the First, Fourth, Sixth and Ninth—require a direct comparison of the plausibility of competing inferences. These courts have held that a court should consider all the reasonable inferences that might be drawn (both of scienter and of an innocent mental state) and then compare the relative plausibility of the culpable inference to the innocent inference. Unless the culpable inference is the *most* plausible, then it is not "strong" and the complaint should be dismissed. See *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); *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002).

The Tenth Circuit also considers all the inferences, both of scienter and of an innocent mental state, that may be drawn from the record. *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003). But the Tenth Circuit has expressly declined to follow the view, which it associated with the Sixth Circuit, that only the "'most plausible of competing inferences'" is "strong." *Id.* at 1188. And the Tenth Circuit has ruled that courts should not directly weigh the relative

plausibility of competing innocent and culpable inferences. *Id.* (emphasizing that the Tenth Circuit's approach "does not involve a 'weighing' of the plaintiff's suggested inference against other inferences"). The Tenth Circuit nonetheless considers the innocent inferences to determine "whether plaintiff's suggested inference is 'strong' in light of its overall context." *Id.* The Eighth Circuit considers innocent and culpable inferences similarly. *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 666-67 (8th Cir. 2001).

Finally, two courts—the Second and Third Circuits—have adopted an altogether different approach to evaluating whether the "strong inference" of scienter exists. Rather than consider all the allegations together, these courts have divided the allegations relating to mental state into two distinct types, "motive and opportunity" on the one hand, and "strong circumstantial evidence" that a defendant knowingly or recklessly issued false statements on the other, either of which might independently satisfy the "strong inference" standard. *Kalnit* v. *Eichler*, 264 F.3d 131, 138 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

That diverse approaches to the interpretation and application of the "strong inference of scienter" standard currently prevail in the courts of appeals is directly contrary to Congress's intent to create a uniform standard for pleading securities fraud nationwide. See H.R. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. In addition, the weakened version of the "strong inference" standard adopted by the Seventh Circuit in this case, the most lenient of any circuit, is also inconsistent with Congress's expressed desire to end the pernicious practice of pleading fraud with hindsight whenever a company's stock price tumbles, subjecting businesses to the Hobson's choice of paying out a quick settlement for a baseless claim or incurring massive risk and litigation costs. See S. Rep. No. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683. Only this

Court can clarify the "strong inference" standard—particularly how lower courts should consider inferences that the defendant was innocent—and provide the uniformity that Congress indisputably sought.

A. Nature Of The Case.

Petitioner Tellabs, Inc. is a manufacturer of specialized optical networks and broadband access equipment whose primary customers are telecommunications carriers as well as internet service providers. Petitioner Richard Notebaert was the CEO of Tellabs during the period relevant to this case. Like many of its competitors, Tellabs experienced a decrease in demand for its products during 2001, when the telecommunications and technology sectors suffered a severe contraction. The price of Tellabs shares consequently declined.

As is relevant here, respondents, plaintiffs below, representing a proposed class of Tellabs shareholders, sued Tellabs and several of its officers and directors under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). Respondents alleged that defendants had engaged in a scheme to inflate Tellabs' stock price between December 11, 2000 (the date when Tellabs first issued its projections for 2001 revenue) and June 19, 2001 (the date Tellabs withdrew its previous guidance for 2001 revenue and revised its projection of revenue for the second quarter of 2001).[1] In general, respondents alleged that Tellabs improperly booked revenue for the fourth quarter of

[1] Between those dates Tellabs revised its guidance several times, including decreasing its projected revenue for the first quarter of 2001 by approximately $90 million on April 6, 2001, and, on April 18, 2001, decreasing expected annual revenue for 2001 to an amount that was approximately $800 million less than originally forecast.

2000 and that, during the relevant period, Tellabs' revenue projections for 2001 were false.

As the case arrives at this Court, the relevant factual allegations have been substantially narrowed. And the only allegations of scienter held sufficient to support a Section 10(b) claim are those pertaining to Notebaert.

1. Respondents' claim that Tellabs' fourth quarter 2000 financial statements were intentionally false is based on certain allegations of what they term "channel stuffing." The complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing" and "unquestionably knew" that "channel stuffing" was occurring. Pet. App. 25a. However, the complaint defines "channel stuffing" to include not only improper conduct (such as writing orders for products customers had not requested), but also conduct that is *not* improper, such as "offering customers discounts of as much as 10% to 20%" and extending credit terms from 30 to 90 days. *Id*. at 58a.

Respondents used this broad definition of "channel stuffing" in the Second Amended Complaint despite having been admonished by the district court, in dismissing an earlier version of the complaint, that "there certainly is nothing inherently wrong with offering incentives to customers to purchase products." Pet. App. 99a-100a. And when the Second Amended Complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing," and knew that "channel stuffing" was occurring, it does not specify the type of "channel stuffing" activity engaged in by Notebaert; nor does it specify whether it is referring to his alleged knowledge of mere discounts and sales incentives or to the improper shipping of unordered products, both of which respondents lumped together under the term "channel stuffing."

2. As alleged by respondents, the reduction in projected second quarter earnings that Tellabs announced on June 19, 2001—an event that Petitioners characterize as disclosure of

"the truth"—was due almost entirely to a decrease in demand for the TITAN 5500, Tellabs' most popular optical networking product. Pet. App. 4a-5a. The claim that Petitioners falsely inflated Tellabs' projections for 2001 is, in turn, based largely on certain earlier statements that Notebaert made concerning the TITAN 5500.

As recounted by the Seventh Circuit, at various points in February, March and April of 2001, Notebaert made public statements of confidence in demand for the TITAN 5500. Specifically, in the 2000 Annual Report, published on February 14, 2001, Notebaert stated that the TITAN 5500, though ten years old, "'is still going strong.'" Pet. App. 23a. In a conference call with investors on March 8, 2001, Notebaert was asked by an analyst whether Tellabs was experiencing weakness in demand for the TITAN 5500; Notebaert responded that Tellabs was not and that the product was continuing "'to maintain its growth rate.'" *Id.* at 3a. On April 6, 2001, Notebaert told analysts that customers were indicating that "'in-user demand for services continues to grow.'" *Id.* at 23a.

Respondents alleged that Notebaert's statements of confidence in customer demand for the TITAN 5500 were knowingly false because Tellabs had commissioned a report by Probe Research that analyzed the strength of demand for that product. The complaint did not specify when this report was received by Tellabs, other than vaguely to assert that it was delivered "'in or about early 2001.'" Pet. App. 23a. According to respondents, however, the Probe Report led to a conclusion that 2001 revenue from the TITAN 5500 would decline by $400 million. Respondents also alleged that a confidential source reported that Tellabs had produced "internal reports" that "revealed by March 2001 that the market for the 5500 was drying up. *Id*. The complaint does not allege that Notebaert received or read either the Probe Research report or any of the unspecified, adverse internal reports, or was otherwise made aware of such reports, prior to having made any of his allegedly false statements.

Critical context as to these allegations was provided by publicly available documents that were referred to in the complaint and properly before the courts below. These documents made clear that on April 6, 2001, Tellabs began a public process of lowering its revenue projections precisely because, as it explicitly informed the market, it had observed a diminution in orders *during the latter portion of March 2001*. On April 6, Tellabs reduced its first quarter revenue guidance to $772 million (down from a range of $830 to $865 million). Tellabs specifically stated, in its analysts conference call held that same day, that it had experienced a fall-off in orders for the TITAN 5500 during the last two and half weeks of the first quarter (the end of March—which is consistent with the complaint's allegation that Tellabs produced internal reports in March 2001 indicating that demand for the product was weakening). Moreover, less than two weeks later, on April 18, 2006, Tellabs reduced its full year revenue projections to $3.6 to $3.7 billion, a nearly $800 million reduction from its original projections for 2001. Pet. App. 37a. This reduction is roughly double the $400 million reduction in revenue projections alleged to have been suggested by the internal report upon which respondents rely to establish Notebaert's scienter.

The reduction was accompanied by a clear statement that the business environment in which Tellabs was operating had changed within recent weeks. Tellabs explicitly advised that its customers were deferring, and in some cases reducing, capital spending. Pet. App. 36a-37a. Still, despite the reductions and concerns about the recent change in the business environment, Tellabs reported that sales in the first quarter of 2001, while not meeting its expectations for 30% growth, did grow by 21% over the prior year's first quarter, *id*. at 4a, which is consistent with Notebaert's alleged statement on April 6, 2001 that demand for the TITAN 5500 was continuing to grow. *Id.* at 23a. Respondents have never challenged the accuracy of those reported results for the first quarter of 2001. *Id.* at 64a.

3. Finally, respondents alleged certain false statements with respect to the TITAN 6500, which was then one of Tellabs' new products. Notebaert publicly stated, in March and April 2001, that customer demand for the 6500 was strong and that the company was shipping the product. As for the claim that Notebaert knew his statements in the spring of 2001 regarding the TITAN 6500 were false, the complaint relies exclusively upon a single confidential source who admittedly was no longer with the company by December 11, 2000, the start of the class period. Pet. App. 72a. The complaint contained no allegation that the confidential source had specific information about what Notebaert knew about the TITAN 6500 during the class period, or any reason to believe the confidential source would have had such specific information. Respondents also alleged, based upon the same source, that a Tellabs statement in December 2000 that the TITAN 6500 was "available now," made in connection with announcement of a $100 million multi-year sales agreement with Sprint for the TITAN 6500, was false.[2] The statement in question was not Notebaert's, however, *id.* at 84a, and no facts as to Notebaert's involvement were alleged.

4. The complaint alleges that the supposed fraud ended when Tellabs announced, on June 19, 2001 (only part-way through the second quarter), that orders for the TITAN 5500 had declined. Based on this reduction in demand, Tellabs revised its revenue projections for the second quarter by $300 million, and withdrew its full-year guidance.

Though Notebaert was allegedly engaged in a fraud to misstate Tellabs' fourth quarter 2000 financial performance

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[2] The putative confidential source claimed that in addition to defendants Jackman and Pullen, both of whom were alleged to be active in the development of the TITAN 6500, "Notebaert also knew about the TITAN 6500 problems." No facts were alleged regarding this assertion as to what Notebaert "knew." And this was the totality of the 6500 allegations pertaining directly to Notebaert. On appeal, respondents abandoned their § 10(b) claims against Jackman and Pullen.

and its 2001 financial projections, the complaint does not provide any reason *why* Notebaert or Tellabs would have suddenly started knowingly to misstate Tellabs' performance in December 2000 and, just as suddenly, stopped making false statements in June 2001—while also making several public downward revisions in projections in between. Notebaert is not alleged to have sold *any* shares of Tellabs stock during the period of alleged stock price inflation, or to have received any other personal benefit. Nor did the Second Amended Complaint allege that this supposed close-ended fraud had been undertaken in order to produce any benefit for the Company.

B. The District Court's Decisions.

The district court twice dismissed respondents' claims in lengthy, reasoned orders. Pet. App. 28-117a. As relevant here, in its second order, dismissing the entirety of respondents' Second Amended Complaint, the district court carefully examined the allegations of channel stuffing and false statements with respect to the TITAN 5500 and the TITAN 6500. The district court concluded that the allegations that respondents claimed pointed toward scienter were too vague to support a "strong inference" of scienter.

Specifically, with respect to the channel stuffing allegations (which form the basis of the claim that Notebaert participated in knowingly falsely inflating Tellabs' financial results for the fourth quarter of 2000), the district court noted that respondents had failed to "provide details" of precisely what "channel stuffing" activities Notebaert had engaged in. Pet. App. 74a. The district court noted that the absence of detail in the allegations was critical because the complaint had defined "channel stuffing" broadly enough to include innocent conduct. *Id.* at 58a, 74a, 99a-100a. These allegations were not enough, in the district court's view, to create a "strong inference" that Notebaert knowingly or recklessly engaged in improper channel stuffing activities.

The district court also examined the claim that the allegations regarding the Probe Research report, along with Tellabs' own internal reports, supported an inference that Notebaert acted with scienter in his statements about continued demand for the TITAN 5500. The district court first noted the conspicuous imprecision with respect to the alleged dates of the reports. Pet. App. 65a. The district court also noted that the complaint nowhere indicated "when Tellabs' revenue would feel the effect" of the allegedly predicted drop in demand. *Id*. The imprecision of the allegations was sufficient, according to the district court, to render the inference of scienter too weak to survive a motion to dismiss.

Finally, with respect to the remaining alleged false statements by Notebaert, the district court concluded that general allegations regarding "Notebaert's position in the company and general conclusions regarding his knowledge of the allegedly fraudulent activities without providing particulars" could not support a "strong inference" of scienter. Pet. App. 74a. Respondents' conclusory allegations regarding Notebaert's putative knowledge of problems with the TITAN 6500 were just that: allegations based on the non-specific assertion of a confidential source who had departed the company prior to the class period.

C. The Seventh Circuit's Decision.

1. Respondents appealed the dismissal of their § 10(b) claims against the company, Notebaert, and Tellabs' chairman of its Board, Michael Birck; the dismissal of the § 10(b) claims asserted against the remaining 4 of 6 individual defendants named in the complaint was not appealed. The Seventh Circuit affirmed the dismissal of the § 10(b) claims as to Birck, but reversed the dismissal as to Notebaert and the company.[3]

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[3] Respondents had also asserted control person liability claims under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), against the various

As relevant here, the Seventh Circuit began with a discussion of the "strong inference of scienter" pleading standard. Pet. App. 17a-19a. Initially, the court rejected the position adopted by the Second and Third Circuits, discussed above, *supra* at 5, that courts should distinguish between different types of allegations for purposes of the "strong inference" analysis. Pet. App. 20a. The Seventh Circuit continued by identifying another disagreement among the courts of appeals regarding the "strong inference" standard: what it termed "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" *Id*. The court was referring to the possibility that allegations in a complaint might give rise to competing inferences with respect to a defendant's mental state, and that courts must decide whether and how much to credit possible innocent inferences against possible culpable inferences.

As the court noted, the Sixth Circuit has expressly held that a strong inference under the PSLRA must be "'the most plausible of competing inferences.'" Pet. App. 20a (quoting *Fidel* v. *Farley*, 392 F.3d 220, 227 (6th Cir. 2004)). The Seventh Circuit expressly rejected that view.

In so ruling, the court suggested that consideration of competing inferences "could potentially" infringe on a plaintiff's Seventh Amendment rights to have a jury draw reasonable inferences in its favor. Pet. App. 20a. Having raised the possibility of a Seventh Amendment issue attached to any weighing of inferences, the court, "while express[ing] no view" on the merits of that putative issue, proceeded to adopt a standard expressly designed to avoid the issue. Specifically, to avoid the possibility of "usurp[ing] the jury's

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individual defendants, and appealed the dismissal of those claims too as to Notebaert, Birck and two of the other individual defendants. In addition, respondents had asserted and appealed a claim for insider trading against Birck under 15 U.S.C. § 78t-1(a). The Seventh Circuit has allowed these additional claims to survive. Those claims are all derivative of the § 10(b) claims against Notebaert and the company, however.

role," the Seventh Circuit adopted a standard that "allow[s a] complaint to survive if it alleges facts *from which a reasonable person could* infer that the defendant acted with the required intent." *Id*. (emphasis added).

2. Consistent with its view that the strong inference standard requires a court to credit what a reasonable person "could" infer, the Seventh Circuit read the ambiguous allegations with respect to whether and when Notebaert became aware of weakness in demand for the TITAN 5500 in respondents' favor, without any consideration for the plausible inferences of an innocent mental state that could be drawn from the same facts. For example, the court noted that the complaint "somewhat vague[ly]" stated that the Probe Research report was created "'in or about early 2001.'" Pet. App. 23a. The court also noted the allegation that internal reports, created at an unspecified time in "March 2001," revealed that demand for the TITAN 5500 was declining.

These allegations, which the court relied upon heavily, were conspicuously ambiguous. First, the timing of the Probe Research report and alleged internal reports was left uncertain. The question of timing was critical, however, to Notebaert's alleged knowledge of the falsity of statements he made about the TITAN 5500, *e.g.*, in February and *early* March. And, this question of timing was particularly acute given that on April 6, 2001, Tellabs itself had publicly disclosed a drop-off in orders for the TITAN 5500 in the last weeks of March, and publicly reduced its first quarter guidance as a result—followed twelve days later by another reduction in its full-year estimates, producing a 2001 total projection that was $800 million less than originally forecast. Second, the court itself observed that it was "conceivable" that Notebaert had not seen the alleged reports at the time of his statements. In fact, the Second Amended Complaint (like prior versions) contained no allegation that he had. The court noted, however, the existence of an allegation that Notebaert had generally "stayed on top of the company's financial health." Pet. App. 23a.

The court nonetheless proceeded to reward respondents' ambiguous pleading as to Notebaert by crediting the inferences of scienter because they were within the realm of what a reasonable person might infer. Pet. App. 23a ("the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false"). In doing so, the court made no mention and took no account of competing innocent inferences arising from, for example, the Company's voluntary, downwardly revised estimates made on April 6 and 18, and its accompanying disclosures of a weakening market.

Similarly, the court found that the complaint adequately alleged scienter with respect to the fourth quarter 2000 results because the complaint alleged that Notebaert knew about the "channel stuffing." Continuing to credit only a culpable inference if the alleged facts "could" support an inference of scienter, the court treated the "channel stuffing" allegation as if it alleged that "channel stuffing" meant *only* that "employees fabricated purchase orders for products that customers had not ordered." The court did not acknowledge what the District Court recognized, which is that the complaint defined "channel stuffing" to include innocent conduct, and failed to specify which type of conduct Notebaert had allegedly engaged in. Pet. App. 25a.

Finally, consistent with its refusal to consider potentially offsetting inferences, the Seventh Circuit did not consider or attempt to weigh the fact that the record revealed no apparent motive for Notebaert to engage in fraud during the class period, or any benefit either to him or the company. The Seventh Circuit simply closed its eyes to the innocent inferences that were readily available because its interpretation of the "strong inference" standard required that it not use its "imagination" to consider those innocent explanations at all.

REASONS FOR GRANTING THE PETITION

Congress passed the Reform Act in 1995 in response to a clear and abiding desire to bring an end to abusive strike suits involving meritless claims of securities fraud. S. Rep. No. 104-98, at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683. Such claims were often "based on nothing more than a company's announcement of bad news, not evidence of fraud." *Id.* Defendants often quickly settled regardless of merit in order to avoid the expense and risk of litigation. *Id.* at 9, *reprinted in* 1995 U.S.C.C.A.N. at 688; see *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 347-48 (2005). The expense of such litigation was indirectly borne by the capital markets, imposing an additional cost on capital formation that hurt both investors and corporations. S. Rep. No. 104-98 at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683.

Congress recognized that one source of the problem was that conflict among circuits on the legal standards for pleading securities fraud had created "opportunities for abuses." *Id.* In order to curb such abuses, Congress incorporated "uniform and more stringent pleading requirements" as a key feature of the Reform Act. H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740. One of the heightened pleading requirements is the critically important provision at issue here: a plaintiff must plead particularized facts giving rise to a "strong inference" that each defendant acted with the requisite mental state with regard to each alleged misrepresentation. 15 U.S.C. § 78u-4(b)(2). This constituted a marked departure from Fed. R. Civ. P. Rule 9(b), which otherwise allows state of mind allegations to be "averred generally." A complaint that fails to satisfy this heightened pleading burden cannot survive a motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(a).

This case presents this Court with the opportunity to ensure that both of Congress's goals with respect to pleading of securities fraud complaints are satisfied. First, the legislative effort to provide uniformity has failed. The courts of appeals

have adopted meaningfully different interpretations of the "strong inference" standard, and of the role of competing inferences in judging whether any inference is "strong." Only this Court can establish a uniform standard. Second, the approach adopted by the Seventh Circuit in this case does serious violence to the deliberately high pleading standard adopted by Congress, and to its desire to provide businesses with relief from costly strike suits.

Both the different approaches among the federal courts of appeals and the Seventh Circuit's particularly lax standard for policing the scienter allegations in securities fraud complaints mark this case as an excellent vehicle for the Court to announce a uniform rule that meaningfully weeds out undeserving cases when the scienter allegations are insufficient. The federal securities fraud laws are frequently invoked in private litigation. According to the most recent statistics, there were 176 federal securities fraud class action claims filed in 2005 alone. Cornerstone Research, *Securities Class Action Case Filings: 2005: A Year in Review* 2 (2006), *available at* http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006012302.pdf. Further, whether a complaint adequately alleges a "strong inference" of scienter is one of the most frequently litigated questions in such cases. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, SL020 ALI-ABA 891, 906 (2005). The venue provisions of the securities laws provide for national service of process, 15 U.S.C. §§ 77v & 78aa, which gives the plaintiff in a securities fraud case flexibility with respect to the jurisdiction in which a claim can be filed. The potential for forum shopping in this commonly litigated area of the law exacerbates the inherent injustice of inconsistent application of federal law.

1. There is a 4-2-2-1 split of authority over the interpretation of the "strong inference" standard and the role of competing inferences. The courts of appeals have now presented four distinct approaches regarding whether, and to

what extent, courts should take into account inferences of a defendant's mental state that are innocent when determining whether the claimed inference of scienter is "strong." The different approaches reflect four very different ways of resolving a tension created by the "strong inference" standard.

In the ordinary case, a court ruling on a motion to dismiss draws all reasonable inferences in favor of the plaintiff. See *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). As various courts have observed, however, to credit only the inferences of a defendant's mental state that are in the plaintiff's favor—only the potentially culpable inferences—"would be to eviscerate the [Reform Act's] strong inference requirement by allowing plaintiffs to plead in a vacuum." *Gompper*, 298 F.3d at 896. If only the inferences in favor of plaintiffs are considered, according to these courts, then the "strong inference" requirement would amount to nothing more than a requirement that plaintiffs plead some facts that merely could reasonably point toward a culpable mental state, which would be contrary to the recognized view that Congress meant to raise the pleading bar for scienter. *E.g.*, *Helwig* 251 F.3d at 553 (strong inference requirement "represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff the 'benefit of *all* reasonable inferences' and contemplated dismissal 'only if it is clear that no relief could be granted under *any* set of facts that could be proved consistent with the allegations'") (citations omitted).

Several courts have thus observed that "[i]n requiring a 'strong inference' of scienter, the PSLRA alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002) (the Reform Act "alters the usual contours of a Rule 12(b)(6) ruling"); *Green Tree*, 270 F.3d at 660-61 (noting that "Congress has effectively mandated a special standard for

measuring whether allegations of scienter survive a motion to dismiss") (citing *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999)). Rather than merely crediting inferences favorable to the plaintiff's view, some courts acknowledge that they also should consider the inferences of an innocent mental state favorable to the defendant. *Credit Suisse*, 431 F.3d at 51 (in a securities fraud case, a court should not "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"); *Gompper*, 298 F.3d at 897 ("when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs"); *Pirraglia*, 339 F.3d at 1187 ("In evaluating the strength of a plaintiff's inference of scienter, we may recognize the possibility of negative inferences that may be drawn against the plaintiff.").

Still, among the courts that consider inferences favorable to the defendant, a dispute has emerged regarding how to incorporate those inferences into the analysis of whether the complaint adequately pleads facts establishing a "strong inference" of scienter. The First, Fourth, Sixth and Ninth Circuits have concluded that if the proposed inference of scienter is not the *most* plausible that may be drawn from the record, the inference of scienter is not "strong" within the meaning of the Reform Act. According to these courts, if an innocent inference is as plausible as a culpable inference, then the complaint should be dismissed. *Helwig*, 251 F.3d at 553 ("plaintiffs are entitled only to the most plausible of competing inferences"); *Gompper*, 298 F.3d at 896-97 (rejecting proposed inference of scienter where "it is equally if not more plausible" that defendants acted without fraudulent intent); *Credit Suisse*, 431 F.3d at 49 ("Scienter allegations do not pass the 'strong inference' test when, viewed in the light of the complaint as a whole, there are legitimate explanations for the behavior that are equally

convincing."); *Ottman*, 353 F.3d at 350 (rejecting inference of scienter because it "was just as likely" that the fact pattern alleged by plaintiffs was the result of an innocent "overgeneralization as it was the product of intentional deception or recklessness"). Under this standard, it is clear that the complaint in this case would be dismissed.

The Tenth and Eighth Circuits, however, do not require that an inference of scienter be more plausible than the inference of an innocent mental state in order to be characterized as sufficiently "strong." That decisional conflict by itself warrants this Court's review. The most thoroughly reasoned explanation for rejecting the "most plausible inference" approach has been provided by the Tenth Circuit in *Pirraglia*. There, the Tenth Circuit reasoned that weighing, in comparative fashion, the relative strength of competing inferences is not the province of a court ruling on a motion to dismiss. 339 F.3d at 1188. The Tenth Circuit expressly stated that if two inferences are "equally strong …, one favoring the plaintiff and the other favoring the defendant," then the complaint should survive a motion to dismiss. *Id.* at 1187-88 (expressly rejecting the Sixth Circuit's standard in *Helwig*).

Rather than determine whether allegations give rise to a "strong inference" by evaluating which among competing inferences is the most plausible, the Tenth Circuit evaluates the strength of any scienter inference in light of "the context of other reasonable inferences that may be drawn." *Id.* at 1188. Ultimately, after considering all the facts and all the reasonable inferences drawn therefrom, the strength of any inference of scienter that emerges is subjected to a threshold standard. So long as that threshold of "strength" is met, the scienter pleading requirement is satisfied; it does not matter if the inference of scienter is the most plausible of the competing inferences. A "strong inference of scienter" in the Tenth Circuit is "a conclusion logically based upon particular 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). Moreover, in an attempt to reconcile the Reform Act with the traditional Rule 12(b)(6) standard that a complaint's factual allegations are to be viewed in the light most favorable to plaintiff, *Leatherman*, 507 U.S. at 164, the Tenth Circuit "will draw no inferences unfavorable to plaintiffs," but "will likewise refuse to draw inferences in the plaintiffs' favor" unless adequately supported in light of the "overall context." *Pirraglia*, 339 F.3d at 1187.

Like the Tenth Circuit, the Eighth Circuit has not adopted the "most plausible of competing inferences" standard of the Sixth Circuit. *In re K-tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). Instead, in *Green Tree* the Eighth Circuit, while not mentioning the Tenth Circuit by name, evaluated the complaint in a way that shows kinship with the Tenth Circuit's approach. The Eighth Circuit reversed the dismissal of a claim that company executives knowingly employed improper accounting practices to overstate the company's performance. The court recognized that the plaintiffs had alleged that the defendants possessed "knowledge of facts indicating crucial information in the statements was based on discredited assumptions." 270 F.3d at 665. It did not, however, stop there and hold that because a reasonable person might conclude that the defendants acted with scienter, the case must proceed. Rather, it confronted the defendants' alternative inferences pointing toward an innocent mental state. The defendants had argued that the accounting issues were complex for the sophisticated transactions at issue and that even "very large mistakes could fall within the realm of good faith." *Id.* at 666. The court recognized that "the defendants have many good arguments explaining how and why they thought their statements [were] proper." *Id.* at 667. Those arguments were not, however, strong enough to "sap[] the investors' allegations of their force at this procedural stage." *Id.*

The Seventh Circuit decision in this case provides a third approach. The Seventh Circuit, like the Tenth, expressly rejected the approach of four circuits that an inference of scienter is "strong" only if it is more plausible than any alternative inference. Pet. App. 20a. And, like the Tenth Circuit, the Seventh Circuit rejected such a comparative approach based on concerns about invading the province of the factfinder. *Id*. at 20a-21a (expressing concern that Sixth Circuit approach would violate the Seventh Amendment). But the Seventh Circuit went farther than any other court. Consistent with the Seventh Amendment concerns it voiced, the court created an especially liberal standard. A complaint should survive "if it alleges facts from which a reasonable person *could* infer that the defendant acted with the required intent." *Id.* at 20a (emphasis added). Conversely, only "[i]f a reasonable person could not draw such an inference from the alleged facts," is a defendant entitled to dismissal. *Id.* at 21a.

The Seventh Circuit's approach reflects the very approach specifically rejected by the Ninth Circuit in *Gompper*, 298 F.3d at 896. All that is necessary for a complaint to survive are facts from which it is merely reasonable to infer that the defendant acted with scienter. The Seventh Circuit nowhere qualified that analysis by recognizing or even discussing the importance of considering any inferences that the defendant acted with an innocent mental state. If a reasonable person "could" conceivably draw an inference of scienter, then the culpable inference is the only one a court should consider. The possibility that those same facts would support an innocent inference, or that other facts undermine the culpable inference, is legally irrelevant.

The limited nature of the Seventh Circuit's inquiry is confirmed by how it discussed the record in this case. Allegations that were said to support an inference of scienter were ambiguous enough, especially in the overall context of the record before the court, to support an inference of innocence. And, there were potential innocent inferences

arising from other facts before the court—*e.g.*, the April 6 and 18 downward guidance revisions and accompanying explanations—to which no consideration was afforded. The various other circuits discussed above would have wrestled with the innocent inferences, either to determine whether the inference of scienter was more plausible than the innocent inference (First, Fourth, Sixth and Ninth Circuits) or to determine whether the innocent possibility sufficiently weakened the inference of scienter to support dismissal (Eighth and Tenth Circuits). Further, the Tenth Circuit's threshold standard for an adequately "strong inference" is noticeably more exacting than that of the Seventh Circuit. The Tenth Circuit requires plaintiffs to plead "facts that *would convince* a reasonable person that the defendant knew a statement was false or misleading." *Adams*, 340 F.3d at 1105 (emphasis added). The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably "*could*" draw an inference of scienter. Pet. App. 20a (emphasis added).

The Seventh Circuit's approach is substantially more lax than that taken by the Second and Third Circuits as well. As noted above, these courts divide scienter allegations into two types: motive and opportunity on the one hand, and strong circumstantial evidence of knowledge or recklessness on the other.[4] *Kalnit*, 264 F.3d at 138; *In re Advanta Corp.*, 180 F.3d at 534-35. How these courts apply the "strong

[4] All the other courts of appeals to have considered the issue have held that the Reform Act requires courts to examine all the allegations in the complaint together, without drawing such distinctions. *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999); *Ottman*, 353 F.3d at 345; *Natheson* v. *Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *Hoffman* v. *Comshare (In re Comshare Sec. Litig.)*, 183 F.3d 542, 551 (6th Cir. 1999); Pet. App. 20a; *Green Tree*, 270 F.3d at 654-56; *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999); *City of Philadelphia* v. *Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir. 2001); *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999).

circumstantial evidence" standard is particularly relevant. Where there are no allegations of motive, these courts require that the strength of the circumstantial evidence of knowledge of falsity must be greater. *Kalnit*, 264 F.3d at 142; *GSC Partners CDO Fund* v. *Washington*, 368 F.3d 228, 238 (3d Cir. 2004). Here, by contrast, the Seventh Circuit made no attempt to factor in the negative inference arising from the absence of any claimed motive for Notebaert to commit fraud.

Moreover, while the Second and Third Circuits have yet to rule on what role innocent inferences should play in evaluating a securities fraud complaint for "strong circumstantial evidence" of knowledge of falsity, both have acknowledged the potential importance of the issue. *Press* v. *Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000) (stating that whether fact pointing toward an innocent mental state could "negate allegations of fraudulent intent … raises serious concerns"); *Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (observing, *in dicta*, that a fact from which an innocent mental state may be inferred can "weaken[]" the strength of an inference of scienter); *Digital Island*, 357 F.3d at 328 (noting that "strong inference" standard "alters the normal operation of inferences" for a Rule 12(b)(6) motion). Both courts have largely avoided the issue for now because they categorically do not allow precisely the sort of ambiguous allegations presented here to suffice. These courts require that a plaintiff plead that a defendant had "knowledge of facts or access to information contradicting their public statements" at the time the public statements were made. *Novak* v. *Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000); *GSC Partners*, 368 F.3d at 239-45. These courts apply this standard strictly by insisting upon particularized allegations that make clear that the relevant information was provided to the defendant. *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001) (claim allowed to proceed against one insider defendant who had allegedly seen original report that had expressed concerns that

were omitted from later distributed modified report, but claim dismissed as to other insider defendants because no allegation that they had seen original report); *In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 150-51 (3d Cir. 2004) (no strong inference of scienter as to insider defendants when there was no allegation that a whistleblower report of financial improprieties at the company's Brazilian subsidiary had been passed on to the defendants); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 278-79 (3d Cir. 2006) (strong inference of scienter alleged as to two insider defendants who allegedly excluded other employees from certain accounts with customers when those customers had pled guilty to creating false invoices and falsely labeling products at the direction of the company's management). The ambiguity in the timing of both the Probe Research report and the alleged internal reports, coupled with the admitted absence of any allegation that Notebaert saw any of these reports at the relevant time, would simply be fatal to the complaint in both the Second and Third Circuits.[5]

In the end, the contrast among the four different approaches is stark. The first two recognize the importance of considering plausible innocent inferences, but disagree regarding how to incorporate those inferences into determining whether any inference of scienter is "strong." The third, adopted by the Seventh Circuit in this case, eschews consideration of the innocent inferences and purports to protect the role of the factfinder by entertaining only the

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[5] The Second and Third Circuits also refuse to credit, as a substitute for particularized allegations of knowledge, the kind of generalized allegations accepted by the Seventh Circuit here, *i.e.*, that an executive "stayed on top of the Company's financial health," Pet. App. 23a. *Rombach*, 355 F.3d at 176 (allegation that defendants had "access to financial information and computer systems" is inadequate); *Advanta*, 180 F.3d at 539 (inadequate to allege that defendant "'must have known' a statement was false or misleading" because of his position in the company).

inferences favorable to the plaintiff. And to determine if those inferences should be credited, the Seventh Circuit asks only if a reasonable person "could" draw such inferences. The fourth approach has, for now, avoided determining how to incorporate innocent inferences by establishing a strict pleading standard, at odds with the Seventh Circuit's lax approach here, for claims that a defendant was aware of information contradicting his public statements at the time those public statements were made. This Court should grant the petition, reject the Seventh Circuit's approach, and provide an effective, clear, and uniform method for evaluating whether the inferences of scienter that may be drawn from a complaint are "strong" within the meaning of the Reform Act.

2. This case presents an excellent vehicle to review the "strong inference" standard. This case provides a strong record for this Court to consider and conclude whether and how to incorporate any inferences of an innocent mental state in the process of determining whether a securities fraud complaint alleges facts that create a "strong inference" that the defendant acted with scienter. The factual allegations at issue here are, at a minimum, subject to competing inferences (both innocent and culpable) in ways that arise frequently in securities litigation. For example, the complaint alleges the existence of internal reports discussing the declining demand for the TITAN 5500, but nowhere alleges that Notebaert actually reviewed any such report. Whether an executive of a corporation, by virtue of his position, "must have known" of internal reports commonly arises. See, *e.g.*, *Abrams* v. *Baker Hughes Inc*., 292 F.3d 424, 432 (5th Cir. 2002); *Fleming*, 264 F.3d at 1263-64; *Advanta*, 180 F.3d at 539; *In re AOL-Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 224, 230 (S.D.N.Y. 2004); *Smith* v. *Circuit City Stores, Inc.*, 286 F. Supp. 2d 707, 715 (E.D. Va. 2003); *D. E. & J Ltd. P'ship* v. *Conaway*, 284 F. Supp. 2d 719, 743 (E.D. Mich. 2003), *aff'd*, 133 F. App'x 994 (6th Cir. 2005); *In re Acterna Corp. Sec. Litig.*, 378 F. Supp. 2d 561, 573-75 (D. Md. 2005); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 475 (M.D.N.C.

2004); *Lirette* v. *Shiva Corp.*, 27 F. Supp. 2d 268, 283 (D. Mass. 1998) (citing *Maldonado* v. *Dominquez*, 137 F.3d 1, 9 (1st Cir. 1998)).

Also, the particularly lax approach to pleading scienter adopted by the Seventh Circuit here provides an especially urgent reason for this Court's review. Not only do meaningful differences in the interpretation of the statute prevail, but the Seventh Circuit has adopted a standard that encourages plaintiffs to employ strategic ambiguity in their pleadings to survive a motion to dismiss and accomplish precisely what the Reform Act was supposed to end: the imposition of massive litigation costs on businesses based on little more than a downturn in share price.

Respondents' claim depends on such strategic ambiguity. For example, it is utterly unclear when Notebaert is alleged to have learned from the Probe Research report and internal reports—reports he is not even alleged to have seen—that demand for the TITAN 5500 was softening. The dates on which the reports were created and when Notebaert might have reviewed them are critical to establishing his scienter. Yet the complaint alleges only that the Probe Research Report was created "'in or about early 2001'" and that the internal report was created in March 2001. Pet. App. 23a. These alleged dates cover the period all the way through the end of March 2001, which is significant in light of the fact that on April 6, 2001, Tellabs began lowering revenue projections precisely because, as it expressly disclosed to the market on that day, there was an unanticipated fall-off in orders for the TITAN 5500 during the last two and a half weeks of March. And on April 18, 2001, Tellabs lowered its own revenue projection for all of 2001 to an amount that was $800 million less than originally forecast, an amount *greater* than that allegedly suggested by the Probe Research report. *Id.* at 23a, 37a. Put simply, these facts make it clear that an inference of an innocent mental state is perfectly consistent with the allegedly broad of range of time in which the reports were issued. The Seventh Circuit has rewarded this ambiguity by

giving respondents the advantage of the most favorable inference that might be drawn from it.

The same is true with respect to the allegations of "channel stuffing." The First Amended Complaint defined both legitimate and illegitimate conduct as "channel stuffing." Despite the opportunity to replead, after the district court identified this critical ambiguity in its first dismissal order, respondents neither narrowed their definition of "channel stuffing" nor ever specified which "channel stuffing" activities Notebaert allegedly knew about or participated in. They left the allegations as to his knowledge of "channel stuffing" ambiguous enough to mean knowledge of either legitimate or illegitimate conduct. Once again, the Seventh Circuit rewarded the ambiguity by crediting the inference most favorable to respondents. Pet. App. 25a.[6]

Any approach to the Reform Act that rewards strategic ambiguity in pleading should be rejected. The fact that the statute requires the pleading of particularized facts that give rise to "a 'strong,' rather than merely a 'reasonable,' inference that the defendant acted with scienter is more than an odd linguistic quirk." *Credit Suisse*, 431 F.3d at 48. Congress's intent in including the "strong inference" requirement was to raise the standard for pleading scienter in

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[6] The Seventh Circuit's lax application of the "strong inference" standard is further illustrated by how it concluded that the § 10(b) claim against the other individual defendant on appeal, Birck, should be dismissed. Birck had sold a small amount of stock during the class period, but the court concluded the sale was insufficient to establish any motive. In addition, Birck's last statement regarding the TITAN 5500 was in February 2001. But, as the court noted, the complaint's allegations supported an inference that the earliest date that "the TITAN 5500's declining status was obvious" to Tellabs executives was sometime in March 2001, Pet. App. 24a. Even though there was no motive, and even though there was no pleaded basis to infer that Birck had been aware of contrary information at the time of his last public statement, the court nonetheless deemed the question whether there was a "strong inference" of his scienter to be a "close" one. *Id.*

securities fraud actions to limit the types of cases that would be allowed to survive a motion to dismiss and go forward to discovery. *E.g.*, *Comshare*, 183 F.3d at 548 ("In 1995, Congress concluded that Rule 9(b) had not prevented abuse of the securities laws by private litigants.'") (quoting H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740)). The Seventh Circuit's decision to credit only the reasonable inferences that favor respondents' view effectively revives the traditional standard of pleading under Rule 8(a), under which a plaintiff is entitled to have all reasonable inferences drawn in its favor. See, *e.g.*, *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 514 (2002). The Reform Act was supposed to put an end to precisely what the Seventh Circuit has allowed.

It was the Seventh Circuit's concern for avoiding supposed Seventh Amendment issues that led it to eschew competing negative inferences, and to focus only on whether reasonable inferences favorable to the plaintiff existed. Pet. App. 20a. That concern was misplaced. Congress's power to impose heightened pleading requirements, whether in a statute or in the Federal Rules of Civil Procedure, has never been questioned. *E.g.*, *Swierkiewicz*, 534 U.S. at 512-13; *Leatherman*, 507 U.S. at 168. Whether a complaint meets these requirements is a procedural matter, and a question of law, properly left to the courts. The jury trial right is simply not implicated at the motion to dismiss stage because "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Harlow* v. *Fitzgerald*, 457 U.S. 800 (1982); see also *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935) (noting that the Seventh Amendment is not implicated where matters of procedure and issues of law are concerned). The "strong inference" standard reflects Congress's policy judgment that plaintiffs should be entitled to impose burdens on the defendants and the courts only if the plaintiffs already have acquired enough facts to

create a strong inference of scienter. And other courts that have similarly considered the Seventh Amendment have not understood the Constitution to bar them from giving due consideration to the inferences that may be drawn in favor of the defendant. *City of Monroe Employees Ret. Sys.* v. *Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005), *cert. denied sub nom.* 126 S. Ct. 423 (2005); *Pirraglia*, 339 F.3d at 1188.

In the end, the courts are deeply divided regarding how to give effect to the "strong inference" protections for securities fraud defendants that Congress adopted in the Reform Act. The Seventh Circuit has uniquely weakened those protections without warrant. This Court should accept review to ensure both the uniform and effective application of "strong inference" standard.

CONCLUSION

This petition for writ of certiorari should be granted.

Respectfully submitted,

DAVID F. GRAHAM
ROBERT N. HOCHMAN
KEVIN C. PECORARO
SIDLEY AUSTIN LLP
One South Dearborn
Chicago, Illinois 60603
(312) 853-7000

CARTER G. PHILLIPS*
SIDLEY AUSTIN LLP
1501 K Street, N.W.
Washington, D.C. 20005
(202) 736-8000

Counsel for Petitioner

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* Counsel of Record