UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, ON BEHALF OF ITSELF AND ALL OTHERS SIMILARLY SITUATED, Plaintiff, - against - HOUSEHOLD INTERNATIONAL, INC., ET AL., Defendants.	Lead Case No. 02-C5893 (Consolidated) CLASS ACTION Judge Ronald A. Guzman

APPENDIX OF UNREPORTED AUTHORITIES
RELIED UPON IN DEFENDANTS' REPLY MEMORANDA
FILED FEBRUARY 13, 2009

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APPENDIX OF UNREPORTED AUTHORITIES

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TAB 1

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IRENE ABRAMS, on behalf of herself and all others similarly situated, Plaintiffs, v. VAN KAMPEN FUNDS, INC., VAN KAMPEN INVESTMENT ADVISORY CORPORATION, VAN KAMPEN PRIME RATE INCOME TRUST, RICHARD F. POWERS, III, STEPHEN L. BOYD, and DENNIS J. McDONNELL, Defendants.

No. 01 C 7538

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

2005 U.S. Dist. LEXIS 531*; *Fed. Sec. L. Rep. (CCH) P93,072

January 12, 2005, Decided
January 13, 2005, Docketed

SUBSEQUENT HISTORY: Settled by, Claim dismissed by *Abrams v. Van Kampen Funds, Inc., 2006 U.S. Dist. LEXIS 2129 (N.D. Ill., Jan. 18, 2006)*

PRIOR HISTORY: *Abrams v. Van Kampen Funds, Inc., 2004 U.S. Dist. LEXIS 11730 (N.D. Ill., June 24, 2004)*

DISPOSITION: Plaintiffs' Motions In Limine granted in part and denied in part.

COUNSEL: [*1] For IRENE ABRAMS, ON BEHALF OF HERSELF AND ALL OTHERS SIMILARLY SITUATED, Plaintiff: Marvin Alan Miller, Matthew Eric Van Tine, Jennifer Winter Sprengel, Miller Faucher and Cafferty, LLP, Chicago, IL; Joel H Bernstein, Christopher J. Keller, Stephanie E Katz, David J Goldsmith, Goodkind, Labaton, Rudoff & Sucharow, New York, NY; Paul Jeffrey Geller, Cauley Gellar Bowman & Coates, LLP, Boca Baton, FL.

For VAN KAMPEN FUNDS, INC., INVESTMENT VAN KAMPEN, INVESTMENT ADVISORY CORP., HOWARD TIFFEN, RICHARD F POWERS, III, STEPHEN L BOYD, DENNIS J MCDONNELL, JEFFREY W MAILLET, Defendants: Michael B Slade, Kirkland & Ellis LLP, Chicago, IL; William H. Pratt, Joseph Serino, Jr, Maria Ginzburg, Kirkland and Ellis, New York, NY.

For VAN KAMPEN PRIME RATE INCOME TRUST, Defendant: Charles F. Smith, Jr., Lee Price Garner, Skadden Arps Slate Meagher & Flom, LLP, Chicago, IL; Joseph Serino, Jr, Maria Ginzburg, Kirkland and Ellis, New York, NY; Victoria Aisen Birov, Law Offices of Victoria A. Birov, Wilmette, IL

JUDGES: WILLIAM T. HART, UNITED STATES DISTRICT JUDGE.

OPINION BY: WILLIAM T. HART

OPINION

MEMORANDUM OPINION AND ORDER

A. BACKGROUND

This is a consolidated class action alleging [*2] federal securities violations involving defendant Van Kampen Prime Rate Income Trust's (the "Fund") valuation of senior loans and is subject to the Private Securities Litigation Reform Act of 1995 ("PSLRA"), *15 U.S.C. § 77z-1*. A class has been certified consisting of all persons who purchased shares in the Fund between September 30, 1998 and March 26, 2001, inclusive, with defendants and certain related parties excluded. *See Abrams v. Van Kampen Funds, Inc., 2002 U.S. Dist.*

LEXIS 16022, 2002 WL 1989401 (N.D. Ill. Aug. 27, 2002) ("*Abrams II*"). Named as defendants are the Fund; Van Kampen Funds, Inc. ("Van Kampen"), the Fund's administrator; Van Kampen Investment Advisory Corp. (the "Adviser"), the Fund's investment adviser; Richard Powers, Fund Chairman of the Board, President, and Trustee during the relevant time period; Dennis McDonnell, former Fund Chairman of the Board, President, and Trustee and Fund Portfolio Manager from July 1999 until December 1999; and Stephen Boyd, Fund Executive Vice President and Chief Investment Officer and Adviser Officer during the relevant time period. Count I of the Consolidated Amended Complaint alleges violations of § 11 of the [*3] Securities Act, *15 U.S.C. § 77k*, against Van Kampen, the Fund, Powers, McDonnell, and Boyd. Against Van Kampen and the Adviser, Count III alleges control person liability under § 15 of the Securities Act, *15 U.S.C. § 77o*, based on the alleged *§ 11* violations. [1] Following a ruling on the parties' cross motions for summary judgment, *see Abrams v. Van Kampen Funds, Inc., 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 (N.D. Ill. June 25, 2004)* ("*Abrams III*"), the parties filed their final pretrial order. Pending are the parties' various motions in limine.

1 Claims for violations of § 12 of the Securities Act, *15 U.S.C. § 77l*, and state law claims, as well as claims against two individual defendants, were voluntarily dismissed. Following notice and a fairness hearing, the voluntary dismissal of those claims was approved by the court. *See* Order dated Dec. 8, 2004. *See also Abrams v. Van Kampen Funds, Inc., 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 *1 n.1, *9 n.3 (N.D. Ill. June 25, 2004)*.

[*4] Plaintiffs contend that defendants violated *§ 11* by making the following misrepresentations in various prospectuses that were issued during the class period. First, plaintiffs contend that defendants misrepresented the value of shares of the Fund in that they overvalued the loans held by the Fund. Plaintiffs contend that using available market quotations and properly determining fair value based on what the loans would have currently sold for would have resulted in lower daily net asset values ("NAV") for the Fund. Second, plaintiffs contend the prospectuses contained misrepresentations that the Fund used market quotations where available when this was not done. [2]

2 Allegations regarding misrepresentations as to the Fund's goals were dismissed on summary judgment. *See Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *9*.

To succeed on their *§ 11* claims, plaintiffs must show that defendants were responsible for untrue statements of material fact or omitted material facts in a prospectus. *See Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82, 74 L. Ed. 2d 548, 103 S. Ct. 683 (1983)*; [*5] *Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *1*; *Ong v. Sears, Roebuck & Co., 2004 U.S. Dist. LEXIS 19425, 2004 WL 2534615 *16 (N.D. Ill. Sept. 24, 2004)*. There is no scienter or reliance requirement; instead responsible persons are liable for the material and misleading statements contained in a prospectus unless they can affirmatively make certain showings as to their knowledge and diligence. *See Herman, 459 U.S. at 382*; *Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 2534615 at *1*; *Ong, 2004 U.S. Dist. LEXIS 19425, 2004 WL 2534615 at *16*. A misstatement is material if there is a substantial likelihood that it would be viewed by a reasonable investor as significantly altering the total mix of available information and thus important to the investor's decision to invest. *TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 48 L. Ed. 2d 757, 96 S. Ct. 2126 (1976)*; *Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *1*; *Ong, 2004 U.S. Dist. LEXIS 19425, 2004 WL 2534615 at *32*.

Here, a central issue for plaintiffs' claims is the method of valuing the senior loans held by the Fund. The parties do not dispute that the applicable general principle is that the loans were to be valued on a daily basis at the amount that could have [*6] been obtained from a current sale. *See* SEC Accounting Release Series No. 118, 1970 WL 5621 *4 (Dec. 30, 1970) ("ASR 118"); *Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *2*; *In re Allied Capital Corp. Securities Litigation, 2003 U.S. Dist. LEXIS 6962, 2003 WL 1964184 *1 (S.D.N.Y. April 25, 2003)*; *In re Eaton Vance Corp. Securities Litigation, 206 F. Supp. 2d 142, 151-52 (D. Mass. 2002)*. *See also 15 U.S.C. § 80a-2(a)(41)(B)*; *17 C.F.R. § 270.2a-4(a)*. The parties also agree that current value is to be determined by "market quotations" where "readily available," or by "fair value" methods if market quotations are not readily available. *See 15 U.S.C. § 80a-2(a)(41)(B)*; *17 C.F.R. § 270.2a-4(a)(1)*; ASR 118, 1970 WL 5621 at *3; *Abrams III, 2004 U.S. Dist. LEXIS*

*11730, 2004 WL 1433620 at *2*; *Eaton Vance, 206 F. Supp. 2d at 147*. Regarding the class period, the parties disagree as to whether the pricing services that were then available qualified as readily available market quotations. To qualify as readily available market quotations that [*7] must be used to value securities, the pricing services must provide quotes that are sufficiently timely, sufficiently frequent, and sufficiently accurate. *Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *2*; *Eaton Vance, 206 F. Supp. 2d at 148-49*. On summary judgment, it was held that genuine factual disputes existed as to when market quotations first became readily available. *See Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *4-6*. It was also held that genuine factual disputes existed as to defendants' affirmative defense that they acted with due diligence in exercising their business judgment in determining that market quotations were not yet readily available. *See 2004 U.S. Dist. LEXIS 11730, [WL] at *6*. Additionally, it was held that genuine factual disputes existed as to whether defendants determined the value of loan assets in the manner described in the pertinent prospectuses. *See 2004 U.S. Dist. LEXIS 11730, [WL] at *7-8*. The parties' agreed statement of contested issues of fact and law is consistent with the foregoing. *See* Proposed Final Pretrial Order Exh. B.

In light of the contested issues and other background described above, rulings will be made as to the pending motions in limine. Plaintiffs' motions [*8] in limine will be considered first.

B. PLAINTIFFS' MOTIONS IN LIMINE

1. To Bar Evidence that Traders Issued False Loan Pricing Data [138-1]

Defendants contend that certain pricing services were unreliable because they were based, in part, on market participants reporting the price at which they would sell or purchase loans, not actual sales. Defendants contend such reports were particularly unreliable because a significant number of market participants would overstate or understate the price so as to gain an advantage when actually selling or buying. Plaintiffs seek to bar any evidence of such manipulative price reporting on the ground that any such evidence is hearsay based on rumors, with there being no potential testimony based on personal knowledge.

Defendants contend that Allison Taylor can properly provide such testimony. She is a former senior loan trader, a founding member of the Loan Syndication and Trading Association ("LSTA"), [3] LSTA's initial Chairman, and, since 1998, the executive director of LSTA and LSTA/LPC. Defendants contend she can testify from personal experience and knowledge regarding her observations as to how LSTA/LPC functions. [*9] Defendants also point to disclaimers on LSTA/LPC forms regarding the pricing being based on estimated values provided by dealers, not necessarily actual trades. Taylor certainly can testify as to LSTA/LPC's procedures and methodologies. The question is whether any testimony that she believes market participants manipulated price reports would be inadmissible speculation or an observation based on personal experience.

3 LSTA is a senior loan pricing service first formed in 1995. In 1999, it merged with the Loan Pricing Corporation ("LPC"), which had began gathering data on senior loans in 1985. *See Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *5-6*.

Since neither party provides Taylor's deposition testimony that is pertinent to this motion [4], this issue cannot be resolved on the documents before the court. If Taylor were to testify that others told her participants were manipulating their price reports, that would be inadmissible hearsay. If she were to testify that she determined that actual participants [*10] were manipulatively reporting prices, that would likely be testimony based on personal observations. As long as there is a proper foundation, she could report such observations and conclusions. She need not be an expert to provide such testimony. *See Fed. R. Evid. 701*. At this time, with a very limited description of the testimony, no ruling can be made as to the admissibility of Taylor's testimony on this subject. Also, a question remains as to whether defendants actually relied on Taylor's findings.

4 Short excerpts of Taylor's deposition testimony in this case and another case are provided regarding other motions in limine.

Defendants also contend that they have "corroborating evidence" that is consistent with Taylor's observations. This consists of testimony from Van Kampen representatives regarding conversations with senior loan market participants making clear they had no intention of honoring bids or asks they had reported and

an email from a Citibank trader expressing [*11] concerns about price reporting manipulation. Defendants do not contend that this evidence is admissible to prove the truth of the matters reported by the participants and Citibank trader. They instead contend that it is admissible to show defendants' reasoning in not accepting certain price information. Plaintiffs contend that is an irrelevant purpose because intent need not be shown to prove a *§ 11* violation. However, information available to defendants would be relevant to defendants' business judgment defense. This evidence will not be excluded. If desired, plaintiffs may submit a proposed limiting instruction regarding the jury's use of this evidence.

This motion in limine will be denied as to the "corroborating evidence." As to Taylor's testimony, the motion will be denied without prejudice to raising objections at trial.

2. To Exclude the Testimony of Kevin Meenan and Anthony DeLuca [139-1]

At trial, defendants intend to call Kevin Meenan as a witness and may call Anthony DeLuca. Meenan started a senior loan pricing service while working for his own firm. That firm was later purchased by Societe Generale Bank ("SocGen") and Meenan continued to provide pricing [*12] services through SocGen. SocGen was one of the pricing services used by the Fund. DeLuca was a managing director for Morgan Stanley, the parent of Van Kampen. In 1999, DeLuca conducted a review of third-party pricing of senior loans, including pricing by LPC, and reported his findings to Van Kampen's Board.

Plaintiffs object to both witnesses on the ground that they were not disclosed in response to interrogatories. Plaintiffs also contend that these two would be expert witnesses, but were not disclosed as such and no expert reports were provided. Defendants contend they did not have to update their interrogatory responses because these two potential witnesses were disclosed to plaintiffs during deposition testimony. Defendants contend they are fact witnesses, not experts.

There is no dispute that Meenan and DeLuca were omitted from certain discovery responses for which their names and knowledge or involvement would have been responsive to the queries. However, defendants were not required to supplement those prior responses if the corrective information was otherwise made known to plaintiffs during the discovery process. *See Fed. R. Civ. P. 26(e)* [*13] . Also, even if there was an improper failure to disclose, the evidence should not be excluded if the nondisclosure was harmless. Here, Meenan's role at SocGen was disclosed during two depositions, including a Van Kampen Vice President testifying that Meenan was the person at SocGen most knowledgeable about third-party pricing. DeLuca's involvement in the review was disclosed in the deposition of Van Kampen's General Counsel and the Board minutes for the meeting at which he made his report. Meenan's and DeLuca's knowledge and potential as witnesses were adequately disclosed during discovery. Therefore, defendants were not obliged to supplement their prior interrogatory responses.

Plaintiffs still complain that the witnesses were not disclosed as providing expert testimony. Since these witnesses were not retained or specially employed to provide expert testimony, the requirement of providing an expert report cannot apply to their testimony. *See Fed. R. Civ. P. 26(a)(2)(B)*; *Musser v. Gentiva Health Services, 356 F.3d 751, 756-57 (7th Cir. 2004)*. If some of their testimony would include opinions "based on scientific, technical, [*14] or other specialized knowledge," then they should have been disclosed as expert witnesses in accordance with *Fed. R. Civ. P. 26(a)(2)(A)*. *Musser, 356 F.3d at 756* & n.2.

It is doubtful that Meenan and DeLuca would be testifying as experts. Like Taylor, Meenan can testify about practices at SocGen, including drawing conclusions and expressing some opinions about what happened there, without having to rely on scientific, technical, or specialized knowledge. And even if his testimony could be properly characterized as including some expert testimony, the deposition testimony disclosing his role at SocGen would have served to disclose that possibility. Meenan's testimony would not be excluded for failure to name him as an expert. DeLuca's testimony also does not appear likely to include expert testimony. Presumably he will testify as to what he reported to the Board and possibly as to methods he used during his investigation. But, even if some of DeLuca's testimony is properly classified as expert testimony, his potential testimony was also adequately disclosed. His testimony will not be excluded.

Although there was discovery in [*15] which Meenan and DeLuca were disclosed and therefore no technical violation of *Rule 26*, defendants still should have clarified to plaintiffs that Meenan and DeLuca were

potential witnesses, especially if defendants have any intention of eliciting expert testimony from either witness. Counsel for defendants likely were aware of Meenan's and DeLuca's roles prior to their names being mentioned at depositions and should have disclosed them prior to the depositions. Moreover, as plaintiffs point out, they were limited as to the number of witnesses they were permitted to depose and therefore focused on persons who were expressly named by defendants as potential witnesses. Had Meenan and DeLuca been expressly identified by defendants, plaintiffs may have chosen to depose one or both of them. The court will exercise its discretion to reopen discovery for the limited purpose of permitting the deposition of these two witnesses. However, DeLuca is listed as a possible witness, not a definite witness. If defendants represent to plaintiffs that they have decided not to use him as a witness, plaintiffs will not be permitted to depose DeLuca and defendants will not be permitted to present him at [*16] trial.

For the foregoing reasons, this motion in limine will be granted in part and denied. Plaintiffs may depose Meenan and DeLuca within 45 days after the date of today's order.

3. To Exclude the Testimony and Report of Michael P. McAdams [140-1]

Michael P. McAdams, whom defendants intend to use as an expert witness, has more than 20 years of experience in investment management and banking. From its inception in 1988 until 1995, he managed Pilgrim Prime Rate Trust, the first retail, floating-rate loan fund. Since 1995, he has had high-level positions at two other asset management firms. He was an early member of LSTA and has served on its Board, including as Chairman of the Board. He has also been a member of LSTA's valuation project committee. Plaintiffs do not dispute that he has the credentials to be an expert in the field of senior loans. However, plaintiffs contend that the opinions expressed in his expert report are not adequately supported and therefore he does not meet the requirements to testify as an expert that are set forth in *Fed. R. Evid. 702* and *Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993)*. [5]

> 5 Although the title of plaintiffs' motion refers to excluding McAdams's report, the request for relief refers only to excluding his testimony. The report itself would not be admissible evidence absent a stipulation by the parties that the report itself represents McAdams's testimony.

[*17] In 2000, *Rule 702* was amended to conform with *Daubert* and its progeny, including *Kumho Tire Co. v. Carmichael, 526 U.S. 137, 143 L. Ed. 2d 238, 119 S. Ct. 1167 (1999)*. Expert testimony is not to be presented to a jury unless "(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts in the case." *Fed. R. Evid. 702*. *Daubert, 509 U.S. at 592-94*, sets forth a list of factors to consider in determining reliability. The list is not definitive; particular factors in that list may or may not be pertinent in evaluating particular expert testimony. *Kumho, 526 U.S. at 150-51* (quoting *Daubert, 509 U.S. at 593*); *United States v. Romero, 189 F.3d 576, 584 (7th Cir. 1999)*, *cert. denied*, *529 U.S. 1011, 146 L. Ed. 2d 232, 120 S. Ct. 1286 (2000)*. The *Rule 702* inquiry is "flexible." *Kumho, 526 U.S. at 150* (quoting *Daubert, 509 U.S. at 594*). The flexibility of the inquiry is particularly important to keep in mind when the field of expertise is not a scientific [*18] one as in *Daubert. See Romero, 189 F.3d at 584*; *Pease v. Prod. Workers of Chi. & Vicinity Local 707, 2003 U.S. Dist. LEXIS 14751, 2003 WL 22012678 *4 (N.D. Ill. Aug. 25, 2003)*. In determining the reliability of the proffered testimony, the focus must be on the soundness of the methodology that is used, not on whether the conclusions that the expert reaches are correct. *Deputy v. Lehman Brothers, Inc., 345 F.3d 494, 506 (7th Cir. 2003)*; *Dewick v. Maytag Corp., 324 F. Supp. 2d 894, 898 (N.D. Ill. 2004)*; *Pease, 2003 U.S. Dist. LEXIS 14751, 2003 WL 22012678 at *4*.

McAdams presently offers the following five opinions: [6]

> 2. Market quotations in the traditional sense--i.e. prices that reflect where bona fide transactions between willing buyers and sellers actually took place or where a buyer or seller definitely would transact business--do not exist in the senior loan market except in the most unusual and unpredictable circumstances. Market indications are not the same thing as market quotations.
>
> 3. From September 1998 through

January 25, 2000, Van Kampen's method of valuing senior loans, and particularly how it used third-party pricing data when [*19] and if it was reasonably available, was consistent with the markets' development at that time and was consistent with the methodology set forth in the prospectus.

4. In January 2000, Van Kampen's decision to base its fair value determinations on LSTA/LPC indications where there were at least three bids, three asks and a spread of less than 100 basis points was reasonable given the market's development at that time and was consistent with the methodology set forth in the prospectus.

5. In November 2000, Van Kampen's decision to base its fair value determinations on LSTA/LPC indications where there were at least two bids, two asks and a spread of less than 200 basis points, was reasonable given the status of the market's development at that time, and was consistent with the methodology set forth in the prospectus.

6. In making its fair value determinations, Van Kampen made a good-faith effort to consider factors important to an arms-length [sic] buyer in assessing what they would pay for the loans on a current sale.

McAdams Report at 5-6 (April 4, 2003).

6 The opinion numbered 1 is no longer at issue following the court's ruling on summary judgment.

[*20] Plaintiffs do not dispute that McAdams is an expert in the field. His experience qualifies him to testify as to how pricing services function, particularly how LSTA/LPC functioned. Opinion 2 is essentially descriptive and historical. It does not require applying any sort of testing or statistical methodology in order to be reliable. This opinion also does not involve a particularized application to the Fund's procedures. Therefore, questions that plaintiffs raise regarding McAdams's knowledge of the Fund's procedures are not pertinent to this opinion. McAdams's experience is enough to support reliability as to Opinion 2. *Cf. Den norske Bank AS v. First National Bank of Boston, 75 F.3d 49, 57-58 (1st Cir. 1996)* (employee of defendant bank with 40 years of banking experience was qualified to testify as to banking industry practices); *Dahlin v. Evangelical Child & Family Agency, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881 *6-7 (N.D. Ill. Dec. 18, 2002)* (expert was qualified to testify as to history of adoption practices and information being provided to adoption professionals at various periods of time).

Opinion 3 is different than Opinion 2. While it still requires an expert [*21] understanding of the pricing services that were available, it also requires an understanding of the Fund's actual practices. Plaintiffs contend that McAdams was not fully informed as to the Fund's practices because defendants did not supply him with all the pertinent evidence. Plaintiffs also contend that this opinion is unreliable because McAdams never examined the Fund's particular valuations to determine if they were accurate.

Plaintiffs contend that McAdams is not qualified to opine as to whether the Fund's practices corresponded with pricing resources available in the market because McAdams has insufficient knowledge of the Fund's actual practices. In particular, plaintiffs complain that (a) McAdams has not read a July 1999 PricewaterhouseCoopers LLC ("PwC") review of the Fund's valuation practices and (b) at his deposition, McAdams could not recall SEC correspondence questioning the Fund's valuation methods. While familiarity with the PwC report may have provided McAdams with additional information about the Fund's actual practices, the other documents that he was provided should have been sufficient to allow McAdams to be familiar with the practices. His lack of complete familiarity [*22] and recall goes more to the weight of his opinion, not whether it is admissible. The jury will be able to determine whether McAdams's assumptions about actual practices of the Fund correspond with the evidence of actual practices that will be presented at trial. Similarly, to the extent the SEC correspondence sets forth factual findings and not legal analysis, McAdams's failure to recall details of the correspondence goes to the weight to be given his testimony and the jury will resolve factual questions as to the actual practices that were in place. Plaintiffs do not contend that McAdams was not

shown the correspondence when preparing his report, only that, at the time he was disposed, he could not recall having seen it.

The other issue raised by plaintiffs is that McAdams should not be permitted to testify about the Fund reasonably applying valuation methods when he never tested the accuracy of the valuations. Plaintiffs contend McAdams is not qualified to testify as to the efficacy of the Fund's actual valuation procedures because he made no comparison between the values given to particular loans and the prices the loans may have sold at during the same time period. According to [*23] McAdams's admissible testimony, however, there is only limited available data as to actual prices that loans sold for in the secondary market. Plaintiffs would like to rely on pricing information provided by LSTA/LPC and other services as being accurate, but the accuracy of those prices is a question of fact for the jury. McAdams may properly testify that the valuation practices of the Fund complied with the price information for loans that was contemporaneously available. Plaintiffs may cross examine him as to the lack of any price comparison study in order to raise questions as to the weight or credibility of his testimony, but that is not enough to make his testimony inadmissible.

Plaintiffs also generally raise the contention that McAdams's opinions are conclusory and lack supporting details. *See generally Mid-State Fertilizer Co. v. Exchange National Bank of Chicago, 877 F.2d 1333, 1339-40 (7th Cir. 1989)*. McAdams's discussion of Opinion 3, however, is sufficiently detailed and not conclusory. *See* McAdams Report at 21-24.

There is one aspect of Opinion 3 as to which McAdams will not be permitted to testify. He opines that the Fund's actual valuation practices [*24] were consistent with the description of those practices contained in the prospectuses. That is a purely factual question of comparing the evidence of actual practices with the descriptions contained in the prospectuses. No expertise is required to make such a comparison. McAdams's testimony as to this issue would not assist the jury. McAdams will not be permitted to testify as to that aspect of Opinion 3.

Opinions 4 and 5 both concern whether the particular practices involved, the "3 x 3 x 100 screen" and "2 by 2 x 200 screen," *see Abrams III, 2004 U.S. Dist. LEXIS 11730, 2004 WL 1433620 at *6*, were reasonable in light of pricing information then available in the market. His testimony concerns the reasonableness of each particular practice in light of then-available information, not whether the Fund's actual application produced accurate valuations. McAdams may properly testify as to these opinions. As with Opinion 3, however, McAdams will not be permitted to testify as to whether the Fund's actual practice was consistent with the descriptions of the practices contained in the prospectuses.

Although McAdams's summarized statement of Opinion 6 refers only to the Fund's good-faith intent, the [*25] specifics of this opinion explain why it is unnecessary to discount from the par value of a loan to take into account the illiquid nature of senior loans. He opines that the "illiquidity discount" is taken into account at the time par is first set. He also opines as to the effect on the value of a loan that a breach of a bank covenant or a bankruptcy filing may have. McAdams may testify regarding his opinions on these subjects. However, he will not be permitted to testify as to whether he believed any defendant acted in good faith in determining the price an arm's length buyer would pay for a loan. That is a factual issue of intent that is for the jury to decide. The jury's determination of intent would not be assisted by McAdams's opinion on that issue. *See Dahlin, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881 at *3*.

For the foregoing reasons, this motion in limine will be granted in part and denied in part. This motion will be denied except that McAdams will not be permitted to testify as to (a) whether any actual valuation practice of the Fund is consistent with a description of the practice contained in a prospectus nor (b) whether any defendant acted in good faith or with some other type [*26] of intent.

4. To Exclude Testimony of Expert Witnesses Daniel R. Fischel and David J. Ross [141-1]

Defendants intent to use Daniel Fischel and David Ross as damages liability experts. The two provided a joint report, but defendants now clarify that they intend to have Fischel testify regarding two of the opinions expressed therein and Ross testify as to one. Plaintiffs argue that neither of the witnesses should be allowed to testify as to one of the opinions. Plaintiffs also argue that the two witnesses are duplicative and only one should be permitted to testify.

Both experts are officers of Lexecon Inc., a

consulting firm that specializes in the application of economics to legal and regulatory issues. Plaintiffs do not question the qualifications of either of these experts. Plaintiffs only question the methodology used to reach the conclusions contained in Opinion 1 below. [7]

7 In a separate motion in limine, plaintiffs also object to an aspect of Opinion 2. *See* § B(5) *infra.*

Fischel [*27] and Ross were retained to examine the conclusions set forth by plaintiffs' valuation expert, Linda Allen, and damages expert Michael J. Barclay. Allen opines as to the amounts by which the Fund overvalued its NAV during the class period. Barclay, in part based on Allen's overvaluation calculations, provides a calculation of damages to the class of plaintiffs.

As summarized by defendants, Fischel's and Ross's opinions and defendants' contention as to the related evidence they will submit may be summarized as follows:

Opinion 1: Barclay's calculations do not account for factors other than the alleged wrongdoing that caused the Fund's NAV to decline during the Class Period. The experts opine that adverse market conditions account for all or a substantial portion of the decline in NAV, in particular an increase in loan default rates and a widening credit spread. Defendants intend to introduce testimony regarding Opinion 1 through Fischel. This will include evidence that is intended to show that all senior loan funds and a published index of senior loans experienced declines in value comparable to the decline in the NAV of the Fund.

Opinion 2: Barclay's calculations do not measure [*28] the class's economic loss attributable to the alleged overpricing of the Fund. A drop in NAV does not strictly correlate with economic loss to the class plaintiffs. Defendants intend to introduce testimony regarding Opinion 2 through Fischel. Defendants will present evidence that they contend will show that Barclay's methodology for calculating damages is flawed because it creates windfall recoveries that bear no relationship to the alleged overpricing of the Fund's shares.

Opinion 3: On the assumption that the Fund should have used LPC prices, Ross calculates the amount that the NAV was overvalued to be somewhat different from Allen's initial calculation. Ross then uses this overvaluation calculation and a different methodology than Barclay to calculate the amount of purported damages to be substantially less than Barclay's total. Ross proposes a number of alternative calculations based on different methods or assumptions. In their report, this Opinion is stated to be that of Ross only. Defendants intend to introduce testimony regarding Opinion 3 through Ross.

In Opinion 1, defendants' experts rely on a Standard & Poor/Loan Syndication and Trading Association ("S&P/LSTA") index [*29] of loans to establish an increase of loans in default or bankruptcy during the pertinent time period, from near zero in 1996 to significantly higher from 1999 through 2001. As stated in their report: "An increase in default rates obviously will reduce the value of senior loans and the value of funds holding such loans." Fischel & Ross Report at 6 (April 30, 2003). They also rely on the London Interbank Offered Rate ("LIBOR") to establish an increasing credit spread between October 1998 and October 2001. LIBOR is the rate at which major international banks in London lend dollars to each other and is often used as a benchmark for floating rates. The credit spread relied upon is the difference between the yield of leveraged loans and LIBOR. As stated by defendants' experts: "Because there is an inverse relationship between the price of any given loan and the relevant credit spread, the increase in credit spreads also reduced the value of senior loans and the value of funds holding such loans."

Plaintiffs do not dispute the general principles that increased default rates and an increased credit spread will result in a general decline in the value of floating-rate loans, nor do they dispute [*30] that default rates and the credit spread increased during the pertinent time period. Plaintiffs, however, object that the experts failed to apply any methodology for connecting the general economic conditions to an effect on senior loans in general or the Fund's NAV in particular. The experts provide no data purporting to show how much of the Fund's drop in NAV was caused by these conditions. The experts do not give any consideration to the actual loans held by the Fund nor do they attempt to correlate the Fund's NAV changes over the class period with particular changes in economic conditions during the class period. Under *§ 11*, decreases in the value of the security are presumed to be caused by the material misstatements that are shown. *McMahan & Co. v. Wherehouse Entertainment, Inc., 65 F.3d 1044, 1048 (2d Cir. 1995)*, *cert. denied*, *517 U.S. 1190, 134 L. Ed. 2d 781, 116 S. Ct. 1678 (1996)*; *Pirelli Armstrong Tire Corp. Retiree Med. Benefits Trust v. Dynegy, Inc. (In*

re Dynegy, Inc.), 339 F. Supp. 2d 804, 867 (S.D. Tex. 2004); *In re Initial Public Offering Securities Litigation, 241 F. Supp. 2d 281, 351 n.80 (S.D.N.Y. 2003)*. If plaintiffs prove liability, the burden is on defendants to show that drops [*31] in NAV were caused by something other than the alleged misstatements in the prospectuses. [8] *15 U.S.C. 77k(e)*; *In re Adams Golf, Inc. Securities Litigation, 381 F.3d 267, 277 (3d Cir. 2004)*; *McMahan, 65 F.3d at 1048*; *Dynegy, 339 F. Supp. 2d at 867-68*; *Nielsen v. Greenwood, 1996 U.S. Dist. LEXIS 14441, 1996 WL 563539 *12 (N.D. Ill. Oct. 1, 1996)*. Here, however, the experts do not attempt to connect changes in loan default rates and the credit spread to changes in the Fund's NAV nor do they make any attempt to show how much of an effect there may have been. Therefore, it has not been shown that this testimony is relevant to the damages issues in this case.

> 8 This is often referred to as the defense of "negative causation." *See McMahan, 65 F.3d at 1048*.

Defendants' experts do point to general data regarding decreases in loan values and senior loan fund NAV's during the class period. The loan indices used, however, do not index senior [*32] loans. Instead, the indices used were for all loans, B-grade loans, and BB-grade loans. While there is some overlap between the indices used and the types of loans held by the Fund, apparently none of the indices correspond with the mix of loans held by the Fund. Fischel and Ross do not explain the correlations or possible differences between the indices used and the assets of the Fund. Also, Fischel and Ross provide no statistical or other sufficient method for correlating changes in the indices to changes in default rates or credit spreads. [9] As to other senior loan funds, the experts generally do not consider similarities and differences with the Fund nor whether the other funds may or may not have overstated NAV.

> 9 In rebuttal, Barclay opines that multiple regression analysis shows a lack of statistically significant correlations between the indices and changes in the Fund's NAV.

Because not supported by adequate methodology nor shown to be relevant to issues in the present case, Fischel and Ross will not [*33] be permitted to testify regarding Opinion 1.

Still to be considered is whether both Fischel and Ross will be permitted to testify. Defendants agree that ordinarily only one expert per side should opine on a particular subject. *See* N.D. Ill. Loc. R. Form 16.1.1 n.7; *Dahlin, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881*. Defendants contend, however, that Fischel will testify as to Opinion 2 and Ross as to Opinion 3. The two opinions, however, are closely related. Ross will not be able to opine as to Opinion 3 without also addressing many aspects of Opinion 2. Defendants will be precluded from using both experts. They may choose which expert they prefer to use. [10] *See id.*

> 10 Fischel did not join in Opinion 3. Therefore, testimony as to both Opinions would probably require the use of Ross. No ruling is made as to whether Fischel could testify as to Opinion 3 if, prior to trial and because he fully agrees with Ross as to Opinion 3, he supplements his report by adopting Opinion 3 as well.

For the foregoing reasons, [*34] this motion in limine will be granted in part and denied in part. Fischel and Ross will be barred from testifying as to Opinion 1 and defendants will be limited to using one expert to testify as to the remaining opinions contained in the Fischel/Ross Report.

5. To Preclude Evidence and Argument Concerning Dividends Paid by the Van Kampen Prime Rate Income Trust to Shareholders [142-1]

Section 11 itself contains a provision as to damages for violations of *§ 11(a)*.

> The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the

> value thereof as [*35] of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. . . .

15 U.S.C. § 77k(e).

As discussed in § B(4) *supra*, the decrease in value of a security (in this case, effectively the decrease in NAV of the Fund) is presumed to have been caused by any material misstatements that are proven to have been included in one or more of the Fund's prospectuses. On the issue of damages, the burden is on defendants to prove that any such decrease was caused by factors other than the material misstatements. The decrease in value of the security (during the relevant time period) is the exclusive measure of damages for violations of *§ 11(a)*; other standard measures of contractual damages are inapplicable under the statute. *McMahan, 65 F.3d at 1048*; [*36] *Goldkrantz v. Griffin, 1999 U.S. Dist. LEXIS 4445, 1999 WL 191540 *3 (S.D.N.Y. April 6, 1999)*, *aff'd by unpublished order*, *201 F.3d 431 (2d Cir. 1999)*.

Defendants want to introduce evidence that members of the plaintiff class received dividend payments from the Fund. They contend that evidence would show that an investor who held a single share of the Fund during the class period would have had a drop in NAV of $ 1.18, but also would have received $ 1.69 in dividends for a net gain of $ 0.51 on the share. Defendants contend this evidence will fit into the statutory method for measuring damages because the receipt of dividends is part of their evidence showing negative causation. Defendants contend that paying dividends caused a decrease in the Fund's NAV. They point to a conclusory statement in their damages experts' report as supporting this contention. *See* Fischel & Ross Report at 8 n.7 (April 30, 2003) ("Professor Barclay's calculations do not measure Class members' out-of-pocket losses because he ignores the dividends paid by the Fund to its shareholders."). *See also* Ross Suppl. Report at 8-9 (Oct. 17, 2003) ("I understand that the defendants contend that plaintiffs [*37] cannot recover under *Section 11* for declines in the value of a security attributable to factors other than the alleged material misstatements and omissions. If defendants' contention is correct, then an offsetting adjustment for dividend payments should be made, because the payment of dividends necessarily caused the value of the fund to decline by the amount of dividends paid.").

In a somewhat lengthier, but still essentially conclusory manner, plaintiffs' damages expert stated that the payment of dividends does not decrease NAV. As he sees it, the effect of dividends on NAV is that retaining dividends, instead of distributing them, would increase NAV.

> Q. And if a fund pays out dividends, what impact, if any, would that have on the NAV Of the fund?
>
> * * *
>
> A. At some level, it's correct that a dividend paid on the fund would reduce the NAV of the fund. However, it's clear from looking at the fund's NAV that it was possible to pay these dividends over a long period of time without having the fund's NAV vary from $ 10 per share by more than a penny or two.
>
> So what happens in these cases is that the senior loans held by the fund pay interest to the fund. The fund takes those interest [*38] payments that are received from the loans and passes them through to investors.
>
> So rather than thinking about the dividends as reducing NAV, which clearly they didn't over the history of the fund prior to the class period, since the fund's NAV never varied by more than a couple of pennies from $ 10 per share, what you're doing is paying out those dividends rather than retaining them in the fund and reinvesting them which, in fact, would tend to increase the fund's NAV.

Barclay Dep. at 75-76.

One issue that goes to the admissibility of the testimony is whether the potential effect of dividends on NAV is a question of law as to the measure of damages or a question of fact as to whether or not paying dividends affects NAV. Here, the Fund's stated goal was to achieve a high level of current income consistent with preservation of capital. If, as Barclay indicates, dividends simply represented the distribution of interest earned on the loans, such a distribution would be independent of the value of the shares themselves that is represented by NAV. Defendants point to no evidence that this is not true. Therefore, for purposes of ruling on this motion in limine, it is assumed that [*39] dividends represented interest earned on the loans and were separate from the loan asset itself that represented the value of the Fund's shares. Therefore, as a matter of law, the payment of dividends would not be part of the calculation of damages based on a decline in share value (NAV).

Even if that should not taken as true, defendants have not shown that they have admissible evidence that the distribution of dividends negatively affected NAV. All they can point to is conclusory statements by their damages experts. Such unsupported, conclusory statements are not admissible evidence. *See Huey v. UPS, 165 F.3d 1084, 1087 (7th Cir. 1999)*; *Mid-State Fertilizer, 877 F.2d at 1339-40*; *Ab v. Sekendur, 2004 U.S. Dist. LEXIS 21715, 2004 WL 2434220 *6 (N.D. Ill. Oct. 28, 2004)*; *Comer v. American Electric Power, 63 F. Supp. 2d 927, 936-37 (N.D. Ind. 1999)*. Alternatively, since the evidence related to the effect of distributing dividends is inadmissible in form, defendants will not be permitted to present it.

Defendants also argue that evidence as to dividends is admissible so that the jury will have a complete picture. They contend [*40] that the jury should know that class members received dividends as well as any proceeds from the redemption of their shares. Defendants contend the jury may make a decision based on sympathy for the plaintiffs if the jury believes the plaintiffs had a net loss. The jury will be instructed that they are not to decide the case based on sympathy for a party. Since, as discussed above, dividends are not relevant to calculating damages, there is no reason for the jury to know the amount of dividends received by class members. Defendants will not be permitted to present evidence regarding the amount of dividends distributed by the Fund. As part of the basic background for this case, including evidence as to how the Fund functioned, the parties are not precluded from presenting evidence that the loans held by the Fund earned interest and that the interest was distributed in the form of a dividend. The parties are only prohibited from presenting evidence as to the amount of the dividend and any effect the distribution of dividends may have had on the Fund's NAV.

For the foregoing reasons, this motion in limine will be granted. The parties will not be permitted to present evidence as to the [*41] amount of dividends that the Fund paid nor will they be permitted to argue that any distribution of dividends affected the Fund's NAV or the amount of damages to be awarded in this case. This includes that Fischel or Ross will not be permitted to testify as to the aspect of Opinion 2 that is based on the distribution of dividends affecting NAV and damages.

C. DEFENDANTS' MOTIONS IN LIMINE

1. To Exclude the Testimony and Report of Linda Allen [137-1]

Plaintiffs' valuation expert, Linda Allen, has a Ph.D. in Economics and Finance from New York University and is currently a Professor of Finance at Baruch College of the City University of New York and an Adjunct Professor of Finance at New York University. She is the author or coauthor of three books and numerous articles, primarily in the field of loan valuation and credit risk analysis. Her books include *Understanding Market, Credit and Operational Risk: The Value at Risk Approach* and *Credit Risk Measurement: New Approaches to Value at Risk and Other Paradigms*.

Allen opines that, during the class period, the LPC database was a reliable benchmark of market prices for a majority of the loans held by [*42] the Fund. She bases this opinion on "(a) the number, sophistication and financial resources of dealers providing market quotations to LPC, (b) the number of quotes provided for each loan, (c) the quality controls put in place by LPC in response to the demand for quality by its customers, (d) the general acceptability of the database in the market, (e) the general acceptability of the database for the purposes of academic research, and (f) the internal studies conducted by LPC comparing LPC quotations to actual trade prices." Additionally, Allen opines that, during the class period, there was a secondary loan market for syndicated bank loans and readily available market quotations for a majority of the loans in the Fund's portfolio. The latter conclusion was based in part on data

regarding the average number of bid quotes and ask quotes available for loans held by the Fund. Further, taking available LPC pricing data as accurate, Allen recalculated NAV for each day of the class period and determined how much NAV was overvalued on each day of the class period. She also compared LPC pricing data to the Fund's valuation of its loans, resulting in statistically significant evidence that [*43] the Fund generally overvalued loans.

Defendants do not dispute that Allen is qualified as an expert on finance. They contend, however, that she lacks expertise to opine on the senior loan secondary market because she has never traded in that market, she has never worked for a senior loan fund, and she has never been associated with LPC or LSTA. Defendants contend that being a generalist on loan markets is not good enough, that she must be a specialist as to the senior loan market in order to be able to provide useful testimony for the jury. This objection is without merit. Allen's educational background and the research background shown by her publications show that she is well versed on loans, factors and conditions that affect loan markets, and other aspects of the pertinent financial markets. Her report also exhibits an understanding of the senior loan market and how it functions. One need not have been a participant in a particular market in order to qualify as an academic expert who can provide useful testimony. *Compare Crowley v. Chait, 322 F. Supp. 2d 530, 554-55 (D.N.J. 2004)* (Fischel's academic and consulting expertise in economics qualified him to provide [*44] useful testimony related to insurance accounting, loss reserve, and management issues).

Defendants also contend that Allen's statistical evidence comparing LPC pricing to the Fund's valuation of loans would not be useful to the jury because it assumes LPC pricing is accurate. This objection is without merit for two reasons. First, Allen also provides competent and admissible evidence supporting that LPC pricing was reliable and readily available. Second, even if she did not personally provide such support, the reliability of LPC pricing is a disputed issue of fact in this case. The jury will decide the extent to which LPC/LSTA pricing information qualifies as reliable and readily available market quotations. In light of that finding, the jury will accordingly consider and apply Allen's testimony comparing the LPC pricing to the Fund's valuations.

This motion in limine will be denied in its entirety.

2. To Exclude the Eaton Vance Documents [143-1]

Eaton Vance is a senior loan fund unrelated to the Fund. A lawsuit is pending against Eaton Vance regarding their valuations of senior loans. Some of the same attorneys represent the plaintiffs in both this case and the [*45] Eaton Vance case. When deposed in the Van Kampen case, Taylor testified that monthly LSTA pricing information was not available to buy-side institutions like Van Kampen and Eaton Vance until September 1999. After fact discovery closed in the Van Kampen case, Taylor was deposed in the Eaton Vance case. At that time, Taylor corrected her testimony and stated that the reports were available to buy-side "founding" or "full" members as of July 1998. Van Kampen did not become a full member of LSTA until 2000, but could have become a full member in 1998. Eaton Vance was a full member in 1998 and therefore received the reports beginning in 1998. Those reports were disclosed in discovery in the Eaton Vance case. In the Eaton Vance case, reliability studies were also disclosed in which Eaton Vance had compared LPC market prices to actual prices Eaton Vance had paid for senior loans. Both the reports and reliability study are included as plaintiffs exhibits in the Van Kampen case. The reliability study was considered by Allen in rendering her opinions. Defendants object to use of these documents on the ground that they were not properly disclosed in discovery in the Van Kampen case and on grounds [*46] of relevance.

While defendants had some notice of the existence of these documents prior to the time the pretrial order was prepared, plaintiffs do not dispute that they should have provided fuller notice and also do not dispute that the actual documents were not provided to defendants until defendants filed the present motion in limine. Plaintiffs indicate that the failure to provide the documents was an oversight, but also note that defendants were informed of the documents during the time the final pretrial order was being prepared and did not take the opportunity to request copies at that time. Defendants were also offered the opportunity to further depose Allen regarding these documents, but decided not to do so. Defendants do not dispute that they now have the documents and do not point to any manner in which the delayed disclosure has prejudiced their preparation for trial. The documents will not be barred based on failure to timely and adequately

disclose them if the deficiencies were harmless. *See Fed. R. Civ. P. 37(c)(1)*. Here, there is no indication that defendants were prejudiced in any manner by the delays. No sanction will [*47] be imposed.

Defendants' other objection is relevance. Since the reports were available to entities like the Fund, the reports are relevant to the issue of whether there were readily available market quotations. The reports will not be stricken as exhibits. The reliability study represents a method for testing the accuracy of LPC pricing information and was relied upon one of plaintiffs' experts. The studies are also relevant evidence.

For the foregoing reasons, this motion in limine will be denied.

3. To Exclude the Testimony of Thomas Hudson [144-1]

Thomas Hudson has been a senior loan trader at Goldman Sachs and was on the Distressed Loan Committee of LSTA. Plaintiffs represent that they decided to use him as a witness after defendants proposed Meenan and DeLuca as witnesses. Plaintiffs intend to use Hudson to rebut all or some of the testimony of Meenan and DeLuca. Plaintiffs do not dispute that Hudson was not previously disclosed in response to interrogatories. However, neither had defendants expressly disclosed Meenan and DeLuca in response to interrogatories. *See* § B(2), *supra*. Unlike Hudson, though, Meenan and DeLuca had been mentioned during deposition [*48] testimony. In any event, defendants have not been prejudiced by the delayed disclosure. Hudson will not be barred as a witness, but, if they desire, defendants may depose Hudson within the next 45 days.

4. To Exclude Evidence Of, or Reference To, the SEC Letters [145-1]

In November 1999, the Midwest Regional Office of the SEC conducted an on-site inspection of Van Kampen. The inspection was not limited to the Fund, but it did include an examination of valuation procedures used by the Fund. Related to this inspection, there was correspondence between Van Kampen officials and SEC officials. Defendants move to exclude from evidence three letters from the SEC to Van Kampen, dated October 20, 1999, March 28, 2000, and June 28, 2000. [11] Plaintiffs contend all three letters are admissible under *Fed. R. Evid. 803(8)*.

11 There are also four letters from Van Kampen to the SEC. Plaintiffs point out that the motion does not raise any objection to those letters. In the final pretrial order, however, defendants object to those letters as well. *See* Pl. Exh. 3, 6, 8, 10. Any issues that exist regarding the admissibility of the letters written by Van Kampen officials would be distinct from the *Rule 803(8)* issues raised regarding the letters from the SEC that are the subject of the present motion.

[*49] In a letter dated September 1, 1999, Van Kampen's General Counsel, A. Thomas Smith, wrote to the SEC's Chicago Branch Chief of Investment Company Examinations. This letter included a lengthy explanation of Van Kampen's methods for valuing loans. [12] In a letter dated October 20, 1999, which is one of the letters that is a subject of this motion in limine, the SEC's Midwest Regional Office Assistant Director wrote to Smith confirming an October 18 conversation. The letter referred to the SEC's upcoming inspection regarding three SEC senior loan funds, including the Fund, which would begin November 1, and requested certain additional documents.

12 Neither side's brief attaches a copy of this letter. The remainder of its content is not disclosed in the briefs and neither side makes any representation as to what caused the General Counsel to write this letter. Presumably, it was a response to a prior inquiry from the SEC.

According to Smith's deposition testimony, the inspection lasted approximately one week. The [*50] inspection team interviewed Smith, the Fund's President and Portfolio Manager, and the Fund's Assistant Portfolio Manager. Records were also examined.

In January 2000, the Fund adopted the 3 x 3 by 100 screen and requested a meeting with the SEC to discuss it. This meeting took place on January 25, 2000 in Washington, D.C. With a letter dated February 1, 2000, Van Kampen sent additional documents to the SEC.

In a letter dated March 28, 2000, which is one of the letters that is a subject of this motion in limine, the SEC's Assistant Regional Director wrote to the Fund's President. The letter sets forth findings made during the November inspection. The SEC sets forth a number of deficiencies that were found with the pricing guidelines that were in effect as of November 1999 (the "Old

Guidelines"). The inspection found a failure to adequately consider secondary market indications, including market quotations received directly from market makers or indirectly through LPC. A failure to consider fluctuations in spreads over the base rate of interest for pricing purposes was also found. In the letter, the Assistant Regional Director also commented on the new 3 x 3 x 100 pricing procedure [*51] (the "Proposed Guidelines") and found deficiencies. It was found that the Proposed Guidelines too readily permitted the Adviser to override prices otherwise indicated by the 3 x 3 x 100 procedure. Where 3 x 3 x 100 data was not available for pricing a loan, the Proposed Guidelines still failed to adequately consider spread when fair valuing a loan. The letter also criticizes Van Kampen for finding that no Fund Board Member was on the Adviser's Pricing Committee that made fair value determinations. The Board was also criticized for having made no attempt to compare fair valuation determinations with actual recoveries on distressed loans.

In a response letter dated April 27, 2000, Smith responded to the SEC's findings as to the Proposed Guidelines and the criticisms of the Board. Smith noted new procedures that limited overrides of market indicators to one day, required daily approval by the Pricing Committee, and quarterly review by the Board. He disagreed with the criticism regarding not adequately considering spreads on the ground that it required too complex an application to be feasibly implemented. As to the Board criticisms, Smith noted that the Board would not be reviewing certain [*52] information on a quarterly basis and that it would be provided reports comparing distressed loan recoveries with their valuations.

The last letter to which defendants object is the SEC's Regional Director's June 28, 2000 letter to Smith, which was a response to Smith's April 27, 2000 letter. The June letter notes that the valuation techniques used by the three funds had been discussed with the Division of Investment Management's Office of Chief Counsel and that that office concurred with the views expressed in the June letter.

First, the June letter reemphasized that, when available, the law requires that market quotations be used to price financial instruments and that the funds had to look to other possible sources for quotations when LPC supplied quotes could not be used.

> It is our understanding that the Funds do not seek other sources of market quotations whenever LPC-supplied quotes were deemed unreliable. We were not shown any evidence that explained precisely why the LPC-supplied quotes did not reflect current market values other than the fact the quotes fell outside the predetermined parameters. We also did not see any documentation evidencing that the Funds made a determination [*53] in these circumstances that reliable market quotations were not readily available.

June 28, 2000 SEC Letter at 2.

The letter again criticized the three funds' applications of fair value methodology.

> In a majority of situations in which the Funds used fair value to price their portfolio instruments, the fair value methodology used resulted in such instruments being valued higher than the LPC-supplied quotes. We also noted that in most circumstances when valuations are not based on LPC-supplied quotes, loans were fair valued at approximately par value.
>
> The Funds have not provided us with any analysis and documentation that supported the use of such higher values. . . . The only support presented for valuation at par was that this reflected the amount the Funds would receive if instruments were held to maturity or the loan prepaid. As discussed in the Division of Investment Management's December 8, 1999 letter to the ICI, the Staff has consistently rejected a policy of equating fair value with par value absent evidence that an instrument could be sold currently at approximately par.

Id.

The letter agreed that certain factors suggested by Van Kampen could appropriately [*54] be considered when it was appropriate to apply fair value methodology,

but emphasized that these were not the only factors to consider. "All relevant factors" were to be considered.

> . . . The following issues suggest that all relevant factors are not being considered in using fair values to price certain of the Funds' portfolio instruments:
>
> > . The substantial difference that often exists between quotations provided by LPC and fair values used by the Funds in situations where Van Kampen's price discovery mechanism does not produce alternative market quotations that Van Kampen deems reliable.
> >
> > . The absence of any demonstrated analysis on an instrument-by-instrument basis supporting a valuation at approximately par value.

Id. at 3.

Rule 803(8) provides:

> Records, reports, statements, or data compilations, in any form, of public offices or agencies, setting forth (A) the activities of the office or agency, or (B) matters observed pursuant to duty imposed by law as to which matters there was a duty to report, excluding, however, in criminal cases matters observed by police officers and other law enforcement personnel, or (C) in civil actions and proceedings and [*55] against the Government in criminal cases, factual findings resulting from an investigation made pursuant to authority granted by law, unless the sources of information or other circumstances indicate lack of trustworthiness.

Fed. R. Evid. 803(8).

Plaintiffs contend that the October 29, 1999 letter is admissible under *Rule 803(8) (A)* and that the other two letters are admissible under *Rule 803 (8) (C)*. The October letter is a request for information that occurred prior to the November inspection; it does not include any factual findings that would bring it within the purview of subsection (C). The trustworthiness clause of *Rule 803(8)* still applies to subsection (A). *See Nachtsheim v. Beech Aircraft Corp., 847 F.2d 1261, 1273 (7th Cir. 1988)*; *United States v. Koontz, 143 F.3d 408, 412 (8th Cir. 1998)*; *Chapman v. San Francisco Newspaper Agency, 2002 U.S. Dist. LEXIS 18012, 2002 WL 31119944 *2 (N.D. Cal. Sept. 20, 2002)*; *United States v. May, 18 M.J. 839, 842-43 (1984)*. The October 29 letter, however, certainly is trustworthy as to what it is, a simple statement confirming that additional documents had [*56] been requested. The October 29 letter is nonhearsay in accordance with *Rule 803(8) (A)*. Whether other grounds for excluding it exist will be discussed below.

The other two letters contain findings based on the November inspection. To be nonhearsay, they must satisfy the criteria of *Rule 803(8) (C)*, including that they do not have indicia of lacking trustworthiness. If the threshold requirements of being factual findings resulting from an investigation made pursuant to authority granted by law are satisfied, trustworthiness is presumed and the burden is on the party opposing admission to show a lack of trustworthiness. *Amtrust Inc. v. Larson, 388 F.3d 594, 599 (8th Cir. 2004)*; *Bridgeway Corp. v. Citibank, 201 F.3d 134, 143 (2d Cir. 2000)*; *Huff v. State of Illinois*, 2003 WL 168630 *5 (N.D. Ill. Jan. 23, 2003); *Klein v. Vanek, 86 F. Supp. 2d 812, 820 (N.D. Ill. 2000)*. Here, the letters contain factual findings [13] that were made following an SEC inspection performed pursuant to authority of law. Therefore, the findings are presumed to be trustworthy.

13 Conclusions and opinions that are factual in nature may fall within the *Rule 803(8)(C)* exception. *Beech Aircraft Corp. v. Rainey, 488 U.S. 153, 162, 102 L. Ed. 2d 445, 109 S. Ct. 439 (1988)*; *United States v. Romo, 914 F.2d 889, 896 (7th Cir. 1990)*, *cert. denied*, *498 U.S. 1122, 112 L. Ed. 2d 1183, 111 S. Ct. 1078 (1991)*; *United States v. Peitz, 2002 U.S. Dist. LEXIS 17750, 2002 WL 31101681 *5 (N.D. Ill. Sept. 20, 2002)*.

However, legal conclusions of an agency will not be admitted under the *Rule 803(8)(C)* exception. *Hines v. Brandon Steel Decks, Inc., 886 F.2d 299, 302-03 (11th Cir. 1989)*, *cert. denied*, *503 U.S. 971, 118 L. Ed. 2d 305, 112 S. Ct. 1587 (1992)*; *Miranda-Ortiz v. Deming, 1998 U.S. Dist. LEXIS 17147, 1998 WL 765161 *1 (S.D.N.Y. Oct. 29, 1998)*. To the extent any of the SEC letters contain legal conclusions; any admissible portions would be limited to those findings that are factual in nature. *Cf. Peitz, 2002 U.S. Dist. LEXIS 17750, 2002 WL 31101681 at *5*.

[*57] In evaluating trustworthiness, four nonexclusive factors set forth in the Advisory Committee Notes to *Rule 803(8)* are generally considered. *See Coleman v. Home Depot, Inc., 306 F.3d 1333, 1342 (3d Cir. 2002)*; *Klein, 86 F. Supp. 2d at 820*. They are the timeliness of the investigation; the special skill or expertise of the official; whether a hearing was held; and possible motivational problems with the investigator. Additional factors that have been considered include the finality of the findings; the extent to which the findings are based on materials that would not be admissible in evidence; the degree to which any hearing complied with due process; the extent to which there is an ascertainable record; the extent to which the findings represent an implementation of a policy in contrast to findings of fact; whether the findings incorporate findings of another agency that may not have been trustworthy; and, if expert opinions were involved, the extent to which the usual criteria for such opinions was present. *Coleman, 306 F.3d at 1342 n.4* (quoting *Zenith Radio Corp. v. Matsushita Electrical Industries Co., 505 F. Supp. 1125, 1147 (E.D. Pa. 1980),* [*58] *aff'd in part, rev'd in part on other grounds, In re Japanese Electronic Products Antitrust Litigation, 723 F.2d 238 (3d Cir. 1983)*, *rev'd, Matsushita Electrical Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 89 L. Ed. 2d 538, 106 S. Ct. 1348 (1986))*.

Here, no questions are raised regarding the SEC's motivation. The subject of the investigation was well within the expertise of the SEC. The inspection was conducted in November and the first letter was issued within a few months. Timeliness is also satisfactory. Defendants contend there are indicia of a lack of trustworthiness because no formal hearing was held and the findings were made by the Midwest Regional Office without ever being adopted by the Commission itself.

It is true that findings following a formal hearing with full due process procedures are more likely to be found to be trustworthy. However, findings based on other investigative procedures may still be admissible. *Bank of Lexington & Trust Co. v. Vining-Sparks Securities, Inc., 959 F.2d 606, 617 (6th Cir. 1992)*; Michael H. Graham, *Federal Practice & Procedure* § 7049 at 498 n.24 (2d Interim Ed. 1997). *See, e.g., Coleman, 306 F.3d at 1341-43* [*59] (determination letter based on EEOC investigation); *Bank of Lexington, 959 F.2d at 616-17* (letters of caution from National Association of Securities Dealers); *United States v. Peitz, 2002 U.S. Dist. LEXIS 17750, 2002 WL 31101681 *5 (N.D. Ill. Sept. 20, 2002)* (SEC action memorandum). Here, there is nothing presented by defendants to indicate that the SEC's inspection was not thorough or adequate. Although no hearing was held, the correspondence shows the SEC provided Van Kampen with a number of opportunities to provide additional documentation or evidence as well as opportunities to argue that the three funds' valuation procedures were adequate. Defendants contend the inspection was not intended to fully examine the Fund's valuation procedures because one of the letters refers to the inspection as being pursuant to § 31 of the 1940 Act, *15 U.S.C. § 80a-30*, which defendants contend is an inspection to ensure that proper records are kept. Although § 31 (a) (*15 U.S.C. § 80a-30 (a)*) requires that certain records be maintained, the examination provided for in § 31(b) (*15 U.S.C. § 80a-30 (b)*) is not limited [*60] to an examination to determine compliance with the recordkeeping requirement of *§ 31(a)*. "All records required to be maintained and preserved in accordance with subsection (a) of this section shall be subject at any time and from time to time to such reasonable periodic, special, and other examinations by the Commission, or any member or representative thereof, as the Commission may prescribe." *15 U.S.C. § 80a-30(b)*. The correspondence makes clear that the inspection was not intended merely to confirm that certain records were maintained. Defendants do not show that the SEC employed inspection procedures that raise questions as to the findings' trustworthiness.

Defendants also contend that the letters are untrustworthy because they were never adopted by the Commission itself. Where recommendations are being made to the Commission, findings made by SEC officials may be found to be untrustworthy if not adopted by the Commission. *See Peitz, 2002 U.S. Dist. LEXIS 17750, 2002 WL 31101681 at *5*. That, however, is not the

present situation. The Regional Office had not made any recommendation to the Commission. The investigative procedures that were employed had not reached [*61] a stage that required Commission approval. As the last letter indicated, the Regional Office did get the concurrence of the Chief Counsel's Office. The findings in the letters will not be found untrustworthy simply because they were not approved by the Commission.

There is nothing to support that the Regional Office's findings based on its inspection were untrustworthy. The presumption of trustworthiness remains intact. Therefore, in accordance with *Rule 803(8)*, the factual findings contained in the three letters are not hearsay. However, legal conclusions contained in the letters would not be admissible to prove the truth of the matters contained therein. Statements that the funds failed to use market quotations that were readily available would itself be an admissible factual statement. The additional statements that such conduct violated statutes or regulations would not be admissible.

Although factual findings in the letters are not excluded as hearsay, it still must be considered whether the findings should be excluded on other grounds. Statements that fall within a *Rule 803* exception may still be excluded as unduly prejudicial under *Rule 403* or as irrelevant. *See Cooper v. Carl A. Nelson & Co., 211 F.3d 1008, 1018 (7th Cir. 2000)*; [*62] *Klein, 86 F. Supp. 2d at 820*.

Defendants argue that the present case involves misstatements of fact that violated *§ 11* whereas the letters address violations of § 2 of the 1940 Act which is not the issue in this case. As previously held, however, the legal conclusions regarding compliance with the 1940 Act are not parts of the letters that are nonhearsay under *Rule 803(8)(C)*. Facts supporting possible violations of the 1940 Act, though, are the same facts that support misstatements or omissions in the prospectuses. Basically, some of the alleged misstatements in the prospectuses were that the Fund was following valuation procedures, ones that complied with statutory requirements, but in actuality it was not. These facts will be before the jury. The jury would not be confused by being told that the SEC found facts that are consistent with plaintiffs' allegations regarding the Fund's actual valuation practices. They will not be told that the SEC found or indicated such practices violated the 1940 Act.

Defendants' other contention is that it would be unfairly prejudicial to provide evidence showing that the SEC reached conclusions that go to core issues that plaintiffs [*63] must prove to the jury. *See Klein, 86 F. Supp. 2d at 820-21*. Defendants argue the jury will have before it the same evidence that was before the SEC plus more and that, without knowing the conclusions reached by the SEC, the jury can conclude for itself whether there were readily available market quotations that the Fund did not adequately take into account when valuing its holdings. There is case law supporting that it is within the trial court's discretion to exclude *Rule 803(8)(C)* evidence on this ground. *See Tulloss v. Near North Montessori School, Inc., 776 F.2d 150, 153-54 (7th Cir. 1985)*; *Klein, 86 F. Supp. 2d at 820-21*. *See also Young v. James Green Management, Inc., 327 F.3d 616, 624-25 (7th Cir. 2003)*. Defendants do not cite any case holding that it is necessarily an abuse of discretion to admit such evidence. The Supreme Court has held that, as with expert and lay opinions (*see Fed. R. Evid. 704 (a)*), *Rule 803 (8)(C)* evidence that goes to ultimate issues may be admitted. *See Beech Aircraft, 488 U.S. at 169-70*.

Here, the jury will not simply be presented [*64] with evidence of the pricing information available to the Fund and then decide whether, contrary to representations in the prospectuses, there were readily available market quotations that were not used by the Fund in valuing loans or pertinent pricing information that was not considered when using fair value methods. Each side will also present experts who will opine as to whether such quotations or pricing information was available. In other words, even without the SEC letters, there will be experts opining as to some of the factual issues that must be decided by the jury. The SEC letters are analogous to having another expert's testimony regarding such ultimate issues, but an expert who is not biased by being connected to a particular party. Unlike the actual experts, the SEC letters will not be subject to cross examination. However, the parties will still be able to challenge the SEC's conclusions through the testimony of their own experts as well as in closing arguments.

The SEC letters apparently would also be relevant and admissible for another reason. Defendants will raise a business judgment defense based on their believing alleged misstatements in the prospectuses are actually [*65] true. The criticisms contained in the letters from the SEC, to the extent known by particular defendants and only as to prospectuses issued after such knowledge, would go to the question of those defendants' good faith

beliefs regardless of whether the letters are admitted for the truth of the matters contained therein.

It is found that admission of the SEC letters would not be unfairly prejudicial to defendants. Therefore, in redacted form as discussed above, none of the letters will be excluded from evidence.

For the foregoing reasons, this motion in limine will be granted in part and denied in part. The letters will not be excluded from evidence except that legal conclusions must be redacted from the letters. The parties are to meet in an attempt to agree upon redacted versions of the letters.

D. CONCLUSI0N

The parties previously attempted to settle this case with the aid of a mediator, but could not reach an accord. Perhaps, in light of today's ruling, the parties will now be able to settle the case. Within one week, the parties shall contact each other to discuss the possibility of settlement. As a possible aid in the process, this case will be referred to the assigned [*66] magistrate judge to conduct settlement proceedings. The parties shall promptly contact the minute clerk of the assigned magistrate judge to arrange for a date to appear before the magistrate judge.

At the next status hearing, the parties shall report on the possibility of settlement.

IT IS THEREFORE ORDERED that:

(1) Plaintiffs' Motion In Limine To Bar Evidence that Traders Issued False Loan Pricing Data [138-1] is denied, but without prejudice to objecting to Taylor's testimony at trial.

(2) Plaintiffs' Motion In Limine To Exclude the Testimony of Kevin Meenan and Anthony DeLuca [139-1] is granted in part and denied in part. Within 45 days, plaintiffs may depose Meenan and DeLuca.

(3) Plaintiffs' Motion In Limine To Exclude the Testimony and Report of Michael P. McAdams [140-1] is granted in part and denied in part. McAdams will not be permitted to testify as to (a) whether any actual valuation practice of the Fund is consistent with a description of the practice contained in a prospectus nor (b) whether any defendant acted in good faith or with some other type of intent.

(4) Plaintiffs' Motion In Limine To Exclude Testimony of Expert Witnesses Daniel R. Fischel and David [*67] J. Ross [141-1] is granted in part and denied in part. Fischel and Ross will be barred from testifying as to Opinion 1 (the effect of adverse market conditions on the Fund NAV) and defendants will be limited to using one expert to testify as to the remaining opinions contained in the Fischel/Ross Report.

(5) Plaintiffs' Motion In Limine To Preclude Evidence and Argument Concerning Dividends Paid by the Van Kampen Prime Rate Income Trust to Shareholders [142-1] is granted. The parties will not be permitted to present evidence as to the amount of dividends that the Fund paid nor will they be permitted to argue that any distribution of dividends affected the Fund's NAV or the amount of damages to be awarded in this case.

(6) Defendants' Motion In Limine To Exclude the Testimony and Report of Linda AAllen [137-1] is denied.

(7) Defendants' Motion In Limine To Exclude the Eaton Vance Documents [143-1] is denied.

(8) Defendants' Motion In Limine To Exclude the Testimony of Thomas Hudson [144-1] is granted in part and denied in part. Within 45 days, defendants may depose Hudson.

(9) Defendants' Motion In Limine To Exclude Evidence Of, or Reference To, the SEC Letters [145-1] [*68] is granted in part and denied in part. Legal conclusions must be redacted from the SEC letters.

(10) This case will be referred to the assigned magistrate judge to supervise settlement discussions.

(11) A status hearing before Judge Hart will be held on March 16, 2005 at 11:30 a.m.

ENTER:

WILLIAM T. HART

UNITED STATES DISTRICT JUDGE

DATED: JANUARY 12, 2005

TAB 2

LEXSEE 2002 U.S. DIST. LEXIS 5887

In re ADAPTIVE BROADBAND SECURITIES LITIGATION; This Document Relates to: ALL ACTIONS

No. C 01-1092 SC

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

2002 U.S. Dist. LEXIS 5887; Fed. Sec. L. Rep. (CCH) P91,759

April 2, 2002, Decided
April 2, 2002, Filed

DISPOSITION: [*1] Defendants' Motion to Dismiss DENIED. Defendants' Request for Judicial Notice GRANTED as to Exhibit A, and DENIED as to Exhibits B and C.

COUNSEL: For FRANK LETTIERI, JAMES K. NG, LEON LEYBOVICH, Plaintiffs: Lionel Z. Glancy, Glancy & Binkow LLP, Los Angeles, CA.

For GLAZER CAPITAL MANAGEMENT, L.P., ASSET MANAGEMENT COMPANY, CHICHESTER OFFSHORE, Plaintiffs: Jeffrey A. Klafter, Bernstein Litowitz Berger & Grossmann, New York, NY.

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For DAVID CHANG, SARAH DOUGHTY, Plaintiffs: Joseph J. Tabacco, Jr., Berman DeValerio Pease Tabacco Burt & Pucillo, San Francisco, CA.

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For DAVID SHEEHY, Plaintiff: Bruce G. Murphy, Law Offices of Bruce G. Murphy, Vero Beach, FL.

For DAVID SHEEHY, Plaintiff: Francis M. Gregorek, Francis A. Bottini, Jr., Betsy C. Manifold, Wolf Haldenstein Adler Freeman & Herz LLP, San Diego, CA.

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For T. ROBERT LACOUR, Plaintiff: Jeffrey R. Krinsk, Howard D. Finkelstein, Gregory A. Hartlett, Finkelstein & Associates, San Diego, CA.

For ADAPTIVE BROADBAND CORPORATION, FREDERICK D. LAWRENCE, DONNA S. BIRKS, defendants: William S. Freeman, Grant P. Fondo, Cooley Godward LLP, Palo Alto, CA.

JUDGES: Samuel Conti, UNITED STATES DISTRICT JUDGE.

OPINION BY: Samuel Conti

OPINION

ORDER DENYING DEFENDANTS' MOTION TO DISMISS

I. *INTRODUCTION*

This is a class action filed on behalf of all purchasers ("Plaintiffs") of the publicly-traded securities of Adaptive Broadband Corporation ("Adaptive") against Adaptive and four of its officers: Frederick D. Lawrence ("Lawrence"), Adaptive's former Chief Executive Officer and Chairman of the Board of Directors; [*5] Donna S. Birks ("Birks"), Adaptive's former Chief Financial Officer; Daniel Scharre ("Scharre"), Adaptive's former President and Chief Operating Officer and, later, its President, CEO and Director; and Peter J. Maloney ("Maloney"), Adaptive's former Senior Vice President of Finance and later, its Chief Financial Officer (collectively "Defendants"). On October 23, 2001 Plaintiffs filed a Corrected Consolidated Complaint for violations of the Securities and Exchange Act of 1934. Specifically, Plaintiffs allege all Defendants violated Sections 10(b) of the 1934 Act and Securities and Exchange Commission ("SEC") Rule 10b-5 and that the Individual Defendants violated Section 20(a) of the 1934 Act. Now before the Court are the Individual Defendants' Motion to Dismiss and Request for Judicial Notice. For the following reasons, the Individual Defendants' Motion to Dismiss is denied and their Request for Judicial Notice is granted in part and denied in part.

II. *BACKGROUND*

Adaptive is a Delaware corporation based in San Jose, California. Before it filed for bankruptcy protection on July 26, 2001, Adaptive supplied equipment related to broadband wireless communication over the [*6] Internet. As a result of its bankruptcy filing, all proceedings against Adaptive in this Court are stayed pursuant to 11 U.S.C. § 362(a).

Prior to its bankruptcy filing and throughout the class period, Adaptive common stock was traded on the

NASDAQ National Market System under the symbol "ADAP." Changes were made to senior management on or around January 11, 2001. Prior to January 11, 2001 Defendant Lawrence was Adaptive's Chairman and CEO, Defendant Birks was its CFO, Defendant Scharre was its President and COO and Defendant Maloney was the Senior Vice President of Finance. After January 11, 2001, Defendants Lawrence and Birks resigned, Defendant Scharre became the CEO, President and Director and Defendant Maloney became the CFO.

The facts in this case are complicated slightly by the fact that Adaptive switched operating calendars around the time the class period began. As of June 2000, Adaptive operated on a fiscal calendar year ending June 30. The company later transitioned to a calendar ending December 31. For ease of reference, the Court, like the parties, will refer to a quarter by the month in which it ended, i.e., June 2000 Quarter, etc.

The class period [*7] in this case extends from August 10, 2000 through March 15, 2001. Plaintiffs allege that the Individual Defendants either participated in directly or sanctioned by virtue of their authority in the company a scheme to improperly recognize revenue in violation of Generally Accepted Accounting Principles (GAAP). According to Plaintiffs, Defendants were motivated by a desire to bolster the company's economic outlook in order to attract a merger partner. Specifically, Plaintiffs allege that the Individual Defendants overrode accounting methods and internal company policies to extend credit to customers with questionable credit histories and to "ship" products to Adaptive's own warehouse in an attempt to move them off the books. According to Plaintiffs, contemporaneously with these maneuvers, the Individual Defendants were reporting to the investing public grossly overinflated revenue in order to maintain or raise the price of Adaptive's securities.

Plaintiffs describe statements from four confidential witnesses who have reported details of Defendants' alleged fraud. Confidential witness 1 ("CW1") is a 15-year employee of Adaptive and its predecessor, California Microwave. CWI was a manager [*8] in charge of Adaptive's order fulfillment department in 2000 until approximately July 2001. *Id.* at P 41. CW1 claims that Adaptive had specific policies for Revenue Recognition Procedure, Order Entry Procedure and Commercial Booking Policy, all of which were incorporated into an Oracle database housing Adaptive's general ledger. *Id.* at P 43.

Confidential witness 2 ("CW2") began work at Adaptive in 1999. In 2000, and until approximately July 2001, CW2 worked in Adaptive's finance division and reported directly to Defendant Maloney. CW2 generated regular reports for senior management, including a "BBB Customer Report" detailing billings, bookings and backlog. *Id.* at P 42. These reports, which were generated from Adaptive's Oracle database, were used by senior management to support Adaptive's SEC filings and its reports to the investing public and securities analysts. *Id.*

Confidential witness 3 ("CW3") worked for Adaptive and its predecessor company for 10 years. *Id.* at P 60. In 2000 and until approximately July 2001, CW3 was a department head-level information officer in Adaptive's Rochester, New York offices, the hub of Adaptive's sales and order administration [*9] department. *Id.* CW3 reported to Adaptive's Chief Information Officer, Steve Bringham ("Bringham").

Confidential witness 4 ("CW4") was an administrative assistant who worked for Defendants Lawrence and Birks between July 2000 and February 2001. *Id.* at P 63.

For the purposes of a motion to dismiss, the Court takes all of Plaintiffs' allegations as true. They allege the following misleading statements:

The Announcement of Fiscal Year 2000 Results

On the first day of the class period, August 10, 2000, Adaptive issued a press release "prepared by defendants" and signed by Defendant Lawrence describing financial information and results of operations. *Id.* at PP 33, 89. ("August 2000 release"). These same statements were included in an August 29, 2000 Annual Report on Form 10-K filed with the SEC. *Id.* at P 33.

In the August 2000 release, Adaptive claimed a 106 percent increase in revenue for the June 2000 Quarter as compared to the previous quarter. *Id.* at P 34. Defendants Lawrence, Scharre and Birks were quoted in the release touting the company's success. *Id.* at PP 35-37. These same three defendants signed the Form 10-K, filed August 29, 2000 for FY2000 which [*10] repeated figures detailed in the August 2000 Release. In the FY2000 10-K, Adaptive reported that it generally recognizes revenue "upon shipment to a credit-worthy customer." *Id.* at P 38.

Plaintiffs claim this statement was false and misleading because Adaptive falsified its financial results by improperly recognizing revenue. According to CW1, Defendant Maloney overrode these procedures frequently in 2000 to ship products to companies that did not meet Adaptive's own creditworthiness standards, or to companies that had canceled orders or never placed orders in the first place. *Id.* at P 45. CW1 reported that Defendants Lawrence and Birks "knew what [Maloney] was doing" and "consented to his actions." *Id.* CW1 reported that "no one trusted [Maloney]" when it came to compliance with internal order procedures. *Id.*

In particular, CW1 reported that at the end of June 2000, Defendant Maloney overrode Adaptive's proce-

dures for several transactions and created a second set of accounting records for transactions that violated the procedures and were recommended for rejection by Adaptive's Order Administration Department. *Id.* at P 46. According to CW1, Defendant Maloney [*11] kept a separate accounting sheet for a $ 4 million purchase from a customer called BroadbandNow, which became the subject of arguments between Defendant Maloney and employees in the order administration department and finance division. *Id.* at P 47. CW1 told Defendant Maloney that the $ 4 million transaction was not supported by a purchase order. *Id.* Defendant Maloney responded that a purchase order would be forthcoming, but CW1 reports it never was. *Id.* CW1 discussed this issue with the manager-level head of Adaptive's accounting department, who agreed that recording the transaction was improper. CW1 reported that Defendant Maloney was confronted about the transaction by CW1 and the accounting department manager. *Id.* In addition, CW1 reported that email correspondence from June 2000 between Defendant Maloney and the order administration department chronicled admonitions to Defendant Maloney about his actions. CW1 and the accounting manager "jokingly" gave Defendant a Monopoly-esque "get-out-of-jail-free card" in recognition of their view that what he was doing was improper. *Id.*

CW1 reported another alleged improper transaction in the June 2000 Quarter, this one [*12] with Cybertech Wireless Inc. ("Cybertech"). *Id.* at P 48. Cybertech canceled its June 2000 order and was in debt to Adaptive, having failed to pay for a prior shipment. *Id.* A customer support representative, after calling Cybertech to confirm that it had canceled its order, recommended that Adaptive not ship it. *Id.* According to CW1, Defendant Maloney extended Cybertech's credit line, overrode the order entry procedures and directed Adaptive to ship the product to Cybertech anyway. *Id.* Cybertech refused the shipment and Adaptive refused the return until December 2000 when it was re-inputted into the Adaptive accounting system. *Id.*

CW1 describes another transaction with TESSCO Technologies, Inc. ("TESSCO"), also reflected in the June 2000 Quarter results. *Id.* at P 49. Adaptive received TESSCO's order by email at approximately 11:00 p.m. on a Saturday night from a TESSCO engineer. *Id.* This was unusual since all prior (and subsequent) orders came via purchase orders on TESSCO letterhead, as specified by Adaptive's Order Entry procedure. *Id.* Adaptive's order administration department contacted TESSCO about the order and was informed that the TESSCO engineer [*13] had not been authorized to make the purchase and that TESSCO did not want the product. *Id.* According to CW1, Defendant Maloney overrode usual procedure and directed Adaptive to ship the product to TESSCO. TESSCO refused to accept it. *Id.*

According to Plaintiffs, all of these transactions were reflected in the June 2000 Quarter financial statements. *Id.* at PP 39, 48, 49.

On March 15, 2001 Adaptive admitted it wrongfully recorded the Broadband Now transaction. *Id.* at P 50. On July 5, 2001, Adaptive admitted that it had wrongfully recorded a total of $ 4.8 million in revenue, or over 20 percent of the year's total. *Id.* In its July 5, 2001 Annual Report on Form 10-K, Adaptive told the SEC that the results reported in the August release were overstated because of "two additional revenue transactions, one relating to an unauthorized shipment and the other to the inappropriate recognition of a customer deposit, both recorded in the [June 2000 Quarter], which have also been restated." *Id.* at P 51.

Defendant Lawrence's Statements Relating to the Fuzion Deal

Prior to the class period, on July 18, 2000, Adaptive issued a press release describing an agreement [*14] it had entered with Fuzion Wireless Communications ("Fuzion") for the joint development of new technology for wireless broadband networks. *Id.* at P 53. On September 22, 2000, Adaptive issued another press release announcing a $ 100 million contract with Fuzion. *Id.* Also on September 22, 2000, Bloomberg quoted Defendant Lawrence's statements about the Fuzion deal. *Id.* at P 55. Defendant Lawrence noted that "the contract goes over a multiple-year period, but there is immediate revenue for the current and following quarters. . . . This will hit our top-line growth over the next five years, and when you add up our customer list, you'll see over 50 names and $ 1.5 billion in contracts." *Id.*

According to Plaintiffs, Lawrence's statement that revenue would be reflected in the immediate quarter was false and misleading because Defendants knew that Fuzion could not place or accept any orders from Adaptive before the close of the September 2000 Quarter. *Id.* at P 56. Nonetheless, in an attempt to rush the order through, Defendants demanded that the order administration department fulfill a $ 13 million order from Fuzion before the close of the quarter. *Id.* at P 57. According [*15] to CW2, Adaptive never received a purchase order from Fuzion. *Id.* at P 58. Moreover, CW2 reported that Fuzion had previously defaulted on an earlier, $ 12 million order, which under normal procedures would preclude its being issued further credit. *Id.* Nonetheless, according to Plaintiffs, Adaptive "senior management" extended Fuzion's credit to allow for another shipment. *Id.*

CW1 reported that Fuzion could not accept products shipped under the new order. *Id.* According to CW1, Defendants Maloney, Lawrence and Birks devised a scheme whereby Fuzion could "lease" storage space at Adaptive's Sunnyvale, California headquarters. *Id.* at P 59. *Id.* CW1 told Defendant Maloney that Adaptive could not ship to its own warehouse without a written lease agreement. *Id.* CW1 reported that Defendant Maloney overrode procedure and ordered Adaptive to "ship" the order, consisting of eight or nine tractor loads, to its own warehouse. *Id.*

CW3 confirmed the informal arrangement between Fuzion and Adaptive. CW3 reported that he visited Adaptive's Sunnyvale, California headquarters in early July 2000 and noticed 15 pallets of 600 units of merchandise in an Adaptive warehouse. [*16] *Id.* at P 61. According to CW3, this struck him as unusual, and when he asked Bringham about it, he was told that the products belonged to Fuzion. *Id.*

CW3 reported that the Fuzion relationship was handled in part by Defendant Scharre. *Id.* at P 62. According to CW3, when the Fuzion/Adaptive partnership was announced on July 18, 2000, Defendant Scharre directed Adaptive employees to provide Fuzion employees with access to Adaptive's technical information. *Id.* As an example, CW3 reported that Fuzion was granted the right to provide wireless services to Adaptive's Rochester office. *Id.* CW3 reported that Adaptive employees were subsequently ordered to terminate all contact with Fuzion, and that questions from Fuzion employees were to be referred to Adaptive's counsel. *Id.* CW3 then contacted Scharre to determine whether he should continue to provide a Fuzion employee with access to the Rochester facility. *Id.* Defendant Scharre told CW3 to stall the Fuzion employee, and not to connect him to Adaptive's systems. *Id.* CW3 reported that Fuzion had refused to pay Adaptive, and was experiencing financial difficulties. *Id.*

CW4 confirmed that the products Adaptive [*17] sold to Fuzion were stored at Adaptive's Sunnyvale, California headquarters. *Id.* CW2 reported that Adaptive's general ledger did not record the Fuzion order in the first quarter of FY01 because the order was never received, nor were the products shipped. *Id.* at P 64. CW2 generated the BBB Customer Report for senior management to review. *Id.* CW2 reported that senior management falsely altered the report to reflect the first quarter Fuzion sale. *Id.*

Announcement of September Quarter 2000 Results

On October 23, 2000, Adaptive released its financial statements and results of operations for the September 2000 Quarter in a press release disseminated to investors. *Id.* at P 65 ("October 2000 release"). On November 3, 2000, Adaptive filed a quarterly report with the SEC on Form 10-Q reporting these same revenue figures. *Id.* The October 2000 release reported revenue for the first quarter of FY2001 of $ 24.2 million, a 42 percent increase from the previous quarter. *Id.* at P 66. It also contains statements from Defendants Lawrence, Birks and Scharre, making glowing predictions for Adaptive's future. *Id.* at P 67. Defendant Birks predicted a 30 percent or greater [*18] quarter-to-quarter growth rate, and that gross margins would increase by 10 percent to 40 percent by the March 2001 quarter. *Id.* The October 2000 release announced a recorded net income of $ 1.7 million in the September 2000 Quarter compared to a net loss of $ 15.9 million for the June 2000 Quarter and a net loss of $ 3.9 million for the comparable quarter of the previous year. *Id.* at P 68.

The Form 10-Q report was signed by Birks. *Id.* at P 69. It read, in part, "In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (all of which are normal and recurring in nature) necessary to present fairly the financial position, results of operations and cash flows for the periods presented." *Id.* at P 89.

Plaintiffs allege that the Fuzion order, worth $ 13 million, was improperly included in the September 2000 Quarter results, rendering the October 2000 release and the FY01 Form 10-Q false and misleading. *Id.* at P 70. On July 5, 2001, Adaptive admitted that its September 2000 Quarter revenues were overstated by 981.6 percent; $ 21.4 million of the $ 23.6 million in revenue was wrongly recorded. *Id.*

[*19] Adaptive also reported in the October 23, 2000 release that it had backlog orders at the close of the September 2000 Quarter totaling $ 72.4 million. *Id.* at P 66. According to Plaintiffs, Adaptive's reported backlog of orders was falsely inflated. Adaptive's invoicing system was based on 30-day net payment terms. *Id.* at P 72. If a customer was 90-days past due or more, it was red-flagged for review by Defendant Maloney. *Id.* CW1 reported that purchase orders received prior to the close of FY2000 with shipment dates between January and March 2001 that were red-flagged were reported nonetheless. *Id.* CW2 reported that in the first and second quarters of FY2001 certain orders were shipped and never paid for and never returned, but were recorded by Defendant Maloney as having been returned to inventory anyway. *Id.* at P 73.

Announcement of December 2000 Quarter Results

On January 25, 2001, Adaptive issued a press release detailing its results for the December 2000 Quarter. *Id.* at P 77. ("January 2001 Release"). It reported revenue

Rule 9(b) provides that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. P. 9(b). The allegations must be "specific enough to give defendants notice of the particular misconduct which is alleged to constitute the fraud charged so that they can defend against the charge and not just deny that they have done anything wrong." *Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985).

Rule 9(b) applies to actions brought under the federal securities laws. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1548 (9th Cir. 1994)(en banc). In 1995, Congress enacted the Private Securities Litigation Reform Act, ("PSLRA"), to clarify and strengthen [*25] the particularity requirements of Rule 9(b) in the context of federal securities class actions. In the Ninth Circuit, this requirement has been interpreted and explained by *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970 (9th Cir. 1999).

Section 10(b) of the Securities Exchange Act of 1934 provides, in relevant part, that it shall be unlawful "to use or employ in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe..." 15 U.S.C. § 78j(b). Exchange Commission Rule 10b-5, issued by the SEC to implement Section 10(b), makes it unlawful for any person to use interstate commerce:

> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would [*26] operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. A plaintiff bringing a claim under these sections must show: (1) a false and misleading statement or omission of material fact; (2) reliance; (3) scienter; and (4) resulting damage. *Paracor Fin., Inc. v. General Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996).

The PSLRA places additional pleading requirements on a plaintiff in a securities fraud action. To state a claim under the PSLRA, for each defendant, a plaintiff must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief...[to] state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The plaintiff must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The PSLRA further requires that a district court, upon [*27] motion of the defendant, "shall" dismiss any complaint that does not meet these requirements. 15 U.S.C. § 78u-4(b)(3)(A).

C. *Control Person Liability*

Rule 20(a) of the 1934 Act defines control persons as: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder . . .." 15 U.S.C. § 78t(a). Such a person "shall also be liable jointly and severally with and to the same extent as such controlled to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.*

D. *Judicial Notice*

A party requesting judicial notice must show that the fact in question is not subject to reasonable dispute because it is generally known in the community or "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201(b). In ruling on a motion to dismiss, a district court may take judicial notice of a document if the plaintiff relies upon it [*28] in her complaint and its authenticity is not questioned. *Parrino v. FHP, Inc.*, 146 F.3d 699, 706 (9th Cir. 1998). A court may consider SEC filings incorporated by reference in a complaint. *Ronconi v. Larkin*, 253 F.3d 423, 427 (9th Cir. 2001); *In re Silicon Graphics*, 183 F.3d at 986.

IV. *DISCUSSION*

In this securities class action, Plaintiffs claim that Adaptive falsely reported financial results by improperly recording revenue in an attempt to inflate its stock price. According to Plaintiffs, revenue overstatement and inadequate loss recognition was effected by violating generally-accepted accounting principles ("GAAP") and Adaptive's own internal policies. As a result, FY2000 and FY2001 financial results were materially false and misleading when made. Plaintiffs claim they would not have purchased Adaptive stock at the prices they paid, or

at all, if they had known that the market price had been inflated by Defendants' alleged fraud.

Plaintiffs allege violations of Section 10(b) of the 1934 Act and SEC Rule 10b-5 against all defendants and violations of Section 20(a) of 1934 Act against the individual defendants. They [*29] request class damages, interest and costs and any other equitable/injunctive relief as the Court deems just and proper.

The Court will first address whether the Complaint states facts sufficient to support fraud generally under the PSLRA's heightened pleading standards. The Court will next address whether the Complaint's allegations are sufficient to support the claim that the individual defendants were control persons under Section 20(a).

A. *Section 10(b) and SEC Rule 10b-5*

Plaintiffs allege that Defendants engaged in a series of conscious decisions to falsify financial statements in order to attract a merger partner and to profit personally thereby. To support these allegations, Plaintiffs cite reports from four confidential witnesses from inside the company. They also cite to Adaptive's own public admission that it had misstated its financials, the NASDAQ's decision to delist Adaptive's stock, reshuffling (and replacement) of top executives and a failed merger attempt as evidence that Adaptive knowingly, or at least with deliberate recklessness, defrauded them by engaging in questionable business practices. Defendants dispute Plaintiffs' contention that their Complaint [*30] pleads securities fraud with the necessary particularity.

Under the PSLRA and Rule 9(b), a plaintiff must show that an alleged false statement was false when made, and must also plead specific facts creating a strong inference that the fraud was committed with deliberate recklessness. *In re Silicon Graphics*, 183 F.3d at 974; *Ronconi*, 253 F.3d at 429. If an allegation regarding a statement or omission is made on information and belief, the complaint must state with particularity all facts on which that belief is based. 15 U.S.C. § 78u-4(b)(1). Allegations are presumed to have been made on information and belief unless and until the plaintiffs demonstrate they have personal knowledge of the facts. *In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 2002 U.S. App. LEXIS 4231, 2002 WL 398498, at *2 n.3 (9th Cir. 2002).

The first prong of the *Silicon Graphics* formula is satisfied here; Defendants do not contest that financial statements for the June, September and December 2000 Quarters were false when made. In their Motion to Dismiss, however, the Individual Defendants deny these results were knowingly false when made; that is, [*31] they argue that Plaintiffs' complaint is fatally flawed for failure to plead the required level of scienter. They explain the readjustment of Adaptive's financial disclosures as the combined result of the discovery that some transactions had been improperly recorded and the collapse in the market for Adaptive's product which made prior credit extensions to certain customers insupportable.

In the Ninth Circuit, the required state of mind in a securities fraud case is actual knowledge or "deliberate recklessness," or if the statement is forward-looking, "actual knowledge . . . that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(i); *Ronconi*, 253 F.3d at 429. This stricter standard was codified in an attempt to prevent cases based upon "fraud by hindsight." *In re Silicon Graphics*, 183 F.3d at 988 (internal citations omitted).

A securities fraud complaint need not be dismissed for relying on circumstantial evidence, as long as that evidence meets the "strong inference" standard. *In re Silicon Graphics*, 183 F.3d at 996; *In re Northpoint Comm. Group, Inc. Sec. Litig.*, 184 F. Supp. 2d 991, 997 (N.D. Cal. 2001). [*32] In order to adequately plead that statements were intentionally false, misleading or made with deliberate recklessness, the complaint must allege specific "contemporaneous statement or conditions" demonstrating the deliberately reckless or intentional nature of the statements at the time they were made. *Ronconi*, 253 F.3d at 432; *In re Vantive*, 283 F.3d 1079, 2002 U.S. App. LEXIS 4231, 2002 WL 398498 at *7. In assessing whether a complaint sufficiently pleads scienter, it must be read in its entirety. *In re Silicon Graphics*, 183 F.3d at 985.

Plaintiffs argue scienter on many different levels. First, they argue that GAAP violations in and of themselves support an inference of scienter. They also argue that by restating its financials, Adaptive effectively admitted that its original filings and releases were knowingly false when made. But most importantly, Plaintiffs point to a series of deliberate transactions by corporate executives designed to override standard accounting procedures in an effort to attract a potential buyer for the company. Plaintiffs argue that collectively, these transactions and the deliberateness with which they were entered into support the necessary [*33] inference that the fraud alleged was knowing, or at least deliberately reckless.

1. *Unnamed Sources*

As an initial matter, the Court will address Defendants' concern over Plaintiffs' use of confidential witnesses. Defendants claim the use of unnamed sources violates the PSLRA's particularity requirement. Defendants demand that Plaintiffs should be required to at least provide the witnesses' names and titles, or more facts establishing that they are likely to possess the information attributed to them. Defendants note in particular that

the Complaint is vague as to the starting dates of three of the four witnesses, suggesting that they may not have been working at the jobs that gave them access to the knowledge they are supposed to have until after the events happened.

The credibility to be attributed to an anonymous source should be evaluated on a case-by-case basis. *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1271 (N.D. Cal. 2000). The failure to name sources may reduce the weight to be allocated to their testimony when evaluating the complaint's ability to meet the strict requirements for pleading scienter. 126 F. Supp. 2d at 1272. But [*34] the failure to name sources will not doom an otherwise well-plead securities complaint. According to *Silicon Graphics*, a plaintiff need only "mention . . . the sources of [plaintiff's] information." 183 F.3d at 985. This has been interpreted to mean that "it is possible to identify sources and provide other corroborating details without disclosing names of sources." *In re McKesson*, 126 F. Supp. 2d at 1271.

Plaintiffs' Complaint would be more credible if their sources were named, since, in the context of pleading securities fraud, the more detail the better. But their refusal to provide this detail is not fatal. Plaintiffs allege that CW1 was a 15-year employee of Adaptive and its predecessor, California Microwave, and that in 2000 until approximately July 2001 the witness was a manager in charge of Adaptive's order fulfillment department. (Compl. at P 41.) Plaintiffs claim that CW2 began work at Adaptive in 1999 and from 2000 to July 2001 worked in Adaptive's finance division and reported directly to Defendant Maloney. CW2's responsibilities included generating regular reports for senior management, including a "BBB Customer Report" detailing billings, [*35] bookings and backlog. *Id.* at P 42. CW3 worked for Adaptive and its predecessor company for 10 years. *Id.* at P 60. In 2000 and until approximately July 2001, CW3 was a department head-level information officer in Adaptive's Rochester, New York office, the hub of Adaptive's sales and order administration department. *Id.* CW3 reported to Adaptive's Chief Information Officer. Finally, CW4 is described as an administrative assistant who worked for Defendants Lawrence and Birks between July 2000 and February 2001. *Id.* at P 63.

Defendants correctly note that Plaintiffs are vague as to the dates witnesses one through three began work in their positions. And it is indeed odd that employees whose descriptions give away so much of their identities would not let their names be used. But the Court finds that the failure to name them is more than compensated for by the fact that the witnesses are long-term employees whose positions are described in detail.

Defendants cite to *In re Northpoint*, a case in which the use of eight confidential witnesses could not overcome the PSLRA's particularity requirement. 184 F. Supp. 2d at 1001. But the Court finds that case to [*36] be distinguishable. There, Judge Alsup noted that the complaint never described the witnesses' duties, nor did it discuss how they came to learn of the information in the complaint. *Id.* Here, by contrast, Plaintiffs provide much more that the four witnesses' titles. For example, they describe that CW1 had first-hand knowledge of Defendant Maloney's decision to extend credit to certain customers and to override internal accounting procedures in the process. They describe how CW2 generated reports and knew first-hand that a report had been altered to reflect the Fuzion deal. They describe how CW3 saw for himself the Fuzion's supposedly completed order stored in Adaptive's Sunnyvale warehouse, a scheme later confirmed by his supervisor. While less concrete, the information provided by CW4 confirms the Fuzion warehouse deal.

This is not to say that everything attributable to these witnesses is acceptable. CW1's allegations that Defendants Lawrence and Birks actually "knew what Peter was doing" and "consented to his actions," and that "no one trusted [Maloney]" are far too vague. (Compl. P 45). The same goes for CW2's allegations that "certain orders during [the first and second [*37] quarters of FY2001] had been shipped to customers, never paid for, and never returned." *Id.* at P 73. But the places where the complaint suffers for vagueness are counterbalanced by detailed allegations elsewhere. The Court is persuaded that on the whole, Plaintiffs have provided sufficient detail as to the job descriptions and responsibilities of their confidential sources, and the ways in which they came to know the information pleaded in Plaintiffs' complaint. The fact that they are not named, while not ideal, does not prove fatal to Plaintiffs' complaint.

2. *The Allegedly Misleading Statements* [2]

> 2 The Court notes that while the hard numbers falsely reported in press releases announcing financial results and corresponding SEC filings are actionable, the vast majority of the statements made by the individual defendants to the media are not. Reasonable investors do not take heed of puffery when making investment decisions. *In re Northpoint*, 184 F. Supp. 2d at 1005 (citing *Raab v. General Physics Corp.*, 4 F.3d 286, 288-90 (4th Cir. 1990)).

[*38] a. *SEC Filings/Press Releases Announcing Financial Results*

Plaintiffs argue that a series of SEC filings and press releases announcing financial results were false when

made, and were made with the intent to deceive or with a deliberately reckless regard for the truth. They attempt to show scienter with a variety of corroborating circumstantial evidence, the sufficiency of which the Court will presently address.

1) *GAAP violations*

Plaintiffs claim that in their zeal to prop up Adaptive's financial health, Defendants deliberately failed to follow the SEC's admonition that financial statements filed with the SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate. 17 C.F.R. § 210.4-01(a)(1) ("SEC Reg. S-X"). According to Plaintiffs, a failure to follow GAAP demonstrates deliberate recklessness in reporting financial results, and thus, scienter. Defendants disagree.

While it is true that conclusory allegations of GAAP violations standing alone cannot be used to prove intentional or reckless misconduct, if pled in detail and read in context, GAAP violations may support an inference of scienter. *In re McKesson*, 126 F. Supp. 2d at 1273 [*39] ("After all, books do not cook themselves."); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1082 (N.D. Cal. 2001); *compare In re Northpoint*, 184 F. Supp. 2d at 998 (finding GAAP violations alone to be insufficient proof of scienter).

GAAP violations are particularly credible evidence where a plaintiff provides specific amounts by which revenue was overstated, dates of transactions and/or the identities of the customers or company employees involved. *In re McKesson*, 126 F. Supp. 2d at 1273; *compare In re Vantive*, 283 F.3d 1079, 2002 U.S. App. LEXIS 4231, 2002 WL 398498 at *7 (finding an allegation of revenue overstatement insufficient where the amount of overstatement was not specified). Such information is adequately supplied here. The Broadband Now transaction in and of itself is specific as to amount ($ 4 million), approximate date (June 2000 Quarter) and customer. In addition, Plaintiffs provide specific evidence that there was an internal debate at Adaptive as to whether to override internal policies and GAAP restrictions and book the transaction. Plaintiffs also provide specific detail as to the TESSCO and Cybertech transactions, both recorded in the [*40] June 2000 Quarter.

The Court finds similarly sufficient detail in Plaintiffs' description of the September 2000 Quarter Fuzion deal for $ 13 million. There is detailed evidence to suggest the customer, amount and approximate date of the Fuzion transaction, which was booked despite Fuzion's faulty credit status and the questionable arrangement to "ship" the order to Adaptive's own warehouse. *See In re Secure Computing Corp. Sec. Litig.*, 184 F. Supp. 2d 980, 988-89 (N.D. Cal. 2001) ("*Secure II*")(finding allegations about a scheme to warehouse unfinished products for which the government would not accept delivery and treating it as delivered for accounting purposes to support a strong inference of deliberate recklessness under the PSLRA); compare In re Guess?, *Inc. Sec. Litig.*, 174 F. Supp. 2d 1067, 1077 (C.D. Cal. 2001) (failing to find sufficient evidence of scienter allegations that did not amount to anything as "egregious and the booking of entirely contingent contracts as sales, followed by hiding the side letters that established the contingencies").

Defendants' suggestion that these transactions might somehow have been mismanagement, overconfidence [*41] or "growing pains" is best raised on a motion for summary judgment or at trial. At this stage in the litigation, by corroborating GAAP violations with detailed evidence of the contemporaneous decision-making behind the accounting errors, Plaintiffs have set forth sufficient circumstantial evidence that the statements released to the SEC and the investing public were known to be false at the time they were made. *Ronconi*, 253 F.3d at 432 (holding that allegations of deliberate recklessness must be supported by "contemporaneous statements or conditions" of knowing falsity). Defendant Maloney's actions alone -- ignoring basic accounting principles and refusing to heed warnings from the accounting department about the propriety of his actions in overriding company policy -- are sufficient to suggest that he knew what he was doing would lead to falsified financial results.

2) *Financial Restatements*

Plaintiffs allege that the fact that financials had to be restated at all supports an inference that they were knowingly false when made. Again, Defendants disagree, citing *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 553-54 (6th Cir. 1999).

While it [*42] is true that a one-time restatement, without more, probably does not create the necessary strong inference of scienter, *In re Northpoint*, 184 F. Supp. 2d at 1003, there is at least one case from the Northern District of California supporting Plaintiffs' position. In *In re Cylink*, the Court noted that "the mere fact that the statements were restated at all supports . . . an inference [of scienter]." 178 F. Supp. 2d at 1084. Given the fact that Adaptive was forced to announce restatements at least twice - once on March 15, 2001 and again on July 5, 2001 - the Court finds that while they would be insufficient to support a scienter inference on their own, when coupled with the strong evidence of deliberately reckless accounting, these restatements shore up and place in context the allegations of fraud.

3) *Corporate Reshuffling*

As Adaptive's financial difficulties were coming to light, three of the named individual defendants either left

the company or were moved to new positions. On January 11, 2001 Defendants Lawrence and Birks resigned. In April 2001, Adaptive Defendant Maloney was replaced as CFO and reassigned. In addition, in May 2001, severance [*43] payments to Defendants Lawrence and Birks were suspended. Plaintiffs suggest that these changes provide further support for an inference of scienter.

As with the restatement of Adaptive's financials, these changes, taken alone, would not support scienter. But because the changes occurred as Adaptive's financials were being restated and as Adaptive was conducting its own internal investigation (which resulted in a determination that the extension of credit to certain customers was unsupportable), they add one more piece to the scienter puzzle. This comports with *In re McKesson*, where the court inferred that the corporation had a factual basis for firing employees for cause because they "knew or should have known" of accounting improprieties. 126 F. Supp. 2d at 1274. While Adaptive's actions do not rise to such a level in this case (no one was publicly fired), the fact that the CFO was moved and former executives' severance payments were discontinued is highly suspicious, especially given the additional allegations in the Complaint.

4) *Internal Reports*

Defendants take issue with Plaintiffs' reference to internal BBB Reports to support a scienter inference, because [*44] while named, their contents are not alleged in sufficient detail. Plaintiffs counter that the details in their Complaint are sufficient; they allege that CW2 drafted some of them (BBB) and that the Fuzion order was specifically left out of at least one of them. Plaintiffs also claim that the existence of the BBB reports is corroborated by their witnesses.

Defendants are correct that *In re Silicon Graphics* explicitly rejected a plaintiff's attempt to ground scienter on general, uncorroborated allegations that defendants had received internal reports. 183 F.3d at 984, 985, 988. To overcome *In re Silicon* Graphic's proscription against vague references to a defendant's access to internal reports, details such as dates and contents of the reports in question are required. *In re Vantive*, 283 F.3d 1079, 2002 U.S. App. LEXIS 4231, 2002 WL 398498 at *5.

Plaintiffs actually make few if any references to company internal reports; their complaint rests on details wholly unrelated to what company executives were seeing or should have been seeing in internal memoranda. Unlike those cases in which scienter failed because it could not be shown that executives should have known something because they [*45] had access to internal documents detailing failing company prospects, this case rests on other evidence, most notably, witness reports that Defendants were deliberately violating accounting rules with side agreements and insupportable credit extensions. Indeed, the premise of Plaintiffs' theory of the case is that Defendants perpetrated a scheme more notable for what was *not* in the BBB reports generated from Adaptive's general ledger. In other words, it would not even matter what the internal documents said, because according to Plaintiffs, they were doctored. Defendants' argument about the use of internal reports as it relates to scienter is therefore unavailing.

5) *Motive/Stock sales*

Finally, Defendants argue that Plaintiffs' complaint is fatally flawed in that it fails to allege that any of the Individual Defendants made any stock sales during the class period. [3] The Court interprets Defendants' argument to mean that the Complaint fails to demonstrate a motive for the alleged fraud.

> 3 Defendants have requested that the Court take judicial notice of the fact that Defendant Scharre's purchased 10,000 shares of Adaptive stock between January 30, 2001 and February 5, 2001. (Defs. Req. for Judicial Notice, Ex. C). Plaintiffs oppose the request because the issue of stock sales was not raised in their Complaint. In the alternative, Plaintiffs argue that Defendant Scharre's purchase only supports their theory; he wanted more shares so that he could sell more shares post-merger. Because the Court denies the Request for Judicial Notice, *see* section IV C, *infra*, neither argument will be addressed in this Order.

[*46] Plaintiffs counter that Defendants sought to profit personally from the proposed Western Multiplex merger because their stock holdings, if sold to an acquiring company, were collectively worth $ 14 million. Plaintiffs hypothesize that a merger with Western Multiplex would have allowed Defendants to sell all of their stock to the acquiring company without raising suspicion of insider trading.

Defendants dismiss this argument as boilerplate and conclusory. They argue that in addition to Plaintiffs' failure to make it in the original complaint, if this argument were persuasive, every potential merger would create an inference of scienter. Moreover, Defendants contend that the stock they were holding after the merger would have been devalued once the financials were restated. In support, Defendants cite *Florida State Bd. of Admin. v. Green Tree Fin. Corp*, 270 F.3d 645 (8th Cir. 2001), for the proposition that a motive to overstate revenue to make a company more attractive to potential buyers is "too thin a reed on which to hang an inference of scienter . . .." *Id.* at 664; *see also In re McKesson*, 126 F. Supp.

2d at 1274 n. 14 (recognizing [*47] that incentive compensation has been consistently rejected as a motive for fraud, for if this was enough it "would effectively eliminate the state of mind requirement as to all corporate officers and defendants" (quoting *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994)).

It is true that insider trading, if contemporaneous with knowingly false statements, tends to directly support the inference that a defendant knew that a statement she made was false at the time she made it. *Ronconi*, 253 F.3d at 434. But other motive evidence, while not as persuasive, is not necessarily unpersuasive if coupled with other allegations of fraud. *See, e.g., Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1064 (9th Cir. 2000) (holding on summary judgment that a desire to raise company financing combined with other "red-flags" of a company's financial condition can be probative of a motive to defraud investors); *In re Imperial Credit Indus. Sec. Litig.*, 2000 U.S. Dist. LEXIS 2340, No. CV 98-8842 SVW, 2000 WL 1049320, at *3 (C.D. Cal. Feb. 22, 2000) (finding allegations of motive to attract a buyer "before the company fell apart entirely," while not sufficient to support an inference [*48] of scienter on their own, "still probative to the inquiry").

The $ 645 million merger agreement would have made Defendants Lawrence and Scharre members of Western Multiplex's board of directors, and Scharre would have become President and COO. (Compl. P 74). The merger was called off on January 10, 2001, and a little over six months later, Adaptive filed for bankruptcy. *Id.* at PP 75, 86. While these facts are not persuasive on their own, when read in light of the facts supporting the deliberately reckless accounting violations, the Court finds that they support an inference that the individual defendants were falsifying Adaptive's revenue in an attempt to bail the company out and save and perhaps increase the value of their shares. In the process, many investors, including Plaintiffs, could have also been misled.

The Court recognizes that in isolation, this evidence would not come close to the level required to strongly infer scienter; as Defendants note, preserving a merger may provide "an incentive to feign success," but on its own, a fraud case it does not make. *In re Northpoint*, 184 F. Supp. 2d at 1003. But under the circumstances, when Plaintiffs relied [*49] on the misstated revenues and purchased stock at inflated prices, the fact that Defendants did not sell their own stock matters little. *In re Nuko Info. Sys., Inc. Sec. Litig.*, 199 F.R.D. 338, 344-45 (N.D. Cal. 2000).

Plaintiffs are only obliged to state some set of facts giving rise to a strong inference of deliberate recklessness. If they have done so, it is irrelevant whether another, different set of facts might have accomplished the same thing. *In re Cylink*, 178 F. Supp. 2d at 1083. Therefore, given the sufficiency of the facts supporting the deliberately reckless GAAP violations, it makes no difference that there were no stock sales, or that the Complaint only alludes to internal company reports. These additional facts provide a backdrop for a portrait of fraud, painted in sufficient detail to satisfy the Court that the case is not one of the "fishing expeditions" the PSLRA was designed to discourage. At this stage, taken as true, Plaintiffs' pleadings are sufficient to suggest egregious GAAP violations in necessary detail to support a scienter inference, and therefore a violation of federal securities laws.

In sum, the Court finds that the [*50] statements made about Adaptive's revenue and loss in the June, September and December 2000 Quarters may very well have been made with a deliberately reckless regard for the truth. The Complaint provides specific details about a scheme to overinflate revenue in clear violation of internal policy and federal guidelines. Coupled with a formal admission that the revenues were overstated in the form of financial restatements filed with the SEC, public admonition of those involved and the results of Adaptive's own internal investigation, Plaintiffs have provided sufficient evidence to survive a motion to dismiss.

3. *Allegations as to Each Individual Participant*

Aside from proving whether the statements themselves were made with the requisite scienter, Plaintiffs must also satisfy the Court that it can prove who is liable for making them. Plaintiffs claim Section 10(b) violations against Adaptive and Defendants Lawrence, Birks, Scharre and Maloney. In addition to arguing that Plaintiffs have failed to allege scienter generally, Defendants also argue that Plaintiffs have failed to allege scienter separately as to each of these individual defendants.

As an initial matter, the Court is [*51] convinced that the allegations pertaining to Defendant Maloney are specific enough to infer that he acted at least with deliberate recklessness. Plaintiffs allege that he overrode internal revenue recognition policies and refused to reverse his decision even after being confronted by accounting staff. (Compl. P 47.) In response, CW1 and another accounting department staffer jokingly gave Defendant Maloney a "get-out-of-jail free" card in recognition that he had acted inappropriately. *Id.* Defendant Maloney is also alleged to have overridden an internal policy that orders could not be shipped to Adaptive's own warehouse without a written lease agreement. *Id.* at P 59. Again, Defendant Maloney was confronted with the policy and ignored it. Together these allegations are detailed enough to pinpoint an inference of scienter as to Defendant Maloney.

As to Defendants Lawrence, Birks and Scharre, Plaintiffs' allegations amount to a series of suggestions that they "knew" about events, devised the fraudulent schemes, or spoke publicly about revenue figures they knew were false. Plaintiffs rely on the group publication doctrine and the core operations inference to support their allegations [*52] of securities fraud against all individual defendants, but as the Court has already determined that the specific allegations as to Defendant Maloney stand on their own, it will only address the doctrine's application to the remaining three: Lawrence, Birks and Scharre.

a. *Group Published Information Doctrine*

Defendants take issue with Plaintiffs' reliance on group published information doctrine, which Defendants argue has not survived the passage of the PSLRA. The doctrine, described in *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433 (9th Cir. 1987), states that a defendant's participation in securities fraud can be shown by reference to that defendant's position, since false statements are the collective acts of officers:

> In cases of corporate fraud where the false and misleading information is conveyed in prospectuses, registration statements, annual reports, press releases or other "group-published information," it is reasonable to presume that these are the collective actions of the officers. Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and where possible [*53] the roles of the individual defendants in the misrepresentations.

[Oil, Chemical & Atomic Workers, etc., Local No. 4-228 v. Union Oil Co.], 818 F.2d 437, 440; *see also In re Glenfed Inc. Sec. Litig.*, 60 F.3d 591, 593 (9th Cir. 1995) (citing *Wool* with approval).

Both *Wool* and *In re Glenfed* were decided before the enactment of the PSLRA. According to Defendants, the PSLRA now requires that falsity and scienter be pled as to each defendant. 15 U.S.C. §§ 78u-4(b)(1)-(2). Defendants acknowledge that the Ninth Circuit has yet to tackle head-on whether the group published information doctrine survives the PSLRA, but claim that it is clear that "its historical underpinnings have been destroyed." (Mem. P&A's in Supp. of Defs.' Mot. to Dis., 11:21-22.)

Plaintiffs cite numerous cases from the Ninth Circuit affirming the viability of the group publication doctrine even after the passage of the PLSRA. *See, e.g., In re Guess?*, 174 F. Supp. 2d at 1079-80 (recognizing the viability of the doctrine); *In re Secure Computing Corp. Sec. Litig.*, 120 F. Supp. 2d 810, 821-22 (N.D. Cal. 2000) ("*Secure I*") (collecting Ninth Circuit cases recognizing the doctrine). The [*54] Court agrees that the doctrine has not been specifically abrogated, and is still good law in this Circuit.

In this case, Plaintiffs rely on statements published in press releases and SEC filings, both of which are subject to the group publication doctrine. *Wool*, 818 F.2d at 1440. Defendants Lawrence, Birks and Scharre signed the August 2000 10-K SEC report, which Plaintiffs allege reported knowingly false revenue results for the June 2000 Quarter. The same three Defendants were quoted in the October 2000 release announcing Adaptive's September 2000 Quarter financial results, which Plaintiffs allege falsely overstated revenue by nearly 981 percent. (Compl. PP 38, 66-67, 70.) [4] Under the group publication doctrine, the statements are presumed to be the collective acts of Adaptive's officers. At the time of the August 2000 release, Defendant Lawrence was the CEO and Chairman of the Board, Defendant Birks was the CFO and Defendant Scharre was the President and COO of Adaptive. These were not just officers of the company, they were the highest ranking officers, and the Court has no trouble inferring that the press releases and SEC filings that contain the false statements [*55] were issued with their blessing.

> 4 In the alternative, Plaintiffs rely on the core operations inference, which states that if a proper factual foundation is laid, "it may be inferred that facts critical to a business's core operations or an important transaction are known to a company's key officers." *In re Northpoint*, 184 F. Supp. 2d at 998. This requires a minimal showing that the critical facts were "actually known within the company." *Id.* Plaintiffs allege that Adaptive consciously focused its efforts on their AB-Access products, and that the importance of this niche supports the inference that the corporate officers would have been well aware of important transactions relating to it, including the Fuzion and Broadband Now deals. (Compl. PP 18, 25, 27, 39, 53, 67). Because the Court finds the group publication doctrine applicable to this case, it need not address Plaintiffs' core operations inference.

The Court's conclusion is supported by the Ninth Circuit's recognition in *Howard* [*56] that when corporate officers sign documents, they attest to their accuracy. 228 F.3d at 1061 ("When a corporate officer signs a document on behalf of the corporation, that signature will be rendered meaningless unless the officer believes

that the statements in the document are true."). While it is true that a plaintiff cannot make general references to a defendant's attendance at a meeting or her "hands-on" managerial style in an attempt to prove scienter, *In re Vantive*, 283 F.3d 1079, 2002 U.S. App. LEXIS 4231, 2002 WL 398498 at *4, it is a different matter when an officer signs a document. In the latter case, the officer is effectively making a statement herself.

Here, Plaintiffs allege that the FY00 Form 10-K was signed by Defendants Lawrence, Birks and Scharre and that the Form 10-Q Report of September 2000 Quarter results was signed by Birks. By signing the forms, which are alleged to contain a deliberately reckless and false report of FY2000 revenue, these Defendants have themselves become liable for securities fraud.

B. *Control Person Liability: Section 20(a)*

Plaintiffs hold the individual defendants responsible for the alleged fraud as control persons under Section 20(a) [*57] of the 1934 Act. The 1934 Act defines a control person as someone "who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder . . .." 15 U.S.C. § 78t(a). Such a person "shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." *Id.*

To successfully plead control person liability, Plaintiffs must show a primary violation of the federal securities laws and that each defendant "directly or indirectly" controlled the violator. *Paracor Fin., Inc. v. General Elec. Capital*, 96 F.3d 1151, 1161 (9th Cir. 1996); *Hollinger v. Titan Capital. Corp*, 914 F.2d 1564, 1575 (9th Cir. 1990). According to Defendants, Plaintiffs have not pled control person liability with particularity. Defendants contend that Plaintiffs must allege specific facts to support each defendant's control over the transaction or activity that gave rise [*58] to the primary violation.

According to Plaintiffs, the fact that the named individual defendants held important positions in the company is sufficient at the pleadings stage. The Court agrees. While it is true that the identification of a control person is "intensely factual," it is also true that a control person need not be a "culpable participant" in the alleged fraud. *Howard*, 228 F.3d at 1065 (citing *Hollinger*, 914 F.2d at 1575; *Paracor*, 96 F.3d at 1161). Indeed, at least one court has determined that allegations that individual defendants, by virtue of their executive and managerial positions, could control and influence the company and did so, are sufficient at the pleadings stage. *In re Cylink*, 178 F. Supp. 2d at 1089 ("Plaintiffs need not allege that the individual defendants actually participated in the wrongful conduct or exercised actual power to be derivatively liable under section 20(a).")

The Court finds that the allegations that the Individual Defendants held the highest offices in the corporation, spoke frequently on its behalf, and made key decisions in how to present its financial results are sufficient [*59] to survive Defendants' contention that the Complaint lacks specificity as to control person liability. Later in the proceedings, when and if Plaintiffs present evidence of such control, Defendants will have the opportunity to assert a good faith defense of lack of participation. *Howard*, 228 F.3d at 1065; *In re Cylink*, 178 F. Supp. 2d at 1089. Defendants' Motion to Dismiss the control person liability claims against Defendants Birks, Maloney, Scharre and Lawrence is therefore denied. [5]

5 As an aside, the Court notes that the Second Claim for Relief in Plaintiffs' Complaint alleges that the individual defendants are liable under Section 20(a) only for their control over Adaptive, not for their liability for their collective acts as corporate executives; that is, for their control over each other. The fact that the case is stayed against Adaptive's pending bankruptcy may be problematic, since Plaintiffs cannot prove that Adaptive has committed a primary violation of federal securities laws until the stay is lifted. As noted, the establishment of a primary violation is a threshold inquiry in determining control person liability. *Howard*, 228 F.3d at 1065. The parties do not address this in their papers, but the Court assumes that since the individual defendants themselves are named as Section 10(b) violators, the above analysis applies. According to the 1934 Act, joint and several liability can be imposed upon anyone who "controls any person liable under any provision" of the Act. 15 U.S.C. § 78t(a).

[*60] **C. *Judicial Notice***

Defendants request that the Court take judicial notice of the following documents: 1) Adaptive's Form 10-K for the transition period July 1, 2000 to December 31, 2000 filed with the SEC on July 5, 2001 attached to the Request at Exhibit A; 2) Adaptive's Schedule 14A, Proxy Statement filed with the SEC on October 2, 2000 attached as Exhibit B to their Request; 3) Two statements of Changes in Beneficial Ownership ("Form 4s") filed on behalf of Defendant Scharre with the SEC on February 7, 2001 and March 9, 2001, reflecting Defendant Scharre's purchases of Adaptive stock, attached as Exhibit C to the Request. Plaintiffs oppose the Request, arguing that judicial notice of the truth of documents referred to in a complaint is not allowed.

Federal Rule of Evidence 201(b) requires a party requesting judicial notice to show that the fact in question not be subject to reasonable dispute because it is "generally known in the community" or "capable of ready determination by resort to sources whose accuracy cannot reasonably be questioned." Fed. R. Evid. 201(b). In ruling on a motion to dismiss, a district court may consider a document, including an SEC filing, if [*61] the plaintiff relies upon it in her complaint and its authenticity is not questioned. *Parrino*, 146 F.3d at 705-06; *Ronconi*, 253 F.3d at 427; *In re Silicon Graphics*, 970 F. Supp. 746, 751-52 (N.D. Cal. 1997) (noting that the document must be "referenced in plaintiff's complaint" and "'central' to plaintiff's claim"). Importantly, if facts contained in a document are disputed, a court may only consider the document for the limited purpose of recognizing the fact that the document exists. *Lee v. City of LA*, 250 F.3d 668, 688-90 (9th Cir. 2001).

Plaintiffs properly concede that the Form 10-K attached as Exhibit A was referenced in the Complaint. The Court therefore takes judicial notice the fact that the statements therein were made, but does not take judicial notice of their truth. *Lee*, 250 F.3d at 690.

As to Exhibits B and C, Plaintiffs argue they are not subject to judicial notice at all because they are not referenced or relied upon in the Complaint. According to Plaintiffs, judicially noticing these documents would improperly convert the motion to dismiss into a motion for summary judgment. *Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir. 1994). [*62]

Defendants allege that Plaintiffs must have relied on the Proxy Statement in Exhibit B in order to come up with the Defendants' exact stock holdings. As far as the Court can tell, however, Defendants were the first to mention this number in their Motion to Dismiss. *See* Mem. P&A in Supp. of Defs.' Mot. to Dis., 17:15. The Court cannot see any other relevance for it, thus it will not be judicially noticed or incorporated by reference into the Complaint.

As to Exhibit C, Defendant Scharre's Form 4s, Defendants say that as an SEC filing, under *In re Silicon Graphics*, it is indisputable that it can be judicially noticed. Defendants allege, moreover, that Plaintiffs necessarily relied on it in their Complaint when they put forth their theory about Adaptive's motive to inflate the stock price.

The Court disagrees that there is no dispute as to whether the Form 4s can be judicially noticed. If the parties dispute its authenticity or the form is not referenced in a plaintiff's complaint, it will not be noticed. Here, there is no dispute that Defendant Scharre sold stock, and the document was filed publicly. But Plaintiffs never refer to stock sales by any defendant in their Complaint. [*63] Plaintiffs only raised their theory about motive in response to Defendants' Motion to Dismiss, which explicitly referred to a lack of stock sales. Therefore, the Court declines to take judicial notice of the Form 4S.

V. *CONCLUSION*

For the above-mentioned reasons, Defendants' Motion to Dismiss is hereby DENIED. Defendants' Request for Judicial Notice is GRANTED as to Exhibit A, and DENIED as to Exhibits B and C. The parties shall appear for a status conference on Friday, April 12, 2002 at 10:00 a.m. in Courtroom 1, San Francisco Division. The parties shall file one joint statement seven days prior to the status conference.

IT IS SO ORDERED.

Dated: April *2*, 2002

Samuel Conti

UNITED STATES DISTRICT JUDGE

TAB 3

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
AMAKUA DEVELOPMENT LLC, a Nevada Limited Liability Company, Plaintiff,
v.
H. Ty WARNER, an individual; Ty Inc., a Delaware Corporation; Ty Warner Hotels & Resorts LLC, a Delaware Limited Liability Company; and JTL Capital LLC, a Texas Limited Liability Company, Defendants.
No. 05 C 3082.

July 10, 2007.

Daniel L. Rasmussen, Erik M. Andersen, Payne & Fears, LLP, Irvine, CA, Todd H. Flaming, Schopf & Weiss LLP, Chicago, IL, for Plaintiff.
Gregory J. Scandaglia, Eric J. Munoz, James Robert Ahler, Matthew Boyd Steffens, Therese Lynn Tully, Scandaglia & Ryan, Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER DENYING SUMMARY JUDGMENT

MARK FILIP, United States District Judge.
***1** Plaintiff, Amakua Development LLC (also "Amakua" or "Plaintiff"), filed this diversity suit against Defendants, H. Ty Warner (also "Mr. Warner"), Ty Inc. ("Ty Inc."). Ty Warner Hotels & Resorts LLC (also "Warner Hotels," and together with Mr. Warner and Ty Inc., the "Warner Defendants"), and JTL Capital LLC ("JTL") in the District Court for the Central District of California (the "California Court"), (D.E.1.) On May 11, 2005, the California Court transferred the suit to this Court on the grounds that it lacked personal jurisdiction over Mr. Warner and that venue was improper. (D.E. 38 (attached as Exhibit A to D.E. 53) .) This Court subsequently ruled that the suit was properly brought under the district court's diversity jurisdiction and that California law controlled Counts II (which the Court then dismissed) and III (for common law fraud). (*See* D.E. 69 at 7, 16-18, 24.)

The suit involves the sale of a resort hotel and surrounding property located in Los Cabos, Mexico. Plaintiff alleges that, after bringing the Defendants together so that Warner Hotels could purchase the hotel portion of the property from JTL, the Defendants cut Plaintiff out of the deal, in breach of a Confidentiality and Non-Circumvention Agreement (the "Noncircumvention Agreement") Plaintiff had executed with the Warner Defendants, Plaintiff's operative complaint (D.E.64) alleges state law claims against the Warner Defendants for breach of the Noncircumvention Agreement (Count I), fraud (Count III), quantum meruit (Count IV), and intentional interference with contract against JTL (Count V). (*See* D.E. 64.) Plaintiff claims some $30 million in alleged damages.

This Court previously dismissed Count II, for breach of the implied covenant of good faith and fair dealing. (*See* D.E. 69 at 2.) Defendants have filed a counterclaim that is not addressed in this opinion. (*See* D.E. 73.) Before the Court are the parties' cross-motions for summary judgment on Plaintiff's claims (D .E. 100; D.E. 111); the parties' motions to strike evidence submitted in support of summary judgment (D.E. 120; D.E, 129); and the parties' motions to strike each other's expert testimony (D.E. 121; D.E. 136; D.E. 140). For the reasons discussed below, the motions for summary judgment are denied, the motions to exclude expert testimony are granted in part and denied in part, and the motions to strike other evidence are dismissed as moot in light of the summary judgment denial, which is based on evidence either not challenged by either party, or else deemed admissible by the Court despite a party's challenge. (D.E.99, 110, 129, 135, 138.)

FACTS

The Court takes the facts from the parties' respective Rule 56.1 Statements. (*See* D.E. 101; D.E. 112; D.E. 113; D.E. 118.) Where the parties disagree over relevant facts, the Court sets forth the competing versions. In addition, the Court resolves genuine factual ambiguities in the respective non-movant's favor.

***2** Local Rule 56.1 ("L.R.56.1") requires that statements of facts contain allegations of material fact, and the factual allegations must be supported by admissible record evidence. *See*L.R. 56.1; *Make v. Sanford,* 191 F.R.D. 581, 583-85 (N.D.Ill.2000). The Seventh Circuit teaches that a district court has broad discretion to require strict compliance with L.R. 56.1. *See, e.g., Koszola v. Ed. of Ed. of City of Chicago,* 385 F.3d 1104, 1109 (7th Cir.2004); *Curran v. Kwon,* 153 F.3d 481, 486 (7th Cir.1998) (citing *Midwest Imports, Ltd. v. Coval,* 71 F.3d 1311, 1316 (7th Cir.1995) (collecting cases)). Where a party has offered a legal conclusion or a statement of fact without offering proper evidentiary support, the Court will not consider that statement. *See, e.g., Make,* 191 F.R.D. at 583 ("[A] movant's 56.1(a) statement should contain only factual allegations. It is inappropriate to allege legal conclusions."); *id.*("Factual allegations not properly supported by citation to the record are nullities."). Additionally, where a party has improperly denied a statement of fact by failing to provide adequate or proper record support for the denial, the Court deems admitted that statement of fact. *See*L.R. 56.1(a), (b)(3)(B); *see also Make,* 191 F.R.D. at 584.The Court disregards any additional statements of fact contained in a party's response rather than its statement of additional facts. *See Make,* 191 F.R.D. at 584 (stating that the L.R. 56.1(b)(3)(B) statement is the only acceptable means of presenting additional facts to the Court).

The Parties

This case is about a small company that alleges it was cut out of a deal by two larger companies, after the smaller company brought the two larger companies together to do business. The Plaintiff, Amakua Development LLC, is a Nevada limited liability company whose sole member is Michael Scofield, a Nevada resident. Amakua allegedly was formed for the purpose of "consulting, identifying, developing and transacting" in hotel properties. (D.E. 101 ¶¶ 1, 8.) However, neither Scofield nor Amakua has a real estate broker's license (D.E. 112 ¶ 9), and Amakua has never closed any real estate transaction involving a resort or hotel property-either as a broker or as a principal/equity owner (D.E. 112 ¶ 11). Moreover, Amakua has no assets or capital, and it has never received a loan from any lender. (D.E. 112 ¶ 16.)

Defendant Ty Warner, an Illinois resident, is the sole member of Defendant Warner Hotels & Resorts LLC, a Delaware limited liability company. Mr. Warner also heads Ty Inc., a Delaware corporation with its principal place of business in Illinois. (D.E. 112 at 5.) Defendant JTL is a Texas limited liability company whose only members, David Lane and Mark Sullivan, are Texas residents. (D.E. 101 ¶ 5.)

Amakua's Proposed Transaction

Through a variety of introductions, representatives of Amakua met John Hong, Ty Warner's principal adviser for business affairs, and David Lane, JTL's principal. Through these introductions, Amakua had become aware of the Warner Defendants' desire to buy a hotel, and JTL's desire to sell one. Defendant JTL was under contract to purchase a hotel in Mexico called Las Ventanas al Paraiso Hotel and Resort ("Las Ventanas") from a prominent Mexican family (the "Burillo family") for $68 million. (D.E. 101 ¶ 13.) JTL's Lane agreed to talk to Scofield after another potential buyer, Omni Hotels, decided not to pursue the deal and Omni's vice president of development, Scott Johnson, referred Lane to Scofield. (D.E. 101 ¶ 18; D.E. 112 ¶ 30.) In response to discussions with Scofield, Lane sent Scofield an offering memorandum on the property and some information about potential financing

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from Morgan Stanley. (D.E. 112 ¶ 33.) Scofield then "took the Las Ventanas opportunity" to Hong. (D.E. 101 ¶¶ 19-20.)

The Noncircurnvention Agreement

***3** Around September 18, 2003, Greg Blake, one of Amakua's two agents, called Hong to determine if Mr. Warner FN1 was interested in purchasing the hotel portion of Las Ventanas. (D.E. 118 ¶ 35.) Hong expressed interest, and a day or two later Amakua faxed Hong the Noncircumvention Agreement at issue in this case, which Hong signed. The Agreement stated that Amakua would provide confidential information about the hotel property to Warner in exchange for a promise that Warner would not "circumvent" Amakua in any eventual purchase of the hotel. (*See* D.E. 75 ¶ 18; Ex. 1025 ¶ 1.) The noncircumvention provision of the Agreement stated, in its entirety: "Specifically 'Hong' agrees to refrain from circumventing 'Amakua' in any dealings either directly or indirectly."(Ex. 1025 ¶ 10.)

> FN1. Throughout their L.R. 56.1 Statements, the parties disagree about whether Hong was working on behalf of Mr. Warner, in his individual capacity, or Warner Hotels & Resorts, LLC. (*See e.g.,* D.E. 113 ¶ 31.) Hong signed the Noncircurnvention Agreement as "Principal Advisor/Business Affairs" without stating whether he was signing on behalf of Mr, Warner or Warner Hotels. Hong stated in response to Plaintiff's interrogatories that he was acting on behalf of Warner Hotels, *see* D.E. 113 at 12 (citing Pl .'s Ex. 345 at 191), but Plaintiff has variously asserted that Hong purported to be working on behalf of Mr. Warner individually, *see, e.g.,* D.E. 118124.

Defendants argue that Hong signed the agreement because Amakua told Hong it represented the seller and that it "controlled the deal." (D.E. 112 ¶ 36.) Amakua disputes this statement as untrue. (D.E. 118 ¶ 36.) Defendants state that the parties never discussed or negotiated the Noncircurnvention Agreement or any of its provisions, and that it does not contain a compensation provision. (D.E. 112 ¶¶ 38, 39.) Defendants' chief argument against enforcement of the Noncircurnvention Agreement, however, is that it constitutes brokerage activity, which was illegal on Amakua's part because neither Amakua nor Scofield is a licensed real estate broker. (D.E. 112 ¶ 9.) Defendants also assert that a "principal," as opposed to a "broker," does not rely on noncircumvention agreements "because [a principal, unlike a broker, has] no fee or commission to protect."(D.E. 112 ¶ 13 (citing Ex. 365, Morone Expert Report at 5).) Amakua disputes this as well, stating that "[p]articipants in the acquisition of real estate are well aware that they could be circumvented by the capital-heavy entity in a transaction. Thus, it is common to require a non-circumvention promise to prevent being 'cut out of the deal.' " (D.E. 118 ¶ 13 (citing Ex. 1061, Robinson Decl., at 2, 6-7).) This assertion comes from Plaintiff's putative damages expert, Maurice Robinson. As discussed below, this opinion of Mr. Robinson's is stricken from the record because it is beyond the scope of Mr. Robinson's expertise. However, because the Court has denied the parties' cross-motions for summary judgment-based on much more than just this purported dispute of fact-this admission is not outcome determinative. The Court includes this dispute only to demonstrate how thoroughly the parties dispute the material facts of the case.

After Hong signed the Noncircumvention Agreement, Amakua provided him with the identities of JTL and David Lane, with details of a Revised Management Contract that JTL was negotiating with Rosewood Hotel Company, with two pages of historical and projected financial information about Las Ventanas, and with David Lane's private cell phone number. (D.E. 101 ¶¶ 33, 35, 37, 38.) Beyond these facts, much is disputed about the details surrounding the execution of the Noncircumvention

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Agreement, including whether Amakua described to Hong the nature of JTL's contract with the Burillo family or JTL's earlier failed negotiations with Omni Hotels, and whether Amakua itself created any of the financial information it provided to Hong or simply forwarded financial information it had received from JTL. (*See id.* ¶¶ 34, 36; D.E. 113 ¶¶ 34, 36; D.E. 112 ¶ 40; D.E. 118 ¶ 40.)

The Facilitation Agreement

***4** On September 23, 2003, Scofield drafted and sent to Lane a two-page Facilitation Agreement, which attempted to memorialize a deal with JTL regarding the sale of Las Ventanas in a "dual escrow" transaction for $70.25 million. (D.E. 112 ¶ 45.) The Agreement states: "Broker [Amakua] shall earn its commission, which shall be defined as the difference between the Gross Sales Price and the Client's Purchase Price. ('Client Price') This amount will include any and all cash as well as any and all real estate not included in client's asset list."(Ex. 1023 at A0144.) Further, the Agreement states:

> It is understood and agreed that Buyer [JTL] is willing to complete the transaction with what is commonly referred to as a dual escrow whereby, Buyer will be a party to two separate escrows, one for the purchase of the Property from the current owners, and one for the sale of the Property to the Client. Buyer will act as facilitator for these transactions and will have no rights to negotiate or accept any other price from Client unless receiving prior approval from Broker.

(*See id.* at A0144-A0145.)The parties disagree about whether the Facilitation Agreement established that Amakua was to be a "broker" or a "principal" in the deal, and whether the Facilitation Agreement contemplated a "flip" of the property or some other arrangement. The parties also disagree about the meaning of the terms "broker," "principal," and "flip." (D.E. 118 ¶ 46; D.E. 112 ¶ 51 (citing Ex. I, Wallace Dep. at 190:1-191:9 (stating that agreements entitling a broker to a commission in the amount the sales price exceeds the list price is known as a "net listing agreement," not a flip)); Ex. 1023 at A0143; D.E. 112 ¶ 14; D.E. 118 ¶ 14; D.E. 118 ¶ 51 (citing Robinson Dep, 333:5-334:5 ("In most of the flips that I've heard of, the flipper really doesn't put in any significant amount of equity."')).) The deal expressed in the Facilitation Agreement is the only deal that Amakua tried to negotiate in writing with JTL. (D.E. 112 ¶ 50.) On September 24, 2003, Lane rejected the Facilitation Agreement, without knowing who Amakua's client was. (D.E. 112 ¶¶ 52, 53.)

Interactions Between the Warner Defendants and JTL

After Lane rejected the Facilitation Agreement, he stopped returning Scofield's phone calls. (D.E. 112 ¶¶ 58, 59, 61.) Meanwhile, Hong requested that Amakua set up a meeting with Lane. (D.E. 112 ¶ 60.) Because Scofield could not get Lane on the phone, Hong ultimately called Lane himself, at the cell phone number Scofield had given him. Hong arranged a meeting between Lane and Warner that took place at Las Ventanas on October 1, 2003. (D.E. 101 ¶ 39.) Following this meeting, Hong informed Scofield that the Warner Defendants were no longer interested in Las Ventanas. However, negotiations between JTL and the Warner Defendants continued, in fits and starts, throughout the rest of the year and into 2004. After many stalls in the negotiation process, Warner Hotels purchased Us Ventanas, after JTL had purchased it from the Burillo family in a joint venture with Farallon Capital. The new owners marketed the property to Warner Hotels via Secured Capital in an open auction. Defendants argue that this sale was completely separate from the deal proposed by Amakua; Amakua disagrees. The parties agree that Amakua played no part in the transaction, and received no compensation from it. (D.E. 112 ¶¶ 72, 77, 78, 79, 82, 86, 88; D.E. 101 ¶¶ 46, 47, 48, 49; Pls. Ex. 206; D.E. 101 ¶¶ 51-54, 55, 56.)

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DISCUSSION

***5** The Court addresses the parties' motions to strike expert testimony first, followed by the parties' cross-motions for summary judgment. The Court has considered the parties' remaining motions to strike evidence in support of the summary judgment motions in reaching its conclusions, but does not issue separate rulings on each of those paragraph-by-paragraph disputes. Moreover, these motions/disputes are, for practical purposes, moot, inasmuch as the Court would deny the summary judgment motions based on broader evidentiary disputes. In other words, even if the Court granted the parties' motions to strike this additional evidence, the Court would still deny summary judgment based on the substantial disputes of material fact.

I. Motions to Strike Expert Testimony

A. Standards for Admitting Expert Testimony

Precedent teaches that a district court judge is to act "as a 'gatekeeper' for expert testimony, only admitting such testimony after receiving satisfactory evidence of its reliability." *Dhillon v. Crown Controls Corp.,* 269 F.3d 865, 869 (7th Cir.2001) (citing *Daubert v. Merrell Dow Pharm., Inc.,* 509 U.S. 579, 589, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993)); *see also* *DataQuill Ltd. v. Handspring, Inc.* No. 01 C 4635, 2003 WL 737785, at *1 (N.D.Ill. Feb.28, 2003). Admissibility of expert testimony is governed by Fed.R.Evid. 702, which provides:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

Daubert held that Rule 702 requires the trial judge to ensure " 'that any and all scientific testimony or evidence admitted is not only relevant, but reliable.' " *Smith v. Ford Motor Co.,* 215 F.3d 713, 718 (7th Cir.2000) (quoting *Daubert,* 509 U.S. at 589).

To gauge reliability, the court must determine whether the expert is qualified in the relevant field, and whether the expert's reasoning or methodology is valid. *See* *Richman v. Sheahan,* 415 F.Supp.2d 929, 934 (N.D.Ill.2006) (citing *Daubert,* 509 U.S. at 592-93, and *United States v. Parra,* 402 F.3d 752, 758 (7th Cir.2005)). All purported expert opinions are governed by the *Daubert* standard, whether the opinion relates to "areas of traditional scientific competence or whether it is founded on engineering principles or other technical or specialized expertise." *Smith,* 215 F.3d at 719 (citing *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137, 141, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999)). An expert may be qualified by "knowledge, skill, experience, training, or education."Fed.R.Evid. 702. " '[E]xtensive academic and practical expertise' in an area is certainly sufficient to qualify a potential witness as an expert," *Smith,* 215 F.3d at 718 (quoting *Bryant v. City of Chicago,* 200 F.3d 1092, 1098 (7th Cir.2000)), and Rule 702 specifically contemplates the admission of testimony by expert witnesses who are qualified based on experience alone. *See, e.g.,* *Kumho Tire,* 526 U.S. at 156; *Walker v. Soo Line R. Co.,* 208 F.3d 581, 591 (7th Cir.2000). Thus, a court should consider a proposed expert's full range of practical experience as well as academic or technical training when determining whether the expert is qualified to render an opinion in a given area. *See, e.g.,* *Smith,* 215 F.3d at 718.Furthermore, an expert's "competence in the general field ... [at issue] must extend to his specific testimony on the matter" before the Court. *Ty, Inc. v. Publications Int'l, Ltd.,* No, 99 C 5565, 2004 WL 2359250, at *5 (N.D.Ill. Oct.19, 2004) (Zagel, J.); *accord, e.g.,* *Carroll v. Otis Elevator*

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Co., 896 F.2d 210, 212 (7th Cir.1990) (citing *Gladhill v. Gen'l Motors Corp.,* 743 F.2d 1049, 1052 (4th Cir.1984)). As the Seventh Circuit has explained, even "[a] supremely qualified expert cannot waltz into the courtroom and render opinions unless those opinions are" well-founded and comport with the requirements of, *inter alia, Daubert, Clark v. Takata Corp.,* 192 F.3d 750, 759 n. 5 (7th Cir.1999); *accord Smith,* 215 F.3d at 718 (citing *Takata Corp., supra*).

***6** The Seventh Circuit has emphasized, however, that "the court's gatekeeping function focuses on an examination of the expert's methodology. The soundness of the factual underpinnings of the expert's analysis and the correctness of the expert's conclusions based on that analysis are factual matters to be determined by the trier of fact, or, where appropriate, on summary judgment," *Smith,* 215 F.3d at 718 (citing *Daubert,* 509 U.S. at 595, and *Walker,* 208 F.3d at 587);*see also Smith,* 215 F.3d at 719 ("It is not the trial court's role to decide whether an expert's opinion is correct. The trial court is limited to determining whether expert testimony is pertinent to an issue in the case and whether the methodology underlying that testimony is sound.") (citation omitted).*Daubert* listed several factors that may illuminate the analysis of an expert's methodology, but it emphasized that they were merely guides, that they were not meant to serve as a series of prerequisites, and that their applicability depended on the particular facts of each case.[FN2] *See Daubert,* 509 U.S. at 594-95; *United States v. Cruz-Velasco,* 224 F.3d 654, 660 (7th Cir.2000) (collecting cases).

FN2. The factors listed in *Daubert* include: (1) whether the theory or technique can be and has been verified by the scientific method through testing; (2) whether the theory or technique has been subject to peer review and publication; (3) the known or potential rate of error of the technique; and (4) whether the theory or technique has been generally accepted by the relevant scientific community. *See id.,* 509 U.S. at 590-91.

Finally, a district court must determine whether the proposed expert testimony is relevant, *i.e.,* whether it would assist the trier of fact in understanding the evidence or determining a fact in issue. *See*Fed.R.Evid. 702. Expert testimony does not assist the trier of fact when the jury is able to evaluate the same evidence and is capable of drawing its own conclusions without the introduction of a proffered expert's testimony. *See Taylor v. Illinois Cent. R.R. Co.,* 8 F.3d 584, 586 (7th Cir.1993) (citation omitted); *accord, e.g., Hoffman v. Caterpillar, Inc.,* 368 F.3d 709, 714 (7th Cir.2004) (affirming the district court's exclusion of a purported expert's opinion based upon a videotape because "the videotape could be played for the jury and entered into evidence, and consequently, jurors could make a determination for themselves.... Based upon this independent assessment .... the jury could then draw [its own] inferences .... and expert testimony would be of no help.").

Where an expert's hypothetical explanation of the possible or probable causes of an event would aid the jury in its deliberations, that testimony satisfies *Daubert'* s relevancy requirement, *See Smith,* 215 F.3d at 718-19 (citing *Walker,* 208 F.3d at 589-90). However, these hypothetical alternatives must themselves have "analytically sound bases" so that they are more than mere "speculation" by the expert. *Smith,* 215 F.3d at 719 (quoting *DePaepe v. General Motors Corp.,* 141 F.3d 715, 720 (7th Cir.1998)).

The party offering the expert's testimony must establish by a preponderance of the evidence that the expert testimony is admissible and that the expert is qualified. *See Daubert,* 509 U .S. at 593;*see also Allison v. McGhan Med. Corp.,* 184 F.3d 1300, 1312 (11th Cir.1999) ("[T]he proponent of the testimony does not have the burden of proving that it is scientifically correct, but that by a preponderance of the evidence, it is reliable.") (citation omitted). However, the question of whether an expert is

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"credible or whether his or her theories are correct given the circumstances of a particular case is a factual one that is left for the jury to determine after opposing counsel has been provided the opportunity to cross-examine the expert regarding his conclusions and the facts on which they are based." *Smith,* 215 F.3d at 719.In this regard, "[v]igorous cross examination, presentation of contrary evidence and careful jury instructions ... are the traditional and appropriate means of attacking shaky but admissible evidence." *Richman,* 415 F.Supp.2d at 933 (citing, *inter alia, Daubert,* 509 U.S. at 596).

B. Clark E. Wallace

***7** Plaintiff moves to strike the expert report and opinions of Clark E, Wallace. (D.E.121.) Plaintiff argues primarily that his opinions embody legal conclusions and are therefore irrelevant to the fact-finder's analysis of factual issues, but Plaintiff also argues that Mr. Wallace's report is unreliable because it is based on the *ipse dixit* of the expert instead of sound methodology. (*See* D.E. 121 at 6.) Defendants respond that Mr. Wallace's report addresses applicable professional standards and a party's performance in light of those standards, and therefore is admissible. (*See* D.E. 134 at 4.) Defendants retained Mr. Wallace to address two issues: (1) whether Amakua and its agents acted as a "broker" in the proposed deal with the Warner Defendants and JTL, and (2) whether Amakua was a putative "principal" in the deal. These questions are relevant because, as both sides acknowledge, if Amakua was acting as a broker when it brought Warner and JTL together, then the Noncircumvention Agreement is likely unenforceable due to illegality because Amakua did not have a real estate license. For the reasons discussed below, the Court grants in limited part and denies in large part Plaintiffs motion to strike Mr. Wallace's report and opinions.

1. Qualifications

The first question is whether Mr. Wallace is qualified to be an expert in this case. Mr. Wallace previously served as the Commissioner of Real Estate for the State of California (1991-94), in which position he oversaw the regulation of 375,000 real estate licensees, both brokers and salespersons. (*See* D.E. 134-2 at 6.) In that capacity, it was part of his job responsibility to interpret and apply real estate custom, practice, standards of care, and regulations to the conduct of individuals and companies involved in real estate transactions.(*Id.*) He also has worked as a real estate developer since 1969, and has been a licensed real estate broker since 1958. (*Id.*) He presently does business by providing consulting services regarding real estate acquisitions, regulation, brokerage standard of care, and matters related to the California Department of Real Estate. (*Id.*) He states in his report that he has been qualified as an expert witness in numerous cases. (*See id.*)His experience is primarily in commercial real estate development. (*See* D.E. 134-10 at 8 (Ex. C, Wallace Dep. at 92:13).) He has purchased commercial real estate as a principal "hundreds" of times. (*Id.*) Moreover, Mr. Wallace has "brokered" several commercial real estate transactions. (*See* D.E. 134-10 at 8 (Ex. C, Wallace Dep. at 91:15).) Mr. Wallace has testified before Congress; before various state legislative committees or regulatory bodies; and before various city councils, boards of supervisors, planning commissions, etc. (on hundreds of occasions) in connection with real estate matters. (D.E. 134-4 at 6.) The Court finds that Mr, Wallace's experience qualifies him to testify in this case, because his experience as a commercial real estate developer and as a residential real estate broker allows him to speak to the differences between brokers and principals in the context of real estate transactions, which is relevant to determining whether Amakua was illegally acting as a broker when it entered the Noncircumvention Agreement with the Warner Defendants.

2. Methodology

***8** Next, the Court must determine whether Mr.

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Wallace's methodology is valid. Mr. Wallace's report includes four opinions:

1. Amakua, Scofield, and Amakua's agents did not perform activities as principals in these matters.

2. Amakua, Scofield, and Amakua's agents performed activities that render them brokers under California real estate industry, custom, and practice, and the California Business and Professions Code ("California B & P Code").

3. Amakua, Scofield, and Amakua's agents' activities do not satisfy industry custom and practice or the California B & P Code because: (a) Amakua and Scofield are not licensed in California; (b) Amakua, Scofield, and Amakua's agents failed to carry out duties of disclosure and fair dealing owed to the Warner Defendants; and (c) Amakua, Scofield, and Amakua's agents improperly acted as dual agents.

4. The California B & P Code provides that individuals and companies cannot be compensated where they fail to satisfy licensing requirements.

(*See* D.E. 134-2 at 5 (Wallace Report Executive Summary).) To reach these opinions, Mr. Wallace read the deposition transcripts of Amakua's agents, Doug Owen and Greg Blake, and Amakua's principal, Michael Scofield; he conducted an online license check of Amakua, Scofield, Owen, and Blake through the California Department of Real Estate; he discussed the issues with John Liberator, chief deputy of the Department of Real Estate; and he read various materials from the case that were forwarded to him by defense counsel. (*See* D.E. 134-10 at 3-6.) Mr. Wallace's report states that, "[b]ased upon my extensive knowledge and practice in the real estate industry, 1 analyzed the activities and conduct of Amakua, Scofield, and Amakua's agents in this case against the real estate industry standard of care in the State of California, including custom and practice, relevant laws and regulations, common law, and industry codes of ethics."(*See* D.E. 134-2 at 7.) He compared the standard of care for real estate licensees in California with the activities of Amakua. (*See id.*)

Plaintiff argues that Mr. Wallace used *no* methods to reach his conclusions-that his opinions "stem[ ] from the expert's simple *ipse dixit"*-because Mr. Wallace supposedly was unable, in his deposition, to say whether a broker's license would be required in certain other hypothetical situations posed by Plaintiffs counsel. (D.E. 121 at 15-16.) The Court respectfully disagrees. Mr. Wallace's deposition reveals that he did not want to give off-the-cuff answers to counsel's questions, not that he could not answer them or that he was incompetent to speak to issues within his decades of experience. (*See, e.g.,* D.E. 134-12 at 4 (Wallace Dep. at 134:21-136:9); D.E. 134-12 at 8-134-13 at 2 (Wallace Dep. at 153:11-154:19).) This does not meaningfully speak to his methods.[FN3]

FN3. At trial, Plaintiff potentially may try to use this testimony to show a lack of broader competence and concomitant lack of credibility. In turn, Defendants will undoubtedly argue that the testimony reflects that Mr. Wallace is a careful and deliberative person who does not shoot from the hip and therefore is more credible. These sorts of credibility assessments are left to the jury, however, under *Daubert.*

Plaintiff does not otherwise challenge Mr. Wallace's methods on any of the traditional grounds for calling an expert's reliability into question. *See supra,* n. 2 (discussing *Daubert'* s four nonexhaustive factors for determining whether an expert's methods are valid). The Court independently finds that Mr. Wallace's report would survive such a challenge to his methods. Because his testimony, like that of the other three experts offered in this case, is not scientific but is based instead on his personal experience in the real estate industry, there is no reason (and perhaps no way) to verify his technique through "scientific testing ." In addition, although Mr. Wallace may not have subjected his

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"theory" or "technique" to peer review and publication (it is not clear from his credentials whether he publishes in his field), this would not appear to be relevant, particularly if he is simply applying standard techniques from his field that do not warrant publication. *See* *Smith,* 215 F.3d at 720 ("[I]f Muszar was merely applying well-established engineering techniques to the particular materials at issue in this case, then his failure to submit those techniques to peer review establishes nothing about their reliability. Similarly, if Cassassa's accident reconstruction methodology is based on his extensive practical experience in this area, rather than novel methodology subject to publication, his failure to publish does not cast doubt on the reliability of his analytical technique."). Furthermore, Mr. Wallace has qualified repeatedly as an expert witness and has testified before city councils, boards of supervisors, and planning commissions "probably in excess of 500 times over 30-plus years."(*See* D.E. 134-4 at 6.) He was also involved in developing California's real estate licensee standard of care, and is a periodic participant on California Bar Association panels and in U.C. Berkeley-Boalt Law School real estate law classes. (*See id.*)These credentials suggest (particularly in light of the fact that they have not been challenged) that Mr. Wallace's methodologies are generally accepted in the real estate field, and that he has extensive practical experience performing those techniques. *See* *Daubert,* 509 U.S. at 590-91.The Court concludes that Mr. Wallace's methods are sufficiently reliable for him to testify as an expert.

3. Relevance-Legal Conclusions Are Irrelevant

***9** Plaintiffs primary objection to Mr. Wallace's opinions attacks their relevance. Plaintiff argues that Mr. Wallace's opinions consist largely of legal conclusions and therefore are irrelevant insofar as they will not help the trier of fact determine *factual* issues in the case. This objection is overstated, but it is important to delimit the boundaries by which Mr. Wallace will be allowed to testify.

To be sure, "[i]t is black-letter law that 'it is not for witnesses to instruct the jury as to applicable principles of law, but for the judge.' " *Nieves-Villanueva v. Sato-Rivera,* 133 F.3d 92, 99 (1st Cir.1997) (quoting *United States v.* *Newman,* 49 F.,3d 1, 7 (1st Cir.1995) (internal punctuation omitted)); *see also* *Naeem v. McKesson Drug Co.,* 444 F.3d 593, 610 (7th Cir.2006) ("[W]e previously have stated that allowing a witness to testify as to a legal conclusion may cause the jury to accord too much weight to that testimony, and may infer that the jury should look to that witness for legal guidance.") (citations omitted). "The analysis here begins with the proposition that under our system it is the responsibility-and the duty-of the court to state to the jury the meaning and applicability of the appropriate law, leaving to the jury the task of determining the facts which may or may not bring the challenged conduct within the scope of the court's instruction as to the law," *Adalman v. Baker, Watts & Co.,* 807 F.2d 359, 366 (4th Cir.1986), disapproved on other grounds, *Pinter v. Dahl,* 486 U.S. 622, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988); *see also Highland Capital Mgmt., L.P. v. Schneider,* 379 F, Supp.2d 461, 470 (S.D.N.Y.2005) (citing *Adalman* for the rule that expert's cannot testify regarding legal conclusions). Because the jury does not decide pure questions of law, expert testimony on the law is not helpful to the jury and so does not fall within the terms of Fed.R.Evid. 702, which allows expert testimony " '[i]f scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue.' " *Nieves-Villanueva,* 133 F.3d at 100 (quoting Rule 702). This is because the judge's expert knowledge of the law makes any such assistance at best cumulative, and, at worst, prejudicial. *See* *id.,* 133 F.3d at 100 (collecting authorities). "It is not the common knowledge of the jury which renders the witness' opinion unnecessary, but the special legal knowledge of the judge." *Id.,* 133 F.3d at 100 (citation and internal quotation marks omitted).

Fed.R.Evid. 704(a), which removes the common-

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law bar on "otherwise admissible" testimony that "embraces an ultimate issue to be decided by the trier of fact," is not to the contrary, Rule 704(a) allows the expert to offer *factual* conclusions to aid the jury-which can choose to accept or reject them-but Rule 704"should not, and does not, permit the expert witness to usurp the province of the judge." *Adalman,* 807 F.2d at 368,*Legal* conclusions are for the judge; they are not "to be decided by the trier of fact," and therefore do not fall under Rule 704. *See* *Nieves-Villanueva,* 133 F.3d at 100.

***10** Case law instructs, however, that there is a fine line between legal conclusions and factual conclusions:

> The line we draw here is narrow. We do not exclude all testimony regarding legal issues. We recognize that a witness may refer to the law in expressing an opinion without that reference rendering the testimony inadmissible. Indeed, a witness may properly be called upon to aid the jury in understanding the facts in evidence even though reference to those facts is couched in legal terms. For example, we have previously held that a court may permit an expert to testify that a certain weapon had to be registered with the Bureau of Alcohol, Tobacco, and Firearms, *United States v. Buchanan,* 787 F.2d 477, 483 (10th Cir.1986). In that case, however, the witness did not invade the court's authority by discoursing broadly over the entire range of the applicable law. Rather, the expert's opinion focused on a specific question of fact.

Specht v. Jensen, 853 F,2d 805, 809 (10th Cir.1988) (further citations omitted).

> These cases demonstrate that an expert's testimony is proper under Rule 702 if the expert does not attempt to define the legal parameters within which the jury must exercise its fact-finding function. However, when the purpose of testimony is to direct the jury's understanding of the legal standards upon which their verdict must be based, the testimony cannot be allowed. In no instance can a witness be permitted to define the law of the case.

Id. at 809-10.

Often, the same information can be elicited as a fact where it would be inadmissible in the guise of a legal conclusion. For instance, where a court excluded an expert's testimony that the plaintiff had been "discriminated against because of her national origin," the court "emphasize[d] that a more carefully phrased question could have elicited similar information and avoided the problem of testimony containing a legal conclusion. The defendants could have asked Dr. Quiroga whether she believed Torres' national origin 'motivated' the hiring decision." *Torres v. County of Oakland,* 758 F.2d 147, 151 (6th Cir.1985); *see also* *Marx & Co. v. The Diner's Club, Inc.,* 550 F.2d 505, 512 (2d Cir.1977) ("The expert, for example, may tell the jury whether he thinks the method of [securities] trading was normal, but not, in our view, whether it amounted to illegal manipulation under Section 9 of the Securities Exchange Act of 1934."). In *Marx,* the court excluded testimony of a securities law expert that related to the construction of a contract between the parties and the validity of certain defenses advanced by Diner's justifying its performance under the contract. *See* *id.,* 550 F.2d at 508-09.The court stated: "Testimony concerning the ordinary practices of those engaged in the securities business is admissible under the same theory as testimony concerning the ordinary practices of physicians or concerning other trade customs: to enable the jury to evaluate the conduct of the parties against the standards of ordinary practice in the industry."*Id.* (citations omitted)."In the case at bar, however, witness Friedman's objectionable testimony did not concern only the customary practices of a trade or business. Rather, he gave his opinion as to the legal standards which he believed to be derived from the contract and which should have governed Diners' conduct. He testified not so much as to common practice as to what was necessary 'to fulfill the covenant' [of the contract]."*Id*

***11** The advisory committee's note to Rule 704 of-

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fers similar advice:

> Under Rules 701 and 702, opinions must be helpful to the trier of fact, and Rule 403 provides for exclusion of evidence which wastes time. These provisions afford ample assurances against the admission of opinions which would merely tell the jury what result to reach, somewhat in the manner of the oath-helpers of an earlier day. They also stand ready to exclude opinions phrased in terms of inadequately explored legal criteria. Thus the question, "Did T have capacity to make a will?" would be excluded, while the question, "Did T have sufficient mental capacity to know the nature and extent of his property and the natural objects of his bounty and to formulate a rational scheme of distribution?" would be allowed.

Fed.R.Evid. 704 advisory committee's note; *see also Burkhart v. Washington Metropolitan Area Transit Authority,* 112 F.3d 1207, 1212 (D.C.Cir.1997) (quoting same); *Hygh v. Jacobs,* 961 F,2d 359, 363-64 (2d Cir.1992) (quoting same)."In other words, an expert may offer his opinion as to facts that, if found, would support a conclusion that the legal standard at issue was satisfied, but he may not testify as to whether the legal standard has been satisfied." *Burkhart,* 112 F.3d at 1212-13.

"There is no doubt that under Rules 702 and 704 an expert may testify about applicable professional standards and the defendants' performance in light of those standards." *Richman,* 415 F.Supp.2d at 945;*see id.* at 946 & n. 16 (collecting cases)."Cases like the instant one, at first blush, seem difficult, because the relevant professional standards are drawn in part from the applicable law and the terms in which they are expressed."*Id.*

> Where the testimony contains terms that have a separate, distinct, and specialized meaning in the law different from that present in the vernacular, the testimony may be deemed to constitute a legal conclusion and exclusion would not be inappropriate. However, where, as here, the word also has an everyday meaning, the testimony should not be excluded as constituting a legal conclusion.... Even if the everyday understanding of a term and its legal meaning are congruent, exclusion is inappropriate where the opinion will not consist of a naked conclusion (i.e., the defendant's conduct was reasonable, was negligent, etc.) but will be based on "adequately explored legal criteria." That is, they will explain the reasons underlying the ultimate conclusion. Moreover, the court will instruct the jury on the appropriate meaning of the legal standard and that the jury is free to reject the testimony of the expert. Consequently, the risk of jury confusion is not present.

Id. at 947-48.

In this case, the Court finds that some of Mr. Wallace's opinions-as written in his expert report-appear to be legal conclusions, or conclusions of mixed law and fact. These are likely problematic.FN4 He states, for example, that particular provisions of California law state that a real estate brokerage license is required in certain defined situations, quoting directly from California Business and Professions Code Section 10130 as the basis for his conclusion. (D.E. 134-2, Ex. A at 5.) Mr. Wallace also appears to elucidate applicable legal principles by which agency is established. (*See* D.E. 134-3, Ex. A at 6 ("Ostensible or implied agency can be created from the actions and conduct of the parties/licensees.").) Mr. Wallace also states that the receipt of secret profits by a real estate broker violates Section 10176(g) of the California Business and Professions Code. (*Id.,* Ex. A at 12.) These conclusions or assertions are legal ones and therefore would be inadmissible if elicited as such by defense counsel. They are like responses to the question, "Does T have the capacity to enter a will?"*See Marx,* 550 F.2d at 508-09;Fed.R.Evid. 704 advisory committee's note. They are issues that should be addressed by jury instructions from the Court, not by an expert's testimony.

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FN4.*Daubert* motions can be helpful in broad terms to exclude patently unqualified experts, or to exclude purveyors of "junk science" who offer no credible methodology for their purportedly "expert" views. That is not the situation here, as explained above. Instead, the *Daubert* challenge to Mr. Wallace here, to the extent it has potential traction, relates to issues that need to be assessed on a question-by-question basis, with the appropriate answer turning on the precise language of the question posed and the context in which it is asked at trial. As a result, the Court cannot sensibly attempt to turn Plaintiff's *Daubert* motion into an omnibus motion in limine concerning Mr. Wallace's fourteen-page, single-spaced report. Therefore, the Court articulates only the broad principles by which Mr. Wallace's testimony will be excluded or admitted at trial.

***12** However, Mr. Wallace also offers factual conclusions that are based on legitimate foundations (if credited by the jury) and that are the product of reliable methods. The fact that those factual conclusions are structured so as to conform to applicable underlying principles of California law is not exceptional; if the factual assertions were unmoored from the underlying legal framework, they would be potentially irrelevant and/or misleading. For example, Mr. Wallace addresses the standards that govern real estate brokers in California, and what kinds of activities make someone a "broker." His opinions are based on years of experience in the real estate industry. In assessing whether Amakua and its agents were acting like real estate brokers when they entered the Noncircumvention Agreement (as well as whether Defendants were entering a "brokerage agreement"), these factual conclusions may be helpful to the trier of fact, Although Mr. Wallace may not testify to the ultimate legal conclusion that Amakua and its agents *were* illegal brokers when they entered the Noncircumvention Agreement, he may testify as to what activities, in his experience, constitute brokering, as opposed to acting as a principal, and whether Amakua's activities were more like that of a broker than of a principal. The latter is more like the answer to the fact question, "Did T have sufficient mental capacity to know the nature and extent of his property and the natural objects of his bounty and to formulate a rational scheme of distribution?" than the legal question, "Did T have capacity to make a will?"*See*Fed.R.Evid. 704 advisory committee's note. This sort of testimony is admissible.

C. Thomas F. Morone

Plaintiff also moves to strike the expert report and opinions of Thomas F. Morone. Much of the analysis with respect to the admissibility of Mr. Wallace's expert testimony also applies to Mr. Morone. As with Mr. Wallace, Defendants retained Mr. Morone to render an opinion on whether Amakua was acting as a broker or a principal in the proposed transaction with the Warner Defendants and JTL. As with Mr. Wallace, Plaintiff moves to strike two of Mr. Morone's opinions on the basis that they offer legal conclusions. (*See* D.E. 121 at 16-18.) Plaintiff moves to strike Mr. Morone's remaining three opinions because they are "unreliable and/or irrelevant." (*See id.* at 18.)The Court respectfully grants in part and denies in part Plaintiff's motion to strike Mr. Morone's expert testimony.

1. Qualifications

Like Mr. Wallace, Mr. Morone is qualified as an expert in this case based on his experience in the real estate business. Mr. Morone is a principal in Warnick & Company, a consulting and investment banking firm that specializes in the recreational real estate and hospitality facility business. (*See* D.E. 134-6 at 5.) He has 35 years of experience in the hotel industry and a bachelor of science degree in hotel administration. (*See id.*)He has represented many types of buyers and sellers as a consultant and as a broker, including large institutions and real

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estate investment trusts. (*See id.* at 6.) In addition, he has experience in hospitality management and operations, as well as corporate real estate development. (*See id.*)He has testified as an expert witness (including in arbitrations) roughly half a dozen times. (*See* D.E. 134-16 at 5 (Ex. D, Morone Dep. at 12:20-12:23).) Mr. Morone has worked primarily in California (*see* D.E. 134-7 at 2-7), and his experience is sufficient to qualify him to testify about the transaction Amakua proposed to the Warner Defendants and JTL, and the nature of Amakua's role in that transaction.

2. Methodology

***13** Mr. Morone's report includes five opinions:

> 1. Based upon my experience in the hospitality real estate industry, the proposed Confidential Non-Disclosure and Non-Circumvention Agreement is missing essential terms.
>
> 2. The sale transaction through which Ty purchased Las Ventanas was a completely separate real estate transaction from the sale Amakua had proposed.
>
> 3. Amakua was acting as a real estate broker in connection with the Las Ventanas transaction.
>
> 4. The information that Amakua represented as Confidential was already in the public domain and in the possession of Ty before Amakua delivered it to Ty.
>
> 5. Amakua lacked the experience and wherewithal to consummate the transaction to acquire the Hotel.

(*See* D.E. 134-6 at 5.) Mr. Morone states in his report that he arrived at these opinions by "us[ing] my background, training and experience in the hospitality real estate industry to analyze the relationship between ... [Amakua] and ... [Warner] and ... [JTL] as described in the Facilitation Agreement and the Confidential Non-Disclosure and Non-Circumvention Agreement ... relative to the ultimate sale of the" Las Ventanas property.(*Id* .) As discussed above with respect to expert Mr. Wallace, Mr. Morone's methods are also valid. He has based his opinions on his specialized experience in a field relevant to the issues of this case, as applied to the facts of this case. This satisfies the "reliable principles and methods" requirement of Rule 702. *See Kumho Tire,* 526 U.S. at 126; *Walker,* 208 F.3d at 591.

3. Relevance

As with Mr. Wallace, Plaintiff challenges the relevance of two of Mr. Morone's opinions to the extent they offer legal conclusions (opinions 1 and 3 above). And, as with Mr. Wallace, the analysis of the admissibility of expert legal opinions applies equally to Mr. Morone. For example, he will not be allowed to testify that the Confidential Non-Disclosure and Non-Circumvention Agreement is unenforceable at law because it lacks essential terms; however, he can explain that, based on his experience, he believes that the Agreement fails to address certain issues and further explain why-again, based on his experience-those issues can be significant ones in the real estate transaction context. A jury cannot credibly be expected to intuit what other issues might be germane to transaction-participants in the commercial real estate context, nor to guess at how common such contractual terms are in the industry. Such opinion testimony is relevant to the issues in this case, because if the jury finds that the Agreement lacks common, significant terms, then the jury itself can conclude whether or not the agreement is unenforceable.

With respect to Mr. Morone's three remaining opinions (that the ultimate sale of Las Ventanas was "completely separate" from the transaction Amakua proposed, that the information Amakua represented as confidential was already in the public domain, and that Amakua lacked the experience and wherewithal to consummate the transaction), Plaintiff argues that they are unreliable and/or irrelevant. (D.E.

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121 at 18-19.) Plaintiff argues that Mr. Morone's opinion that the ultimate sale of Las Ventanas to Warner Hotels & Resorts was a separate transaction from the one Amakua proposed "is not an opinion, but a statement of fact" that Mr. Morone is unqualified to make because he does not have personal knowledge as required by Fed.R.Evid. 602. (D.E. 121 at 18.) But, as an expert, Mr. Morone is not required to have personal knowledge of the facts as a transaction participant. He can base his expert opinion on his expertise as applied to the facts (or hypothetical facts) as presented by the party who retained the expert. That is legitimate expert testimony and one of its chief distinctions from "fact" testimony. Moreover, Mr. Morone's long experience in the real estate business qualifies him to testify about whether a transaction like this one qualifies as "separate" from the one proposed by Amakua in that the ultimate transaction had nothing to do with the deal originally proposed by Amakua. Amakua is free, of course, to challenge this opinion on cross-examination.

***14** With respect to Mr. Morone's opinion that the Las Ventanas financial information Amakua provided to the Warner Defendants was already in the public domain, the Court is inclined to agree with Plaintiff that this opinion should be excluded because it does not apply Mr. Morone's expertise to the facts of the case. At least as framed in the briefs, the proposed testimony seems merely to reiterate the facts as Defendants view them. For example, Mr. Morone's report states that "[t]he Las Ventanas financial information actually provided to Ty was not confidential because virtually the same information was already in Ty's files. This is so because in April 2003-before Hong received the 'confidential' information from Amakua in September 2003-Ty had already received a copy of a comprehensive offering memorandum detailing Las Ventanas from Greg Rice, [who] himself received it from JMJ Holdings."(D.E. 134-6 at 13 (Morone Report).) Mr. Morone then states that his opinion that the financial information was not confidential is "[b]ased on my experience in working with similar agreements."(D.E. 134-6 at 14.) But this does not save this opinion, which is essentially just an assertion of fact. The jury does not need Mr, Morone's expertise to understand this bit of evidence. A layperson is quite capable of understanding-based on the testimony of proper fact witnesses or the introduction of other documentary evidence, which Defendants will be allowed to introduce-whether the Warner Defendants already possessed the financial information in question, and therefore whether that information was "confidential" when Amakua provided it to them.

As for Mr, Morone's final opinion, that Amakua did not have the experience or wherewithal to consummate the purchase of the property, the Court finds that Mr. Morone's experience in the industry qualifies him to offer an opinion on this issue. He may testify, based on his experience, about the amount of capital and experience typically required to engage in a deal like the one in question. Again, Plaintiff is free to challenge that opinion on cross-examination.

In summary, Plaintiff's motion to strike Mr. Morone's expert opinions is granted in part and denied in part. Mr. Morone may not offer bare legal conclusions, nor may he testify about whether the financial information Amakua provided was "confidential." But he may offer opinions about what sorts of activities make a person or entity a "broker," whether the sale of Las Ventanas was separate from the transaction proposed by Amakua, and whether Amakua had the experience and capital typically necessary to carry off a deal such as this one.

D. Maurice Robinson

Plaintiff retained Maurice Robinson to appraise the property involved in Amakua's proposed transaction and to render an opinion on the Plaintiff's damages due to Defendants' alleged breach of the Non-circumvention Agreement. (*See* D.E. 136-2 at 2 (Ex. A) (Robinson's report, stating that he was re-

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tained to evaluate what Amakua might have expected to earn if the proposed transaction had occurred near the end of 2003).) Mr. Robinson rendered four opinions in his expert report:

> ***15** 1. The development and subsequent sale of the 15 residential units that were entitled in the "Phase V" land at Las Ventanas could have yielded approximately $19.8 million.
>
> 2. The sale of the three unsold "Phase IV" villas could have yielded approximately $5,8 million.
>
> 3. Amakua's "position as a player" in the transaction was "a legitimate effort to fulfill a common role in such mixed-use resort projects."
>
> 4. The use of a non-circumvention promise, such as the one Amakua used, was a necessary requirement by Amakua to ensure that its interests were not circumvented by the Warner Defendants. These types of promises are used commonly by the hotel and real estate community.

(*See* D.E. 136-2 at 3.)

Defendants have moved to strike Mr. Robinson's report and to exclude him from testifying at trial, on grounds that his opinions are based on unsupported assumptions, that they are beyond the scope of his expertise, and that they are irrelevant and speculative. (*See* D.E. 136 at 4.) The Court agrees in part and disagrees in part.

1. Qualifications

Mr. Robinson has been a market and financial consultant to the hotel and real estate industries for more than 25 years. (D.E. 136-2 at 2.) He has conducted appraisals and market feasibility studies for dozens of hospitality properties, including many high-end resorts with related residential developments. (*See id.*)He is the president of Maurice Robinson & Associates, LLC, which provides advisory services to lenders, investors, public agencies, and developers in the hospitality and real estate industry. (*See id.* at 13.)Mr. Robinson has a master of public administration degree in municipal finance from the University of Southern California, a B.A. in economics from Macalester College, a professional designation in financial planning from the University of California, Los Angeles, and a California Real Estate Appraisal certificate. (*See id.*)As a principal with KPMG Peat Marwick, Mr. Robinson was the primary resource in the western United States for hotel development and financing issues, particularly full-service urban and resort properties. (*See id.* at 12.)KPMG's clients included the Four Seasons, Hilton, Hyatt, Intercontinental, and other hotel chains. (*See id.*)

Mr. Robinson is currently the financial advisor to the U.S. National Park Service on concession-related matters, and he has provided appraisal, feasibility, acquisition analysis, lease negotiation assistance and/or expert witness testimony for 35 national park concessions over the past 14 years, including those at Yosemite, Yellowstone, and the Grand Canyon. (*See id.*)He sits on the board of directors and is chairman of the professional conduct committee of the International Society of Hospitality Consultants; and he holds positions with the Counselors of Real Estate, the American Society of Appraisers, the Southern California Mediation Association, and the Forensic Expert Witness Association. (*See id.* at 13.)Since 2001, he has served as an expert witness in numerous courts, arbitral panels, mediations, and depositions. (*See id.* at 14-16.)He is a frequent lecturer at various real estate and hospitality industry-related seminars, and he has published a variety of articles in his field. (*See* D.E. 136-2 at 13.) Based on his background and experience, the Court finds that Mr. Robinson is qualified to testify as an expert in this case with respect to appraisal of the property in question.

2. Methodology

***16** Defendants argue that Mr. Robinson's opinions regarding Amakua's "project role" in the transaction and regarding the necessity of the Noncircum-

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vention Agreement are beyond the scope of his expertise. (*See* D.E. 136 at 5-6, 7-8.) Defendants also challenge these opinions, as well as Mr. Robinson's valuation opinions, on reliability grounds. (*See* D.E. 136 at 9, 11-15.) The Court agrees with Defendants that Mr. Robinson's “project role” opinion and his opinion regarding the common use of noncircumvention agreements are beyond the scope of his expertise. The project role opinion is based on a handful of anecdotes and examples (some of which are of questionable relevance) collected for the purpose of rendering this opinion. The project role opinion is not based on Mr, Robinson's own experience in the hotel industry, and it is not established in Mr, Robinson's report why the examples he lists suggest in any way that Amakua's proposed role in the transaction was a common one. (*See* D.E. 136-2 at 6.) Likewise, Mr. Robinson's noncircumvention agreement opinion is based on anecdotes he collected from others in the field, not his own experience. In this regard, he acknowledged in his deposition that, prior to talking to the ten people he contacted to “educate myself about non-circumvention agreements” (including Mr. Morone, one of the Defendants' experts), he did not know whether there was an industry standard noncircumvention agreement, and had never negotiated or drafted such an agreement, nor participated in a real estate transaction involving such an agreement. (D.E. 136-4 at 7-8 (Robinson Dep, at 77:10-79:25).) Moreover, noncircumvention agreements are not documents he typically uses in his business, nor does he have any opinion about what terms need to be included in a putative noncircumvention agreement. (*See id.*(Robinson Dep. at 79:6-79:25).) Under these circumstances, the Court concludes that Mr. Robinson's opinions on Amakua's project role and on the common use of noncircumvention agreements by entities such as Amakua are beyond the scope of his expertise. These two opinions are therefore excluded from his testimony. In addition, and independently, his attempt to offer “expert” testimony based on interviews of other people who actually may know something about noncircumvention agreements is not permitted. It is undisputed that these putative “interviewees” have not been tendered or qualified as experts in this case by Plaintiff, and also, it appears that none of the “interviewees” actually reviewed the alleged noncircumvention agreement at issue in this case. (*See* D.E. 136-7 at 10 (Robinson Dep. at 208:20-209:3).) A party cannot elide the prerequisites required to qualify such potential expert testimony-*i.e.,* from the interviewees themselves-through the contrivance of having a person simply call the interviewees and then relate what they have told the interviewer. *See, e.g., Dura Automotive Sys. of Indiana v. CTS Corp.,* 285 F.3d 609, 613-14 (7th Cir.2002).

***17** Mr. Robinson's valuation opinions, however, appear to be within the scope of his expertise, and properly supported by reliable methodology. Defendants argue that Mr. Robinson's valuation opinions are based on the unsupported assumptions that (a) JTL and the Warner Defendants were willing to do business with Amakua and the transaction Amakua was involved in would have ultimately closed; (b) Amakua had the financial ability to develop and build the residential units that would have made up the property to be sold for the amounts projected by Mr. Robinson; (c) Amakua's closing costs would have been the same as Warner Hotels' costs; and (d) Amakua would have been able to sell the Phase IV villas in the first quarter of 2004. (*See* D.E. 136 at 12.) Defendants argue that there is no evidence in the record supporting any of these assumptions. (*See id.*)The Court respectfully disagrees. Mr, Robinson's report makes clear what record evidence he relies on and how he has calculated the valuations of the property in question. (*See, e.g.,* D.E. 136-2 at 3-5 (Robinson's report, explaining how he determined how many homes could be built on the “Phase V” land and how they should be valued, as well as how he valued the existing “Phase IV Villas”).) This methodology is sufficient to support the reliability of Mr. Robinson's testimony. Again, Defendants are free to challenge his conclusions on cross-examination.

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3. Relevance

Defendants challenge Mr. Robinson's reliance on case law as irrelevant to the trier of fact, both because case law is not information that he usually relies on in his field and because his analysis of legal issues is not appropriate expert testimony, inasmuch as legal questions are for the court, not the finder of fact. (*See* D.E. 136 at 7.) The Court agrees that, like Mr. Wallace and Mr. Morone, Mr. Robinson should not be allowed to testify about legal conclusions. Therefore, Defendants' motion to strike this aspect of his expert testimony is granted.[FN5]

> FN5. Defendants also challenge Mr. Robinson's report and opinions because both Mr. Robinson and Plaintiff failed to produce drafts of his report and his notes, in violation of Rule 26. (*See* D.E. 136 at 16.) Plaintiffs counsel asserts that he is engaged in a "meet-and-confer" process with defense counsel to attempt to resolve this aspect of the dispute. (*See* D.E. 150 (affidavit of Pl's, counsel, Daniel Rasmussen); D.E. 151 at 15-16.) Such meet and confer sessions must be exhausted before parties may file discovery motions in this district. *See* Local Rule 37.2. Defendants are free to file a motion to compel in advance of trial, if one is appropriate, and to move to exclude Mr. Robinson at that time if they believe any alleged destruction of evidence has been willful. At a minimum, Plaintiff's counsel certainly should produce the supposed draft copy of the Robinson expert report that they have, and Defendants are free to redepose Mr. Robinson about that draft. *See, e.g., Trigon Ins. Co. v. United States,* 204 F.R.D. 277, 282-83, 290 (E.D.Va.2001) (discussing obligations to tender draft copies of testifying experts' reports, and discussing significance of such drafts in search for truth). In this regard, the Court notes that the parties appear to dispute whether the duty to disclose such drafts is self-executing, or whether it is triggered by a request from the other side. This debate seems, with all respect, to be misplaced: it is clear that Defendants have requested any drafts, and clear that they cannot be withheld concerning a testifying expert. *See Trigon,* 204 F.R.D. at 282-83;*accord, e .g., W.R. Grace & Co. v. Zotos Int'l, Inc.,* No. 98-CV-838S(F), at *10 (W.D.N.Y. Nov. 2, 2000) (collecting cases). Defendants state that they never received any of the exhibits attached to the Rasmussen Declaration (*See* D.E. 150, Exs. A, I-L) prior to the filing of that Declaration, and that these exhibits should be stricken to the extent Mr. Robinson intends to rely on them. Plaintiff states that these exhibits were not offered in support of Mr, Robinson's opinions, but only in response to Defendants' motion regarding Mr. Robinson's draft report. That being the case, the Court finds that Mr. Robinson may not rely on these exhibits as forming bases for his opinions, as they were filed roughly eighteen months after the discovery cutoff.

E. Russell W. Mangum

Defendants have also moved to strike the expert report and testimony of Russell W. Mangum, also hired to offer damages opinions for Plaintiff, because his opinions are outside the scope of his expertise, are based on speculation and assumptions, are irrelevant, and otherwise threaten to confuse the issues and mislead the jury. (*See* D.E, 140 at 4.) At the outset, Defendants challenge parts V and VI(A) of Mr. Mangum's expert report because they consist of "an extensive, multi-page summary of the negotiations between Plaintiff, the Warner Defendants and JTL regarding Las Ventanas," which Defendants argue is "a blatant attempt to bolster Plaintiff's ... preferred version of the facts."(D.E. 140 at 7.)

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The Court agrees that the summary of the case included in Mr. Mangum's report is lengthy, and that Plaintiff should not expect to question Mr. Mangum at length at trial in a manner that would suggest that Mr. Mangum has any direct knowledge of the underlying disputed facts.[FN6] However, Plaintiff may elicit from Mr, Mangum his general understanding of the facts, in the context of determining what materials he reviewed to render his opinion and in the context of demonstrating the factual predicates upon which his conclusions rest. (Defendants are also free to question Mr. Mangum about those factual predicates; such questioning is common, because a litigant typically wants the jury to appreciate that if the factual bases for the opposing expert's conclusions are not accepted by the jury within the universe of disputed factual contentions, then the expert's conclusions similarly are eroded.) Likewise, to the extent that parts of Mr. Mangum's opinion offer legal conclusions or interpretations of the Noncircumvention Agreement, he will not be allowed to testify to those conclusions or interpretations.

FN6. This factual recitation also may not be introduced as an exhibit. *Accord, e.g., Highland Capital Mgmt., LP. v. Schneider,* 379 F.Supp.2d 461, 468-69 (S.D.N.Y.2005) (collecting cases).

1. Qualifications

***18** Mr. Mangum is an economist who holds a Ph.D. and an M.S. in economics from the University of Southern California, as well as a B .A. in economics, with honors, from California State University, Fullerton. (*See* D.E. 141-2 at 2.) He is a vice president of Analysis Group, Inc., an economic, financial, and strategic consulting firm. (*See id.*)He is a member of several professional associations, including the American Economic Association, the Intellectual Property Law Association, and the American Bar Association. (*See id.*)Prior to joining Analysis Group, Inc., he was an economist at the U.S. Federal Trade Commission, Bureau of Economics, Antitrust Division. (*See id.*)His professional experience includes estimating damages in a variety of areas, including royalty damages related to alleged patent infringement; anticompetitive effects, and estimated damages related to alleged monopolization in the market for acute care hospital and physician services in East Texas; and lost recreational value related to proposed construction of a coastal bluff seawall. (*See* D.E. 141-3 at 6-8.) In addition, he has testified as an expert witness on damages on numerous occasions (*see* D.E. 141-3 at 3-5), and he has published in his field (*see* D.E. 141-3 at 9-10). The Court finds that Mr. Mangum is qualified to testify as a damages expert in this case.

2. Methodology

Like the other experts in this case, Mr. Mangum's methodology consists of reviewing the documents in the case and applying his experience to the facts as they are presented to him by those documents. This is unobjectionable. Defendants challenge Mr. Mangum's opinions as too speculative, arguing that they are based on improper factual underpinnings. (*See* D.E. 140 at 9-10.) Defendants argue that there is no evidence in the record supporting the numbers Mr. Mangum uses in his expert report. (*See id.*)As discussed below, the Court respectfully disagrees.

Mr. Mangum offers two opinions in this case, premised on the idea that Amakua had identified an "arbitrage position," or "imbalance between the amount JTL was willing to accept for Las Ventanas and the amount Warner was willing to pay for a portion of the property (the hotel only)." (D.E. 141-2 at 3.) First, Mr. Mangum opines that the value of the financial benefits to Amakua was approximately $33,130,000, in the form of cash and property, that the portion of these benefits in cash was approximately $10,198,000, and that the portion of these financial benefits in property was approximately $22,932,000. (*See id.*)Mr. Mangum states that his estimates of property value are based on analysis and opinions rendered by Maurice Robinson, Plaintiff's other expert witness. (*See*

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)Second, Mr, Mangum offers an opinion based on a hypothetical negotiation between Amakua and the defendants, through which Amakua would release the Defendants from any and all obligations owed to Amakua with respect to Las Ventanas. Mr. Mangum concludes that Amakua would have agreed with Defendants to release its rights for approximately half of the value of the market imbalance identified above, or $16,565,000. (*See id.* at 3-4.)

***19** Defendants challenge the factual underpinnings of Mr. Mangum's opinions, arguing that there is no support for them in the record. Mr. Mangum posits that JTL would have sold Las Ventanas to Amakua for $70,250,000, and that Warner would have bought the hotel portion of the property from Amakua for $76,000,000, leaving Amakua with $5,800,000 in cash and the remaining land and residential units on the property. (*See* D.E. 141-2 at 12.) Though it is not pellucid from Mr. Mangum's report, there appears to be adequate support for this calculation in the record, at least if the jury were to credit all the evidence in Amakua's favor. The Facilitation Agreement Amakua proposed to JTL included the price of $70,250,000 (*see* Ex. 1023), and Scofield states that JTL's David Lane agreed that was the price for which he would sell Las Ventanas (Scofield Decl. at 7). Likewise, Scofield states that John Hong agreed that Warner would purchase the hotel portion of the property for $76,000,000. (Scofield Decl. at 8.)

Furthermore, none of Defendants' record citations supports their assertion that "[b]oth Michael Scofield, Amakua's principal, and Greg Blake, Amakua's agent, stated in their depositions that they had not reached any agreement that Warner Hotels would buy the hotel for $76 million."(D.E. 140 at 10.) The record citations do not support or require such a conclusion; for the most part, they do not address the potential for a $76 million purchase by the Warner Defendants; in one instance among these citations where that number *is* addressed, it is by Scofield, and his testimony (while a bit opaque) appears to be susceptible to the interpretation that Ty had agreed to pay that amount for the hotel. (*See* D.E. 141-21 at 8 (Ex. F, Scofield Dep. at 142:13).)

The evidence relied on by Mr. Mangum may not be the strongest evidence for calculating damages, but it is admissible evidence and its persuasiveness is properly evaluated by the jury. "Vigorous cross examination, presentation of contrary evidence and careful jury instructions, the [*Daubert*] Court said, are the traditional and appropriate means of attacking shaky but admissible evidence." *Richman,* 415 F.Supp.2d at 933 (citing *Daubert,* 509 U.S. at 596). It appears that Defendants are really challenging Mr. Mangum's conclusions, as opposed to his methods, which is not an appropriate basis to exclude an expert witness. Assessment of an expert's conclusions is for the finder of fact, not the Court in advance of trial. Defendants' motion to strike Mr. Mangum's opinions on this basis is therefore denied.

Defendants also challenge Mr. Mangum's methods because he relied on Mr. Robinson's property analysis in calculating his damages estimates with respect to the property values. Defendants argue that Mr. Mangum should not be allowed to be a mouthpiece for another expert. But that is not what Mr. Mangum is doing-and to the extent it is, such testimony will be excluded as cumulative at trial. As things appear from the briefs, Mr. Mangum is taking another expert's opinion on the value of the property in question and incorporating that value into his overall damages calculation. He is not stating that he has appraised the property at the same value given by Mr. Robinson; he is clearly stating that he is not an appraiser, and so he has relied on another expert's appraisal in reaching his conclusions. The trier of fact may credit his conclusions or not, but that decision is for the trier of fact, not the Court. The trier of fact also may assess whether Mr. Robinson's underlying valuation is credible when Mr, Robinson testifies. There is no need to preclude Mr. Mangum's testimony so as to prevent Plaintiff from protecting discrete expert testimony, outside

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Mr. Mangum's area of competence, from adversarial testing through cross-examination.

***20** Finally, Defendants challenge the reliability of Mr. Mangum's hypothetical negotiation opinion. (D.E. 140 at 12.) Defendants' challenge to the hypothetical is, in part, derivative of its challenge to Mr. Mangum's damages calculation: Defendants argue that the hypothetical is faulty because it is based on that damages calculation. In particular, Mr. Mangum opines that if the parties had negotiated a settlement, they would have settled for half of what the transaction was worth to Amakua, or $ 16,565,000 (half of the damages calculation of $33,130,000). Inasmuch as the Court has deemed the damages calculation admissible, this challenge to the hypothetical negotiation opinion fails.

Defendants also challenge Mr. Mangum's hypothetical on the basis that Mr, Mangum's conclusion that the parties would have evenly split the "surplus" identified by Amakua is "entirely based on Mr. Mangum's unsubstantiated and unreasoned speculation."(D.E. 140 at 13.) Again, the Court respectfully disagrees. Mr, Mangum explains in his report that this conclusion is based on bargaining theory consistent with a "Nash Equilibrium" outcome among parties with equal negotiating power, so called for Nobel-prize-winning economist John Nash. (*See* D.E. 141-2 at 15 n. 58 (citing John F. Nash, "The Bargaining Problem," Econometrica (April 1950)).) Defendants have not challenged the reliability of Nash's theories, and the assessment of whether the theory persuasively can be applied in the context of this case is for the jury. Again, the Court finds that the proper method of challenging this testimony is on cross-examination. Defendants' motion to strike Mr. Mangum's testimony on this basis is denied.

3. Relevance

Finally, Defendants challenge Mr. Mangum's opinion that Amakua identified a financial "arbitrage" opportunity as irrelevant. (*See* D.E. 140 at 8-9.) The Court disagrees. Mr. Mangum's opinion regarding the "market imbalance" or "arbitrage" position Amakua identified may assist the trier of fact in assessing Amakua's role in the proposed transaction. Determining whether Amakua was acting as a broker or as a principal is a critical issue in this case. Thus expert opinions that would assist the jury in assessing Amakua's role are relevant. The Court will not exclude Mr. Mangum's "arbitrage" opinion on this basis.

II. Cross-Motions for Summary Judgment

Plaintiff seeks summary judgment with respect to the breach of contract claim against the Warner Defendants (Count I) and the interference with contract claim against JTL (Count V), and requests that only damages be resolved by jury trial. (*See* D.E. 100 at 2 .) Plaintiff argues that the Noncircumvention Agreement is enforceable, that the Warner Defendants breached that agreement by dealing directly with JTL (and that JTL interfered with the agreement), and that the breach caused Plaintiff $30 million in damages. (*Id.* at 10, 12-13; D.E. 64 at 9.) Defendants' cross-motion for summary judgment seeks judgment on Counts I, III, IV, and V, arguing that the Noncircumvention Agreement between Plaintiff and the Warner Defendants is unenforceable because it is a contract for illegal brokerage activity; it is an illegal restraint on competition; there was no meeting of the minds regarding the meaning of the noncircumvention provision; and Amakua's damages are too speculative to be proven. (*See* D.E. 111 at 11.)

A. Summary Judgment Standard

***21** Summary judgment is proper where "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."Fed.R.Civ.P. 56(c). In determining whether there is a genuine issue of

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fact, the court "must construe the facts and draw all reasonable inferences in the light most favorable to the nonmoving party." *Foley v. City of Lafayette,* 359 F.3d 925, 928 (7th Cir.2004) (citation omitted). To avoid summary judgment, the opposing party must go beyond the pleadings and "set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 250, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Summary judgment is proper against "a party who fails to make a showing sufficient to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial." *Celotex Corp., v. Catrett,* 477 U.S. 317, 322, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). The nonmoving party "must do more than simply show that there is some metaphysical doubt as to the material facts." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 586, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986)."The mere existence of a scintilla of evidence in support of the [non-moving party's] position will be insufficient; there must be evidence on which the jury could reasonably find for the [non-movamt]." *Anderson,* 477 U.S. at 252.

Courts in this district have recognized that where, as here, parties have filed cross-motions for summary judgment, the analysis requires consideration of any legitimate factual disputes or gaps in the record in the light most favorable to each of the two competing parties. *See, e.g., Northern Contracting, Inc. v. State of Illinois,* No. 00 C 4515, 2004 WL 422704, at *46 (N.D.Ill. Mar.3, 2004) (Pallmeyer, J.) ("In cases such as this involving cross-motions for summary judgment, 'the court must extend to each party the benefit of any factual doubt when considering the other's motion-a Janus-like perspective that sometimes forces the denial of both motions.'") (quoting *Buttitta v. City of Chicago,* 803 F.Supp. 213, 217 (N.D.Ill.1992)). The Seventh Circuit instructs that "[w]e are particularly leery of resolving issues involving a state of mind on summary judgment."*Ashman v. Barrows,* 438 F,3d 781, 784 (7th Cir.2006) (citing *Alexander v. Wisconsin Dept. of Health & Family Servs.,* 263 F.3d 673 (7th Cir.2001)). In fact, "[s]ummary judgment is notoriously inappropriate for determination of claims in which issues of intent, good faith and other subjective feelings play dominant roles."*Ashman,* 438 F.3d at 784 (internal quotation marks and citations omitted).

B. Summary Judgment Is Inappropriate in This Case

In this case, summary judgment is inappropriate. The parties disagree about most of the relevant issues, and their disagreements encompass numerous material factual issues. The Court will not extend the length of this opinion even further by setting forth all of the factual disputes, but the Court notes, by way of example, that the parties disagree about what information Amakua provided to the Warner Defendants after John Hong signed the Noncircumvention Agreement, and whether that information complied with the terms of the Agreement. (*See, e.g.,* D.E. 113 ¶¶ 34, 35, 36.) They disagree factually about what role Amakua was to perform in the transaction between JTL and the Warner Defendants, and, in particular, whether Amakua was acting-or would act, assuming the transaction proceededas a real estate broker or as a principal. These disputes relatedly implicate a factual dispute about whether the Noncircumvention Agreement is unenforceable inasmuch as it contemplates an illegal contract for brokerage services. The parties disagree about whether, in general, principals use noncircumvention agreements; whether Amakua had the financial wherewithal to engage in the contemplated transaction; and whether it was even necessary for Amakua to contribute its own capital in order to participate in the transaction. They have factual disputes about whether the transaction, as contemplated when Amakua was involved, was to consummate in a "flip" of the hotel property, about the prevalence of flipping property in the resort hotel industry, and even about what it means to "flip" property. Moreover, the record is replete with incidents that are open to interpretation and inference, *see Ashman,* 438 F.3d at 784, and the parties dis-

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agree about their intentions, beliefs, and knowledge regarding the transaction and Amakua's role in it, and about whether Amakua misled the Defendants about its proposed role.

***22** In sum, there are numerous disputed issues of material fact, as well as matters from which competing inferences could legitimately be drawn in different directions by a reasonable factfinder. As a result, the parties' cross-motions for summary judgment are respectfully denied.

CONCLUSION

For the reasons given above, the parties' cross-motions for summary judgment are denied, and their respective motions to strike expert testimony are granted in part and denied in part. (D.E.99, 110, 129, 135, 138.)

So ordered.

N.D.Ill.,2007.
Amakua Development LLC v. Warner
Not Reported in F.Supp.2d, 2007 WL 2028186 (N.D.Ill.)

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TAB 4

LEXSEE 2006 U.S. DIST LEXIS 28855

APOTEX CORP., Plaintiff, vs. MERCK & CO., INC., Defendant.

Case No. 04 C 7312

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

2006 U.S. Dist. LEXIS 28855

April 25, 2006, Decided
April 25, 2006, Filed

SUBSEQUENT HISTORY: Affirmed by *Apotex Corp. v. Merck & Co., Inc., 2007 U.S. App. LEXIS 26562 (Fed. Cir., Nov. 16, 2007)*

PRIOR HISTORY: *Apotex Corp. v. Merck & Co., 229 F.R.D. 142, 2005 U.S. Dist. LEXIS 14758 (N.D. Ill., 2005)*

COUNSEL: [*1] For Apotex Corporation, Plaintiff: Robert B. Breisblatt, Avrum Sidney Katz, Brian J Sodikoff, James Patrick White, Joseph Eben Cwik, Kathleen A. Rheintgen, Thomas Lawson Gemmell, Welsh & Katz, Ltd., Chicago, IL.

For Merck & Co Inc, Defendant: Ernest Summers, III, John F. Lynch, Michael K Obernesser, Howrey Simon Arnold & White, LLP, Chicago, IL; Jason C. Abair, Nicholas G. Barzoukas, Suzy S. Harbison, Weil, Gotshal & Manges, Houston, TX.

JUDGES: MATTHEW F. KENNELLY, United States District Judge.

OPINION BY: MATTHEW F. KENNELLY

OPINION

MEMORANDUM OPINION AND ORDER

MATTHEW F. KENNELLY, District Judge:

Apotex Corp. has sued Merck & Co., alleging that Merck obtained a favorable judgment in an earlier case, in which Apotex had sued Merck for patent infringement, by making a number of fraudulent representations to this Court. Apotex has filed an action in which it asks the Court to vacate the judgment in the previous case pursuant to *Federal Rule of Civil Procedure 60(b)(3)* (Count 1) and also asserts state law claims against Merck for common law fraud (Count 2) and tortious interference with prospective economic advantage (Count 3). Merck has [*2] moved for summary judgment. For the following reasons, the Court grants Merck's motion.

Facts

The resolution of this motion is the latest chapter in Apotex's prolonged attempt to establish the validity of two patents (Nos. 5,573,780 and 5,690,962) that cover a process for making a pharmaceutical compound used to treat high blood pressure. The process involves the following steps:

> (i)(a) mixing enalapril maleate with an alkaline sodium compound and at least one other excipient, adding water sufficient to moisten, and mixing to achieve a wet mass, or
>
> (b) mixing enalapril maleate with at least one excipient other than an alkaline sodium compound, adding a solution of alkaline sodium compound in water, sufficient to moisten and mixing to achieve a wet mass; thereby to achieve a [virtually complete] reaction without converting the enalapril maleate to a clear solution of enalapril sodium and maleic acid sodium salt in water.
>
> (ii) drying the wet mass, and;
>
> (iii) further processing the dried material into tablets.

See 780 Patent. The Court ruled in January 2000 that the claim required a "virtually complete" reaction of the active ingredient, enalapril [*3] maleate. *See Apotex Corp. v. Merck & Co., Inc., 2000 U.S. Dist. LEXIS 641, No. 96 C 7375, 2000 WL 97582, *3 (N.D. Ill. Jan. 25, 2000)* (*Apotex I*).

Apotex originally sued Merck for patent infringement in 1996, and after the case was reassigned to this Court's docket in June 1999, we ruled in January 2000 that Merck had infringed the patents but that the patents were invalid under *35 U.S.C. § 102(g). 2000 U.S. Dist. LEXIS 641, [WL] at *5, 8. Section 102(g)* provides that an applicant is not entitled to a patent if "before the applicant's invention thereof the invention was made in this country by another who had not abandoned, suppressed, or concealed it."

In the previous case, the parties agreed that Merck invented the allegedly infringing process long before Apotex conceived of the idea. Apotex maintained, however, that its patents were valid because Merck had suppressed or concealed the invention. The Court rejected Apotex's argument, relying on evidence that prior to the date of Apotex's alleged invention, Merck had widely distributed a list of ingredients found in its product and that Merck's vice president of marketing, Brian McLeod, narrated a videotape describing the process during [*4] the trial of a lawsuit in Canada. The Court also relied on admissions from Apotex witnesses that "any chemist who knew the ingredients and knew that the process involved adding water to the mix would automatically know that a reaction of the enalapril malete occurred." *See 2000 U.S. Dist. LEXIS 64, [WL] at * 8.* The Federal Circuit affirmed this Court's ruling. *See Apotex USA, Inc. v. Merck & Co., 254 F.3d 1031, 1040 (Fed. Cir. 2001).*

Apotex now maintains that the Court's January 2000 ruling as well as the Federal Circuit's June 2001 ruling were obtained by fraud. Specifically, Apotex claims that Merck falsely responded to a discovery request seeking "all facts and documents" supporting its allegations of patent invalidity by stating that "the entire process was publicly discussed in open court by Brian McLeod during the Canadian Litigation" and that "this process has not been abandoned, suppressed, or concealed." Apotex Mem. at 2-3. Apotex also claims that Merck misrepresented facts in its summary judgment brief submitted to this Court and in its brief submitted to the Federal Circuit. It points to Merck's statements in those briefs that "the details of the process were the subject of public [*5] testimony in a court action in Canada"; Brian McLeod provided a "*step by step* explanation of Merck's process"; "one could reverse engineer Merck's process by examining Merck's tablets and by reviewing the ingredient list"; "Merck disagrees that it ever suppressed or concealed the invention"; and Merck's "conduct in the late 1980s and early 1990s belies any intention to keep its process secret." *See id.*

Apotex contends that Merck admitted the untruth of these statements in 2004 when its key witness in the 2000 case, Dr. Brenner, testified as follows in a different case:

> . "The lynch pin' [sic] of Merck's process for making stable enalapril tablets was the conversion of enalapril maleate to enalapril sodium, and the key factor in the stabilization of enalapril tablets was the extent to which this reaction went to completion." Apotex Mem at 3.
>
> . A number of factors played important roles in the stabilization process, including "the type of mixing equipment, the duration and temperature of the mixing, the holding time in the mixing equipment after mixing, and the particle size of sodium bicarbonate." *Id.*
>
> . Merck's Canadian demonstration did not disclose [*6] that Merck was converting enalapril maleate to enalapril sodium, the above listed factors, or the need to have a complete or virtually complete reaction. *Id.*
>
> . The process for making enalapril tablets could not be reverse engineered because it would be difficult to determine that there was enalapril sodium in Merck's VASOTEC(R) tablets. *Id.* at 4.
>
> . "Merck decided to maintain as a trade secret the critical process steps for reacting enalapril maleate and sodium bicarbonate to produce enalapril sodium in the wet granulation rather than seeking patent protection for the process." *Id.*
>
> . Merck had maintained the critical role of sodium bicarbonate in its process a trade secret until December 1994. *Id.*
>
> . Merck never disclosed its actual process for making VASOTEC(R) until May 2004. *Id.*

On July 22, 2005, Apotex moved to compel the production of documents that included the thoughts and impressions of the attorneys who participated in the earlier

case. Merck objected to the request on the basis of attorney-client privilege, but Apotex contended that this privilege had been waived because Merck used the attorney-client relationship to perpetuate a [*7] fraud. The Court denied Apotex's motion, concluding that Apotex had not made a *prima facie* showing of fraud. *Apotex Inc. v. Merck & Co., Inc., 229 F.R.D. 142, 147 (N.D. Ill. 2005)*. The Court said that Merck's purported fraudulent statements were nothing more than its attorney's reasonable inferences from the evidence as it existed in the record. *Id. at 148*.

Discussion

Apotex's motion involves two *Federal Rules of Civil Procedure: Rule 56(c)* and *Rule 60(b)(3)*. *Rule 56(c)* says that a motion for summary judgment shall be granted "if the pleadings depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." In considering a motion for summary judgment, the Court views the facts in the light most favorable to the nonmoving party and draws reasonable inferences in its favor. *Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 255, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986)*.

Rule 60(b)(3) allows a court to "relieve a party or a party's legal representative from a final judgment, order, or proceeding [*8] for the following reasons: . . . (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party." Under this rule, "the victim of the fraud . . . need show only that it affected his ability to present his case, not that he would have won had the fraud or misconduct not occurred." *Ty Inc. v. Softbelly's Inc., 353 F.3d 528, 536 (7th Cir. 2003)*. At the same time, a court will not relieve a party from a final judgment if the alleged misrepresentations were not relevant to the theory on which the district court based its decision. *See Williams v. U.S. Drug Enforcement Admin., 51 F.3d 732, 736 (7th Cir. 1995)*. Fraud must be shown by clear and convincing evidence. *See Ty Inc., 353 F.3d at 537*. Motions under *Rule 60(b)(3)*, even when they involve patent cases, are resolved according to regional circuit law. *See Schreiber Foods, Inc. v. Beatrice Cheese, Inc., 402 F.3d 1198, 1204-05 (Fed Cir. 2005)*.

Apotex has pointed to three different groups of fraudulent statements that it contends require the Court to grant Apotex relief from judgment. The first group involves [*9] statements in which Merck allegedly said that it publicly disclosed its entire process, the second group involves statements in which Merck allegedly said that one could reverse engineer Merck's process, and the third group involves statements in which Merck allegedly said that it never suppressed its invention. We examine each group of statements in turn.

1. "[T]he entire process was publicly discussed"

During discovery in *Apotex I*, Apotex served Merck with Interrogatory No. 17, which asked Merck to identify "all facts and documents" that supported Merck's allegation of patent invalidity. Merck responded as follows:

> Merck was wet granulating enalapril maleate with sodium bicarbonate and at least one excipient in the early 1980s. This process has not been abandoned, suppressed, or concealed. These ingredients were clearly published in the Dictionnaire Vidal since at least 1985. The ingredients were also published on numerous promotional materials provided to pharmacists and doctors in Canada. The formulation process has been used continuously in Merck's plants in the United States. Moreover, the entire process was publicly discussed in open court by Brian McLeod [*10] during the Canadian Litigation. All of this occurred before the date of conception by the alleged inventor.

Apotex's L.R. 56.1 Stmt. of Add'l Facts P 3. Apotex contends that Merck's statement was fraudulent because Merck had not disclosed "the entire process" by 1994. Specifically, Apotex says, Merck had not disclosed five critical factors used to perfect the stabilization of the product: the type of mixing equipment used, the duration of mixing, the temperature of the water, the holding time after mixing, and the particle size of the sodium bicarbonate. Apotex contends that Merck had also not disclosed that the purpose of sodium bicarbonate in the solution was to react with enalapril maleate to form enalapril sodium.

Apotex's argument is premised on a faulty assumption. It assumes that when Merck was referring to a "process" in its response to Interrogatory 17, it was referring to the entire process, from start to finish, used by Merck to make its VASOTEC(R) tablets. Read in context, however, it is clear that Merck was referring not to the VASOTEC(R) process in its entirety, but rather to the process described in the first sentence of the interrogatory answer: the process [*11] of "wet granulating enalapril maleate with sodium bicarbonate and at least one excipient" -- the process patented by Apotex. In short, read in context, no reasonable fact finder could conclude that the response to Interrogatory 17 was false or fraudulent and certainly could not conclude that this had been shown by clear and convincing evidence: the

five critical factors cited by Apotex were not a part of Apotex's patented process.

Apotex contends that even if the word "process" is understood to include only those processes listed in Apotex's patent, it was nevertheless dishonest for Merck to assert that it had disclosed the "entire process" because Merck had not disclosed the fact that its process "combined enalapril maleate and sodium bicarbonate in a manner that created enalapril sodium[] and failed to disclose the fact that the reaction between the two had to be complete or mostly complete." Apotex Mem. at 16. This argument is a partial rehashing of an argument that was previously resolved in the Court's January 2000 ruling, where we stated as follows:

> To the extent Apotex is implying that in 1983 Merck was hiding the fact that its process involved reacting enalapril [*12] maleate to form a more stable enalapril sodium compound, that time frame is irrelevant. The relevant time frame for purposes of *§ 102(g)* is when the later inventor conceives of his invention -- in this case, some time between March 30, 1994 and April 19, 1994. By that time, Merck had fully disclosed the ingredients and the process. Plus, even Apotex's witnesses agreed that any chemist who knew the ingredients and knew that the process involved adding water to the mix would automatically know that a reaction of the enalapril maleate occurred. Dr. Richard McKeag, a scientist who worked with Dr. Sherman at Apotex Canada, testified that "it was so simple that it was obvious; any chemist would know that, if you added bicarbonate or carbonate to a solution containing enalapril maleate, you would get the formation of the salt. You would get a chemical reaction to form a salt." McKeag Deposition Transcript, at 41. He also testified that "if you take sodium bicarbonate and put it into water and you have enalapril maleate in the same solution, it will react virtually spontaneously and irreversibly to form a new compound, to form enalapril sodium and disodium maleate." *Id.* at 46. Finally, [*13] he testified that "any chemist who looks at enalapril maleate would automatically assume its going to react with three moles of sodium bicarbonate . . . if they are placed together in solution or in slurry or whatever, anything wet." *Id.* at 47. In short, what Apotex characterizes as "rank suppression and concealment" would not have fooled anyone -- or at least anyone with a fundamental knowledge of chemistry.

*See Apotex I, 2000 U.S. Dist. LEXIS 641, 2000 WL 97582 at *8.* As this excerpt reflects, Apotex contended during the original summary judgment briefing in this case that Merck had not disclosed the presence of enalapril sodium in its tablets. Thus, Apotex was well aware of this purported misrepresentation during the previous litigation and was fully capable of bringing it to the Court's attention. As a result, the statement cannot constitute a basis for relief under *Rule 60(b). See Oxxford Clothes XX v. Expeditors Int'l, 127 F.3d 574, 578 (7th Cir. 1997)* (denying relief under *Rule 60(b)* where party was aware of alleged misrepresentations during previous litigation).

Insofar as Apotex contends that Merck's "entire process" statement was fraudulent [*14] because Merck had not disclosed that the enalapril reaction needed to be "virtually complete," the Court again concludes that this argument was available to Apotex during the previous litigation. McLeod's presentation in the Canadian lawsuit and the VASOTEC(R) ingredient list has been available to Apotex since at least May 1994. If there was an aspect of Apotex's process that Apotex felt Merck had not publicly disclosed -- such as the virtual completeness of the reaction -- then Apotex was free to argue that point to the Court in the previous litigation. As a result, Apotex has failed to offer evidence that Merck's response to Interrogatory 17 requires the Court to grant relief under *Rule 60(b)*.

Apotex also argues that Merck made fraudulent statements in the briefs submitted to this Court and the Federal Circuit that "the details of the process were the subject of public testimony in a court action in Canada"; that "McLeod provided a visual, step by step explanation of Merck's process"; and that McLeod's presentation "was so detailed that it would allow one to understand Merck's process." First, as discussed above, if there was some aspect of Apotex's patented process -- some "detail" [*15] or "step" -- that Apotex believed Merck did not publicly disclose through McLeod's presentation in Canada, then Apotex had every opportunity to present this argument in the previous litigation and cannot now claim Merck committed a fraud on the court. Second, as discussed in more detail below, these statements were not responses to discovery requests or deposition testimony offered by Merck. Rather, they were permissible arguments based on the evidence and were therefore not fraudulent.

2. "One could reverse engineer Merck's process by examining Merck's tablets and by examining Merck's tablets and by reviewing the ingredient list in the Product Monograph."

Apotex next contends that Merck made a fraudulent statement on page forty-four of its brief filed in the Federal Circuit. There Merck argued, based on the testimony of Apotex's inventor Dr. Sherman, that "one could reverse engineer Merck's process by examining Merck's tablets and by reviewing the ingredient list in the Product Monograph." Apotex maintains that this statement was fraudulent because Merck's Dr. Brenner admitted in 2004 that one could not "practice the process" simply by examining the tablets and reviewing the [*16] ingredients list.

As with the statement by Merck discussed in the previous section, Apotex takes this argument about reverse engineering completely out of context. In the two paragraphs immediately preceding the "reverse engineering" statement, Merck's brief recounts several parts of Dr. Sherman's testimony in which he stated that he determined that VASOTEC(R) tablets were prepared through a wet granulation process simply by examining them; after learning the ingredients in the tablets, he concluded that only Merck's actual process was probable; and tests he performed on the tablets revealed that they contained enalapril sodium. After recounting this testimony, Merck's brief goes on to conclude, "Thus one could reverse engineer Merck's process by examining Merck's tablets and by reviewing the ingredient list."

As noted in the Court's June 29, 2005 ruling on the attorney-client privilege issue, "the lawyer's statements in Merck's briefs were not an attempt to characterize the truth as an omniscient observer might see it." *Apotex Inc., 229 F.R.D. at 147*. Rather, the "reverse engineering" statement was a reasonable inference that could be drawn from the evidence revealed [*17] during discovery, specifically, from the statements made by Dr. Sherman. As the Court concluded in its previous ruling, "It was not a fraud' for Merck to argue the inferences from the evidence that had been presented in the case -- even if it now turns out that the evidence that was presented might not have represented the full story." *Id.*

Apotex has not offered evidence that it made discovery requests concerning whether Merck's process could be "reverse engineered," nor has it offered evidence that Merck responded dishonestly to any such requests. Instead, Apotex's argument amounts to a contention that Merck failed to disclose voluntarily evidence that may have undercut the statement it made in its appellate brief-a statement, that was, again, a reasonable inference based on the evidence produced during discovery. Mere non-disclosure by a party or a party's attorney in a civil case does not amount to a fraud upon the court. *See* 11 Charles A. Wright & Arthur R. Miller, Federal Practice & Procedure § 2870 (1995); *Wilson v. Johns-Manville Sales Corp., 873 F.2d 869, 872 (5th Cir. 1989)* (declining to grant plaintiffs' 60(b) motion when defendants successfully [*18] used a "state of the art" defense in a products liability trial and plaintiffs later learned of studies, of which the defendants were aware, that undercut the defendants' theory). For these reasons, Apotex has not offered evidence that Merck's statements in its appellate brief require the Court to grant relief under *Rule 60(b)*.

3. "Merck disagrees that it ever suppressed or concealed the invention"

Apotex's last group of purportedly fraudulently statements relate to the alleged suppression of Merck's process. Apotex points to a statement in Merck's response to Interrogatory No. 17, in which it said, "This process has not been abandoned, suppressed, or concealed"; a statement in Merck's summary judgment brief in which it argued, "Merck disagrees that it ever suppressed or concealed the invention"; and a statement in Merck's appellate brief in which it argued, "Merck's conduct in the late 1980s and early 1990s belies any intention to keep its process secret." Apotex maintains that Dr. Brenner effectively showed these statements were untrue when he testified in 2004 that Merck decided to maintain the role of sodium bicarbonate in its process a trade secret until the late 1980s [*19] or early 1990s and that part of the discussion relating to that decision was the fact that the process could not be discerned simply by knowing the ingredients contained in the VASOTEC(R) tablet.

With regard to Merck's response to Interrogatory 17, in which Merck said the "process had not been abandoned, suppressed, or concealed," Apotex has again taken a single sentence out of context in an attempt to support its contention that fraud occurred. In this response, Merck first asserted that the process had not been suppressed. Then, in support of this contention, it asserted that the VASOTEC(R) ingredients had been published in the 1980s and that Apotex's claimed process was publicly discussed during the Canadian litigation on March 28, 1994. Thus, Merck was only asserting that it had not suppressed the process after March 28, 1994. Read this way, Dr. Brenner's testimony, in 2004, that Merck had suppressed the role of sodium bicarbonate in its process until the early 1980s or 1990s, is not evidence from which a fact finder could conclude that Merck's response to Interrogatory 17 was fraudulent, let alone by clear and convincing evidence.

Even if Merck had fraudulently asserted that [*20] it had not suppressed the process before March 28, 1994,

however, this fact would not have been material to the Court's previous ruling. The time period relevant to the Court's suppression analysis was the period after March 30, 1994. [1] *See Apotex 1, 254 F.3d at 1040* ("though Merck may have suppressed or concealed the process for a period of time . . ., as long as it resumed activity' (i.e., made the benefits of its invention known to the public) before Apotex's entry into the field, it cannot be deemed to have suppressed or concealed [it]."); *Apotex I, 2000 U.S. Dist. LEXIS 641, 2000 WL 97582 at *8* ("To the extent Apotex is implying that in 1983 Merck was hiding [its process], that time frame is irrelevant. The relevant time frame for purposes of *102(g)* is when the later inventor conceives of his invention -- in this case, some time between March 30, 1994 and April 30, 1994."). Misrepresentations that are immaterial to the legal issues upon which a district court decides a case cannot form the basis for relief under *Rule 60(b). See Simons v. Gorsuch, 715 F.2d 1248, 1253 (7th Cir. 1983).* [2]

1 Apotex has not offered any evidence -- let alone clear and convincing evidence -- from which a fact finder could determine that Merck suppressed its process (i.e., the process patented by Apotex) after March 28, 1994.

[*21]

2 Apotex argues that Merck's alleged misrepresentations concerning the suppression of its process must have been relevant because another court, in *Warner-Lambert Co. v. Teva Pharms. USA, Inc., 2004 U.S. Dist. LEXIS 12915, No. Civ.A. 99-922DRD, 2004 WL 1498162, *20 (D.N.J. June 29, 2004)*, ruled that Merck's suppression of its process was relevant. In *Warner-Lambert*, however, the plaintiff's patented process was conceived not in March 1994, but in August 1986. *Id.* Consequently, the court's ruling does not demonstrate that Merck's alleged suppression of its process prior to March 30, 1994 is relevant in this case.

Apotex also contends that Merck made fraudulent assertions in its summary judgment and appellate briefs, in which it stated that "Merck disagrees that it ever suppressed or concealed the invention," and that "Merck's conduct in the late 1980s and early 1990s belies any intention to keep its process secret." These statements, however, like those discussed previously, were statements made by Merck's attorneys concerning the reasonable inferences that could be drawn from the evidence uncovered [*22] during discovery. As such, they were not fraudulent and cannot form the basis of relief under *Rule 60(b). See supra* at 9-10.

The cases cited by Apotex do not call for a different result. In *Hazel-Atlas Glass Oil Co. v. Hartford-Empire Co., 322 U.S. 238, 246, 64 S. Ct. 997, 88 L. Ed. 1250, 1944 Dec. Comm'r Pat. 675 (1944)*, the Court held that a patent attorney committed fraud on the court when he fabricated a trade journal article to obtain a patent and then to establish the validity of the patent in the court of appeals. In *Pumphrey v. K. W. Thompson Tool Co., 62 F.3d 1128, 1131 (9th Cir. 1995)*, the court held that the defendant committed fraud on the court when he deliberately concealed damaging evidence that the plaintiff had specifically requested during discovery. Apotex has not offered evidence that Merck deliberately withheld or fabricated evidence in the previous litigation.

4. Apotex's expert testimony

Apotex offers expert testimony from two distinguished legal scholars in support of its argument that Merck committed fraud during the underlying litigation. Merck contends that this testimony is inadmissible because it offers opinions on whether Merck committed a fraud. The admission of [*23] expert testimony is governed by *Federal Rule of Evidence 702* and the principles set forth in *Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 113 S. Ct. 2786, 125 L. Ed. 2d 469 (1993).* According to the Seventh Circuit, the Court first must determine whether the expert's testimony is reliable by assessing whether the expert is qualified in the relevant field and by examining the expert's methodology. *Smith v. Ford Motor Co., 215 F.3d 713, 718 (7th Cir. 2000).* The Court must then determine if the expert's testimony will assist the trier of fact in understanding the evidence or determining a fact at issue in the case. *Id. at 721.* Though *Rule 704 of the Federal Rules of Evidence* allows experts to opine on "ultimate issues to be decided by the trier of fact," the testimony must still assist the fact finder to reach a decision on a particular issue in controversy.

The Seventh Circuit has held that legal conclusions that will determine the outcome of a case are inadmissible expert testimony. *See Good Shepherd Manor Found., Inc. v. City of Chicago, 323 F.3d 557, 564 (7th Cir. 2003).* [*24] In addition, several judges in this district, including this Court, have held that expert testimony is not helpful to a trier of fact when the expert simply opines that an individual acted dishonestly or fraudulently, issues traditionally resolved by a trier of fact. *See Ass'n Benefit Svcs. v. AdvancePCS Holding Corp., 2005 U.S. Dist. LEXIS 21529, No. 04 C 3271, 2005 WL 2335484, *4 (N.D. Ill. Sept. 23, 2005)* (holding that expert could not testify about ultimate issue of defendant's fraudulent intent); *Klaczak v. Consol. Med. Transp. Inc., 2005 U.S. Dist. LEXIS 13607, No. 96 C 6502, 2005 WL 1564981, *8, 10 (N.D. Ill. May 26, 2005)* (holding that expert could not testify that defendants committed fraud within the meaning of the Anti-Kickback statute); *Dahlin*

*v. Evangelical Child & Family Agency, 2002 U.S. Dist. LEXIS 24558, No. 01 C 1182, 2002 WL 31834881, *3 (N.D. Ill. Dec. 18, 2002)* (excluding expert testimony that the defendant's employees acted dishonestly).

Much of Apotex's expert testimony -- which reads more like a legal brief than an expert report -- consists of plainly inadmissible legal conclusions concerning Merck's alleged fraud and would be completely unhelpful to the fact finder. *See* Ex. E P 36 [*25] ("It is my opinion based on the evidence that . . . Merck's conduct . . . [was] a fraud on the courts."); Ex. F P 58 ("In my view, the fraud perpetrated on this court in *Apotex I* was more serious that the misconduct that occurred in that leading Supreme Court case"). The Court, not an expert, must determine whether Merck's statements rise to the level of fraud under *Rule 60(b)*, and the fact finder, not an expert, must determine whether Apotex has offered evidence that Merck committed common law fraud. Because Apotex has not shown how these experts' testimony would assist us in doing so, the testimony is inadmissible under *Rule 702*.

5. State law claims

Apotex has also asserted state law claims for common law fraud and tortious interference with prospective economic advantage. Apotex premises both claims, however, on the theory that "this Court invalidated Apotex's patents based on Merck's false assertions." *See* Apotex Mem. at 22. Because the Court has already concluded that Apotex has not offered evidence from which a reasonable fact finder could conclude that Merck made material misrepresentations in the previous litigation, Merck is entitled to summary judgment on [*26] these claims as well. *See Rauenhorst v. United States, 104 F.R.D. 588, 603 (D. Minn. 1985)* (dismissing plaintiff's common law fraud claims that were based on the same alleged misstatements that formed the basis of plaintiff's 60(b) motion).

Conclusion

For the reasons stated above, the Court grants defendant's motion for summary judgment [docket no. 71]. The Clerk is directed to enter judgment in favor of the defendant.

MATTHEW F. KENNELLY

United States District Judge

Date: April 25, 2006

TAB 5

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
In re BALLY TOTAL FITNESS SECURITIES LITIGATION.
Nos. 04 C 3530, 04 C 3634, 04 C 3713, 04 C 3783, 04 C 3844, 06 C 3936, 04 C 4697, 04 C 1437.

July 12, 2006.

MEMORANDUM OPINION

JOHN F. GRADY, United States District Judge.
***1** Before the court are defendants' motions to dismiss the consolidated class action complaint. For the reasons explained below, the motions are granted.

BACKGROUND

Plaintiffs have filed several related securities fraud putative class actions against Bally Total Fitness Holding Corporation ("Bally"); three of its current or former officers and directors, Lee S. Hillman, John W. Dwyer, and Paul A. Toback; and Bally's former auditor, Ernst & Young, LLP, for violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (the "SEC"), 17 C.F.R. 240.10b-5. Plaintiffs allege that defendants violated federal securities laws by publicly disseminating false and misleading corporate reports, financial statements, and press releases primarily through "two related fraudulent techniques": improperly recognizing revenue prematurely and improperly delaying the recordation of expenses. (Consolidated Class Action Complaint ("CCAC") ¶ 5.)

We previously granted the parties' motions for consolidation of the cases for all purposes and directed that the consolidated cases be referred to as "In re Bally [Total] Fitness Securities Litigation."(Minute Order of Sept. 8, 2004.) [FN1] We also appointed Cosmos Investment Company, LLC ("Cosmos") as lead plaintiff (Memorandum Opinion of March 15, 2005), and appointed lead and local counsel (Minute Order of May 23, 2005). On January 3, 2006, Cosmos filed a consolidated class action complaint on behalf of a class consisting of those who purchased or acquired Bally securities during the period of August 3, 1999 through and including April 28, 2004. The complaint alleges the following facts, which are taken as true for purposes of the instant motions.

> FN1. The consolidated cases are as follows (abbreviating defendants to "Bally"): *Petkun v. Bally,* 04 C 3530; *Marcano v. Bally,* No. 04 C 3634;*Garco Invs., LLP v. Bally,* No. 04 C 3713;*Salzmann v. Bally,* No. 04 C 3783;*Rovner v. Bally,* No. 04 C 3844;*Koehler v. Bally,* No. 04 C 3936;*Eads v. Bally,* No. 04 C 4697; and *Levine v. Bally,* 06 C 1437.
>
> *Strougo v. Bally,* No. 04 C 3864, was voluntarily dismissed on March 15, 2005, and *Rosenberg v. Bally,* No. 04 C 4342, was voluntarily dismissed on April 7, 2005.

Defendant Bally is a corporation that operates hundreds of fitness centers throughout North America with approximately four million members. Bally's securities are publicly traded on the New York Stock Exchange. During the time period relevant to this action, defendant Dwyer was Bally's Chief Financial Officer ("CFO"), Executive Vice President, and a member of Bally's Board of Directors (the "Board"); defendant Hillman was Chief Executive Officer, President, and Chairman of the Board until December 2002. Defendant Toback is Bally's current Chief Executive Officer, President, and Chairman of the Board. We will refer to Hillman, Dwyer, and Toback collectively, where appropriate, as the "Individual Defendants." The accounting firm Ernst & Young, LLP ("E & Y") was Bally's outside auditor until it resigned the engagement on March 31, 2004.

From August 3, 1999 through April 2004, Bally issued press releases and filed 8-K, 10-K and 10-Q forms with the SEC stating its financial results for various time periods. Some of the SEC filings contained certifications by Dwyer and Hillman, or Dwyer and Toback, pursuant to the Sarbanes-Oxley Act of 2002. In the Sarbanes-Oxley certifications, the

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Individual Defendants attested that they had reviewed the contents of the particular report to confirm that it did not contain any untrue statement of material fact or omit a material fact necessary to make the statements not misleading.

***2** Plaintiffs allege that Bally's financial statements were materially false and misleading because, contrary to defendants' representations, they had not been prepared in conformity with Generally Accepted Accounting Principles (GAAP). Bally is alleged to have violated GAAP in the following ways:

• improperly recognizing membership revenue

• deferring costs incurred in signing up members instead of recognizing membership acquisition expenses, thereby reflecting the costs as an asset

• establishing accruals for unpaid dues on inactive membership contracts instead of writing them off as uncollectible

• improperly accounting for payment obligations in relation to the acquisition of a business

• improperly classifying proceeds from the sale of a future revenue stream

• recognizing cash received in advance of the performance of personal training services as fees earned instead of as deferred revenue

• improperly separating multiple-element bundled contracts for health club services, personal training services, and nutritional products into multiple accounting units, resulting in premature revenue recognition

• failing to estimate the ultimate cost of settling self-insurance claims for workers' compensation, health and life, and general liability, thereby materially understating its liability for these claims

• improperly capitalizing costs incurred to develop internal-use software

• failing to record and assign a fair value to certain separately identifiable acquired intangible assets

• establishing a practice of amortizing goodwill over forty years when this amortization period was inconsistent with the maximum reasonable and likely duration of material benefit from the acquired goodwill

• ignoring “trigger events” and other conditions which, at various dates, indicated that the carrying amounts of fixed assets were impaired, and failing to perform any impairment analyses or recognize impairment losses

• reporting the dollar amount of uncashed checks as income instead of as escheatment liabilities;

• capitalizing advertising costs and amortizing those costs over the estimated life of the advertising campaign instead of expensing them when the first advertisement took place

• adding maintenance costs to the costs of property and equipment and then depreciating this improperly established “asset”

• improperly deferring costs associated with start-up activities, such as rent

• failing to properly compile and record inventory on a periodic basis and failing to match appropriate costs with revenues in order to make a proper determination of the realized income

• failing to accrue obligations as of the end of each accounting period even though transactions and events giving rise to the obligations arose during the accounting period

• failing to recognize gains and losses from various foreign currency transactions that affected individual assets, liabilities, and cash flows

***3** • failing to recognize rent expense on club leases with escalating rent obligations using the required straight-line method; failing to reflect lease incentives as reductions of rental expense over the term of the lease; and improperly reflecting tenant allowances as a reduction to property and equipment and depreciating these amounts

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• reflecting deferred tax assets and valuation allowances based upon improperly-determined taxable income and without having performed a realistic and objective assessment as to whether it was more likely than not that some or all of the deferred tax asset would not be realized

(CCAC ¶¶ 121-174.)

Plaintiffs also allege that E & Y, in its capacity as Bally's outside auditor during most of the relevant time period, played a role in the fraud. E & Y issued several unqualified audit opinions on Bally's consolidated financial statements for the years 1999-2003. Plaintiffs maintain that E & Y diverged from Generally Accepted Auditing Standards (GAAS) when auditing Bally in that it either identified and ignored flagrant multiple violations of GAAP or recklessly failed to identify these violations.

The complaint alleges that "[t]he truth concerning [Bally's] chronic accounting improprieties began to emerge on April 28, 2004."(CCAC ¶ 8.) On that day, Bally issued a press release announcing that its CFO, Dwyer, had resigned "pursuant to the terms of a separation agreement" and that "[s]eparately, the Company announced" that the SEC had commenced an investigation connected to Bally's recent restatement regarding the timing of recognition of prepaid dues.[FN2](*Id.* ¶ 8 (quoting from press release).) In plaintiffs' view, the press release "cast serious doubt on the accuracy and reliability of Bally's financial statements, and, significantly, on the integrity of Bally's management."(*Id.* ¶ 9.)

FN2. On April 2, 2004, Bally had issued an initial restatement of previously-reported 2003 financial results. (CCAC ¶ 8 n. 1.)

Plaintiffs assert that in response to the April 28, 2004 announcement, the price of Bally common stock fell from $5.40 per share on April 28 to $4.50 per share on April 29, a 16.6% drop. In the period of ninety trading days following the April 28 disclosure, the stock reached a mean trading price of $4.56 per share.

When Bally found out that it was being investigated by the SEC, it initiated an internal investigation of its accounting practices, spearheaded by its Audit Committee. On November 15, 2004, Bally announced that based on the internal investigation, the Audit Committee had concluded that Bally's financial statements for the years 2000 through 2003 (including the initial restatement of 2003 that had been issued on April 2, 2004) and the first quarter of 2004 could no longer be relied upon and should be restated. Bally also announced that it would be unable to issue any financial statements for the remainder of 2004 or for 2005 until it had completed the restatements, which were expected to be issued in July 2005 (but were not actually issued until November 2005).

***4** On February 8, 2005,[FN3] Bally issued a press release announcing the findings of the Audit Committee. Bally announced that it was suspending the severance pay of Hillman and Dwyer (the former CEO and CFO, respectively), who, in the Audit Committee's view, "were responsible for multiple accounting errors and creating a culture within the accounting and finance groups that encouraged aggressive accounting."(CCAC ¶ 14.) Bally also stated that it had identified deficiencies in its internal controls over financial reporting.

FN3. Plaintiffs state in their briefs that the complaint incorrectly refers to this date as February 10, 2005. (Plaintiffs' Response to E & Y's Mot. at 4 n. 2, Plaintiffs' Response to Bally Defs.' Mot. at 6 n. 3.)

On November 30, 2005, Bally filed a restatement that comprehensively restated its financial results for 2000, 2001, 2002, and 2003, and first reported results for 2004 and the first three quarters of 2005 (the "Restatement"). The adjustments in the Restatement resulted in an increase in previously-reported net loss of $96.4 million for the year 2002 and a decrease in net loss of $540 million for the year 2003. Bally also increased the January 1, 2002 opening accumulated stockholders' deficit by $1.7 billion to recognize the effects of corrections in financial statements prior to 2002.

The first of these related cases was filed on May 20, 2004. The consolidated class action complaint of January 3, 2006 contains two counts. In Count I, plaintiffs allege that the defendants violated § 10(b) of the Securities Exchange Act and Rule 10b-5. Count II is a "control person" claim in which plaintiffs allege that the Individual Defendants violated § 20(a) of the Securities Exchange Act. Plaintiffs seek

compensatory damages as well as attorney's fees, costs, and expenses.

Four separate motions to dismiss the consolidated class action complaint have been filed by (1) Bally and Toback; (2) Hillman; (3) Dwyer; and (4) E & Y. Those motions are now fully briefed.

DISCUSSION

Section 10 (b) of the Securities Exchange Act makes it unlawful for a person "[t]o use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe."15 U.S.C. § 78j(b). Among those rules is Rule 10b-5, which "prohibits the making of any untrue statement of material fact or the omission of a material fact that would render statements made misleading in connection with the purchase or sale of any security." *In re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 280 (7th Cir.1996).[FN4] To prevail on a Rule 10b-5 claim, a plaintiff must establish that the defendant: (1) made a false statement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff justifiably relied, and (6) that the false statement or omission proximately caused the plaintiff's injury. *Otto v. Variable Annuity Life Ins. Co.,* 134 F.3d 841, 851 (7th Cir.1998).

> FN4. Rule 10b-5 provides:
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
>
> 17 C.F.R. § 240.10b-5.

The heightened pleading requirements of Federal Rule of Civil Procedure 9(b) apply here because plaintiffs' claims are based on securities fraud. *See* *Sears v. Likens,* 912 F.2d 889, 893 (7th Cir.1990) ("Rule 9(b)... governs claims based on fraud and made pursuant to the federal securities laws.").Rule 9(b) requires plaintiffs to plead with particularity the factual bases for averments of fraud, including "the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff."*Id.* (citation omitted); *see also* *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir.1990) (stating that the plaintiff must plead the who, what, when, where, and how of the alleged fraud).

***5** Plaintiffs' claims are also subject to the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4*et seq.,*[FN5] which the Seventh Circuit recently described:

> FN5. The PSLRA "was designed to curb abuse in securities suits, particularly shareholder derivative suits in which the only goal was a windfall of attorney's fees, with no real desire to assist the corporation on whose behalf the suit was brought." *Green v. Ameritrade, Inc.,* 279 F.3d 590, 595 (8th Cir.2002).

> Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief, the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading-one that exceeds even the particularity requirement of [Rule] 9(b). Under the PSLRA, a securities fraud complaint must (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the

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> statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."15 U.S.C. § 78u-4(b)(1), (2). In other words, plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that the defendants likely intended to deceive, manipulate, or defraud.
> *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 594 (7th Cir.2006) (citations and some internal quotation marks omitted).

Defendants contend that plaintiffs have failed to plead their claims with the required particularity and that plaintiffs have failed to adequately plead the elements of scienter and loss causation.

A. *Scienter*

To satisfy the scienter requirement of § 10(b) and Rule 10b-5, a plaintiff must demonstrate that a defendant either had the "intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 (1976), or a "reckless disregard for the truth of the material asserted, whether by commission or omission," *Ambrosino v. Rodman & Renshaw, Inc.,* 972 F.2d 776, 789 (7th Cir.1992) (internal quotation marks omitted)."[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."*Sundstrand Corp. v. Sun Chem. Corp.,* 553 F.3d 1033, 1045 (7th Cir.1977), *cited in* *Makor Issues,* 437 F.3d at 600.

"Congress did not, unfortunately, throw much light on what facts will suffice to create [a strong inference of scienter]. Currently three different approaches toward the way to demonstrate the required 'strong inference' exist among the courts of appeals." *Makor Issues,* 437 F.3d at 601. One approach is to allow plaintiffs to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior. The second approach declines to adopt the "motive and opportunity" analysis and imposes a more onerous burden of pleading in great detail facts constituting strong circumstantial evidence of deliberately reckless or conscious misconduct. *See id.*(summarizing case law). In *Makor Issues,* the Seventh Circuit chose the middle ground, which neither adopts nor rejects particular methods of pleading scienter, such as alleging facts showing motive and opportunity, but instead requires plaintiffs to plead facts that together establish a strong inference of scienter. *See id.*"[T]he best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient."*Id.*

***6** Another concern discussed in *Makor Issues* is the degree of imagination we can use in deciding whether a complaint creates a strong inference of scienter. The Seventh Circuit held: "Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, [FN6] we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent ."*Id.* at 602.

> FN6. The Court was referring to the Sixth Circuit's pronouncement in *Fidel v. Farley,* 392 F.3d 220, 227 (6th Cir.2004), that the "strong inference" requirement creates a situation where plaintiffs are entitled only to the most plausible of competing inferences. The Seventh Circuit declined to express a view on whether the Sixth Circuit's approach is constitutional, but stated: "[W]e think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role." *Makor Issues,* 437 F.3d at 602.

The Seventh Circuit also held in *Makor Issues* that the "group pleading doctrine," pursuant to which scienter allegations made against one defendant could be imputed to all other defendants in the same action, did not survive the heightened pleading requirements of the PSLRA. *See id.* at 603. "While we will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter, *plaintiffs must create this inference with respect to each individual defendant* in multiple defendant cases."*Id.* (emphasis added).

Defendants contend that plaintiffs have failed to plead any particularized facts sufficient to give rise to any inference, much less the requisite strong inference, of scienter. Defendants point out that plaintiffs have failed to allege any particular "red flags" that should have warned defendants of accounting problems or any particular conversations, meetings, or documents. Moreover, the complaint fails to allege that the Individual Defendants sold any stock during the class period and thereby benefited from the allegedly inflated stock prices. Defendants also argue that the complaint is problematic because it expressly relies on the "group pleading doctrine," which was rejected in *Makor Issues.*[FN7]

> FN7. The complaint states: "It is appropriate to treat the Individual Defendants as a group for pleading purposes ...." (CCAC ¶ 33.)

In their responses [FN8] to defendants' motions, plaintiffs submit that they have met their burden of pleading scienter by alleging the following, taken collectively: (1) the "admissions" in Bally's press release of February 8, 2005; (2) the characteristics of the Restatement; (3) "motive and opportunity" allegations; and (4) Bally's violation of its own internal accounting policies.[FN9]We will address each category in turn and then address each of the defendants.

> FN8. Plaintiffs filed two responsive briefs to defendants' motions. One brief responds to the motions of Bally and Toback, Hillman, and Dwyer; the second brief responds to the motion of E & Y.

> FN9. Plaintiffs categorize their allegations slightly differently, but we have reorganized them to facilitate our discussion.

Plaintiffs first point to Bally's press release of February 8, 2005, which announced the findings of Bally's Audit Committee, and quote extensively in their briefs from that press release. (The press release is also attached as an exhibit to plaintiffs' briefs.) The press release included, *inter alia,* the following statements: there had previously been numerous accounting errors; Bally had taken "aggressively optimistic positions" on accounting policies "without a reasonable empirical basis"; Hillman and Dwyer, who had both resigned by then, had been responsible for a culture of "aggressive accounting"; Dwyer had made a "false and misleading" statement to the SEC; as a result of the findings, Hillman and Dwyer's severance pay was being discontinued; two employees (who are not defendants in this action) had engaged in unspecified "improper conduct"; E & Y had "made several errors" in its audit work; and Bally's "internal controls" had numerous deficiencies. (Plaintiffs' Response to Bally Defs.' Mot. at 6-7.)

***7** Plaintiffs maintain that through these statements, Bally "admitted its own scienter." If that is the case, we find it curious that the complaint refers to the press release in only two paragraphs and quotes from it only in relation to the statement regarding Hillman and Dwyer creating a culture of "aggressive accounting." (CCAC ¶¶ 14-15.) Plaintiffs argue that they are permitted to allege additional facts in response to a motion to dismiss so long as those facts are consistent with the complaint's allegations. The cases they cite for this proposition, however, were not cases where fact pleading was required, as it is here.

Nevertheless, for purposes of this motion and so we do not have to revisit this issue, we will consider the complaint as incorporating the press release. We do not believe it assists the plaintiffs in raising an inference of scienter. First of all, the findings are vague and unspecific, and many of the terms, such as "aggressive accounting" and "aggressively optimistic," are imprecise. None of the alleged errors, aggressively optimistic positions, improper conduct, or deficiencies in controls constitute particularized allegations. And contrary to plaintiffs' argument, the fact that Bally acknowledged that false statements were made is not equivalent to admitting scienter. A false statement is one element of a securities fraud claim; scienter is a wholly separate element. The Audit Committee's findings are essentially of negligence, but not scienter. It is important to remember that simple negligence and even "inexcusable negligence" does not amount to scienter. What is required to be shown is an *extreme* departure from the standards of ordinary care. The findings do not rise to this level. Another reason why the press release does not support an inference of scienter is that the findings are simply hindsight conclusions. They do not assist in determining the state of mind behind the misstatements at the time they were made. *See generally* *DiLeo,* 901 F.2d at 628 ("There is no 'fraud by hindsight' ...."); *Sundstrand,* 553 F.2d at 1045 n. 19

("[T]he circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight."); *Davis v. SPSS, Inc.,* 385 F.Supp.2d 697, 714 (N.D.Ill.2005) ("Permutations of 'fraud by hindsight' do not create an inference, much less a strong inference, of *scienter."*).

The second factor relied on by plaintiffs is the Restatement and its characteristics. Plaintiffs assert that the Restatement "totaled 438% of the aggregate pre-restatement net income" and that we can infer scienter from the magnitude of the Restatement, combined with the high number and repetitiveness of the GAAP violations and the simplicity of the accounting principles that were violated. (Plaintiffs' Response to Bally Defs.' Mot. at 14-16.)

The Seventh Circuit has observed that even a very large restatement is not itself evidence of scienter:

> ***8** Four billion dollars is a big number, but even a large column of big numbers need not add up to fraud.
>
> ...
>
> The story ... is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase .... Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud.

DiLeo, 901 F.2d at 627 (citing, *inter alia, Goldberg v. Household Bank, F.S.B.,* 890 F.2d 965, 967 (7th Cir.1989), which noted: "Restatements of earnings are common.").*See also Fidel v. Farley,* 392 F.3d 220, 231 (6th Cir.2004) ("Allowing an inference of scienter based on the magnitude of fraud ... would ... allow the court to engage in speculation and hindsight, both of which are counter to the PSLRA's mandates."); *Davis,* 385 F.Supp.2d at 713 ("Restatements establish that misleading statements were made, but ... provid[e] no assistance in determining the intent behind the misstatements."); *Chu v. Sabratek Corp.,* 100 F.Supp.2d 815, 824 (N.D.Ill.2000) ("A company's overstatement of earnings, revenues, or assets in violation of GAAP does not itself establish scienter.").

We are not prepared to say that the magnitude of a restatement could never contribute to an inference of scienter. But this is not such a case, especially considering that the SEC filings and press releases at issue did not consistently overstate revenues and income or consistently understate losses. Rather, the revenue for some quarters was at times understated and losses for some quarters were at times overstated during the class period. On these facts, it is clear that significant mistakes were made, but we cannot infer scienter. The same can be said for plaintiffs' argument that the number and repetitiveness of the GAAP violations and the purported simplicity of the pertinent accounting principles support an inference of scienter. These "characteristics" of the Restatement are simply another way of saying that multiple accounting errors were made, but they are not facts tending to show that defendants acted with the required intent.

Another category of allegations relied upon by plaintiffs can be deemed the "motive and opportunity" allegations. One allegation is that the Individual Defendants had the opportunity to commit fraud based on their positions in the company and their access to financial information. Scienter, however, may not rest on the inference that defendants must have been aware of a misstatement based simply on their positions within the company. *See Davis,* 385 F.Supp.2d at 713-14 (quoting *Johnson v. Tellabs, Inc.,* 262 F.Supp.2d 937, 957 (N.D.Ill.2003) and *Abrams v. Baker Hughes Inc.,* 292 F.3d 424, 432 (5th Cir.2002)). Plaintiffs assert that they have not pled scienter based merely on the Individual Defendants' positions in the company, but also on the Individual Defendants' personal responsibility for the accounting errors and aggressive accounting as well as their signed Sarbanes-Oxley certifications attesting that they had evaluated the company's internal controls. As noted above in relation to the Audit Committee's findings, the assertion that the Individual Defendants were personally responsible for the errors and "aggressive accounting" is conclusory; there are no facts alleged to bolster this allegation. Nor are any particular facts alleged as to what internal controls the Individual Defendants were familar with and how these related to the accounting misstatements.

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***9** Plaintiffs also emphasize their allegation that the accounting misstatements were related to Bally's "core business" and contend that we can therefore infer scienter because senior executives are presumed to know facts critical to a company's core operations. They also assert that we can infer scienter from Hillman and Dwyer's backgrounds in accounting. These arguments are attempts at an end-run around the requirement that plaintiffs set forth particularized facts to suggest that defendants acted knowingly or recklessly. Plaintiffs cannot rely on a "must have known" theory. *See* *Friedman v. Rayovac Corp.,* 295 F.Supp.2d 957, 995 (W.D.Wis.2003) (stating that the inference that officers and directors are aware of the corporation's "core business matters" relies on a "must have known" logic that the Seventh Circuit has rejected even under Rule 9(b)) (citing *DiLeo,* 901 F.2d at 629).

Plaintiffs' "motive" allegations are twofold: (1) defendants were motivated to misstate Bally's financial results in order to obtain financing, refinance outstanding debt, and complete acquisitions; and (2) the Individual Defendants were motivated to misstate financial results in order to earn bonuses contingent on financial performance and stock awards pursuant to incentive plans. We will first address these allegations in relation to the Individual Defendants and will then return to the first category of allegations in relation to Bally.[FN10]

FN10. These allegations have no relevance to the scienter of E & Y.

Neither category of "motive" allegations is evidence of scienter as to the Individual Defendants. "Motives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud." *Kalnit v. Eichler,* 264 F.3d 131, 139 (2d Cir.2001). We cannot infer scienter on the part of the Individual Defendants merely from their general desire for their corporation to appear profitable and thereby obtain financing and engage in mergers or acquisitions. *See id.;* *Davis,* 385 F.Supp.2d at 714 (increased company buying power afforded by an overvalued stock is a broad motive that easily applies to a majority of corporate executives and is insufficient to establish scienter); *Malin v. IVAX Corp.,* 17 F.Supp.2d 1345, 1361 (S.D.Fla.1998) (motive of maintaining a stock price in order to facilitate mergers and acquisitions "can be ascribed to virtually all corporate officers and directors" and thus fails to raise a strong inference of scienter).

Regarding the motive to earn bonuses and awards, we agree with the view of numerous courts that these allegations are too common among corporations and their officers to be considered evidence of scienter. *See, e.g.,* *Abrams,* 292 F.3d at 434 ("Incentive compensation can hardly be the basis on which an allegation of fraud is predicated.... It does not follow that because executives have components of their compensation keyed to performance, one can infer fraudulent intent."); *Sandmire v. Alliant Energy Corp.,* 296 F.Supp.2d 950, 959 (W.D.Wis.2003) ("Motivations to keep stock prices high to increase personal salaries and to boost financial standing to gain regulatory approval are so common among corporations and their officers that allowing them to satisfy the scienter allegation requirement would be tantamount to eliminating it."). As the court in *Davis* observed:

> ***10** The complaint alleges that [defendants] shared certain motives to inflate the stock price-increased compensation for the officers, an ability to meet analyst expectations, and increased company buying power afforded by an overvalued stock. Just as these broad motives apply to [defendants], they easily apply to a majority of corporate executives. The desire to increase the value of a company and attain the benefits that result, such as meeting analyst expectations and reaping higher compensation, are basic motivations not only of fraud, but of running a successful corporation. Were courts to accept these motives as sufficient to establish *scienter,* most corporate executives would be subject to such allegations, and the heightened pleading requirements for these claims would be meaningless.

Davis, 385 F.Supp.2d at 714.

As for defendant Bally, some courts (largely in the Eastern District of Pennsylvania) have held that stock-based acquisitions that occurred at the time of alleged misrepresentations can support an inference of scienter in some circumstances. *See, e.g.,* *In re NUI Sec. Litig.,* 314 F.Supp.2d 388, 412 (D.N.J.2004); *Marra v.. Tel-Save Holdings, Inc.,* No.

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Master File 98-3145, 1999 WL 317103, at *8-10 (E.D.Pa. May 18, 1999). We do not believe that these allegations give rise to a strong inference of scienter here. It is not alleged that the two acquisitions that were completed during the class period were strictly for stock only, as is the situation in most of the cases where such transactions have been held to give rise to an inference of scienter. Moreover, there are no allegations that any particular financial results were misstated in order to effectuate any particular acquisition. Instead, plaintiffs allege generally that defendants were motivated to misstate results in order to artificially inflate Bally stock, and that defendants then "took advantage of th[e] artificial inflation" to obtain financing and effectuate acquisitions. (CCAC ¶ 272.) These allegations, at most, give rise to only a very weak inference of scienter on the part of Bally.

A final allegation on which plaintiffs rely in support of scienter is that Bally violated its own internal accounting policies. This allegation is similar to the allegations of GAAP violations in that it only goes toward establishing that misstatements were made. Allegations that GAAP or Bally's internal accounting policies were violated do not establish that the misstatements were made with the requisite intent. *See* *In re BISYS Sec. Litig.,* 397 F.Supp.2d 430, 448 (S.D.N.Y.2005).

So, where do these allegations leave us with respect to each defendant? We will begin with the Individual Defendants-Hillman, Dwyer, and Toback. None of the allegations discussed *supra* have raised a strong inference of scienter with respect to them. In addition, there are no allegations of circumstances suggestive of scienter, such as large insider stock sales or specific meetings during which particular financial representations were discussed. Plaintiffs emphasize that we have to consider the allegations in their totality. This is indeed the correct standard, see *Makor Issues,* 437 F.3d at 603 ("[W]e will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter ...."), and it is the one that we are employing. Nonetheless, even under this standard, plaintiffs' allegations fall far short of adequately pleading scienter with respect to the Individual Defendants. The complaint relies largely on conclusory allegations, speculation, and a "must have known" approach. Plaintiffs have simply failed to allege with particularity facts giving rise to a strong inference that Hillman, Dwyer, or Toback acted with the required intent or recklessness.[FN11]

> FN11. We note that Hillman also argues that he is not responsible for statements made after his retirement on December 11, 2002. Plaintiffs concede that Hillman is not responsible for any statements made after his retirement. (Plaintiffs' Response to Bally Defs.' Mot. at 25 n. 10.)

***11** Plaintiffs contend, without explanation, that even if the complaint fails to allege scienter against the Individual Defendants, it still sufficiently alleges scienter against Bally. (Plaintiffs' Response to Bally Defs.' Mots. at 27 n. 14.) Plaintiffs argue that scienter on Bally's part can be alleged based on the "collective knowledge of its employees." (*Id.* at 12.) We disagree. The Seventh Circuit has expressed doubt about an "independent corporate scienter theory." *See* *Caterpillar, Inc. v. Great Am. Ins. Co.,* 62 F.3d 955, 963 (7th Cir.1995); *see also* *Higginbotham v. Baxter Int'l, Inc.,* Nos. 04 C 4909, 04 C 7906, 2005 WL 1272271, at *8 (N.D.Ill. May 25, 2005) (rejecting the theory and noting that the Fifth Circuit and the Ninth Circuit have also rejected it)."A corporation can only 'know' those things known by persons acting on its behalf." *Ong ex rel. Ong IRA v. Sears, Roebuck & Co.,* 388 F.Supp.2d 871, 901 n. 19 (N.D.Ill.2004). Plaintiffs have failed to allege facts giving rise to a strong inference that *anyone* acting for Bally had the requisite state of mind, let alone the Individual Defendants. In addition, as stated *supra,* Bally' s acquisitions that were partly paid for in stock give rise to only a very weak inference of scienter. In any event, even if we accepted plaintiffs' argument that "collective knowledge" allegations are sufficient, there is virtually nothing in the complaint suggesting with particularity what that "collective knowledge" was.

As for E & Y, it was Bally's outside auditor, and as applied to outside auditors, "recklessness means that the accounting firm practices amounted to no audit at all, or to an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *Chu,* 100 F.Supp.2d at 823 (internal quotation marks omitted). E & Y argues that the section of the complaint setting forth plaintiffs' principal scienter allegations fails to state any facts regarding E & Y and that the complaint

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fails to point to any "red flags" suggesting recklessness.

Plaintiffs first contend that we can infer scienter from the fact that the press release announcing the Audit Committee's findings stated that Bally believed that E & Y had made several errors in the course of its auditing work. (CCAC ¶ 16.) In plaintiffs' view, they are "entitled to an inference that the press release reveals conduct by E & Y that was at least reckless, if not fraudulent."(Plaintiffs' Response to E & Y's Mot. at 9.) Plaintiffs are incorrect. As discussed *supra,* possible accounting errors alone do not raise an inference of scienter. *See, e. g., Fidel,* 392 F.3d at 231 (holding that a subsequent revelation of the falsity of previous statements does not imply scienter by an outside auditor); *In re Ikon Office Solutions, Inc.,* 277 F.3d 658, 673 (3d Cir.2002) ("[T]he discovery of discrete errors after subjecting an audit to piercing scrutiny post-hoc does not, standing alone, support a finding of intentional deceit or of recklessness.").

***12** Aside from allegations about the characteristics of the restatement and Bally's violation of its internal accounting policies, which we have discussed and rejected *supra* as sufficient bases for an inference of scienter, the only other argument proffered by plaintiffs regarding E & Y's scienter is that E & Y was "indifferent" to red flags during its audits. (Plaintiffs' Response to E & Y's Mot. at 10-14.) In their response brief, plaintiffs list twelve red flags that "should have prompted E & Y to exercise greater professional skepticism during its audits."(*Id.* at 12-14.) The problem is that plaintiffs fail to describe these red flags in the complaint. Plaintiffs cite cases for the proposition that we may consider facts alleged in their brief if those facts are consistent with the complaint's allegations, but those cases are inapposite because they involved notice pleading, not fact pleading as required by the PSLRA.

For the sake of judicial economy, however, we will consider the twelve "red flag" items listed in plaintiffs' brief as if they had been included in the complaint.[FN12] Although allegations of obvious "red flags" or warning signs that financial reports are misstated can give rise to a strong inference of scienter in some circumstances, *see Chu,* 100 F.Supp.2d at 824, plaintiffs' allegations are insufficient to raise a strong inference that E & Y acted with scienter. Plaintiffs' "red flags" are largely reconstituted versions of their allegations couched in the context of the Audit Standards of the American Institute of Certified Public Accountants. Four items deal with what was "revealed" in the Audit Committee's investigation. The Audit Committee's findings involve hindsight; they do not shed light on what E & Y knew at the time of the audits. Therefore, they do not constitute red flags relevant to scienter. *See, e.g., Davis,* 385 F.Supp.2d at 713-14 (red flags cannot arise out of later discoveries).

FN12. Plaintiffs have requested leave to amend the complaint in the event that defendants' motions are granted. Plaintiffs would undoubtedly amend the complaint to include the "red flag" allegations, and the scienter issue would arise again. Better to resolve it sooner than later and avoid duplication of efforts.

None of the remaining items raises a strong inference of scienter. Five items are problematic because they are not based on facts that are actually alleged. Plaintiffs assert that the following situations constitute "red flags": where "significant portions" of management's compensation are contingent upon achieving aggressive financial targets; where management has "significant" financial interests in the entity; where a company "needs" to obtain additional debt or equity to stay competitive; where a company has an "active" merger or acquisition calendar; and where a company has "unusually rapid growth or profitability." Plaintiffs have not alleged, though, that Bally's management had incentives or financial interests that were "significant" in that they were much larger than executives at comparable entities. Nor have plaintiffs alleged that Bally needed to obtain the financing it obtained or complete the acquisitions that it did in order to stay competitive, or that Bally's merger calendar was more active than comparable entities, or that Bally had unusually rapid growth compared to other companies. It is not evident that any of these five red flags actually existed on the facts that have been alleged.

***13** The three remaining purported "red flag" items are too weak to raise a strong inference of scienter. One is management's failure "to correct known reportable conditions on a timely basis."(Plaintiffs' Response to E & Y's Mot. at 14.) Plaintiffs contend that E & Y stated in 2004 that it had been aware of

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material weakness in "internal accounting control" for the years 2001-2003 and took that into account in performing its audits. We do not believe that it follows from this allegation that there was a failure to correct a "known reportable condition" on a timely basis. It is not even clear what constitutes a "known reportable condition."

The final two items are not even characterized by plaintiffs themselves as red flags. One is that Bally inadequately disclosed its accounting policies and therefore E & Y should have been alerted to the risk of fraud. The other is that each of the Individual Defendants worked for E & Y prior to joining Bally and that therefore E & Y should have exercised "increased audit skepticism." These items do not strike us as red flags; rather, they are risk factors."[S]o-called 'red flags', which should be deemed to have put a defendant on notice of alleged improprieties, must be closer to 'smoking guns' than mere warning signs." *Nappier v. Pricewaterhouse Coopers LLP,* 227 F.Supp.2d 263, 278 (D.N.J.2002) (citation and some internal quotation marks omitted). Plaintiffs have failed to identify any true red flags, which are "specific, highly suspicious" facts or circumstances available to E & Y at the time of its audits. *Riggs Partners, LLC v. Hub Group, Inc.,* No. 02 C 1188, 2002 WL 31415721, at *9 (N.D.Ill. Oct. 25, 2002). E & Y argues that plaintiffs have attempted to "cherry-pick a handful of very generalized risk factors, label them as 'red flags,' and stitch them together to show scienter."(E & Y's Reply at 13.) We agree. Plaintiffs have failed to allege facts tending to show that E & Y acted with the requisite scienter.

Because plaintiffs have failed to allege particularized facts sufficient to give rise to a strong inference that any of the defendants acted with the requisite intent or recklessness, Count I of the consolidated class action complaint, the § 10(b) claim, will be dismissed. Count II, the § 20(a) "control person" claim against the Individual Defendants, will also be dismissed because if there is no actionable underlying violation of the securities laws, there can be no control person liability. *See* *Sequel Capital, LLC v. Rothman,* No. 03 C 678, 2003 WL 22757758, at *17 (N.D.Ill. Nov. 20, 2003); *In re Allscripts, Inc. Sec. Litig.,* No. 00 C 6796, 2001 WL 743411, at *12 (N.D. Ill. June 29, 2001).

Plaintiffs have requested leave to amend the complaint in the event of a dismissal. Plaintiffs will be granted leave to amend; therefore, the dismissal will be without prejudice.

B. *Loss Causation*

We could have ended our discussion by stating that it is unnecessary to address defendants' loss causation arguments because we are dismissing on scienter grounds. But plaintiffs have requested, and we will grant, leave to amend the complaint. In light of the possibility of another motion to dismiss, it is useful to take up the loss causation issue now.

***14** Plaintiffs suing under the PSLRA must plead and prove that the defendant's purported fraudulent statement or omission was the cause of their loss. *See*15 U.S.C. § 78u-4(b)(4); *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 347 (2005). Pursuant to *Dura,* the complaint must provide defendants "with some indication of the loss and the causal connection that" plaintiffs have in mind. *Id.* The complaint in *Dura* alleged that the price of the stock plaintiffs had purchased was inflated because of defendants' misstatements, but not that the share price had fallen after the truth became known. The Supreme Court held that the complaint was insufficient because an inflated purchase price does not itself constitute or proximately cause economic loss. *Id.*

Here, as in *Dura,* it is alleged in the complaint that as a result of defendants' false and misleading statements, Bally stock traded at artificially inflated prices during the class period. (CCAC ¶¶ 274-79.) But what it also alleges distinguishes this case from *Dura:* that when the truth became known by virtue of the April 28, 2004 announcement, the price of Bally stock "fell precipitously" and, as a result, plaintiffs suffered economic loss. (CCAC ¶¶ 280-81.)

Defendants maintain that plaintiffs have failed to plead loss causation because the "truth" actually became known in an earlier announcement indicating that Bally was planning on issuing a restatement of certain financial results. Defendants also argue that the price of Bally stock had already greatly declined over the course of the class period and thus the announcement was not the cause of plaintiffs' loss. Defendants frame their position as a *Dura* argument, but in reality it goes to the merits of plaintiffs' case. The essence of defendants' arguments is that plaintiffs

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cannot *prove* loss causation. But that is not an appropriate consideration on a motion to dismiss. It is axiomatic that on a motion to dismiss, we accept as true all factual allegations in the complaint. *See* *Hentosh v. Herman M. Finch Univ. of Health Sciences,* 167 F.3d 1170, 1173 (7th Cir.1999). Plaintiffs have sufficiently alleged loss causation in accord with *Dura,* and that is all that is required of them at this juncture.

CONCLUSION

For the foregoing reasons, the following motions to dismiss the consolidated class action complaint are granted: (1) the motion of Lee S. Hillman; (2) the motion of John W. Dwyer; (3) the motion of Bally Total Fitness Holding Corporation and Paul A. Toback; and (4) the motion of Ernst & Young, LLP. The consolidated class action complaint is dismissed without prejudice.

Plaintiffs may file an amended consolidated class action complaint by August 14, 2006.

A status hearing is set for September 13, 2006, at 10:00 a.m.

N.D.Ill.,2006.
In re Bally Total Fitness Securities Litigation
Not Reported in F.Supp.2d, 2006 WL 3714708 (N.D.Ill.)

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TAB 6

This case was not selected for publication in the Federal Reporter.

NONPRECEDENTIAL DISPOSITION To be cited only in accordance with Fed.R.App.P. 32.1.
United States Court of Appeals, Seventh Circuit.
Geraldine BARBER, Plaintiff-Appellant,
v.
UNITED AIRLINES, INC. Defendant-Appellee.
No. 00-3546.

Argued May 15, 2001.
Decided Aug. 16, 2001.

Passenger brought action against airline to recover for injuries sustained when plane encountered turbulence. The United States District Court for the Northern District of Indiana, Andrew Rodovich, United States Magistrate Judge, entered judgment as matter of law in favor of airline, and passenger appealed. The Court of Appeals held that: (1) aviation expert was properly excluded from testifying; (2) refusal to grant continuance was not abuse of discretion; and (3) passenger's unsubstantiated testimony was insufficient to create fact issue.

Affirmed.

West Headnotes

[1] Evidence 157 555.2

157 Evidence
157XII Opinion Evidence
157XII(D) Examination of Experts
157k555 Basis of Opinion
157k555.2 k. Necessity and Sufficiency. Most Cited Cases
Trial judge must determine whether expert's opinion is grounded in methods and procedures of science, and whether opinion has sufficient factual underpinnings. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

[2] Evidence 157 555.7

157 Evidence
157XII Opinion Evidence
157XII(D) Examination of Experts
157k555 Basis of Opinion
157k555.7 k. Due Care and Proper Conduct. Most Cited Cases
Aviation expert's failure to explain why he ignored weather data and testimony given by pilots to extent that those facts conflicted with his opinion that pilots were negligent for failing to properly use radar while flying through area where thunderstorms were predicted precluded expert from testifying in passenger's negligence action against airline; expert did not give any additional data or information that he relied upon. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

[3] Federal Courts 170B 823

170B Federal Courts
170BVIII Courts of Appeals
170BVIII(K) Scope, Standards, and Extent
170BVIII(K)4 Discretion of Lower Court
170Bk823 k. Reception of Evidence. Most Cited Cases
Court of Appeals reviews district court's decision to exclude expert testimony for abuse of discretion. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

[4] Evidence 157 514(1)

157 Evidence
157XII Opinion Evidence
157XII(B) Subjects of Expert Testimony
157k514 Management and Operation of Vehicles, Machinery, and Appliances
157k514(1) k. In General. Most Cited Cases
District court's refusal to permit aviation expert to testify in passenger's negligence action against airline as to fact that thunderstorms could create severe turbulence was not abuse of discretion, where airline's pilots admitted that thunderstorms were known to cause severe turbulence, but undisputed evidence indicated that turbulence that plane struck was clear-air turbulence, not thunderstorm-related turbulence. Fed.Rules Evid.Rule 702, 28 U.S.C.A.

[5] Federal Civil Procedure 170A 1852

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170A Federal Civil Procedure
170AXII Continuance
170Ak1852 k. Discretion of Court. Most Cited Cases
District court has broad discretion in determining whether to grant continuance.

[6] Federal Civil Procedure 170A 1856

170A Federal Civil Procedure
170AXII Continuance
170Ak1855 Grounds
170Ak1856 k. Absence of Witness or Evidence in General. Most Cited Cases
District court's refusal to grant continuance in passenger's negligence action against airline in order to give passenger more time to retain aviation expert after her expert was rejected was not abuse of discretion, where case was almost two and a half years old, it had already been continued and delayed so as to allow passenger opportunity to obtain expert witnesses, passenger had plenty of time to evaluate proffered expert's report and deposition, and airline had filed motion in limine within time established by court.

[7] Federal Courts 170B 776

170B Federal Courts
170BVIII Courts of Appeals
170BVIII(K) Scope, Standards, and Extent
170BVIII(K)1 In General
170Bk776 k. Trial De Novo. Most Cited Cases
Court of Appeals reviews district court's grant of judgment as matter of law de novo. Fed.Rules Civ.Proc.Rule 50, 28 U.S.C.A.

[8] Federal Civil Procedure 170A 2515

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2515 k. Tort Cases in General. Most Cited Cases
Passenger's unsubstantiated testimony that pilot told her immediately after flight that they had flown through thunderstorm was insufficient to create fact issue in passenger's action to recover for injuries sustained when plane encountered turbulence as to whether pilot had duty to warn of possible turbulence, where undisputed testimony indicated that turbulence was clear-air turbulence, not thunderstorm-related turbulence, passenger did not make claim until she took stand at trial, claim contradicted passenger's deposition testimony, pilot's testimony, and testimony of all other witnesses, and passenger submitted no weather reports confirming thunderstorms at that time and in that location.

[9] Carriers 70 295.1

70 Carriers
70IV Carriage of Passengers
70IV(D) Personal Injuries
70k294 Management of Conveyances
70k295.1 k. Air Carriers. Most Cited Cases
Pilot had no duty to warn passengers to fasten their seatbelts when he saw clouds and haze in front of him, and thus airline was not liable for injuries sustained by passenger when plane struck turbulence, where cirrus clouds observed by pilot were not capable of causing type of turbulence they experienced.

[10] Carriers 70 305(4)

70 Carriers
70IV Carriage of Passengers
70IV(D) Personal Injuries
70k305 Proximate Cause of Injury
70k305(4) k. Management of Conveyances. Most Cited Cases
Pilot's alleged failure to properly use plane's radar during flight was not proximate cause of injuries sustained by passenger when plane encountered turbulence, where clear-air turbulence that caused passenger's injuries could not have been detected by radar.

[11] Evidence 157 78

157 Evidence
157II Presumptions
157k74 Evidence Withheld or Falsified
157k78 k. Suppression or Spoliation of Evidence. Most Cited Cases
Airline's destruction of documents pertaining to weather at time of flight did not give rise to inference

that missing evidence was favorable to passenger seeking to recover for injuries sustained when plane encountered turbulence, where documents were destroyed in ordinary course of business, and passenger obtained independent reports as to actual conditions that day.

***435** Appeal from the United States District Court for the Northern District of Indiana, Hammond Division. No. 98 C 119. Andrew Rodovich, Magistrate Judge.

Before RIPPLE, MANION, DIANE P. WOOD, Circuit Judges.

ORDER

****1** United Airlines Flight 516 from New Orleans to Chicago encountered turbulence on May 3, 1996. One of the passengers on board, Geraldine Barber, was injured, and she sued United Airlines for negligence. Prior to trial, the district court granted United Airlines' motion in limine, barring Barber's proffered aviation expert, Dr. Michael Hynes. The trial proceeded, but at the close of evidence the district court granted United Airlines judgment as a matter of law. Barber appeals, and we affirm.

I. Background

On May 3, 1996, Geraldine Barber was returning to the Chicago area aboard United Airlines Flight 516 from an educational conference held in New Orleans. Flight 516 was in Captain James Kainer's charge, and First Officer James O'Neal was second in command. The initial leg of the flight was smooth, but about forty miles south of St. Louis the plane encountered moderate to severe turbulence, which caused the plane to suddenly pitch up severely and then level off.

The incident lasted only a few moments, and the remainder of the flight was uneventful, but at the time the plane struck the turbulence, the “fasten seatbelt” sign was off and Geraldine Barber, whose seatbelt was loosely fastened, was thrown forward. She struck her head and shoulders against the seat in front of her. Barber claims that as a result she suffered shock, fright, and severe pain, and that the accident tore her rotator cuff, which required surgery. Barber also claims that while at work the following year, she fell after having tried to lift herself up using her injured shoulder. As a result, Barber claims that she suffered severe damage to her knee which also required surgery. Barber further contends that her injuries eventually caused her to take early retirement from her job as a school administrator.

Almost two years after the incident, Barber sued United Airlines alleging that United Airlines was negligent because it flew through an area where thunderstorms were predicted, because the pilot failed to properly use the radar, and because the pilots failed to avoid the weather system which caused the turbulence. To support ***436** her case, Barber retained Dr. Michael Hynes as an aviation expert, but prior to trial, on United Airlines' Motion in Limine, the district court [FN1] barred Hynes's testimony, concluding that Hynes's methodology was flawed because he ignored weather data and testimony given by the pilots to the extent that those facts conflicted with his opinion.

> FN1. The parties consented to trial by a magistrate judge pursuant to 28 U.S.C. § 636(c)(1). For simplicity, we refer to the trial court as the district court.

Barber then presented her case to the jury without Dr. Hynes's testimony. At trial, Captain James Kainer testified that from the moment of takeoff in New Orleans to approximately 100 miles south of St. Louis, the flight “was smooth, visibility was good, the seatbelt sign was off, it was a routine flight.” He further testified that about forty miles outside of St. Louis, he turned on the plane's radar.[FN2] Captain Kainer explained that it takes about ten seconds for the radar to warm up, and that after he had turned it on and it had warmed up, he had a clear picture which showed no “convective or precipitative activity.” However, a few minutes later, as Captain Kainer was tweaking the radar,[FN3] the aircraft struck clear air turbulence, pitching up. Captain Kainer explained that clear air turbulence cannot be seen either visually or on radar. He further testified that he had flown the same route earlier in the day and had not experienced any turbulence, nor did any other pilots report incidents of clear air turbulence along that route. Additionally, Captain Kainer stated that while thunderstorms were predicted in the area for later in the day, at the time that the plane struck the turbulence there were no

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thunderstorms.

> FN2. Captain Kainer explained that a plane's radar is not always kept on; rather, pilots switch the radar on only when they believe there is a need for it. Captain Kainer explained that he turned the radar on because he knew that storms were predicted for later in the evening and he wanted to see what the weather would be like on his drive home from the Chicago airport, and to get an overview of the weather coming into Illinois.

> FN3. Captain Kainer also explained that the radar picture must be continuously "tweaked," i.e., adjusted for distance and/or intensity.

****2** Geraldine Barber then took the stand. She testified that after the plane landed, while she was waiting inside the Chicago airport to go home, Captain Kainer approached her, telling her that he had flown through a thunderstorm and that he did not have his radar on. This was the first time that Barber made such a claim; she did not mention these statements in either her deposition or in a diary that she kept following the incident. Barber claimed that she remembered Captain Kainer's remarks after having seen him testify the previous day, which according to Barber jogged her memory.

Following the close of Barber's case, United Airlines moved for Judgment as a Matter of Law, arguing that Barber failed to present any evidence that United Airlines was negligent. Specifically, United Airlines asserted that because the undisputed evidence established that the turbulence was "clear air" turbulence which cannot be seen, and was not turbulence associated with thunderstorms, United Airlines was not liable for Barber's injuries. The district court agreed, granting United Airlines' Motion for Judgment as a Matter of Law. Barber appeals.

II. Analysis

A. Motion in Limine

On appeal, Barber initially argues that the district court erred in barring Dr. ***437** Hynes's expert testimony. Federal Rule of Evidence 702 provides that

> If scientific, technical or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, or training or education may testify thereto in the form of an opinion or otherwise.

[1] In *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993), the Supreme Court held that Rule 702"imposes on the trial court the obligation, when dealing with expert witnesses, to ensure that scientific testimony is 'not only relevant but reliable.' " *Goodwin v. MTD Products, Inc.,* 232 F.3d 600, 608 (7th Cir.2000) (quoting *Daubert,* 509 U.S. at 589, 113 S.Ct. 2786). This requires a trial judge to determine whether an expert's opinion was grounded in the methods and procedures of science, and whether the opinion had sufficient factual underpinnings. *Id.*

[2] A review of Dr. Hynes's proffered expert opinion, his deposition testimony, and the overall record confirms the district court's conclusion that in formulating his opinion, "Dr. Hynes relied on weather data, but he rejected some weather data that contradicted his opinion." The district court also accurately noted that Dr. Hynes "rejected the testimony of the pilot and the copilot, which contradicted his opinion, [and][i]n formulating his opinion, Dr. Hynes did not give any additional data or information that he relied upon, which formed the basis of rejecting some of the weather data and the opinions of the copilots." Dr. Hynes also did not adequately explain why he ignored certain facts and data, while accepting others. Nor did Dr. Hynes present any other data which supported his opinion-he merely accepted some of the testimony and weather data that suited his theory and ignored other portions of it that did not. Because in formulating his opinion Dr. Hynes cherry-picked the facts he considered to render an expert opinion, the district court correctly barred his testimony because such a selective use of facts fails to satisfy the scientific method and *Daubert,* and it thus fails to "assist the trier of fact." Fed.R.Civ.Proc. 702.

****3** [3] On appeal, Barber does not challenge the district court's reasoning that Dr. Hynes's proffered expert opinion failed to satisfy *Daubert* because of his selective use of data. Rather, she argues that in-

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stead of prohibiting Dr. Hynes from testifying entirely, he should have been allowed to testify about the effect of thunderstorms, namely that they are known to cause severe turbulence. She also believes that the district court should have allowed him to testify concerning the steps that United Airlines could have taken to avoid the turbulence or to warn passengers. We review the district court's decision to exclude expert testimony for an abuse of discretion. *United States v. Crotteau,* 218 F.3d 826, 831 (7th Cir.2000).

[4] Barber's argument ignores the fact that the pilots themselves admitted the obvious-that thunderstorms are known to cause turbulence, including severe turbulence, and that company policy is to re-route flights to avoid thunderstorms and to warn passengers to fasten their seatbelts. Because these points were already established-and by the defendants' own employees-we do not believe the district court abused its discretion by failing to allow Dr. Hynes to likewise opine on the effects of thunderstorms. Moreover, the real question was not whether thunderstorms cause turbulence or whether United Airlines could have re-routed the flight, but whether the turbulence which Flight 516 struck was clear air turbulence or thunderstorm-related turbulence. As explained***438** below, the evidence presented during trial established that the turbulence was clear air turbulence. Therefore, even had Dr. Hynes been allowed to testify on more limited grounds, he would have added nothing new and United Airlines would still have been entitled to judgment as a matter of law.[FN4]

FN4. Barber also argues that the district court should have held an evidentiary hearing to determine whether Dr. Hynes was qualified to testify on a more limited basis. There was no need for an evidentiary hearing, however, given the extensive briefing on the issue and the district court's more than thorough review of Dr. Hynes's proffered expert opinion and deposition testimony. Also, as just noted, even if Dr. Hynes were allowed to testify on more limited grounds, that would not have altered the outcome of this case, and therefore we find no abuse of discretion in the district court's decision not to hold an evidentiary hearing.

[5][6] Barber also argues that the district court should have granted her a continuance so as to allow her more time to retain another expert witness. A district court has broad discretion in determining whether to grant a continuance. *Brooks v. United States,* 64 F.3d 251, 256 (7th Cir.1995). In this case, the district court refused to grant a continuance, noting that the case was almost two and a half years old and that it had already been continued and delayed so as to allow the plaintiff the opportunity to obtain expert witnesses. The district court also noted that the plaintiff had plenty of time to evaluate Dr. Hynes's report and deposition and that the defendant had filed the motion in limine within the time established by the court. Under these circumstances, the district court did not abuse its broad discretion in denying Barber's request for a continuance.

B. Judgment as a Matter of Law

Following the close of Barber's case, United Airlines moved for Judgment as a Matter of Law pursuant to Federal Rule of Civil Procedure 50, arguing that Barber had failed to present sufficient evidence to support her theory of negligence. Specifically, United Airlines asserted that while thunderstorms may cause turbulence, and while thunderstorms were predicted in the area of the flight for later in the day, there was no evidence that the turbulence which Flight 516 encountered was caused by thunderstorms. Rather, the only evidence presented during Barber's case-in-chief established that the turbulence which caused Barber's alleged injuries was clear air turbulence, which cannot be seen visually or by radar. Thus, United Airlines could not have avoided the turbulence or warned the passengers to fasten their seatbelts. The district court agreed with United Airlines and granted it judgment as a matter of law.

****4** [7] We review a district court's grant of judgment as a matter of law *de novo,*“asking whether the evidence presented, combined with all the reasonable inferences permissibly drawn therefrom, is sufficient to support the verdict when viewed in the light most favorable to the party against whom the motion is directed.” *Lane v. Hardee's Food Systems, Inc.,* 184 F.3d 705, 707 (7th Cir.1999).

In this case, Barber did not introduce enough evidence to support her claim. Specifically, she failed to introduce any evidence demonstrating that United Airlines could have predicted (and thus either have

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avoided or warned passengers about) the turbulence which caused her alleged injuries. Rather, the undisputed evidence established that the turbulence which Flight 516 struck was what is called “clear air turbulence.” Clear air turbulence cannot be seen either visually or by radar. Additionally, the evidence established that United Airlines had no other warning of ***439** the clear air turbulence, as Captain Kainer had flown the same route earlier in the day and had not experienced any clear air turbulence, and no other pilots who had flown that same route had called in reports of turbulence. Because there was no way that United Airlines could have known of the presence of clear air turbulence, it could not have avoided the turbulence or warned Barber of its presence.

[8] Barber responds by arguing that she was entitled to get to the jury because she presented evidence that Captain Kainer had flown through a thunderstorm. The evidence she refers to is her own trial testimony; Barber testified that after the incident while she was waiting inside the airport to return home, Captain Kainer came up to her and told her that he had flown through a thunderstorm. This (i.e. at trial) was the first time that she made such a claim, having never mentioned this alleged statement in the pleadings or during discovery. In fact, she was thoroughly questioned in her pre-trial deposition about her conversation with the pilots immediately after the flight. She then said that one pilot told her they had no prior warning of bad weather. He thought it was fog. She said nothing about the pilot telling her they flew through a thunderstorm. Barber claims that she only remembered this statement after she saw Captain Kainer testifying at trial.

Initially, we note that no other witnesses claimed that the plane flew through a thunderstorm. In fact, several of Barber's coworkers (including her sister) testified that the day was sunny and beautiful, and they mentioned nothing about a storm. Nor were there any weather reports confirming thunderstorms at that time and in that location. In fact, the weather reports for that day in St. Louis, Missouri showed only a trace of water at 3:00 p.m., and by 4:00 p.m. there was only 1/100 of an inch of rain, and by that time Flight 516 had passed through St. Louis and had landed at O'Hare. Both pilots also testified as to the weather conditions, and stated specifically that they did not fly through a thunderstorm. Captain Kainer also testified that the weather information he had received prior to leaving New Orleans was that “there was some activity that was developing that was supposed to come into the Midwest maybe at the end of the evening, into that night,” but the flight took place in the early-to-mid afternoon. Thus, Barber's last-minute recollection contradicts all of the other evidence, including her own deposition. And while we must be careful to avoid “supplanting our view of the credibility or the weight of the evidence for that of the jury,” to avoid judgment as a matter of law a party must present “more than a mere scintilla of evidence.” *Lane*, 184 F.3d at 706 (internal quotation omitted). In light of the entire record and the overwhelming contradictory evidence, Barber's self-serving statement that Captain Kainer had told her that he had flown through a thunderstorm constitutes, at best, a mere scintilla of evidence, and thus is insufficient to support her claim of negligence.[FN5]

FN5. This statement also does not contradict the other trial evidence which established that the turbulence was clear air turbulence, as opposed to thunderstorm-related turbulence. Thus, even considering this statement, Barber still has not presented any evidence that thunderstorms in the area caused the turbulence which led to her alleged injuries.

****5** [9] Next, Barber argues that the evidence supports her theory that United Airlines was negligent in failing to warn the passengers that it was approaching a weather system and that turbulence was possible. In support of this theory, Barber points to Captain Kainer's testimony that prior to striking the turbulence, he saw clouds and haze in front of him. Accordingly,***440** even if there were no thunderstorms in the vicinity, Barber asserts that because Captain Kainer saw clouds and a haze before experiencing the turbulence, he could have warned the passengers to fasten their seatbelts. While it is true that Captain Kainer stated that he saw clouds prior to striking the turbulence, he explained that they were “little cirrus type clouds, just-it might have been a haze layer,” and that such clouds cannot cause the type of turbulence they experienced. Barber did not presented any evidence to the contrary. Moreover, she had the opportunity to cross-examine Captain Kainer and to ask whether it were possible that the clouds were something else or could have caused the turbulence. Yet that was not the testimony; rather, Captain Kainer explained that the clouds were unrelated to a weather

system and could not have caused the turbulence they experienced. Therefore, there is insufficient evidence to support this theory as well.

[10] Barber further contends that the evidence created a reasonable inference that Captain Kainer failed to properly use the plane's radar, having turned it on only seconds before the incident. She argues that this constituted negligence. Initially, we note our skepticism of Barber's portrayal of the evidence. While Captain Kainer did note that he had turned on the radar only a few minutes before the plane pitched up, he definitively stated that the radar was on, warmed up, and that he had a clear picture of the flight path prior to encountering any turbulence. Barber challenges this evidence with her own last-minute recollection that Captain Kainer had told her that he did not have the radar on at all. This testimony contradicted her own diary in which she stated that Captain Kainer had told her that he got no warning from the radar. In any event, even if Captain Kainer failed to properly use the radar during the flight, Barber still could not succeed on her negligence theory because the evidence established that the turbulence which caused her alleged injuries was clear air turbulence, and that clear air turbulence can not be detected by radar. Therefore, any alleged negligence did not cause Barber's alleged injuries.

C. Standard of Care

On appeal, Barber also argues that the district court improperly determined the appropriate standard of care. Prior to trial, the district court concluded that 14 C.F.R. § 91.13(a) establishes the standard of care at issue: “No person may operate an aircraft in a careless or reckless manner so as to endanger the life or property of another.” Barber asserts that the appropriate standard is set forth in 49 U.S.C. § 44701(1)(A), which provides “the duty of an air carrier [is] to provide service with the highest possible degree of safety in the public interest.” Barber also cites the standard of care section in Section 44702 which recognizes “the duty of an air carrier to provide service with the highest possible degree of safety in the public interest.” 49 U.S.C. § 44702. Thus, according to Barber, United Airlines owed her a duty of the “highest possible” care. We need not decide this issue today, however, because no matter how high the standard of care, as discussed above, Barber has failed to present sufficient evidence to support her claim against United Airlines under any standard of care because there is no evidence from which a reasonable jury could conclude that United Airlines could have foreseen (and thus warned about or avoided) the turbulence.

D. Missing Evidence Instruction

****6** [11] Finally, Barber argues that the district court erred in concluding that she was not entitled to a missing evidence instruction. Specifically, Barber contends that United Airline's failure to present certain***441** documents pertaining to the weather at the time of the flight justifies giving a missing evidence instruction. In support of her position, she cites *Niehus v. Liberio,* 973 F.2d 526, 530 (7th Cir.1992), wherein this court explained that such an instruction may be appropriate if “there is evidence that a party would surely have introduced it had it been helpful, permitting an inference that the evidence would instead have helped his opponent.” First, since this case never got to the jury, any issue of jury instructions is moot. Second, to the extent that Barber is really arguing that in considering the motion for judgment as a matter of law the district court should have inferred that the weather data destroyed by United Airlines favored Barber's case, no such inference is appropriate here because the evidence established that the records were destroyed in the ordinary course of business. Moreover, the records Barber complains were destroyed consisted merely of the weather forecast provided to the pilots prior to the flight, and since Barber obtained independent reports as to the actual conditions that day, the missing reports would still be insufficient to create an issue of fact for the jury because those reports merely predicted weather conditions. The evidence established the actual conditions the plane encountered, namely, clear air turbulence which cannot be seen and thus cannot be avoided or warned against.

III. Conclusion

While there is no dispute that United Airlines Flight 516 struck turbulence en route from New Orleans to Chicago and that the plaintiff Geraldine Barber was injured, Barber has failed to present sufficient evidence to establish negligence on United Airlines' part, no matter how high the standard of care, because the undisputed evidence establishes that the turbulence was clear air turbulence which could not

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have been predicted. The district court also did not abuse its discretion in barring Barber's proffered expert because in formulating his opinion Dr. Hynes selectively considered the pilots' testimony and the weather reports and thus his opinion lacked a scientific basis. For these and the foregoing reasons WE AFFIRM.

RIPPLE, Circuit Judge. I concur in the result.
C.A.7 (Ind.),2001.
Barber v. United Airlines, Inc.
17 Fed.Appx. 433, 2001 WL 950885 (C.A.7 (Ind.))

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TAB 7

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
BASF CORPORATION, Plaintiff,
v.
THE OLD WORLD TRADING COMPANY, INC., Defendant.
No. 86 C 5602.

Sept. 8, 1992.

MEMORANDUM OPINION AND ORDER

LEINENWEBER, District Judge.
***1** On May 25, 1992, the court made Findings of Fact and Conclusions of law upon which judgment was entered in favor of the plaintiff, BASF Corporation ("BASF"), in the amount of $2,498,726, together with prejudgment interest and attorney's fees. BASF now seeks to alter or amend the judgment pursuant to Federal Rules of Civil Procedure 59(e) and to amend the Findings of Fact and Conclusions of Law pursuant to Rule 52(b).

Rule 59(e) Motion

1. BASF points out that on the Rule 58 judgment order entered by the court, the last sentence inadvertently ends with the words "this case is dismissed in its entirety." What the court meant to say was that all of BASF's claims had been dealt with and disposed of. The last sentence of the Rule 58 judgment order is hereby amended to read as follows:

"The court has previously granted Old World's motion for summary judgment on Count II. The court reserves jurisdiction over the award of costs, attorney's fees, and prejudgment interest."

2. BASF next contends that the court erroneously failed to award BASF its profits on lost customer sales occurring in the 1988 antifreeze year, i.e., the period between April 1, 1987 and March 31, 1988. With respect to lost customer sales for the 1988 antifreeze year, the court made Finding of Fact No. 36 that defendant, Old World Trading Company, Inc. ("Old World"), terminated its business relationship with Dearborn Chemical Company ("Dearborn") with the conclusion of the 1987 antifreeze year which was March 31, 1987, and did not purchase inhibitor chemicals from Dearborn after that date. The court, therefore, declined to award BASF any lost profits due to lost 1988 antifreeze sales. BASF asks the court to amend the judgment to include damages for at least a portion of 1988 because it contends that Old World continued to blend the Dearborn formula up to at least July 24, 1987.

The basis for the court's Finding of Fact was the testimony of George Beck ("Beck") and other witnesses called by BASF, and the absence of any direct evidence of sales of the Dearborn formula to Old World customers in 1988, even though there was some evidence that Old World continued to blend the Dearborn formula at some of its blending stations.

Specifically, Beck, a salesman for Dearborn in charge of the Old World account, testified that Dearborn lost the Old World account for the 1988 season, when Old World went exclusively with the Peak formula and gave Dearborn no more orders (Tr. 1225-1226). Richard Tumm, Dearborn's director of sales, testified in a similar vein (Tr. 444 and 458-459). John Hurvis, Old World's chairman, testified that the relationship with Dearborn ended on or about that date (Tr. 612 and 632-633). The evidence to the contrary consisted of blending records which indicate some blending may have occurred after April 1, 1987 (presumably with leftover Dearborn inhibitors in stock). There was also testimony of Larry Birch ("Birch") of Citgo attempting to interpret a reference in a memorandum to the effect that Old World was holding 90,000 gallons of the Dearborn formula for sale by Citgo. However, in the same memo, Birch is advised of the BASF lawsuit against Old World based on the formula failing to met Ford's specifications. There was no evidence that Citgo ever sold or even took possession of this product.

***2** BASF next argues that the records Old World produced and identified through Jeff Grizzle at his deposition show that all of Old World's blenders continued to blend the Dearborn formula for varying periods of time after April 1, 1987, up until July, 1987. However, these records were to the best of the

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court's knowledge not submitted to the court as part of the record in the case. These records, at least the summary prepared and submitted by BASF, does not tell to whom the antifreeze was sold. The evidence was that the heaviest call for antifreeze commenced in late July or early August (Tr. 458). Finally, the customers claimed lost by BASF were aware of BASF's pending lawsuit against Old World and the charge that the Old World antifreeze did not meet its claims. It is hard to believe that BASF lost any sales because of the false claims of Old World after April 1, 1987.

3. BASF also claims that the court's market share analysis improperly used the entire antifreeze market instead of just the private label market. It contends that its share of the non-Old World private label market was 28 percent in 1985 and rose to 34 percent in 1988, instead of the 15.6 percent to 21.2 percent of the total antifreeze market utilized by the court in its damage calculations. However, BASF did not introduce evidence of the respective market shares in the private label market.

BASF in its reply brief explained how it computed its percentage of the private label market. It deducted the market share percentage of Union Carbide, manufacturer of Prestone, from the total market and computed BASF's percentage share of that remaining on the theory that all of Union Carbide's market share was in the branded market. However, the evidence disclosed that Union Carbide was a strong player in the private label market and did not exit this portion of the antifreeze market until near the end of the 1987 antifreeze year [FN1] (Finding of Fact No. 20). Thus, during the damage period as established by the Findings of Fact, Union Carbide was a strong competitor of BASF in the private label market. *See* Defendant's ex.D. It may well have been the competition provided by Old World that led Union Carbide to the decision to get out of the private label market, which, of course, greatly benefited those that remained in it, such as BASF and Old World. Therefore, in the absence of direct testimony on the subject, to conclude what the respective market shares are of the private label market would require the court to undergo a great deal of speculation, which the court is unwilling to do.

It can be argued that the court in awarding damages to BASF based on market share of the total antifreeze market has already engaged in speculation. *See* Findings of Fact and Conclusions of Law, p. 24, n. 2. However, the court had no choice but to speculate in order to award BASF some damages, which the court felt was deserved. Some speculation is always required when it is necessary to construct a world absent some offending conduct. This is usually referred to as requiring the wrongdoer to bear the risk of the uncertainty which his wrong created. *Otis Clapp & Son, Inc. v. Filmore Vitamin Co.,* 754 F.2d 738 (7th Cir.1985). BASF's trial strategy was to go for the "home run" and shoot for 100 percent of the business that went from BASF to Old World and ignore the probability that some or most of the business would go elsewhere. This forced the court to devise its own formula for the award of damages and, in doing so, the court used the best available evidence introduced at trial.

***3** It was clear from the testimony of representatives of each of the customers in question who were called to testify by BASF and Old World, that each was angered at BASF because of perceived price inflexibility, that each had a relationship with one or more of BASF's other private label competitors before it purchased from Old World, that each considered others at the time it was considering purchasing from Old World, and that some of them did purchase a portion of their requirements from others besides Old World. In fact, both Citgo and Phillips had actually terminated BASF as a supplier before awarding the business to Old World. Phillips said it would not have purchased from BASF under any circumstances. Findings of Fact Nos. 50 and 51. The court rejected Old World's argument that it should award BASF nothing for these accounts (and the five others to which there was no testimony) because it was possible in a market where Old World was not making misrepresentations that BASF might well have been more competitive (Finding of Fact No. 54). However, being competitive is not the same as getting orders. It is not enough to say that the accounts had they not gone to Old World would have gone (or remained) with BASF. "*Post hoc ergo propter hoc* will not do...." *Schiller & Schmidt, Inc. v. Nordisco Corporation,* Nos. 91-2195, 91-2781, slip op. 10-11(7th Cir. July 23, 1992). The short of the matter is that BASF presented damage opinion evidence that gave the court no alternative short of total victory, to which it was clearly not entitled. The court attempted to fashion as fair an award as possible under the circumstances and the evidence.

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This is all it was required to do. *Otis Clapp,* at 744. The court declines to alter the award of damages or the Findings of Fact in support of them.

4. BASF complains next about the court's failure to order disparagement of profits, enhancement, or punitive damages. Under the Lanham Act, an award is governed by equitable principles. The court exercised its discretion in declining to apply any of these three elements to the award. The court sees no reason to alter these portions of the court's Conclusions.

5. BASF was awarded prejudgment interest to “be compounded annually.” The year is the anti-freeze year, i.e., April 1 to March 31. The prejudgment interest is to continue until the judgment is final. BASF's two calculations are rejected and it is ordered to submit a third.

Old World's Counterclaim

The court found in favor of Old World on its claim against BASF for product disparagement. There was evidence that BASF employees told customers that Old World used reclaimed glycol or “bottoms.” The court found that this charge was not true. Accordingly, the court will not disturb the counterclaim.

Rule 52(b) Motion

Request to Amend Findings

Finding No. 4

The court fails to see any inaccuracy in Finding No. 4.

Finding No. 37

The evidence at the trial disclosed that the engine by which Janeway Engineering was conducting the Dynamometer test overheated, which the court equated with equipment failure.

Finding No. 33

***4** The court found that Old World had misrepresented its product by claiming that it met certain specifications for which it had not tested. The purpose of quality control it to insure that a product is within certain specifications. Since the Old World product was not within specifications, quality control is irrelevant, unless it claimed that it performed to a certain quality control level, which Old World did not.

Finding No. 17

BASF attempted to call as witnesses certain individuals who were dissatisfied with the Old World product. The court disallowed this evidence partially on the basis of Rule 403. The court felt, and continues to feel, that anecdotal evidence, unless accompanied by testimony that such evidence was statistically significant, was irrelevant and would consume too much time. The court did suggest that BASF compile a list of consumer complaints and, if accompanied by testimony that the number of complaints was statistically significant, the court would consider the evidence. BASF did not provide the court with the statistical significance of the number of complaints. Admission of such evidence would invite Old World to call satisfied customers and the trial would still be going on.

Finding No. 34

The court found that the Old World product met the Cummins' specification. By that, the court meant to find that the Old World product met the Cummins' low silicate level. Accordingly, the court will amend the last sentence of Finding No. 34 to read as follows:

“The court, therefore, finds that Old World did not make a misrepresentation to the extent that it claimed that its AF met the Cummins' low silicate specification.”

Finding Nos. 37 and 38

The court declines to make any changes in Finding Nos. 37 and 38.

CONCLUSION

The court amends the Rule 58 judgment entered in the case as described in paragraph 1 above. The court

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also amends the last sentence of Finding of Fact No. 34. The remainder of BASF's motion is denied.

IT IS SO ORDERED.

FN1. It should be recalled that the antifreeze year runs from April 1 of the previous year to March 31 of the year in question. *See* Findings of Fact and Conclusions of Law, p. 4 n. 1.

N.D.Ill.,1992.
BASF Corp. v. Old World Trading Co., Inc.
Not Reported in F.Supp., 1992 WL 232078 (N.D.Ill.)

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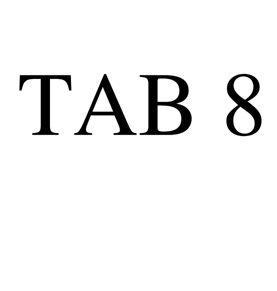
TAB 8

Only the Westlaw citation is currently available.
United States District Court, N.D. Texas, Dallas Division.
Richard BELL, et al., Plaintiffs,
v.
ASCENDANT SOLUTIONS, INC., et al., Defendants.
No. Civ.A. 301CV0166N.

July 1, 2004.

W. Kelly Puls, Puls Taylor & Woodson, Fort Worth, TX, James S. Notis, Richard B. Margolies, Abbey Gardy, Jeffrey S. Abraham, Abraham & Associates, Joseph H. Weiss, Weiss & Yourman, Jules Brody, Stull Stull & Brody, New York, NY, Roger F. Claxton, Claxton & Hill, Dallas, TX, for Plaintiffs.
Paul R. Bessette, Jennifer R. Brannen, Michael J. Biles, Blair C. Hedges, Akin Gump Strauss Hauer & Feld, Austin, TX, James N. Kramer, Brobeck Phleger & Harrison, San Francisco, CA, for Defendants.

MEMORANDUM OPINION AND ORDER

GODBEY, J.
***1** Before the Court are Defendants' Motion to Exclude the Expert Testimony of Professor R. Richardson Pettit, filed March 24, 2004, and Plaintiffs' Motion to Certify Class, filed September 12, 2003. Defendants argue that the principles and methodology employed by Plaintiffs' expert witness fail to satisfy the standard for reliable expert testimony set forth by Federal Rule of Evidence 702 and *Daubert v. Merrill Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993), and Professor Pettit's testimony concerning market efficiency is accordingly inadmissible for the Court's consideration of Plaintiffs' Motion for Class Certification. Because Professor Pettit's use of absolute values and the dates he chooses to support his contention of market efficiency are not reliable, Defendants' motion to exclude is granted. Absent Professor Pettit's testimony, the presumption of market efficiency, which would support an application of the fraud on the market theory, does not apply. Accordingly, proof of individual reliance is required for each Plaintiff, and Plaintiffs do not satisfy the predominance element required for class certification under Federal Rule of Civil Procedure 23.

I. BACKGROUND

Plaintiffs purchased Ascendant Solutions Inc. ("Ascendant") common stock between its initial public offering on November 11, 1999, and January 24, 2000. Ascendant provided proprietary software and comprehensive service solutions that enabled Internet retailers and direct marketing companies to outsource their order management and fulfillment operations. Plaintiffs allege that Ascendant and its top executives issued materially false and misleading statements regarding Ascendant's sales, revenues, and business model immediately before and following Ascendant's initial public offering, artificially inflating the price of Ascendant common stock. Specifically, Plaintiffs claim that Ascendant's 1999 prospectus included false and misleading statements concerning the scope of Ascendant's systems and services and its success in establishing successful systems for existing clients. According to Plaintiffs, the failures obscured by Ascendant's public statements soon surfaced, resulting in a breakdown in Ascendant's ability to generate order and shipping information, a loss of existing clients, and a swift drop in stock price.

On January 23, 2001, investors filed the first of five class actions against Ascendant and its top executives, alleging violations of federal securities laws. On April 25, 2001, the five actions were consolidated, and the Court appointed lead plaintiffs. The lead plaintiffs filed a consolidated amended class action complaint on July 26, 2002. The Court granted in part and denied in part Ascendant's motion to dismiss by order dated July 22, 2003. Plaintiffs filed the instant motion for class certification on September 13, 2003, without any supporting expert testimony. Ascendant contends that Plaintiffs do not satisfy the predominance requirement for a class action under Rule 23, because they fail to establish the element of efficiency needed in order to utilize the presumption of individual reliance through the "fraud on the market" theory. Plaintiffs in their reply for the first time offered expert testimony on market efficiency.[FN1] Defendants filed their Motion to Exclude the Expert Testimony of Professor R. Richardson Pettit on March 24, 2004, challenging the testimony

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of Professor Pettit concerning the market efficiency for Ascendant stock.

FN1. The Court discourages that practice.

II. PROFESSOR PETTIT'S CONCLUSION THAT THE MARKET WAS EFFICIENT IS NOT RELIABLE

***2** Initially, Plaintiffs argue that any consideration of the admissibility of Professor Pettit's testimony is premature, since class certification is not the appropriate stage to indulge in a "battle of the experts." While Plaintiffs are correct that the class certification stage is not the time to conduct an inquiry into the merits of the case, the Court must still determine whether Plaintiffs have met their burden of proving market efficiency-so as to satisfy the Rule 23 requirement of predominance-when considering class certification. *See* *Lehocky v. Tidel Technologies, Inc.,* 220 F.R.D. 491, 507-08 (S.D.Tex.2004) (examining Professor Pettit's analysis of market efficiency at class certification stage); *Krogman v. Sterritt,* 202 F.R.D. 467, 477 n .14 (N.D.Tex.2001) (weighing conflicting expert testimony concerning market efficiency in order to conclude that plaintiff was not entitled to presumption of reliance for class certification purposes). Although many courts, such as the *Lehocky* court, weigh the admissibility of expert testimony in the context of a motion for class certification rather than a *Daubert*-style motion to strike, the Fifth Circuit has made clear that:

A district court certainly may look past the pleadings to determine whether the requirements of rule 23 have been met. Going beyond the pleadings is necessary, as a court must understand the claims, defenses, relevant facts, and applicable substantive law in order to make a meaningful determination of the certification issues.

Castano v. Am. Tobacco Co., 84 F.3d 734, 744 (5th Cir.1996). In many cases, it makes sense to consider the admissibility of the testimony of an expert proffered to establish one of the rule 23 elements in the context of a motion to strike prior to considering class certification. *See* *McNamara v. Bre-XMinerals Ltd.,* No. 5:97-CV-159, 2002 WL 32076175, at *4 (E.D.Tex. Sept.30, 2002) (considering defendants' rule 702 motion to strike expert's testimony of market efficiency prior to subsequent class certification analysis). In order to consider Plaintiffs' motion for class certification with the appropriate amount of scrutiny, the Court must first determine whether Plaintiffs' expert testimony supporting class certification is reliable. Accordingly, a *Daubert*-type review is not premature.

Defendants move to exclude Professor Pettit's testimony concerning the efficiency of the market for Ascendant stock, because, they contend, his analysis of stock price movement in response to company-specific news is severely flawed. Courts frequently utilize analysis of cause-and-effect relationship between unexpected corporate events or financial releases and immediate responses in the stock price in order to measure market efficiency. *See* *Cammer v. Bloom,* 711 F.Supp. 1264, 1287 (D.N.J.1989); *Krogman,* 202 F.R.D. at 477. However, Professor Pettit's seemingly ad hoc use of "information days" and improper use of absolute value compels the Court to find his testimony unreliable.

***3** Professor Pettit's identification of "information days" includes dates that appear to be consciously chosen in order artificially to support his hypothesis of efficiency. Many of the dates identified by Professor Pettit do not conform to any generally-accepted finance methodology used to establish efficiency.[FN2] For example, Professor Pettit includes November 11, 1999, the date of Ascendant's initial public offering, as an information day. Because the closing price on November 10, 1999 was not set on an open, efficient market-indeed, the stock was not available on November 10-the "news" of an initial public offering cannot reasonably be said to be reflected in the stock's price change on November 11, 1999.

FN2. Professor Pettit's analysis is further complicated by his limited data set of just six or seven "information days," his failure to control for industry effects, and his inconsistent application of a two-day window.

Similarly, the inclusion of December 1, 1999, appears to skew Professor Pettit's analysis artificially. Plaintiffs contend that a Bloomberg News article concerning the resignation of Ascendant's corporate operating officer was responsible for a statistically significant price change, showing the efficiency of the market for Ascendant stock by quickly reflecting

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the new information through stock price movement. However, the Bloomberg article, released late in the trading day, simply reports the earlier price drop and attributes such price movement to incorrect rumors circulating on Internet message boards. The use of Internet rumors as "information" to support a hypothesis that the market quickly reflects unexpected corporate events or financial releases appears to be unprecedented in finance methodology.[FN3] Certainly, it does not comport with the *Cammer* factors of market efficiency. *Cammer,* 711 F.Supp. at 1287.

> FN3. Thus, while Internet rumors may one day be an acceptable basis for expert opinion in a court, use of them is not at present a reliable methodology.

Professor Pettit's inclusion of November 15, 1999, as an information day is similarly flawed. Plaintiffs suggest that November 15, 1999 is an appropriate "information day" because that day a Wall Street Journal article was published that included positive information concerning the Internet outsourcing industry. However, the news article did not mention Ascendant at all and does not appear to implicate Ascendant's business model directly. The *Cammer* efficiency factors evaluate whether stock price responds to company-specific news, not industry-specific news. *Cammer,* 711 F.Supp. at 1287; *Krogman,* 202 F.R.D. at 477.

In fact, while Ascendant's stock price rose an astonishing 69.7 percent from the market close on Friday November 12, 1999, through market close Monday, November 15, 1999 (defined in Professor Pettit's analysis as a 68.5 percent residual return), none of the stocks specifically mentioned in the Wall Street Journal article had a price increase higher than 4 percent. Indeed, over half of the stocks mentioned by name in the Wall Street Journal piece were unchanged or closed at a lower price, suggesting that the article could not have been responsible for the incredible one-day gain.

Most importantly to the Court's analysis of Professor Pettit's methodology, the single data point provided by the November 15 price spike biases Plaintiffs' analysis so vastly that without that date, the difference between information and non-information days is not statistically significant. According to Professor Paul Gompers' report, the simple inclusion of November 15, 1999, without more, drives Professor Pettit's conclusion that Ascendant was traded on an efficient market. The very fact that the November 15 outlier alone dictates the result of Professor Pettit's analysis compels the Court to conclude that Plaintiffs have not established that Professor Pettit's testimony is the product of reliable principles and methods, as required by Federal Rule of Evidence 702.

***4** In addition, Professor Pettit utilizes absolute value to determine market price reaction to company news, a technique never previously used to test for market efficiency and disavowed by the author of an article presented by Plaintiffs to support its use. Although the use of absolute value can certainly reflect responsiveness to new information, it cannot determine whether changes in stock price are unbiased, a central requirement of market efficiency theory. The very purpose of requiring market efficiency before applying the fraud-on-the-market presumption is severely undercut by ignoring the direction of price movement in response to new information. Indeed, if stock price is inversely related to the content of new information (for example, stock price decreases upon the announcement of good news, and increases on the announcement of bad news), a plaintiff class cannot be presumed to have relied upon positive statements in purchasing stock. This common sense conclusion explains why the use of true values, rather than absolute values, is generally accepted in the field of financial economics, and absolute values have never been used to test for market efficiency. As Professor Gompers explains, the use of absolute values undercuts Professor Pettit's central conclusion, because:

> Pettit treats absolute price changes as if they are distributed normally when converting t-values to significance levels. This is clearly incorrect, since a normal distribution includes negative values, while the absolute values of residuals cannot be negative. Accordingly, Pettit's claim that "there is a 97% and 98% probability that the market reactions are different (larger) on 'information days' than on 'non-information days" ' is false because that conclusion is based on a normal distribution and absolute values are not distributed normally.

Rebuttal Expert Report of Paul A. Gompers, dated March 18, 2004, at 12. Accordingly, the techniques supporting Professor Pettit's finding of market efficiency have not been tested, have not been subject to

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peer review and publication, and do not enjoy general acceptance within a relevant scientific community. *Daubert,* 509 U.S. at 592-94. For those reasons, the Court finds Professor Pettit's testimony not to be reliable and grants Defendants' motion to strike it.

III. WITHOUT PROOF OF EFFICIENCY, PLAINTIFFS' MOTION FOR CLASS CERTIFICATION IS DENIED

Rule 23 of the Federal Rules of Civil Procedure sets forth the elements that must be met before a class is certified. First, Rule 23(a) states:

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

***5** FED. R. CIV. P. 23(a); *Stirman v. Exxon Corp.,* 280 F.3d 554, 558-59 (5th Cir.2002). Also, the proposed class action must satisfy at least one element of Rule 23(b).*Id.* at 559. Here, Plaintiffs rely on Rule 23(b)(3), which requires that the questions common to the class predominate over questions affecting individual members and that a class action be superior to other available methods for the fair and efficient adjudication of the controversy. FED. R. CIV.P. 23(b)(3).

In the instant matter, Ascendant argues that Plaintiffs have failed to satisfy the element of predominance, because the individual plaintiffs cannot be presumed to have relied upon the representations of Ascendant without an initial showing that Ascendant common stock traded in an efficient market. Without establishing efficiency, Plaintiffs may not resort to the "fraud on the market" theory of reliance, and will have to establish individual reliance for each individual plaintiff-thus foreclosing class certification. *Castano v. Am. Tobacco Co.,* 84 F.3d 734, 745 (5th Cir.1996) ("a fraud class action cannot be certified when individual reliance will be an issue"). District courts have consistently explained that:

The key issue regarding predominance is whether plaintiffs are entitled to a presumption of reliance applicable to all class members. *Griffin v. GK Intelligent Sys., Inc.,* 196 F.R.D. 298, 303 (S.D.Tex.2000). The fraud-on-the-market presumption of reliance "is only available when a plaintiff demonstrates that a defendant made fraudulent misrepresentations or omissions concerning a security that is actively traded in an 'efficient market,' thereby establishing a 'fraud on the market." ' *Binder v. Gillespie,* 184 F.3d 1059, 1064 (9th Cir.1999) (citing *Basic Inc. v. Levinson,* 485 U.S. 224, 241-42, 108 S.Ct. 978, 99 L.Ed.2d 194(1988); *O'Neil v. Appel,* 165 F.R.D. 479, 498 (W.D.Mich.1996); *Krogman,* 202 F.R.D. at 477; *GK Intelligent,* 196 F.R.D. at 303-04 (indicating that Plaintiff bears the burden of proof on showing that the market was efficient throughout the class period). Whether a company's stock traded in an efficient market is a complex issue that requires an analysis of numerous factors, including: (1) how quickly new information about the company is reflected in the stock price; (2) the stock's trading volume; (3) analyst coverage; (4) market maker activity; and (5) eligibility to file a Securities Exchange Commission ("SEC") Form S-3 registration statement. *Krogman,* 202 F.R.D. at 477. Federal courts typically look to expert testimony to decide this issue. *See, e.g., Krogman,* 202 F.R.D. at 477; *O'Neil,* 165 F.R.D. at 484.

Lehocky, 220 F.R.D. at 504-05.

Plaintiffs contend that efficiency has been established by the listing of Ascendant common stock on the NASDAQ National Market and the expert testimony of Professor Pettit. Initially, no court has ever held that efficiency is established solely by the listing of a stock on a national stock exchange. *See id.* at 505 n. 15 ("The fact that a company's stock is listed on a national exchange does not establish that it trades in an efficient market."); *O'Neil,* 165 F.R.D. at 504 ("The issue is *not* whether NASDAQ is efficient.... No court has ever held that a finding of efficiency can be based on the mere fact that a stock is traded on NASDAQ ...") (emphasis in original). In addition, the Court's holding that Professor Pettit's testimony does not satisfy Rule 702 or *Daubert* forecloses its use to establish market efficiency. Plaintiffs have thus failed to establish market efficiency, which prevents them from use of the "fraud on the market" presumption of reliance. Lacking the presumption of reliance, the question of individual reliance must be proved for

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each Plaintiff, and the Rule 23 requirement of predominance is not established. Accordingly, Plaintiffs' motion for class certification is denied.

N.D.Tex.,2004.
Bell v. Ascendant Solutions, Inc.
Not Reported in F.Supp.2d, 2004 WL 1490009 (N.D.Tex.)

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TAB 9

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.

Lisa BOYNTON, Plaintiff,
v.
Joel MONARCH, Defendant.

No. 92 C 140.

Aug. 25, 1994.

MEMORANDUM OPINION

KOCORAS, District Judge:

***1** This matter is before the Court on eleven motions in limine brought by the defendant, Joel Monarch. For the reasons that follow, five of the motions are granted and six are denied.

LEGAL STANDARD

In general, motions in limine seek to exclude, prior to trial, irrelevant or otherwise inadmissible evidence that may prejudice or confuse a jury. In this case, though, Monarch mainly brings these motions to exclude evidence as a sanction for Boynton's alleged violations of discovery rules.

The District Court has broad discretion in determining whether to impose sanctions, including exclusion of evidence, for discovery violations. *Scaggs v. Consolidated Rail Corp.,* 6 F.3d 1290, 1295 (7th Cir.1993). Among the factors to be considered in determining whether to exclude evidence as a sanction are prejudice and unfair surprise to the party opposing the admission of the evidence.

Here, several of Monarch's motions seek to bar the testimony of individuals not identified in Boynton's answers to interrogatories but listed in the pre-trial order. Monarch asserts that Boynton's failure to supplement her interrogatory answers to name these individuals constitutes a violation of Federal Rule of Civil Procedure 26(e)(1)(A). That Rule provides as follows:

A party is under a duty seasonably to supplement [its discovery responses] with respect to any question directly addressed to the identity and location of persons having knowledge of discoverable material ...

Fed.R.Civ.P. 26(e)(1)(A) (1992).

Monarch failed to note that Rule 26 has been amended. As amended, Rule 26(e)(2) provides that,

A party is under a duty seasonably to amend a prior response to an interrogatory ... if the party learns that in some material respect the information disclosed is incomplete or incorrect *and* if the additional or corrective information has not otherwise been made known to the other parties during the discovery process or in writing.

Fed.R.Civ.P. 26(e)(2) (1993).

We will apply the current Rule 26(e)(2). This does not conflict with the Northern District's decision to opt out of the amended Rule 26(a)(1).

DISCUSSION

I. *Non-Expert Witnesses*

Motions 2, 3, 4, 5, and 7 concern non-expert witnesses named in the pre-trial order but not identified in supplemental answers received by Monarch. Motion 2 concerns Ladine Brislin and Cathy Kadison. They are friends of Boynton and she discussed her work situation with them. Monarch seeks to bar their testimony because their identities were not revealed in interrogatory answers or supplemental answers. In response, Boynton includes a copy of a letter identifying Brislin and Kadison as additional persons with knowledge pertaining to the case. The letter is dated January 8, 1993. However, the City

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attorneys representing Monarch assert that they never received the letter, which was mailed to 180 North LaSalle Street. Monarch's attorneys had moved from that address to 30 North LaSalle Street in November, 1992 and notified Boynton's attorneys of the new address in December, 1992. We have no reason to believe that the supplemental answer was purposefully sent to a prior address. Thus, we find that Boynton complied with the Rule and we will not bar these witnesses from testifying. We note further that Boynton identified these two women by name in her deposition on May 21, 1993 as persons with whom she had discussed her work situation; thus, these witnesses were "made known to the other party during the discovery process" as required by Rule 26(e)(2). Motion 2 is denied.

***2** Motion 3 concerns Andrew Varga, an attorney who represented a taxpayer in a case before Boynton. Boynton asserts that her inclusion of Varga in the pretrial order does not constitute unfair surprise to Monarch because Varga's name and his taxpayer-client's name was in documents produced by Monarch. The opposing party's knowledge of the existence or participation of a person in the underlying events is certainly relevant to the question of surprise. However, in this instance we are not satisfied that Monarch had sufficient knowledge of Varga's relevance to this case prior to the close of discovery and the filing of the pre-trial order. Monarch did not have an opportunity to depose Varga after learning that Boynton considers him a possible witness. We find that allowing Varga to testify would constitute unfair surprise to Monarch. Accordingly, we grant motion 3.

Motion 4 concerns Ray Hartman, who was Boynton's supervisor in a prior job. Boynton represents that he will testify about his opinion as to her competence in legal research and writing, as this issue has been raised by Monarch. Boynton has established that she listed Hartman in her answers to interrogatory questions 2 and 3 and indicated there that Hartman was willing to act as an employment reference for her. We find that her answers were clearly sufficient to place Monarch on notice of Hartman's existence and his relevant knowledge, especially since Monarch chose to make Boynton's competence an issue here. Further, it would have been inappropriate to list Hartman in response to interrogatory question 6, which asked for names of persons with knowledge about the allegations in her complaint and damages. Thus, Monarch's suggestion that Boynton's failure to list Hartman in answering question 6 deserves the sanction of exclusion of the witness is unmeritorious. Motion 4 is denied.

Motion 5 concerns George Skontos and William Woloshin, who are also attorneys who represented taxpayers in cases before Boynton. However, we will not bar their testimony because Boynton has pointed out deposition testimony that should have alerted Monarch to the relevance of these witnesses to the case. *See* Boynton Dep. at 254-56. Boynton stated in her deposition that she contacted Skontos and Woloshin to ask if they would testify if she needed them. *Id.* While we cannot condone Boynton's omission of the names of these attorneys from her interrogatory answers and her subsequent failure to amend her answers, we find that it is clear that Monarch knew that Boynton considered Skontos and Woloshin to have knowledge relevant to her case. In light of the amended Rule 26(e)(2), we find that Boynton has not committed a discovery violation. Hence, no sanction is appropriate and Motion 5 is denied.

Motion 7 concerns four other attorneys for taxpayers who appeared before Boynton: James Hardt, Arthur Solomon, Harvey Waller, and Diane Anderson. It also names Jean Harper, a part-time hearing officer during Boynton's employment as a full-time hearing officer. The purported disclosure of the first four attorneys was quite similar to that analyzed above regarding Varga. Like Varga, these attorneys' names appeared on documents produced by Monarch and Boynton testified about the cases in which they appeared. However, Boynton did not mention the attorneys' names in her deposition or indicate

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that she considered them to possess relevant information. Thus, we are not satisfied that Monarch had sufficient notice that they were potential witnesses and, consistent with our ruling on Motion 3, we will bar the testimony of Hardt, Solomon, Waller, and Anderson.

***3** We now turn to the fifth person listed in Motion 7, Jean Harper. Harper was a part-time hearing officer with the City during Boynton's tenure as a hearing officer. Harper filed a complaint with the City's Law Department, alleging that Monarch and another attorney had interfered with her decisions as a hearing officer. Boynton first contacted Harper in March, 1994 and revealed her existence to the defendant in the pre-trial order in June, 1994. Monarch points out that discovery closed nearly one year prior to March, 1994. Boynton urges that Monarch had notice of Harper's identity and potential usefulness in this case because the City's Corporation Counsel, who represents Monarch, received Harper's complaint. Boynton has not explained her late discovery of Harper and in light of the information before us, we conclude that it would be unfairly prejudicial to Monarch to allow Harper to testify. In sum, we grant Motion 7 in its entirety.

II. *Expert Witnesses*

Motions 6 and 8 concern expert witnesses. Motion 6 concerns Ronald Domsky. Domsky was identified in a supplemental answer; however, like the answer discussed in Motion 2 above, it was addressed to Monarch's counsel's previous address. Consistent with our ruling above, we will not bar Domsky's testimony. However, Domsky may testify only if he is qualified to do so in an expert capacity, because Boynton has testified that he has no personal knowledge of her case. Additionally, Domsky will be allowed to testify only if Boynton complies with the mandates of Rules 26(a)(2)(B) and 26(a)(4)(A) within three weeks from the date of this Opinion. If these Rules are not complied with, Motion 6 will be granted. We will presently conditionally deny Motion 6.

Motion 8 concerns Paul Faherty and Sandra Oriel. Boynton identified Faherty as an expert in tax law in her pretrial order but did not identify him prior to that time. The first mention of this witness came almost one year after the close of discovery and Boynton provides no explanation for this delay. This is a clear violation of the discovery rules and as a consequence, we will not allow Faherty to testify. *See Schearbrook Land & Livestock Co. v. United States,* 124 F.R.D. 221 (M.D.Fla.1988).

The other person mentioned in Motion 8, Sandra Oriel, acted as a counselor to Boynton. Monarch objects to her testifying as an expert, as she is not licensed, but does not seek to bar her from testifying as a layperson. Boynton indicates that she does not intend to call Oriel as an expert witness. Since the parties agree that Oriel may only testify as a lay witness, we will grant this portion of Motion 8. Specifically, Oriel may testify, but may not offer expert opinions. Further, Boynton may not refer to Oriel as a "counselor" as this may confuse the jury about the capacity in which Oriel is testifying. In sum, Motion 8 is granted in its entirety.

III. *Motions Concerning Other Subjects*

Motion 1 concerns documents that were allegedly placed in Boynton's files at work and which she has referred to as pornography. Boynton's contentions about the documents have been known to Monarch for quite some time; however, the documents themselves were only recently produced. While we certainly encourage early production of relevant documents, we will not sanction Boynton by excluding the documents, as we are unable to identify any prejudice or unfair surprise to the defendant that would result from its admission. Motion 1 is denied.

***4** In Motion 9, Monarch seeks to bar evidence (1) that he might be indemnified by the City of Chicago, (2) that the City was previously a defendant in this action, (3) that William Cerney and Paul Vallas were defendants who were dismissed from this ac-

tion, and (4) that Monarch is represented by attorneys from the City's Corporation Counsel's office. Boynton does not object to the first three topics being excluded; accordingly, we will grant that portion of the motion. Boynton urges that the fact that the City would undertake to represent Monarch in this case is relevant to prove the existence of institutional pressure within the Department of Revenue for hearing officers to issue determinations favoring the City. We will grant this portion of the motion as well, because reference to Monarch's attorneys as City attorneys could undermine the effectiveness of excluding evidence about indemnification and the information is not highly relevant. Motion 9 is granted.

Motion 10 seeks to bar evidence of communications between Boynton and Cerney, on the basis that Cerney prevailed in his motion for summary judgment and has been dismissed from the case. Monarch also asserts that the jury might improperly attribute Cerney's alleged remarks to him. We will deny this motion. This motion would not succeed if Cerney had never been a defendant, and the fact that he was named but later was dismissed should not alter that result. We do not find that the risk of jury confusion is significant. Accordingly, we deny motion 10.

Finally, Motion 11 is a motion to bar witnesses from the courtroom during others' testimony, pursuant to Federal Rule of Evidence 615. This motion is unopposed and therefore, will be granted.

CONCLUSION

For the reasons stated above, Motions 3, 7, 8, 9 and 11 are granted. Motions 1, 2, 4, 5 and 10 are denied and Motion 6 is conditionally denied.

N.D.Ill.,1994.
Boynton v. Monarch
Not Reported in F.Supp., 1994 WL 463905 (N.D.Ill.)

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TAB 10

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
Carolyn H. BROWN, Plaintiff,
v.
PRIMERICA LIFE INSURANCE COMPANY, d/b/a Primerica, a corporation, Defendant.
No. 02 C 8175.

April 29, 2006.

Benjamin Obi Nwoye, Mendoza & Nwoye, P.C., Chicago, IL, for Plaintiff.
Daniel J. Zollner, Ross Dixon & Bell, LLP, Chicago, IL, for Defendant.

MEMORANDUM OPINION

CHARLES P. KOCORAS, Chief District Judge.
***1** This matter comes before the court on the motion of Defendant Primerica Life Insurance Company ("Primerica") to strike the supplemental affidavit and to exclude any testimony of putative handwriting expert Curtis Baggett. For the reasons set forth herein, the motion is granted.

BACKGROUND

Plaintiff Carolyn Brown ("Carolyn") is the widow of Terrance Brown ("Terrance"), son of Alberta Brown ("Alberta"). Before Carolyn and Terrance were married, Terrance purchased a life insurance policy from Primerica. Initially, Alberta was the named beneficiary of the policy. In 2000, after the couple married, Terrance substituted Carolyn as the beneficiary. Approximately two years later, Terrance and Carolyn separated, and Terrance moved into his mother's home.

On August 23, 2002, a man identifying himself as Terrance Brown entered a Primerica office in Chicago. He informed the agent, Francis Giroux, that he wished to change the beneficiary of his life insurance policy from Carolyn back to Alberta. He also stated that he wanted to make his premium payment. Giroux elicited the necessary biographical information to complete the form, which was then signed. He did not request that the man produce any form of identification. A premium payment was also made via Western Union money order.

About two weeks later, Terrance drowned off the coast of Massachusetts.

According to the terms of the policy, a change of beneficiary is effective on the date that Primerica receives written notice from the insured that the change is desired. Based on the form Giroux submitted as well as an informal internal investigation, Primerica determined that a change of beneficiary had been effected on August 23 and that Alberta was the beneficiary of the policy at the time of Terrance's death. Accordingly, the proceeds of the policy were paid to Alberta.

Carolyn disputes the validity of the August 23 change of beneficiary. She contends that the man at Giroux's office was not Terrance and thus that the form he executed has no legal effect on the terms of the policy. According to Carolyn, the operative document is the 2000 change of beneficiary, which names her, not Alberta, as the designated recipient of the policy proceeds. After various unfruitful conversations with Primerica in which she advanced the theory that the August 23 form was a forgery, Carolyn filed the instant suit, alleging that Primerica breached its contractual obligations under the policy by paying to Alberta rather than her.

Discovery was initially set to close on July 11, 2003. It was extended three times, to September 15, then November 17, and finally to December 1. On December 8, 2003, Primerica moved for summary judgment, and Carolyn followed suit at the end of the following February. In support of her motion, Carolyn supplied a four-paragraph affidavit from

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Baggett wherein he conclusorily opined that the August 23 signature was in fact a forgery. Primerica moved to strike the affidavit on the grounds that it was insufficient to satisfy Fed.R.Evid. 702. In conjunction with the reply for her motion for summary judgment, Carolyn filed a "supplemental" affidavit from Baggett, which set forth the same opinion embodied in the prior affidavit and provided some indication of the methods Baggett used to come to his conclusions. We ordered that Carolyn produce Baggett for a voir dire hearing to allow us to determine if Baggett was qualified to provide expert testimony. The hearing was postponed a number of times and as yet has not taken place.

***2** Primerica filed the instant motion attacking the admissibility of Baggett's second affidavit for two reasons.[FN1] First, it argues that the opinion was not submitted in a timely fashion, making its exclusion mandatory under Fed.R.Civ.P. 37(c)(1). Second, it continues to press arguments with respect to the sufficiency of Baggett's qualifications and his proffered opinion.

> FN1. Primerica requested that the affidavit be stricken in the reply it filed in support of the motion to strike the original affidavit. Because Carolyn had no opportunity to respond to the arguments in the course of that briefing, we were unwilling to address the issue at that time. Thus, this is the first time that the request to strike is properly before us in a posture suitable for adjudication.

LEGAL STANDARDS

Rule 26(a)(2)(B) provides that expert witnesses must prepare and sign a written report containing a complete statement of all opinions to be expressed. The statement must provide the basis and reasons for the opinions, the data the expert considered in reaching the opinion, the witness's qualifications, and other specified information. Rule 26(e)(1) provides that if any correction or addition is necessary to provide complete disclosure of an expert opinion, that process must take place before the time for disclosure has expired under Rule 26(a)(3). The sanction for failure to abide by these rules can be substantial; Rule 37(c)(1) states that "[a] party that without substantial justification fails to disclose information required by Rule 26(a) or 26(e)(1) ... is not, unless such failure is harmless, permitted to use as evidence at trial, at a hearing, or on a motion any witness or information not so disclosed."

Admissibility of expert testimony is governed by Fed.R.Evid. 702. The rule provides that if "(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case," the expert will be allowed to offer testimony regarding his or her opinion. When expert scientific testimony is proffered, the court must serve as a gatekeeper and exclude the testimony unless the expert's testimony is based on scientific knowledge rather than speculation, and the testimony will assist the trier of fact in determining a factual issue in the case. *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 591 (1993); *Chapman v. Maytag Corp.,* 297 F.3d 682, 686 (7th Cir.2002). Professed scientific knowledge will not be acceptable unless the expert employs the scientific method and supports the outcome with appropriate validation. *Daubert,* 509 U.S. at 590. The term "scientific" indicates "a grounding in the methods and procedures of science" and the term "knowledge" indicates "more than subjective belief or unsupported speculation." *Porter v. Whitehall Laboratories, Inc.,* 9 F.3d 607, 613 (7th Cir.1993). In determining whether testimony is based upon scientific knowledge and thus is reliable, the court should consider whether the hypothesis can and has been tested, whether the hypothesis has been the subject of peer review and publication, the "known or potential rate of error" for the method or theory, and whether the scientific community generally accepts the hypothesis as true. *Daubert,* 509 U.S. at 594.

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***3** With these principles in mind, we turn to the motion at hand.

DISCUSSION

According to Primerica, the information contained in Baggett's supplemental affidavit was not disclosed to it until the affidavit was filed in conjunction with Carolyn's response to the motion to strike the initial affidavit. Carolyn does not dispute this contention; her only response is that the affidavit supplemented her prior disclosure and thus was proper under the rules. She relies upon the first sentence of Rule 26(e)(1), which states that "[a] party is under a duty to supplement at appropriate intervals its disclosures under subdivision (a) if the party learns that in some material respect the information disclosed is incomplete or incorrect and if the additional or corrective information has not otherwise been made known to the other parties during the discovery process or in writing."

Carolyn's argument fails for two independent reasons. First, as described above, Rule 26(a)(2) requires that experts provide a report containing a complete statement of the opinion to be proffered and the informational and methodological components that led to the ultimate opinion. Under Carolyn's formulation of the process, rather than abiding by this rule in the first instance, a party can supply a vague and conclusory expert statement and wait to comply with this provision until a report is challenged in a motion to strike. This completely defeats the purpose of the disclosure process, making it possible to delay full disclosure until after the time for discovery has elapsed. As Primerica notes, this scenario is precisely what took place in this case, and it is foreclosed both from deposing Baggett or supplying its own expert to counter his conclusions. The prejudicial effect to Primerica of allowing Carolyn to benefit from this course of action is clear.

Second, as also described above, the second sentence of Rule 26(e)(1) specifically refers to the manner in which expert testimony is to be supplemented. It unequivocally states that any supplementation must be done within the time that disclosures are due under Rule 26(a)(3). Our direction to the parties was to complete all discovery, including anything pertaining to experts, by November 17, 2003. The supplemental affidavit, filed April 27, 2004, is not timely. Rule 37(c)(1) addresses the consequences of untimely disclosure. Unless the party proffering the information has a substantial justification for the failure to provide it in a timely manner or the failure is harmless, it may not be used as evidence. Carolyn has provided no justification for her failure, and Primerica's inability to explore Baggett's assertions or counter them precludes any possibility that the failure could be deemed harmless. Accordingly, the supplemental affidavit will be stricken.

Without the supplemental affidavit, the only testimony Baggett could give in this case would be limited to that advanced in the initial affidavit. In its entirety, Baggett's affidavit states the following:

***4** I have examined four documents purported to have been written and signed by Terrance Brown. For the purpose of this examination, I have labeled these exhibits "K1" [sic], "K2", "K3", and "K4". Today, I have compared the known signatures and handwriting of Terrance Brown on the "K" exhibits to a questioned document identified herein as "Q 1", to determine if the same author signed Terrance Brown's name to the questioned document. It is my professional expert opinion that a different person authored the questioned document "Q1". Someone indeed forged Terrance Brown's name on the insurance agreement and authorization section on the "Q1" document. I am willing to testify to this fact in a court of law and I will prove to the court that my opinion is correct.

This affidavit is unquestionably inadequate to underlie expert testimony. First, it offers no hint of what comprised Baggett's comparison of the two documents; we have no information that would allow a determination of whether he employed any

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methodology at all, let alone whether it could be separated from "subjective belief or unsupported speculation." *Daubert v. Merrill Dow Pharmaceuticals, Inc.,* 509 U.S. 579, 590, 113 S.Ct. 2786 (1993). Second, he gives no explanation of the basis for or reasons behind his opinion that document Q1, the August 23 beneficiary change form, was forged. Baggett has provided no information whatsoever to enable this court to assess whether it satisfies any of the criteria listed in Rule 702. "An expert who supplies nothing but a bottom line supplies nothing of value to the judicial process." *Mid-State Fertilizer Co. v. Exchange Nat'l. Bank of Chicago,* 877 F.2d 1333, 1339 (7th Cir.1989); *see also* *McMahon v. Bunn-O-Matic Corp.,* 150 F.3d 651, 657-58 (7th Cir.1998).

Based on the materials provided by Baggett, we are simply to take his word blindly, which is not a course that we can or will follow. *See* *Minasian v. Standard Chartered Bank,* 109 F.3d 1212, 1216 (7th Cir.1997). Even assuming that Baggett is qualified to render the opinion he states, a point on which we make no comment,[FN2] there is no indication that he applied any specialized knowledge or skills to the task he was asked to perform. *See* *Huey v. United Parcel Serv., Inc.,* 165 F.3d 1084, 1087 (7th Cir.1999). As the court in *Minasian* said, "an expert's report that does nothing to substantiate this opinion is worthless, and therefore inadmissible."*Id.* Thus, Baggett cannot offer any knowledge that would assist a jury in understanding the evidence or determining any facts in issue in this case, his testimony is not admissible under Rule 702.

> FN2. Because we cannot analyze the viability of Baggett's methodology as required by *Daubert* and its progeny, no purpose is served by examining whether his credentials would permit him to offer expert testimony.

CONCLUSION

Based on the foregoing discussion, the motion to strike the supplemental affidavit of Curtis Baggett and to exclude him as an expert witness is granted.

N.D.Ill.,2006.
Brown v. Primerica Life Ins. Co.
Not Reported in F.Supp.2d, 2006 WL 1155878 (N.D.Ill.)

END OF DOCUMENT

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TAB 11

United States District Court, S.D. Illinois.
Vicki CHAMBLISS, Plaintiff,
v.
ILLINOIS DEPARTMENT OF CORRECTIONS and Brent Finley, Defendants.
No. 05-cv-4175-JPG.

Feb. 15, 2007.

John A. Baker, Baker, Baker & Krajewski LLC, Springfield, IL, for Plaintiff.
Ericka Sanders, Matthew D. Bilinsky, Illinois Attorney General's Office, Springfield, IL, for Defendants.

MEMORANDUM AND ORDER

J. PHIL GILBERT, U.S. District Judge.
***1** This matter comes before the Court on the motion for summary judgment filed by defendants the Illinois Department of Corrections ("IDOC") and Brent Finley ("Finley") (Doc. 25). Plaintiff Vicki Chambliss ("Chambliss") has responded to the motion (Doc. 29) and the defendants have replied to that response (Doc. 37). Chambliss has also filed a motion to strike certain exhibits upon which the defendants' summary judgment motion relies (Doc. 30), and the defendants have responded to that motion (Doc. 34).

In this case, Chambliss alleges that IDOC, her employer, is liable under Title VII of the Civil Rights Act, 42 U.S.C. § 2000e*et seq.,* for sexual harassment, and that Finley, her supervisor, is liable under 42 U.S.C. § 1983 for sexual harassment in violation of her Fourteenth Amendment equal protection rights. The defendants contend that Chambliss cannot establish a case of sexual harassment and, if she could, they would be entitled to assert an affirmative defense and, as for Finley, he would be entitled to qualified immunity.

I. Standard for Summary Judgment

Summary judgment is appropriate where "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."Fed.R.Civ.P. 56(c); *see* *Celotex Corp. v. Catrett,* 477 U.S. 317, 322 (1986); *Spath v. Hayes Wheels Int'l-Ind., Inc.,* 211 F.3d 392, 396 (7th Cir.2000). The reviewing court must construe the evidence in the light most favorable to the nonmoving party and draw all reasonable inferences in favor of that party. *See* *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 255 (1986); *Spath,* 211 F.3d at 396. This standard is applied with special scrutiny in cases such as employment discrimination cases that often turn on issues of intent and credibility. *Michas v. Health Cost Controls of Ill., Inc.,* 209 F .3d 687, 692 (7th Cir.2000). Where the moving party fails to meet its strict burden of proof, a court cannot enter summary judgment for the moving party even if the opposing party fails to present relevant evidence in response to the motion. *Cooper v. Lane,* 969 F.2d 368, 371 (7th Cir.1992).

In responding to a summary judgment motion, the nonmoving party may not simply rest upon the allegations contained in the pleadings but must present specific facts to show that a genuine issue of material fact exists. Fed.R.Civ.P. 56(e); *Celotex,* 477 U.S. at 322-26; *Johnson v. City of Fort Wayne,* 91 F.3d 922, 931 (7th Cir.1996). A genuine issue of material fact is not demonstrated by the mere existence of "some alleged factual dispute between the parties," *Anderson,* 477 U.S. at 247, or by "some metaphysical doubt as to the material facts," *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 586 (1986); *Michas,* 209 F.3d at 692. Rather, a genuine issue of material fact exists only if "a fair-minded jury could return a verdict for the [nonmoving party] on the evidence presented." *Anderson,* 477 U.S. at 252;*accord* *Michas,* 209 F.3d

at 692.

II. Evidence Considered

A. *Motion to Strike*

***2** As a preliminary matter, the Court must address to what extent, if at all, it will consider the exhibits Chambliss seeks to strike when it assesses the evidence in support of the motion for summary judgment. In ruling on a motion for summary judgment, the Court considers only evidence that would be admissible at trial. *See* *Smith v. City of Chicago,* 242 F.3d 737, 741 (7th Cir.2001); *Woods v. City of Chicago,* 234 F.3d 979, 988 (7th Cir.2000).

Chambliss asks the Court to strike three exhibits offered in support of the defendants' motion for summary judgment:

- A February 3, 2004, IDOC report by Leslie McCarty ("McCarty"), an IDOC investigator, about the investigation of a sexual harassment complaint made by Sharon Humm ("Humm"), one of Chambliss's coworkers ("Humm Report");

- An April 25, 2004, IDOC report by McCarty about the investigation of a sexual harassment complaint made by Chambliss ("Chambliss Report"); and

- A February 6, 2004, letter from Humm to McCarty ("Humm letter"). Chambliss claims that these documents are out of court statements and cannot therefore be offered for the truth of the matters asserted therein under Federal Rule of Evidence 802.

1. *Humm and Chambliss Reports*

Chambliss does not contest that the two reports are admissible for the purposes of showing that an investigation was conducted, but believes they cannot be used to show that the statements in the reports are true. She believes the reports do not fall into the business records exception to the hearsay rule. Fed.R.Evid. 803(6).

The defendants agree with Chambliss that they may use the reports to show that an investigation was conducted and also believe that they may use the reports to show the extent of the investigation, what information IDOC had been given, and whether its response was reasonable based on that information. *See*Fed.R.Evid. 803(3). It also believes Chambliss's statements as recorded in the Report would be admissible as admissions of a party-opponent, *see*Fed.R.Evid. 801(d)(2), and that the entire reports are admissible as public records or reports, *see*Fed.R.Evid. 803(8)(C), or business records, *see*Fed.R.Evid. 803(6).

The defendants are correct that the reports can be used to show the existence of their investigations as well as what information IDOC received during those investigations for the purpose of demonstrating their knowledge and explaining their beliefs and responses in light of that knowledge. When used for those purposes, the reports are not being used for the truth of the matters asserted in them but for IDOC's state of mind, regardless of whether the statements in the reports were truthful. Thus, the reports are not hearsay under Rule 801(c) and are admissible when offered for those purposes. *See* *Woods v. City of Chicago,* 234 F.3d 979, 986-87 (7th Cir.2000) (criminal complaint and arrest report admissible to show whether reasonable officer in arresting officers' position would have had probable cause to believe crime had been committed).

***3** The Court further finds that the reports are not admissible for the truth of their substance under Rule 803(8)(C) as public records or reports.Rule 803(8) is an exception to the hearsay rule for

> [r]ecords, reports, statements, or data compilations, in any form, of public offices or agencies, setting forth ... (C) in civil actions and proceedings ... factual findings resulting from an investigation made pursuant to authority granted by law, unless the sources of information or other circumstances indicate lack of trustworthiness.

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Although the reports at issue here may technically qualify as "factual findings resulting from an investigation made pursuant to authority granted by law," the sources of information in the reports-the complainants' fellow IDOC employees-lack sufficient trustworthiness. The report essentially contains responses from IDOC employees who were asked to describe various aspects of their work environment. The witnesses' statements were not under oath and were full of subjective statements and opinions. Furthermore, as demonstrated by some of the statements themselves, the witnesses may have been motivated by petty gripes and jealousies about their coworkers rather than a desire to tell the truth. There was no hearing held to assess the credibility of the witnesses and to arrive at a conclusion, and the reports themselves were rendered by a representative of a party to this litigation. In the foregoing respects, the reports at issue here are distinguishable from the administrative Equal Employment Opportunity Commission ("EEOC") findings found to be admissible in *Young v. James Green Mgmt., Inc .,* 327 F.3d 616, 624 (7th Cir.2003). For these reasons, the statements in the reports are not the kind of trustworthy data that this Court will accept as evidence absence additional safeguards such as, for example, being subject to cross-examination or being sworn to or declared under penalty of perjury.

The Court further finds that the reports are not admissible under Rule 803(6) as business records. Rule 803(6) is an exception to the hearsay rule for records of regularly conducted activities:

> A memorandum, report, record, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record or data compilation, all as shown by the testimony of the custodian or other qualified witness, or by certification that complies with Rule 902(11), Rule 902(12), or a statute permitting certification, unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness. The term "business" as used in this paragraph includes business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit.

***4** This exception does not generally render reports admissible, even when kept in the regular course of business, where the supplier of the information in the report does not act in the regular course of business. *See*Fed.R.Evid. 803 advisory committee's notes on 1972 proposed rules. Furthermore, for the same reason the Court did not find the reports trustworthy as public records under Rule 803(8)(C), it finds that they are not trustworthy as business records under Rule 803(6) and will not consider this for the truth of the matters reported in them in deciding the pending summary judgment motion.

As for Chambliss's statements in the reports, the defendants are correct that if they are sought to be used against her in this case, they are not hearsay because they fall under Rule 801(d)(2)(A). However, the defendants have not overcome the first layer of hearsay, that McCarty has not testified herself as to what Chambliss said. Had McCarty testified in a deposition or affidavit as to what Chambliss said in the interviews, that evidence would be admissible. McCarty's out of court statement recounting Chambliss's alleged statements are not.

2. *Humm Letter*

Chambliss asks the Court to disregard the statements in the Humm letter that Chambliss was engaging in sexually inappropriate behavior in the workplace because they are hearsay-Humm's out-of-court statements about what she heard other people say happened when she was on a leave of absence.

Again, Humm's letter does not qualify as a public

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record or a business record, and had Humm herself testified in a deposition or stated in an affidavit about her first-hand knowledge about what Chambliss said or did, it might have been admissible as an admission of a party opponent. However, her letter is hearsay and will not be considered by the Court for the truth of the matters asserted in it.

For these reasons, the Court will grant the motion to strike (Doc. 30) to the extent it asks the Court not to consider the interviewees' statements in the reports or Humm's statements in her letter for the truth of the events they report.

B. *Chambliss Affidavit*

In their reply brief, the defendants ask the Court to disregard portions of Chambliss's affidavit offered in opposition to the summary judgment motion on the ground that it conflicts with her deposition testimony and that she has not given a reasonable explanation for the conflict.

The law is well-established that "in general, parties may not 'patch-up potentially damaging deposition testimony' with a contradictory affidavit." *Commercial Underwriters Ins. Co. v. Aires Envtl. Servs.,* 259 F.3d 792, 799 (7th Cir.2001) (quoting *Maldonado v. U.S. Bank,* 186 F.3d 759, 769 (7th Cir.1999)). "Where deposition and affidavit are in conflict, the affidavit is to be disregarded unless it is demonstrable that the statement in the deposition was mistaken, perhaps because the question was phrased in a confusing manner or because a lapse of memory is in the circumstances a plausible explanation for the discrepancy." *Russell v. Acme-Evans Co.,* 51 F.3d 64, 67-68 (7th Cir.1995))); *Lawson v. CSX Transp., Inc.,* 245 F.3d 916, 919 n. 4 (7th Cir.2001). This rule applies, however, only where the discrepancies are transparent shams, not where they are simply clarifications of earlier ambiguous or confusing statements where they merely go to the credibility of the witness. *Bank of Ill. v. Allied Signal Safety Restraint Sys.,* 75 F.3d 1162, 1169-72 (7th Cir.1996). Furthermore, the Court will consider a contradictory affidavit if the declarant satisfactorily explains the discrepancy in the testimony. *Commercial Underwriters,* 259 F.3d at 799.

***5** If Chambliss's affidavit contradicts her deposition testimony and there is no plausible explanation for the conflict, the Court will disregard that portion of the affidavit in ruling on the summary judgment motion. The Court will examine each alleged conflict separately and, if necessary, will note in its recitation of the facts when affidavit statements have been disregarded.

Most of the defendants' objections, however, are to additional facts presented in Chambliss's affidavit that supplement but do not conflict with her deposition testimony. To the extent that the defendants object because Chambliss adds in her affidavit details that she did not include in her deposition but that do not contradict her deposition, the Court will consider those affidavit statements. Chambliss's lack of completeness at her deposition can easily be attributed to poor or insufficient questioning; a deponent cannot be faulted for failing to answer questions that were not asked.

III. Facts

Taken in the light most favorable to Chambliss, the evidence establishes the following facts.

A. *Chambliss's Employment*

Chambliss, a woman, has worked for IDOC at Big Muddy Correctional Center ("Big Muddy") since October 1994. During her employment, IDOC maintained a sexual harassment policy which Chambliss concedes was part of IDOC's reasonable efforts to prevent and correct promptly sexually harassing behavior about which it knew. Under that policy, if a person feels she is being sexually harassed, she is supposed to tell the harasser she does not want the harassment, tell the harasser to stop and inform the harasser's supervisor. If her supervisor is the harasser, she is supposed to inform the next higher person in the chain of command and fill

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out an incident report.

Chambliss started working in the business office as an Account Tech 1 in 1999. The business office consisted of a common room about 40 feet by 40 feet containing about 9 to 12 desks arranged in rows and two adjacent, private offices for the business administrator and the business manager. Most of the business office employees, including Chambliss and one male coworker, worked in the common area, and because of the relatively small size of the room, the heavy workload, lack of sufficient staff and the fast pace, the environment was stressful. To relieve the stress, light chatter among employees was common, and the chatter often included comments and jokes with sexual or vulgar content. Many employees also joked openly about their personal sex lives and teased other employees about theirs. Male and female employees alike participated in the vulgar and sexual chatter, although at least one female employee, Sharon Humm, was extremely uncomfortable with it.

Chambliss herself discussed personal sexual matters with female friends in the office but did not participate in the office-wide comments of a sexual nature.

B. *Finley's Arrival*

In January 2003, Finley became the business administrator. Chambliss and all the other business office employees reported directly to Finley, who was responsible for conducting their evaluations and approving leave time and overtime.

***6** To relieve office stress, Finley joined in the office chatter, often speaking using casual sexual overtones and constantly making sexual jokes and comments when both men and women were present in the office. Finley was also the butt of jokes by business office employees, which he would tolerate with good humor. Chambliss never made any comment of a sexual nature in front of Finley. He was a large man, and Chambliss was intimidated by him.

About three months after he began to work in the business office, Finley began the conduct about which Chambliss complains in this case. At that time, he made faces and commented that Lisa Asbury ("Asbury"), who had come in the office from another department, had a "nice ass" and that he would like to "have some of that." He repeated this comment approximately 25 times between April and November 2003.

Three to five times Finley described pornographic movies to the entire office generally and one time to Chambliss when he was alone with her in his office. When he described the movie to Chambliss alone, she told him she did not want to hear about it.

On one occasion in July 2003, Chambliss had submitted a request to leave work early one day. Finley wrote a note and stuck it on Chambliss's leave request reading, "Nooner?" implying she needed time off to have sex in the middle of the day. Chambliss did not say anything to Finley about the note.

Another time in July or September 2003, Finley called Chambliss into his office after she had taken time off and asked her if she had had sex during her leave and other detailed questions about her private sex life. When she refused to answer his questions, he kept inquiring about the details of her sexual experiences on her vacation. Throughout the conversation, Chambliss said she did not want to discuss it and she ultimately left Finley's office.

Also in July 2003, after Finley and Chambliss had argued about something, Finley hugged Chambliss tightly for five to ten seconds in his office to signify that they had made up. She did not hug him back and did not think the hug was appropriate, but she did not say anything to him about it.

In October 2003, Finley brought in a birthday cake shaped like a woman's breasts for Chambliss's and another employee's birthday.

Also in October 2003, Finley called Chambliss into

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his office and told her in detail about a sexual dream he had had about her best friend, Karla Klindworth ("Klindworth"), who worked in the Big Muddy warden's office. Chambliss said she did not want to hear it. Finley then asked Chambliss to tell Klindworth about the dream and to help Finley get to know Klindworth better. Again, Chambliss refused. Finley approached Chambliss another time about Klindworth, but Chambliss said she did not want to listen to him.

On another occasion in October or November 2003, Chambliss challenged Finley to lose weight and discussed with Finley and other business office employees what the office could do to reward him if he met his weight loss goal. Later, Finley called Chambliss into his office and asked her to go out for drinks with him as a reward for his weight loss. She refused and returned to her desk. This was the only time Chambliss believed Finley was making any attempt to become romantically involved with her.[FN1]

FN1. To the extent that Chambliss's affidavit conflicts with her deposition testimony, the affidavit testimony has been disregarded.

***7** In addition to these specific instances, Finley also made numerous comments of a sexual nature. For example, he also said in Chambliss's presence on multiple occasions that his "memory was as short as his penis," and whenever he went to the bathroom he complained that he needed to lose weight so he could reach his penis. Finley also commented once that after work he liked to jump naked into his hot tub and that sex was good with his wife. When speaking to Chambliss, he also said once that in Texas you could hire women to clean your house while naked and that they were fun to watch.

C. *Humm's Sexual Harassment Complaint*

In response to a sexual harassment complaint against Finley by Humm in December 2003, IDOC investigator McCarty began an internal investigation. In February 2004, she compiled the Humm Report for her IDOC superiors. It did not contain a report of complaints from Chambliss about the sexual jokes in the workplace or about Finley's behavior. Chambliss failed to report Finley's behavior to McCarty because Finley had reminded her that he could be vindictive to her by, for example, moving her desk or changing her work hours from the 7 a.m. to 3 p.m shift to the 8 a.m. to 4 p.m. shift. She was afraid Finley would treat her badly if she told the truth. McCarty ultimately concluded in the Humm Report that there had been no sexual harassment in violation of IDOC's sexual harassment policy.

Following Humm's complaint, Chambliss threatened that she would file another sexual harassment complaint against Finley if he made her mad.

D. *Office Changes*

In early March 2004, Finley met with Mary Ann Bohlen ("Bohlen"), IDOC central accounting supervisor and the IDOC employee ultimately responsible for giving guidance to Big Muddy's business office. Prior to the meeting, Finley had assigned duties relating to the inmate trust fund to several employees, including Chambliss, but Bohlen recommended that Finley assign all duties relating to maintaining the inmate trust fund to one employee, Chambliss, as had been done at Big Muddy in the past. Bohlen also reminded Finley that employees should be expected to complete their regular job tasks during normal working hours without working overtime.

On March 5, 2004, shortly after his meeting with Bohlen, Finley assigned all trust fund duties to Chambliss, adjusted her work hours from the 7 a.m. to 3 p.m. shift to the 8 a.m. to 4 p.m. shift and stopped authorizing her overtime to complete her assigned job tasks. Chambliss then began taking de-

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tailed notes about events in the business office; none of her notes reflected any conduct or speech of a sexual nature. When Finley declined to approve overtime for Chambliss on March 23, 2004, she and Finley got into an argument.

The following day, March 24, 2004, Chambliss orally complained to Big Muddy's warden, Greg Lambert, that Finley had been sexually harassing her. Warden Lambert immediately instructed Chambliss to speak to IDOC's Affirmative Action office and set up a telephone conference the same day for her to speak with McCarty. McCarty later interviewed Chambliss in person and told Chambliss to e-mail her if she wanted to report anything else. Chambliss did not experience any sexual harassment by Finley after she reported him to Warden Lambert.

***8** Chambliss never submitted an incident report to the warden about Finley's offensive conduct as IDOC's sexual harassment policy provides because she thought it would be futile, she thought the warden did not like her and she thought she would have been treated like an outcast in the office.

In April 2004, McCarty submitted the Chambliss Report, which ultimately determined that Chambliss's claims of sexual harassment by Finley could not be substantiated.

On May 10, 2004, Chambliss learned that Warden Lambert did not want her to visit Klindworth in his office anymore, and she was worried that she would be referred for discipline. That same day, Chambliss began a leave of absence because of workplace stress she attributed to Finley's offensive conduct. She has been in counseling since July 2004 to work through issues regarding the treatment she received from Finley.

On September 12, 2005, Chambliss timely filed this lawsuit. The complaint makes claims of sexual harassment against IDOC in violation of Title VII of the Civil Rights Act of 1964 ("Title VII"), 42 U.S.C. § 2000e-2(a)(1) (Count I), sexual harassment against Finley in violation of 42 U.S.C. § 1983 and the Fourteenth Amendment's equal protection clause (Count II), and retaliation against Finley in violation of § 1983 and the First Amendment (Count III). Chambliss concedes that Count III should be dismissed with prejudice in light of the recent decision of the Supreme Court in *Garcetti v. Ceballos,* 126 S.Ct. 1951 (2006). Counts I and II are the subject of the pending summary judgment motion filed by the defendants.

IV. Analysis

Title VII prohibits discrimination on the basis of sex: "It shall be an unlawful employment practice for an employer to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's ... sex...."42 U.S.C. § 2000e-2(a)(1). The Fourteenth Amendment's equal protection clause contains a similar prohibition. It forbids any state to "deny to any person within its jurisdiction the equal protection of the laws."U.S. Const. amend. XIV. Essentially, the clause guarantees "a right to be free from invidious discrimination in statutory classifications and other governmental activity," *Harris v. McRae,* 448 U.S. 297, 322 (1980), and includes the right to be free from sexual harassment, *Valentine v. City of Chicago,* 452 F.3d 670, 682 (7th Cir.2006); *Bohen v. City of E. Chicago,* 799 F.2d 1180, 1185 (7th Cir.1986). The standard of proof for Title VII and § 1983 equal protection sexual harassment claims is essentially the same, *Murray v. Chicago Transit Auth.,* 252 F.3d 880, 887 (7th Cir.2001), so although this analysis primarily speaks in the Title VII vocabulary, most of it applies equally to Chambliss's § 1983 claim against Finley.

The sex discrimination prohibited by Title VII and the Fourteenth Amendment includes sexual harassment that is so severe or pervasive that it alters the condition of the victim's employment and creates an abusive working environment even where there is

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no tangible employment action. *Meritor Sav. Bank v. Vinson,* 477 U.S. 57, 67 (1986). Courts generally refer to these types of cases as "hostile environment" cases. Chambliss does not argue that she suffered a tangible employment action in this case and has thus forfeited that position for the purposes of this motion, so the hostile environment framework guides the Court's consideration of Chambliss's claims.[FN2]

FN2. To the extent that Chambliss may be arguing that her May 2004 leave of absence amounted to a constructive discharge, that claim is simply unsupported by the record. "A constructive discharge occurs when an employee resigns his or her current position because the employee considers the conditions intolerable and a reasonable employee also would have found the conditions made remaining in the job unbearable." *Robinson v. Sappington,* 351 F.3d 317, 336 (7th Cir.2003) (citing *Lindale v. Tokheim Corp.,* 145 F.3d 953, 955 (7th Cir.1998)). The evidence in this case shows that Chambliss suffered no sexual harassment after her complaint to Warden Lambert on March 24, 2004. Thus, no reasonable jury could find that her working conditions in May 2004 were intolerable.

***9** In order to establish such a hostile environment sexual harassment claim, a plaintiff must show,

> (1) she was subjected to unwelcome sexual advances, requests for sexual favors or other verbal or physical conduct of a sexual nature; (2) the conduct was severe or pervasive enough to create a hostile work environment; (3) the conduct was directed at her because of her sex; and (4) there is a basis for employer liability.

Rhodes v. Illinois Dep't of Transp., 359 F.3d 498, 505 (7th Cir.2004).[FN3]

FN3. Some Seventh Circuit opinions continue to add the requirement that the hostile work environment seriously effect the plaintiff's psychological well-being. *See Valentine v. City of Chicago,* 452 F.3d 670, 677 (7th Cir.2006); *Durkin v. City of Chicago,* 341 F.3d 606, 611 (7th Cir.2003). These cases rely on cases that predate *Harris v. Forklift Systems, Inc.,* 510 U.S. 17 (1993). *See Valentine,* 452 F.3d at 677 (citing *Parkins v. Civil Constrs. of Ill., Inc.,* 163 F.3d 1027, 1032 (7th Cir.1998) (citing *Rennie v. Dalton,* 3 F.3d 1100, 1107 (7th Cir.1993) (citing *Swanson v. Elmhurst Chrysler Plymouth, Inc.,* 882 F.2d 1235, 1238 (7th Cir.1989)))); *Durkin,* 341 F.3d at 611 (citing *Hall v. Bodine Elec. Co.,* 276 F.3d 345, 354-55 (7th Cir.2002) (citing *Parkins,* 163 F.3d at 1032 (citing *Rennie,* 3 F.3d at 1107 (citing *Swanson,* 882 F.2d at 1238)))).*Harris* held that "[s]o long as the environment would reasonably be perceived, and is perceived, as hostile or abusive ..., there is no need for it also to be psychologically injurious." *Harris,* 510 U.S. at 22.

In this case, the defendants argue that (1) Finley's conduct was not unwelcome to Chambliss, (2) Finley's conduct was not based on Chambliss's sex, (3) Chambliss's working environment was not severe or pervasive enough to create an objectively hostile environment and (4) there is no basis for employer liability. In discussing the subject of employer liability, the defendants assert an affirmative defense that Chambliss did not reasonably seek to avoid the harassment. Finley individually argues that he cannot be liable under § 1983 because (1) he was not acting under color of state law and (2) he is entitled to qualified immunity.

1. *Unwelcome Sexual Advances*

A reasonable jury could find that the sexual harassment to which Finley subjected Chambliss was unwelcome.

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The defendants argue that Chambliss herself instigated and encouraged sexually explicit conversations and jokes in the workplace and that such conduct indicates that the sexual talk Finley subjected her to was not unwelcome. It is true that where a plaintiff was a willing and welcome participant in sexual banter, jokes and teasing in the workplace, she cannot establish that such conduct was unwelcome. *See* *Reed v. Shepard,* 939 F.2d 484, 491 (7th Cir.1991) (holding that plaintiff who exhibited an "enthusiastic receptiveness to sexually suggestive jokes and activities" and whose "preferred method of dealing with co-workers was with sexually explicit jokes, suggestions and offers" did not establish the conduct was unwelcome).

This case, however, is not like *Reed.*Considering the evidence in Chambliss's favor, as the Court must at this stage, the Court finds that although Chambliss may have spoken about sexual topics at work, she did so in private conversations and not as a part of the office-wide sexual banter. Furthermore, the evidence viewed in Chambliss's favor also demonstrates that Chambliss never made comments of a sexual nature in front of Finley, and frequently expressed her objections or ignored Finley when he talked about sexual topics with her. This presents a picture vastly different from that in *Reed,* where overwhelming evidence at trial painted the plaintiff as a willing creator of and participant in the sexually charged environment. Based on the facts in this case, the Court believes a reasonable jury could find that Finley's conduct toward Chambliss was unwelcome.

2. *Directed at Chambliss Because of Her Sex*

A reasonable jury could find that the sexual harassment to which Finley subjected Chambliss was based on her sex.

***10** The defendants argue that Chambliss was subject to sexual comments because of her personality-she was inclined to sexual talk-not her gender. Citing *Reed* again, the defendants note that where sexual comments are in response to the plaintiff's preference for resorting to sexual jokes, suggestions and offers, they cannot be said to be because of her sex. *See* *Reed v. Shepard,* 939 F.2d 484, 491 (7th Cir.1991). The defendants further note that Finley's sexual talk in the office occurred in the presence of men as well as women, so both sexes were equally harassed.

Had Finley's sexual comments to the office as a whole been the sole conduct about which Chambliss complained, the defendants' argument might have merit. However, the record contains several instances that a reasonable jury could view as targeting Chambliss because she is a woman. For example, it is reasonable to believe that Finley would not have hugged a male employee when making up from a fight or asked a male employee out on a date. The record also contains several instances that a reasonable jury could view as harassment of other women or women in general that Chambliss was exposed to second hand. For example, Finley made improper sexual comments repeatedly about Asbury and brought in a cake shaped like a woman's breasts. These instances could be viewed as harassment because of Chambliss's sex.

3. *Hostile Environment*

Chambliss has not presented enough evidence from which a reasonable jury could find that she was subject to an actionable hostile environment. A hostile work environment is created by conduct that has "the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile, or offensive working environment." *Meritor Sav. Bank v. Vinson,* 477 U.S. 57, 65 (1986); *accord* *Cooke v. Stefani Mgmt. Servs.,* 250 F.3d 564, 566 (7th Cir.2001). Sexual harassment that creates a hostile work environment is actionable under Title VII only if it is "so 'severe or pervasive' as to 'alter the conditions of [the victim's] employment and create an abusive working environment.' " *Faragher v. City of Boca Raton,* 524 U.S. 775, 786 (1998) (quoting Meritor, 477

U.S. at 67) (further internal quotations omitted); *see also* *Clark Co. Sch. Dist. v. Breeden,* 532 U.S. 268, 270 (2001) (*per curiam*); *Burlington Indus., Inc. v. Ellerth,* 524 U.S. 742, 752 (1998). "Harassment need not be severe *and* pervasive to impose liability; one or the other will do." *Hostetler v. Quality Dining, Inc.,* 218 F.3d 798, 808 (7th Cir.2000).

Whether an environment is objectively sufficiently hostile or abusive must be judged by " 'looking at all the circumstances,' including the 'frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or a mere offensive utterance; and whether it unreasonably interferes with an employee's work performance.' " *Faragher,* 524 U.S. at 787-788 (quoting *Harris v. Forklift Sys.,* 510 U.S. 17, 23 (1993)) (further internal quotations omitted); *accord* *Breeden,* 532 U.S. at 270-71; *Murray v. Chicago Transit Auth.,* 252 F.3d 880, 888-89 (7th Cir.2001). Courts "should not carve up the incidents of harassment and then separately analyze each incident, by itself, to see if each rises to the level of being severe or pervasive." *Mason v. Southern Ill. Univ.,* 233 F.3d 1036, 1045 (7th Cir.2000). "[S]imple teasing, offhand comments, and isolated incidents (unless extremely serious) will not amount to discriminatory changes in the terms and conditions of employment." *Faragher,* 524 U.S. at 788 (quotations and citations omitted); *accord* *Breeden,* 532 U.S. at 271. For example, a court has found that "teasing about waving at squad cars [like a prostitute might], ambiguous comments about bananas, rubber bands, and low-neck tops, staring and attempts to make eye contact, and four isolated incidents in which a co-worker briefly touched her arm, fingers, or buttocks" did not amount to an impermissibly hostile environment as a matter of law. *Adusumilli v. City of Chicago,* 164 F.3d 353, 361-62 (7th Cir.1998). On the other hand, an uninvited kiss and an attempt at a second one, an attempt to remove a plaintiff's bra, and lewd proposition for sex were sufficient to state a hostile environment claim. *Hostetler,* 218 F.3d at 807-08.

***11** In addition, "[t]he employee must subjectively perceive the harassment as sufficiently severe and pervasive to alter the terms or conditions of employment, and this subjective perception must be objectively reasonable." *Cooke,* 250 F.3d at 566-67 (citing *Harris,* 510 U.S. at 21-22);*accord* *Murray,* 252 F.3d at 889.

This is a close case, but considering all the circumstances the Court must conclude that Chambliss has not presented enough evidence from which a reasonable jury could find that she was subject to an objectively hostile work environment because of Finley's conduct. There is evidence that from the day Finley began working in the business office, he participated in chatter of a sexual nature on a daily basis to the office in general, but Chambliss does not complain of Finley's behavior when he first began working in the business office. She only complains of the conduct that began about three months after Finley started work: his 25 comments about Asbury, his describing pornographic movies once to her alone and as many as five times to the office in general, his note on her leave request, the one time he interrogated her about her sexual experiences on her vacation, his hugging her for five to ten seconds, his bringing in a birthday cake in the shape of a woman's breasts, his telling her about his dream about Klindworth, his asking her out on a date, and numerous other comments to the office in general. This conduct all occurred over an approximately one year period.

While Finley's behavior was certainly boorish, it did not create an objectively hostile work environment for Chambliss. His behavior consisted mostly of relatively innocuous and non-threatening offensive utterances, many of which were in line with the sexual banter in the business office that existed before he began working there in January 2003. Although Finley's comments were frequent, a good number of them were not directed at Chambliss herself. When harassing statements are "directed at someone other than the plaintiff, the impact of [such] 'second hand harassment' is obviously not as

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great as the impact of harassment directed at the plaintiff." *McPhaul v. Madison Co. Board of Comm'rs,* 226 F.3d 558, 567 (7th Cir.2000) (internal quotations and citations omitted). The conduct that was directed at Chambliss was neither severe nor pervasive; there was only one instance of physical touching-a hug-and a handful of offensive comments and questions. Chambliss only viewed one instance as a sexual advance toward her, and she was able to rebuff it simply by refusing Finley's invitation for a date and returning to her desk. Furthermore, all of the conduct about which Chambliss complained occurred over about a year and was simply not sufficiently severe or pervasive to alter the terms and conditions of Chambliss's employment by creating an objectively abusive working environment.

4. *IDOC's Liability*

Even if Chambliss's work environment had been objectively hostile, the Court finds that IDOC is not liable for the sexually harassing hostile environment experienced by Chambliss.

***12** Generally, employers are vicariously liable for an actionable hostile environment created by a supervisor with authority over the victimized employee. *Faragher v. City of Boca Raton,* 524 U.S. 775, 807 (1998); *Burlington Indus., Inc. v. Ellerth,* 524 U.S. 742, 765 (1998); *Molnar v. Booth,* 229 F.3d 593, 600 (7th Cir.2000). If the harassment culminated in tangible employment action against the employee, the employer is strictly liable for the supervisor's acts. *Faragher,* 524 U.S. at 808; *Ellerth,* 524 U.S. at 760-61; *Rhodes v. Illinois Dep't of Transp.,* 359 F.3d 498, 505 (7th Cir.2004). However, if the supervisor did not take any tangible employment action against the employee, as it did not in this case, the employer may raise an affirmative defense to liability or damages. *Faragher,* 524 U.S. at 807; *Ellerth,* 524 U.S. at 765; *Rhodes,* 359 F.3d at 505-06. To succeed in its affirmative defense, the employer must show (1) that it exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (2) that the employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by her employer or to avoid harm otherwise. *Faragher,* 524 U.S. at 807; *Ellerth,* 524 U.S. at 765; *Molnar,* 229 F.3d at 600.

Chambliss does not seriously contest that IDOC has met its burden of showing that it exercised reasonable care to prevent and correct promptly sexually harassing behavior about which it knew. She takes issue, however, with IDOC's proof of the second element-that she unreasonably failed to take advantage of preventative or corrective opportunities provided to her. The requirement that an employee report sexually harassing conduct arises out of her duty to take reasonable care to avoid harm. *Faragher,* 524 U.S. at 806; *Cerros v. Steel Techs., Inc.,* 398 F.3d 944, 952 (7th Cir.2005)."[T]he law against sexual harassment is not self-enforcing and an employer cannot be expected to correct harassment unless the employee makes a concerted effort to inform the employer that a problem exists." *Parkins v. Civil Constrs. of Ill., Inc.,* 163 F .3d 1027, 1038 (7th Cir.1998) (quotations omitted).

The Court finds that IDOC has met its burden of showing that Chambliss unreasonably failed to take advantage of its sexual harassment reporting mechanisms. It is undisputed that Chambliss had the opportunity to report Finley's harassing activities at any time by either speaking to the warden or filing an incident report and that during the investigation of Humm's complaint, McCarty specifically gave Chambliss an opportunity to comment on Finley's behavior. Instead of telling the truth, Chambliss actively deceived McCarty as to the nature of Finley's conduct in the business office. Furthermore, it is clear that Chambliss knew about the sexual harassment reporting channels, for she threatened to use them to report Finley after the investigation of Humm's complaint if Finley made her mad. It is also undisputed that Chambliss did not report Finley's harassing activity until March 24, 2004, when she spoke to Warden Lambert, and that after her re-

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port, Finley's sexual harassment stopped. Thus, the critical question is whether Chambliss's failure to use available reporting mechanisms before March 24, 2004, was unreasonable.

***13** IDOC argues that Chambliss's failure to use the multiple avenues of redress available to her establishes the second element of its affirmative defense. "[W]hile proof that an employee failed to fulfill the corresponding obligation of reasonable care to avoid harm is not limited to showing an unreasonable failure to use any complaint procedure provided by the employer, a demonstration of such failure will normally suffice to satisfy the employer's burden under the second element of the defense." *Faragher,* 524 U.S. at 807-08.

Chambliss, on the other hand, argues that she did not use the reporting channels in IDOC's sexual harassment policy or report Finley's conduct to McCarty in her investigation of Humm's complaint because she was afraid of retaliation by Finley, she thought a report would be futile, she thought the warden did not like her and she thought she would have been treated like an outcast in the office. A reasonable fear of retaliation can constitute a legitimate excuse for failing to take advantage of preventative or corrective opportunities or otherwise to avoid harm. *See* *Johnson v. West,* 218 F.3d 725, 732 (7th Cir.2000). For example, in *Johnson,* the Court of Appeals held that a probationary employee's failure to report harassment might be reasonable where the supervisor had threatened that she would lose her job if she complained, verbally abused her and threw mail in her face. *Id.* However, the thing feared must be substantial before it can render a failure to report reasonable. "[A]n employee's subjective fears of confrontation, unpleasantness or retaliation" are not enough to render a failure to report reasonable. *Shaw v. AutoZone, Inc.,* 180 F.3d 806, 813 (7th Cir.1999) (employee unreasonably failed to report sexual harassment where she simply "didn't feel comfortable enough with anyone at [her place of employment] to speak with them about the offensive and repulsive sexual conduct displayed towards her by [her supervisor]"); *see* *Hill v. American Gen. Fin., Inc.,* 218 F.3d 639, 644 (7th Cir.2000) (noting that "apprehension does not eliminate the requirement that the employee report harassment").

This case does not present the type of situation that might have prompted a reasonable failure to report sexual harassment. Chambliss states that she feared retaliation by Finley if she reported him, but the retaliation she feared was that he would change her shift by one hour, move her desk or be vindictive or treat her badly in some other unspecified way. She also thought her coworkers would treat her like an outcast. However, these fears, even if true, are not of such a serious nature that they would excuse a reasonable employee from carrying out her very important duty to report sexual harassment in order to avoid further harm to herself. The evidence reflects that Chambliss did not fear for her job, her personal safety or her emotional well-being, like the *Johnson* plaintiff might have. She simply did not want to work different hours or sit in a different location in the office. Furthermore, her unspecified fears that Finley would be vindictive or treat her badly, that her complaints would be futile and that the warden did not like her are simply too vague and unsupported to carry any weight.

***14** In the circumstances in the record, a reasonable jury would be compelled to find that Chambliss's failure to report Finley's harassment before March 24, 2004, was unreasonable. As a consequence, IDOC has established an affirmative defense to liability had Chambliss been able to prove her case.

5. *Finley's Liability*

Finley offers a number of theories about why he, as an individual, should not be liable for sexual harassment under § 1983. The Court will address each theory in turn as an alternative basis for finding that the defendants are entitled to summary judgment because Chambliss cannot prove an objectively hostile work environment.

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a. *Avoidable Consequences Doctrine*

Finley first argues that the avoidable consequences doctrine applies to shield him from liability because Chambliss unreasonably failed to report Finley's harassment prior to March 24, 2004. The only case he cites for the application of this principle to § 1983 sexual harassment cases is *Savino v. C.P. Hall Co.,* 199 F.3d 925 (7th Cir.1999), a case which does not contain a § 1983 claim. The Court therefore finds that Finley has failed to carry his burden of establishing that he is entitled to judgment as a matter of law because of this doctrine.

b. *Color of State Law*

Finley also denies that he was acting under color of state law when he harassed Chambliss because he was pursuing his own personal objectives. In order to prevail on a § 1983 claim, a plaintiff must prove, among other things, that the defendant was acting under color of state law. *See Gomez v. Toledo,* 446 U.S. 635, 640 (1980).“Action is taken under color of state law when it involves a misuse of power, possessed by virtue of state law and made possible only because the wrongdoer is clothed with the authority of state law.” *Honaker v. Smith,* 256 F.3d 477, 484 (7th Cir.2001) (internal quotations omitted).“[A]cts by a state officer are not made under color of state law unless they are related in some way to the performance of the duties of the state office.” *Id.* at 485.

Finley's claims that he was not acting under color of state law are disingenuous. During each instance of his offensive conduct, he was at work, acting as the business office administrator, exercising his discretion to manage the business office and cloaked in the authority given him by IDOC, an arm of the State of Illinois. Each act was related to the performance of his duties as business administrator and was facilitated by his professional status as a supervisor. That Finley did not expressly invoke his authority as supervisor to impose his harassment on Chambliss does not mean he was not acting with the authority and backing of the state Thus, no reasonable jury could find that he was not acting under color of state law.

c. *Qualified Immunity*

Finally, Finley argues that he is entitled to qualified immunity from liability for Chambliss's sexual harassment charges. Qualified immunity is an affirmative defense that shields government officials from liability for civil damages where their conduct does not violate clearly established statutory or constitutional rights of which a reasonable person would have known. *Harlow v. Fitzgerald,* 457 U.S. 800, 818 (1982); *Denius v. Dunlap,* 209 F.3d 944, 950 (7th Cir.2000). It protects an official from suit “when she makes a decision that, even if constitutionally deficient, reasonably misapprehends the law governing the circumstances she confronted.” *Brosseau v. Haugen,* 543 U.S. 194, 198 (2004); *accord Saucier v. Katz,* 533 U.S. 194, 206 (2001). It applies only to state officials who occupy positions with discretionary or policymaking authority and who are acting in their official capacities. *Harlow,* 457 U.S. at 816; *Denius,* 209 F.3d at 950.

***15** A court required to rule upon the qualified immunity issue must first consider whether the facts alleged, taken in the light most favorable to the party asserting the injury, show that the officer's conduct violated a constitutional right. *Saucier,* 533 U.S. at 201;*see Brosseau,* 543 U.S. at 197; *Wilson v. Layne,* 526 U.S. 603, 609 (1999). If it is clear that there has been no constitutional violation, there is no need for further inquiry; the officer is entitled to qualified immunity. *Saucier,* 533 U.S. at 201. In the interest of promoting clarity in legal standards, the Court should decide the first question even if the officer is clearly immune. *Wilson,* 526 U.S. at 609; *Denius,* 209 F.3d at 950.

If the evidence demonstrates that there may have been a constitutional violation, then the court should determine whether the right allegedly viol-

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ated was clearly established at the relevant time. *Saucier,* 533 U.S. at 202."This inquiry, it is vital to note, must be undertaken in light of the specific context of the case, not as a broad general proposition." *Id.* at 201;*see* *McNair v. Coffey,* 279 F.3d 463, 465 (7th Cir.2002)."If the law did not put the officer on notice that his conduct would be clearly unlawful, summary judgment based on qualified immunity is appropriate." *Saucier,* 533 U.S. at 202. The plaintiff bears the burden of demonstrating that a constitutional right is clearly established. *Denius,* 209 F.3d at 950.

The Court has already decided that Chambliss cannot established a constitutional violation because she cannot prove that she was exposed to an objectively hostile work environment. Thus, she cannot overcome the first prong of the qualified immunity test.

To the extent that this finding was a close call, Finley is further protected, for he is entitled to qualified immunity if it was not clear to a reasonable official that his conduct would violate the equal protection clause. It is true that it was clearly established in 2003 and 2004 that, as a general proposition, sexual harassment severe or pervasive enough to create an objectively hostile environment violates the equal protection clause. *See* *Bohen v. City of E. Chicago,* 799 F.2d 1180, 1185 (7th Cir.1986). It was not clear, however, that the things Finley did amounted to an objectively hostile environment. Sexual harassment cases involve unique fact patterns, and while some of those fact patterns involve sexual harassment that is so extremely severe or so extremely pervasive that a reasonable official should know that such conduct is definitely over the line, most cases fall into a gray area. It is hard to determine equivalent levels of harassment in caselaw to guide one's conduct. Are twenty comments, one touch and six leers better or worse than ten comments, two touches and no leers? As long as conduct falls into a gray area, the unlawfulness of an official's conduct is not clearly established. Thus, had the Court not found that Chambliss's work environment was not objectively hostile, it would have found that it was not clearly established at the time that Finley's conduct was unlawful.

***16** For these reasons, the Court finds that Finley is entitled to qualified immunity and to summary judgment on that basis.

V. Conclusion

For the foregoing reasons, the Court

• **DISMISSES** Count III with prejudice;

• **GRANTS** Chambliss's motion to strike (Doc. 30) to the extent it asks the Court not to consider the interviewees' statements in the Humm Report and the Chambliss Report and Humm's statements in her letter for the truth of the events they report;

• **GRANTS** the defendants' motion for summary judgment (Doc. 25) on Counts I and II; and

• **DIRECTS** the Clerk of Court to enter judgment accordingly.

IT IS SO ORDERED.

S.D.Ill.,2007.
Chambliss v. Illinois Dept. of Corrections
Not Reported in F.Supp.2d, 2007 WL 518774 (S.D.Ill.), 72 Fed. R. Evid. Serv. 533

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TAB 12

LEXSEE 2003 U.S. DIST. LEXIS 12628

CHICAGO PRIME PACKERS, INC., Plaintiff, v. NORTHAM FOOD TRADING CO., Defendant.

Cause No. 01 C 4447

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

2003 U.S. Dist. LEXIS 12628

July 22, 2003, Decided
July 22, 2003, Docketed

SUBSEQUENT HISTORY: Judgment entered by Chi. Prime Packers v. Northam Food Trading Co., 2004 U.S. Dist. LEXIS 9347 (N.D. Ill., May 21, 2004)

PRIOR HISTORY: *Chi. Prime Packers, Inc. v. Northam Food Trading Co., 2003 U.S. Dist. LEXIS 9122 (N.D. Ill., May 28, 2003)*

DISPOSITION: [*1] Plaintiff's Motion to Bar Expert Testimony of John Maltby denied and Defendant's Motion in Limine denied without prejudice.

COUNSEL: For Chicago Prime Packers, Inc, PLAINTIFF: R Matthew Simon, Joseph J Griseta, Simon & Spitalli, Chicago, IL USA.

JUDGES: GERALDINE SOAT BROWN, United States Magistrate Judge.

OPINION BY: GERALDINE SOAT BROWN

OPINION

MEMORANDUM OPINION AND ORDER

Before the court are Plaintiff's Motion to Bar Expert Testimony of John Maltby [dkt # 84] and Defendant Northam Food Trading's Motion in Limine [dk # 85]. For the reasons set out below, Plaintiff's motion is denied. Defendant's motion is also denied, but without prejudice and with a caveat.

As an initial matter, "motions in limine are disfavored." *Mi-Jack Products v. International Union of Operating Engineers, Local 150, 1995 U.S. Dist. LEXIS 16930, No. 94 C 6676, 1995 WL 680214 at *1 (N.D. Ill. Nov. 14, 1995)*(Conlon, J.) Generally, "evidence should not be excluded in limine unless it is clearly inadmissible on all potential grounds." *Id.* Rather, rulings on evidence "ordinarily should be deferred until trial" when they may be resolved in the proper context. *Id.* The movant bears the burden of showing that the evidence that it seeks to preclude is "clearly inadmissible." *Plair v. E.J. Branch & Sons, Inc., 864 F. Supp. 67, 69 (N.D. Ill. 1994).* [*2] Denial of a motion in limine is *not* a ruling that the material that is the subject of the motion is necessarily admissible. Denial of a motion in limine means only that "outside the context of trial, the court cannot determine whether the evidence in question is admissible." *Id. at 69*. Thus, "[a] ruling on a motion in limine is not a final ruling on the admissibility of the evidence which is the subject of the motion." *Moore v. General Motors Corp., Delco Remy Division, 684 F. Supp. 220 (S.D. Ill. 1988)*. Indeed, "an order on a motion in limine has been characterized as an 'advisory opinion subject to change as events at trial unfold.'" *Id.* (*quoting Sales v. State Farm Fire & Casualty Co., 632 F. Supp. 435, 436 (N.D. Ga. 1986))*.

I. Plaintiff's Motion to Bar Expert Testimony of John

Maltby

Plaintiff has moved to bar any expert testimony and reports by John Maltby. Dr. Maltby is not a retained expert. He is the United States Department of Agriculture ("USDA") inspector who, in May, 2001, ordered the destruction of the pork ribs that are at issue in this case. Dr. Maltby did not prepare a report pursuant to *Fed. R.* [*3] *Civ. P. 26(a)(2)(B)*. Rather, he wrote a memorandum "to whom it may concern" on May 23, 2001, the day he inspected the ribs, discussing his examination of the ribs, information he had learned from other individuals including USDA Inspector Ken Ward and Compliance Officer Chris Chlarson, and questions that remained to be answered. That memorandum, referred to by the parties as Dr. Maltby's report, is written on USDA letterhead. Plaintiff argues that Dr. Maltby has not been properly disclosed pursuant to *Fed. R. Civ. P. 26(a)(2)(B)* and is thus precluded from testifying as an expert.

Rule 26(a)(2)(A) requires that ". . . a party shall disclose to other parties the identity of any person who may be used at trial to present evidence under *Rules 702, 703, or 705* of the Federal Rules of Evidence." *Rule 26(a)(2)(B)* includes more detailed disclosure requirements for "a witness who is retained or specially employed to provide expert testimony in the case or whose duties as an employee of the party regularly involve giving expert testimony." Plaintiff does not offer any support for its argument that Dr. Maltby falls within the scope of *Rule 26(a)(2)(B)*.

Defendant's disclosure relating to Dr. [*4] Maltby complies in format with *Rule 26(a)(2)(A)*. Defendant stated in an interrogatory response:

> It is anticipated that Dr. John Maltby of the USDA will testify as an opinion witness at any trial of this matter. Defendant furthermore states that the qualifications of Dr. Maltby and the subject matter and conclusions to which Dr. Maltby will testify are fully contained in his discovery deposition transcript and his written report of May 23, 2001.

(Def.'s Interrogatory Res. P 10, cited in Pl.'s Mot. at 2.)

Plaintiff cites the *Mi-Jack* case for the proposition that failure to comply with *Rule 26(a)(2)* precludes the use of the non-disclosed expert. (Pl.'s Mot. at 3.) It is apparent from the context, however, that the decision in the *Mi-Jack* case involved motions to bar the testimony of *retained* witnesses for failure to comply with *Rule 26(a)(2)(B)*'s detailed disclosure requirements. Thus, the *Mi-Jack* case does not apply to the present case.

Rule 26(a)(4) provides that "unless the court orders otherwise, all disclosures under *Rules 26(a)(1) through (3)* must be made in writing, signed, and served." *Rule 26(a)(2)(C)* states that expert disclosures are to be [*5] made as directed by the court. Plaintiff asserts that, while unsigned responses were provided earlier, Defendant's signed interrogatory responses were not received until October 30, 2002, fifteen days after expert disclosures were required by the parties' Joint Discovery Plan. (Pl.'s Mot. at 2, n. 1.) The Joint Discovery Plan was adopted by the court. [Dkt # 39]. Thus, Plaintiff implicitly argues, Dr. Maltby was not properly disclosed even under *Rule 26(a)(2)(A)*.

Failure to comply with the expert disclosure provisions of *Rule 26* is addressed by *Rule 37*. *Rule 37(c)(1)* states:

> A party that without substantial justification fails to disclose information required by *Rule 26(a)or 26(e)(1)*, or to amend a prior response to discovery as required by *Rule 26(e)(2)*, is not, unless such failure is harmless, permitted to use as evidence at a trial, at a hearing, or on a motion any witness or information not so disclosed. In addition to or in lieu of this sanction, the court, on motion and after affording an opportunity to be heard, may impose other appropriate sanctions.

The Seventh Circuit has stated:

> The sanction of exclusion is automatic and mandatory unless the sanctioned [*6] party can show that its violation of *Rule 26(a)* was either justified or harmless. . . . We have indicated that the following factors should guide the district court's discretion [in determining whether a *Rule 26(a)* violation is justified or harmless]: (1) the prejudice or surprise to the party against whom the evidence is offered; (2) the ability of the party to cure the

> prejudice; (3) the likelihood of disruption to the trial; and (4) the bad faith or willfulness involved in not disclosing the evidence at an earlier date.

David v. Caterpillar, Inc., 324 F.3d 851, 857 (7th Cir. 2003)(citations and internal quotations omitted).

Regardless of whether Defendant's failure to serve a signed and sworn interrogatory answer within the required period of time was justified, it is clear that Plaintiff suffered no prejudice as a result. Dr. Maltby's existence and the nature of his findings were well known to Plaintiff prior to Defendant's formal disclosure of its intention to call him as a witness. Indeed, by that time Plaintiff had deposed him and had access to his report. *See* Pl.'s Mot. at 3. The unsigned interrogatory answers provided explicit written notice [*7] that Defendant was contemplating calling him as an opinion witness. The formal, signed interrogatory answers followed shortly after the deadline had passed. Plaintiffs have not identified any specific prejudice that resulted from the short delay. Thus, Plaintiff's motion to exclude opinion testimony by Dr. Maltby is denied.

Working on the erroneous assumption that Dr. Maltby will not be able to testify as an opinion witness, Plaintiff then argues that Dr. Maltby's report is not a public report under *Fed. R. Evid. 803(8)*, and seeks to have it stricken as based on inadmissible hearsay evidence, specifically, information provided by Inspector Ward to Dr. Maltby. (Pl.'s Mot. at 4-5). [1] That part of Plaintiff's motion is likewise denied.

> 1 Under *Fed. R. Evid. 703*, an expert may base his or her opinion on inadmissable evidence if such evidence is "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject." *See Daubert v. Merrelll Dow Pharmaceuticals, Inc., 509 U.S. 579, 592, 125 L. Ed. 2d 469, 113 S. Ct. 2786 (1993)*("an expert is permitted wide latitude to offer opinions, including those that are not based on firsthand knowledge or observation.") That includes hearsay. *Grant v. Chemrex, 1997 U.S. Dist. LEXIS 6058, No. 93 C 0350, 1997 WL 223071 at *7 (N.D. Ill. April 28, 1997)*(Marovich, J.).

[*8] Dr. Maltby's report is admissible under *Fed. R. Evid. 803(8)*, which creates an exception to the hearsay rule for "reports . . . of public offices or agencies, setting forth (A) the activities of the office or agency, or (B) matters observed pursuant to duty imposed by law as to which matters there was a duty to report . . . or (C) in civil actions and proceedings and against the Government in criminal cases, factual findings resulting from an investigation made pursuant to authority granted by law, unless the sources of information or other circumstances indicate lack of trustworthiness." That exception to the rule against hearsay is "grounded on the premise of trustworthiness [,] the notion that reports prepared by those with a duty to do so were inherently trustworthy." *Wetherill v. University of Chicago, 518 F. Supp. 1387, 1389 (N.D. Ill. 1981)*.

The fact that the report is based in part on information Dr. Maltby received from Inspector Ward does not require its exclusion. Although "the person who prepared the report is typically required to have personal knowledge of the activities or facts . . . government officials may rely on colleagues or subordinates who [*9] have the requisite knowledge." Jack B. Weinstein and Margaret A. Berger, 5 *Weinstein's Federal Evidence* § 803.10[3][a] at 803-91 (2003). "Nothing in either the text or the history of *Rule 803(8)* supports an approach that would make the rule essentially useless--for the bureaucrat who fills out a governmental form usually incorporates information furnished by others." *In the Matter of Oil Spill by the Amoco Cadiz, 954 F.2d 1279, 1308 (7th Cir. 1992)*. Plaintiff does not dispute the reliability of Dr. Maltby's report beyond asserting that it is based in part on hearsay. *See Beech Aircraft Corp. v. Rainey, 488 U.S. 153, 167, n.11, 102 L. Ed. 2d 445, 109 S. Ct. 439 (1988)*(discussing nonexclusive four factor test for determining the trustworthiness of report admitted pursuant to *Fed. R. Evid. 803(8)*).

Plaintiff's Motion is therefore denied. [2]

> 2 An issue not briefed by the parties is whether the information that was communicated by Inspector Ward to Dr. Maltby and used by Dr. Maltby as the basis of his findings can be admitted for the truth of Inspector Ward's statements. *Compare In re Oil Spill by the Amoco Cadiz, 954 F.2d at 1308* ("*Rule 803(8)* is a multi-level exception, in the footsteps of its common law precursors") *with In re James Wilson Associates, 965 F.2d 160, 172-73 (7th Cir. 1992)*(expert may explain facts underlying

opinion even if facts are inadmissible, but the facts may not be admissible for other purposes).

[*10] **II. Defendant's Motion**

Defendant seeks an order "barring Plaintiff from offering opinion testimony from any person, employee of Chicago Prime Packers, Inc., or Nationwide Foods that was not properly disclosed pursuant to *Rule 26(a)(2)(B)*. . . ." (Def.'s Mot. at 1.) Defendant states that Plaintiff has not identified any individuals who will offer opinion testimony at trial. (*Id.*) Defendant further states that although Plaintiff was granted permission to adopt the opinion witnesses of now-dismissed co-defendant Nationwide Foods, Nationwide likewise had not disclosed any opinion witnesses. (*Id.* at 2.)

Defendant's motion is denied without prejudice as moot because Plaintiff has disclaimed any intention of offering an opinion witness, and admits that it never disclosed any opinion witness. (Pl.'s Resp. Def.'s Mot. in Limine at 1-2.) However, Plaintiff's Response also states that "Plaintiff will seek testimony from witnesses that may be considered opinion testimony under *Rule 701 of the Federal Rules of Evidence*," particularly about industry practice and the spoliation of frozen foods. (*Id.* at 2-3.) Plaintiff quotes a version of *Rule 701* that was superceded by the [*11] 2000 amendments to that Rule. (*Id.* at 2.) Significantly, *Rule 701* was amended to add an additional *subsection (c)*, requiring that lay opinion evidence "not [be] based on scientific, technical, or other specialized knowledge within the scope of *Rule 702*." *Fed. R. Evid. 701(c)*.

As the Committee Comments to the 2000 amendments demonstrate, that subsection was added specifically to "ensures that a party will not evade the expert witness disclosure requirements set forth in *Fed. R. Civ. P. 26* and *Fed. R. Crim. P. 16* by simply calling an expert witness in the guise of a layperson." Committee Comments, 2000 Amendments to *Rule 701*. *See also Nichols v. Johnson, 2002 U.S. Dist. LEXIS 7745, No. 00 C 7785, 2002 WL 826482 at *4 (N.D. Ill. May 1, 2002)*(Schenkier, M.J.)(excluding testimony of police officer that would be based on his training and experience where officer was not disclosed as expert witness).

Plaintiff is therefore cautioned that, although Defendant's motion is, strictly speaking, moot at this time, the court will entertain an objection at the time of trial to any evidence or testimony that would present opinion testimony that is dependant on scientific, technical, or other specialized [*12] knowledge without appropriate prior disclosure under *Rule 26(a)(2)*.

Defendant's motion is denied as moot without prejudice.

IT IS SO ORDERED.

GERALDINE SOAT BROWN

United States Magistrate Judge

DATED: July 22, 2003

TAB 13

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.

Joardis DAVIS, Plaintiff,

v.

Harold M. ROWE, individually and doing business as Rowe Company Fine Arts; and the Rowe Company Fine Arts, Inc., an Illinois corporation, Defendants.

No. 91 C 2254.

Feb. 10, 1993.

MEMORANDUM OPINION

KOCORAS, District Judge:

***1** This matter comes before the Court on defendants' six motions in limine seeking to prohibit the plaintiff from presenting certain evidence and witness testimony at trial. For the following reasons, the motion is granted in part and denied in part.

First Motion in Limine: The Hartford Letter, the Rowe Statement, and the Davis Letter

Plaintiff, Joardis Davis ("Davis"), filed this suit to recover for the loss of art she had consigned to defendants, Harold M. Rowe, individually and doing business as Rowe Company Fine Arts, and the Rowe Company Fine Arts, Inc. (collectively referred to as "Rowe"). The art was destroyed in a fire on April 15, 1989. Under the Illinois Consignment of Art Act, Rowe is responsible to Davis for the fair market value of the Davis art in its possession at the time of the fire. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(5) (Smith-Hurd Supp.1992). In addition, Rowe is responsible for paying Davis a portion of the insurance proceeds it received due to an insurance contract that Rowe procured in fulfillment of a consignment agreement between Davis and Rowe. On May 20, 1992, this Court denied Rowe's motion for summary judgment, finding that Davis' claims depended upon the fair market value of the art lost and that the fair market value of the consigned art at the time of the fire was an issue of fact to be determined by the jury at trial.

Citing Federal Rule of Evidence 408, Rowe asks this Court to prohibit Davis from submitting several statements made by Rowe concerning the value of the Davis art collection that was lost in the fire. The first statement that Rowe seeks to exclude from the jury was made October 19, 1989 by Harold M. Rowe ("the Hartford letter"). Harold Rowe indicated that "the value of the collection was $4,635,000." He later affirmed this under oath ("the Rowe statement"). Rowe secondly seeks to exclude a letter that was sent by the Rowe Company to Davis ("the Davis letter"), which states, "The total value of the art library and the works of art destroyed in the Rowe Company Gallery far exceeded the insurance coverage." [FN1] The Davis letter additionally states that "the parties ... recognize and acknowledge that the value of the consigned works of art of Warren Davis far exceeded $250,000."

Before we determine the merits of Rowe's motion in limine as to these statements, we first shall recount the principles of law that apply under Rule 408.

A. *The Legal Standard Under Rule 408*

Rule 408 makes inadmissible evidence of offers, acceptances, conduct, or statements made during settlement negotiations that are presented to prove a party's liability for or the invalidity of a claim or its amount.[FN2] Rule 408"does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness...."

In *Kritikos v. Palmer Johnson, Inc.,* 821 F.2d 418 (7th Cir.1987), the Seventh Circuit commented upon the policy behind Rule 408 in addressing the situation of a plaintiff who had refused to accept

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late delivery of a yacht from the defendant shipbuilder on the ground that the yacht failed to meet specifications. Shortly after the plaintiff refused to accept late delivery of the yacht, the plaintiff's representative wrote letters summarizing discussions with the boat architects, discussions which indicated that the defendant was not responsible for all of the delays in delivery. The court held that the letters were not admissible under Rule 408 because they were written with the objective of advising the plaintiff of a possible compromise solution before legal action was commenced. According to the court, the purpose of Rule 408 is "to encourage settlements. The fear is that settlement negotiations will be inhibited if the parties know that their statements may later be used as admissions of liability." *Kritikos,* 821 F.2d at 423 (quoting, *Central Soya Co., Inc. v. Epstein Fisheries, Inc.,* 676 F.2d 939 (7th Cir.1982)); *see also, U.S. v. Lorince,* 773 F.Supp. 1082, 1101 (N.D.Ill.1991). In view of this policy, documents prepared in connection with settlement efforts should not be admitted as evidence. *Lorince,* 773 F.Supp. at 1101 (citing, *Blu-J, Inc. v. Kemper C.P.A. Group,* 916 F.2d 637, 642 (11th Cir.1990) (holding that an independent evaluation prepared for purpose of exploring settlement was inadmissible under Rule 408; *Ramada Development Co. v. Rauch,* 644 F.2d 1097 (5th Cir.1981) (finding a report detailing flaws in construction of motel, which was commissioned as a basis for settlement negotiations, inadmissible)).

***2** Therefore, if we find that the statements that Davis seeks to admit into evidence were made within the context of settlement efforts, we shall exclude them under Rule 408. The question presented by the parties is how broadly to construe the term "settlement efforts." As Judge Moran noted in *Prudential Ins. Co. v. Curt Bullock Builders, Inc.,* 626 F.Supp. 159, 164 (N.D.Ill.1985), the admission of any statement made during, or any document prepared for, any kind of conciliation effort raises a Rule 408 issue. However, in order for this evidence to be excluded, a claim must actually be in dispute at the time the statement was made or that the document was prepared. *Id.* Several courts have found that an actual dispute existed sufficient to invoke Rule 408 even though the parties had not yet asserted their claims. *See e.g., E.E.O.C. v. Gear Petroleum, Inc.,* 948 F.2d 1542, 1544-45 (10th Cir.1991) (refusing to admit a letter from the defendant even though it was sent prior to the completion of the EEOC investigation); *Mundy v. Household Finance Corp.,* 885 F.2d 542, 546-47 (9th Cir.1989) (upholding the exclusion of a settlement offer to a former employee made after the employee's termination and after he had retained legal counsel, but prior to the employee's filing his claim). In addition, although Rule 408 applies where an actual dispute exists, an apparent difference of opinion between the parties as to the validity of a claim is enough to call the Rule into play. *Alpex Computer Corp. v. Nintendo Co.,* 770 F.Supp. 161, 163-65 (S.D.N.Y.1991) (citing, *Dallis v. Aetna Life Ins. Co.,* 768 F.2d 1303, 1307 (11th Cir.1985); 2 J. Weinstein and M. Berger, *Weinstein's Evidence,* ¶ 408[01] at 408-10 (1990)).

For the reasons stated below, we find that at the time Rowe made the statements at issue, an adversarial relationship existed between the parties that can be deemed an actual dispute. On this basis, we conclude that Rule 408 prohibits the statements' admission into evidence.

B. *The Hartford Letter and the Rowe Statement*

At the time of the fire on April 15, 1989, the Rowe gallery contained art belonging to Rowe and contained art it had received on consignment from other individuals, including art created by Warren Davis, now deceased, and owned by Joardis Davis. Prior to the Davis consignment, Rowe had secured business interruption insurance and insurance covering furniture and fixtures from Hartford. Harold M. Rowe also had insurance from Hartford that would cover his and his wife's personal property located in the gallery. After executing the consignment agreement with Davis, the Rowe Company secured an additional $250,000 of fine arts insurance

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from Lloyds.

On May 24, 1989, Rowe's counsel gave formal notice to Hartford of its claim under the business interruption insurance. The business interruption insurance covered losses incurred by Rowe equal to its net income for a year after the fire. The business interruption insurance policy did not include any recovery limitations based upon Rowe's prior operating history. Thus, Rowe indicated to Hartford that it intended to include in its claim projected sales from art collections from which it had never sold art prior to the fire. These projected sales would include future sales from the Davis art collection, which was a collection from which Rowe had never sold art prior to the fire.

***3** Hartford responded to Rowe's assertion by hiring counsel and an accounting firm. Hartford made it clear that it would oppose any Rowe claim that included projected sales and that did not stem from historical experience. Counsel for Rowe responded by sending a letter to Hartford on October 20, 1989 ("the Hartford letter"). In the letter, Harold M. Rowe stated that "the value of the collection was $4,635,000." According to Rowe, the purpose of this letter was to convince Hartford that the Rowe Company could have sold some art in the year after the fire from art collections from which it had never sold previously. Rowe suggests that it was attempting to settle the business interruption claim without suit.

After sending the Hartford letter, Rowe and its counsel participated in meetings and telephone negotiations with an adjuster and an attorney for Hartford. During the course of these discussions, Hartford's attorney requested that Rowe provide a sworn statement ("the Rowe statement") in connection with the projected sales figures earlier given to Hartford. Rowe did provide such a statement under oath.

Notwithstanding these efforts, the parties could not reach an agreement over the interpretation of the business interruption policy. Hartford continued to take the position that the Davis art had no value prior to its consignment and could not have been sold or promoted successfully. Suit was filed, and Rowe and Hartford settled, "primarily on the basis of the Rowe Company's actual sales prior to the fire."

Davis asks this Court to admit the Hartford letter and Rowe statement into evidence. Davis argues that the letter and statement were made solely for the purpose of supporting Rowe's claim under the business interruption insurance policy. Under the terms of the policy, the insured, that is Rowe, possessed a duty in case of loss to prepare an inventory of damaged property and to submit a signed, sworn statement of loss incurred. According to the policy, fulfilling these duties was a condition precedent to filing suit. Hence, Davis argues that the Hartford letter and the Rowe statement were not documents or statements made during a negotiation effort, and thus excludable under Rule 408, but rather, were made as a *pro forma* step in asserting a claim under the policy. Davis argues that the Hartford letter was not made in an effort to compromise a disputed claim, but rather was made to fulfill the terms of the policy that required such information from a claimant in order to process a claim for insurance benefits. According to Davis, no actual dispute arose concerning the amount of benefits payable under the policy until this information was provided and considered by the insurer.

We reject Davis' contention. The relationship between a claimant and its insurer is inherently adversarial and can generally be assumed to be clothed in continual negotiation and conciliation efforts. When Rowe realized that it would be disallowed from including projected sales figures into its claim under the business interruption insurance, an actual dispute arose between Rowe and Hartford to which Rule 408 applied. It was at that time that Hartford engaged counsel and an accounting firm to defend its position that the claim's parameters would be set by prior operating history only. Moreover, Rowe claims that in the Hartford letter and the Rowe statement, it was providing Hartford

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with projected sales figures, that is, what the art could have been worth in light of Rowe's sales and promotional efforts. Without the inflation caused by Rowe's sales and promotional efforts, Rowe contends that the valuation of the Davis art is much lower. We conclude that Rule 408 precludes the admission of the Hartford letter because it was prepared as part of a negotiation effort. Davis' motion in limine is therefore granted.

C. *The Davis Letter*

***4** After the fire on April 15, 1989, Rowe communicated with all persons who had art in the gallery at the time of the fire. Rowe had numerous discussions with the plaintiff.

Rowe describes what followed next in this way. According to Rowe, during the phone conversations, Davis demanded payment of the entire $250,000 of insurance provided under the consignment agreement, and also discussed strategies whereby she and Rowe could claim additional amounts for the Davis art from those responsible for causing the fire. Rowe contends that it never agreed that Davis was contractually entitled to the $250,000, and in any event was unwilling to make any payment to Davis without a full release from liability. On May 31, 1991, Rowe prepared a letter ("the Davis letter"), which Rowe deems a settlement proposal. The draft proposed to meet plaintiff's demand in exchange for a complete release of the defendants from any further liability.

The draft included what Rowe claims was a self-serving recital, that the Davis art in the gallery at the time of the fire was worth more than the $250,000 of insurance agreed upon in the consignment contract. It said, "The total value of the art library and the works of art destroyed in the Rowe Company Gallery far exceeded the insurance coverage." This was followed by an offer to pay Davis $210,000 (the $250,000 amount less $40,000 advanced to Davis earlier). Davis seeks to admit this statement into evidence.

The draft sent to Davis was not signed by the defendants. It was delivered to Davis in June of 1989. Davis' attorney contacted defendants' counsel directly on June 27, 1989. Thereafter, several revised settlement proposals were exchanged between the attorneys. The parties signed none of these proposals.

Davis contends that, until the May 19, 1989 letter was sent to her indicating that the amount of Davis' loss "far exceeded the insurance proceeds," she had not threatened litigation. She therefore concludes that the letter was sent prior to the existence of an actual dispute between the parties. She claims that she was merely seeking the insurance proceeds that both parties agreed were payable under the consignment agreement. Only later did she retain a lawyer to obtain insurance proceeds she believed were due to her.

We again must reject Davis' contentions. Davis claims that prior to the Davis letter she was merely seeking the insurance proceeds that both parties agreed were payable under the consignment agreement. Although both parties may have agreed that Davis was owed some amount under the agreement, the parties were not in agreement over the exact amount owed at the time the Davis letter was sent, and indeed, are still in dispute over that issue. We determine that this request for a release from liability in exchange for a payment of $250,000 was a negotiation effort. In the Davis letter, Rowe did not say we agree that we owe you $250,000, but said that we "agree to make payment to you of" the $250,000. There is a subtle distinction. Rowe did not recognize that it was responsible for that liability, but merely offered to pay that amount in exchange for a release. After the Davis letter, Davis wrote two letters further demanding that the insurance proceeds payable under the consignment agreement be paid to her. The amount demanded by Davis was never paid, and we subsequently held that the amount owed to Davis depends upon the value of the art, a question that is to be determined by the finder of fact at trial. Because we believe

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that the Davis letter was written in an effort to settle an actual dispute, we decline to admit it in evidence.

D. *Use of the Evidence for Purposes Other Than to Prove the Claim*

***5** Rule 408 provides that exclusion of evidence is not required when the evidence is offered for a purpose other than to prove a claim amount, such as proving bias or prejudice of a witness...." Davis argues that Rowe's "receipt of insurance proceeds from Hartford Insurance in the case at bar in an amount in excess of the $250,000 insurance coverage agreed upon in the consignment agreement, and their subsequent failure to pay all of such proceeds renders Harold Rowe's expected testimony at trial concerning the value of the destroyed Warren Davis art works to be far less credible than it may otherwise appear to a jury." Davis suggests that Harold Rowe's testimony will be biased, and that the statements need to be admitted to establish this bias.

Davis' argument is off the mark. Because Harold Rowe is a defendant and is the president of the corporate defendant to the suit, he will not be testifying as a disinterested witness; his bias will be assumed. Hence, Davis need not introduce Rowe's statements to illustrate his bias. Furthermore, Davis may not use the statements to impeach Rowe. Inconsistent conduct or statements made in connection with compromise negotiations may not be used for impeachment purposes. *E.E.O.C.,* 948 F.2d at 1545 (citing, M. Graham, *Federal Rules of Evidence* 116 (2d ed. 1987)).

Davis additionally argues that this Court must admit the Hartford letter as evidence to show Rowe's intent to defraud and convert the insurance proceeds. This argument is unfounded. The value of the art, and thus, the amount of money that Rowe owes Davis for it, is the factual question central to the claims in this dispute. We held above that Rowe's statements are inadmissible to help prove the amount of Rowe's liability to Davis. Davis attempts to subvert our holding and the policies of Rule 408 by introducing the Hartford letter under the guise of proving claims of fraud and conversion, both of which depend upon the outcome of the factfinder's determination regarding the value of the art. We therefore reject Davis' argument that the evidence should be admitted to prove her claims of fraud and conversion. In doing so, we abide by the admonition of the Tenth Circuit in *Bradbury v. Phillips Petroleum Co.* According to the *Bradbury* court, "when the issue is doubtful, the better practice is to exclude evidence of compromises or compromise offers." *Bradbury v. Phillips Petroleum Co.,* 815 F.2d 1356, 1364 (10th Cir.1987).

To summarize, based on the facts as presented by the parties, we decline to admit either the Hartford letter, the Rowe statement, or the Davis letter into evidence. We find that the statements were made in the midst of settlement negotiations, and that admission for other purposes poses too great a risk that the evidence will be used by the fact finder in evaluating the value of the art.

The Second Motion in Limine: Amount of Insurance Received

Rowe also seeks to exclude evidence of any insurance claimed or collected by it, other than the $250,000 of insurance specified in the consignment contract. Davis responds that this information should be allowed because "[m]ost of those funds were received *only* because defendant was in possession of the plaintiff's artwork." Davis again argues that evidence of the existence of these insurance proceeds is necessary in proving her claims of fraud and conversion of those same proceeds.

***6** Unless events suggest otherwise at trial, we shall exclude all evidence of Rowe's receipt of insurance proceeds beyond the $250,000. This evidence is irrelevant to the question of the value of the Davis art. It is this question upon which the success of Davis' claims under the consignment agreement and under the Illinois Consignment of Art Act rests. Al-

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though this evidence would be relevant to claims for fraud or conversion should these claims be of merit, we hold that allowing such evidence would mislead the jury in their determination of the value of the Davis art and, thus, may be excluded under Federal Rule of Civil Procedure 403.

The Third Motion in Limine: Use of Funds Received

Rowe also asks this Court to refuse to admit evidence illustrating how Rowe used the insurance funds it received, in ways other than making payments to Davis. For example, Davis seeks to tell the jury about babysitting and hairdresser expenses paid with the proceeds of the insurance funds. Davis contends that evidence of Rowe's use of the funds should be admitted because the contract compelled the insurance to be paid over to Davis. Moreover, Davis portrays Rowe as a trustee for the funds that are owed to her and suggests that Rowe's use of the funds for purposes other than for payment to Davis violated that trust arrangement.

The Illinois Consignment of Art Act says that works of fine art received by art dealers are held in trust for the owners. The art dealer is trustee for the benefit of the artist until the work of fine art is sold to a bona fide purchaser or is returned to the artist. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(3) (Smith-Hurd Supp.1992). The proceeds of the sale of a work of fine art are trust property and the art dealer is trustee for the benefit of the artist until the amount due the artist from the sale is paid in full. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(4). We have not been asked to decide and shall not decide in the present motion to what extent Rowe possessed a duty to maintain insurance proceeds that it received due to the destruction of art which it held in trust, in particular, in a case where the question of the value of the art so held is in contention. We do hold, however, that until the value of the art is determined by the fact finder at trial, we shall not admit evidence of how Rowe used funds it received as a result of the fire. This information would be prejudicial and is therefore excludable under Rule 403.

Fourth Motion in Limine: Testimony of Kenneth Cone

Rowe argues that Davis' proposed witness Kenneth Cone should not be allowed to testify. According to Rowe, Kenneth Cone is merely an economist, and he has no knowledge or familiarity with art. He allegedly intends to apply the Consumer Price Index and Sotheby's Index of Contemporary American Art to 19 pieces of Davis art. Rowe points to a myriad of evidentiary problems with Cone's use of these two indices.

We decline to exclude Cone's testimony at this juncture of the litigation. At trial, we of course, shall demand compliance with Federal Rule of Civil Procedure 703. If we deem Cone's testimony admissible after a proper showing, Rowe will be allowed to cross examine Cone in order to expose the purported weakness in his testimony. Accordingly, Rowe's motion in limine as to this evidence is denied.

Fifth Motion in Limine: Testimony of Linda Durham

***7** Rowe asks the Court to exclude the testimony of Linda Durham, an expert witness who will testify as to the value of the Davis art. Rowe contends that Durham has changed the basis of her opinion in this case from that previously stated during her deposition and requests that we exclude any testimony different from that previously testified to in her deposition.

Davis responds by arguing that Durham has not changed the basis of her opinion as set forth in the deposition. She has completed a piece by piece appraisal of the artwork based upon photos, her knowledge of the artwork, and on other information previously set forth in her answer to Rowe's interrogatory. Durham's appraisal was prepared at Davis' request, and Davis asserts that the final appraisal re-

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port will be sent to Rowe's counsel as soon as it is completed.

We decline to decide at this time whether testimony not given by Durham in her deposition will be excluded at trial. Because Davis contends that she shall provide Rowe with additional information obtained from Durham in accordance with Federal Rule of Civil Procedure 26(e)(2), we feel that it would be better to hold off on our determination. Moreover, we choose not to make such a decision based solely on a page or two of written argument, and instead, shall hear from the parties in person on this issue.

Sixth Motion in Limine: Davis' Income Tax Returns

Rowe complains that Davis has not furnished copies of her income tax returns and has failed to sign IRS forms allowing Rowe to obtain copies of the returns. Rowe argues that Davis should not be allowed to proceed with this action until her income tax returns are furnished.

According to Davis, the forms requesting copies of the returns from the IRS are being forwarded to Rowe. Therefore, unless we are otherwise advised, there seems to be no remaining basis for Rowe's request, and we deny Rowe's motion as to this matter.

CONCLUSION

For the reasons stated above, Rowe's first, second, and third motions in limine are granted and Rowe's fourth, fifth, and sixth motions in limine are denied.

FN1. Although in our Memorandum Opinion, we commented in *dictum* that this statement could later be used by Davis to prove the value of the art, we now decline to allow this statement into evidence. Upon further consideration of the policies behind Rule 408 and the context within which this statement was offered, we find this statement inadmissible.

FN2. Rule 408 of the Federal Rules of Civil Procedure provides the following:

> Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible. This rule does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negativing a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution.

N.D.Ill.,1993.
Davis v. Rowe
Not Reported in F.Supp., 1993 WL 34867 (N.D.Ill.)

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TAB 14

VELMA DICKER, PATRICIA HOOD, and RHONDA MOORE, Plaintiffs, v. ALLSTATE LIFE INSURANCE COMPANY, Defendant.

No. 89 C 4982

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

1997 U.S. Dist. LEXIS 4512

April 7, 1997, Decided
April 9, 1997, DOCKETED

DISPOSITION: [*1] Plaintiffs' disparate treatment claims dismissed with prejudice.

COUNSEL: For VELMA DICKER, plaintiff: Jeffrey Lynn Taren, Kinoy, Taren, Geraghty & Potter, Chicago, IL. Ronald L. Futterman, Futterman & Howard, Chtd., Chicago, IL. Stephen G. Seliger, Stephen G. Seliger, Ltd., Chicago, IL.

For ALLSTATE LIFE INSURANCE CO, defendant: Brian Wegg Bulger, Paul R. Garry, Judith Yvette Gaston, Bates, Meckler, Bulger & Tilson, Chicago, IL. Marc David Sherman, Marc D. Sherman, Esquire, Lincolnwood, IL.

JUDGES: REBECCA R. PALLMEYER, United States Magistrate Judge

OPINION BY: REBECCA R. PALLMEYER

OPINION

MEMORANDUM OPINION AND ORDER

Plaintiffs Velma Dicker, Patricia Hood, and Rhonda Moore represent a class of black persons employed in nonexempt positions in the Underwriting Department at Defendant Allstate Life Insurance Company in 1988 and 1989. Plaintiffs claim Allstate's performance evaluation system had a disparate impact on black employees, resulting in lower wage growth and lower promotion rates for black employees. Plaintiffs Dicker, Hood, and Moore each also allege disparate treatment; that is, each believes she was treated less favorably than similarly situated white employees on the basis [*2] of race.

In June 1989, Plaintiffs filed this lawsuit under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000, *et seq.*, and *42 U.S.C. § 1981* on behalf of themselves and other black employees in June 1989. Their amended complaint, filed in August 1989, alleges, in Count I, that Defendant violated Title VII by refusing to promote class members on the basis of race; paying class members less than similarly-situated white employees; utilizing different standards to evaluate class members in comparison to similarly-situated whites; failing to provide adequate training; and condoning racial harassment. Count II alleges that Defendant discriminated against named Plaintiffs and the class in promotion determinations on the basis of race in violation of *42 U.S.C. § 1981*.

In October 1989, Judge Suzanne Conlon granted summary judgment in favor of Defendant on Count II, on the basis that post-hiring or post-contract formation claims are not actionable under *42 U.S.C. § 1981*. (Memorandum Opinion and Order of 10/19/89, at 10.) Several months later, on July 11, 1990, Judge Conlon denied Plaintiffs' motion for certification of a class with respect to their disparate treatment claims. [*3] (Memorandum Opinion and Order of 7/11/90, at 11.) Judge Conlon granted the motion for class certification with respect to the disparate impact claims, however. Specifically, she certified a class of "all black nonexempt employees at Allstate's Personal Life Service Center employed beetween January 31, 1988 and June 21, 1989," characterizing the question these class members have in common as "whether the summary rating system disfavors blacks and disproportionately excludes blacks from promotions and salary increases." *Id.* at 10.)

In December 1990, the parties consented to proceed before a U.S. Magistrate Judge pursuant to *28 U.S.C. § 636(c)*. The case was assigned to this court in February 1992. On March 4, 1993, the court denied Defendant's

motion for summary judgment on Plaintiffs' disparate impact claims. (Memorandum Opinion and Order of 3/4/93.) Beginning in August of that year, the court conducted a lengthy bench trial. Following an extended briefing schedule and the court's own delays, the matter is ready for decision.

FINDINGS OF FACT

I. Background Facts

Plaintiffs' Positions; Organization of the PLSC

1. Velma Dicker, Patricia Hood, [*4] and Rhonda Moore are black citizens who were employed by Defendant Allstate Life Insurance Company ("Allstate") at Allstate's Personal Life Services Center (the "PLSC") in Deerfield, Illinois. Plaintiffs represent a class of all black nonexempt persons employed at the PLSC between January 31, 1988 and June 21, 1989. Each of the three named Plaintiffs also brings an individual disparate treatment claim.

2. The PLSC processes applications for life insurance and performs underwriting of policies sold by Allstate agents throughout the United States. From the time an Allstate agent receives an application until the time the company chooses whether or not to accept it, Allstate is bound to provide coverage for the applicant, even if the applicant is ultimately deemed an excessive risk and the application is rejected. In addition, if no underwriting decision is made within 60 days of the policy application, it is deemed accepted. To minimize the risk to Allstate and promote customer satisfaction, Allstate emphasizes speed in the underwriting process. Because of the importance and sensitivity of information in an insurance application, the accuracy with which such an application is processed [*5] is also critical.

3. Between 1984 (when the PLSC began operations) and 1989 (when the Department was reorganized), the Underwriting Department of the PLSC was divided into three territories, East, West, and Central. Although there was some variation in the types of products sold and the processing of applications, the work of the nonexempt employees in the three territories was essentially the same. Each of the three divisions consisted of several units of nonexempt employees, including one or two Clerical units, a Data Preparation unit, and the Quality Verification ("QV") unit. As explained below, these employees were responsible for inputting data from each insurance application into the computer system, obtaining relevant medical information, and preparing and sending the written policy to the insured. In addition, other nonexempt employees worked in the Department, including secretaries and Underwriting Communication Assistants ("UCUs").

4. Nonexempt employees occupied grades 1-8 of the employment hierarchy at Allstate. Exempt employees were those above grade 8, who performed supervisory or underwriting functions. The vast majority of exempt employees were underwriters, many [*6] of whom, as part of their training, served for brief periods as supervisors of clerical employees.

5. During the time periods at issue in this case, each unit of clerical employees was typically supervised by an underwriter or underwriter trainee. Each unit supervisor typically served in that role for a period of six to twelve months before being assigned to another responsibility. The unit supervisors were themselves supervised by a unit manager who in turn reported to a department manager. UCUs were supervised by field underwriting managers, and secretaries by the department manager.

6. The three named Plaintiffs were hired in 1984 for lower-level nonexempt positions in the Eastern Underwriting territory at the PLSC. Velma Dicker and Pat Hood remained in pay grade 4 during the relevant time period (January 1988 through June 1989). Rhonda Moore was employed at pay grade 6 for most of the time she worked at Allstate. Each of the three Plaintiffs filed a charge of discrimination with the Equal Employment Opportunity Commission ("EEOC") on December 1, 1988. As of the August 1993 trial date, Ms. Hood and Ms. Moore had resigned, but Ms. Dicker remained employed at Allstate.

[*7] **Clerical Job Functions**

A. Data Prep

7. Data Preparation unit employees performed "data collection"--that is, these employees transferred information from handwritten or typed application forms to various computer screens. At the direction of the underwriters, Data Prep employees also made the appropriate computer entry when an application was accepted, thus generating a printed policy ("issue"), or when an insurance application was withdrawn by the applicant or denied by Allstate, generating a letter declining coverage ("drop"). A Data Prep A had a job grade of 1, 2, 3, or 4 and spent 90% of her time entering data from life insurance applications and generating issues or drops. The position of Data Prep B had a job grade of 6, 7, or 8. In addition to entering data and working on issues and drops, a Data Prep B's responsibilities included performing "complex change re-issues," training the Data Prep As on various job functions, and assisting the supervisor in performing spotchecks on the work of the Data Prep As.

B. Clerical

8. Clerical unit employees were responsible for two functions: Clerical "mail match" employees were respon-

sible for opening mail, [*8] date-stamping it, identifying the corresponding life insurance application, and making a computer record of the material received. The mail match employee would then place the mail in the appropriate underwriting file. Underwriting files were maintained in alphabetical order, and each mail match employee was responsible for files in one section of the alphabet. Clerical "mechanized" employees were assigned to one of several tasks, including (i) comparing the computer-generated letter denying coverage with the underwriter's directions, and insuring the correct amount on the refund check (a job assignment referred to as "drop desk"); (ii) typing a six-digit code into a computer terminal that communicates with an industry-wide data base (referred to as "medical information bureau"); (iii) making a computer record of any request by an underwriter for particular information; (iv) reviewing the computer-generated letters to physicians requesting information pursuant to the underwriter's requests (known as attending physician services or "APS"); and (v) maintaining records of bills and payments to outside vendors. Persons employed in this unit had the title of Record Clerk B or Record Clerk [*9] C and job grades of 1, 2, 3, or 4.

C. Quality Verification ("QV")

9. QV employees assembled policies. First, employees in the QV units received files from the underwriters containing the application and other underwriting information. In addition, the QV unit received computer-generated documents from the Data Entry unit, an information card about each insured, and a "pick list" which directed the QV employee as to which forms were needed in order to assemble the policy. The QV employee was responsible for pulling printed policy pages that had been generated overnight on the Allstate computer, and for checking each policy against the original application to be sure that there were no misspelled words or other inaccuracies. Once the policy was checked for accuracy, the QV employee would assemble and staple the printed pages, fold them, and place them into a vinyl jacket for issuance.

D. UCU and Others

10. Underwriting Communications Unit employees ("UCUs") worked closely with underwriters. UCUs were responsible for reviewing and underwriting certain simple applications of limited value, responding to questions from field agents, and communicating with agents [*10] and insureds on underwriting issues. The job required considerable telephone work.

11. In addition, other clerical employees included secretaries to department managers and ASAP processors ("ASAPers") who took applications on which underwriters had questions and called insureds for the answers.

Career Paths at Allstate

12. A common career path in the Underwriting Department included promotion from a lower-graded record clerk, typist, or QV position to the position of Data Prep A. An employee could obtain an in-grade promotion from the position of Record Clerk A to Record Clerk B or from B to C simply in recognition of the employee's increased job knowledge. To be promoted to Data Prep A, on the other hand, an employee would have to compete for an available vacancy. From the position of Data Prep A, an employee could advance to a position as Data Prep B (a grade 6 job) or to a UCU position (grades 6 and 8). Data Prep B, UCU A, and UCU B were the highest positions within nonexempt underwriting. From these positions, an employee could seek promotion to the exempt position of associate underwriter, assuming he or she desired to pursue the training needed for that position. [*11] Nonexempt employees in the Underwriting Department could also seek promotions outside of the Department.

13. By 1986, Allstate had begun posting positions that were not in-grade promotions, at least in circumstances in which no employee had expressed an interest in a vacant position. Prior to that time, at least some promotions were awarded by managers who decided on their own which employee was most qualified for an available vacancy. Beginning in 1986, open positions were posted on a bulletin board outside the employee cafeteria. An employee seeking a position through a posting was required to submit a "career opportunities" form to her supervisor, who wrote a recommendation based upon the employee's performance in her current position.

II. Facts Concerning Disparate Impact Claim

The Progress Development Summary ("PDS") System

14. At regular intervals, supervisors at the PLSC prepared a written performance evaluation for each nonexempt employee. This evaluation, known as the Progress Development Summary ("PDS"), resulted in one of four possible performance ratings:

- Performance consistently and significantly **exceeds** expected level for position [*12] (an "exceeds" rating).

- Performance **meets** expected level for the position (a "meets" rating).

- Performance is **acceptable but needs improvement** to meet the expected level for the position (a "needs improvement" rating)

- Performance **requires immediate improvement** to achieve an acceptable level for the position (an "RII" rating)

After the supervisor prepared a PDS, it was reviewed both by a unit manager and a department manager, who checked to be sure the performance rating was warranted by the narrative description of the employee's performance and by any available records concerning his or her performance. Following these reviews, the PDS was reviewed by a human resources manager. At the time the PDS was administered, the employee was permitted to take it home, review it, and discuss any issues with the supervisor before signing and returning it.

15. With certain exceptions, supervisors understood they were expected to evaluate employees on four parameters: **quantity** or productivity; **quality** of work; **attendance**; and **deportment**. For quantity and quality, each underwriting unit had written standards; Allstate had a company-wide [*13] attendance policy. As more fully described below, supervisors utilized point totals to assess the quantity of work performed, based upon the employee's own report on numbers of work units completed. Similarly, supervisors assessed the quality of employees' work as a percentage of errors identified in spotchecks and QV review. Quantity point totals and quality ratings translated into ratings of "exceeds," "meets," and "needs improvement" on these parameters. Generally, there was no actual PDS rating for deportment, but there often were positive or negative comments about deportment. All four of these parameters were to be considered together in awarding an overall PDS rating.

16. Supervisors were expected to maintain a written monthly record of each employee's quality and quantity scores and attendance data, and to meet with each employee monthly on an individual basis to review that employee's progress. These monthly meetings, as well as the individual monthly records maintained by the supervisor and copied for the employee herself, were referred to as "one-on-ones." Employees were entitled to, and did on occasion, question the production and quality figures maintained by the supervisor [*14] and discussed at the one-on-one meeting. It was expected that the monthly one-on-one performance ratings would be factored into the overall PDS rating. Although there was no formal policy for exchange of information between supervisors, in situations where a supervisor was new to the position, he or she would often obtain information concerning the employee to be evaluated from the previous supervisor and from notes or files maintained at the supervisor's desk, including a file containing these monthly one-on-ones.

17. An employee at the PLSC received an initial PDS after nine months of employment and approximately every 12 months thereafter. An employee who had not had her first evaluation or whose previous evaluation was not at least at a "meets" level was not eligible for promotion. If an employee was promoted at a time other than when her annual PDS was administered, the supervisor usually prepared a PDS to update the information from the annual evaluation and make a salary increase recommendation. The supervisor then forwarded these promotion materials for review and approval by the Underwriting Department territory manager and by the Human Resources Department. A promotion had [*15] the effect of resetting the date for the employee's next PDS.

18. In addition to the regularly-scheduled PDS, a supervisor would issue an off-schedule "attendance PDS" to an employee whose attendance was particularly poor. Such a PDS ranked the employee as "RII" (requires immediate improvement) with respect to attendance and set a period of time in which the employee was expected to improve her attendance. Such an "RII" attendance PDS ordinarily did not affect the PDS schedule, except that an employee could not receive an annual performance PDS until the probationary attendance period had been successfully completed.

Training of Supervisors

19. When the PLSC began operations in 1984, Allstate hired supervisor trainees and provided them with classroom training. After the PLSC was in operation, supervisors received minimal formal training; instead, they received primarily on-the-job training from the outgoing supervisor and/or the unit manager on supervisory functions, such as writing evaluations, timekeeping, and one-on-ones. Regarding the actual clerical job functions, the supervisor often received instructions from the nonexempt employees themselves. Allstate conducted [*16] occasional formal training sessions and provided printed materials on How to Write a PDS, Timekeeping, and Salary Administration.

20. Supervisors of nonexempt underwriting units often were underwriter trainees who rotated between underwriting assignments and supervisory assignments. Even after a supervisor had rotated out of the unit, he or she was often within close physical proximity of the new supervisor and was available to answer questions and otherwise assist.

The Salary Planning Process

21. In the fall of each year, in order to estimate its wage costs for the coming year, Allstate directed its supervisors and managers to engage in a salary planning process. As part of the process, the supervisor would review each employee's current salary and recent salary history, and make a notation concerning the employee's expected salary increase and any expected promotion, based on the supervisor's prediction concerning the employee's likely PDS rating. The unit manager, department manager, and Human Resources Division manager approved and signed each supervisor's salary planning documents. The following year, approximately 45 days prior to each employee's scheduled PDS [*17] date, Human Resources forwarded to the employee's supervisor a notice that the PDS form was due. The notice also set forth the previous fall's plan concerning that employee's expected PDS rating, expected salary increase, and any planned promotion. When the supervisor believed an employee was entitled to a salary increase different from the one projected on the notice from Human Resources, the supervisor was required to cross out the projected salary increase and fill in the new amount, and to submit an additional form.

22. Supervisors and unit managers testified uniformly that the salary planning process was intended as an estimate of salary growth, not as a guide to the supervisor in evaluating the employee's performance. Every supervisor who testified understood that he or she was required to evaluate each employee on the basis of that employee's actual performance, without regard to the estimate used for the previous fall's salary planning process. The fact that a work unit did or did not maintain its projected budget had no effect on the evaluation of the supervisor's performance, nor were supervisors required to explain any decision to vary from the plan. The evidence showed [*18] that in numerous instances supervisors did in fact depart from the salary plan, both by awarding overall ratings other than what had been projected, and by awarding merit increases in amounts other than what had been projected. Defendant demonstrated that these departures from the plan benefited and disadvantaged both white and non-white employees.

Impact of PDS Ratings on Promotions

23. As a matter of Allstate policy and practice, an employee could not be promoted unless he or she had received either an "exceeds" or a "meets" rating on the most recent PDS. Thus, there was a substantial relationship between an employee's overall PDS rating and the likelihood that he or she would be promoted. Promotions were often awarded at or near the time of the employee's scheduled PDS evaluation. If an employee received a promotion at some other time, the supervisor would prepare a PDS at the time of the promotion. This "promotional PDS" provided a vehicle for awarding the promoted employee, who would otherwise be required to wait for the completion of a new PDS cycle before receiving a merit increase, the pro rata portion of any merit increase he or she had earned in the previous [*19] position.

24. Of 474 PDSs administered from 1985 through 1988, 93 were contemporaneous with promotions. Forty-four percent (44%) of those employees who received an "exceeds" PDS rating were promoted, as were 14% of those who received a "meets" rating. No employee whose overall rating was lower than "meets" received a promotion. Similarly, in the period from February through November 1988, 55% of those employees with "exceeds" ratings were promoted, as were 11% of those rated "meets," but none of those employees having "needs improvement" or "requires immediate improvement" scores was promoted. In addition to the employee's performance as reflected in the PDS, factors relevant to a promotion decision included the employee's tenure with Allstate and his or her ability to perform the work in the new position--for example, keyboard skills would be helpful to an employee seeking promotion to a position in Data Entry.

Impact of PDS Ratings on Wage Growth

25. As a matter of Allstate policy, there was a direct causal link between an employee's overall PDS rating and his or her merit increase. Pursuant to written policy directives, employees were awarded prescribed percentage [*20] increases at the time of their performance evaluations, based on their overall PDS ratings. Generally, an employee who had earned an overall "exceeds" rating was entitled to a merit increase of 8 to 11%; an employee with a "meets" rating earned a 5 to 7% increase; and a "needs improvement" rating resulted in a zero to 4% raise. The precise increase awarded to an employee was also influenced by his or her "compra ratio" (the relationship between the employee's salary and the midpoint salary range for his or her position) and by the length of time that had passed since the employee's last PDS.

Non-Merit Pay Adjustments

26. On occasion, Allstate raised the minimum base pay for its entry-level positions in order to keep salaries competitive. When this occurred, any incumbent employee in such a position whose pay rate fell beneath the new minimum had his or her pay raised to the new level. Such increases were termed "salary adjustments" and did not affect the employees' next scheduled merit increase. Where an employee scheduled for a merit increase was also entitled to an adjustment in his or her base pay, the employee's base pay would first be adjusted to the new minimum, [*21] and the merit increase then calculated on the basis of the new minimum. Neither the Human

Resources Department, nor any of the PLSC managers, participated in the decision to make an adjustment to the minimum salary levels.

Plaintiffs' Statistical Analysis: Comparison of PDS Ratings for Black and White Employees

27. Raymond Mendel, Ph.D., Plaintiffs' expert witness, reviewed the 474 PDS evaluations (330 for whites, 144 for blacks) completed from January 1, 1985 through December 31, 1988. Dr. Mendel concluded that black nonexempt employees at Allstate received significantly lower PDS ratings than whites during the period from 1985 through 1988 and within 300 days of the filing of the EEOC charges in this case. Thus, of the 330 PDSs administered to whites, 33% resulted in an "exceeds" rating, compared with only 20% of those administered to black employees. White employees received "needs improvement" ratings only 10% of the time, compared with approximately 21% the PDSs administered to blacks. If the two lowest categories of "needs improvement" and "requires immediate improvement" are combined, the record shows that only 15% of the PDSs administered to whites, as opposed [*22] to 30% of those administered to black employees, resulted in such scores. These results, Dr. Mendel testified, are significant at the $p < .0001$ level; that is, the chance that such a disparity in scores would occur by chance is one in 10,000. Such results fall well beyond the standard $p < .05$ threshold for statistical significance (*i.e.*, possibility less than one in 20 that the observed results would occur by chance).

28. Analysis of the 113 PDSs issued in the 300-day period prior to the filing of the EEOC charge (February 1, 1988 through November 30, 1988) showed similar disparities. Whites received "exceeds" ratings 23% of the time, while only 6% of blacks received such a rating. When the "needs improvement" and "requires immediate improvement" ratings are combined, only 19% of whites received those low ratings as compared with 30% of blacks. According to Dr. Mendel, these results are also statistically significant ($p < .02$).

Promotions and Wage Growth

29. To compare the rate of promotion between black and white employees, Dr. Mendel examined the number of grades advanced for all nonexempt underwriting employees having at least six months tenure from [*23] January 1985 through December 1988. Of 193 employees, 37% received promotions from January 1985 through December 1988, most of those promotions (85%) occurring in the four bottom grades. A higher percentage of black underwriting employees was employed in these lower grades (83% of blacks were employed in grades one through four, as compared with only 71% of whites). Still, Dr. Mendel's analysis showed that 42% of all white employees were promoted during this period, as compared with only 29% of blacks. Only 5% of black employees were promoted to grade 6, a position that Dr. Mendel believes is a springboard to greater advancement; 20% of whites achieved promotion to grade 6. Dr. Mendel's analysis found a small but statistically significant difference between the two groups: the t-statistic (a measure of standard deviation in which any departure of two or more standard deviations is viewed as significant) was just under 2, and the *p* value (the probability of the results occurring by random chance) was $< .05$.

30. Dr. Mendel limited his subject pool to persons employed for at least six months and considered only those PDSs administered through December 31, 1988. Thus, as Defendant [*24] notes, Dr. Mendel's analysis excluded all persons employed in nonexempt Underwriting after July 1, 1988. Defendant contends that Dr. Mendel's use of the Kruskall-Wallace statistical test is inappropriate for the kind of data Dr. Mendel considered. Defendant further criticizes Dr. Mendel's reliance on a "one-tailed" standard of significance, a less conservative standard that assumes any differences between the observed results and those that would be expected by chance will be differences in one direction only (that is, that any differences from a purely random distribution of scores will be unfavorable to blacks). In addition, Defendant urges that Dr. Mendel's analysis is flawed in that it assumes that the length of time that it takes for an individual to achieve a promotion is irrelevant (that is, it assumes that an individual employed for six months but not promoted is in a more favorable position than one promoted only once in four years). Most significantly, Dr. Mendel's analysis excluded from consideration any promotions to positions outside nonexempt Underwriting. Defendant's statistical expert, Robert Topel, Ph.D., demonstrated that if such promotions are included, then there [*25] is no statistically significant difference in pay grades advanced between blacks and whites, even when Dr. Mendel's Kruskall-Wallace test is used. And, even when utilizing Dr. Mendel's subject pool and statistical analysis, Dr. Topel demonstrated that the black-white difference in promotions is rendered far below significance when controlling for starting grades and attendance.

31. Plaintiffs did not offer a statistical analysis of the race differences in wage growth as part of their case in chief. As described *infra*, Findings PP 74-80, Defendant's expert found no statistically significant difference between wage growth among black employees and white employees.

PDS Performance Criteria

32. No witness was able to explain the origin of the criteria used in preparing PDSs. Quality of work, quantity of work, and attendance were evaluated in each of

the three underwriting territories. There were some variations in the standards for measuring quality and quantity among the territories, but no evidence that these variations could have had any racial impact, as black employees were distributed randomly throughout the territories.

A. Quality Assessment

33. [*26] Both parties agree that quality or accuracy of work performed is an appropriate job-related criterion for performance evaluation. Plaintiffs insist, however, that the quality criterion was invalid and unreliable.

34. Supervisors in the Underwriting Department attempted to measure and rate the quality of nonexempt work by (a) randomly selecting and checking a portion of the employee's work output for errors on a monthly basis, a process called "spotchecks"; (b) determining an accuracy percentage ratio, either by dividing the number of files in which errors were found by the total number checked (*e.g.*, 3 files out of 100 in error = 97% accuracy ratio), or by assigning points for particular errors and subtracting the points from the total (*e.g.*, errors totaling 60 points out of 2,000 possible = 97% accuracy ratio); and then (c) rating the employee on the basis of accuracy percentage standards (*e.g.*, an accuracy ratio between 98.5 and 100% would earn an **exceeds** rating, 97.0 to 98.5% was **meets**, etc.) Occasionally, supervisors exercised discretion to round the accuracy ratio percentages up or down.

35. After May 1988, the quality standards were made uniform across [*27] all three territories as follows: 98.5% and above earned an "exceeds" rating; 69.5% through 98.4% earned "meets"; 95% to 96.4% merited an "acceptable, needs improvement" rating; and accuracy ratios below 95% were deemed unacceptable. Prior to May 1988, the standards for rating employees showed minor differences from one unit or territory to another. There is, however, no evidence that persons of one race were more likely to be assigned to units utilizing more lenient accuracy standards than persons of any other race.

36. In addition to the spotchecks, data entry employees' work was checked as part of the QV process. If a QV employee detected errors in the final printed policy, the file containing the error would be returned to the data entry unit for review by a Data Prep B. By comparing the information input in data entry with the application and the underwriter's instruction, the Data Prep B determined whether an error had been made and made a record of the error. An employee who disagreed with a co-worker's error determination could appeal the issue to a supervisor. Because every issued policy was reviewed in the QV unit, 100% of issues were checked for accuracy.

37. For clerical [*28] employees, spotcheck procedures were designed to review the work performed in the employee's particular job assignment. To check the mail match employees' work, the supervisor determined whether a tag was made for each file; whether the files were in alphabetical order, in the appropriate Pendaflex divider; whether the files were in the file tubs; and whether all the mail had been forwarded to the underwriter.

38. For QV employees, the supervisors spotchecked work by simply re-doing the QV work on a random sample of files already processed by the employee.

39. Supervisors did not consider quality ratings for months during which an employee was in training to learn a new job function.

40. No supervisor described any routine process for selecting the files to be checked; several supervisors explained that they simply selected a number of files at random, without advance warning. Supervisors themselves performed the spotchecks, except that, as described above, Data Prep Bs performed the spotchecks for Data Prep As. Where the spotcheck revealed an error with respect to the clerk's processing of a file, it was counted as an error regardless of whether the employee's job assignment required [*29] as many as 11 tasks with respect to that file or as few as three. To the extent this difference resulted in employees assigned to perform 11 tasks per file being "graded" more harshly than those with less difficult assignments, Dr. Mendel characterized the circumstance as reflecting "opportunity bias" in favor of certain employees at the expense of others. There was no evidence that employees of any race were more likely to be assigned to the more detailed assignments than others, however. Similarly, although Plaintiffs note that at one time, different quality standards were in place in different territories, there was no evidence that employees of one race were more likely to be assigned to territories where evaluations were more generous than employees of other races.

41. In Dr. Mendel's view, the number of files on which each employee is spotchecked is too small to rely on as a meaningful measure of the quality of that employee's work. For example, clerical employees worked on 3,000 to 4,000 files per month, but were spotchecked on only 100 per month. For QV employees, 50 files were checked each month, and for data prep employees, 20 were checked per month, again, a very small [*30] fraction of the month's work. In order to generate a fair measure of performance, Dr. Mendel testified, approximately 1,500 files would have to be checked for each PDS period. Allstate demonstrated, however, that in order to spotcheck 1,500 files for each employee, supervi-

sors would be required to devote all of their working time to checking their subordinates' work.

42. Dr. Mendel compared quality accuracy ratios for Data Preps as determined in the QV process (which checked 100% of all files processed) with those developed from the employees' spotchecks. Dr. Mendel believes such scores should have been very close to one another. In fact, Plaintiffs observe, in 1988 Data Preps in the Eastern Territory had different ratings for spot checks than for QV more than half of the time. Allstate pointed out that in some instances one Data Prep would perform data collection for a particular file, but another employee would perform other tasks on the same file, with the result that more than a single employee's work might be reflected in a file reviewed in the QV unit.

43. Given the comparatively small number of files spotchecked each month, Dr. Mendel believes that the numeric standards used [*31] to distinguish "exceeds" performance from "meets" and "meets" from "acceptable" are too fine to distinguish accurately between employees.

B. Assessment of Work Quantity

44. With the exception of mail match employees and secretaries, Allstate supervisors assessed the productivity of nonexempt employees by assigning points to each job function and maintaining records of the number of points earned by each employee for a particular time period. The goal in assigning points to particular tasks was to approximate a point for each minute of work. Secretaries were not evaluated on the basis of quantity of performance.

45. For mail match employees, supervisors evaluated the quantity of work performed simply by observing whether the employee was able to process the mail promptly and stay current with respect to the filings in that portion of the files. Although Plaintiffs have suggested that more precise numerical standards were available for assessing the work of mail match employees, there is no evidence that utilization of such standards would have resulted in more accurate measurement of their performance. Nor is there any evidence that employees advantaged (or disadvantaged) [*32] by their assignment to mail match were more likely to be of one race than another.

46. For those employees whose production was based on points earned for performance of particular job functions, Allstate relied on production tallies maintained by the employees themselves on a daily basis, and then totaled by supervisors for each week and each month. Plaintiffs note that there was no "consistent process" for checking the accuracy of point totals recorded by employees, nor any procedure for ensuring that workers did not overstate their production numbers. Indeed, although Allstate could have checked these figures by comparing the tallies maintained by the employees themselves with computer records of work performed, such checks were not done on a routine basis. There was no evidence of any widespread over-reporting of work performed, however, nor any evidence to suggest that employees of one race were more likely to "pad" their records than employees of any other race. Nor was there any evidence of complaints by employees concerning the accuracy of the point totals that they themselves maintained.

47. Plaintiffs challenge the point system as arbitrary. They point out that Allstate [*33] had no documentation to establish that the points assigned for particular tasks were well-suited to that goal, and note that some of the point values assigned to particular tasks differed from one territory to another. Plaintiffs point out, further, that supervisors had some discretion to change the points assigned to particular tasks. For example, supervisor Vicki Kummer testified that she changed the number of points assigned to a particular task in 1987 when she learned that employees were unwilling to perform that task because their point totals suffered when they did. Similarly, Janine French, another supervisor, raised the number of points assigned to a particular task because she believed the task took more time than the points reflected. No employee complained about the new point values assigned to particular tasks. Furthermore, employees rotated to various job assignments within the unit. Because employees of one race were no more likely than those of any other race to be assigned to perform particular tasks or to be assigned to one territory than another, Plaintiffs have not demonstrated how this claimed flaw in the evaluation system could have resulted in race differences [*34] in PDS scores.

48. Early in 1987, the Underwriting Department formed a "Data Entry Improvement Team" ("EIT") to review the quantity point system for data entry work across the three regional territories. The team consisted of seven volunteers from among the three data entry units, including named Plaintiff Rhonda Moore, who met regularly under the leadership of unit manager Deborah Lorch. The EIT was assigned to review the point system and recommend changes, if appropriate. Although the team had the authority to recommend that the point system be abolished, it chose not to do so. Relying on their own data entry experience, the team members developed a standardized point system for use in all three data entry units, then sought the views of other Data Preps by means of a survey. After reviewing the survey results, the team made final recommendations to entry supervisors and unit managers. By March 1987, a new point system was approved and implemented, and the team then monitored the impact of the new system on per-

formance ratings. Team members concluded that the new point system did not require an adjustment to the rating standards (*i.e.*, number of points needed for an "exceeds" [*35] rating).

49. There were no specific guidelines for combining separate quantity ratings for different jobs within an evaluation period to determine an overall quantity rating; that process was left to the supervisor's discretion.

50. Employees assigned to training others or to receiving training themselves, or assigned to assist in other departments, were awarded "general points" of one point per minute. Because a full day of general points yielded a total meriting an "exceeds" performance rating on the production criterion, assignments to perform work earning general points were desirable. Supervisors exercised discretion to assign employees to assignments earning general points, but there is no evidence that such discretion was exercised in favor of white employees; in fact, named Plaintiff Rhonda Moore earned 85% of all general time points assigned to Data Preps in the Eastern Underwriting territory. There is no evidence that any other employee, white or black, received such a disproportionate allocation of general time assignments.

C. Assessment of Attendance

51. Jane Alexander, Allstate's Human Resources manager, issued attendance rating standards applicable to nonexempt [*36] Underwriting Department employees. The standards were distributed in June 1984 and again in May 1986 when Ms. Alexander learned that a number of supervisors were not familiar with the standards. Under those standards, employees who had no more than two absence occurrences in a year were ranked as "exceeds" for this criterion; those with three or four occurrences were ranked as "meets"; those with five or six occurrences were ranked as "acceptable"; and those having seven or more occurrences were ranked as "unacceptable." In preparing a PDS, the supervisor was expected to consider the employee's attendance during the previous twelve months. In determining whether disciplinary measures were necessary, the supervisor sometimes would consider the number of occurrences over a shorter period of time.

52. Pursuant to Allstate policy, an absence due to illness constituted an absence occurrence, whether that absence was for a single day or for several consecutive days. Where an employee experienced non-consecutive absences that were related to the same illness, some Allstate supervisors exercised discretion to determine whether those absences would count as a single occurrence or multiple [*37] occurrences. To determine whether differences in the way supervisors counted absence occurrences had a racial impact, Defendant's expert witness, Dr. Topel, analyzed the raw data on attendance, applying a non-discretionary standard to count absence occurrences. Dr. Topel's analysis demonstrated that the exercise of discretion in counting occurrences did not have a disproportionate impact on blacks. It is undisputed that black employees had poorer attendance records than whites, and Plaintiffs offered no evidence that supervisors' evaluations exacerbated the differences between attendance ratings of blacks and whites.

53. According to Jane Alexander, tardies were not considered in a PDS unless they were at an unacceptable level. [1] In some circumstances, an employee could use "emergency time" rather than have a tardy counted against him or her. Supervisors exercised discretion in determining whether a tardy would be recorded at all and in determining whether the employee might use "emergency time" or work late to make up the time and avoid being recorded as tardy.

1 Thus, unit manager Eric Hjerpe testified that Vivian Wilson, whose performance merited a "meets" on quantity and "exceeds" for quality and attendance, nevertheless received an overall "meets" rating on her January 1988 PDS because she had eight tardies.

[*38] 54. Supervisors treated attendance in different ways on the PDS and in determining an overall rating. Some supervisors believed that unless the employee's attendance was below the "meets" level, it had no effect on his or her overall rating. Others believed attendance did not have to be mentioned in the PDS at all. Indeed, Plaintiffs demonstrated that attendance data was missing from a number of PDSs (31 of the 158 PDSs in the data base considered by Dr. Topel). There was no evidence, however, that any supervisors considered attendance in preparing the PDS for employees of any one race but not those of another race. Further, black employees were distributed randomly between territories and units; thus, the fact that one supervisor may have given credit for good attendance and another did not could not have had any race-based impact on overall PDS scores. As noted, Dr. Topel found that black employees were in fact absent more often than whites.

55. Plaintiffs believe that supervisors had the discretion to manipulate the importance of employee attendance data in order to benefit their favorites. They cite as an example the fact that Gigi Soeder, a white clerical employee in the Eastern [*39] territory who received her previous PDS in August 1977, did not receive her next PDS until September 1988. There is no evidence of the reason for this delay, and Defendant contends that Allstate's policy allowed for a PDS cycle to last as long as 15 months. Plaintiffs point out, however, that Ms. Soeder had several attendance occurrences prior to Sep-

tember 1987; due to the fact that the PDS was not administered until September 1988, those older attendance occurrences were not considered for purposes of her overall PDS rating, and Ms. Soeder was promoted.

D. Deportment

56. Supervisors described the deportment criterion in different terms. Supervisor Linda Shumilas explained that it meant cooperation and demeanor, or office conduct. Eric Hjerpe, a unit manager, testified that this criterion included the employee's office attire, relationships with his or her supervisor and department manager, and "general office conduct."

57. Supervisory personnel differed in the weight to be given to deportment in the overall PDS rating. Deportment was not ordinarily the subject of a specific subrating, as were quantity and attendance. Instead, the supervisor often simply commented in the [*40] PDS on the employee's willingness to work toward unit goals. Where the supervisor did not view the employee's deportment as particularly positive or negative, there might be no mention of that factor in the PDS, suggesting that at least some supervisors relied on the deportment factor as a kind of tie-breaker to justify a particular overall rating in situations where the factors of quantity and quality were inconsistent. Because deportment was not precisely defined for purposes of evaluation, it provided a ready vehicle for the exercise of supervisory discretion in favor of some employees at the expense of others. Defendant does not argue that the "deportment" criterion was job-related. Instead, as described below, Defendant offered evidence that the more objective factors of quality, quantity, and attendance accounted for a significant proportion of the race differences in overall PDS scores.

58. At least some supervisors testified that yet another criterion, that of "extraordinary customer service," emerged over the years as a factor in employee evaluations. Like the comportment criterion (with which it appeared to overlap to some degree), [2] the criterion of extraordinary customer [*41] service was not addressed in every PDS and may have been used to break the tie in determining an overall evaluation where the more objective factors were on the border of a particular rating.

2 For example, Vicki Kummer explained that extraordinary customer service was subsumed in the deportment criterion.

E. Overall Rating

59. The Underwriting Department had no specific guidelines for weighing or combining the four factors in determining an overall rating. The weight of the evidence supports a finding that, although supervisors and other managers testified to a variety of approaches to weighing the components in determining an appropriate overall rating, all viewed quality and quantity as central to the overall performance evaluation. Thus, for example,

--Janine French, a supervisor in the Eastern Territory, testified that quality and quantity were the major components, and that attendance did not affect the overall rating unless it was below a "meets" level.

--Christine Swiss, another Eastern [*42] Territory supervisor, believed that quality, attendance, customer service, and deportment were all of equal importance in determining the overall PDS rating.

--Deborah James, a supervisor in the Eastern Territory's quality verification unit, weighed quality, quantity, attendance, and extraordinary customer service equally.

--Thomas Price, another Eastern Territory supervisor, was uncertain about the relative weights of quality, quantity, and attendance, but believed they were of equal importance in the overall rating, with deportment having less importance.

--Mary Sobeski, a unit supervisor in the Western Territory, at first believed that quality was more important than quantity, but later concluded these two factors had equal weight (together accounting for 60% of the overall rating) and were more important than attendance and deportment (together accounting for 30%). Later, when Ms. Sobeski became a unit manager in the Eastern Territory, she began considering the factor of extraordinary customer service, ultimately giving that factor equal weight to quantity and quality.

--Karl Friedman, manager of the Western Territory, identified quality, quantity, attendance, and deportment [*43] as factors to be considered in the overall PDS rating, with quality and quantity being most important. He identified extraordinary customer service as an additional factor, one he characterized as broader than deportment and including assessments of quality and quantity.

--Cynthia Polakis, initially a supervisor in the Western Territory, learned that quality, quantity, attendance, and deportment were all weighed equally. Later, when Ms. Polakis became a unit manager in the Western Territory, she instructed supervisors to weigh each of the four factors equally.

--Deborah Lorch, who served as a supervisor and as a unit manager in the Western Territory, considered quality and quantity the most important factors in determining the overall PDS rating, with attendance and deportment to be considered only if they fell below a "meets" level.

--Central Territory manager Eugene O'Neill believed that quantity, quality, and attendance should be rated

equally, and that deportment should seldom be mentioned in a PDS.

--Dan McCarran, supervisor of QV employees in the Central Territory, considered quality, quantity, attendance, and deportment, and provided ratings in the PDS for all of them. McCarran [*44] believes he had discretion as a supervisor to determine the weight to be accorded to each of the four factors.

60. Plaintiffs pointed out numerous instances in which the overall PDS score awarded to an employee appeared to be inconsistent with the supervisor's own description of his or her evaluation practices. The most frequently occurring situation was one in which the supervisor relied on the employee's deportment or attendance to explain the decision to award a particular overall rating, where that rating otherwise appeared to be inconsistent with the employee's quality and quantity rating (or inconsistent with the overall rating given another employee having identical quality and quantity ratings). With respect to one PDS rating, Defendant's witnesses explicitly acknowledged that the employee's overall rating was probably too high, when viewed in light of the individual components of that employee's rating.

61. Because Allstate had no written or oral rules for combining the underlying criteria into a single overall PDS score, Dr. Mendel believes there are "as many PDS systems as there [were] supervisors at various points in time." Dr. Mendel characterized the discretion exercised [*45] by supervisors in assigning overall PDS scores as a "huge loophole in the performance measurement system," enabling a supervisor to grant a higher score to a personal favorite by deciding to emphasize one of the underlying criteria over another.

Dr. Mendel's Criticisms of the PDS System

62. In addition to his statistical analysis, Plaintiffs offered Dr. Mendel as an expert on the job-relatedness of the PDS system. Dr. Mendel is a professor of industrial psychology at Western Kentucky University and a licensed industrial psychologist. Dr. Mendel has taught courses on industrial psychology, equal employment opportunity, and statistics, and has performed research on, among other topics, the job-relatedness of procedures used for selection of clerical employees in the insurance industry. He has published articles on his research in the area of performance appraisal and selection devices, and has been retained by both plaintiffs and defendants as an expert on the job-relatedness and adverse impact of various performance measures.

63. Dr. Mendel examined the job-relatedness of the PDS system, specifically assessing its validity (*i.e.*, accuracy) as a measure of current [*46] job performance, and its validity as a predictor of performance in a position to which the assessed individual is promoted. Dr. Mendel's analysis was based on two generally-recognized sets of standards for evaluating employee assessment measures, the *Uniform Guidelines on Employee Selection Procedures* published by the EEOC (the "Uniform Guidelines"), and the *Principles for the Validation and Use of Employee Selection Procedures* published by the Society of Industrial and Organizational Psychologists.

64. In Dr. Mendel's view, an assessment of the job-relatedness of a particular measure of performance must address issues of validity, reliability, standardization, representativeness, norming, and fairness. Dr. Mendel understands **validity** as the accuracy of the measure; that is, the degree to which the measure accurately predicts job performance. A measure is **reliable** if the performance being assessed draws the same score, even when evaluated by different raters (or by the same rater, at different points in time). A **standardized** measure is one that is administered in the same way and under the same conditions to each person whose performance is being assessed. [*47] **Representativeness** requires that each of the component ratings or criteria used in the performance measure contribute to the overall rating in proportion to its importance to the job. **Norming** is the process by which data is collected so as to ensure that the employee's performance is not affected by factors that are not fairly attributable to him or her. Dr. Mendel described **fairness** as the absence of systematic under-or over-prediction of an employee's performance as a function of race or gender.

65. Under the Uniform Guidelines, the validity of a performance evaluation may be determined either by way of a content-oriented strategy or a criterion-related strategy. A content-oriented assessment focuses on the knowledge, skills, and abilities needed to do the job and on a ranking of the tasks to be performed. Dr. Mendel explained that the first step in developing a content-oriented measure is a careful job analysis in which information is gathered from job incumbents, and a detailed job description is developed. [3]

3 Criterion-related tests measure the characteristics or traits (for example, intelligence) believed relevant to job performance. Thus, a criterion-related validation study determines whether the test is correlated with the applicant's future job performance. The Uniform Guidelines do not favor reliance on criterion-related validity. *See Gillespie v. State of Wisconsin, 771 F.2d 1035, 1040 n.3 (7th Cir. 1985).*

[*48] 66. Prior to this litigation, Allstate had neither conducted a study to determine whether the PDS evaluation system had an adverse impact based upon

race, nor assessed the job-relatedness of the system. Dr. Mendel criticized the system as needlessly subjective. He identified several specific deficiencies:

a. The salary planning process generated a predicted PDS rating which was communicated to the supervisor before the actual evaluation was prepared, thus potentially influencing the supervisor's evaluation. Supervisors were aware that the predicted performance evaluation, salary increase, and promotion, if any, had been approved by the previous supervisor, unit manager, and territory manager during the previous year's planning process.

b. Allstate supervisors, most of them relatively recent college graduates, had limited supervisory experience, little formal training, and brief supervisory tenure before being rotated to another job assignment. A clear majority of the supervisors of nonexempt employees in the Underwriting Department from 1985 through 1988 were white. Because of the frequent turnover, supervisors were often called upon to prepare PDSs for employees whom they had supervised [*49] for only a small part of the time period on which the employees were evaluated.

c. Dr. Mendel expressed concern that supervisors had discretion to adopt their own standards regarding the criteria to be considered in preparing the PDS and in weighing those criteria. He was particularly critical of Allstate's failure to establish rules for combining the individual component ratings into the overall PDS score. That failure, Dr. Mendel observed, permitted supervisors to exercise discretion in favor of an employee "simply by deciding that one particular category for that particular individual was more important and thereby adjust the ratings."

d. With respect to the quantity and quality ratings assigned by supervisors, Dr. Mendel believed the distinctions were often too fine to measure meaningful differences in job performance. For example, as Dr. Mendel observed, 80% of Allstate's nonexempt Underwriting employees are ranked as either "meets" or "exceeds." An employee whose overall PDS rating is "exceeds" is more than twice as likely to be promoted as a "meets" employee. Yet the distinctions between employees rated as "meets" and those rated as "exceeds" were often very fine ones; most [*50] quality ratings were in the high 90% range. Given the great significance of very small distinctions in ratings, Dr. Mendel believes Allstate had a duty to exercise "tighter control over the measurement process."

67. In numerous instances, individual PDSs did not include a rating for each of the four criteria, or included a rating without the underlying raw data to support the particular rating assigned. By design, an attendance PDS addressed only the employee's attendance problem and made no mention of the quality, quantity, or deportment criteria. Where a PDS was prepared at the time of an off-cycle promotion, that PDS did not always make mention of each of the criteria. Even with respect to annual performance PDSs, Plaintiffs demonstrated that in at least some instances, data concerning quality, quantity, or attendance appears to be missing.

Allstate's Expert Witness on Job-Relatedness of the PDS System

68. Kathleen Goeppinger, Ph.D., is an Associate Professor of Human Resources Management, Industrial Relations and Organization Development at the Graduate School of Loyola University of Chicago. Dr. Goeppinger earned her Ph.D. in comparative international policy in [*51] Loyola's School of Education. Prior to her teaching career, Dr. Goeppinger was an executive in human resources at Carson Pirie Scott & Co. Defendant Allstate called Dr. Goeppinger as an expert witness on the job-relatedness of the PDS system.

69. Prior to her testimony in this case, Dr. Goeppinger had testified as an expert in employment discrimination cases, but not on the issue of job-relatedness of a company's employee selection procedures or performance appraisal systems. She is not an industrial psychologist and has no familiarity with the *Principles for the Validation and Use of Employee Selection Procedures* published by the Society of Industrial and Organizational Psychologists, nor with the strategies identified in those principles for assessing the job-relatedness of employee selection devices. Indeed, in attempting to explain the definition of reliability as used in those principles and in the professional literature, Dr. Goeppinger appeared to confuse reliability with validity. Similarly, Dr. Goeppinger had limited familiarity with the EEOC's Uniform Guidelines, although she did recall having used them in validating a test while employed at Carson Pirie Scott.

70. [*52] Like Dr. Mendel, Dr. Goeppinger believes that careful job analysis is necessary to ensure that the requirements established for a job are those that have an impact on job performance. Nevertheless, Dr. Goeppinger pointed out that many organizations do not perform a formal job analysis but, instead, look only at the business needs of the organization in developing an evaluation mechanism. According to Dr. Goeppinger, job analysis is not necessary in order to establish that a particular evaluation procedure is job-related. It is undisputed that Allstate did not perform any formal job analysis prior to or during the 1985-1988 period during which it used the PDS for evaluation of employee performance.

71. Defendant asked Dr. Goeppinger to determine whether Allstate's PDS system was consistent with the

performance evaluation systems of other large corporations having large clerical functions, and whether the PDS system was job-related. Dr. Goeppinger testified that she considered six criteria in evaluating the PDS system. These six criteria were: (1) whether employees were aware of the standards and received ongoing feedback during the evaluation process; (2) whether the criteria bore [*53] a relationship to the business and the ability to be measured; (3) whether controls were placed on the supervisory personnel administering the evaluations; (4) whether managers reviewed the evaluation; (5) whether there was a process for appealing the evaluation rating; and (6) whether employees and supervisors were trained to use the evaluation process.

72. Dr. Goeppinger concluded that the PDS system was business-related because it focused on quality and quantity of performance and measured attendance and deportment. She believed the performance criteria were consistently applied within units, that the manner in which supervisors evaluated employees was appropriate, and that employees and management supported the process. In reaching her conclusions, Dr. Goeppinger relied in part on what she called inherent or facial validity; that is, acceptance of the process by employees and managers. According to Dr. Mendel, such a factor has no support in the professional literature as a measure of the job-relatedness of an employee selection device. Dr. Goeppinger performed no tests to determine whether the points and rating scales used at Allstate accurately measured performance. (Dr. Mendel [*54] also performed no such tests.) Dr. Goeppinger did not address Dr. Mendel's criticism of Allstate's failure to specify how the criteria were to be combined in determining an employee's overall PDS rating. Plaintiffs note that Dr. Goeppinger's testimony reflected that she was apparently unfamiliar with the fact that not all supervisors included all four evaluation criteria in every PDS. Further, she was unaware that at least some supervisors believed deportment was to be given equal weight in the overall evaluation as quantity and quality of work performed. Despite having interviewed supervisor Mary Sobeski, Dr. Goeppinger was unaware that Ms. Sobeski believed extraordinary customer service was a separate criterion, to be considered equally with quantity and quality of work to develop the overall PDS rating.

Defendant's Statistical Analyses

73. Defendant's statistical expert, Robert H. Topel, Ph.D., is the Brown Professor of Urban and Labor Economics at the University of Chicago. Dr. Topel earned his undergraduate degree at the University of California at Santa Barbara and his Ph.D. from UCLA in 1981. Dr. Topel concentrates his research in labor economics and has recently [*55] performed research on wage trends, the increasing wage inequality in the United States, and the evolution of labor markets in the United States and abroad. He teaches graduate level courses on microeconomics; work place management (in which he teaches matters including the effect of wage growth on employee turnover); labor markets; and pay and promotion practices. Dr. Topel is the editor of the Journal of Political Economy; serves on the editorial board of the Journal of Business Economics; and has served on the board of editors of the American Economic Review and the Journal of Labor Economics. Dr. Topel has performed research for the U.S. Department of Labor on the unemployment insurance system and on changes in labor markets and their effects on unemployment and wage growth in the United States. Since 1985, Dr. Topel's research has been supported by grants from the National Science Foundation. He has testified before the Senate Finance Committee on ways to reform the unemployment system in the United States. All of Dr. Topel's research employs empirical statistical methods to analyze data concerning individuals.

A. Wage Growth

74. In Dr. Topel's view, wage growth is [*56] a more accurate measure of advancement than promotion rates. As described below, Dr. Topel found that the difference in wage growth between white employees and black employees was statistically insignificant. To perform his analysis, Dr. Topel compared the wage rate of each employee at the beginning of a job with that employee's wage rate at the time the employee left the job, either by termination, promotion, transfer, leave of absence, or demotion. Dr. Topel referred to each such period as a "job spell." He then calculated the wage growth for the job spell as the difference between the beginning and ending wage rate, deflated by the Consumer Price Index. For this analysis, Dr. Topel considered only those employees who had five months of seniority in the Underwriting Department and had received at least one PDS. For the period from January 1, 1985 through October 24, 1989, Dr. Topel found the average real wage growth for all employees (within the certified class and similarly situated whites employed during the class period) was 4.8%. The black-white difference was .005 and the "t-statistic" (a measure of standard deviation, with 1.96 as a threshold for statistical significance) was [*57] 0.58, well below any statistical significance.

75. Because Plaintiffs had offered some statistical evidence that also included persons who worked in non-exempt underwriting positions outside the court-defined class period, Dr. Topel performed another analysis that considered those persons, as well, referring to them as "others." When he looked at the court-certified class, comparable whites, and others employed at any time in the same time period, Dr. Topel found a black-white

difference of .007 and a t-statistic of 0.82, not a significant finding.

76. In another analysis, Dr. Topel used a regression calculation to compare the wage progress between blacks and whites when controlling for starting pay grade, years of service, and absence days per months. Controlling for those factors, Dr. Topel found the black-white difference in wage growth was virtually eliminated. For class members, comparable whites, and others, the black-white difference was .002, and the t-statistic was 0.24.

77. To eliminate the effect, if any, of corrective efforts Allstate may have made to "clean up its act" in 1989, after the filing of these charges, Dr. Topel performed the same analysis but eliminated data [*58] that post-dated the filing of Plaintiff's EEOC charges. Again, Dr. Topel found no statistically significant black-white difference: the difference was .015, with a t-statistic of 1.7 when comparing class members and comparable whites, and .015, with a t-statistic of 1.67 when class members, comparable whites, and others were included. Once again, when he controlled for the factors of starting pay, seniority, and attendance, Dr. Topel found the black-white difference declined further: For the court-certified class and comparable whites, the difference was .012 with a t-statistic of 1.43; when looking at the certified class, comparable whites, and others, the difference was .011 with a t-statistic of 1.19.

78. Dr. Topel performed another analysis, in which he looked at all those employed from January 1985 through October 1989, regardless of whether they had received a PDS. Again, the differences between blacks and whites were not statistically significant. Among the court-certified class and comparable whites, he found a race difference of .010, with a t-statistic of .08. Adding the others to the analysis, Dr. Topel found a black-white difference of .012 and a t-statistic of 1.37. Again, [*59] when he controlled for starting pay, seniority, and attendance, the black-white difference was eliminated.

79. Finally, Dr. Topel studied class members and comparable whites during the period from January 1, 1985 through November 1988, and found a black-white wage growth difference of only .009, with a t-statistic of 1.03. When he included others in the analysis, the black-white difference was .013 with a t-statistic of 1.38. Controlling for starting pay, seniority, and attendance reduced the black-white difference to .002, with a t-statistic of .28 for class members and comparable whites, and to .005 with a t-statistic of .52 for class members, comparable whites, and others. These findings reflected no statistically significant differences.

80. Plaintiffs criticize Dr. Topel's work on the ground that his analysis examined overall wage increases without eliminating the "salary adjustments" described in paragraph 26 above, which were unrelated to the merit increases associated with PDS evaluations. According to Dr. Topel, salary adjustments must be included in the analysis. Eliminating such adjustments, he testified, would skew the results because some adjustment increases were subsumed [*60] in merit increases and not coded separately. The court's statistical sophistication is limited. Given that the inquiry here focuses on differences in wage growth rather than differences in wage levels between the two groups, Plaintiffs' criticism of Dr. Topel's failure to eliminate adjustments appears to the court to be a valid one. Unfortunately, Plaintiffs themselves performed no wage growth analysis and therefore offered no evidence that eliminating salary adjustments would have yielded significant differences in wage growth between the two groups.

B. Promotion Rates

81. In addition to the wage growth analysis described above, Dr. Topel performed a statistical analysis of the differences in promotion rates between whites and blacks. In spite of the conceded race disparities in overall PDS scores, Dr. Topel found no statistically significant differences in the promotion rates of whites and blacks from 1985 through 1988. As with his wage growth analysis, Dr. Topel's analysis began by addressing periods of employment ending in termination, promotion, transfer, leave of absence, or demotion, referred to as "job spells." He found no statistically significant difference between [*61] blacks and whites in the number of job spells that ended in promotion. For the period from January 1, 1985 through October 24, 1989, looking at black class members and comparable whites, Dr. Topel found a chi square statistic [4] of .003, yielding a *p* value of .96 (that is, a 96% probability that the small black-white difference in promotion rates would have occurred by chance). When he considered the certified class, comparable whites and others, [5] the chi square statistic was .05, yielding a *p* value of .82.

4 The chi square is a numerical measure of differences between the values actually observed and those expected by chance, which permits comparison of the performance of one group with another. *Smith v. Salt River Project Agricultural Improvement and Power District, F.3d , 1997 U.S. App. LEXIS 5421*, No. 95-16951, 1997 WL 129035, *3 (9th Cir. Mar. 24, 1997). By reference to a standard statistical table, the chi square statistic allows the researcher to determine whether differences between the groups are statistically significant. *See N.A.A.C.P. v. City Of Mansfield, 866 F.2d 162, 167 (6th Cir. 1989)*; *Coates v. Johnson & Johnson, 756 F.2d 524, 537,*

n.11, 13 (7th Cir. 1985); *Chisholm v. U.S. Postal Serv., 665 F.2d 482, 496 n.21 (4th Cir. 1981).*

[*62]

5 See Finding P 75.

82. In an alternative version of this analysis, Dr. Topel excluded the time period after November 30, 1988, to eliminate the effect of any efforts on Allstate's part to improve its record. For class members and comparable white employees, Dr. Topel found that job spells ended in promotions for white employees 36% of the time, and 34% of the time for blacks. The *p* value for this finding was .72 and the chi square statistic was .12. When he looked at the experience of class members, comparable whites, and others, Dr. Topel found similar results. Nor did he find a statistically significant black-white difference in promotion rates when he excluded all lateral transfers from consideration.

83. Dr. Topel found no statistically significant difference in the distribution of blacks and whites in their starting pay grade. Nevertheless, his study addressed the possibility that blacks were over-represented in the lower pay grades, in which one might expect a higher proportion of promotions. Accordingly, he compared the promotion rates for the certified class and comparable whites, [*63] controlling for the employees' starting pay grade. For the period from January 1, 1985 through October 1989, he found a black-white difference in promotion rates, but it was not statistically significant ($p = .24$). Limiting the time period to November 30, 1988 also did not change the outcome. Finally, when he controlled for number of days absent from work, Dr. Topel concluded that the difference in rates of promotions between blacks and whites was "virtually zero."

84. Dr. Topel believes that actual salary increases are the most relevant measure of differences in treatment. Nevertheless, he looked at changes in pay grades (rather than salaries) in order to respond to Dr. Mendel's pay grade analysis. Specifically, Dr. Topel compared each employee's pay grade from the time he or she began in Underwriting to the time the employee left the department. He found no statistically significant black-white difference, regardless of whether he examined the period ending in 1989 or in 1988, and regardless of whether the population examined included class members and comparable whites, or class members, comparable whites, and others. Similarly, when Dr. Topel controlled for the time an employee [*64] had spent in a given grade, he again found no statistically significant difference in the change in job grade per year between blacks and whites.

85. Dr. Topel counted all job spells at the end of 1988, regardless of the length of time, as non-promotions; but given that he did so for both blacks and whites, Plaintiffs' suggestion that this practice reduced the racial variance is unsupported. Most unpersuasive to this court is Plaintiffs' argument that Dr. Topel erred in considering promotions outside the Underwriting Department. Although the Underwriting Department supervisor did not make final decisions concerning such promotions, it is undisputed that an employee's performance record, including past PDSs, was considered in such a decision. Notably, as discussed *infra* PP 121-22, named Plaintiff Rhonda Moore herself complains of Allstate's failure to promote her outside the Department to a position in Acceptance Testing.

C. Overall PDS Ratings

86. As described above, Dr. Topel found no statistically significant difference in the wage growth rates or rates promotion between black and white employees. Dr. Topel does agree with Dr. Mendel that the overall PDS ratings [*65] show a statistically significant difference between black and white employees. Further, in published work, Dr. Topel has acknowledged that supervisors can manipulate apparently objective elements in a performance appraisal system so as to maximize the likelihood of favoring some subordinates over others. Dr. Topel performed certain additional analyses to test Plaintiffs' contention that such manipulation occurred at Allstate.

87. To do so, Dr. Topel collected a sample of PDSs prepared for 158 employees during the period from 1988 through 1989 in order to determine (i) whether the less objective factors in the overall PDS were responsible for the PDS system's disparate impact; (ii) whether the more objective factors were weighted differently for blacks than for whites in determining the overall PDS rating; and (iii) whether, in evaluating the more objective factors, supervisors applied the standards differently for blacks than for whites. Dr. Topel limited his sample to the period from 1988 to 1989, the court-certified class period. He noted, however, that the black-white difference in the distribution of performance ratings in his sample was greater than the difference for all blacks [*66] and whites employed in nonexempt Underwriting from January 1985 through October 1989. Thus, Dr. Topel believes his sample selection exaggerates any disparate impact that exists.

88. From his PDS sample, Dr. Topel created a database in which he listed the ultimate rating and, where available, the underlying subratings on quality, quantity, and attendance. To ensure accuracy, Dr. Topel read nearly every one of the PDSs included in his sample. In any situation where the supervisor had made a specific quality or quantity rating, Dr. Topel placed that rating in the database. Where the supervisor provided neither a rating nor a numerical score for quality or quantity, no rating was recorded in the database. In situations where

the supervisor had placed quantity or quality raw scores on the PDS, but no rating, Dr. Topel supplied the rating from the unit guidelines, if they existed. In situations where there were two ratings for quality and quantity in a single PDS (for example, where an employee had worked on two job assignments during the evaluation period), but no final rating for that component, Dr. Topel averaged them and rounded down. He did not include a rating for deportment.

89. [*67] Dr. Topel found, first, that there was no statistically significant difference between blacks and whites in the probability that they would receive an overall "meets" rating. He did find significant differences in the high and low ratings, however; blacks were more likely to receive an "acceptable, needs improvement" rating, whites more likely to receive an "exceeds." "Requires immediate improvement" ratings were nearly always given because of attendance or tardiness problems. Of the employees who received "acceptable, needs improvement" ratings, most had at least two such low ratings on quantity, quality, or attendance. When Dr. Topel controlled for receiving two "needs improvement" ratings in quantity, quality, or attendance, and for receiving a special "attendance PDS," [6] he found no remaining significant difference between blacks and whites in the likelihood of getting an overall "needs improvement" rating.

6 See Finding P 18.

90. Dr. Topel next examined the group of employees ranked as "meets" and "exceeds." [*68] When he controlled for whether the individual had at least two "exceeds" ratings in the underlying quantity, quality, and attendance criteria, Dr. Topel found that the black-white difference in probability of getting an overall "exceeds" rating was reduced below statistical significance ($t = 1.33$). [7] From this data, Dr. Topel concluded that supervisors apply the underlying ratings on quality, quantity, and attendance in similar ways when assigning overall ratings to black and white employees. Thus, according to Dr. Topel, there is no statistically significant difference in the manner in which supervisors evaluated more subjective factors, such as deportment, for black and white nonexempt employees.

7 In response to this testimony, however, Dr. Mendel pointed out that for employees who received only one underlying "exceeds" rating, the odds of receiving an overall "exceeds" rating varied significantly by race. Thus, of 32 whites who had received one underlying "exceeds" rating, 11 were awarded "exceeds" ratings overall; of 13 blacks who received one underlying "exceeds" rating, none received an overall "exceeds."

[*69] 91. Dr. Topel also addressed the question of whether supervisors exercised discretion in favor of whites with respect to attendance ratings. To do so, Dr. Topel reviewed attendance records compiled from each employee's own weekly record of his or her absences. Rather than accepting the supervisors' evaluations of the attendance data, which Plaintiffs suspect may reflect the exercise of discretion for or against individual employees, Dr. Topel applied a mechanical rule, counting consecutive days of absence as a single occurrence. Dr. Topel found no statistically significant difference between the number of occurrences as counted by supervisors and the number counted by a mechanical rule (the difference was .018, t-statistic = 0.06).

92. Plaintiffs challenge the job-relatedness of the PDS system on the ground (among others) that the PDS rating does not accurately predict performance in a job to which the employee is promoted. To evaluate this challenge, Dr. Topel compared the PDS rating last received prior to an employee's promotion with the first performance rating in the new position. Of 55 employees who were promoted during the class period, 40 were rated "exceeds" in their last [*70] PDS, and 15 were rated "meets." In their subsequent PDSs, 21 of the 40 who had "exceeds" ratings were rated as "meets" in their new position; the remaining 19 received "exceeds" ratings. Of the 15 who were rated "meets" prior to their promotions, only one received an "exceeds" rating in the first PDS following the promotion; 12 were rated "meets"; and two received "requires immediate improvement" ratings. These results established a statistically significant ($p < .003$) relationship between the before- and after-promotion PDS ratings, with a chi square of 11.71 and a t-statistic of more than 3 standard deviations. Dr. Topel concluded that the PDS issued immediately prior to an employee's promotion was a strong predictor of performance in the new position.

93. Dr. Topel concluded that the PDS system did not cause a statistically significant difference in the wage growth or promotion rates between black and white nonexempt employees in the Underwriting Department. He concluded, further, that there is no evidence that supervisors applied subjective evaluations of deportment differently between blacks and whites, nor that supervisors combined the subratings in different fashion as [*71] between blacks and whites. Finally, Dr. Topel found no evidence that supervisors calculated the underlying ratings differently for whites than for blacks.

94. Plaintiffs criticize Dr. Topel's analysis on several grounds; as set forth below, the court concludes that these criticisms do not undermine the analysis:

a. Plaintiffs note, first, that where underlying ratings for quality, quantity, and attendance were missing from

the PDSs, Dr. Topel in some instances imputed such a rating. As Defendant notes, however, Dr. Topel did so only where the PDS included raw data from which the appropriate underlying rating could be determined.

b. Plaintiffs further criticize Dr. Topel's practice of applying a standardized rule in the situation where an employee received more than one quality or quantity rating and the supervisor did not combine that rating into a single score for the criterion. Plaintiffs are correct that Allstate practice permitted the supervisor to exercise discretion in such a situation--indeed, the discretion available to supervisors is a key target of Plaintiffs' disparate impact claim here. Dr. Topel's effort was to determine whether, if such discretion were eliminated, [*72] racial disparities would also be diminished. Applying a standardized rule was necessary in order to make that determination.

c. For the same reason, Plaintiffs' criticism of Dr. Topel's use of other rules to determine an appropriate PDS rating where data was missing falls short.

d. Plaintiffs criticize Dr. Topel's use of a sample of PDSs rather than all of those administered during the relevant time period, but there was no evidence that Dr. Topel's sample was not representative; indeed, as noted earlier, his own analysis suggested that the sample he selected placed Defendant in a worse light than would the overall database from which his sample was drawn.

e. In particular, the fact that Dr. Topel compared some of the sampled PDSs to themselves in determining the sample's representativeness does not provide grounds for criticism; where a sample is drawn from a larger population, that sample will by definition include individuals who are part of the larger population.

f. Plaintiffs are correct that, because in 1989 supervisors began including more underlying ratings in their PDSs, Dr. Topel's database included more PDSs that contained ratings on the underlying criteria. They did [*73] not demonstrate, however, that this change so altered the evaluation practices that Dr. Topel's analysis has no weight.

III. Facts Concerning the Named Plaintiffs' Disparate Treatment Claims

95. In addition to their disparate impact claim, each of the three named Plaintiffs brought a claim of disparate treatment. Each Plaintiff adduced evidence in support of that claim, discussed below. All three also emphasize a 1987 incident involving a black doll as "an example of racial animus or insensitivity at Allstate." In this incident, which occurred during the summer of 1987, several white employees, including one supervisor, were involved in taking the doll from the desk of supervisor Janine French, to whom it belonged, and hanging it from a stanchion in public view. When Plaintiff Velma Dicker saw the doll hanging from the stanchion, she complained to Ms. French, who immediately removed the doll. Ms. Dicker acknowledged that she did not bring the matter to the attention of Vicki Kummer, at that time the unit manager in the Eastern Territory. Ms. Dicker explained that she did not do so because she believed that Ms. Kummer had reacted to the doll with laughter (Ms. Kummer [*74] denied this) and because she believed that Ms. Kummer had made a racially-stereotyped comment to a black Allstate employee on a prior occasion.

96. Janine French concluded that the incident was a practical joke, apparently intended to echo a previous incident in which co-workers had taken Vicki Kummer's teddy bear and "held it hostage." When Ms. Kummer, the unit manager, observed the doll, she recalls feeling annoyed; the workload was heavy and there was little time for joking. Plaintiffs Velma Dicker and Rhonda Moore testified that they were deeply upset upon seeing the doll. Ms. Moore recalled that the doll had paper clips stuck into its chest. Christina Farina, one of the co-workers responsible for the incident, became upset and cried upon learning of Ms. Dicker's reaction. Ms. Farina then met with Ms. Dicker and told her she had not meant to convey any racial message, and apologized to her.

97. Although Ms. Dicker did not bring this incident to the attention of Allstate management, Ms. Moore raised the issue in a meeting with Ms. Alexander of Human Resources. Upon learning about it, Eric Hjerpe investigated and concluded that "there was no racial motivation" behind the incident. [*75] In a memo dated August 17, 1987, Hjerpe reported to William A. Knapp, Jr., Director of Underwriting, that "there was a pin or paperclip stuck in the doll," and observed, "Needless to say, this was done in very poor taste and several employees took offense." Hjerpe recalled that when he discussed the matter with Ms. Farina, she became very upset and apologetic, insisting she had no intention to hurt anyone's feelings. Nevertheless, both Eric Hjerpe and Vicki Kummer apologized to Ms. Dicker. None of the white employees involved in the incident was disciplined, nor was any mention made of the incident in the employees' subsequent PDSs. Indeed, two of the white employees involved, including Ms. Farina, were promoted soon after their next PDSs. Ms. French, their supervisor, testified credibly and at length under cross-examination that she felt great remorse about the offense the incident had engendered, but that she was certain that it was not intended to have racial connotations and reflected, at worst, poor judgment rather than malice.

Velma Dicker

98. Plaintiff Velma Dicker, a high school graduate, has taken college-level courses, including sociology and psychology. She has [*76] served as an elected school board member, is an active church member, and has done volunteer work at Great Lakes Naval Base. Prior to beginning work with Allstate, Ms. Dicker was employed by School District No. 64 in North Chicago, Illinois as a liaison between school administrators and parents. In April 1984, Ms. Dicker began working for Allstate, initially at a facility on Old Skokie Road and, six months later, at the PLSC in Deerfield, Illinois. Soon after transferring to the PLSC, Ms. Dicker was assigned to the position of Record Clerk B in the mail match department of the Eastern Underwriting territory. She remained in that position until April 1987, when she was promoted to Record Clerk C. In July 1987, Ms. Dicker was promoted to the position of Data Prep A. She worked as a Data Prep A until 1987.

99. From 1984 through 1988, Ms. Dicker was evaluated on the quality and quantity of her work, as well as her attendance. She was not told directly or indirectly what weight each of these components had in her overall PDS rating. Although she knew that comments concerning her on-the-job conduct appeared in her PDSs, she was not told explicitly that she was being evaluated on the parameter [*77] of "deportment." Nevertheless, Ms. Dicker testified that she agreed with her PDS rating of "meets" for the period 1984 through January 1985 and with the rating of "meets" for the period from January 1985 through October 1985. During the period January 1985 through October 1985, Ms. Dicker was awarded the Allstate Good Hands Award, an award Allstate makes to one of its employees for his or her community service. Gigi Soeder, a white employee hired after Ms. Dicker, was promoted in 1985 to the position of Record Clerk C.

100. During the period covered in her next PDS, from October 1985 through July 1986, Ms. Dicker had two different job assignments. In the first of those jobs, the "drop desk," her production points put her at an "exceeds" level, but her quality ratings averaged 95.5% (unacceptable). In February 1986, Ms. Dicker rotated to the mechanized desk, where her production merited a rating of "meets," but her quality was 96.5%, at the "acceptable, needs improvement" level. Although she acknowledged having one-on-one meetings with her supervisor to discuss her performance during this period, she was surprised by the "acceptable, needs improvement" rating on her July 1986 PDS. [*78] [8] Ms. Dicker made no written comments on the PDS, but complained to unit manager Joy Reveal that the rating was unfair because her supervisor, Victoria Kummer, had changed the point values for her job assignments in the middle of the evaluation period. Ms. Dicker believes the changes made it more difficult for her to earn points for job functions she was performing. Because the point changes applied to all employees, including a white employee doing the same work as Ms. Dicker, Ms. Reveal declined to alter the PDS rating. In any event, the court notes that despite the point changes, Ms. Dicker's production was at an "exceeds" level; thus her overall "needs improvement" rating was a product of her low quality rating, not her production rating.

8 Plaintiffs contrast this rating with the "meets" rating Ms. Dicker was awarded in October 1985; from June to October of that year, she had a 92% error rate (an unacceptable quality level) and production at the "meets" level. As Defendant observes, however, Ms. Dicker's performance during the earlier portion of that evaluation period (January through May 1985) had been at the "meets" level. The court finds no inconsistency in the two overall PDS ratings.

[*79] 101. After the July 1986 PDS, Ms. Kummer met with Ms. Dicker to discuss ways to improve her performance. Because Ms. Dicker had difficulty with typing, Ms. Kummer moved her to the APS desk, where less typing was required. During a one-on-one session, Ms. Dicker told Ms. Kummer that she did not want to go into the Data Entry unit because of the typing skills required, and instead preferred promotion to the QV unit.

102. Ms. Dicker recalled one incident in 1986 in which Vicki Kummer assigned one of Ms. Dicker's white co-workers, either Janice Letteri or Christina Farina, to take some materials to the mailroom. When that co-worker refused to run the errand, Ms. Kummer said she would make Plaintiff Dicker do it, and did so. Nevertheless, the PDSs for both of these workers covering at least some portions of 1986 contained no negative deportment references. (*See* Letteri PDS, 4/86-1/1/87 (referring to Ms. Letteri as a "team player"); Farina PDS 9/85-6/86 (characterizing Ms. Farina as "very valuable").)

103. Ms. Dicker believes that Ms. Kummer chastised her, but not her white co-workers, for taking personal phone calls. On one occasion when Ms. Dicker had taken a call concerning teacher [*80] contract negotiations, she pointed out to Ms. Kummer that co-worker Janice Letteri had made wedding plans over the telephone at work. Ms. Kummer replied that the rules applied to everybody, but Ms. Dicker challenged this, observing that other employees in the unit had made calls without comment from Ms. Kummer. Under cross-examination, however, Ms. Dicker acknowledged that she did not know whether Ms. Kummer had reprimanded other employees for personal phone calls.

104. Approximately one month before her April 1987 PDS, Ms. Dicker had a conversation with her su-

pervisor, Janine French, in which Ms. French told her that Anita Hartmann (a co-worker who was also Ms. French's cosmetologist) and Christina Farina would be promoted to Record Clerk C, and that Maryann Ciaja (white) would be promoted to Data Prep A, but that Ms. Dicker herself would not be promoted. Ms. Dicker, who had trained all three of these employees, believed it unfair that they were to be promoted before her. Ms. Dicker complained to Eric Hjerpe, the unit manager. Hjerpe advised her that it was not "her turn" to be promoted; Defendant explains that Ms. Dicker's "acceptable, needs improvement" rating on her July 1986 [*81] PDS was a bar to promotion and that Ms. Dicker was not eligible for promotion until she earned a "meets" or better on her PDS. On her April 1987 PDS, Ms. Dicker did earn a "meets" rating and won a promotion to Record Clerk C. Three months later, in July 1987, Ms. Dicker was again promoted, this time to the position of Data Prep A.

105. Having received a promotion in July 1987, Ms. Dicker was not scheduled for another PDS until July 1988. [9] She believed that she was entitled to a review in April 1988, however, and requested a PDS from her supervisor, John Mueting. When Mr. Mueting told her that a PDS was not due, Ms. Dicker insisted she was entitled to one. After that conversation, Ms. Dicker was summoned to Mr. Hjerpe's office. Hjerpe also told her that she was not entitled to a PDS in April 1988, and that she should have accepted Mr. Mueting's explanation. Mr. Hjerpe then arranged for Ms. Dicker to see Ms. Alexander, the Human Resources director. Although Defendant denies that Mr. Hjerpe referred to Ms. Dicker's conduct as insubordinate, Defendant has provided no other explanation for the direction that she see Ms. Alexander.

9 As support for her claim that she was entitled to a PDS in April 1988, Plaintiff relies on notations in her monthly reviews in April 1987 and May 1987. (*See* Plaintiffs' Proposed Findings of Fact P 208.) The court notes, however, that each of those reviews preceded Ms. Dicker's July 1987 promotion to Data Prep A.

[*82] 106. When Ms. Dicker met with Ms. Alexander the following day, she asked why she had been required to attend a meeting to discuss her request for a PDS when, in contrast, employees who had been involved in an incident with a black doll had not been called to Human Resources. Ms. Dicker noted that she had not been disrespectful in regard to her request for a PDS. Ms. Alexander, until then unaware of the black doll incident, asked Ms. Dicker for details. Although Mr. Hjerpe had told Ms. Dicker that he planned to file a report concerning the black doll incident with Ms. Alexander, at the time Ms. Dicker met with her, Ms. Alexander was unaware of any such reports.

107. Ultimately, Ms. Dicker did receive a PDS reviewing her performance in April 1988, but did not receive a salary increase. In August 1988, Ms. Dicker received a PDS and salary increase. As of the time she filed her charge of discrimination at the end of November 1988, Ms. Dicker and Plaintiff Patricia Hood were the highest-paid Data Prep As in the Eastern division.

108. Ms. Dicker recalls that on one occasion, Gigi Soeder, a white employee, complained to her supervisor, John Mueting, that she had been incorrectly charged [*83] with an error by the Data Prep B who had spotchecked Ms. Soeder's work. Mueting agreed to change the record and remove the error notation. Ms. Dicker told Mueting that she also had been charged with the same error, but Mueting refused to change the record for Ms. Dicker as he had for Ms. Soeder, purportedly because Ms. Dicker would not have known about the error had Ms. Soeder not raised the issue.

109. Ms. Dicker believes she was discriminated against with respect to training in at least two respects. First, she claims that she was denied training on work involving applications from New York. According to Defendant, New York law requires that insurance application files from that state be kept separate from files of other states; Allstate complied with this requirement and assigned a single individual to process all New York files (rather than an alphabetical section of the remaining files), but the work involved was otherwise the same as what all other mail match employees performed. Second, Ms. Dicker believes that Chris Carlstrand, a white employee, was trained before she was. The record shows that Ms. Carlstrand became employed with Allstate's Midwest Regional Life Office beginning [*84] in May 1983 and moved to the PLSC when it opened. Thus, the fact that Ms. Carlstrand received some training before Ms. Dicker is not indicative of discrimination.

110. In June 1988, Janice Letteri was promoted from the Data Prep A position to a UCU. Letteri's PDS rated her as "meets" overall, with underlying scores of "meets" for production; "exceeds" for quality (although, as Plaintiffs note, her QV rating of 97.6% fell just below the 98% required for an "exceeds" according to Allstate's standards); "meets" in attendance; and positive comments for extraordinary customer service. In Ms. Dicker's August 1988 PDS, she also received a "meets" overall, with underlying scores of "meets" for production; "exceeds" for quality as measured by spotchecks and "meets" as measured by QV errors; and very positive comments concerning extraordinary customer service. Ms. Dicker, who had been promoted to the position of Data Prep A before Ms. Letteri, believes she was more qualified for promotion to UCU than was Ms. Letteri. The position was one for which Ms. Letteri posted, however; Ms. Dicker did not post for the position. Mr. Hjerpe

filled another UCU position during 1988 by hiring a black female [*85] from outside Allstate because none of the Data Preps was interested in transferring to that position.

111. Ms. Dicker understood that it was standard practice for employees in Underwriting to assist clerks in mail match in keeping current with the incoming mail. Nevertheless, Ms. Dicker claims that her supervisor, Janine French, instructed her not to assist employees in the mail match unit during the time that Monique Gregory, a black woman, was a supervisor in that unit. The court does not find Ms. Dicker's testimony concerning this purported instruction not to help credible. Defendant offered evidence that in September, 1987, Ms. French prepared a PDS for Christina Farina, specifically thanking her for helping Monique Gregory's unit.

112. At some point during the course of Plaintiffs' employment, Mr. Hjerpe asked Patrice Boone, a black supervisor new to Allstate, to help him communicate with Plaintiffs Velma Dicker and Rhonda Moore. Ms. Boone was new to Allstate. Ms. Dicker recalls that Ms. Boone believed Eric Hjerpe wanted her, Ms. Boone, to be a "hatchet person" with respect to black employees, and that Ms. Boone warned that Mr. Hjerpe was looking for any excuse to terminate [*86] Plaintiffs Dicker and Moore. Ms. Boone took no action against either Ms. Dicker, who continued to work for Allstate as of the time of the hearing, or Ms. Moore, who resigned voluntarily in April 1990.

113. In August 1989, Plaintiff Dicker was rated "exceeds" and promoted to the Data Prep B position. She remains employed at Allstate.

Rhonda Moore

114. Plaintiff Rhonda Moore was employed by Allstate from January 1984 until April 1990, when she resigned voluntarily. At the time she testified in August 1993, Ms. Moore was employed by Wright Video Services America in Deerfield, Illinois, as a customer service representative. During her two and one-half years with Wright, Ms. Moore has been promoted twice. Ms. Moore was active in community work during her employment with Allstate, serving as president of the PTA of her children's school, running a support group for dysfunctional families, and volunteering time to prepare food baskets for the needy.

115. Ms. Moore was hired into the position of Data Prep A in the Midwest Regional Office, and was among the first employees transferred to the PLSC when it formed. She was assigned to train other data prep employees hired at the [*87] PLSC and was responsible, as well, for training new supervisors on the daily procedures at the PLSC. Other employees who started with her were Karen Levek, Sandy Wright, Peggy Labus, Alberta Cruz, and Lois Newberry, all white employees, as well as black employees Patty Jones and Carey Earl. Two other white employees, Chris Fortmiller and Janice Letteri, began working in Ms. Moore's unit shortly after the PLSC opened. Ms. Moore recalls that soon after she began work at the PLSC, a supervisor informed her that it was not possible for an employee to be promoted from the position of Data Prep A to that of UCU. Instead, the employee would first have to be promoted to Data Prep B and then make a lateral move to the UCU slot. According to Ms. Moore, this supervisor also told her she could not be promoted for at least nine months.

116. From the beginning of her employment with Allstate, Ms. Moore was instructed to keep a record of her production and was aware that she received a certain number of points for each task. Ms. Moore's work was spotchecked nearly each month; her desk files revealed that she had regular monthly one-on-one meetings with her supervisor. Nevertheless, although aware [*88] that she was keeping production records and being spotchecked, Ms. Moore testified that it "never crossed her mind" that these records were being maintained in order to evaluate her performance. Thus, before receiving her first PDS for the period from February through November 1984, she claims she was unaware that she would be evaluated on the basis of quantity, quality, and attendance.

117. Ms. Moore was unhappy about the frequent changes in supervisors and complained about the matter to Human Resources, but the practice of rotating underwriter trainees into these supervisory positions continued. Ms. Moore recalls being under the supervision of three different supervisors during the seven-month period covered by the November 1984 PDS; the record shows, however, that Thomas Price was her supervisor for at least six of the seven months, beginning in June 1984 and continuing as her supervisor through April 1985.

118. In September 1985, Ms. Moore received a second PDS covering the period from December 1984 through September 1985. Thomas Pludray, the supervisor who signed that PDS, had supervised Ms. Moore for a portion of that period, as had Thomas Price and Stephanie Baker. Ms. Moore's [*89] overall evaluation was "exceeds," and she was promoted to the position of Data Prep B. This was Ms. Moore's last promotion while employed at Allstate; although managers approached her about promotion into the UCU position, Ms. Moore chose instead to wait for a promotion outside the department.

119. One of the responsibilities of a Data Prep B was "complex change re-issues." White employees

Karen Levek, Lois Newberry, and Peggy Labus performed this work, but Ms. Moore had not yet been trained on the task as of June 1986, nine months after being promoted to Data Prep B. She brought this issue to the attention of her supervisor, Tom Pludray, and to Alton Grant, a black employee then working as unit manager. Ms. Moore received a "meets" rating overall on her May 1986 PDS, but was rated "exceeds" in her next PDS in March 1987. Like Ms. Moore, Lois Newberry, a white employee promoted in August 1985 to Data Prep B, was not trained on a function (in her case, QV errors) until nine months after her promotion to Data Prep B. Defendant attributes the nine-month delay in training Ms. Moore to the time of year in which she took on the new position, just prior to the fall. At that time every year, [*90] Allstate gears up for a "fall promotion," the company's busiest season and a time when few supervisors or co-workers can be spared from their own job responsibilities to train other workers. Ms. Moore ultimately was trained on complex change re-issues in June 1986. Karen Levek, who had started working for Allstate at the same time as Ms. Moore, was her trainer. Levek and Newberry had both been trained on this task before Ms. Moore.

120. From September 1, 1985 through May 1, 1986, Ms. Moore was supervised by Kim Graham and Stephanie Baker. She contends that during the period covered by her May 1986 PDS, she expressed confusion to supervisor Tom Pludray [10] and unit manager Alton Grant concerning the assignment of points for "general time," but that neither Pludray nor Grant responded prior to May 1986. By June 1986, however, Ms. Moore understood that whenever she worked on something that did not have a specific point value assigned to it, the work was credited with one point per minute.

10 In paragraph 236 of her Proposed Findings of Fact, Ms. Moore refers to Mr. Pludray as her supervisor at the time of the May 1986 PDS; in paragraph 234, however, she refers to Ms. Graham and Ms. Baker as her supervisors from September 1985 through May 1986.

[*91] 121. In addition to her concerns about training, Ms. Moore was troubled by the fact that she was not provided with information from the Acceptance Testing unit at Allstate, information that she understood was being provided informally to her white co-workers. In August 1987, Ms. Moore met with Mr. Hjerpe to discuss this issue and others. Mr. Hjerpe recalls that Ms. Moore told him that an employee who had worked previously in the Eastern underwriting territory had transferred to Acceptance Testing, and had been making calls to her friends in Eastern underwriting, providing them with problem-solving suggestions and new procedures. She told him, as well, that all of the supervisors she had worked for were racist; that she had been misinformed about evaluation standards; and that she believed there was unfair treatment at Allstate with respect to compensation and promotions. With respect to evaluation, Ms. Moore told Mr. Hjerpe that she believed supervisors inappropriately emphasized quantity and quality ratings, although she had been led to believe that deportment would also be an important factor in evaluation. With respect to racism on the part of supervisors, Ms. Moore specifically [*92] mentioned the delay in training while she was supervised by Mr. Pludray. Ms. Moore told Mr. Hjerpe that she did not believe he himself was racist, but refused to discuss other supervisors or managers. At the conclusion of the conversation, Mr. Hjerpe encouraged Ms. Moore to contact him again to resume the conversation. He also called a division manager or unit manger in the Acceptance Testing unit to tell that person that "if there are new procedures or any things of that nature, you need to [communicate the information to everyone]."

122. Also in 1987, [11] Ms. Moore had a conversation with Eric Hjerpe about the possibility of transferring to a position in UCU. Mr. Hjerpe pointed out that such a job change would be a lateral move, without a corresponding pay increase. He also warned her that it was possible her evaluation would be at an "acceptable, needs improvement" level initially. Ms. Moore, whose most recent evaluation had been "exceeds," claims she felt discouraged by this conversation from seeking transfer to UCU. In fact, however, as she testified at her deposition, Ms. Moore did not want a lateral transfer to UCU during 1986 or 1987; instead, her preferred next step was [*93] to the Acceptance Testing unit. Ms. Moore told Joy Reveal and John Mueting that she was not interested in UCU because of the telephone work involved.

11 Hjerpe recalls that this conversation occurred in 1988.

123. In 1987, Ms. Moore told her unit manager, Joy Reveal, of her desire to be promoted to a position in Acceptance Testing. Along with 40 other employees, Ms. Moore applied for one of two posted positions in the Acceptance Testing unit. Although Ms. Moore's supervisor wrote a glowing recommendation for her, she was not promoted. Instead, the positions were awarded to two white employees. Christine Carlstrand, a white employee in the Eastern territory who also applied and had an "exceeds" rating, was denied the Acceptance Testing position as well.

124. In 1987 or 1988, Ms. Moore complained about unfair work distribution to black and white employees. In addition to speaking to Rodney Daniels of Human Resources and William A. Knapp, Jr., Director of Underwriting, Ms. Moore raised the issue with Jane Alexander. [*94] In a meeting in Ms. Alexander's office, Ms. Moore

said she believed whites were being treated more favorably with respect to work assignments and were disrespectful to black supervisors without repercussions. She told Ms. Alexander that she believed blacks were not being trained in a timely fashion, and suggested that all job information be communicated in writing to make sure everyone had access to it.

125. Ms. Moore was rated as "exceeds" in her PDS for the period from March 1987 to March 1988 and was awarded a 10.1% pay increase. Nevertheless, she refused to sign the employee signature line on the PDS because it contained what she believed to be an untrue statement: that she was unwilling to perform tasks assigned by her supervisor when she believed them to be inappropriate or inimical to her personal goals. Significantly, the PDS also commended Moore's "positive attitude" as "displayed in her willingness to assist peers, supervisors and other department members" and noted that she had received the Chairman's Award for outstanding service. Ms. Moore believed that the 10.1% increase was insufficient; she believed she was entitled to a 20% raise, although, as she acknowledged at [*95] trial, it is "probably" true that no employee had ever been given a merit increase of that size. On her next PDS, in March of 1989, Moore was rated "exceeds" and received another 11% increase.

126. On one occasion, after a meeting of unit employees, Stephanie Baker asked Ms. Moore for suggestions on work efficiency. Ms. Moore, who was at this time a Data Prep B, suggested that only Data Prep As should be assigned to work on a project involving preauthorized check payment of insurance premiums ("PAC"). Ms. Baker rejected the suggestion. Ms. Moore recalls that she was not disrespectful to Ms. Baker and that Ms. Baker was not angry with her; nevertheless, the following Monday Ms. Moore was summoned to meet with Mr. Hjerpe, who told her that he understood she "had a problem with work flow." Ms. Moore denied having any such problem. Her PDS for that time period rated Ms. Moore as "exceeds."

127. On one occasion, a few minutes before the scheduled start of the work day, John Mueting, at that time a supervisor in another unit, asked Ms. Moore to help him with some work. Ms. Moore declined, explaining that the system was down and that she was busy preparing to do her Data Prep B work. Mr. [*96] Mueting repeated his request more than once, but Ms. Moore continued to refuse it. Shortly thereafter, Vicki Kummer, the unit manager, directed Ms. Moore to meet with Ms. Kummer and Mr. Mueting in an empty office. Ms. Kummer asked Ms. Moore whether she understood Allstate policy on insubordination. Ms. Moore denied having been insubordinate, but Ms. Kummer stated that she had been, and asked whether Ms. Moore understood. Rather than saying that she understood, Ms. Moore only responded, "I hear you." Ultimately, Ms. Kummer referred Ms. Moore to Human Resources; when Ms. Moore explained the events to Rodney Daniels in Human Resources, Mr. Daniels concluded she had not been insubordinate.

128. In spite of the fact that Mr. Mueting himself considered Ms. Moore to be an excellent employee, he never recommended her for a promotion. According to Defendant, the only position for which he could have recommended her was UCU, a position she did not want. In fact, in 1988, Eric Hjerpe approached every one of the Data Prep Bs in the Eastern Territory, including Ms. Moore, and asked whether he or she would accept a transfer to UCU. All declined. Mr. Hjerpe then posted the position. Janice Letteri, [*97] a white employee who began working at Allstate at the same time that Ms. Moore did but whose most recent PDS ratings were not as high as Ms. Moore's, applied for the posted position and was awarded the posting effective June 1988. Also in 1988, Mr. Hjerpe hired a black employee from outside Allstate for another vacant UCU slot. It is undisputed that Ms. Moore was qualified for the position.

129. In 1987 or 1988, Ms. Moore complained to Jane Alexander in Human Resources about what she perceived to be an unequal distribution of general time points. Moore claimed that whites received more opportunities to receive such points than did blacks. Ms. Alexander discovered, on performing a spotcheck, that Ms. Moore herself had performed far less data collection work (for which specific points were assigned) than her co-workers, but received far more general time points than other data preps.

130. As of December 20, 1988, Ms. Moore was the highest paid Data Prep B, with the exception of a white woman hired by Allstate one year before her. On her March 1989 PDS, Ms. Moore was again rated "exceeds" and awarded an 11% salary increase. After her transfer to the UCU position, Ms. Moore voluntarily [*98] terminated her employment with Allstate in 1990.

Pat Hood

131. Plaintiff Pat Hood, a registered cardiology technician, began working for Allstate in October 1984 as a claims examiner. By January 1988, Ms. Hood was working as a Data Prep A. She had moved to that Grade 4 position from a Grade 3 position as Data Processor A, but did not receive a salary increase. Ms. Hood's first supervisor as Data Prep A was John Mueting. Mr. Mueting told Ms. Hood in January 1988 that Lois Newberry would be her trainer. Ms. Newberry was not present at the time, however, so Mr. Mueting directed Ms. Hood to sit with any available Data Prep B to begin learning the

Data Prep A functions. Two or three weeks later, Ms. Hood began her formal training. At or about the same time, Anita Hartmann, a white employee, entered the unit and was assigned to be trained by Peggy Labus.

132. Lois Newberry, Ms. Hood's trainer, left the unit in April 1988 and was on sick leave for part of the time prior to that. Ms. Hood herself was out on sick leave from February 2, 1988 through March 4, 1988. Soon after she began working in the unit, Ms. Hood complained to Mr. Mueting about inadequate training. She claims that [*99] the only assistance he provided was an instruction that when Ms. Newberry was unavailable, Ms. Hood should sit with other employees to get training. In a note written to Ms. Hood in April 1988, Mr. Mueting asked whether she needed any additional training; Ms. Hood did not respond. She did initial forms acknowledging having received training, but explains that she did so even though she had not actually received the training because Mr. Mueting assured her she would eventually receive the necessary instruction. As of September 1988, her training was still not complete.

133. After Lois Newberry's promotion, Ms. Hood received some training from Peggy Labus and other training from other employees when they were available to assist her. In June 1988, supervisor Christine Swiss again asked Ms. Hood what additional training she needed. Subsequently, Ms. Swiss arranged for additional training for Ms. Hood on "short downs" and "sales suspense" tasks. At trial, Ms. Hood testified that she complained to her supervisor that Lois Newberry was a bad trainer; in her deposition, Ms. Hood testified that she never complained about Ms. Newberry. Similarly, Ms. Hood testified at trial that she complained [*100] about her training to Christine Swiss, but in her deposition she denied making any such complaints.

134. Like Plaintiffs Dicker and Moore, Ms. Hood complains of Janice Letteri's promotion to the UCU position in June 1988. Ms. Hood notes that Ms. Letteri had lower production figures than Ms. Hood did. Like Plaintiff Dicker and Moore, however, and unlike Ms. Letteri, Ms. Hood did not post for the UCU slot.

135. Ms. Hood's first PDS while in Underwriting in December 1988 rated her as "acceptable, needs improvement." Ms. Hood refused to sign the PDS. She believed that it unfairly penalized her for Allstate's failure to provide her with effective training. She noted that one of the functions described in the PDS as among her responsibilities ("APS check reversal") was one on which she had not yet been trained. Anita Hartmann, the white employee who started in the unit at the same time as Ms. Hood, received a PDS for the period January 1988 through January 1989 that reflected that she had received training on this assignment. Ms. Hood acknowledged, however, that that function constituted only a small part of her job.

136. As of December 20, 1988, Patricia Hood was the highest paid Data [*101] Prep A in the Eastern Territory.

137. Ms. Hood never posted for any available UCU positions. In December 1989, she tendered her resignation, but subsequently changed her mind and remained employed there, was promoted in March 1990, and ultimately resigned later that year to pursue employment closer to her home. She testified that she did not feel she was treated unfairly after she filed her charge in 1988.

DISCUSSION

I. Disparate Impact Claim

A. Standards of Proof

Although the parties differ sharply concerning the appropriate statistical analysis of the evidence in this case, they agree that the controlling law is set forth in *Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 104 L. Ed. 2d 733, 109 S. Ct. 2115 (1989)*. In *Wards Cove*, a class of non-white workers at an Alaska salmon cannery brought a disparate-impact challenge to their employer's hiring and promotion practices. Plaintiffs claimed these practices resulted in a racial stratification in which white workers predominated in skilled positions and non-whites were overrepresented in the unskilled cannery jobs. *490 U.S. at 646-48*. In reversing and remanding a judgment in favor of the [*102] plaintiffs, the Supreme Court acknowledged that statistical proof alone can establish that an employer's hiring practices have a disparate racial impact. *Id. at 650*. Such proof is insufficient, however, the Court concluded, if the statistical analysis ignores the possibility that the racial imbalance is caused by factors beyond the employer's control--for example, the racial imbalance in the pool of qualified jobseekers. *Id. at 651-652*.

The Court then went on to discuss other arguments raised by defendant. First, the Court noted, the plaintiff in a disparate impact case bears the burden of "'identifying the specific employment practices that are allegedly responsible for any observed statistical disparities.'" *Id. at 656* (quoting *Watson v. Fort Worth Bank and Trust, 487 U.S. 977, 994, 101 L. Ed. 2d 827, 108 S. Ct. 2777 (1988))*. The Court referred to this issue as "the question of causation," and emphasized that plaintiffs in a disparate impact case must "demonstrate that the disparity they complain of is the result of one or more of the employment practices that they are attacking here . . . ." *Id. at 656, 657*. To assist them in making that demonstration, the Court [*103] suggested, employees may need

to consider records maintained by employers pursuant to EEOC regulations. *Id. at 657-58*.

If the plaintiff demonstrates that an employer's practices cause racial disparities, the court's inquiry shifts to the business justification offered by the employer for using the challenged practices. This analysis has two components: consideration of the justification offered by the employer, and the availability of alternative business practices with less racial impact. *Id. at 658*. Although the employer must offer more than "a mere insubstantial justification," the Court distanced itself from any suggestion that the challenged practice must be "essential" or "indispensable" in order to survive a disparate-impact challenge. Instead, according to the Court, "the dispositive issue is whether a challenged practice serves, in a significant way, the legitimate employment goals of the employer." *Id. at 659*. The employer must offer evidence on this matter, but it is plaintiffs who bear the burden of persuasion. If the plaintiffs cannot meet the burden of proving that the challenged practice does not serve legitimate goals, they may nevertheless prevail by [*104] offering alternatives that are "equally effective" in achieving the employer's goals without the undesirable racial effect, bearing in mind the attendant costs and burdens. *Id. at 660-61*.

Disparate impact challenges are often leveled at objective performance measures, such as the standardized tests at issue in *Melendez v. Illinois Bell Tel. Co., 79 F.3d 661 (7th Cir. 1996)* and *Allen v. Seidman, 881 F.2d 375 (7th Cir. 1989)*. As the Supreme Court recognized in *Watson*, however, a subjective hiring or evaluation practice may also be subject to such a challenge. Thus, in *Mozee v. American Commercial Marine Serv. Co., 940 F.2d 1036 (7th Cir. 1991)*, plaintiffs demonstrated the unlawful disparate impact of defendant's practice "of allowing its foremen complete discretion in their choice of whom to promote." *Id. at 1044, 1045-46*. In this case, Plaintiffs challenge a performance evaluation system that has both objective and subjective components.

To make out a prima facie case, Plaintiffs bear the burden of proving that the practice they challenge has caused the loss of pay increases or promotions. To do so, they must present evidence of statistical disparities between [*105] racial groups that are "sufficiently substantial that they raise such an inference of causation." *Watson, 487 U.S. at 995*; *see also Cox v. City of Chicago, 868 F.2d 217, 220 (7th Cir. 1989)* (effect of challenged rule must be "'significant' or 'substantial'") (citing *Griggs v. Duke Power Co., 401 U.S. 424, 426, 28 L. Ed. 2d 158, 91 S. Ct. 849 (1971))*; *Morgan v. Harris Trust and Sav. Bank, 867 F.2d 1023, 1028 (7th Cir. 1989)* ("it is well settled that evidence of statistical disparity must be significant or substantial to establish that an otherwise neutral employment practice results in a discriminatory impact").

Statisticians consider whether a significant difference between groups is shown by reference to the "standard deviation": a measure that "quantifies the degree to which disparities spread out above and below the mean of distribution . . . ." *Coates v. Johnson & Johnson, 756 F.2d 524, 537 n.11 (7th Cir. 1985)*. The higher the number of standard deviations, the lower the probability that the result occurred by chance. *Waisome v. Port Auth. of New York and New Jersey, 948 F.2d 1370, 1376 (2d Cir. 1991)*.

Both parties' statistical experts in this case recognized [*106] two standard deviations between the groups being compared as a minimum standard of statistical significance. The Seventh Circuit, likewise, has endorsed this standard. *See E.E.O.C. v. Chicago Miniature Lamp Works, 947 F.2d 292, 300 n.4 (7th Cir. 1991)* (citing *Hazelwood School Dist. v. United States, 433 U.S. 299, 308 n.14, 53 L. Ed. 2d 768, 97 S. Ct. 2736 (1977)* for the proposition that "the hypothesis that decisions were made without regard to a protected characteristic is suspect if there are more than two standard deviations between the actual value and the expected value"). *But see Coates, 756 F.2d at 547 n.22* (courts should use caution in drawing conclusions of statistical significance at a two to three standard deviation level); *E.E.O.C. v. Sears, Roebuck & Co., 628 F. Supp. 1264, 1286-87 (N.D. Ill. 1986)*, *aff'd*, *839 F.2d 302 (7th Cir. 1988)* (differences that exceed three standard deviations may be statistically significant); *E.E.O.C. v. Western Elec. Co., 713 F.2d 1011, 1018 (4th Cir. 1983)* ("courts 'should be extremely cautious in drawing any conclusions from standard deviations in the range of one to three'") (quoting *E.E.O.C. v. American Nat'l Bank,* [*107] *652 F.2d 1176, 1192 (4th Cir. 1981))*.

Another way of assessing statistical significance focuses on the "*p* value"--a measure of the likelihood that a given result will occur by chance. Where the probability (*p* value) that the differences between two groups of subjects is merely a product of chance falls below .05, the court will reject the chance hypothesis and conclude that a statistically significant showing has been made. *See, e.g. Daniels v. Pipefitters' Ass'n Local Union No. 597, 945 F.2d 906, 924 (7th Cir. 1991)*, *cert. denied*, *503 U.S. 951, 112 S. Ct. 1514, 117 L. Ed. 2d 651 (1992)*; *Ottaviani v. State Univ. of New York at New Paltz, 875 F.2d 365, 371-72 (2d Cir. 1989)*; *Segar v. Smith, 238 U.S. App. D.C. 103, 738 F.2d 1249, 1282 (D.C. Cir. 1984)*. The court refers to both methods of assessing significance in its discussion of Plaintiffs' claims that the PDS system had an adverse effect on their wage growth and promotion rates.

B. Wage Growth

Plaintiffs here offered no statistical evidence of any difference in the wage growth of white and black nonexempt employees. Instead, to prove their wage growth claim, Plaintiffs rely on the statistical [*108] disparity between overall PDS ratings awarded to black employees and those awarded to whites. Wage increases at Allstate were explicitly linked to PDS scores, Plaintiffs note; it logically follows that a disparity in overall PDS ratings must translate into a disparity in wage increases as between whites and blacks.

In fact, however, several factors other than PDS scores alone influenced wage increases at Allstate. For example, the employee's "compra ratio" (*see* Findings P 25) and the length of time since the employee's last increase had an influence. Further, Allstate made salary adjustments from time to time that affected all employees within a particular pay grade.

Plaintiffs suggest that, to the extent these other factors "corrected" the disparate impact of PDS scores on wage growth, they should not bar a finding of liability. In *Connecticut v. Teal, 457 U.S. 440, 73 L. Ed. 2d 130, 102 S. Ct. 2525 (1982)*, the plaintiff challenged a Connecticut state agency's requirement that candidates for a supervisory position pass a written examination that had a significantly lower pass rate for blacks than for whites and that was not shown to be job related. *Id. at 443-44*. In [*109] defense of its procedure, the state agency noted that additional factors in the promotion process resulted in promotion of a greater percentage of black than white candidates, with the result that the "bottom line" of the promotional process--that is, the numbers of persons selected for promotion--reflected racial balance. *Id. at 444*.

The Court was not persuaded. Title VII guarantees *each individual* a fair promotional opportunity, the Court observed. *Id. at 453-54*. Because the written examination was an absolute barrier to further consideration for individual applicants, and had a significant adverse effect on minorities, defendant's practice denied an employment opportunity to those candidates who did not pass. The fact that defendant had evidence of racial balance in the "bottom line" numbers of promotees did not constitute a defense to plaintiff's disparate impact showing. *Id. at 455-56*.

The situation in *Teal* was different from this one, however, in that the employer in that case made a conscious effort to achieve racial balance, apparently by manipulation of the factors other than the promotional examination. In this case, there is no basis for a conclusion [*110] that any of the non-PDS factors in the wage increase equation--the employee's "compra" ratio; the length of time since the employee's last PDS; the across-the-board adjustment--were the product of efforts to eliminate whatever effect the PDS had on wages. Thus, if the PDS had a disparate effect on wage growth, that effect should remain apparent, in spite of the other factors involved in determining any individual employee's wage increase.

Yet Defendant's statistical analysis found no statistically significant difference in the wage growth of black and white employees. As noted (*see* Findings P 75), Dr. Topel found only a small (.007%) difference in the average wage growth between blacks and whites. That difference, less than half a standard deviation, falls well below the standard for statistical significance. These results were the same whether or not Dr. Topel included within his analysis persons who worked in nonexempt underwriting positions outside the court-defined class period, and whether or not he ended the analysis at the time that Plaintiffs filed their charge. Dr. Topel concluded that the PDS ratings did not create a statistically significant difference in the wage growth [*111] of black and white nonexempt employees in the Underwriting Department. Plaintiffs criticize Dr. Topel's analysis on the basis that he did not exclude the effect of Department-wide salary "adjustments," non-merit wage increases which improved the lot of all employees (white and black), and might, Plaintiffs suggest, have masked the effect of black-white disparities in wage increases. Thus, for example, Plaintiffs contend that Dr. Topel "simply ignored the impact of the PDS scores on wage growth by refusing to isolate their influence on merit increases and remove non-merit-related factors." (Plaintiffs' Post-Trial Reply Brief, at 11.) Unfortunately, however, Plaintiffs themselves performed no wage-growth analysis at all. Thus, Plaintiffs offer nothing to support their suspicion that, had Dr. Topel removed "non-merit-related factors" from his analysis, the result would reflect disparate impact.

The court concludes that Plaintiffs have not met their burden of showing a statistically significant difference in wage growth among black and white employees. Plaintiffs' claim that the PDS system resulted in such a difference is dismissed.

C. Promotional Opportunity

Defendant argues [*112] that Plaintiffs' promotional opportunity claim must also be dismissed. First, Defendant points to the results of its expert's statistical analysis of the likelihood that a "job spell" would end in promotion. Within the relevant time frame, job spells ended in promotion 36% of the time for white employees, and 34% of the time for blacks--not a statistically significant difference. To satisfy a concern that the employee's job grade, PDS rating, or number of days absent might exert enough of an influence over likelihood of promotion as

to mask the race effect, Dr. Topel controlled for those factors, but still found no statistically significant difference in the likelihood of promotion for blacks and whites. Notably, when Dr. Topel controlled for job grade and absences, but not for PDS ratings, he found no statistically significant difference in the likelihood of promotion between blacks and whites. Thus, the difference between black and white employees in average pay grades advanced per year was virtually zero if the number of days of absence were held constant.

Plaintiffs' expert, Dr. Mendel, did find a significant difference in those promotion rates, but the court finds his statistical [*113] analysis less persuasive for several reasons. First, as Dr. Topel explained, Dr. Mendel utilized a test statistic, the Kruskall-Wallis, that is more appropriate for ordinal data. The data Dr. Mendel considered is, strictly speaking, ordinal because he counted the number of promotions each employee received and assumed that an employee who was promoted more often had received more favorable treatment than one promoted less often. That assumption does not fit the facts of this case well, however; a person promoted only once after four years on the job cannot fairly be said to have received more favorable treatment than an employee who has never been promoted but has been on the job for only a few months.

Further, both experts acknowledged that the Kruskall-Wallis test statistic must be adjusted to account for ties in the data. Here, the number of ties (*i.e.*, the number of persons in the sample who had been promoted the same number of times) was quite large, requiring that the Kruskall-Wallis statistic be adjusted by 37%, a correction that Dr. Topel testified credibly was large enough to render the statistical results suspect. When Dr. Mendel's data was evaluated using the chi square [*114] statistic utilized by Dr. Topel, there was no statistically significant difference in the number of pay grades advanced by black and white nonexempt employees in the Underwriting Department.

Beyond these concerns regarding the appropriateness of the Kruskall-Wallis statistic, the court finds certain of Dr. Mendel's factual assumptions puzzling. Most important, in counting promotions, Dr. Mendel excluded any promotions to positions outside the Underwriting Department. The result of this exclusion was that persons promoted outside the Department were counted as having received no promotion at all. Such a result appears inappropriate because the evidence shows that promotion to a position outside the Department required a favorable recommendation from the employee's supervisor. Moreover, Plaintiffs themselves appeared to understand promotion outside the Department as a positive outcome: named Plaintiff Rhonda Moore repeatedly voiced her desire for a position in Acceptance Testing in lieu of promotion within the Underwriting Department and claimed that Defendant's failure to award her the Acceptance Testing position was a product of discrimination. If promotions outside the Department [*115] are considered, then there is no statistically significant difference in promotion rates for blacks and whites, even under Dr. Mendel's analysis. [12]

> 12 After hearing some of Defendant's evidence, Dr. Mendel performed an additional analysis, utilizing the chi square analysis relied on by Dr. Topel, rather than the Kruskall-Wallis test. According to Dr. Mendel, this analysis revealed a statistically significant black-white differential in numbers of pay grades advanced, controlling for the employees' starting grade and tenure with Allstate. Defendant argues that this analysis itself is flawed because it failed to measure the difference between blacks and whites in numbers of pay grades advanced per unit of time. In any case, as Defendant demonstrated, when promotions outside the Underwriting Department are included, then even under Dr. Mendel's model there is no statistically significant black-white difference in pay grades advanced.

[*116] The court-certified class consists of black nonexempt employees in the Underwriting Department through June 21, 1989. Because Plaintiffs filed their EEOC charges on December 1, 1988, however, Dr. Mendel's statistical analysis excluded all data after that time. The rationale for such an exclusion is straightforward: After being placed on notice of Plaintiffs' claims, Allstate might be expected to make particular efforts to eliminate the effects of past discrimination by more favorable treatment of black employees. Yet in this case there was no evidence that such efforts were made; indeed, Plaintiffs offered no evidence that any of the first-line supervisors who made PDS ratings decisions were even aware of the filing of the charges. Thus, this court concluded that the exclusion of data from 1989 was inappropriate.

In addition to his exclusion of post-November 1988 data, Dr. Mendel's analysis utilized a "six-month filter"--that is, Dr. Mendel included within his analysis only those employees who had been on the job for at least six months.As a result of the exclusion of 1989 data and of the six-month filter, all of Dr. Mendel's analyses excluded data concerning persons who were first employed at any time after July 1, 1988, a large chunk of the court-certified class.

[*117] Dr. Mendel believes the criticisms leveled by Defendant at the Kruskall-Wallis test are somewhat irrelevant because he believes the data in this case will reveal significant race disparity if analyzed using a "one-

tailed" standard for statistical significance. Unlike the more common "two-tailed" standards, which assess the likelihood that any differences between two groups would occur by chance, a one-tailed standard assumes that any deviation from what might be predicted by chance will be in only one direction. For purposes of this case, a one-tailed standard assumes that any differences in outcomes for white and black employees reflect more favorable outcomes for whites. Even if one assumes the truth of this assumption, [13] this court is unwilling to relax the standards necessary for a showing of statistical significance as Dr. Mendel suggests. The Court of Appeals for the District of Columbia addressed this issue at some length in *Palmer v. Shultz, 259 U.S. App. D.C. 246, 815 F.2d 84 (D.C. Cir. 1987)*. In that case, female foreign service officers challenged the State Department's promotional practices and argued, *inter alia*, that any statistical difference in promotion [*118] rates could only reflect adverse results for women. *815 F.2d at 89, 114*. Thus, plaintiffs argued, a one-tailed standard was appropriate, and where the probability that women would be underselected to the extent shown by the evidence was only four percent, the court should find a statistically significant sex effect. The court was unwilling to adopt this approach, however:

> Even if in the case before the court the disparity disfavors women and not men, how can the court ignore the possibility that the case might still be one of the 8 % cases in which a fair selection process would by chance produce disparities in this magnitude or greater? Thus, we think a court should generally adopt a two-tailed approach to evaluating the probability that the contested disparity resulted by chance. . . . . Consequently, if plaintiffs come into court relying *only* on evidence that the underselection of women for a particular job measured 1.75 standard deviations, it seems improper for a court to establish an inference of disparate treatment on the basis of this evidence alone.

Id. at 96. The court went on in a footnote to observe that under Supreme Court precedent, it is improper [*119] to lower the threshold for statistical significance below 1.96 standard deviations, "whether one views this number as signifying a 5% probability of randomness using a two-tailed approach or a 2.5% probability of randomness using a one-tailed approach." *Id. at 96 n.9*.

13 The assumption has common sense appeal. Although Plaintiffs challenge the PDS system under a disparate impact theory, their claim assumes that individual subjective decisions were adverse to blacks. The majority of supervisors and managers were white and college-educated, and a far larger proportion of the nonexempt employees were black. Nevertheless, the court notes that the assumption is subject to at least some further scrutiny. The black doll incident in the spring of 1987 undoubtedly made at least some supervisors aware that their conduct could have racial impact. The evidence shows that in June 1988 Eric Hjerpe was conscious enough of race issues at Allstate that he asked a black supervisor, Patrice Boone, to assist him in communicating with black employees. Defendant points out that Allstate supervisors and unit managers were evaluated on their ability to help their minority employees develop additional skills and suggests that "Allstate unit supervisors and unit managers had a **direct incentive** tied to their own PDS rating to promote and further the careers of their black employees." (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 34, n.25 (emphasis in original).) And Plaintiffs themselves have suggested that the court should disregard statistical information that post-dates the filing of their charges of discrimination, a tacit acknowledgment that Allstate may have made conscious efforts after that point to eliminate the adverse race impact of the PDS system. The assumption that differences between the treatment of blacks and whites prior to that date must have favored white employees is, thus, not a perfectly safe one.

[*120] This court finds the *Palmer* court's analysis sound. Indeed, insistence on use of a "two-tailed" standard is arguably more appropriate here than in *Palmer*, where plaintiffs argued that they were victims of disparate *treatment*; here, where Plaintiffs claim that a facially neutral (albeit subjective) practice had a disproportionate impact, they must demonstrate that the effect is robust enough to meet standards commonly relied on by social scientists. To the extent that Dr. Mendel's analysis does not result in a finding of significance at the $p < .05$ level, his findings cannot be shored up by reliance on a "one-tailed" standard.

As with the wage growth claim, Plaintiffs have argued that Defendant improperly relies on overall statistics showing the apparent absence of any statistically significant differences in promotional rates. Under *Teal*, a "bottom line" defense is unavailable to defeat a showing that the PDS has a disparate impact on promotional opportunities based on race. Thus, the argument proceeds, the fact that Defendant may have succeeded in eliminating the effects of the PDS on overall promotion

rates should not constitute a defense. Defendant devotes [*121] significant attention to this argument in its opening brief (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 31-33), distinguishing *Teal* on several bases: First, unlike *Teal*, an individual disparate impact case, the Plaintiffs here must demonstrate that the PDS denied opportunities to a class. Thus, as the court observed in *E.E.O.C. v. Andrew Corp., 51 Empl. Prac. Dec. (CCH) P 39,364 (N.D. Ill. 1989)*, "Whereas the *Teal* court was troubled because a 'bottom-line' defense in that case precluded valid individual claims, in this case the EEOC's proof of adverse impact necessarily depends upon the fortune of the group." Defendant argues, further, that if Plaintiffs rely on *Teal*, they must identify at least some individual class members who were denied promotions that, but for the PDS system, they would have received.

This court is not prepared to accept the argument that *Teal* has no application in a class action. Nevertheless, the court concludes, as with respect to the wage claim, that *Teal* does not provide a basis for ignoring the showing Defendant has made that there is no statistically significant difference in promotional opportunities [*122] between whites and blacks. *Teal*, again, presented a situation in which the employer made efforts to achieve racial balance in promotions in spite of the fact that a promotional examination eliminated black candidates in significantly greater numbers than whites. The fact that blacks who did pass the examination were more likely to be promoted than whites did not ameliorate the effect of the exam on blacks who did not pass. Here, in contrast, although there certainly were individual black employees who were passed over for promotion on the basis of a poor PDS score, there is no basis for a conclusion that blacks who did achieve high PDS scores were more likely to be selected for promotion than whites. [14] Nor is there any basis for suspicion that any non-PDS-related factors in promotion decisions were aimed at eliminating the racial disparatures in PDS scores. Thus, if there is no overall showing of a significant race difference in promotional opportunities at Allstate, the court must conclude that the PDS system does not have an adverse impact on the promotional opportunities of blacks at Allstate.

14 Plaintiffs' disparate treatment claims urge that the contrary is true. (*See*, for example, Plaintiffs' Proposed Findings of Fact and Conclusions of Law PP 239, 249.)

[*123] Dr. Topel's analysis found no statistically significant difference in the promotion rates of blacks and whites, and no difference at all when he controlled for job grades and days of absence. Dr. Mendel's analysis did reveal a difference, but for the reasons described above, the court finds his analysis flawed. In particular, Dr. Mendel's decision to include promotions outside the underwriting department is inappropriate and inconsistent with a central claim of one of the named Plaintiffs. The court concludes that Plaintiffs have not met the burden of showing a statistically significant difference in promotion rates among black and white employees. Their claim that the PDS system produced such a difference is dismissed.

D. Disparate Impact of Overall PDS Ratings

As noted, Plaintiffs have focused their attention in this case on the overall PDS ratings themselves. For the reasons described above, the statistical evidence appears to support Defendant's argument that Plaintiffs have not demonstrated that the PDS system harmed them because they have not shown that PDS ratings mapped into significant race differences in wage growth and promotional opportunities. Nevertheless, [*124] both parties have devoted considerable attention to the overall PDS ratings themselves, litigating and briefing the issue of whether the PDS system was applied equally to black and white nonexempt Underwriting employees. Indeed, in Plaintiffs' view, "even if [Defendant's] promotional and wage growth analyses were correct, . . . , they cannot undermine the undisputed *prima facie* case that the PDS scores *themselves* are discriminatory and have a direct and substantial relationship to salary increases and promotions." (Post-Trial Brief for Plaintiffs, at 3.)

It is undisputed that black employees in Allstate's Underwriting Department had lower PDS scores than did whites. Whites substantially outnumber blacks (33% to 20%) in receiving an "exceeds" rating, and twice as many blacks (30%) as whites (15%) received "needs improvement" or "requires immediate improvement" ratings. Although, for the reasons discussed above, there appears to be no statistically significant difference in the promotion rates of whites and blacks, Plaintiffs urge that the link between PDS scores and promotional opportunities is also undisputed. They note that a much greater percentage of those employees rated [*125] "exceeds" (44%) on the most recent PDS were promoted than those rated "meets" (14%), and that no employee with a "needs improvement" or "requires immediate improvement" rating was promoted. (*Id.* at 8.) They point out, further, that Allstate's written directives link higher salary increases with higher PDS ratings.

Defendant concedes the substantial race differences in PDS scores, but argues that the race effect is reduced to statistical insignificance if the analysis controls for the individual subratings of quality scores, quantity scores, and attendance. According to Dr. Topel, the ratings an employee received on quality, quantity, and attendance explained away the significant race difference between

the chances of receiving a "needs improvement" or an "exceeds" rating. As the Seventh Circuit has observed, successful performance on an evaluation mechanism may be influenced by factors other than race; if these other factors account for enough of the variance as to render any race effect statistically insignificant, then there is "no proof of disparate impact." *Allen v. Seidman, 881 F.2d at 378.* [15]

> 15 Plaintiffs suggest that Dr. Topel's analysis must be disregarded for the reason, among others, that the three factors he considered accounted for only 33% of the variance. In the cases they cite, however, courts concluded that *plaintiffs* had not proven their claims by means of studies that accounted for only 45% (*Griffin v. Board of Regents, 795 F.2d 1281, 1291 (7th Cir. 1986))* or 52% (*Wilkins v. University of Houston, 654 F.2d 388, 403-4 (5th Cir. 1981)*, *vacated on other grounds*, *459 U.S. 809 (1982))* of the variance between performance of the protected group and others. As noted, in *Allen* the Seventh Circuit recognized that if an analysis accounts for enough of the variance that no significant race effect remains, there is no showing of disparate impact. Thus, if Dr. Topel's analysis is otherwise legitimate, the fact that other factors account for enough of the variance as to reduce the disparate impact showing below statistical significance will constitute a defense to Plaintiffs' claims.

Plaintiffs insist this type of analysis is inappropriate. Although it may [*126] make sense to control for "independent and neutral factors such as education, seniority, age, job title and hiring qualifications," Dr. Topel's analysis here is flawed, say Plaintiffs, because the three subratings themselves are "subjective and prone to discrimination." (Post-Trial Brief for Plaintiffs, at 13, 14.) In *James v. Stockham Valves & Fittings Co., 559 F.2d 310 (5th Cir. 1977)*, a class of black workers alleged that defendant employer had discriminated against them in promotions and job assignments. *Id. at 313*. Reversing a judgment for defendant, the court specifically rejected a statistical analysis aimed at isolating the effects of various factors in the plaintiffs' slow advancement. The court noted that defendant's expert had included, among the purported objective variables, factors that plaintiff believed were themselves the product of supervisory bias--for example, "skill level," which was a function of the employee's job assignment, and "merit rating," which was the product of the supervisor's subjective evaluation. *Id. at 332*. In addition, defendant's expert included, as a purported objective factor, the employees' educational level, although it was not [*127] a job requirement. The court concluded that the fact that plaintiffs' poor progress could be attributed to these factors did not defeat a showing of disparate racial impact. *Id.* For related reasons, the court in *Bouman v. Block, 940 F.2d 1211 (9th Cir. 1991)* was unmoved by evidence that female plaintiffs' poor performance on a promotional examination correlated with "the supposedly neutral factors of years of experience and familiarity with departmental examinations." *Id. at 1229 n.3*. The court refused to assume without question the notion that years of experience and familiarity with the examination were associated with better performance in the desired position.

[*128] Certainly Plaintiffs in this case are correct that a regression analysis can be inappropriate where the factors considered as potential explanations for the disparate racial impact are themselves a product of discriminatory policies. The Seventh Circuit has acknowledged this, *Griffin v. Board of Regents, 795 F.2d 1281, 1289-90 (7th Cir. 1986)*, but appears to assign to the plaintiff the task of demonstrating the impropriety of the analysis. Thus, where a defendant offers a non-discriminatory factor as an explanation for a statistical disparity, plaintiff must demonstrate "that that factor was itself tainted with discrimination." *Mozee, 940 F.2d at 1049* (citing *Coates, 756 F.2d at 544*.) [16] With this burden in mind, the court addresses Plaintiffs' challenge to the subratings below.

> 16 *Wilkins*, cited by Plaintiffs, also reflects the court's understanding that plaintiffs must prove that the purported independent factors (in that case, experience as an associate professor) were themselves a product of discrimination. *Wilkins, 654 F.2d at 404*.

[*129] **1. Quantity Ratings**

As noted, Plaintiffs argue that the individual subratings, including the quantity subrating, were themselves subjective; thus, the fact that these subratings explain a significant proportion of the race variance in PDS scores does not defeat the disparate impact claim.

With respect to the quantity subrating, the argument finds little support in this record. Plaintiffs do not challenge the notion that an employee's productivity is an appropriate measure of her performance. At least one court has characterized "job knowledge, accuracy and productivity" as "the most concrete criteria upon which to base a promotion decision." *Grant v. Morgan Guaranty Trust Co., 638 F. Supp. 1528, 1537 (S.D.N.Y. 1986)* (citing *Sweeney v. Research Found. of State Univ. of New York, 711 F.2d 1179, 1185 (2d Cir. 1983))*. Nor is there any basis for suspicion that the quantity measures utilized by Allstate in this case were inappropriate criteria. As described in the Findings of Fact, Allstate assigned points to various tasks in an effort to measure the work performed by each employee. The employees

themselves kept tabs of the points they had earned; although Plaintiffs suggest [*130] that this system invited abuse, they offered no basis for a conclusion that white employees were more likely than black employees to over-report their productivity. There is no evidence that the employees themselves believed that assigning point totals to their work was inappropriate or inaccurate. Indeed, as Defendant notes, named Plaintiff Rhonda Moore had point totals far in excess of most of her peers. Certainly Moore would not argue that her high totals did not reflect superior work performance.

In 1987, several data entry employees in the three regions worked on a team to evaluate the point assignment system. The Entry Improvement Team, on which Plaintiff Moore participated, concluded that the point system should remain in effect, although certain of the points assigned to various tasks required adjustment. When the EIT presented its proposals to all data entry employees, none objected to reliance on such a system for measuring productivity. Employees met with their supervisors on a regular basis to discuss their progress, as reflected in part by their quantity scores. Again, there is no evidence that any employee objected to his or her quantity score as an inaccurate measure [*131] of performance.

Plaintiffs themselves have not explicitly argued that the quantity measure discriminated against black employees. They argue, instead that "there is no evidence to prove these subratings [quality, quantity and attendance] are not susceptible to or infected by discrimination." (Post-Trial Brief for Plaintiffs, at 14.) On this record, the court finds no basis for suspicion that the quantity rating was so infected. Although Plaintiffs point out that the quantity measure was vulnerable to abuse by employees, there was no evidence that employees did, in fact, over-report their production. More importantly, there was no evidence that white employees were more likely than blacks to inflate their productivity scores. Finally, Plaintiffs have offered no argument or evidence that the quantity measure is unrelated to Allstate's legitimate goals. *Ward's Cove* teaches that Plaintiffs might nevertheless prevail if they can offer an alternative standard that would have met Allstate's goals. Here, however, Plaintiffs have not suggested what alternative standards would serve Allstate's objective of promoting productivity among its nonexempt employees. Their criticism of the quantity [*132] standard fails.

2. Quality Ratings

The quality of most nonexempt employees' work was assessed in two ways: by means of "spotchecks," and as part of the "quality verification" process in issuance of the policy. Again, Plaintiffs do not argue that assessment of the accuracy of the work performed is inappropriate. Instead, Plaintiffs have argued that, as Dr. Mendel testified, the quality measures did not function effectively to reflect actual differences between employees. Dr. Mendel noted, for example, that all quality scores were clustered in the very high percentages, and that very slight differences in quality scores translated into different ratings. *See* Findings P 66d. In order for such fine distinctions to measure meaningful differences, Dr. Mendel testified, Allstate would need to evaluate much more of the work performed by each employee than it did. In addition, Dr. Mendel suggested that the quality or accuracy scores were poor measures because in some instances, a given task presented a number of error possibilities; other tasks included comparatively fewer specific steps, with less opportunity for error. Yet employees assigned to error-intensive tasks were compared [*133] with employees whose assignments were less likely to yield high error scores.

Defendant argues that the quality scores nevertheless serve legitimate objectives. First, the fact that employees' performances were checked for accuracy would, presumably, impress upon them the need for accuracy and blunt the temptation to sacrifice accuracy in favor of high scores. Second, Defendants note, employees themselves did not perceive the quality assessment mechanism as unfair or inaccurate. Pat Hood, for example, who received a low quality score during one evaluation period, complained that her low score was the result of inadequate training, not that the score itself was inaccurate. As with the quantity ratings, the Entry Improvement Team chose to continue with the spotcheck procedure, and no employee objected to this measure.

Again, Plaintiffs have not suggested a practicable alternative measurement of the accuracy of nonexempt employees' work. In order for the accuracy scores to have the degree of validity that Dr. Mendel believes is necessary, he testified, Allstate would need to check approximately 1,500 files per employee per month. Allstate contends that such extensive checking would [*134] have been wholly impracticable. There simply were not enough supervisory staff to do such checking. Courts do recognize that the practicability of the evaluation mechanism is a relevant factor in determining job-relatedness. *See Robinson v. Talladega Revenue Comm'n*, 1987 U.S. Dist. LEXIS, at *9 n.12 (N.D. Ala. 1987) (spotcheck procedure was job-related where "the quantity of the records made it impracticable to check all records every day"). *Wards Cove* recognized that a proposed alternative to the employer's challenged practice must take into account the costs and burdens of the alternative. *490 U.S. at 660-61*. This court concludes that Plaintiffs' challenges to the quality performance measure do not survive scrutiny.

3. Attendance Ratings

Again, Plaintiffs do not dispute the propriety of evaluating employees on the basis of their attendance. Nor do they raise any challenge to the accuracy of the attendance calendars, which were composed from data reviewed by employees themselves. Plaintiffs do argue that Allstate's measurement of attendance was not job-related because supervisors exercised discretion in counting absence occurrences. Granting such discretion to first-line [*135] supervisors, most of whom were white, provided an avenue for treating black employees less favorably, Plaintiffs believe.

Plaintiffs' suspicion is understandable. Supervisors testified to a variety of approaches in making determinations concerning numbers of absences and tardies. And, although Allstate had written attendance policies, supervisors' testimony reflected poor understanding of the written standards. Nevertheless, the record does not support the conclusion that the exercise of discretion operated to disfavor blacks. Although supervisors testified to inconsistent policies, there was no evidence that any individual supervisor applied his or her own policy inconsistently. Nor is there any evidence that black employees were more often assigned to work under supervisors having more stringent attendance practices. Most significantly, Dr. Topel performed an analysis of attendance records in which non-consecutive absences were always treated in the same fashion. His analysis found no difference in treatment between whites and blacks.

This court concludes that Plaintiff has not shown that any of the subratings discriminated against blacks.

D. Job-Relatedness of the PDS

[*136] For reasons discussed above, the court concludes that the individual components of the PDS score--quantity of work, quality of work, and attendance [17]--"serve[], in a significant way, the legitimate employment goals of the employer." *Wards Cove, 490 U.S. at 659*. Allstate argues that the overall PDS evaluation system is also job-related. Defendant contends that overall PDS scores not only fairly measure performance in the assigned job, but also provide a reliable prediction of performance after a promotion. Plaintiffs' own expert has concluded that whether the overall PDS may predict performance in a promotion position "bears directly on the job relatedness/validity/business necessity question."

17 Defendant does not challenge Plaintiffs' criticisms of the "deportment" factor of the overall PDS score, but argues that the three remaining factors account for enough of the variance that no statistically significant race impact remains.

The only evidence in the record on this question supports Defendant's [*137] position. Dr. Topel examined PDS ratings at the time of promotion (or just prior to the promotion date) with the first PDS after the promotion. He found a strong correlation between the two scores. *See* Findings P 92. The court agrees that an accurate prediction of job performance in a new position is a legitimate employment goal. [18] *Cf. Melendez v. Illinois Bell Tel. Co., 79 F.3d at 669 (7th Cir. 1996)* (plaintiff's disparate impact claim supported by expert testimony that there is no correlation between performance on challenged test and performance in job for which applicant is being tested).

18 Plaintiffs concede as much by offering an analysis that they believe demonstrates the opposite--that is, that PDS scores do not accurately predict performance following promotion. Plaintiffs ultimately withdrew that analysis because of inaccuracies in the database.

There is, to be sure, much to criticize in Allstate's performance evaluation system. Most serious, in this court's view, was the "churning" of inexperienced [*138] young workers into supervisory positions. These young people, often fresh from college or other professional training, were assigned to supervise and evaluate far more seasoned clerical workers. Supervisors lacked any formal training in supervision and often relied on their own subordinates for training in the jobs being performed in their work units. Supervisors were frequently called upon to write annual performance evaluations on employees they had supervised for only a few weeks or months. The fact, emphasized by Allstate, that the previous supervisor(s) in each unit was ordinarily in close physical proximity to the new supervisor, could not completely ameliorate this structural problem. Although supervisors utilized "desk file" and past "one-on-one" records, there were numerous instances in which those files were at least partially incomplete.

Finally, Allstate presents no argument at all for utilization of the "salary planning" targets in the performance evaluation process. As noted (Findings P 22), no supervisor felt bound by the previous fall's prediction concerning an individual employee's performance, nor was any supervisor required to account for his or her decision to [*139] depart from the prediction set forth in the plan. Under these circumstances, there would appear to be no need at all to provide plan data to the evaluating supervisor, with the attendant risk that the PDS score becomes no more than a self-fulfilling prophesy.

There were at the same time, however, notable strengths in the PDS process. Each employee received monthly feedback on his or her performances, both in writing and in a private meeting with his or her supervi-

sor. These "one-on-one" meetings addressed the same performance factors that weighed heavily in the annual PDS. Although Plaintiffs make much of the variations in the descriptions provided by supervisors of their evaluation process (*see* Findings P 61), this court concludes that there was in fact significant consistency from one supervisor to the next. Every supervisor focused on quantity and quality of work performed; and, while Plaintiffs argue that these measures have not been properly validated pursuant to EEOC regulations, [19] they offer nothing to suggest that the production measure was not an accurate assessment of comparatively simple tasks. Unlike the kinds of measures that ordinarily fall to disparate impact [*140] scrutiny, measures of quality, quantity, and attendance are directly related to job performance. Indeed, Plaintiffs do not argue otherwise.

19 Plaintiffs suggest that Allstate's failure to perform a formal job analysis is itself an indication that the PDS is not job-related. The court cannot accept the suggestion that the absence of a job analysis establishes liability. *See Tye v. City of Cincinnati, 794 F. Supp. 824, 833 (S.D. Ohio 1992)* ("we refuse to adopt the rigid requirement that a hiring process cannot be job-related unless a job analysis is done"). *See also Aguilera v. Cook County Police and Corrections Merit Bd., 760 F.2d 844, 847 (7th Cir. 1985)*, where the court observed that educational requirements for promotion are sometimes rejected where they have not been validated pursuant to EEOC guidelines, but noted that "the guidelines . . . do not have the force of law" and that in some situations "the appropriateness of an educational requirement is sufficiently obvious to allow dispensing with empirical validation." *Id. at 847*. Although the quantity, quality, and attendance measures are not educational requirements, Defendant here argues that their propriety is sufficiently obvious that formal validation ought not be required.

[*141] Plaintiffs do present numerous examples of what they characterize as "play" in the system--*i.e.*, situations in which persons with similar underlying ratings on factors of quantity, quality, attendance, or deportment nevertheless received different overall PDS scores. Indeed, in their reply brief, Plaintiffs characterize "needless subjectivity" in the PDS system as the "central issue" concerning job relatedness. (Plaintiffs' Post-Trial Reply Brief, at 3.) This kind of subjectivity is troublesome, but significant here only if Plaintiffs demonstrate that it resulted in unfairness to blacks. Plaintiffs believe they have done so by offering evidence of overall racial disparities, but this begs the question of whether the overall disparities are a function of the exercise of discretion or of legitimate differences in valid performance measures. Under *Wards Cove*, it is Plaintiffs who must bear the burden of proving that the PDS system does not serve legitimate goals. Anecdotal evidence that Allstate made mistakes on occasion does not amount to proof that the overall PDS process was not job-related. *Tye, 794 F. Supp. at 834*. Alternatively, Plaintiffs may prevail by demonstrating [*142] that "other tests or selection devices without a similar undesirable racial effect would also serve the employer's legitimate interests . . . ." *Gillespie, 771 F.2d at 1045*. Although Plaintiffs leveled effective criticisms of the PDS System, they offered no genuine proposal for a less-flawed system that would effectively evaluate job performance and otherwise serve Allstate's legitimate goals of encouraging employees to work quickly and accurately.

The court concludes Plaintiffs have not met the burden of proving their disparate treatment claims.

II. Disparate Treatment Claims

Each of the three named Plaintiffs also brings an individual disparate treatment claim. The standards for proving such a claim are well-established and familiar. Plaintiffs must present a *prima facie* case of disparate treatment by offering evidence that, left unexplained, gives rise to an inference of discrimination. In this case, a *prima facie* case would likely consist of evidence that similarly situated white employees were treated more favorably than Plaintiffs. If Plaintiffs make such a showing, Defendant may present evidence of legitimate, nondiscriminatory factors that explain [*143] the difference in treatment; Plaintiffs then rebut such a showing by offering evidence that Defendant's purported reasons for its action are pretextual, and that discrimination more likely than not infected the decision. *See St. Mary's Honor Ctr. v. Hicks, 509 U.S. 502, 506-07, 125 L. Ed. 2d 407, 113 S. Ct. 2742 (1993)*; *McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802, 36 L. Ed. 2d 668, 93 S. Ct. 1817 (1973)*.

Although Plaintiffs offered proposed findings on the individual disparate treatment claims, they make no other mention of those claims in their post-trial opening brief or reply brief, choosing instead to focus on the disparate impact claims. The court addresses each of the individual claims below.

A. Velma Dicker

Velma Dicker claims that she was treated unfairly in a variety of ways. From the testimony and proposed findings, the court gleans the following claims: (1) Gigi Soeder, a white employee hired after Ms. Dicker, was promoted before her in 1985; (2) Ms. Dicker's "acceptable/needs improvement" rating in July 1986 was too low; (3) supervisor Vicki Kummer assigned Ms. Dicker, but not two white co-workers, to run an errand, and chas-

tised Ms. Dicker [*144] but not her co-workers for personal phone calls; (4) two white co-workers were promoted one month before Ms. Dicker in 1987; (5) Ms. Dicker was denied a review due in April 1988; (6) Ms. Soeder, but not Ms. Dicker, was granted a requested change in an error record; (7) Ms. Dicker was denied training; (8) Janice Letteri, but not Ms. Dicker, was promoted to the position of UCU in 1988; and (9) Eric Hjerpe instructed a black supervisor to be his "hatchet person."

Defendant Allstate argues that the first four of these claims are untimely. Title VII requires an employee who believes she has suffered discrimination to file a charge with the EEOC within 300 days of the alleged wrong. *See 42 U.S.C. § 2000e-5(e)*. Plaintiff Dicker filed her charge on November 30, 1988. Thus, to the extent that Dicker's failure to promote claims, her challenge to her July 1986 PDS rating, and her claim of discriminatory treatment by Vicki Kummer are intended as independent claims for relief, they are dismissed. Moreover, for the reasons explained in Findings P 100 this court concludes that Dicker's July 1986 PDS rating was not a product of discrimination. Allstate has offered a legitimate, non-discriminatory [*145] reason for its promotion of Dicker's two white co-workers one month before she herself was promoted--Dicker's July 1986 PDS rating--and Dicker has offered no evidence that that reason was pretextual.

As explained in Findings P 105, although Dicker believes she was entitled to an annual performance evaluation and raise in April 1988, the court concludes she was mistaken; in any event, Allstate did provide Dicker with a PDS in April 1988, though she received no salary increase until July of that year. As explained in Findings P 110, Allstate has articulated a legitimate, non-discriminatory reason for the promotion of Janice Letteri to UCU in July 1988: Ms. Letteri posted for the position, but Ms. Dicker did not. Plaintiff has offered no evidence that Mr. Hjerpe's selection of Ms. Letteri was a function of her race rather than a function of her posting. *See Jones v. Flagship Int'l, 793 F.2d 714, 724 (5th Cir. 1986)*, (female employee who did not apply for position cannot claim that hiring of male was discriminatory). Indeed, the evidence shows that Mr. Hjerpe filled another UCU position at the same time by hiring a black employee from outside the company when he could find no other [*146] internal applicants. As explained in Findings P 109, the court concludes that neither the fact that Ms. Dicker did not receive training concerning New York applications, nor the fact that Chris Carlstrand received training before Ms. Dicker did, are indications of discrimination. Further, for reasons explained in Findings P 112, the court finds that the testimony concerning a "hatchet person" comment does not support a finding of discrimination on the part of Mr. Hjerpe.

What remains of Ms. Dicker's claims of discrimination is her contention that Ms. Soeder received more favorable treatment with respect to an error in her work. Without intending to trivialize this assertion, the court concludes that unless the incident was reflected in a particular poor PDS rating or loss of pay raise or promotion, the assertion does not support a claim of disparate treatment on the part of Allstate. No such results were demonstrated here. Velma Dicker's individual disparate treatment claims are dismissed.

B. Rhonda Moore

Rhonda Moore began employment with Allstate in February 1984 as a Data Prep A. In September 1985, Ms. Moore was rated "exceeds" and promoted to the position of Data Prep [*147] B. In spite of several more "exceeds" ratings, Ms. Moore was not again promoted during her tenure with Allstate. She alleges that she was treated less favorably than her white colleagues with respect to training; with respect to communication from employees in the Acceptance Testing Unit; and with respect to promotions.

The court concludes that Moore's failure-to-promote claims must be dismissed. The evidence reflects that on several occasions, Moore's supervisors approached her regarding a transfer to UCU; on each occasion, Moore declined such a move, preferring instead to wait for an open position in Acceptance Testing. At some point in 1987 or 1988, Ms. Moore claims, Eric Hjerpe discouraged her interest in a transfer to UCU by warning her that she might not receive "exceeds" PDS evaluations immediately after such a move. Allstate suggests the comment "makes sense" in the context that Ms. Moore had previously told Hjerpe she needed "exceeds" ratings because she wanted the highest possible raises. (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 64-65.) In any event, as she acknowledged, Ms. Moore at all times preferred a transfer to Acceptance Testing. In 1988, [*148] for example, Eric Hjerpe made a particular effort to fill positions in UCU by directing inquiries to each of the Data Prep B employees regarding such a transfer. Ms. Moore did not post for the position, but Janice Letteri did and was ultimately transferred to UCU. Mr. Hjerpe hired a black female from outside Allstate for another UCU slot.

Ms. Moore did post for an Acceptance Testing position in 1987; she believes her failure to receive the position is a product of discrimination. In fact, a white employee who, like Ms. Moore, had an "exceeds" rating on her most recent PDS, was awarded the job. Significantly, however, the evidence shows that Moore was one of 40 applicants for the position and that her own supervisor,

Joy Reveal, provided a strong recommendation for her. Moreover, because this failure to promote occurred more than 300 days before the filing of her charge of discrimination on November 30, 1988, such a claim is time-barred.

Similarly, Moore's claims that she was not trained promptly on all Data Prep B functions prior to June 1986 are untimely. Allstate explains that the delay in training Ms. Moore on the "complex change re-issue" function was a result of the busy fall [*149] promotion schedule. Allstate notes, further, that the alleged delay in her training had no serious consequences in Ms. Moore's work performance; by March 1987, Ms. Moore was rated "exceeds" in her work as a Data Prep B.

Ms. Moore complained in August 1987 to Mr. Hjerpe about her perception that she was being left "out of the loop" with respect to information from persons in Acceptance Testing. Mr. Hjerpe promptly contacted a division manger in that unit to explain that information should be provided to all employees when appropriate. Ms. Moore expressed concern about the assignment of "general time points," but a spotcheck revealed that Moore herself had earned far more such points than any of her co-workers. Moore consistently received high salary increases and, by the time of the filing of her charge, was earning more than any other Data Prep B, with the exception of one person hired a year earlier than she.

The evidence does not support a claim of disparate treatment of Rhonda Moore on the basis of race.

3. Patricia Hood

Patricia Hood's claim is that she did not receive adequate training following her promotion to the position of Data Prep A in January 1988. She claims, [*150] further, that Allstate failed to promote her. Although her trial testimony focused on the unavailability of the person assigned to train her, Lois Newberry, she testified in her deposition that she had never complained about Ms. Newberry. To the extent that Ms. Newberry's absence was a problem for Ms. Hood, the court notes that Ms. Hood herself was absent from work throughout the month of February 1988. At trial, Ms. Hood claimed she had complained to her supervisor, Christine Swiss, about the lack of training; in her deposition, she stated that she had never done so.

The record demonstrates that Hood's supervisors offered her additional training during her one-on-one meetings, but that Ms. Hood did not respond. She in fact acknowledged having received training on several functions by initialing the relevant forms, although she claimed at trial that she had not in fact received such training.

With respect to her failure to promote claim, Ms. Hood identifies Janice Letteri's promotion to the UCU position as an example of discrimination. Like Ms. Dicker and Ms. Moore, however, Ms. Hood did not post for the UCU position and therefore cannot establish that Allstate's stated reason for [*151] choosing Ms. Letteri for the position is pretextual. In any event, Ms. Hood's PDS rating of "acceptable/needs improvement" precluded promotion in 1988. As of December 20, 1988, Ms. Hood was the highest paid Data Prep A employee in the Eastern Territory. Although she resigned in December 1989, Ms. Hood changed her mind and remained at work, where she was promoted four months later.

The evidence does not support Ms. Hood's claims of discrimination.

CONCLUSION

Plaintiffs have established that black nonexempt employees in Allstate's Underwriting Department received significantly lower overall PDS scores than did white employees. The evidence does not, however, establish that these overall PDS scores resulted in decreased wage growth or diminished promotional opportunities for black employees. The evidence shows, further, that underlying factors of quality of work performed, quantity of work performed, and work attendance accounted for enough of the variance in PDS scores that no statistically significant race effect remains; and Plaintiffs did not meet their burden under *Wards Cove* of demonstrating that those underlying factors were not job-related. The court dismisses [*152] with prejudice the class claims of disparate impact.

Plaintiffs Dicker, Moore, and Hood also presented evidence in support of their claims of individual disparate treatment. Having examined that evidence, the court concludes that it does not support the claims of any of the individual Plaintiffs. Their disparate treatment claims are, therefore, dismissed with prejudice.

ENTER:

Date: April 7, 1997

REBECCA R. PALLMEYER

United States Magistrate Judge

TAB 15

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
Jane DOE, a Minor, By and Through her Guardians and Next Friends, G.S. and M.S., Plaintiffs,
v.
TAG, INC., n/k/a Childserv, Susan Clement, and Robin and David Swaziek, Defendants.
No. 92 C 7661.

Dec. 14, 1993.

MEMORANDUM OPINION AND ORDER

CONLON, District Judge.
***1** Jane Doe, through her guardians and next friends G.S. and M.S. (collectively “the plaintiffs”), sues Tag/ChildServ (“Tag”), Susan Clement (“Clement”), a Tag supervisor, and Robin and David Swaziek, Doe's former foster parents (“the Swazieks”), for placing and keeping Doe in a foster home in which she allegedly suffered severe physical and psychological abuse.[FN1] The plaintiffs and defendants moved *in limine* to exclude evidence. Tag and Clement move for reconsideration of some of the court's rulings.

DISCUSSION

1. Motion For Reconsideration

A motion for reconsideration serves a limited purpose. The court's rulings “are not intended as first drafts, subject to revision and reconsideration at a litigant's pleasure.” *Quaker Alloy Casting v. Gulfco Industries, Inc.,* 123 F.R.D. 282, 288 (N.D.Ill.1988). Nevertheless, a motion for reconsideration may be proper to correct manifest errors of law or to present newly discovered evidence. *See Publishers Resource, Inc. v. Walker-Davis Publications, Inc.,* 762 F.2d 557, 561 (7th Cir.1985); *Lewis v. Hermann,* 783 F.Supp. 1131, 1132 (N.D.Ill.1991). Although a motion for reconsideration is not a vehicle for introducing new evidence or legal theories that could have been introduced prior to the earlier ruling, it may be appropriate when “the Court has patently misunderstood a party ... or has made an error not of reasoning but of apprehension.” *Bank of Waunakee v. Rochester Cheese Sales, Inc.,* 906 F.2d 1185, 1191 (7th Cir.1990).

2. Evidence Regarding James C.

Tag moved to exclude evidence regarding James C., another foster child who was placed in the Swazieks' home. In denying Tag's motion *in limine,* the court found that evidence regarding James C. was relevant to this case and was not “substantially outweighed by the danger of unfair prejudice” to the defendants. *See*Fed.R.Evid. 403; Memorandum Opinion and Order, No. 92 C 7661 (N.D.Ill. Nov. 16, 1993) at 7-8.[FN2] The court noted that evidence is excluded on a motion *in limine* only if it clearly is not admissible for any purpose. *See Hawthorne Partners v. AT & T Technologies, Inc.,* 831 F.Supp. 1398, 1400 (N.D.Ill.1993). The court recognized one possible purpose for introducing evidence regarding James C.-proving Tag's negligence in placing Doe with the Swazieks.

On reconsideration, Tag contends that the court's reasoning was exclusive. Tag understands the court's ruling to mean that evidence regarding James C. may be introduced only for the limited purpose of proving Tag's negligence in placing Doe with the Swazieks. Tag argues that because Doe was placed with the Swazieks prior to James C.'s placement,[FN3] evidence regarding James C. is irrelevant and must be excluded.

Tag misconstrues the court's ruling, as well as the purpose of a motion *in limine.* By recognizing one possible purpose for introducing evidence regarding

James C., the court was not limiting the introduction of the evidence to one purpose, but was demonstrating that the evidence is not clearly inadmissible. After noting that there is at least one legitimate purpose for the introduction of evidence regarding James C., the court deferred ruling until trial-where questions of foundation, relevancy, and potential prejudice can be resolved in their proper context. *See The Middleby Corp. v. Hussman Corp.,* 1993 WL 15129 *1 (N.D.Ill. May 5, 1993). Although James C. was placed with the Swazieks after Doe, it still may be possible to establish Tag's negligence for not removing Doe from the Swazieks' earlier. Because the evidence is not clearly inadmissible, the court's earlier ruling will not be disturbed on reconsideration.

3. Expert Testimony

***2** Clement moved to exclude expert testimony concerning Doe's current medical condition and future mental state. In denying Clement's motion, the court noted that the plaintiffs had informed the defendants that their experts would testify about Doe's current and future medical condition. The court also rejected Clement's contention that the plaintiffs' experts would be testifying on mere surmise or conjecture. *See* Memorandum Opinion and Order, No. 92 C 7661 (N.D.Ill. Nov. 16, 1993) at 2-4. In moving to exclude the expert testimony, Clement contended that the plaintiffs never disclosed that their experts would testify concerning Doe's current or future medical needs. On reconsideration, Clement concedes that the plaintiffs did notify the defendants of the content of their expert testimony, but argues that the notice was late. After contending in her motion *in limine* that the plaintiffs never disclosed the content of their expert testimony, Clement cannot raise on reconsideration the new argument that the disclosure came after the discovery cutoff date. *See Lewis v. Hermann,* 783 F.Supp. 1131, 1132 (N.D.Ill.1991) (party may not raise new argument on reconsideration that could have been raised in earlier proceeding).[FN4] Clement contends that the plaintiffs' experts are not qualified to render expert opinions. The court has ruled that the experts are qualified to offer expert opinions "based on their clinical experience in addition to their work with Doe." Memorandum Opinion and Order, No. 92 C. 7661 (N.D.Ill. Nov. 16, 1993) at 3. On reconsideration, Clement cites apparent admissions that the experts are not qualified, and asserts that the plaintiffs' experts have no basis upon which to render expert opinions regarding Doe's current or future condition. However, Clement fails to note that the quoted statements were made in June and July. In the past four months the experts have been able to acquaint themselves with the case more fully through a review of Doe's files. There is no question that the experts are qualified to testify on Doe's current or future condition based on their clinical experience. The court's ruling that the plaintiffs' experts are qualified is sound, and will not be disturbed.

4. Prior Abuse In The Swaziek Household

Clement moved to exclude evidence that Robin Swaziek and Christie Stimpson were abused by a family member who did not live with the Swazieks. The court denied Clement's motion *in limine* because her arguments were conclusory, and she failed to meet the burden of showing that the evidence was inadmissible for any purpose. Memorandum Opinion and Order, No. 92 C 7661 (N.D.Ill. Nov. 16, 1993) at 4-5. The court noted that "it is not clear exactly what evidence Clement seeks to exclude." *Id.* at 5 n. 4.

Clement seeks a modification of the court's ruling so as to prohibit the plaintiffs from alluding to alleged abuse sustained by Robin Swaziek and Christie Stimpson in their opening statement. Clement is concerned that any allusion to other abuse in the Swaziek home "without a proper foundation risks poisoning the jury with potentially irrelevant, inflammatory and prejudicial comments." Motion at 2. Clement's motion is identical to her motion *in limine.* Clement once again makes conclusory

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statements without identifying the evidence she wishes to exclude. She fails to demonstrate why evidence of other abuse is unfairly prejudicial or even what that evidence is. Nevertheless, Clement correctly notes that such unproven allegations may be highly inflammatory, and may prejudice the jury if they are presented in the opening statement. Clement's motion for modification is granted. The plaintiffs may not allude to other alleged abuse in the Swaziek household in their opening statement.

CONCLUSION

***3** Defendant Tag/ChildServ's motion for reconsideration and defendant Susan Clement's motion for reconsideration are denied; defendant Susan Clement's motion for modification is granted.

FN1. The complaint named the Illinois Department of Child and Family Services ("DCFS"), and caseworkers and administrators of the DCFS. These defendants have been dismissed from this action. *See* Memorandum Opinion and Order, No. 92 C 7661 (N.D.Ill. Feb. 23, 1993); Memorandum Opinion and Order, No. 92 C 7661 (N.D.Ill. Oct. 18, 1993).

FN2. It is worth noting that Tag, the moving party, is not the defendant in danger of being unfairly prejudiced by the introduction of the evidence regarding James C.

FN3. The court was led to understand that James C. had been placed with the Swazieks before Doe because the sequence of events was not well-delineated in Tag's motion.

FN4. Clement's position is further undermined by the fact that the plaintiffs disclosed the content of their experts' testimony of August 16, yet the defendants never moved to reopen discovery.

N.D.Ill.,1993.

Doe By and Through G.S. v. Tag, Inc.
Not Reported in F.Supp., 1993 WL 524773 (N.D.Ill.)

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TAB 16

Only the Westlaw citation is currently available.
United States District Court, W.D. Tennessee,
Western Division.
EQUAL EMPLOYMENT OPPORTUNITY COMMISSION, Plaintiff,
v.
AUTOZONE, INC., Defendant.
No. 00-2923 Ma/A.

Aug. 29, 2006.

C. Gregory Stewart, Equal Employment Opportunity Commission, Washington, DC, Celia S. Liner, Deidre Smith, Faye A. Williams, Gwendolyn Young Reams, Katherine W. Kores, Terry L. Beck, Thomas J. Borek, Adele Rapport, Jeffrey Bannon, Equal Employment Opportunity Commission, Memphis, TN, for Plaintiff.
Jef Feibelman, Lisa A. Krupicka, Burch Porter & Johnson, Memphis, TN, Tracy K. Hidalgo, Walter W. Christy, Frilot Partridge Kohnke & Clements, New Orleans, LA.
Ellen Shirer Kovach, Leslie W. Ehret, Madeline D. West, Frilot Partridge Kohnke & Clements, New Orleans, LA, for Defendant.

ORDER GRANTING IN PART AND DENYING IN PART DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

SAMUEL H. MAYS, JR., District Judge.
***1** Before the court is Defendant Autozone, Inc.'s ("Autozone") motion for summary judgment, filed on July 8, 2005. Plaintiff Equal Employment Opportunity Commission ("EEOC") filed a response on July 25, 2005. On August 22, 2005, Autozone filed a reply in support of summary judgment, and the EEOC filed a surreply on August 26, 2005. For the following reasons, the court GRANTS in part and DENIES in part Defendant's motion for summary judgment.

I. Background

Plaintiff EEOC brings this action under Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.* ("Title VII"). The complaint, filed on September 29, 2000, alleges that Autozone "[I] failed to hire Black applicants for official/manager positions because of their race; [II] failed to hire female applicants for official/manager, technician and service worker positions because of their sex; [III] failed to promote Black and female employees into official/manager positions; and [IV] failed to comply with the record keeping requirements of Title VII."(Compl.1.) The pattern or practice claims of failure to hire female applicants for technician positions and failure to promote Black employees into official/manager positions were dismissed on May 16, 2005, and July 7, 2005, respectively, although the EEOC continues to pursue individual disparate treatment claims alleging failure to promote Black employees into official/manager positions.

II. Jurisdiction

The court has jurisdiction to adjudicate federal claims under 28 U.S.C. § 1331.

III. Standard for Summary Judgment

The party moving for summary judgment "bears the burden of clearly and convincingly establishing the nonexistence of any genuine issue of material fact, and the evidence as well as all inferences drawn therefrom must be read in a light most favorable to the party opposing the motion." *Kochins v. Linden-Alimak, Inc.,* 799 F.2d 1128, 1133 (6th Cir.1986). The moving party can meet this burden by pointing out to the court that the respondents, having had sufficient opportunity for discovery, have no evidence to support an essential element of their case. *See Street v. J.C. Bradford & Co.,* 886 F.2d 1472, 1479 (6th Cir.1989).

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When confronted with a properly supported motion for summary judgment, the nonmoving party must set forth specific facts showing that there is a genuine issue for trial. A genuine issue for trial exists if the evidence is such that a reasonable jury could return a verdict for the nonmoving party. *See* *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248 (1986). The party opposing the motion must "do more than simply show that there is some metaphysical doubt as to the material facts." *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.,* 475 U.S. 574, 586 (1986). The nonmoving party may not oppose a properly supported summary judgment motion by mere reliance on the pleadings. *See* *Celotex Corp. v. Catrett,* 477 U.S. 317, 324 (1986). Instead, the nonmoving party must present "concrete evidence supporting its claims." *Cloverdale Equip. Co. v. Simon Aerials, Inc.,* 869 F.2d 934, 937 (6th Cir.1989). The district court does not have the duty to search the record for such evidence. *See* *InterRoyal Corp. v. Sponseller,* 889 F.2d 108, 110-11 (6th Cir.1989). Nonmovants have the duty to point out specific evidence in the record that would be sufficient to justify a jury decision in their favor. *See id.*

IV. Analysis

A. Counts I-III

***2** The EEOC advances three theories of liability to support the first three counts in its complaint: 1) pattern or practice disparate treatment; 2) pattern or practice disparate impact; and 3) individual disparate treatment.

A claim for disparate treatment arises when an employer or prospective employer "treats some people less favorably than others because of their race, sex, religion, or national origin." *Int'l Bhd. of Teamsters v. United States,* 431 U.S. 324, 335 n. 15 (1977). Where a systemwide pattern or practice of disparate treatment is alleged, the plaintiff must "prove more than the mere occurrence of isolated or 'accidental' or sporadic discriminatory acts. It ha [s] to establish by a preponderance of the evidence that racial discrimination was the company's standard operating procedure ..."*Id.* at 336.

The plaintiff in a pattern or practice case has the initial burden of showing "that unlawful discrimination has been a regular procedure or policy followed by an employer."*Id.* at 360. The employer must then show "that the [plaintiff]' s proof is either inaccurate or insignificant." *Id.*"Proof of discriminatory motive is critical, although it can in some situations be inferred from the mere fact of differences in treatment."*Id.* at 335 n. 15.

Disparate impact claims do not require a plaintiff to show that the employer had a discriminatory motive. *Wards Cove Packing Co. v. Atonio,* 490 U.S. 642, 646 (1989). A plaintiff claiming that an employment practice has a disparate impact must show that the practice "caused a significant adverse effect on a protected group." *United States v. City of Warren, Mich.,* 138 F.3d 1083, 1091 (6th Cir.1998). Once the plaintiff has proven there is a significant adverse effect, the employer must show "that the challenged practice is a business necessity."*Id.* at 1091-92.

A plaintiff alleging individual disparate treatment, where there is no direct evidence of discriminatory motive, has the initial burden of establishing a prima facie case of discrimination under the *McDonnell Douglas* framework. *McDonnell Douglas Corp. v. Green,* 411 U.S. 792, 802 (1973). When a plaintiff produces evidence to establish a prima facie case, the burden shifts to the employer to put forth a legitimate, nondiscriminatory reason for its action. *Id.* Once an employer has offered such a reason, the plaintiff must show that this reason is merely a pretext. *Id.* at 805.

A plaintiff, who seeks to establish a prima facie case of discrimination in hiring, must show that: (1) he is a member of a protected class; (2) he applied and was qualified for the position; (3) he was rejected; and (4) after he was rejected, the position remained open and the employer continued to seek

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applicants with the plaintiff's qualifications. *Id.* at 802. To establish a prima facie case for failure to promote using circumstantial evidence, the first three elements are the same. *Nguyen v. City of Cleveland,* 229 F.3d 559, 562-63 (6th Cir.2000). As the fourth element, a plaintiff must show that "other employees of similar qualifications who were not members of the protected class received promotions at the time the plaintiff's request for promotion was denied."*Id.* at 563.

1. Pattern or Practice Claims

***3** Under its pattern or practice theories, the EEOC specifically alleges that Autozone failed to hire blacks for low-salary management positions between 1993 and 2002, failed to hire females for medium-salary management positions between 1998 and 2002, failed to hire females for guard positions between 1993 and 1997, and failed to promote females to manager positions between 1998 and 2002. (Pl.'s Mem. 9.) These allegations are based on the EEOC's statistical evidence and, therefore, are more specific than the general allegations in the EEOC's complaint. In addition to statistical evidence, the EEOC presents anecdotal evidence of Autozone's practice of advertising job openings and promotion opportunities by word of mouth, a practice which the EEOC contends had an adverse impact on blacks and females because the majority of those responsible for hiring and promotion decisions were white males.

a. Statistical Evidence

In its motion for summary judgment, Autozone makes a number of arguments questioning the reliability of the analyses conducted by the EEOC's expert, Dr. Burt Barnow ("Dr.Barnow"). It also asserts that Dr. Barnow's results do not support the EEOC's allegations.

1) General Reliability

Autozone has two primary criticisms of Dr. Barnow's analyses as a whole: (1) that he did not employ a Bonferroni Adjustment to account for multiple testing; and (2) that he used an arbitrary significance level that does not conform to the requirements of *Castaneda v. Partida,* 430 U.S. 482 (1997).

There is no basis for Autozone's claim that the use of a significance level of 2.5% [FN1] rather than 2.3% as in *Castaneda* is arbitrary or unacceptable. The Supreme Court in *Castaneda* stated, "As a general rule ..., if the difference between the expected value and the observed number is greater than two or three standard deviations, then the hypothesis that [the result] was random would be suspect to a social scientist." 430 U.S. at 496 n. 17. Two standard deviations is often approximated at 5% for two-tailed tests.[FN2] *See* *Hazelwood School Dist. v. United States,* 433 U.S. 299, 318 n. 5 (1977) (Stevens, J., dissenting); Daniel L. Rubinfeld, *Reference Guide on Multiple Regression,* in Reference Manual on Scientific Evidence 179, 213-14 (Fed. Judicial Ctr.2000). In a footnote in *Hazelwood,* the Court stated, "These observations are not intended to suggest that precise calculations of statistical significance are necessary in employing statistical proof," 433 U.S. at 311 n. 17, indicating that an approximation of two standard deviations at 5% is acceptable.

FN1. Dr. Barnow established a significance level of 5% for two-tailed tests, with half of the probability (2.5%) in each tail of the test, and 2.5% for one-tailed tests.

FN2.*Castaneda* dealt with a one-tailed test.

That Dr. Barnow did not use any method of statistical adjustment to account for multiple testing is, however, more troubling. "Repeated testing complicates the interpretation of significance levels. If enough comparisons are made, random error almost guarantees that some will yield 'significant' findings, even when there is no real effect."David H. Kaye & David A. Freedman, *Reference Guide on*

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Statistics, in Reference Manual on Scientific Evidence 83, 127 (Fed. Judicial Ctr.2000). Certain statistical methods can be used in some cases to determine whether the findings are significant, but in other cases there is no solution capable of overcoming the flaws caused by multiple testing. *Id.* at 128.

***4** The EEOC argues that statistical adjustments are not used in the field of labor economics or in employment discrimination actions and that Autozone's expert has admitted that he is not aware of other employment discrimination actions where the method was used or whether the method is generally used in the field of labor economics. (Levine Dep. 46:4-9, 55:6-18, May 26, 2005.) In a motion for summary judgment, "weighing the credibility of the competing expert reports amounts to improper fact-finding." *Phillips v. Cohen,* 400 F.3d 388, 399 (6th Cir.2005). Given the contradictory views on the use of statistical adjustments, particularly the Bonferroni adjustment, the court does not have a sufficient basis to find that statistical adjustment was required in this case or that the non-utilization of any statistical adjustment makes Dr. Barnow's results unreliable. Therefore, the court will not grant summary judgment on the EEOC's pattern or practice claims on this basis.

In addition to its other general criticisms of Dr. Barnow, Autozone argues that Dr. Barnow's analyses should be disregarded because, in other cases where he presented evidence as an expert, courts have criticized or disregarded Dr. Barnow's opinions. The court will not, however, disregard Dr. Barnow's testimony solely on the basis of other courts' opinions of his past testimony, although those opinions, particularly where they reveal similar deficiencies in Dr. Barnow's proposed testimony in the present case, will be taken into consideration. *See* *Prohaska v. Sofamor, S.N.C.,* 138 F.Supp.2d 422 (W.D.N.Y.2001) (excluding testimony from an expert whose testimony had been excluded for similar reasons in previous cases); *Cooper v. Smith & Nephew, Inc.,* No. Civ. JFM 97-2578, 2000 WL 1728024 (D.Maryland.Nov. 20, 2000) (same).

2) Hiring Analyses for Official/Manager Positions

In conducting his hiring analyses of blacks and females to official/manager positions, Dr. Barnow conducted tests using three different time periods: 1993-2002, 1993-1997, and 1998-2002; and four different income levels: less than $35,000, $35,000-74,999, $75,000 or more, and all income levels. Thus, Dr. Barnow conducted twelve tests on the hiring of black managers and twelve tests on the hiring of female managers. In two of these twenty-four tests, Dr. Barnow found statistically significant underrepresentation: the analysis of the hiring of blacks for managerial positions with incomes less than $35,000 between 1993 and 2002 and the analysis of the hiring of females for managerial positions with incomes of $35,000 to $74,999 between 1998 and 2002. (Def.'s Mot. Ex. 3 at 1, 27-28.)

Autozone asserts that the statistically significant results in two out of twenty-four tests, or one out of twelve tests if the analyses for blacks and females were examined separately, should be regarded as a false positive. Given that the court must examine all evidence in the light most favorable to the EEOC for the purpose of summary judgment, however, the court will not exclude Dr. Barnow's results based on the opinions of Autozone and its expert.

***5** Autozone, however, raises another concern about the results of the managerial hiring analyses for females. According to Autozone, Dr. Barnow's results actually show that there is *no* statistically significant shortfall in the hiring of women for medium-salary management positions between 1998 and 2002. The one-tail probability for this test is 0.029 (2.9%), which is not statistically significant under the standards established by Dr. Barnow. (*Id.* Ex. 3 at 28, Ex. 7 at 11.) According to Dr. Barnow, however, his results are based on the two-tail probabilities, not the one-tail probabilities. (*Id.* Ex. 3 at 12.) In this case, using the two-tail rather than the

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one-tail probabilities is appropriate because one must look for both under-and overrepresentation, rather than looking for underrepresentation only. Therefore, the lack of statistical significance when using the one-tail probability is not determinative.

3) Hiring Analyses for Female Guards

Dr. Barnow conducted three analyses of the shortfall in hiring female guards, using three time periods: 1993-2002, 1993-1997, and 1998-2002. (*Id.* Ex. 3 at 29.) According to Dr. Barnow's results, there was a statistically significant shortfall of females hired as guards during the period from 1993 to 1997. (*Id.*) In addition to arguments similar to those about multiple testing discussed above in the context of hiring blacks and females for manager positions, Autozone asserts that the analyses of hiring female guards are unreliable because Dr. Barnow used census proxy data, rather than information from actual applications, in performing his analyses.

Although there is a general presumption in favor of using the actual applicant data, there are exceptions to that presumption, such as where the applicant data is unreliable. David C. Baldus & James W.L. Cole, *Statistical Proof of Discrimination* §§ 4.1.1, 4 .12 (1980). In this case, the EEOC asserts that Dr. Barnow did not use the actual applicant data because Autozone did not make available all of the applications for guard positions between 1993 and 2002. According to the EEOC, Autozone provided only one hundred thirty-seven applications for guard positions for the entire time period, one hundred twenty-seven of which were from 1994 or 1995. (Def.'s Mot. Ex. 7 at 48-51.) Therefore, for the purposes of summary judgment, the court finds it was reasonable for Dr. Barnow to use census proxy data rather than the actual applicant data because of concerns that the applicant data was incomplete.

4) Promotion Analysis

Dr. Barnow conducted ten tests in analyzing the frequency of women promoted into official/manager positions. The tests studied two time periods: 1993-1997 and 1998-2002; and five management levels: “senior and executive vice presidents”; “vice presidents”; “directors”; “managers”; and “other manager/officials n.e.c.” (*Id.*Ex. 3 at 30-31.) Dr. Barnow found that women were underpromoted in the managers classification between 1998 and 2002 and that the result was statistically significant. (*Id.* Ex. 3 at 31.)

***6** Autozone asserts, however, that Dr. Barnow's tests for the time period from 1998 to 2002 are fatally flawed because, in conducting his analysis of the latter time period, he did not factor in employee tenure. (Barnow Dep. 110:7-9, May 25, 2005.) Tenure was, however, taken into consideration for the period from 1993 to 1997. According to Dr. Barnow, tenure was not factored into the analysis because there were too many negative values for tenure. (*Id.* at 110:10-17.) Autozone contends that the only way Dr. Barnow could have found individuals had negative tenure would have been if they had not yet been hired when a particular promotion was awarded. Dr. Barnow has admitted that such individuals were included in the promotion feeder groups. (*Id.* at 136:24-137:3.) Therefore, Autozone argues that Dr. Barnow's results were fatally flawed because the feeder group included a number of individuals who were not eligible for promotion.

Dr. Barnow's report indicates that other qualifications, including performance ratings, education, awards received, disciplinary actions, and training received, were not factored into his promotion analyses for either time period because the information was not available. (Def.'s Mot. Ex. 3 at 18.) Therefore, the only variables considered in Dr. Barnow's analyses, in addition to tenure in the earlier time period, were the year of observation, the individual's salary and job category at the beginning of the period, and whether the individual worked at corporate headquarters during the period at issue. (*id*)

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The EEOC argues that it is not necessary to "prove discrimination with scientific certainty." *Bazemore v. Friday,* 478 U.S. 385, 400 (1986). The Sixth Circuit has held that statistical evidence does not need to account for candidates' qualifications to be relevant in promotion cases. *Phillips,* 400 F.3d at 400; *Scales v. J.C. Bradford & Co.,* 925 F.2d 901, 908 (6th Cir.1991). The inclusion of individuals who did not work at Autozone when a promotion was awarded in the feeder group for that promotion, however, is a more serious flaw than merely failing to account for all of the factors that an employer might consider in awarding the promotion, particularly given that the high occurrence of negative tenure indicates that this problem is not restricted to a few individuals in the feeder group.

Although it is not proper for the court to weigh the credibility of expert evidence at summary judgment, the flaws in Dr. Barnow's promotion analyses do not merely raise questions of credibility, but of accuracy and relevance."There may, of course, be some regressions so incomplete as to be inadmissible as irrelevant...." *Bazemore,* 478 U.S. at 400 n. 10. There may also be some regressions so flawed and methodologically unreliable as to be irrelevant. Given the flaws in Dr. Barnow's promotion regression analyses, the court cannot consider them relevant evidence of the EEOC's claims.

***7** Therefore, the only relevant evidence supporting the EEOC's pattern or practice theories under Count III is anecdotal.[FN3]"While anecdotal evidence may suffice to prove *individual* claims of discrimination, rarely, if ever, can such evidence show a *systemic pattern* of discrimination." *Middleton v. City of Flint, Mich.,* 92 F.3d 396, 405 (6th Cir.1996) (quoting *O'Donnell Constr. Co. v. Dist. of Columbia,* 963 F.2d 420, 427 (D .C. Cir.1992)). In its response to Autozone's motion, the EEOC cites deposition testimony from several claimants as well as some non-claimants, primarily white males who received promotions, discussing Autozone's promotion policies and the use of word of mouth to advertise open positions. These depositions, however, are *at most* evidence of incidents in which individual white males were given an advantage over other applicants or potential applicants for a promotion and of a sentiment among some women at Autozone that white males received better treatment. They do not show an intent to discriminate on the part of Autozone and are not sufficient to make out a prima facie case of pattern or practice disparate treatment or pattern or practice disparate impact under Count III. Therefore, Autozone's motion for summary judgment is granted on the EEOC's pattern or practice claims in Count III.

FN3. Although Count III alleges claims for failure to promote both female and Black employees to official/manager positions, the claim for failure to promote Black employees is based solely on the theory of individual disparate treatment. Therefore, the pattern or practice theories relate only to the claim for failure to promote female employees.

b. Disparate Impact

The practices that allegedly had a significant adverse effect on blacks and women in hiring-the use of informal hiring procedures, such as word of mouth advertising, favoritism, and subjective decision-making, coupled with the predominance of white males as decision-makers in the hiring process-do not relate to any objective criteria for employment at Autozone. Although subjective hiring practices may give rise to a disparate impact claim, "the plaintiff's burden in establishing a prima facie case goes beyond the need to show that there are statistical disparities in the employer's work force." *Watson v. Fort Worth Bank & Trust,* 487 U.S. 977, 994 (1988). The EEOC must also show causation. "[T]hat is, the plaintiff must offer statistical evidence of a kind and degree sufficient to show that the practice in question has caused the exclusion of applicants for jobs or promotions because of their membership in a protected group."*Id.*

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The statistical evidence compiled by Dr. Barnow is insufficient to establish a prima facie case of disparate impact discrimination. As the Supreme Court has stated,

> It is completely unrealistic to assume that unlawful discrimination is the sole cause of people failing to gravitate to jobs and employers in accord with the laws of chance. It would be equally unrealistic to suppose that employers can eliminate, or discover and explain, the myriad of innocent causes that may lead to statistical imbalances in the composition of their work forces.

Id. at 992 (internal citation omitted). The statistics presented by the EEOC show that out of twenty-seven regression analyses of the hiring of managers and guards conducted by Dr. Barnow, he found a statistically significant shortfall of blacks or females hired in only three. In all three of those analyses, the probability was at or near the cusp of statistical significance.[FN4] Five of Dr. Barnow's tests indicated that the number of blacks or females hired to manager positions would be approximately equivalent to what would be expected, [FN5] and three tests indicated that the number of females hired as managers or guards exceeded what would be expected. (Def.'s Mot. Ex. 3 at 28-29 .)

FN4. The two-tail probability in the analysis of the shortfall of blacks hired to low-salary management positions between 1993 and 2002 was .04, of females hired to mid-salary management positions between 1998 and 2002 was .05, and of females hired as guards between 1993 and 1997 was .048, with .05 or lower considered statistically significant. (Def.'s Mot. Ex. 3 at 27-29.)

FN5. That is, in five of the tests, four analyzing the shortfall in hiring black managers and one analyzing the shortfall in hiring female managers, the two-tail probability was 1.000. (*Id.* Ex. 3 at 27-28.)

***8** The EEOC argues that Autozone cannot move for summary judgment based on a "balancing test," meaning that the overrepresentation of blacks or females in certain time periods or job categories does not negate the evidence of underrepresentation in other periods or job categories. In support of this contention, the EEOC cites the Supreme Court's decision in *Connecticut v. Teal,* 457 U.S. 440 (1982). In *Teal,* however, the Court was addressing the effects of an objective test that was not job-related. *Id.* at 452. As the Court recognized several years later in *Watson,* however, it is generally not practicable to validate subjective hiring practices in the same manner as an objective test. 487 U.S. at 991.

The use of word of mouth advertising and subjective considerations in hiring is hardly uncommon, and employers should not be expected to establish quota systems to ensure that there are never any shortfalls in hiring women and minorities. The statistical evidence presented by the EEOC shows that Autozone did not always meet statistical expectations, but it is not sufficient to show that the employment practices at issue caused the exclusion of applicants because they were black or female. Therefore, Autozone's motion for summary judgment on the EEOC's claims for pattern or practice disparate impact in Counts I and II is granted.

c. Disparate Treatment

The evidence presented by the EEOC also fails to establish a prima facie case of pattern or practice disparate treatment as to Counts I and II because it is insufficient to permit the inference of a discriminatory motive on the part of Autozone. The EEOC cannot establish that racial discrimination was Autozone's standard operating procedure using statistics that indicate that Autozone was more likely to meet or exceed statistical expectations about the number of blacks or females hired as managers or guards than it was to fall short of those expectations.

The anecdotal evidence presented by the EEOC

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does not indicate either directly or inferentially any intent to discriminate on the part of Autozone. To support its claims of discrimination in hiring, the EEOC cites the depositions of four white males who learned of job openings at Autozone by word of mouth. (Pl.'s Mem. 13-14.) The EEOC fails to mention, however, that two of those men learned of the job openings from female managers at Autozone. (Loftiss Dep. 17:9-18:6, July 25, 2002; Poynter Dep. 27:1-24, Aug. 28, 2002.) That a small number of white men were hired for jobs at Autozone after hearing of openings by word of mouth does not suffice to establish that Autozone intentionally discriminated against blacks and females in hiring. Therefore, Autozone's motion for summary judgment on the EEOC's claims for pattern or practice disparate treatment in Counts I and II is granted.

2. Individual Claims

When Autozone filed its motion for summary judgment, there were one hundred forty-eight individual claimants.[FN6] (Def.'s Mem. 3.) Autozone seeks summary judgment on each of these individual claims. In its response, the EEOC "presents specific responses for only a representative sample of its individual claimants."(Pl.'s Mem. 8.) Because the EEOC has not responded to Autozone's motion for summary judgment as to each of its individual claimants and because of the court's ruling granting summary judgment in favor of Autozone on the EEOC's pattern or practice claims, the court cannot render summary judgment on the individual claims at this time. Therefore, Autozone's motion for summary judgment on the EEOC's claims for individual disparate treatment in Counts I, II, and III is denied without prejudice.

FN6. Apparently, at least one claimant, Monique Spikes, has been dropped since Autozone filed its motion. (Def.'s Reply Ex. 1.) The court has received no additional information about the status of the individual claims.

B. Count IV-Record Keeping Violation

***9** Section 709(c) of Title VII requires employers (1) to maintain records relevant to the determination of whether unlawful employment practices have been or are being committed, (2) to preserve those records for a period of time, and (3) to make reports from the records as the EEOC prescribes. 42 U.S.C. § 2000e-8(c). The EEOC specifically alleges that Autozone violated the requirements of 29 C.F.R. § 1607.4(A), enacted in accordance with the provisions of § 709(c). That regulation requires that employers maintain and make available for inspection records that show the impact its hiring procedures have on members of specific races, sexes, and ethnic groups specified in § 1607.4(B).

Autozone asserts that the EEOC has produced no evidence to support its record keeping allegations. The court finds, however, that the EEOC has produced evidence showing a genuine issue of material fact about whether Autozone kept records as required by 29 C.F.R. § 1607.4(A). Shirley Branum, an employee and later a recruiter in personnel services for Autozone from 1994 to 2002, stated in her deposition that personnel services did not keep records on the race and sex of people who were interviewed. (Branum Dep. 9:13-10:25, 50:13-16, Sept. 19, 2002.) The hiring personnel at Autozone also did not make any reports about or track the diversity of the applicant pool according to Branum. (*Id.* at 51:6-24.)

Because Branum's testimony shows that there is a genuine issue of material fact about whether Autozone maintained records showing the impact of its hiring procedures on specified sexes, races, and ethnic groups, Defendant's motion for summary judgment on Count IV of the complaint is denied.

V. Conclusion

Defendant Autozone, Inc.'s motion for summary judgment is GRANTED on Plaintiff Equal Employment Opportunity Commission's claims for pattern

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or practice disparate treatment and pattern or practice disparate impact in Counts I, II, and III of the complaint.

Defendant Autozone, Inc.'s motion for summary judgment is DENIED without prejudice on Plaintiff Equal Employment Opportunity Commission's claims for individual disparate treatment in Counts I, II, and III of the complaint.

Defendant Autozone, Inc.'s motion for summary judgment is DENIED on Count IV of the complaint.

So ordered this 29th day of August 2006.

W.D.Tenn.,2006.
E.E.O.C. v. Autozone, Inc.
Not Reported in F.Supp.2d, 2006 WL 2524093 (W.D.Tenn.)

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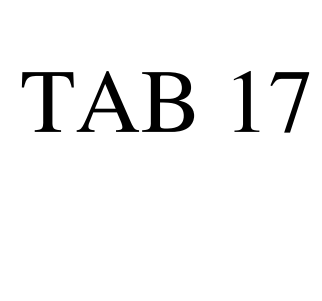
TAB 17

United States District Court, D. Nevada.
FEDERAL TRADE COMMISSION
v.
PIONEER ENTERPRISES, INC., dba Vita-Tek Marketing, Profile Marketing, 21st Century II and Sunshine Promotions, et al.
No. CV-S-92-615-LDG (RJJ).

Nov. 12, 1992.

Order

GEORGE, Chief Judge.
***1** This matter is before the court on Plaintiff F.T.C.'s Motion in Limine Seeking Admission of Consumer Complaints Pursuant to Fed.R.Evid. 404(b) and Summary Testimony Thereof Pursuant to Fed.R.Evid. 1006 (# 51); Motion in Limine to Preclude Testimony of B. Mahlon Brown, Edward R.J. Kane and Andrew Yurko at Trial (# 56); and Motion in Limine to Preclude Testimony of Geraldine Dendmen (sp), Larry Struve, Tammy Smith, Ron Shutt, Anita Mullins, Anthony Shareno, Michael Vogel, Kathy Jones, Richard Taggart and James Howard (# 58). The court will address each motion in turn.

Motion Seeking Admission of Consumer Complaints

The F.T.C. seeks admission of approximately one thousand (1,000) consumer complaints allegedly submitted to the defendants by injured consumers. The F.T.C. obtained the complaints from the defendants through discovery. The F.T.C. seeks to admit the complaints "solely for the limited purpose of demonstrating that the defendants ... were on notice of potential and ongoing problems with the operation of their telemarketing business." The F.T.C. also seeks to admit summaries of the aforementioned complaints and the testimony of Martha Vera, an F.T.C. investigator who reviewed the complaints and prepared the summaries.

Defendants argue that the consumer complaints are inadmissible on several grounds. They first argue that the evidence is irrelevant because knowledge, motive or scienter is not an element of proof in a cause of action brought under Section 13(b) of the F.T.C. Act, 15 U.S.C. § 53(b). Defendants are only partially correct. To the extent that the F.T.C. seeks injunctive relief to enjoin violations of the F.T.C. Act, including unfair or deceptive trade practices, knowledge is not relevant. *F.T.C. v. Amy Travel Servs., Inc.* [1989-1 TRADE CASES ¶ 68,549], 875 F.2d 564, 573 (9th Cir.), cert. denied, 493 U.S. 95, 110 S.Ct. 366 (1989). Further, the F.T.C. is not required to establish state of mind in cases where it seeks to hold corporate defendants liable for restitution to consumers. However, in cases such as this one, where the F.T.C. also seeks to hold individual defendants liable for restitution to consumers, the F.T.C. must demonstrate that the individuals had some "knowledge" of the unfair or deceptive practices. *Amy Travel,* 875 F.2d at 573.[FN1]

While the F.T.C. is not required to prove subjective intent to defraud, it is required to establish that the individual defendants had or should have had knowledge or awareness of the misrepresentations. *Amy Travel,* 875 F.2d at 574. However, that knowledge requirement may be fulfilled by showing that the individuals had "actual knowledge of material misrepresentations, reckless indifference to the truth or falsity of such misrepresentations, or an awareness of a high probability of fraud along with an intentional avoidance of the truth." *F.T.C. v. Kitco of Nevada, Inc.*[1985-2 TRADE CASES ¶ 66,658], 612 F.Supp. 1282, 1292 (D.Minn.1985); see also *Amy Travel,* 875 F.2d at 574; *Sharp,* 782 F.Supp. at 1450. Evidence that the defendants received numerous consumer complaint letters and that individual defendants Easley and Secchiaroli were aware of those letters and their general content would be relevant to establishing that Easley and Secchiaroli had the requisite "knowledge" for holding them individually liable for consumer restitution.[FN2]

***2** Defendants also contend that the consumer complaints are inadmissible hearsay because the F.T.C. is actually seeking to introduce the complaints "to prove the truth of its assertion that the defendants' business practice was widespread and consumers in a large area were affected by Pioneer's business activities." This argument makes little sense, as the relevant issue when a hearsay question is raised is whether the proponent seeks to introduce the state-

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ment for the truth of the matter asserted in the statement itself; whether the statement proves the truth of some assertion made by the proponent is irrelevant to the inquiry of whether the statement constitutes hearsay at all. See Fed.R.Evid. 801(c).

In any case, the consumer complaints do not constitute inadmissible hearsay. The F.T.C. seeks to introduce the complaints, and the court will consider them, solely as they relate to the issue of whether the defendants were on notice of potential problems with their operations. The complaints are not being offered to prove the truth of the matters asserted therein; that is, the truth of the consumers' statements. They are only being offered to establish that the defendants were aware that consumers were complaining of being deceived or misled, not that consumers actually were deceived or that reasonable consumers would have been deceived by the defendants' conduct. As the evidence is only being admitted to show the defendant's knowledge, and not for the truth of the matter asserted, it is not inadmissible hearsay. *Amy Travel,* 875 F.2d at 576 n. 11.

The F.T.C. indicates that it seeks to admit the consumer complaints pursuant to Rule 404(b) of the Federal Rules of Evidence. Defendants contend that this evidence is not admissible under Rule 404(b) because the F.T.C. has failed to establish that the consumer complaints constitute similar or related wrong acts. However, as the court does not consider this to be 404(b) evidence, the defendants' arguments are irrelevant. Rule 404(b) concerns evidence of other crimes, wrongs or acts. As the consumer complaints are not being admitted for the truth of the matters asserted therein, then any allegations of conduct by the defendants contained therein will not be considered by the court. The consumer complaints are relevant only to the issue of whether defendants Easley and Secchiaroli had knowledge of the alleged deceptive practices; they do not constitute evidence of other crimes, wrongs or acts, thus Rule 404(b) is inapplicable.

Finally, the defendants contend that the introduction of 1,000 consumer complaints at the time of trial is likely to place an undue burden on the court, be a waste of the court's time and resources, and delay the trial process. The court is inclined to agree, particularly where another, less burdensome alternative is available. The F.T.C. has indicated that it not only seeks to admit the consumer complaints themselves, but it also wishes to admit summaries of the complaints and the testimony of Martha Vera, an F.T.C. investigator who reviewed the complaints and prepared the summaries. Rule 1006 of the Federal Rules of Civil Procedure provides that

***3** [t]he contents of voluminous writings, recordings, or photographs which cannot conveniently be examined in court may be presented in the form of a chart, summary, or calculation. The originals, or duplicates, shall be made available for examination or copying, or both, by the other parties at a reasonable time and place. The court may order that they be reproduced in court.

The summaries of the consumer complaints are admissible under Rule 1006 if the underlying complaints themselves are admissible evidence and the complaints are available to the defendants for inspection. *Paddock v. Dave Christensen, Inc.,* 745 F.2d 1254, 1259 (9th Cir.1984); see *United States v. Johnson,* 594 F.2d 1253, 1254-57 (9th Cir.), cert. denied, 444 U.S. 964, 100 S.Ct. 451 (1979). As noted above, the consumer complaints are admissible for the limited purpose for which they are offered. Moreover, the complaints were obtained from the defendants themselves and, as such, are available to them for inspection.

It is thus the intention of the court to permit the F.T.C. to present the summaries of the consumer complaints, along with the testimony of Martha Vera, while excluding the actual complaints themselves. The F.T.C. should be prepared, however, to produce the underlying consumer complaints as required by Rule 1006 should the court deem their introduction necessary.

Motion to Exclude Testimony of Brown, Kane and Yurko

The F.T.C. seeks to preclude B. Mahlon Brown, Edward R.J. Kane and Andrew Yurko from testifying to Defendants' "good faith attempts to comply with all state and federal laws." These parties are attorneys, all of whom are apparently former counsel for the defendants.

To the extent the defendants would have these parties testify to their policing of the defendants' business

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practices during the time period in question, to the defendants' lack of bad faith or intent, or to whether the defendants' business practices complied with state law, such testimony is irrelevant and will be excluded. To establish that the defendants engaged in illegal deceptive trade practices, the F.T.C. must prove that the defendants engaged in practices that were likely to mislead reasonable consumers to the consumers' detriment. See *Southwest Sunsites v. F.T.C.*[1986-1 TRADE CASES ¶ 67,021], 785 F.2d 1431, 1435 (9th Cir.)cert. denied, 479 U.S. 828, 107 S.Ct. 109 (1986). “[T]he blessing of an attorney [does] not make the telemarketing scripts truthful. Obtaining the advice of counsel [does] not change the fact that [a] business was engaged in deceptive practices.” *Amy Travel,* 875 F.2d at 575. Moreover, reliance on advice of counsel is not a valid defense on the question of knowledge required for individual liability; “counsel could not sanction something that the defendants should have known was wrong.” *Id.* at 575 and n. 8. Similarly, lack of intent or bad faith is not a defense to liability, *Id.* at 573-74; *Sharp,* 782 F.Supp. at 1450, nor is the fact that the defendants' conduct may be in compliance with state law. See *Simeon Management Corp. v. F.T.C.*[1978-2 TRADE CASES ¶ 62,282], 579 F.2d 1137, 1144 (9th Cir.1978) (“[w]hether a state official has approved the advertisements or not is irrelevant to the operation of the federal regulatory scheme set forth in the FTCA.”).

***4** Contrary to Defendants' assertion, the good faith of the defendants is not relevant to the issue of penalties under 15 U.S.C. § 45(m), because the F.T.C. is not seeking such penalties in this action. The F.T.C. does seek disgorgement of profits, recision of contracts and reimbursement of consumers, but the court is authorized to provide such remedies pursuant to its equitable powers under 15 U.S.C. § 45(b). *F.T.C. v. H.N. Singer* [1982-1 TRADE CASES ¶ 64,569], 668 F.2d 1107, 1113 (9th Cir.1982). Such consumer redress does not constitute a penalty and is available regardless of the defendants' good faith. While these witnesses may have relevant testimony to provide about other matters, any testimony they may have to give concerning the defendants' lack of bad faith or their efforts to comply with federal and state laws is irrelevant and will not be allowed.

Motion to Exclude Testimony of Dendmen(sp), Struve, et al.

The F.T.C. also seeks to preclude Geraldine Dendmen(sp), Larry Struve, Tammy Smith, Ron Shutt, Anita Mullins, Anthony Shareno, Michael Vogel, Kathy Jones, Richard Taggart and James Howard from testifying to the defendants' “good faith efforts to comply with all customer complaints.” Dendmen(sp), Struve, Smith, and Shutt are apparently employees of the State of Nevada; Mullins, Shareno, Vogel, and Jones are apparently employees of the defendants; and Taggart and Howard are apparently employees of banks utilized by the defendants during the course of their telemarketing operations. As noted above, the absence of bad faith or fraudulent intent on the part of the defendants will not absolve them of liability under the F.T.C. Act. Thus, any actions taken by the defendants to resolve consumer complaints, whether taken in good or bad faith are irrelevant to the issue of whether the defendants are liable for violations of the Act. Defendant contends that such testimony would be relevant to the issue of likelihood of recurrence.[FN3] The court fails to see how. That the defendants have attempted to address the complaints of consumers in the past in no way tends to show that the defendants will, in the future, cease engaging in the conduct that provoked such complaints. The case cited by the defendants, *United States v. Papercraft Corp.*[1976-2 TRADE CASES ¶ 60,972], 540 F.2d 131, 141 (3rd Cir.1976), does not stand for the proposition alleged. That case deals with penalties that may be assessed against a company for failure to comply with an F.T.C. divestiture order, and in no manner implies as the defendants do that “[e]vidence of good faith to comply and resolve customer complaints will vitiate any showing of likelihood of recurrence.” While these witnesses may have relevant testimony to provide about other matters, any testimony they may have to give concerning the defendant's efforts to comply with consumer complaints is irrelevant and will not be allowed.

Accordingly, for the reasons above stated,

***5** It Is Ordered that the F.T.C.'s Motion in Limine Seeking Admission of Consumer Complaints Pursuant to Fed.R.Evid. 404(b) and Summary Testimony Thereof Pursuant to Fed.R.Evid. 1006 (# 51) is granted in part and denied in part. The F.T.C. shall be permitted to introduce the summaries of the consumer complaints and the testimony of Martha Vera as it relates to those summaries. The F.T.C. shall not

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be permitted to introduce the 1,000 consumer complaints.

It Is Further Ordered that the F.T.C.'s Motion in Limine to Preclude Testimony of B. Mahlon Brown, Edward R.J. Kane and Andrew Yurko at Trial (# 56) is granted.

It Is Further Ordered that the F.T.C.'s Motion in Limine to Preclude Testimony of Geraldine Dendmen(sp), Larry Struve, Tammy Smith, Ron Shutt, Anita Mullins, Anthony Shareno, Michael Vogel, Kathy Jones, Richard Taggart and James Howard (# 58) is granted.

FN1. The F.T.C. must also establish that the corporate defendants' conduct constituted illegal deceptive trade practices and that the individual defendants participated directly in the practices or acts or had authority to control them. *Amy Travel,* 875 F.2d at 573; *F.T.C. v. Sharp* [1991-2 TRADE CASES ¶ 69,579], 782 F.Supp. 1445, 1449 (D.Nev.1991).

FN2. Of course, only consumer complaints indicating that consumers felt they had been deceived or misled in some way would be relevant. If, for example, the defendants had received 1,000 complaints relating to how long it took Pioneer to deliver a product or complaining that a salesperson was rude, such evidence would not tend to make more likely the fact the defendants Easley and Secchiaroli knew or should have known of the allegedly deceptive behavior.

FN3. Section 13(b) authorizes the court to permanently enjoin the defendants from violating the F.T.C. Act if “there is some cognizable danger of recurrent violation.” 15 U.S.C. § 53(b).

D.Nev.,1992.
F.T.C. v. Pioneer Enterprises, Inc.
Not Reported in F.Supp., 1992 WL 372350 (D.Nev.), 1992-2 Trade Cases P 70,043

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TAB 18

United States District Court, S.D. New York.
In re GLAXO SMITHKLINE PLC Securities Litigation.
No. 05 Civ. 3751(LAP).

Oct. 6, 2006.

C. Mark Whitehead, Jules Brody, Aaron Lee Brody, Stull, Stull & Brody, New York, NY, Timothy Joseph Burke, Stull, Stull, & Brody, Los Angeles, CA, Samuel Howard Rudman, Lerach, Coughlin, Stoia, Geller, Rudman & Robbins, LLP, Melville, NY, for Plaintiffs.
Andrew J. Levander, Neil A. Steiner, Dechert LLP, New York, NY, for Defendant.

OPINION

LORETTA A. PRESKA, United States District Judge.
***1** Lead Plaintiff Joseph J. Masters ("Plaintiff" or "Masters") brings this putative class action alleging that GlaxoSmithkline ("GSK") and GSK CEO and Chairman Jean-Pierre Garnier ("Garnier") (collectively "Defendants") violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1994), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), by making various false and misleading statements resulting in damages to GSK investors during the class period. Defendants move to dismiss pursuant to Rule 12(b)(6) for failure to state a claim on which relief may be granted on grounds, *inter alia,* that certain claims are time-barred, and that Plaintiff has failed to plead fraud with particularity, failed to allege scienter, and failed to allege loss causation. For the reasons set forth below, Defendants' motion (dkt. no. 13) is granted, and the Consolidated Second Amended Complaint ("SAC") is dismissed with prejudice.

I. *Background*

This is a putative class action filed on behalf of individuals who acquired GSK common stock or American Depositary Receipts ("ADRs") during the period from December 27, 2000 to August 5, 2004 (the "Class Period"). (SAC ¶ 9). Plaintiff alleges that he acquired GSK securities during the Class Period and suffered damages as a result. (SAC ¶ 2). More specifically, according to his class representative certifications, Masters purchased 1,400 shares of GSK on September 28, 2001 at a share price of $56.28 and sold the same number of shares on June 13, 2002 at a price of $39.43. Plaintiff purchased an additional 350 shares of GSK on February 17, 2004 at a share price of $42.96 and had not sold those shares as of May 10, 2005.

GSK is a public company whose securities trade on the New York and London Stock Exchanges. (SAC ¶ 3). Garnier was CEO and Chairman of GSK throughout the Class Period. (SAC ¶ 4). The SAC alleges that on February 19, 2004, Garnier sold 142,250 shares of GSK stock for $6,143,293 based on material non-public information. (SAC ¶ 279).[FN1]

FN1. The SAC also alleges that on December 14, 2004, Garnier sold 79,054 shares for $3,774,037, but this transaction occurred after the Class Period end date of August 4, 2004.

A. *Procedural History*

The initial complaint in this action was filed on April 12, 2005. Two additional actions, No. 05-cv-3885 and No. 05-cv-4723, were brought in this district on April 18, 2005 and May 16, 2005, respectively. A fourth related action, No. 05-cv-6231, was transferred here from the Eastern District of Pennsylvania.

By order dated July 25, 2005, this Court consolidated all four actions and granted Masters' unopposed motion for appointment as lead plaintiff. This Court also set up a procedure whereby Plaintiff was directed to serve a consolidated amended complaint, Defendants were to advise Plaintiff of perceived deficiencies, *i.e.,* grounds for a motion to dismiss, and Plaintiff was given the opportunity to file a second amended complaint with the understanding that no further amendments would be permitted. The parties availed themselves of this procedure, and the SAC was docketed on April 6, 2006.

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B. *The Second Amended Complaint*

***2** The SAC alleges violations of the Exchange Act in two counts. The first count alleges that Defendants violated section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by, *inter alia,* making untrue statements of material fact that resulted in damages to Plaintiff and the class. (SAC ¶¶ 282-286). The second count alleges control person liability under section 20(a) of the Exchange Act as to Defendant Garnier. (SAC ¶¶ 287-291).

Broadly speaking, the SAC alleges that GSK violated the Exchange Act in four ways: 1) by misrepresenting the safety and efficacy of the use of its drug Paxil in children (the "Paxil Pediatric Allegations"); 2) by making false statements and omissions regarding the viability of GSK's patents for Paxil and Augmentin and engaging in a course of frivolous litigation with respect to those patents (the "Patent Allegations"); 3) by suppressing information about Paxil's addictiveness and withdrawal effects (the "Paxil Withdrawal Allegations"); and 4) by violating the Federal False Claims Act by overcharging Medicare and Medicaid for GSK's pharmaceutical products, resulting in multiple lawsuits against GSK (the "False Claims Act Allegations"). The SAC also alleges that Garnier sold GSK stock based on material, non-public information (the "Insider Trading Allegations"). (SAC ¶ 279).

1. *The Paxil Pediatric Allegations*

GSK manufactured and sold paroxetine under the name Paxil in the United States and Seroxat in Great Britain (hereinafter "Paxil") throughout the Class period. (SAC ¶ 18).Paxil is a selective serotonin reuptake inhibitor ("SSRI") that is approved by the FDA for treatment of depression, anxiety and other conditions in adults. (*Id.*).Paxil has not been approved by the FDA for treatment of any conditions in children or adolescents. (*Id.*). Physicians, however, are permitted to prescribe FDA-approved drugs for non-FDA-approved uses where, through the exercise of independent judgment, they determine that the prescription is appropriate.(*Id .*). This practice is referred to as an "off-label" use. (*Id.*). GSK reported Paxil sales of £1.55 billion for the year 2000. (SAC ¶ 31). In 2002, Paxil prescriptions to treat children and adolescents totaled $55 million in the United States and "much more" worldwide. (SAC ¶ 19).

The SAC alleges that GSK misrepresented the safety and efficacy of Paxil in treating Major Depressive Disorder ("MDD") in children by allowing positive information about Paxil to be disclosed publicly but withholding or concealing negative information. (SAC ¶ 20). More specifically, the SAC alleges that on various occasions prior to and during the Class Period, research scientists sponsored by or known to GSK published articles and presented posters at research conferences reporting on the safety and efficacy of Paxil for treatment of children and adolescents. (SAC ¶¶ 22-29, 32-47).

The SAC also alleges that GSK made misrepresentations about Paxil by allowing dissemination of a study that showed mixed results about the safety and efficacy of Paxil but withholding the results of studies that had negative results. (SAC ¶¶ 58-80). Two out of three placebo-controlled studies conducted by GSK, studies 377 and 701, showed no statistically significant difference between the effectiveness of Paxil and the effectiveness of the placebo. (SAC ¶ 67). A third study, study 329, presented a mixed picture, with Paxil failing to outperform the placebo on two primary measures of efficacy but outperforming the placebo on three out of five secondary measures of efficacy. (SAC ¶ 68). In all three studies, suicidal thoughts and acts, as well as mood swings and crying (behavior coded as "emotional lability") were significantly higher in the Paxil group compared to the placebo group. (SAC ¶ 70). Specifically, study 329 showed emotional lability in 6.5% of the Paxil group compared with 1.1% of the control group. (*Id.*); study 377 showed emotional lability in 4.4.% of the Paxil group compared with 3.2% of the control group; and study 701 showed emotional lability in 3.6% of the Paxil group compared with 1.4% of the control group. (*Id.*)

***3** The SAC alleges that GSK disseminated the results of study 329, concealing or downplaying its negative aspects, but suppressed dissemination of the other studies. (SAC ¶¶ 58-62, 73-80). After GSK submitted studies 329, 377 and 701 to the FDA in connection with an application for approval of Paxil to treat Obsessive Compulsive Disorder ("OCD") in children and adolescents, various regulatory agencies in the United States and abroad issued warnings against the use of Paxil in children and adolescents. (SAC ¶¶ 81-90).

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With regard to loss causation, the SAC specifies two price drops of GSK securities following the release of information to the public about Paxil's adverse effects on children. On June 2, 2004, the New York State Attorney General announced a lawsuit against GSK based on suppression of the adverse pediatric studies, resulting in a price drop from $42.77 to $41.39, or $1.38 per share, on that date. (SAC ¶ 48). On December 9, 2004, the ABC News program Primetime Live aired a story about the adverse effects of Paxil on children, resulting in a stock price drop from $45.08 to $44.82, or 23 cents per share, the following day. (SAC ¶ 51).

2. *The Paxil Withdrawal Allegations*

The SAC alleges that GSK engaged in a "disinformation campaign" designed to suppress information about the withdrawal effects of Paxil. (SAC ¶ 238). The SAC alleges that GSK knew from pre-marketing studies that Paxil had higher addictive potential than other SSRIs. (SAC ¶¶ 240-242). Despite this alleged awareness, GSK included in its promotional literature the following statement: "Paxil belongs to a class of medications called SSRIs, which have not been shown to be associated with addiction."(SAC ¶ 243). The SAC catalogues 18 scientific studies or reports between 1993 and 2000 documenting withdrawal symptoms as a result of Paxil discontinuation, none of which was acted upon. (SAC ¶¶ 246-263).

In August 2001, a class action was filed in California on behalf of consumers addicted to Paxil. (SAC ¶ 238). The SAC alleges that on September 6, 2001, GSK's share price fell from $45.14 to $44 .10, or $1.04 per share, on news of the class action suit alleging that Paxil caused withdrawal symptoms. (SAC ¶ 264). In December 2001, the FDA ordered GSK to begin warning patients about Paxil's withdrawal symptoms, and the company rewrote Paxil's warning label to include "discontinuation effects." (SAC ¶ 265).

3. *The Patent Allegations*

Broadly speaking, the Patent Allegations allege that GSK misled investors by issuing statements misrepresenting the validity and duration of GSK's patents for Paxil and Augmentin. The Patent Allegations allege that GSK engaged in a course of baseless patent filings and frivolous patent litigation.

With regard to Augmentin, the SAC alleges that in a July 26, 2000 *Financial Times* article, Garnier stated that a newly granted patent on Augmentin would extend patent protection to 2013. (SAC ¶ 132). After a federal court ruled on February 2, 2002 that GSK lost certain patent protections for Augmentin, Garnier appeared for a CNBC interview and said, "We are very confident we can defend our patents."(SAC ¶ 134). Garnier also stated, "The PTO confirmed that those patent[s] were genuine, they were rock solid. And we feel that the courts eventually will recognize the letter of the law and give us the added protection for Augmentin."(*Id.*). On February 25, 2002, a federal district court ruled that GSK's '380 patent for Augmentin was invalid. (SAC ¶ 137). On November 23, 2003, the Federal Circuit upheld the district court's ruling that GSK did not have patent protection for Augmentin. (SAC ¶ 141).

***4** Regarding loss causation, the SAC alleges that after a March 13, 2002 announcement that GSK had lost part of its court battle over Augmentin, GSK's share price fell from $48.81 on March 13, 2002 to $48.27 on March 14, 2002, and to $47.62 on March 15, 2002, a total of $1.19 per share in two days. (SAC ¶ 138). When GSK announced on May 23, 2003 that it lost patent protection for Augmentin completely, GSK's share price fell from $41.47 to $38.03, or $3.44 per share. (SAC ¶¶ 139-140, 174-175).

The SAC alleges that GSK represented in its Form 20-F for the years 1999 through 2001 that its patent protection for Paxil expired in 2006. (SAC ¶¶ 99, 103). The SAC alleges that this representation was false because the patent protection was based upon "evergreening," *i.e.,* obtaining frivolous patents in order to extend patent life. (SAC ¶ 111). More specifically, the SAC alleges that GSK attempted to protect Paxil from generic competition by filing additional patents "concerning chemical properties of the molecule that have nothing to do with its effectiveness."(*Id.*).

The SAC alleges that GSK filed numerous baseless patent infringement lawsuits against competitors who sought to market generic forms of Paxil. (SAC ¶¶ 104-108, 158-161, 202-227). With regard to loss causation, the SAC describes six stock price drops following negative news about Paxil's patent protection.

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After the *Financial Times* reported on Saturday July 13, 2002 that the German company BASF prevailed in court and won the right to produce generic versions of Paxil, GSK shares fell from $38.15 to $36.65 on Monday July 15, 2002. (SAC ¶ 165). When GSK announced on July 23, 2002 that it lost a Paxil patent case in the United States, GSK's stock fell from $34.02 to $32.86, or $1.16 per share. (SAC ¶ 166). On October 24, 2002, GSK's share price dropped from $41.34 to $39.27, or $2.07 per share, on news that GSK had reserved £145 million for legal costs. (SAC ¶ 169). Following a court ruling on March 4, 2003 that competitor Apotex did not infringe GSK's patent on Paxil, GSK's stock price fell from $35.27 to $34.15, or $1.12 per share. (SAC ¶ 173). When Apotex received FDA approval on July 31, 2003 to market a generic version of Paxil, GSK's stock price fell from $39.22 to $37.40, or $1.82 per share. Finally, when GSK announced on February 12, 2004 that Paxil sales were down by 40% because of generic competition, GSK's share price fell from $45.15 to $42.52, or $2.63 per share. (SAC ¶ 179).

4. *The False Claims Act Allegations*

The SAC's False Claims Act Allegations are brief, comprising only three paragraphs, and are focused on lawsuits against GSK for False Claims Act violations. The SAC alleges that GSK was sued for False Claims Act violations several times, starting with an action brought on November 16, 2001, when GSK was trading at $53.96 per share. (SAC ¶ 276). After news of the suit was reported in the *National Law Journal* on December 10, 2001, GSK's share price is alleged to have fallen to $49.40 on December 11, 2001, but the complaint is silent about what the share price was on December 10, 2001. *(Id.)* The SAC states that the lawsuits claimed that GSK was charging the government *(i.e.,* Medicare and Medicaid) higher prices for drugs than it charged private entities. (SAC ¶¶ 276-277). GSK announced settlement of its False Claims Act liabilities for $87,600,922 on April 16, 2003, resulting in a stock price drop from $39.10 on April 14, 2003 to $37.60 on April 16, 2003, or $1.50 per share.

5. *The Insider Trading Allegations*

***5** With respect to all of the above claims, the SAC alleges that Garnier took advantage of material adverse information not known to the public while issuing materially false and misleading statements. (SAC ¶ 279). The SAC alleges that the extent and timing of Garnier's trades establish that he possessed materially adverse information that he failed to disclose. (*Id.*). The only Garnier stock transaction during the Class Period alleged in the SAC is a sale of 142,250 shares of GSK on February 19, 2004, yielding proceeds of $6,143,293.

II. *Applicable Law*

A. *Standard of Review*

On these motions to dismiss the complaint, the Court accepts the factual allegations in the complaint and draws all inferences in favor of Plaintiff. *Karedes v. Ackerly Group,* 423 F.3d 107, 113 (2d Cir.2005). It is well-settled that a case may not be dismissed "unless the court is satisfied that the complaint cannot state any set of facts that would entitle the plaintiff to relief." *Miller v. Wolpoff & Abramson,* 321 F.3d 292, 300 (2d Cir.2002)(citing *Patel v. Contemporary Classics of Beverly Hills,* 259 F.3d 123, 126 (2d Cir.2001). The Court, however, need not give "credence to plaintiff's conclusory allegations" or legal conclusions offered as pleadings. *Cantor Fitzgerald v. Lutnik,* 313 F.3d 704, 709 (2d Cir.2002) (citing *Dawes v. Walker,* 239 F.3d 489, 491 (2d Cir.2001)); *Van Carpals v. S.S. American Harvester,* 297 F.2d 9, 11 n. 1 (1961) (Friendly, J.) ("[I]n federal pleading there is no need to plead legal conclusions; these are for the court to apply."). On a motion to dismiss pursuant to Fed.R.Civ.P. 12(b)(6), the Court may consider materials of which the plaintiff had notice and relied upon in framing his complaint, as well as materials of which judicial notice may be taken. *See Kavowras v. New York Times,* 328 F.3d 50, 57 (2nd Cir.2003); *Cortec Indus. v. Sum Holding,* 949 F.2d 42, 48 (2d Cir.1991).

B. *Section 10(b) Elements and Pleading Requirements*

Section 10(b) of the Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance" in violation of Securities and Exchange Commission ("SEC") rules and regulations. 15 U.S.C. § 78j(b). The SEC implementing rule, Rule 10b-5, 17 C.F.R. § 240.10b-5 (2004), pro-

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hibits the making of untrue material statements of fact or the misleading omission of material facts in connection with the purchase or sale of securities. Courts have implied a private right of action from section 10(b) and Rule 10b-5, with the following basic elements: 1) a material misrepresentation or omission; 2) scienter or "wrongful state of mind;" 3) a connection with the purchase or sale of a security; 4) reliance; 5) economic loss; and 6) loss causation. *See* *Dura Pharmaceuticals v. Broudo,* 544 U.S. 336, 341-42 (2005). In other words, to state a claim for securities fraud, "a plaintiff must plead that 'in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff's] injury.' " *In Re Time Warner Inc. Securities Litigation,* 9 F.3d 259, 264 (2d Cir.1993) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass,* 754 F.2d 57, 61 (2d Cir.1985).

***6** "A complaint asserting securities fraud must also satisfy the heightened pleading requirement of Federal Rule of Civil Procedure 9(b), which requires fraud to be alleged with particularity." *Kalnit v. Eichler,* 264 F.3d 131, 138 (2d Cir.2001) (citing *Ganino v. Citizens Utilities Co.,* 228 F.3d 154, 168 (2d Cir.2000). The Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub.L. No. 104-67, 109 Stat. 737, heightened the requirements for pleading securities fraud. *Id.* It also protected forward-looking statements in a company's SEC filings and press releases from giving rise to a securities fraud claim as long as the statements are identified as forward-looking and are accompanied by sufficient cautionary language. *See*15 U.S.C. § 78u-5(c)(1)(A)(i). Similarly, under the "bespeaks caution" doctrine, "[c]ertain alleged misrepresentations ... are immaterial as a matter of law because it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language." *In re Bausch & Lomb, Inc. Sec. Litig.,* No. 01-CV-6190-CJS, 2003 WL 23101782, at *2 (W.D.N.Y. Mar. 28, 2003) (quoting *Halperin,* 295 F.3d at 357);*see also* *Mercury Air Group, Inc. v. Jet USA Airlines, Inc.,* No. 97 Civ. 3473, 1998 WL 542291, at *4-*5 (S.D.N.Y. Aug. 26, 1998), *aff' d,* 189 F.3d 461 (2d Cir.1999).

The PSLRA also specifies the standard for pleading scienter:

> In any private action arising under this chapter 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 chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2); *Kalnit,* 264 F.3d at 138. To meet the PSLRA requirement for alleging scienter, a securities fraud complaint must set forth allegations "giv[ing] rise to a strong inference of fraudulent intent."*Id.* (quoting *Novak v. Kasaks,* 216 F.3d 300, 307 (2d Cir.2000)).“A plaintiff can establish this intent either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Id.* at 138-39 (citations and internal quotation marks omitted).

Where a plaintiff alleges securities fraud against a public company and its officers and directors, it is motive rather than opportunity that is at issue. *See, e.g.,* *Kalnit,* 264 F.3d at 139; *In Re Time Warner,* 9 F.3d at 269.*Kalnit* explained that in order to allege motive to commit fraud, a section 10(b) complaint must set forth something more than a generalized "assertion that the officers were motivated to inflate the value of stock to increase their executive compensation." *Kalnit,* 264 F .3d at 139. In other words, a plaintiff who alleges that directors or officers misled the public in order to profit from an inflated stock price must point to a "specific benefit that would inure to the defendants that would not be either generalized to all corporate directors or beneficial to all shareholders[.]" *Id.* at 142.Concrete, personal benefits giving rise to a strong inference of fraudulent intent must be alleged. *Id.* at 139.Allegations of stock sales by insiders are insufficient to establish scienter in the absence of factual allegations demonstrating that such sales were unusual in timing or amount. *See, e.g.,* *Rothman v. Gregor,* 220 F.3d 81, 94-95 (2d Cir.2000); *In re Glenayre Techs., Inc. Sec. Litig.,* No. 96 Civ. 8252, 1998 WL 915907, at *4 (S.D.N.Y. Dec. 30, 1998) ("Insider stock sales are [only] unusual where the 'trading was in amounts dramatically out of line with prior trading practices [and] at times

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calculated to maximize personal benefit from undisclosed inside information.'") (citation omitted), *aff'd sub nom.* *Kwalbrun v. Glanayre Techs., Inc.,* 201 F.3d 431 (2d Cir.1999); *In re Health Mgmt. Sys. Inc. Sec. Litig.,* No. 97 Civ. 1865, 1998 WL 283286, at *6 n. 3 (S.D.N.Y. June 1, 1998); see also *Ressler v. Liz Claiborne, Inc.,* 75 F.Supp.2d 43, 60 (E.D.N.Y.1999).

***7** " 'Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater.' " *Id.* at 142 (quoting *Beck v. Mfrs. Hanover Trust* Co., 820 F.2d 46, 50 (2d Cir.1987). A plaintiff who pleads conscious misbehavior or recklessness must allege that defendant engaged in " 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care[.]' " *Id.*(quoting *Honeyman v. Hoyt (In Re Carter Wallace, Inc., Secs. Litig.),* 220 F.3d 36, 39 (2d Cir.2000).

In *Dura, supra,* the Supreme Court clarified the requirements for pleading economic loss and loss causation under the Exchange Act. Noting that the implied cause of action available under section 10(b) resembles a common law tort cause of action for deceit *(i.e.,* fraudulent misrepresentation), *Dura,* 544 U.S. at 343-344, the Court held that a plaintiff who brings an action under section 10(b) must "allege and prove the traditional elements of causation and loss," *id.* at 346.Put simply, a plaintiff must allege that he suffered a loss, *id.* at 344, and that "the defendant's misrepresentation proximately caused the plaintiff's economic loss," *id.* at 346.

In *Dura,* the complaint lacked this element because it alleged merely that the defendant had made misrepresentations and that the plaintiff had purchased stock at an artificially high price. *See id.* at 339-40."The complaint [ ] fail[ed] to claim that Dura's share price fell significantly after the truth became known[.]"*Id.* at 347.The loss causation inquiry, therefore, must focus on a link between dissemination of information about the alleged misrepresentations and significant drops in share price. Needless to say, the inquiry must also include whether the complaint alleges that Plaintiff suffered a loss.

C. *Statute of Limitations*

Section 804(1) of the Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley"), codified in part at 28 U.S.C. § 1658(b), extended the statute of limitations period applicable to section 10(b) and Rule 10b-5 to the earlier of "(1) two years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."The two-year limitations period, or the "inquiry notice" period, applies when " 'circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded[.]' " *LC Capital Partners v. Frontier Ins. Group,* 318 F.3d 148, 154 (2d Cir.2003) (quoting *Dodds v. Cigna Securities, Inc.,* 12 F.3d 346, 350 (2d Cir.1993).

The circumstances giving rise to inquiry notice in the securities litigation context are frequently compared to "storm warnings." *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 168 (2d Cir.2005)."Where ... the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of a fraud can be gleaned from the complaint ..., resolution of the issue on a motion to dismiss is appropriate." *LC Capital,* 318 F.3d at 156.

III. *Discussion*

A. *Statute of Limitations*

***8** The parties agree that, under Sarbanes-Oxley, the statute of limitations for an Exchange Act claim is the shorter of five years from the occurrence or two years from the time plaintiff had actual or inquiry notice of the claim. *See*28 U.S.C. § 1658(b). They also agree that the two-year period begins to run as soon as " 'circumstances would suggest to an investor of ordinary intelligence the probability that she had been defrauded.' " *LC Capital,* 335 F.3d at 193 (quoting *Dodds,* 12 F.3d at 350).

The first action in this litigation was filed on April 12, 2005. Assuming for these purposes that the Paxil Discontinuation Allegations, the Patent Allegations, and the False Claims Act Allegations state a claim under section 10(b), plaintiff was on notice of the facts underlying those claims more than two years earlier, thus any claim arising from those allegations is barred by the statute of limitations.

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The Paxil Discontinuation Allegations assert that, from the early 1990s until August 2001, GSK withheld from physicians and the market information about alleged difficulties experienced by patients taking Paxil who attempted to discontinue use of the drug. (SAC ¶¶ 238, 264). The SAC further alleges that in December 2001, GSK, in consultation with the FDA, changed the labeling of Paxil to include a warning about such effects and the FDA approved the new label. (SAC ¶ 265). Moreover, the SAC alleges that disclosure of the discontinuation effects caused the price of GSK ADRs to drop by $1.04 on September 6, 2001, following the news of the consumer class action lawsuits. (SAC ¶ 264). Thus, even according to the SAC, plaintiff was on notice of any claim based on the Paxil Discontinuation Allegations well more than two years before this lawsuit was commenced. To the extent that plaintiff argues that the consumer actions did not constitute storm warnings because they were not brought by shareholders, (Pl. Mem. at 23), it is a distinction without a difference. The alleged fraudulent conduct-failing to disclose the withdrawal effects of Paxil-is the same.

The allegations of the SAC also show that any claim based on the Patent Allegations is time-barred. The Patent Allegations allege that GSK brought patent litigations seeking to prevent generic drug manufacturers from manufacturing and selling generic versions of Paxil and Augmentin beginning in 1998. (SAC ¶¶ 104, 161). The SAC alleges that in February 2002, at least one court had invalidated certain of GSK's patents covering Augmentin and that information was publicly disclosed no later than March 13, 2002. (SAC ¶¶ 133-134, 137-138). Similarly, on July 23, 2002, GSK announced that it had lost one patent case involving Paxil and on December 30, 2002, GSK publicly disclosed that a different court granted summary judgment in favor of GSK on one patent claim, granted summary judgment against GSK on a different patent, and declined to grant summary judgment to either party on two additional patents. (SAC ¶¶ 110, 166). All of those developments were disclosed, at the latest, in GSK's Form 20-F for the year ending December 31, 2002, which was filed with the SEC on March 28, 2003. (2002 Form 20-F at 103-107).

***9** In July 2002, the FTC issued a report critical of GSK's conduct in pursuing patent listings. (SAC ¶ 231). The SAC also alleges that GSK was sued in private antitrust actions arising out of its patent enforcement activities-litigations that were disclosed, at the latest, in GSK's Form 20-F for the year ending December 31, 2002. (SAC ¶ 99; 2002 Form 20-F at 106). The SAC alleges that GSK stock price dropped on at least five different occasions between April 1, 2002 and March 4, 2003 in response to developments in the patent litigation. Indeed, the SAC quotes a March 5, 2003 article published in *The Times (London)* that "the bad news [concerning the loss of patent protection for Paxil] is fully in the price."Here again, there can be no dispute that plaintiff was on notice of any claim arising from the Patent Allegations more than two years before this action was filed. *See, e.g., Menowitz v. Brown,* 991 F.2d 36, 42 (2d Cir.1993). In any event, because, as noted below, the underlying facts about the patent litigations were all publicly available, there is no doubt that plaintiff was on inquiry notice long before April of 2003, and inquiry would have disclosed all of the facts he relies on now.

To the extent that plaintiff argues, based on *LC Capital,* that Garnier's "reassuring words" that GSK would prevail on its patent litigation somehow toll the statute of limitations, that case is of no assistance. There, the corporate officer announced that the recurring problem of under-reserving "is now behind us" and that the company had "paid the bill" on those items. *LC Capital,* 318 F.3d at 155. The court noted that the problem of under-reserving was a serious one for the company, an insurance company, and that it had recurred. But, because the " 'reassuring' statements by management were mere expressions of hope, devoid of any specific steps taken to avoid under-reserving in the future," the court found that "the claimed reassurances are unavailing." *Id.* at 156.

The logic of *LC Capital* applies with even greater force here. Garnier's statements ("We are very confident we can defend our patents[,]" and "The PTO confirmed that those patent[s] were genuine, they were rock solid. And we feel that the courts eventually will recognize the letter of the law and give us the added protection for Augmentin."(SAC ¶ 134)), can be viewed by a reasonable investor only as mere expressions of hope. The company had no ability to assure the result of the patent litigations, whereas at least in *LC Capital* the company had some ability to avoid under-reserving. Also the words used, "we are

very confident" and "we feel," can only be understood as aspirational, and thus no reasonable investor would understand them to be factual guarantees of patent protection. Accordingly, these supposed "reassuring" words are insufficient to toll the statute of limitations.

Finally, the SAC alleges that GSK "has also violated the Federal False Claims Act numerous times," that it was sued as a result of those violations on November 16, 2001, and that public disclosure of a False Claims Act lawsuit caused a drop in share price on December 11, 2001. (SAC ¶ 276). Because plaintiff had notice of GSK's alleged violations of the False Claims Act more than two years before bringing this action, any claim arising from those allegations is time-barred.[FN2] Accordingly, based on the allegations of the SAC and publicly-filed documents, claims based on the Paxil Discontinuance Allegations, the Patent Allegations and the False Claims Act Allegations are time-barred.

> FN2. The SAC also alleges that GSK agreed to pay $150 million to settle False Claims Act claims involving two additional drugs on September 20, 2005. That allegation cannot give rise to a claim because it occurred more than a year *after* the end of the alleged Class Period.

B. *Material Misrepresentation or Omission*

***10** The crux of the Paxil Pediatric Allegations is that GSK, through employees and sponsored researchers, disseminated information to the medical community about the most promising of its studies on Paxil's effects on children, while suppressing information about several negative studies. Assuming without deciding that 1) Plaintiff's allegations that GSK "sponsored" the doctors' research, (see SAC ¶¶ 34, 47), are sufficient to attribute the doctors' statements to GSK, *see, e.g., Wright v. Ernst & Young LLP,* 152 F.3d 169, 174-75 (2d Cir.1998); *SEC v. Pimco Advisors Fund Mgmt. LLC,* 341 F.Supp.2d 454, 466 (S.D.N.Y.2004) ("[A] defendant must actually make a false or misleading statement in order to be held liable under Sections 10(b).") (quoting *Wright,* 152 F.3d at 175), and 2) articles in medical journals and presentations at medical conferences are statements made in connection with the purchase or sale of securities, *see In re Carter Wallace, Inc. Sec. Litig.,* 150 F.3d 153, 156 (2d Cir.1998) (holding that allegedly misleading advertisements in medical journals could satisfy the "in connection with" requirement where plaintiffs alleged those advertisements were intended to impact stock price, but affirming dismissal of securities fraud claim because alleged misrepresentations were not material), the Paxil Allegations still fail because they are not material.

In order to be material, a pharmaceutical company's failure to disclose information about a drug must be of sufficient magnitude that the commercial viability of the drug would be called into question if the truth were disclosed. *In Re Carter Wallace,* 150 F.3d at 158. The SAC concedes that Paxil was a drug approved for adults, that prescriptions for children were an "off-label" use representing a small fraction of total sales, and that generic competitors were fighting to get a piece of Paxil's market share even after news about Paxil's effects on children came to light. The potential loss of a nominal amount of off-label sales certainly did not threaten the commercial viability of the drug, and thus the failure to disclose that potential loss cannot be said to be material. Because on the face of the SAC the alleged misrepresentations and omissions regarding Paxil's use in children are not material, the Paxil Pediatric Allegations fail to state a claim.

The Paxil Withdrawal Allegations similarly fail to allege a material misrepresentation or omission. The only decline in share price alleged to flow from revelations about Paxil withdrawal symptoms was a drop from $45.14 to $44.10 on September 6, 2001 following the announcement of a class action lawsuit. As with the Paxil Pediatric Allegations, the SAC fails to allege that withdrawal symptoms threatened the commercial viability of Paxil, and therefore the alleged misrepresentations and omissions cannot be found to be material. Thus, the Paxil Withdrawal Allegations fail to state a claim.

Although the loss of patent protection would appear to meet the materiality element, the Patent Allegations fail to allege a misrepresentation or omission. As noted above, the Patent Allegations concern statements made by GSK about the legal positions the company was taking with respect to patent protection for Paxil and Augmentin and Garnier's "confiden[ce]" in the outcome. As to the former, there is simply nothing in the SAC that alleges that GSK mis-

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represented the legal positions it was taking or that GSK misrepresented developments in its patent cases as they occurred. To hold that a legal position taken by a publicly traded company, or an expression of confidence in a legal position, may be converted by hindsight into an actionable misrepresentation if the company later loses the lawsuit would have a chilling effect on publicly traded companies seeking to defend their interests in litigation. In any event, Garnier's and GSK's optimism that GSK would prevail in the litigation is a classic example of a forward-looking statement and is clearly protected as such. *See* *In re Bausch & Lomb, Inc. Sec. Litig.,* No. 01-CV-6190-CJS, 2003 WL 23101782, at *2 (W.D.N.Y. Mar. 28, 2003) (quoting *Halperin v. eBanker USA.com, Inc.,* 295 F.3d 352, 357 (2d Cir.2002)); *see also* *Mercury Air Group, Inc. v. Jet USA Airlines, Inc.,* No. 97 Civ. 3473, 1998 WL 542291, at *4-*5 (S.D.N.Y. Aug. 26, 1998), *aff'd,* 189 F.3d 461 (2d Cir.1999)).

***11** In any event, GSK's regulatory filings fully disclosed to investors like plaintiff all of the Company's material information about the patent litigations. For example, GSK's Form 20-F for the year ended December 31, 2002 fully disclosed, among other litigation, the patent litigation involving Paxil and Augmentin. For example, the "Joint Statement by the Chairman and Chief Executive Officer" of GSK at the very beginning of the Form 20-F explained that:

> In July [2002], in the USA, the first generic version of *Augmentin* was launched. This followed a ruling by a federal judge that our *Augmentin* patents were invalid. We are appealing against the decision, in the firm belief that our patents are valid.
>
> ...
>
> *Seroxat/Paxil* continues to be subject to threat of generic competition, particularly in the USA.
>
> A federal judge in Chicago recently ruled that GlaxosmithKline's patent in the USA covering the hemihydrate form of *Paxil* was valid but not infringed by generics company Apotex's product. We believe our patent to be infringed by Apotex's product and will appeal against the ruling. Also, we will continue to pursue litigation for infringement of other patents relating to *Paxil* against Apotex and other generics companies in the USA.
>
> As a result of these pending matters, the possible timing of generic competition to *Paxil* in the USA is unclear.

(2002 Form 20-F at 4). The "Legal Proceedings" section of the Form 20-F provided additional details of the patent litigations:

> In the USA a number of distributors of generic drugs have filed applications with the FDA to market generic versions of *Paxil/Seroxat* (paroxetine hydrochloride) prior to the expiration in 2006 of the Group's patent on paroxetine hydrochloride hemihydrate. The distributors are looking to bring to market anhydrate or other versions of paroxetine hydrochloride and in one case paroxetine mesylate. The cases are complex but the Group believes that the generic anhydrate and other versions infringe because they contain and/or convert to the hemihydrate form and/or infringe other Group patents. In response the Group has filed actions against all those distributors for infringement of various of the Group's patents.

(2002 Form 20-F at 103). The Form 20-F continued by identifying each of those patent litigations and describing the significant developments in each case-including that GSK had lost one case after trial because the judge had concluded that the generic company's product did not infringe the GSK patent, and that GSK was appealing that ruling. (2002 Form 20-F at 103). In the face of these disclosures in GSK's SEC filings, no reasonable investor can claim to have been deceived into believing that Paxil and Augmentin would remain free of generic competition until 2006 or beyond. *See* *In re Bausch & Lomb,* 2003 WL 23101782, at *2; *Halperin,* 295 F.3d at 357.

The False Claims Act Allegations fail to state a claim upon which relief may be granted because the SAC fails to allege a misrepresentation made by Defendants. The SAC alleges that GSK overcharged Medicare and Medicaid for certain drugs, resulting in lawsuits against GSK under the False Claims Act. (SAC ¶¶ 276-278).

***12** The only alleged misleading statement cited is GSK's April 16, 2003 announcement that it had settled its False Claims Act liabilities by paying $87,600,922 for overcharges on Paxil and Flonase. Plaintiff alleges that this statement was misleading

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because the settlement did not represent *all* of GSK's liabilities under the False Claims Act, referring to a September 20, 2005 report that GSK would pay $150 million to settle False Claims Act liabilities for overcharging the Government for two other drugs, Zofran and Kytril. The SAC, however, alleges no connection between these two settlements, two and a half years apart, involving different drugs. In any event, in light of GSK's annual revenue of £1.55 billion in 2000 on Paxil sales alone, (SAC ¶ 31), these settlement amounts are unlikely to be material.

C. *Scienter*

The SAC fails to plead scienter with the requisite particularity prescribed by the PSLRA. The SAC recites dozens of statements, identifies the speakers and states the approximate dates and locations where those statements were made but fails to explain why the alleged misstatements were fraudulent, how any of the statements affected the price of GSK stock or how any plaintiff was damaged by any statement.

With respect to the Paxil Pediatric Allegations, for example, the SAC lists numerous presentations made at medical conferences by independent doctors and researchers over an approximately five-year period concerning the doctors' views as to the potential benefits of using Paxil to treat children and adolescents and alleges that GSK "sponsored" or "knew of" those presentations. Critically, however, the SAC does not allege that the doctors presented information knowing it was false, that the doctors did not in fact believe in the benefits of Paxil or how any of the doctors would have the motive to misrepresent the benefits of Paxil to the medical community. Accordingly, the Paxil Pediatric Allegations are insufficient.

The same result obtains as to the claim based on Garnier's trading. Although Garnier, like all CEOs, had the opportunity to commit fraud, the SAC fails to allege motive adequately. Plaintiff relies on the allegation that Garnier took advantage of information withheld from the public in order to sell shares of GSK at an artificially high price. As noted above, however, allegations of stock sales by insiders are insufficient absent allegations demonstrating that such sales were unusual in timing or amount. *See, e.g., Rothman,* 220 F.3d at 94-95.

During the Class Period, Garnier is alleged to a have executed a single sale of 142,250 shares on February 19, 2004. Of the thirteen share price declines alleged in the SAC, eleven occurred between September 6, 2001 and February 13, 2004, *i.e.,* prior to the February 19, 2004 stock sale. *(See* SAC ¶¶ 138-140, 165-166, 169, 173, 177, 179, 264, 276-277). Two drops in share price are alleged to have occurred after February 19, 2004, on June 2, 2004 and December 10, 2004, respectively, *(see* SAC ¶¶ 48, 51), but the net effect of these two alleged declines in share price turns out, upon closer examination, to be an increase in share price. According to the SAC, as negative news hit the market about the Paxil's effects on children, GSK stock fell from $42.77 to $41.39 on June 2, 2004, then again from $45.08 to $44.82 on December 10, 2004. If anything is to be drawn from the facts alleged in the SAC, it is that Garnier held GSK stock through eleven price declines that resulted from negative news reaching the market, then sold a large number of GSK shares prior to a period of time in which the stock rose from $42.77 to $44.82 in the face of some additional negative information. Under these circumstances, the SAC fails to allege motive.

***13** In any event, the public record discloses that Garnier's February 2004 sale was in connection with his exercise of stock options granted in 1994 that would expire unless exercised by November 22, 2004. Garnier sold only the number of ADRs necessary to pay the option price and applicable taxes and retained the remaining ADRs. Consequently, Garnier's net holdings of GSK *increased* by 88,802 ADRs as a result of the transaction, he continued to own 204,430 ADRs (worth in excess of $8 million) as of December 31, 2004 and had options to purchase an additional 3.8 million ADRs. *See* Form 6-K dated February 20, 2004; Form 20-F for the year ended December 31, 2004 at 53-54. In these circumstances, Garnier's stock sale cannot be said to have been unusual or suspicious.

In order to allege scienter under the alternative theory of conscious misbehavior or recklessness, the complaint must present strong circumstantial evidence. *Kalnit,* 264 F.3d at 142. " 'Where motive is not apparent, ... the strength of the circumstantial allegations [of conscious misbehavior or recklessness] must be correspondingly greater.' " *Id.* (quoting *Beck v. Mfrs. Hanover Trust Co.,* 820 F.2d 46, 50 (2d Cir.1987)). As noted above, *see supra* Part IV.A, Plaintiff has failed even to allege a material misrepre-

sentation with respect to any of his allegations. Plaintiff falls far short of alleging " 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care[.]" *Id.*(quoting *Honeyman v. Hoyt (In Re Carter Wallace, Inc. Sec. Litig.),* 220 F .3d 36, 39 (2d Cir.2000).

In sum, all of Plaintiff's claims fail to allege the scienter element of securities fraud because Plaintiff has not alleged facts that satisfy either the motive or conscious misbehavior/recklessness prong of scienter.

D. *Economic Loss and Loss Causation*

Even accepting plaintiff's factual allegations as true and drawing all reasonable inferences in favor of Plaintiff, *Karedes,* 423 F.3d at 113, Plaintiff has not alleged loss causation with respect to the Paxil Pediatric Allegations, the Paxil Withdrawal Allegations, or the False Claims Act Allegations. One of Plaintiff's class representative certifications, executed under penalty of perjury, states that Plaintiff acquired 1400 GSK shares on September 28, 2001 for $56.28 per share and sold the same number of shares on June 13, 2002 for $39.43 per share. Although Plaintiff suffered an overall loss on the sale of these shares, the SAC fails to allege that a misrepresentation by Defendants, when revealed to the public, was the proximate cause of any loss suffered by Plaintiff. *Dura Pharmaceuticals,* 544 U.S. at 346-347. A second certification states that Plaintiff purchased 350 shares of GSK on February 17, 2004 at $42.96 and still held those shares as of the date of the certification, May 10, 2005. With respect to these shares, too, Plaintiff fails to allege any particular loss after February 17, 2004 proximately caused by public revelation of Defendants' alleged misrepresentations.

***14** The SAC alleges two GSK share price declines in connection with the Paxil Pediatric Allegations. The first occurred on June 2, 2004, when the New York State Attorney General announced a lawsuit concerning suppression of the Paxil pediatric studies. On that date, GSK shares fell from $42.77 to $41.39. The only other alleged decline occurred on December 9, 2004, when GSK stock price dropped from $45.08 to $44.82 in reaction to a news program highlighting Paxil's effects on children. Plaintiff's certifications show that he held the stock at the time of both alleged price declines, but the SAC fails to allege that Plaintiff suffered a loss. The share price prior to the initial negative market reaction was $42.77, and the share price after the second negative market reaction was $44.82, or $2.05 higher. The SAC, therefore, fails to allege that Plaintiff suffered a loss proximately caused by the truth about Paxil's effects on children reaching the public. In fact, the Paxil Pediatric Allegations fail to allege a loss at all, given that Plaintiff purchased his shares for $42.96 on February 17, 2004 and still held those shares at $44.82, or $1.86 higher, on the date of the second alleged price decline.

The only alleged price decline linked to the Paxil Withdrawal Allegations occurred on September 6, 2001, when news of a class action lawsuit caused GSK shares to fall from $45.14 to $44.10. Here, too, Plaintiff has failed to allege a loss for the simple reason that he did not own GSK stock at the time of the only alleged price drop. Plaintiff made his initial purchase of GSK stock on September 28, 2001, three weeks *after* the alleged fall in share price. Accepting as true the facts put forward by Plaintiff, the only reasonable inference is that Plaintiff, if anything, benefited from a drop in share price due to disclosures made prior to his purchase of stock, not that he suffered a loss as a result of misrepresentations that came to light.

Plaintiff has also failed to plead loss causation with respect to the False Claims Act allegations. Here, news of a class action lawsuit is alleged to have caused a decline in stock price from $53.96 to $49.40 between November 16, 2001 and December 11, 2001. This decline could not possibly have been caused by the only alleged misleading statement made by GSK with respect to the False Claims Act litigation. The alleged misleading statement regarding settlement of GSK's False Claims Act liabilities was made on April 16, 2003, a full 16 months *after* the alleged stock price decline. Plaintiff did not own GSK stock in April 2003 and cannot allege a loss based on a share price decline in that month.

For all of the above reasons, GSK has failed to allege loss causation with respect to the Paxil Pediatric, Paxil Withdrawal, and False Claims Act Allegations.

IV. *Control Person Liability*

Plaintiff has failed to state a primary violation of the securities laws under section 10(b). Without a primary violation, there can be no secondary, or deriva-

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tive, violation under Section 20(a).*See* *Shields v. Citytrust Bancorp, Inc.,* 25 F.3d 1124, 1132 (2d Cir.1994); *Brown v. Hutton Group,* 795 F.Supp. 1317, 1324 (S.D.N.Y.1992). Accordingly, Plaintiff's Section 20(a) claim is also dismissed.

V. *Dismissal with Prejudice*

***15** Prior to the filing of the motion to dismiss, Plaintiff was given the opportunity to correct deficiencies pointed out by Defendants, with the understanding that no further amendments would be permitted. Plaintiff availed himself of this opportunity prior to serving the Consolidated Second Amended Complaint. In addition, the grounds for dismissal set forth above demonstrate that further amendment would be futile. Accordingly, the dismissal is with prejudice.

Conclusion

For the reasons stated herein, Defendants motion to dismiss the complaint (dkt. no. 13) is granted, and the Consolidated Second Amended Complaint is dismissed with prejudice.

The Clerk of the Court is directed to mark this action closed and all pending motions denied as moot.

SO ORDERED.

S.D.N.Y.,2006.
In re GlaxoSmithkline PLC
Not Reported in F.Supp.2d, 2006 WL 2871968 (S.D.N.Y.), Fed. Sec. L. Rep. P 94,104

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TAB 19

Only the Westlaw citation is currently available.

United States District Court, W.D. Pennsylvania.

Albert L. GLOVER, individually and on behalf of all others similarly situated, Plaintiffs,

v.

Anthony J. DELUCA, Harry J. Soose, Francis J. Harvey, James C. McGill, Richard W. Pogue, Daniel A. D'Aniello, Philip B. Dolan, E. Martin Gibson, Robert F. Pugliese, James David Watkins, and the Carlyle Group, Defendants

No. 2:03-CV-0288.

Sept. 29, 2006.

Lionel Z. Glancy, Michael Goldberg, Robert Zabb, Glancy & Binkow, Los Angeles, CA, E. Powell Miller, Marc L. Newman, Miller Shea, Rochester, MI, for Plaintiffs.

Mark A. Willard, Eckert, Seamans, Cherin & Mellott, Charles A. Demonaco, Kimberly L. Haddox, Richard J. Federowicz, Dickie, McCamey & Chilcote, Pittsburgh, PA, Thomas L. Patten, Courtney S. Schorr, David A. Becker, Laurie B. Smilan, Latham & Watkins, Washington, DC, for Defendants.

OPINION

HARDIMAN, J.

***1** This securities class action arises out of the collapse of a Pittsburgh company known as the IT Group, Inc. (ITG or Company). This Court recently entered an opinion in a companion case, *Payne v. DeLuca,* CA 02-1927, dismissing with prejudice the Second Amended Complaint (SAC.) In almost every regard, the *Payne* and *Glover* cases are identical, the only major differences being the class periods and some allegations regarding misrepresentations and scienter. Because this Opinion assumes familiarity with the opinion entered in *Payne,* 433 F.Supp.2d at 547 (W.D.Pa.2006), the Court will focus on the substantive differences between the two cases, although many of the operative facts are the same.

I. INTRODUCTION

A. *Factual History*[FN1]

> FN1. Unless otherwise noted, the facts in this section are taken from Plaintiff's Amended Class Action Complaint. For additional detail, *see Payne,* 433 F.Supp.2d at 553-555.

IT Group was a Delaware corporation headquartered in Monroeville, Pennsylvania, whose primary business was providing environmental remediation services to commercial customers and federal government agencies. Beginning in November 1996, Defendant The Carlyle Group (Carlyle), a private merchant bank located in Washington, D.C., invested some $45 million in ITG, acquiring more than 46,000 shares of convertible preferred stock and 1.2 million shares of common stock, giving it approximately 25% of the voting power of the Company.

By virtue of its position as principal holder of the convertible preferred stock, Carlyle had the right to elect one fewer than the majority of directors. Carlyle was thereby able to install one of its managing directors, Daniel D'Aniello, as Company Chairman, and named four other members of the ITG Board of Directors: Philip Dolan, Martin Gibson, Robert F. Pugliese, and James David Watkins. Francis J. Harvey, who was named to the Board in May 1999, had no formal affiliation with Carlyle, but served on two other boards of Carlyle-controlled companies and on the ITG Board "at Carlyle's behest." Other directors were James C. McGill and Richard W. Pogue. Anthony J. DeLuca served as President and Chief Executive Officer (CEO); Harry J. Soose was Senior Vice President and Chief Financial Officer.[FN2]

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FN2. Collectively, Messrs. DeLuca, Soose, Harvey, McGill, Pogue, D'Aniello, Dolan, Gibson, Pugliese and Watkins will be referred to as the "Individual Defendants." Further details about each Defendant's position and history with ITG are provided in *Payne,* 433 F.Supp.2d at 563-564.

Soon after Carlyle took control of the Company, ITG embarked on an aggressive plan of growth and diversification through acquisition. Between 1997 and May 2000, ITG acquired eleven domestic and international companies which it financed by taking on some $645 million in new debt; this included issuing $225 million of ten-year senior subordinated notes in 1999. One of the most significant acquisitions was that of OHM Corporation in 1998.

The acquisitions and diversification increased ITG revenues from $400 million in 1996 to approximately $1.4 billion in 2000. By the Spring of 2000, however, the Board of Directors realized that the Company's strategy had failed for a number of reasons, including: insufficient revenue to offset the debt incurred as a result of the acquisitions; difficulty managing the diversity of the acquired companies; loss of key personnel; failure of acquired entities to perform as well as expected; failure to realize the expected cost-savings from consolidation, in part because of poor management; and the general economic slowdown of the late 1990s.[FN3]

FN3. The Amended Complaint provides several additional reasons for the failure of ITG. Those allegations are derived from other complaints pending against the Company and against the Individual Defendants, Including: that Cartyle "embarked on an acquisition and debt binge, buying companies for amounts far in excess of their fair value;" and that an unidentified "they" made transfers "for the benefit of insiders, artificially extending the life of the insolvent company to obtain a return on the Carlyle Defendants' equity investment."(AC, ¶¶ 99-100). Since such allegations are not factually supported elsewhere in the AC, they have not been considered in the Court's analysis.

***2** The Board of Directors re-focused its attention on debt reduction, recognizing that the Company was having increased difficulty meeting the financial covenants of its bank loans. Even though ITG had announced that it intended to pay down its outstanding debt by $100 million in 2000, on March 8, 2000, ITG obtained an additional $100 million, seven-year term loan (the Term C Loan) in an attempt to resolve its liquidity problems. Although described as a means to support seasonal working capital requirements, Plaintiff alleges that the Term C Loan was merely a temporary solution to the Company's massive liquidity problems which Defendants concealed from investors.

Despite the burgeoning liquidity crisis, ITG maintained a public relations campaign designed to reassure the investing public about the Company's stability and bright future. At the same time, a number of allegedly deceptive accounting and managerial practices (discussed in more detail *infra*) were implemented at the direction of Defendants DeLuca and Soose. By September 2001, the Company's line of credit was almost depleted and it was having difficulty meeting its loan covenants. As a result, it was forced to renegotiate the terms of its loans.

On November 13, 2001, Defendant DeLuca announced his resignation as President and CEO; he was replaced by Defendant Harvey. According to Plaintiff, Harvey had actually become DeLuca's *de facto* superior at the May 2001 Board of Directors meeting when he was named Vice Chairman of ITG. Plaintiff claims that Carlyle required DeLuca's ouster "due to the [Company's] severe financial situation."(AC, ¶¶ 92, 108).

By December 7, 2001, even the questionable accounting practices instituted by DeLuca and Soose were not sufficient to keep ITG afloat and it was forced to admit to its lenders that without an emergency loan of $35 million, it would be bankrupt

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within the month. The lenders refused to loan more money and Carlyle refused to invest additional funds. Although ITG immediately retained workout and restructuring specialists, the Company acknowledged at a second meeting with the banks on December 18, 2001, that its liquidity and leverage problems prevented it from obtaining new contracts with its largest customer, the federal government. On December 27, 2001, the Company publicly announced to investors that a bankruptcy filing could be expected. On January 16, 2002, just three weeks later, ITG filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code.

B. *Procedural History*

Howard G. Clair, Ralph S. Weaver, and Carol S. Pintek (the Clair Plaintiffs) filed suit on February 27, 2003, alleging that (1) Defendants breached their fiduciary duty to investors by making false and misleading statements; [FN4] (2) the Individual Defendants violated Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. §§ 78j(b) and 78(n) and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder by preparing and issuing public statements containing misrepresentations and omissions which induced the Clair Plaintiffs and members of the Class to purchase IT common stock at artificially inflated prices, and (3) Defendants caused the Company to engage in the illegal conduct and practices described above inasmuch as they were "controlling persons" of IT Group as that term is defined in Section 20(a) of the Act, 15 U.S.C. § 78t(a). The Clair Plaintiffs brought suit on "behalf of all other persons or entities who purchased or acquired [ITG] common stock during the Class Period and were damaged thereby."[FN5](Complaint, ¶ 50.) The Class Period was defined as October 21, 1998, through February 23, 2000. In light of the Third Circuit's decision in *Lieberman v. Cambridge Partners, LLC,* 432 F.3d 482, 492 (3d Cir.2005), discussed in the margin,[FN6] the Class Period is now defined as July 30, 1999, through February 23, 2000.

FN4. This claim was deleted from the Amended Complaint.

FN5. This definition was modified in the Amended Complaint to include all "public investors who purchased IT Group securities, including the $225,000,000 debt offering of October 1999," during the Class Period.

FN6. Defendants argue that following the Third Circuit's decision in *Lieberman,* the Class Period herein may not begin prior to July 30, 1999. Plaintiff apparently concedes this point, both by failing to offer any argument in his brief in opposition to the motion to dismiss and by a footnote in the Amended Complaint itself, recognizing that the Class Period may be limited by *Lieberman.*(AC at 1, n1.)

> The Supreme Court held in 1991 that the period in which a plaintiff could bring a securities fraud action under Section 10(b) was one year "after the discovery of the facts constituting the violation and within three years after such violation." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 501 U.S. 350, 364, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991). While the plaintiff was entitled to the longer period in cases of fraudulent concealment, the Court held that "[b]ecause the purpose of the 3-year limitation is clearly to serve as a cutoff, we hold that tolling principles do not apply to that period." *Id.,* 501 U.S. at 363. On July 30, 2002, Congress enacted the Public Company Accounting and Investor Protection Act of 2002, otherwise known as the Sarbanes-Oxley Act, PL Pub.L. No. 107-204, 116 Stat. 745 (2002). Section 804 of the Act, codified at 28 U.S.C. § 1658(b), extended the time for bringing a private securities fraud action from the periods set out in

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Lampf to two and five-years, respectively. When the Clair Plaintiffs filed suit in February 2003, there was no consensus among the circuit courts as to the effect the extended periods might have on claims which otherwise would have been extinguished under *Lampf.*

On December 27, 2005, the Third Circuit Court of Appeals concluded-as had the other three circuit courts of appeals and lower courts in this Circuit which had considered the question-that extending the amended statute of limitations to revive expired securities fraud claims would have an impermissible retroactive effect. *Lieberman,* 432 F.3d at 492,*citing* *Landgraf v. USI Film Products,* 511 U.S. 244, 265, 114 S.Ct. 1483, 128 L.Ed.2d 229 (1994) for the principle that "the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal appeal."In short, the Third Circuit held that Section 804 could not be used to revive claims which were time-barred as of July 30, 2002, regardless of whether the case pursuing those claims was filed before or after that date. *See also* *In re Enterprise Mortgage Acceptance Co., LLC, Sec. Litig.,* 391 F.3d 401, 409-410 (2d Cir.2004); *Foss v. Bear, Steams & Co.,* 394 F.3d 540, 542 (7th Cir.2005); *In re ADC Telecoms. Inc. Sec. Litig.,* 409 F.3d 974, 978 (8th Cir.2005); *In re Exxon Mobil Corp. Sec. Litig.,* 387 F.Supp.2d 407, 416 (D.N.J.2005) (Wolfson, J.); *In re Interpool, Inc. Sec. Litig.,* CA No. 04-321, 2005 U.S. Dist. LEXIS 18112, *60, n11 (D.N.J. Aug. 17, 2005) (Chesler, J.); and *Lieberman v. Cambridge Partners, LLC,* CA 03-2317, 2004 U.S. Dist. LEXIS 11553, *9-*10 (E.D. Pa. June 21, 2004) (Rufe, J.)

***3** After three attempts at publishing the notice of the pending private securities class action and otherwise satisfying the criteria of the 1934 Act, as amended by the Private Securities Litigation Reform Act of 1995 (the Reform Act or PSLRA), Albert L. Glover was appointed Lead Plaintiff on January 25, 2006. At a status conference held on March 24, 2006, counsel for Plaintiff advised the Court that they intended to file an amended complaint in this matter and were ordered to do so by March 31, 2006. Defendants responded on April 7, 2006, with the pending Motion to Dismiss.

C. *Jurisdiction and Venue*

This Court has jurisdiction pursuant to 28 U.S.C. §§ 1331 and 1337, Section 27 of the Securities Exchange Act of 1934. Venue is appropriate in this District pursuant to 15 U.S.C. § 78aa and 28 U.S.C. § 1391(b) because many of the acts giving rise to the violations alleged herein occurred in this District.

II. STANDARD OF REVIEW-MOTION TO DISMISS

As explained in more detail in *Payne,*[FN7] a securities fraud action brought under the Reform Act is subject to three levels of scrutiny: the standard requirements of Federal Rule of Civil Procedure 12(b)(6), which requires the court to "accept all well-pleaded allegations in the complaint as true and to draw all reasonable inferences in favor of the non-moving party,"[FN8] the requirement of Federal Rule of Civil Procedure 9(b), requiring that "in all averments of fraud, ... the circumstances constituting fraud ... shall be stated with particularity," and the requirement of the Reform Act that "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."*See* *In re Rockefeller Ctr. Props., Inc. Secs. Litig.,* 311 F.3d 198, 216 (3d Cir.2002); *In re Burlington Coat*

Factory Sec. Litig., 114 F.3d 1410, 1417-1418 (3d Cir.1997); and 15 U.S.C. § 78u-4(b)(2). The heightened requirements of the Reform Act apply most rigorously to Plaintiff's claims regarding the mental state of each Defendant. That is, although Rule 9(b) allows malice, intent, knowledge, and other mental states to be averred generally in suits claiming fraud, the Reform Act requires more than vague or unspecific allegations concerning each Defendant's state of mind at the time in question. *In re Rockefeller Ctr.,* 311 F.3d at 216 and n. 15. Heightened particularity also applies to statements which are alleged to have been misleading or false, requiring Plaintiff to state with regard to each such statement "the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."15 U.S.C. § 78u-4(b)(1)."If a complaint fails to comply with the PSLRA's pleading requirements, dismissal is mandatory." *GSC Partners CDO Fund v. Washington,* 368 F.3d 228, 237 (3d Cir.2004), *citing*15 U.S.C. § 78u-4(b)(3)(A).

FN7.*See Payne,* 433 F.Supp.2d at 556-557.

FN8. Plaintiff argues that in considering a motion to dismiss, the Court may not weigh competing inferences except with regard to allegations of scienter. He further claims that *In re Alpharma Sec. Litig.,* 372 F.3d 137, 150 (3d Cir.2004), stands for the proposition that "all inferences are to favor the plaintiff with respect to scienter allegations."(Plf.'s Memo at 6, n. 13.) This is a misstatement not only of the holding of *In re Alpharma,* but of the law in general. Controlling law in this Circuit establishes that in considering a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6), a court is to draw all reasonable inferences in favor of the plaintiff. *In re Suprema Specialties, Inc. Sec. Litig.,* 438 F.3d 256, 281 (3d Cir.2006) (emphasis added).*See also Benak v. Alliance Capital Mgmt. L.P.,* 435 F.3d 396, 399 (3d Cir.2006). Moreover, the Court of Appeals in *In re Alpharma* explicitly did not hold that all scienter inferences are to favor the plaintiff but, to the contrary, "inferences of scienter do not survive if they are merely reasonable. Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and strong inferences." *In re Alpharma Sec. Litig.,* 372 F.3d at 150 (internal quotation and citation omitted).

***4** As a general matter under Rule 12(b)(6), a court may not consider documents extraneous to the pleadings without treating the motion as one for summary judgment and giving all parties reasonable opportunity to present materials pertinent to such a motion under Rule 56. An exception is made, however, for a "document integral to or explicitly relied upon in the complaint," and it has been long established that "a court may consider an undisputedly authentic document that a defendant attaches as an exhibit to a motion to dismiss if the plaintiff's claims are based on the document." *In re Burlington,* 114 F.3d at 1426 (internal citations omitted). In securities fraud actions, it is equally well-established that a court may consider public documents filed with the SEC.[FN9] *Oran v. Stafford,* 226 F.3d 275, 289 (3d Cir.2000).

FN9. As a public entity trading on the New York Stock Exchange, ITG was required to file quarterly and annual reports with the Securities and Exchange Commission. Under Sections 13(a) and 15(d) of the 1934 Act, any company offering registered securities must file a comprehensive annual report with the SEC on Form 10-K within 90 days of the close of the company's fiscal year. 15 U.S.C. § 78m; 17 C.F.R. § 240.13a-1. Similarly, a quarterly report must be filed on Form 10-Q within 45 days after each of the company's first three fiscal quarters. 17 C.F.R. §§ 240.13a-13. The

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Company filed the required Form S-4 in connection with the OHM merger in 1998 and Form S-4/A when it implemented the exchange offer for $225 million of senior subordinated notes in September 1999. *See*17 C.F.R. § 230.145, reclassification of securities, mergers, consolidations and acquisitions of assets.

III. COUNT I-VIOLATION OF SECTION 10(b) OF THE 1934 ACT

A. *Applicable Law*

In Count I of the Amended Complaint, Plaintiff claims that each Individual Defendant [FN10] violated Section 10(b) of the 1934 Act. In particular, Plaintiff alleges:

FN10. In his supplemental brief in opposition to the motion to dismiss Count II of the Amended Complaint, Plaintiff argues that Carlyle is also culpable under Count I. However, it is clear from the face of the Amended Complaint that Plaintiff did not advise Defendants that Carlyle was also to be considered liable under Count I. (*See* AC, Count I heading preceding ¶ 477, explicitly excluding Carlyle.) Therefore, the Court has disregarded Plaintiff's arguments implying that Carlyle is to be included as a Defendant in those allegations related to Count I. It is well-established that a plaintiff may not amend the complaint through statements contained in a brief in opposition to a motion to dismiss. *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.,* 142 F.Supp.2d 589, 613-614 (D.N.J.2001), *citing* *Pennsylvania ex rel. Zimmerman v. PepsiCo, Inc.,* 836 F.2d 173, 181 (3d Cir.1988).

> At all relevant times, the Defendants, individually and in concert, directly and indirectly, ... engaged and participated in a continuous course of conduct whereby they knowingly and/or recklessly made and/or failed to correct public representations which were or had become materially false and misleading regarding [ITG's] financial results and operations. This continuous course of conduct resulted in the Defendants causing [ITG] to publish public statements which they knew, or were reckless in not knowing, were materially false and misleading, in order to artificially inflate the market price of [ITG] stock and which operated as a fraud and deceit upon the members of the Class.
>
> The Individual Defendants are liable as direct participants in and as a controlling persons [sic] of the wrongs complained herein. By virtue of their positions of control and authority as officers and directors of [ITG] the Individual Defendants were able to and did, directly or indirectly, control the content of the aforesaid statements relating to the Company, and/or the failure [sic] to correct those statements in timely fashion once they knew or were reckless in not knowing that those statements were no longer true or accurate. The Individual Defendants caused or controlled the preparation and/or issuance of public statements and the failure to correct such public statements containing misstatements and omissions of material facts as alleged herein.
>
> (AC, ¶¶ 478-479).

Section 10(b) of the 1934 Act makes it unlawful "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."15 U.S.C. § 78j(b). Among the rules and regulations promulgated under Section 10(b), Rule 10b-5 provides:

> ***5** It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of

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any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud ...

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In a securities fraud action brought pursuant to Section 10(b) and Rule 10b-5, the basic elements to be alleged by a plaintiff are: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) in connection with the purchase or sale of a security; (4) reliance, often referred to in fraud-on-the-market cases as "transaction causation;" FN11 (5) economic loss; and (6) "loss causation, i.e., a causal connection between the material misrepresentation and the loss." *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-342, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

> FN11. As noted in *Payne,* 433 F.Supp.2d at 558-559, a securities fraud suit alleging fraud-on-the-market provides a presumption of reliance for the plaintiff. Because Plaintiff herein makes the same allegations concerning an efficient market for ITG stock as were alleged in the *Payne* SAC (*see*AC, ¶¶ 473-474), transaction causation will not be discussed further herein.

The crux of Defendants' arguments to dismiss Count I of the Amended Complaint is that Plaintiff has failed to establish (1) the requisite scienter on the part of any Defendant and (2) the last of the *Dura* elements, loss causation. Although Defendants begin their analysis with arguments regarding loss causation, the Court first considers scienter.

B. *Scienter*

Defendants argue that Plaintiff's scienter allegations, largely identical to those in *Payne,* fail to give rise to a strong inference of fraudulent intent or any other wrongful state of mind on the part of any Defendant. They further argue that for this long-past Class Period, the allegations are based on hindsight without contemporaneous factual support of scienter on the part of any Defendant. The Court notes that a large part of the Amended Complaint in *Glover* is an exact replica of the *Payne* SAC. Inasmuch as the claims and arguments related to scienter which were raised by the plaintiffs in *Payne* have been exhaustively examined in the opinion dismissing that case, only the new allegations are discussed herein.

The Court disagrees, however, with Defendants' argument that any allegations related to conduct before or after the Class Period should be rejected categorically in considering whether Plaintiff has raised a strong inference as to scienter on the part of a particular Defendant. Defendants rely for this argument on an earlier holding in the opinion dismissing the first amended complaint in *Payne* and cases cited therein. FN12 (*Payne,* Docket No. 68 at 19, n. 6), However, the decision to which Defendants refer was rendered on December 16, 2004, before the Third Circuit Court of Appeals had considered this particular issue. On December 15, 2005, the Court of Appeals held that a district court had erred by concluding the plaintiff could not rely on statistical data collected prior to the class period to support its allegations that later statements by the defendant were misleading. *See In re Merck & Co. Sec. Litig.,* 432 F.3d 261, 271-272 (3d Cir.2005). Drawing on two cases from the Second Circuit, the *In re Merck* Court held that inferences of what the defendants knew during the class period could be based on evidence of their knowledge after the

class period. *Id., citing* *Novak v. Kasaks,* 216 F.3d 300, 312-313 (2d Cir.2000). By the same token, pre-class information was relevant to show the defendants' knowledge at the start of the class period.*Id., citing* *In re Scholastic Corp. Sec. Litig.,* 252 F.3d 63, 72 (2d Cir.2001) (both post- and pre-class-period data could be used to "confirm what a defendant should have known during the class period," noting that "any information that sheds light on whether class period statements were false or materially misleading is relevant"). Therefore, to the extent the Court previously disregarded pre- and post-Class Period information, that decision is no longer good law in light of *In re Merck.*Accordingly, the Court will consider such allegations in determining Defendants' scienter.

> FN12. Defendants also cite to *In re Apple Computer, Inc.,* CA No. 03-16614, 2005 U.S.App. LEXIS 5511 (9th Cir. Apr. 4, 2005), and *In re Read-Rite Corp. Sec. Litig.,* 335 F.3d 843, 847 (9th Cir.2003). Those cases, of course, are not binding precedent on this Court. While the *In re Merck* Court did not address either *In re Apple Computer* or *In re Read-Rite Corp.,* it found that another case from the Ninth Circuit, *In re Clearly Canadian Sec. Litig.,* 875 F.Supp. 1410, 1420 (N.D.Cal.1995), which held that statements made outside the class period were irrelevant to the plaintiffs' fraud claims and upon which the lower court in *In re Merck* had relied, was "meager support" for the conclusion that inferences of scienter could not legitimately be drawn from information outside the class period. *In re Merck,* 432 F.3d at 272.

***6** The Court of Appeals defines scienter as

> a mental state embracing intent to deceive, manipulate or defraud, or, at a minimum, highly unreasonable conduct, involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

In re IKON Office Solutions, Inc. Sec. Litig., 277 F.3d 658, 667 (3d Cir.2002) (citations and internal quotations omitted).

The PSLRA requires a plaintiff, "with respect to each act or omission," to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *GSC Partners,* 368 F.3d at 237,*quoting*15 U.S.C. § 78u-4(b)(2). A plaintiff may satisfy the "strong inference" requirement in either of two ways: "(a) by alleging facts sufficient to show that defendants had the motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *In re Burlington,* 114 F.3d at 1418 (internal quotation omitted). The Third Circuit has held that to the extent the general pleading permitted with respect to mental state established in Rule 9(b) conflicts with the PSLRA's heightened scienter requirements, the PSLRA "supersedes Rule 9(b) as it relates to Rule 10b-5 actions." *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 531, n. 5 (3d Cir.1999). The appropriate sanction for complaints which fail to meet the PSLRA scienter requirement is dismissal. *Id.* at 531.

1. *Motive and Opportunity:* Defendants first argue that the Amended Complaint lacks any allegation as to motive and opportunity for any Individual Defendant to violate the securities laws. They emphasize that during the Class Period, and for more than a year thereafter, no Defendant sold his shares of ITG stock until DeLuca's sales in October and November 2001.[FN13] They further argue that because both Carlyle and some Individual Defendants purchased stock during the Class Period and thereafter, the more logical inference is that they were not engaging in fraudulent activity, but, to the contrary, were motivated to keep the Company strong and prosperous.

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FN13. As the Court concluded in *Payne,* if DeLuca knew "true facts" which were concealed from investors regarding the Company's serious financial trouble, he would have sold his stock during the summer of 2001 when stock prices reached a high of $7.75 per share and not have waited until news of the Company's problems began to emerge in October 2001. Plaintiff here alleges that the fraud actually began as early as 1998 and that DeLuca was at all times a participant in the fraud. If this were true, he logically should have sold in May 1999 when ITG stock reached its historic high of $17.25 per share or at least soon thereafter as the stock began its steady decline.

Plaintiff describes this argument as "misguided" and "irrelevant." Moreover, he contends that Defendants' actions were rationally motivated inasmuch as the Company's existence depended on their scheme to artificially make it appear viable. While conceding that general allegations which can be imputed to any publicly-owned, for-profit endeavor-e.g., a desire to increase stock prices, increase compensation, or continue employment-are not sufficiently concrete to establish scienter, Plaintiff argues that when a company's survival is at stake, the strength of general circumstantial evidence of securities fraud is heightened.

***7** The Amended Complaint makes three explicit allegations regarding motivation.[FN14] First, Plaintiff alleges that Defendants' attempts to conceal the Company's insolvency were the "principal motivating factor for the scheme alleged."(AC, ¶ 7). As numerous cases have held, motives that are generally possessed by most corporate directors and officers-including the desire to avoid breaching loan covenants, maintain the company's credit rating, or avoid disclosing its lack of liquidity-are insufficient to establish scienter. *See, e.g., In re Stonepath Group, Inc. Sec. Litig.,* 397 F.Supp.2d 575, 592-593 (E.D.Pa.2005); *In re Loewen Group Inc. Sec. Litig.,* CA No. 98-6740, 2004 U.S. Dist. LEXIS 16601, *60-*62 (E.D.Pa. Aug. 18, 2004); and *Wilson v. Bemstock,* 195 F.Supp.2d 619, 637 (D.N.J.2002).*But see PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 690-691 (6th Cir.2004) (allegations that defendants were motivated to engage in fraud to avoid default on bank loan agreements and preserve company's continued viability were "suggestive" of scienter and would be considered along with other allegations in determining if defendants had acted at least recklessly). Although the Court agrees that such an allegation, standing alone, is insufficient to establish scienter on the part of any Defendant, it will be considered along with other factors in determining if any Defendant acted recklessly or with conscious misbehavior.

FN14. The Court has disregarded Plaintiff's argument that Carlyle was motivated to prolong the Company's existence because it would lose its $45 million investment, its management and acquisition fees, and its preferred stock dividend if the Company collapsed. While this may be true, Carlyle is not alleged to have violated Section 10(b), and there are no allegations that any Director affiliated with Carlyle took or failed to take actions which would protect Carlyle to the detriment of other stockholders.

Secondly, Plaintiff alleges that Defendant Soose admitted in deposition testimony given in the associated bankruptcy proceedings that the Company "managed" its cash flow in order to meet quarterly loan covenants by accumulating cash receipts at the end of the quarter and disbursing payments after the covenants had been met. According to Plaintiff, Soose acknowledged that this cash flow manipulation "was motivated both by the desire for loan covenant compliance and the Company's bonus program which used day sales outstanding as a parameter."(AC, ¶ 120). The first of those intents, loan covenant compliance, is addressed in the preceding paragraph. As to the second, there is no allegation

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that any Defendant participated in the Company's bonus program or in any way stood to benefit from such a program. Thus, this allegation fails to establish a "concrete and personal benefit to the individual defendants resulting from this fraud." *GSC Partners,* 368 F.3d at 237 (quotation omitted).

The third allegation regarding motivation is that shortly after the OHM acquisition in 1998, Defendants began overstating the Company's revenue and liquidity, "motivated by a desire to conceal the bad receivables and liquidity shortage which the Company experienced as a result of that acquisition."(AC, ¶ 471). In a similar case in which the plaintiffs alleged that the defendants engaged in accounting fraud in order to conceal the "disastrous consequences" of acquiring a subsidiary without discovering "tens if not hundreds of millions of dollars in uncollectible receivables," the court held such an alleged intent was no more than a desire to "conceal a poor management decision" and was not sufficient to show motive and opportunity to commit securities fraud. *Alaska Elec. Pension Fund v. Adecco S.A. (In re Adecco S.A.),* 371 F.Supp.2d 1203, 1222-1223 (S.D.Cal.2005). The Court agrees with that reasoning and finds it apropos here.

***8** Thus, the Court concludes that to the extent Plaintiff has attempted to show that any Defendant had motive and opportunity to commit securities fraud under this prong of the *In re Burlington* test, those attempts have failed. The Court next considers Plaintiff's allegations from which the Court may infer "strong circumstantial evidence of conscious misbehavior or recklessness."

2. *Reckless Behavior and Circumstantial Evidence of Scienter.*Under the PSLRA, the degree of recklessness associated with scienter may not be "merely simple, or even inexcusable negligence," but rather such an "extreme departure from the standards of ordinary care" that the defendant knows he is misleading investors or his misbehavior is so patently obvious that he must have been aware of it. *In re Advanta,* 180 F.3d at 535. The *Adventa* court further noted that "scienter may be alleged by stating with particularity facts giving rise to a strong inference of conscious wrongdoing, such as intentional fraud or other deliberate illegal behavior."*Id.* The Third Circuit has compared the level of reckless behavior required to "closely approach[ ] that which attaches to conscious deception." *In re Digital Island Sec. Litig.,* 357 F.3d 322, 332 (3d Cir.2004). Recklessness is not intended to encompass "claims essentially grounded on corporate mismanagement."*Id., quoting In re Advanta,* 180 F.3d at 540, and comparing recklessness to "conscious disregard" and "deliberate ignorance."

The strong inference of scienter must attach to each Defendant. *In re Digital Island Sec. Litig.,* 223 F.Supp.2d 546, 553 (D.Del.2002), *aff'd* 357 F.3d 322 (3d Cir.2004). As the Court noted in *Payne,* the consensus among courts in this Circuit is that group pleading did not survive enactment of the PSLRA. *Payne,* 433 F.Supp.2d at 569-570,*citing In re Bio-Technology Gen. Corp. Sec. Litig.,* 380 F.Supp.2d 574, 584 (D.N.J.2005). Defendants correctly note that Plaintiff has advanced the same generalized allegations against "Defendants" as a group, rarely mentioning them by name. Other than reference to the fact that each Individual Defendant signed the Forms 10-K for 1998,[FN15] 1999, and 2000 as well as the Form S-4/A filed in September 1999 in connection with the exchange of $225 million in notes,[FN16] no particularized allegations are brought against any Defendant.[FN17]Therefore, the Court cannot rely upon generic allegations, including claims that "Defendants" were alerted to improper accounting practices in September 1999 when the ITG controller resigned or that "Defendants" knew a certain project was "a fiasco" in determining scienter for any particular Defendant.

FN15. Defendant Harvey was not a member of the Board of Directors when the 1998 Form 10-K was signed and therefore this portion of the allegation does not pertain to him.

FN16. This allegation is not pursued by

Plaintiff as a basis for establishing scienter on the part of any Individual Defendant. *See* *Kennilworth Partners L.P. v. Cendant Corp.,* 59 F.Supp.2d 417, 428 (D.N.J.1999) and cases cited therein, rejecting allegations of scienter based on the fact that directors had signed the defendant's SEC forms and "had access to facts" because of their positions as directors or officers of the company.

FN17. Plaintiff makes one additional allegation involving Defendant Dolan. Confidential Witness 6 (CW 6), the Company's director of corporate development, stated that "part of the deal with Carlyle" in exchange for its $45 million investment was that ITG would "embark on a massive acquisition program."Although ITG had its own due diligence team headed by CW 6, Carlyle conducted independent due diligence for each acquisition. During the due diligence process prior to the OHM acquisition, CW 6 met Defendant Dolan who was with Carlyle personnel, performing a parallel due diligence investigation. Plaintiff makes no further reference to this allegation and its import to the Court is unclear insofar as it may pertain to scienter or any material misrepresentation or omission on the part of Defendant Dolan.

Plaintiff also makes general allegations about what Defendants knew by virtue of their positions with the Company. For instance, Plaintiff contends that the members of the Board of Directors "were fully informed about the true state of IT Group's receivables" by virtue of receiving the same information as that provided to the Company's lenders in the Monthly Compliance Letter Packages. Similarly, the Audit Review Committee members FN18 received the same documents in advance of their meetings. Such blanket allegations that an Individual Defendant "knew or should have known" certain facts by virtue of his position in the Company, without more, are insufficient to plead scienter. *See* *In re Advanta,* 180 F.3d at 539 and cases cited therein. Furthermore, while directors should be "fully informed" about problems associated with collecting accounts receivable, possessing such knowledge does not mean that a Defendant acted recklessly or even negligently in failing to demand that the Company immediately disclose those problems to the investing public.

FN18. The Audit Review Committee Included Defendants McGill, Pogue, Gibson and Pugliese.

***9** Plaintiff also argues that knowledge may be attributed to the Individual Defendants because the alleged public misstatements and omissions relate to core operations of the Company, such as: its backlog of government contracts; the growth-by-acquisition strategy and the associated dubious accounting practices, and the need to achieve loan covenant compliance. He analogizes the facts herein to those of *In re Aetna Inc. Sec. Litig.,* 34 F.Supp.2d 935, 954 (E.D.Pa.1999), in which the court held that the plaintiff had sufficiently alleged scienter on the part of officers who were involved on a daily basis with a core activity of the business and who made misrepresentations concerning the success of the integration and its financial impact on the defendant. (*See also* *Epstein v. Itron,* 993 F.Supp. 1314, 1326 (E.D.Wash.1998); *In re Tel-Save Sec Litig.,* CA No. 98-3145, 1999 U.S. Dist. LEXIS 16800, *14-*15 (E.D.Pa. Oct. 19, 1999); and *In re Campbell Soup Co. Sec. Litig.,* 145 F.Supp.2d 574, 599 (D.N.J.2001), all of which denied motions to dismiss in part because the plaintiff successfully pled that facts critical to the business's core operations were so important they could be attributed to key officers).

Accepting that each of the matters identified by Plaintiff could be considered a "core operation" of the Company during the Class Period, such allegations, based on Defendants' status as senior officers and directors, pass muster "only when taken together with more specific allegations linking their posi-

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tions to their knowledge." *Kennilworth Partners, L.P. v. Cendant Corp.,* 59 F.Supp.2d 417, 428 (D.N.J.1999) (internal quotation omitted). Courts have been hesitant to impute knowledge to a defendant pursuant to the core business doctrine "absent particularized allegations showing that defendants had ample reason to know of the falsity of their statements."*In re Stonepath Group, Inc. Sec. Litig.,* CA No. 04-4515, 2006 U.S. Dist. LEXIS 15808, *34-*36 (E.D.Pa. Apr. 3, 2006). This cautious approach is not only prudent, but necessary to remain consistent with the Court of Appeals' position rejecting generalized imputations of knowledge based on the defendant's position in the company.*In re Stonepath Group, id.* at *36,*citing* *In re Alpharma,* 372 F.3d 137, 149 (3d Cir.2004).

The Court first distinguishes between Messrs. Soose and DeLuca and the rest of the Individual Defendants who were members of the Board of Directors. As in *Payne,* the Court concludes that Plaintiff has failed to offer particularized allegations which show that members of the Board of Directors had ample reason to know that the Company's public statements were false. In reaching this conclusion, the Court focuses on what was known by members of the Audit Review Committee, because they are the sub-set of board members most aware of inconsistencies between public and internal financial information.

Plaintiff alleges that the Defendants who were members of the Audit Review Committee knew about the Company's chronic liquidity crisis but failed to take any actions to correct false and misleading statements to the public about this subject. For instance, the audit results reported to the Audit Review Committee in 2001 showed that project cost accruals as of December 29, 2000, included $86 million of "estimates of invoices received but not entered into accounts payable."Plaintiff contends that calling such estimated revenue a "billed" receivable is highly deceptive as to the amount and quality of claimed revenue. Even if this statement goes to a core operation of the Company, namely, calculation of its revenue, such a claim is unavailing to show what members of the Audit Committee knew during the Class Period because it is based on information they received at least ten months thereafter and there are no allegations which would tie that report to any Defendant's state of mind at an earlier time.[FN19]

FN19. Other allegations as to Audit Review Committee members' scienter are stated in ¶¶ 257, 263, 264, and 273 of the Amended Complaint, referring to events which occurred, respectively, on July 25, 2000, September 20, 2000, December 19, 2000, and November 28, 2001.

***10** The inferences of scienter based on events which occurred during the Class Period are weak at best. Plaintiff claims that the Audit Review Committee members "were aware of the shaky basis for much of IT Group's claimed receivables," based on a mid-February 1999 [FN20] report by the Company's external auditors, Ernst & Young, which noted that "the Company continues to take an aggressive position on claim recovery related to certain significant contracts. As of December 31, 1999, there are approximately $83.9 million of significant outstanding claims, of which approximately 52% of the claim value has been recognized in project revenues."(AC, ¶ 240). There is no allegation as to why the auditors believed that either (1) taking an "aggressive position on claim recovery" was a fraudulent or reckless strategy or (2) recognizing half of the claim value on those outstanding claims was improper under generally accepting accounting principles (GAAP) or any other accounting standard.

FN20. The Court assumes this is a typographical error and that the proper date was approximately February 15, 2000. Alternatively, the December 31 date could refer to 1998, not 1999.

Plaintiff alleges that when David Hill, a controller who had joined the Company at the time of the

OHM acquisition, resigned on September 3, 1999, “because of IT Group's inflated receivables and improper accounting practices,” he provided a memo to the Board of Directors objecting to an inadequate reserve allowance for adjustment in the U.S. government billing rate and a $2.1 million upward adjustment in income due to reduction of the reserve. Defendants note, however, that at the September 23, 1999 meeting of the Board of Directors, Defendant McGill, chairman of the Audit Review Committee, reported on

> the steps being undertaken to resolve any issues raised by [Hill's] memorandum. Mr. McGill noted that Ernst & Young has been retained to review the memorandum and conduct an internal audit to confirm compliance with proper accounting procedures.... [T]he Audit Committee will meet with Ernst & Young once their investigation has been completed, and the Committee will make a subsequent report to the Board of Directors.

(Defs.' Memo at 17, n. 11, and Declaration of David A. Becker in Support of Defendants' Motion to Dismiss, Docket No. 57, “Becker Decl.,” Exhibit T, at 2).

Plaintiff fails to explain the outcome of this discussion, either in the Amended Complaint or in his brief in opposition, so the Court is left to speculate as to its import. Although the pleadings appear not to include the subsequent report, the fact that the Audit Review Committee took the memorandum seriously enough to refer it to external auditors for review suggests that Hill's concerns were addressed rather than being recklessly disregarded.

The Court finds that these allegations fail for the same reasons that similar imputations of knowledge failed in *Payne.*Although Plaintiff sets out what Defendants knew about core operations of the Company by virtue of their positions as members of the Audit Review Committee and doubtless such information would be within the scope of what such individuals should know and should act upon, Plaintiff simply leaps to the conclusion that the Individual Defendants were aware of the falsity of public statements made about reserve allowances for government contracts or related financial information. If Plaintiff had come forward with, for instance, an allegation that the Audit Review Committee concluded that the accounting practice in question might be a violation of GAAP, but recklessly allowed the practice to continue without closer scrutiny and thereby generate false financial statements, that would be a completely different matter. But no such allegations have been made here. Moreover, even in such circumstances, a defendant's awareness of improper accounting must be accompanied by allegations showing an intent to defraud the public regarding the content of the company's financial reports. *In re Carter-Wallace, Inc. Sec. Litig.,* 150 F.3d 153, 157 (2d Cir.1998). In the instant case, Plaintiff has failed to allege that any member of the Audit Review Committee had such intent.

***11** Defendants argue that the circumstantial evidence offered by Plaintiff herein consists of no more than “recycled allegations already rejected by the Court, allegations impermissibly based on speculation and conjecture, and fraud-by-hindsight allegations that cannot support a strong inference of scienter.”(Defs.' Memo at 15). According to Defendants, the only new scienter allegations are (1) the accounting issues raised by Hill, which the Court has already addressed, and (2) a hindsight attack on the Company's accounting practices with respect to acquired receivables which were scrutinized throughout the Class Period and ultimately adjusted due to changed circumstances. A detailed review of the Amended Complaint, however, identifies five subjects about which Defendants allegedly misrepresented the Company's financial condition to investors:

> 1. The success of the OHM integration, the negative effect of uncollectible accounts receivable acquired with OHM, and the Company's failure to timely write-off those accounts;

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2. The Company's accounting manipulations and violations of loan covenants;

3. Misleading statements about the Company's financial condition in SEC filings and press releases;

4. The failure to pay vendors, the effect of pay-when-paid regulations on the Company, and its inability to abide by those regulations; and

5. The value and reliability of the ITG contract backlog.

Having concluded for the same reasons as set forth in *Payne,* 433 F.Supp.2d at 567-572, that Plaintiff has failed to establish even a weak inference of scienter on the part of any Individual Defendant except Messrs. Soose and DeLuca, the Court considers the foregoing five subjects vis-a-vis the potential scienter of only those two Defendants.

C. *Material* *FN21* *Misrepresentations and Omissions*

FN21.*See* *Payne,* 433 F.Supp.2d at 573-574 for a further discussion of materiality.

Rule 10b-5 provides that it is a violation of securities law "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading."17 C.F.R. § 240.10b-5(b); *In re Burlington,* 114 F.3d at 1417, n. 5. Rule of Civil Procedure 9(b) requires a plaintiff alleging violation of Section 10(b) to show: "(1) a specific false representation [or omission] of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his damage." *In re Rockefeller Ctr.,* 311 F.3d at 216 (internal quotation omitted). The PSLRA further requires that the complaint "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading."15 U.S.C. § 78u-4(b)(1).

Although Plaintiff argues that the heightened pleading requirements of Rule 9(b) and the PSLRA apply only to allegations regarding scienter, the Court finds that the Third Circuit has determined that a more demanding standard is applied also to allegations of falsity. *See* *Oran,* 226 F.3d at 288, noting that "both the PSLRA and Federal Rule of Civil Procedure 9(b) impose heightened pleading requirements on plaintiffs who allege securities fraud."Since falsity is an element of fraud, it follows that the PSLRA requires a plaintiff to "plead both falsity and scienter with particularity." *In re Digital Island Sec. Litig.,* 223 F.Supp.2d at 551. Therefore, the allegations regarding false and misleading misrepresentations and omissions which have not already been addressed in *Payne* are analyzed under the more exacting standard of the PSLRA.

***12** In most instances, the materiality of a particular statement is a matter to be determined by the fact-finder. *See* *Basic, Inc. v. Levinson,* 485 U.S. 224, 239-241, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). However, certain statements are so clearly immaterial that a court may reach that conclusion in considering a motion to dismiss. *In re Rockefeller Ctr.,* 184 F.3d at 294. For purposes of the analysis which follows, the Court assumes that each of the statements identified by Plaintiff-or the subject matter of the alleged omission-is material.

1. *The negative effect of uncollectible accounts receivable acquired with OHM and problems with ITG/OHM integration:* Defendants argue that the hindsight allegations regarding receivables acquired from OHM and other projects are illogical and do not raise any inference of scienter. Furthermore, there is no contemporaneous evidence of fraud on the part of any Defendant and the theory pursued by Plaintiff is implausible.

ITG acquired OHM Corporation, one of its chief

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competitors in the environmental remediation field, in February and June 1998. After this $303.4 million transaction, ITG refinanced its credit facilities to consist of an eight-year $228 million amortizing term loan and a six-year $185 million revolving credit facility (Revolver).

According to Plaintiff, "the OHM acquisition greatly exacerbated the Company's liquidity problems because OHM carried substantial amounts of accounts receivable on its books which were uncollectible and should have been written off even prior to ... the acquisition."(AC, ¶ 97). Plaintiff alleges that after acquiring OHM, "it soon became known that OHM's receivables were of questionable collectibility" and, as a result of failing to collect those receivables, the Company was secretly insolvent. (AC, ¶ 12)."Rather than take the necessary write-downs, Defendants began a pattern and practice of disguising write-downs through acquisition accounting, while reassuring the investing public at every opportunity that the Company's liquidity was sufficient."(AC, ¶ 13).

In a report dated November 6, 1998, an internal auditor of Citibank (apparently one of the lenders involved in the OHM transaction), reported that "OHM has historically left receivables from troubled accounts on the [accounts receivable] aging rather than write-off the account in a timely fashion."FN22(AC, ¶ 97 and Exhibit D at 3). Plaintiff alleges that because these "bad" OHM receivables were retained on the Company's books, the amounts shown as accounts receivable in the SEC Form 10-K for 1998, the Forms 10-Q for first three quarters of 1999, and the September 1999 Form S-4/A were falsely overstated. He also claims that an unspecified number of these bad receivables remained on ITG's books until December 2001 when the Company made its "covert restatement of receivables." (AC, ¶ 97).

FN22. Although Plaintiff alleges that Defendants knew of the OHM accounts receivable problems in 1998 based on this report (AC, ¶ 251), Exhibit D does not show that any member of ITG management received it, nor are there other factual allegations to support a claim that any Defendant knew of this report in 1998 or any time during the Class Period. Moreover, even if they had, the statement quoted does not show that the receivables from "troubled accounts" were uncollectible, only that OHM had not written them off, reflecting nothing about Defendants' scienter on the collectibility issue.

Succinctly stated, Plaintiff's allegations in this regard focus on the effect the OHM uncollectible accounts had on the Company's reported revenues and assets. If the accounts were known to be uncollectible, they should have been written-off as soon as possible in accordance with GAAP. By keeping uncollectible accounts receivable on the Company's books, its cash flow and assets were falsely inflated, misleading investors about ITG's financial stability and anticipated future income as those accounts were collected.

***13** Plaintiff has scattered the allegations pertaining to OHM throughout the Amended Complaint, but they can be grouped into four categories: the initial valuation of the accounts receivable; the uncollectibility of those accounts; improper purchase accounting practices; and false public statements about the success of the OHM integration.

a. Initial valuation of OHM accounts receivable: Plaintiff argues that OHM accounts receivable were over-valued at the time of the merger. In support of this position, Plaintiff first notes that in the Spring of 1998, ITG wanted to take a maximum of $10 million fair market value decrease for OHM's Occidental Chemical, Sterling Winthrop, and Monticello projects as part of its acquisition accounting. The SEC, "aware of the potential for inflating earnings through acquisition accounting write-downs," asked ITG to justify that amount. (AC, ¶ 252 and n. 11). The subject was addressed in a conference call with the SEC on May 7, 1998, in which Mr. Soose participated. Ultimately, the Form S-4 filed with the

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SEC disclosed a maximum write-down of $1.5 million for the three OHM projects, indicating “heightened awareness on the part of the IT Group that the OHM projects were overvalued.”(AC, ¶ 252).FN23

FN23. A letter to the SEC from Soose also dated May 7, 1998, explained that the three projects involved contracts in process and litigation accruals with a cumulative maximum value of $10 million. (AC, Exhibit R at 5). When the assertions in this letter were questioned by the SEC, the Company agreed to exclude from its “pre-acquisition contingency for contracts in progress and litigation accruals” the two contracts which were in progress, apparently leaving a $1.5 million contingency account for the Occidental Chemical contract. (Exhibit R at 2).

There is no factual support for Plaintiff's speculation that the SEC asked ITG to decrease the amount written off for the OHM projects because it was concerned that ITG would inflate its earnings through acquisition accounting write-downs. In fact, based on the content of the letters between the SEC and ITG, the Court is unable to draw any inference-much less a strong inference-of scienter on the part of Defendant Soose based on his participation in this exchange. It appears ITG had offered a rationale for its “$10 million additional maximum liability or fair market value decrease” for the three projects, the SEC questioned that rationale, and the Company agreed to reduce the amount. Without further analysis or argument by Plaintiff as to why this action reflects a reckless or fraudulent overvaluation of those projects, the Court cannot accept Plaintiff's blanket allegation in this regard.

Plaintiff further claims that IT Group's initial valuation of the OHM receivables was “highly suspect” because it was performed by Ernst & Young, who audited OHM as well as ITG. Permitting the auditor to act in this dual capacity created a conflict of interest which was contrary to GAAP in 1998, as reflected by the fact that in February 2001, the SEC amended its regulations to prohibit such dual representation. The Court declines to draw any inference that the initial valuation of the receivables was highly suspect because the SEC proposed changing its regulations on this subject two years *after* the acquisition was made. Moreover, there are no factual allegations from which to infer that the SEC questioned Ernst & Young's evaluation of OHM receivables in 1998 or that any Defendant knew that dual representation might someday be considered an unsound accounting practice.

***14** *b. The uncollectibility of OHM accounts receivable:* Many of the allegations about the uncollectibility of OHM accounts receivable arise from documents created shortly after the end of the Class Period on February 23, 2000. The Court has considered those documents not for their factual content, but rather to determine if any Defendant would have known during the Class Period that the accounts receivable in question were truly not collectible and, therefore, that including those accounts would misrepresent the Company's financial condition.FN24

FN24. Unless otherwise noted in the text, for purposes of determining Defendants' scienter, the Court has disregarded allegations in AC ¶ 258 and Exhibit W; ¶ 253 and Exhibit S; ¶ 259 and Exhibits V and X; and ¶ 261 and Exhibit Z. None of these documents indicates the author, the recipients, or the purpose for which it was prepared, all of them are dated after the end of the Class Period, and none of them provides any insight into what any Defendant knew during the Class Period.

Plaintiff alleges that “although Defendants knew from ... prior circumstances that the OHM receivables were troubled, Defendant Soose professed to learn this fact for the first time in mid-2000.”(AC, ¶ 254). Plaintiff claims that at the July 25, 2000, meeting of the Board of Directors, Soose reported that the Company had

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recently become aware of potential asset valuation write-downs related to unbilled receivables in connection with the OHM acquisition. This matter will require significant review and investigation to determine the nature, scope and resolution of the matter. It is expected that resolution of this matter will extend into the fourth quarter and may require a noncash charge.

(AC, ¶ 254 and Exhibit T).

At an Audit Review Committee meeting held on September 20, 2000, in-house counsel James Kirk and Soose reviewed specific accounts which were, Plaintiff claims, “doubtful at best.” (AC, ¶ 263 and Exhibit AA). These accounts included four projects which were in litigation: American Creosote/Cape Fear, Coakley, Earth Tech, and TNRCC.FN25 Soose stated, in effect, that the reserves set aside for those projects might have to be increased depending on the outcome of the litigation or future developments. The minutes of the meeting further stated:

FN25. Plaintiff provides only this one reference in the Amended Complaint to “TNRCC” and does not refer to it in his brief in opposition to the motion to dismiss. The Court has been unable to identify this project independently.

An acquisition evaluation review, as well as the ongoing accounts receivable review, including a detailed by-product review of unbilled accounts receivable contained in acquired computer systems including the Oracle system were discussed. In this regard, approximately two hundred (200) projects are being reviewed which represent over 70% of the universe. Discussion with project managers, project administrators, and business line presidents has commenced and is expected to be a lengthy process which will include interface with clients to determine realization estimates. As earlier anticipated, the review process is scheduled to be completed during the later part of the fourth quarter. Mr. Soose summarized that previously established reserves are adequate, however [they] will be evaluated in conjunction with the results of the review.
(AC, ¶ 254 and n. 12).

Plaintiff contends that ITG should have “exhaustively reviewed” the status of OHM's receivables as entered into the Oracle computer system when the company was acquired in 1998, not two years later. (AC, ¶ 254). At best, this is an allegation of mismanagement or negligence, not fraud.

***15** At the December 19, 2000, Audit Review Committee meeting, Messrs. Kirk and Soose again provided a detailed review of accounts receivable problems associated with the four previously-mentioned projects and three other OHM projects: Penn Mines, Occidental, and Wellsville. The minutes of the meeting state: “[a]s a result of recent developments and a change in strategy emphasizing the acceleration of cash receipts over contentious expensive litigation, the previously estimated recoveries are expected to be reduced.”This change in strategy would result in a special non-cash charge in the fourth quarter of the year. (AC, ¶ 264 and Exhibit BB).

Despite all his allegations regarding the uncollectibility of OHM receivables, Plaintiff never clarifies (1) how the Company arrived at the conclusion that a certain account was collectible or uncollectible and who made that decision, (2) the materiality of the amounts which were uncollectible, or (3) which Individual Defendants knew those receivables were uncollectible during the Class Period and how they knew it. A vague allegation that a “substantial amount” of OHM accounts “should have been written off” at the time the company was acquired fails to establish any of those facts. In *Cal. Pub. Emples'. Ret. Sys. v. Chubb Corp.,* 394 F.3d 126 (3d Cir.2004)(*Chubb*), the Third Circuit held that plaintiffs who allege that defendants distorted data disclosed to the public by using unreasonable accounting practices must state what the unreasonable practices were and how they distorted the disclosed

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data. *Chubb, id.* at 153-154,*citing In re Burlington,* 114 F.3d at 1417-1418. These requirements include identifying with particularity the source for their accounting fraud claims, *i.e.,* someone who would reasonably have knowledge supporting the allegations that the defendants' financial statements were false, the data plaintiffs used to arrive at their calculation of the magnitude of the fraud, the amount by which financial data were distorted, or how much revenue was improperly recognized. *Id.* at 154;*see also* note 18, comparing the allegations of accounting fraud in *Chubb* to those set out in *In re Cabletron,* 311 F.3d 11 at 24, 27, 31-32 (1st Cir.2002), where the plaintiffs had pled estimates of the actual amount of improperly recognized revenue and provided adequate supporting details, *e.g.,* names of customers and specific products. After *Chubb,* district courts have concluded that the plaintiff must plead "facts that would demonstrate which accounts were unlikely to be collectible, when and by what level the accounts receivable figure on [the company's] books should have been decreased, why the allowances [the company] set aside for uncollected accounts receivable were unreasonable or how many accounts were in fact uncollectible."*In re Loewen Group Inc. Secs. Litig.,* CA No. 98-6470, 2003 U.S. Dist. LEXIS 15680, *30-*31 (E.D.Pa. July 16, 2003). Plaintiff has not supported his allegations of accounts receivable overstatement with any of these facts; he has merely identified projects and asserted that some unspecified amounts "should have been" written off. Without such allegations, even the company's eventual financial ruin is not "proof that defendants committed any acts worse than mismanagement."*Id.* at *31.FN26

> FN26. In their motion for reconsideration, now pending in *Payne,* Plaintiffs assert that particular claims were known to be improperly included in ITG's accounts receivable. They identify numerous such accounts-Wellsville, Monticello, Weyerhauser, Lake Apopka, Occidental-OHM-based on handwritten notes by an unknown writer from a meeting held November 13, 2000, at which Soose is alleged to have been present. Such notes are not helpful to the claims herein because nothing there or in Plaintiffs' Exhibit 18, an undated list of "Legacy Claims" on which they also rely, shows the knowledge of any Individual Defendant about the uncollectibility of those accounts and when they should have been written off.

***16** In *In re MCI Worldcom, Inc. Sec. Litig.,* the plaintiffs alleged, as does Plaintiff herein, that the defendants "knew or were severely reckless in not knowing that certain accounts should have been written-off much sooner." 191 F.Supp.2d 778, 790 (D.Miss.2002). Nevertheless, the court in that case held that such allegations were insufficient to state a claim of securities fraud. "Rather, to establish scienter based on improper accounting, Plaintiffs must plead with particularity facts demonstrating that the accounting judgments that were made were such that no reasonable accountant would have made the same decision if confronted with the same facts."*In re MCI Worldcom, id.* (internal quotation omitted.) Similarly, the plaintiffs there-again like Mr. Glover-argued that the magnitude of the defendants' eventual write off was probative of severe recklessness. The court held that the size of the write-off did not, by itself or in the context of the facts alleged by the plaintiffs, raise a strong inference of scienter. *Id.* at 791.

In this case, Plaintiff's contention that Defendants were aware of the "highly questionable" nature of many OHM accounts receivable is undercut by facts gleaned from documents he provides. For example, Plaintiff makes a number of claims based on a spreadsheet entitled "Selected Projects Status," dated October 19, 2000. He alleges that the spreadsheet shows two Monticello project claims worth $6.7 million were settled for $435,000. On the Coakley project inherited from OHM, the Company won only $1.1 million dollars on summary judgment and litigation on the remainder was still

pending. On the Wellsville project, multiple change order appeals had been rejected. On the Occidental project, ITG was demanding payment while the client counter-demanded $3.5 million from ITG. (AC, ¶ 265 and Exhibit CC.) A two-page document entitled "Project Analysis-Acquired Claims 12/01/00" reflects that despite this knowledge, the Company wrote off only a limited part of the total claims, *i.e.,* $6.3 million of $15.9 million on Monticello, $1.3 million of $9.3 million on Occidental-OHM, $550,000 of $1.7 million on Occidental-IT, $3.4 million of $6.5 million on Coakley, and $1.9 million of $2.8 million on Wellsville. (AC, ¶ 266 and Exhibit S.) By comparing these two documents, Plaintiff implies that Defendants knew OHM projects would eventually have to be written off but chose not to do so because they wished to present a more positive financial picture of the Company.

In reviewing Exhibit CC, the Court concludes that Plaintiff has "cherry-picked" the worst outcomes from the list of some 30 projects while ignoring more positive results. For instance, on the Monticello projects, Plaintiff's implication that the strength of this claim was "highly questionable" is undercut by the amount of missing information. That is, although ITG inherited this project in 1998, there is no indication of when it was completed or the type of contract. If the contract were a progress payment contract, for example, nothing can be inferred from the fact that $4.1 million in claims were yet to be submitted. Contrary to Plaintiff's assertion in the Amended Complaint, the two projects which settled for $435,000 appear to have been originally worth $2.9 million, not $6.7 million. Even if Plaintiff were correct, the Court finds that the amount of an acceptable settlement is a business decision, not a matter subject to regulation under the securities laws. Second, contrary to Plaintiff's assertion that collection on the Coakley project was questionable, the Company had just received $1.1 million on summary judgment out of a possible $1.6 million claim, while continuing to pursue the balance of a $7.4 million claim plus possible triple damages and attorney fees. In the fourth quarter of 2000, the parties to the Coakley claim settled their lawsuit with ITG receiving approximately $3.1 million from the customer but continuing its suit against the project engineering design firm. The Company's successful pursuit of another OHM acquisition claim which Plaintiff describes elsewhere as uncollectible, Sterling Winthrop, is reflected in the fact that Exhibit CC notes that the claim had closed with "all outstanding amounts now received, including insurance claim amounts."Finally, as late as April 2001, ITG was successfully collecting OHM receivables that Plaintiff describes as "doubtful at best." Plaintiff's Exhibit L, a memo from DeLuca to the Board members dated April 5, 2001, notes that the Company had just received a $9.1 million jury verdict in the Earth Tech litigation. DeLuca wrote: "The total award is estimated at $10 to 11 million, compared to a book value of $1.5 million."All of these successful collections undercut Plaintiff's blanket assertion that ITG did nothing to address these allegedly uncollectible receivables.

***17** The Court agrees with Defendants that Plaintiff's reliance on the write-down of uncollectible receivables in December 2000 and December 2001, many of which were associated with OHM, is inadequate to establish that either DeLuca or Soose knew that those accounts receivable were uncollectible during the Class Period and therefore knowingly allowed the Company's financial statements to be overstated by their inclusion.

Plaintiff again asks the Court to draw conclusions of reckless or fraudulent behavior simply by setting out evidence that the Company's directors and officers were aware of the problems associated with collecting OHM receivables. To some extent, Plaintiff appears to be equating a culpable state of mind with knowledge and concern. The fact that Defendants systematically reviewed the collectibility of certain accounts receivable in the summer of 2000 does not necessarily lead to the conclusion that they thereafter fraudulently manipulated the Company's financial picture by refusing to write off

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those accounts, much less that they had done so prior to the review. The Audit Review Committee discussions of pending litigation and projects that were in prolonged negotiation with customers reflect that it was functioning properly, not developing a scheme to defraud investors.

Plaintiff repeatedly alleges, but never explains why, a particular account receivable was uncollectible. With the benefit of hindsight, any account which is ultimately written off can be considered uncollectible. But there is no allegation that during the Class Period the Individual Defendants knew a particular account was uncollectible *in toto,* only that they were aware that certain accounts might not be collected in full. For those accounts, the evidence shows that the Company set aside reserves as it should have. (*See, e.g.,* AC, Exhibit AA, the minutes of September 20, 2000, Audit Committee meeting discussing possible adjustments in reserves as more was learned about the collectibility of accounts). While management should be expected to reasonably estimate whether the collectibility of a particular account receivable is “highly questionable” or of a “tenuous nature” as Plaintiff argues or, conversely, a good bet, the accuracy of that estimation can only be determined after the fact. As Judge Friendly wrote, while “greater clairvoyance” might have allowed Defendants to predict subsequent developments, “failure to make such perceptions does not constitute fraud.” *Denny v. Barber,* 576 F.2d 465, 470 (2d Cir.1978). Had Defendants taken no action on the OHM accounts receivable, Plaintiff would have a stronger argument that they recklessly or willfully misrepresented the total accounts receivable by including amounts they knew were questionable. But the exhibits provided by Plaintiff himself, including Exhibits L and CC, show that the Company pursued those accounts-with at least some success-from 1998 through and including the second quarter of 2001.

***18** Because Plaintiff has failed to cite-and the Court's review of the voluminous documentation submitted by both parties has failed to disclose-any contemporaneous statement by any Defendant from which one could infer he believed that collectibility of any specific account was questionable, it is only with the benefit of hindsight that Plaintiff has arrived at this claim. A business decision to pursue, rather than write-off, certain accounts receivable or even the ultimate lack of success in pursuing those accounts-without more-does not expose management to liability under the securities laws.

As the final point on the issue of collectibility, Plaintiff points to the fact that when Ernst & Young was preparing the financial statements for fiscal years 1998, 1999, and 2000, the auditors required Defendants DeLuca and Soose to take “the highly unusual step” of providing a list of specific claims and change orders, including receivables for several OHM projects.[FN27] In each instance, management represented that “[t]here is a legal basis for recognition of the claims and change orders included ... for the amounts recorded as assets in the financial statements.”(AC, ¶¶ 245-246 and Exhibit Q).[FN28] Plaintiff claims that the 2001 representation letter in particular shows that “receivables for each of these projects were offset by reserves of approximately 50%, demonstrating again the widespread knowledge that these were dubious claims.”(AC, ¶ 246).

FN27. Plaintiff also relies on a letter to Ernst & Young from the ITG Controller, James J. Pierson, dated March 24, 2000, in which Mr. Pierson states that Ernst & Young was entitled to rely on the “unaudited historical data” as well as ITG management's assumptions and forecasts, and acknowledged that the terms of the auditor's engagement did not require it to update its analysis for events occurring after the auditors issued a valuation analysis of certain “built-in gain assets” in 1998. (AC, ¶ 256 and Exhibit U). Although Plaintiff alleges that this letter is also unusual and reflects Ernst & Young's concerns about the “dubious value of OHM as-

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sets," he has failed to explain these speculative statements in the brief in opposition to the motion to dismiss and nothing in the Amended Complaint or Exhibit U itself indicates what caused Ernst & Young to request this letter.

FN28. The full text referenced to by Plaintiff appears in the section of each representation letter entitled "Receivables." Defendants DeLuca and Soose stated, in relevant part, that "receivables represent valid claims against the debtors indicated and do not include amounts for ... services provided on contingent approval or other types of arrangements not constituting sales."(AC, Exhibit Q, letter of February 15, 1999, at page 4). The letter goes on to say "unbilled and other receivables resulting from unapproved change orders and claims relate to contract costs to which the Company has a legal basis to recover and are generally recorded at zero percent margins. The evidence supporting the claims are [sic] objective and verifiable. The costs incurred on the contracts to which corresponding amounts of revenue are recorded were caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the Company's performance. These costs are identifiable or otherwise determinable and are reasonable in view of the work performed. We believe these receivables will be fully realized. There is a legal basis for recognition of the claims and change orders included [in an appendix] for the amounts recorded as assets in the financial statements."(*Id.*) Comparable language appears in the letters dated February 18, 2000, and February 14, 2001, also included in Exhibit Q.

There is no factual allegation to support Plaintiff's contention that Ernst & Young required such a letter because of its "increasing concerns about the collectibility of IT Group's claimed receivables."(AC, ¶ 245). Nor does Plaintiff explain, either in the Amended Complaint or in the brief in opposition to the motion to dismiss, why he considers this requirement "highly unusual." The statement about there being a legal basis for the claims is only one of many regarding internal documentation and financial analyses on which Ernst & Young could rely in preparing the audited financial statements. Other documents and analyses include: minutes and contracts, disclosure of risks and uncertainties, related party transactions, and methods for revenue recognition. Finally, if the Court is expected to conclude that Messrs. DeLuca and Soose knew when they signed the management letters that there was no legal basis for recognition of the amounts recorded as assets in the financial statements, Plaintiff provides no factual foundation for that speculation.

c. Improper purchase accounting: Plaintiff claims that some OHM write-offs were disguised through "purchase accounting." FN29 In support of this argument, he points first to "apparent" purchase accounting adjustments taken for OHM projects, as shown in a December 1, 2000, spreadsheet which includes some $12.7 million associated with seven OHM claims. (AC, ¶ 253; *see* Exhibit S, page 1). Next, he refers to the minutes of the July 25, 2000, Audit Review Committee meeting FN30 which note that a "correction to OHM acquisition accounting, $10 million" was taken as a retroactive purchase accounting adjustment, because it was written off against goodwill rather than taken as an expense, thus avoiding the disclosure of a write-off. He further claims that a spreadsheet dated March 13, 2001, shows the $10 million write-off was "disguised" as a "purchase accounting utilization." (AC, ¶ 257 and Exhibit V). Finally, a July 21, 2000 spreadsheet FN31 addressing revenue recognition in connection with the LandDiv program, also part of the OHM acquisition, recommends $3.7 million of write-offs, but notes that $2.5 million of that can be eliminated through "purchase accounting" and $830,000 through application of a reserve. Thus,

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the late 2000 special charge included only $1.8 million from the LandDiv program, not the total of $3.7 million. (AC, ¶ 258 and Exhibit W).

FN29. Defendants argue that Plaintiff's allegations are illogical because the fraud alleged concerning OHM receivables would make the Company's financial picture appear worse, not better. Had Defendants determined that the OHM receivables were uncollectible, they would have been motivated to write them off during the allocation period, not keep them on the books since the receivables would ultimately have to be posted as a loss. Plaintiff counters that Defendants never intended to write off the uncollectible receivables and were forced to do so only when the Company was on the verge of bankruptcy in late 2001. This is a factual dispute better left to a later stage of the litigation when accounting experts are permitted to opine on such subjects. *In re Burlington,* 114 F.3d at 1421. The Court need not address these arguments, however, because, as discussed in the text above, the Court finds that the allegations of improper purchase accounting are speculative and based on theoretical violations of GAAP provisions which did not exist at the time the Company made those adjustments.

FN30. Plaintiff refers to the minutes of the July 25, 2000 meeting in his Amended Complaint, which are provided as Exhibit T. (AC, ¶ 257). The Court has been unable to confirm any reference to a "correction to OHM acquisition accounting, $10 million" in those minutes or in the minutes of any other Audit Review Committee or Board meeting.

FN31. The spreadsheet is dated July 21, 2000, but the cover memo is dated October 4, 2000. No Defendant is listed among the recipients of this memo.

***19** Plaintiff claims all these documents support the allegation that ITG engaged in "highly unusual accounting" activities because, generally speaking, "purchase accounting adjustments are restricted to one year from date of transaction."(AC, ¶ 257). This allegation is substantiated by Plaintiff's Exhibit HH, entitled "Issues List for FYE December 28, 2001," and dated December 3, 2001, showing that ITG regularly took purchase accounting write-downs over a two-year period.[FN32] While conceding that such a practice was "technically allowable at the time it was done," Plaintiff argues that it was to be done only in "exceptional circumstances" and not as a regular practice. (AC, ¶ 302). Moreover, even if such adjustments were made within the proper 12-month period, they would have to be disclosed as a "requirement of good accounting practice, as later confirmed by issuance of FAS 141 effective in 2001."[FN33] (*Id.*)."Such disclosure would have alerted investments [sic] that either Defendants were over-paying for acquisitions on a regular basis, or IT Group was engaged in irregular accounting practices to inflate revenues."(AC, ¶ 301).

FN32. Plaintiff alleges that ITG engaged in this same kind of accounting manipulation with regard to acquisitions other than OHM. *See, e.g.,* AC, ¶¶ 352-353, pertaining to the EMCON acquisition in the Spring of 1999 and the acquisitions listed in AC, Exhibit HH.

FN33. FAS 141, which superseded the accounting guidelines discussed in the text, is applicable only to business combinations "initiated after June 30, 2001." (Becker Decl., Exhibit U, at 5).

Plaintiff concedes that the GAAP provisions [FN34] which were in place at the time OHM was acquired permitted ITG to record pre-acquisition contingencies, *i.e.,* foreseeable losses or contingent assets, as part of the fair market values of acquired assets and liabilities if the acquiring entity could show (1) it was probable that the contingency in existence as of the date of the acquisition would actually occur,

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and (2) the amount of the contingency could be reasonably estimated at the time of acquisition. (Becker Decl., Exhibit W, Statement of Financial Accounting Standards No. 38, “FAS 38,” dated September 1980, ¶ 5).FN35 A further complication arises when the contingency probably will occur, but its amount cannot be estimated as of the acquisition date. This situation opens an “allocation period” allowing the pre-acquisition contingency to be recorded at a later date as part of the purchase accounting if: (a) additional information regarding the contingency is required; (b) the additional information is known to be available; (c) arrangements have been made to obtain the additional information; and (d) efforts to obtain the information are continuing. The allocation period closes when it is no longer reasonable to wait for more information and “usually” will not exceed one year from the acquisition date. (FAS 38, ¶ 4.b).

FN34. The Court recognizes that in examining alleged GAAP violations on a motion to dismiss, it is inappropriate to make a factual determination as to whether the company violated a specific accounting rule, particularly where such a ruling would require interpretation and application of complex accounting principles. *See, e.g., Fla. State Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 666 (8th Cir.2001). However, the issue in this case is not so much a complex GAAP interpretation as it is applying the GAAP provisions which Plaintiff concedes were in place prior to 2001 and which, in the Court's view, are not particularly complex as applied to the facts herein.

FN35.*See also* Becker Decl., Exhibit V, Accounting Principles Board Opinion 16, “APB 16,” effective August 1970, which was amended by FAS 38.

Plaintiff's allegations that the Company indulged in improper purchase accounting fail for two reasons. First, like the allegation that valuation of the OHM accounts receivable was questionable because two years after the merger in which Ernst & Young acted as auditor for both OHM and ITG the SEC issued a regulation prohibiting such activities, the Court considers this allegation to be an “anticipatory GAAP violation,” for lack of a better phrase. That is, the changes in FAS 38 which required purchase price adjustments to be taken within one year and disclosure of those adjustments did not occur until June 2001 when FAS 141 went into effect, well after the events in question. Secondly, Plaintiff simply mis-states the accounting provision when he argues that the adjustments must be taken within the fiscal year in which the acquisition was made. The regulation states that “although the time will vary with circumstances,” the “usual” period in which to take such contingent adjustments is “one year from the consummation of a business combination” which, depending on the timing of events, could theoretically extend over two fiscal years of the company. (FAS 38, ¶ 4.b).

***20** In view of the *post hoc* nature of Plaintiff's allegations, the Court declines to draw any inference that Messrs. Soose and DeLuca were aware of, much less recklessly allowed, improper purchase accounting in connection with the OHM acquisition.

d. The success of the OHM integration: Plaintiff alleges that DeLuca falsely presented the integration of OHM as successful when, in reality, the acquisition was plagued with problems in addition to the accounts receivable issue. On October 21, 1998, for instance, ITG issued a press release which Plaintiff characterizes as a “glowing report” about the Company's success in increasing revenues, attributed primarily to the acquisition of OHM. (AC, ¶ 333). Plaintiff alleges that the press release was false and misleading, in part because it claimed that all business lines were doing well and OHM was well-integrated into the Company.

In the press release cited by Plaintiff, DeLuca is quoted as saying:

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> The fundamentals of generally all business lines are tracking well with our operating plan....
>
> The integration of OHM is complete. All actions necessary to achieve our cost savings targets have been taken, and our organization is totally focused on serving clients and pursuing our markets. Cost savings produced during the integration further reduced SG & A expenses (excluding goodwill amortization) to 4.2% of revenues in the current quarter.

(AC, ¶ 333).

The Court finds that the statements to which Plaintiff objects may reasonably be described as inactionable expressions of corporate optimism. *See* *In re Aetna,* 34 F.Supp.2d at 945 (" 'puffing' statements-that is, vague expressions of corporate optimism and expectations about a company's prospects-are not actionable because reasonable investors do not rely on such statements in making investment decisions"); *see also* *Grossman v. Novell, Inc.,* 120 F.3d 1112, 1121-1122 (10th Cir.1997), holding that statements that a company had experienced "substantial success" integrating its sales force, that a merger was moving "faster than we thought," and that "by moving rapidly to a fully integrated sales force, we are leveraging our combined knowledge and expanding scope of network solutions" were inactionable statements of corporate optimism.

Plaintiff offers only a blanket assertion that the statutory safe harbor [FN36] does not apply to "any of the allegedly false statements pleaded in [the] complaint" or, alternatively, that those statements related "to then-existing facts and conditions and were not forward-looking."(AC, ¶¶ 475-476). However, this is far too broad a generalization to be applied to every allegation in a 486-paragraph complaint. The Court is not required to accept such "bald assertions" or "legal conclusions." *Chubb,* 394 F.3d at 143. Plaintiff makes no allegations from which to infer that in October 1998, DeLuca knew that the OHM integration-which had begun only six months before-would ultimately not be successful or even what "complete" integration entailed. Accordingly, the Court cannot infer that he knew the statement was false when it was made. In fact, other than problems associated with accounts receivable and the Oracle computer system which contributed to these problems, the Court has been unable to pinpoint any other factual allegations regarding integration problems.

FN36. As defined in the Reform Act, a forward-looking statement (written or oral) is one which contains "a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items."*See* *In re Advanta,* 180 F.3d at 536,*quoting*15 U.S.C. § 78u-5(i)(1)(A). A forward-looking statement may also address "the plans and objectives of management for future operations."15 U.S.C. § 78u-5(i)(1)(B). Such statements are said to fall within the "statutory safe harbor" of the Reform Act and are not grounds for liability under Section 10(b).*In re Advanta, id.*In order to fall within the safe harbor, a forward-looking statement must be identified as such and "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." *EP Medsystems, Inc. v. EchoCath, Inc.,* 235 F.3d 865, 872-873 (3d Cir.2000), *quoting*15 U.S.C. § 78u-5(c)(1)(A)(i). Cautionary language must be "extensive yet specific." *In re Trump Casino Sec. Litig.,* 7 F.3d 357, 369 (3d Cir.1993).

> By definition, statements which are not forward-looking are not entitled to protection of the statutory safe harbor provision. Also explicitly excluded are any forward-looking statements "included in

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a financial statement prepared in accordance with generally accepted accounting principles."15 U.S.C. § 78u-5(b)(2)(A). Nor does the safe harbor provision apply if the statement was made by a natural person (as compared to a business entity) who had "actual knowledge" at the time that the statement was false or misleading. 15 U.S.C. § 78u-5(c)(1)(B)(i). If a forward-looking statement later proves to be erroneous, there is no duty imposed by the Reform Act to update such a statement. 15 U.S.C.A. § 78u-5(d).

***21** In sum, Plaintiff has failed to establish any material false or misleading misrepresentations regarding the OHM acquisition.

2. *The Company's accounting manipulations and violations of loan covenants:* Plaintiff argues that Defendants' scheme for making a "very troubled, insolvent company" appear healthy and profitable was accomplished in two ways: (1) "vastly" understating the Company's debt and overstating liquidity each quarter by artificially manipulating its revolving debt balance; and (2) "wildly" inflating receivables by overstating billed receivables while understating unbilled receivables and including as receivables unapproved change orders and other amounts which were uncollectible. The Company thereby created the misleading impression that it had a substantial cushion of credit, was meeting its loan covenants, and was progressing satisfactorily in its publicly-stated goal of debt reduction. In fact, Plaintiff claims, ITG suffered from a "prolonged liquidity crisis" and had virtually exhausted its available credit for "a substantial portion of the Class Period-a sure sign that bankruptcy was an imminent threat."(AC, ¶ 29). These allegations are discussed *seriatim.*[FN37]

FN37. Plaintiff makes certain allegations about Revolver usage in 2000 and 2001 and about the $100 million Term C Loan which repeat allegations made in the *Payne* Second Amended Complaint. *See, e.g.,*AC ¶¶ 103-104, 115-119, 124-137, 145-150, 331, 433, 442-445, 449. The inter-related issues of accounting manipulations and violation of loan covenants are discussed at length in *Payne,* 433 F.Supp.2d at 587-600. Only new factual allegations are discussed herein.

a. Accounting manipulations: Plaintiff argues that during the Class Period, Defendants greatly understated the Company's total indebtedness by manipulating the credit line downward to the lowest point on the last day of each quarter. This was chiefly accomplished in two ways: (1) postponing payments, particularly to vendors and subcontractors, until the next quarter in order to avoid using the Company's only source of ready cash, and (2) sweeping the Company's divisions for cash and paying down the Revolver, knowing that immediately after the beginning of the next quarter, those amounts would be re-borrowed, moving the debt back to its previous levels. The manipulation of the credit line affected the financial statements in the Forms 10-K for 1998 and 1999 and in the Forms 10-Q for the first three quarters of 1999. Plaintiff asserts that Defendant Soose made the scheme an entrenched way of doing business during the second half of 2000 and throughout the *Payne* class period. Plaintiff further alleges that liquidity position memos provided to Defendants Soose and DeLuca each business day from 1998 through 2001 showed the true extent of the Company's indebtedness. According to Plaintiff, the pattern evident in these memos supports his allegation that the Company was manipulating the revolving credit line balance and hence its reported indebtedness. These quarterly "gyrations" were admitted by Soose[FN38] and the former ITG Treasurer, Richard Conte (Conte), in depositions and confirmed by other internal Company documents. (AC, ¶ 28).

FN38. While Plaintiff concedes that Soose "did not admit to outright manipulation of the cash flow to obtain the desired numbers," he characterizes Soose's testimony

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> as an "admission as to the overall pattern followed by Defendants to obtain the numbers [which] when coupled with other information alleged herein reflects that manipulation was in fact the means used to achieve the result."(AC, ¶ 120).

Although Plaintiff's allegations pertain to information made public during the Class Period, there are few substantive allegations on this topic which have not already been addressed. *See Payne,* 433 F.Supp.2d at 593-594. Examples of new allegations include Conte's deposition testimony that "my first recollection of, quote management, whatever we could manage to meet a covenant, was at the end of 1999."(AC, ¶ 120). Conte is never quoted as explaining what that "management" entailed. He further stated he was told by an unidentified person that "one of the things we'll need to do is manage the payables through year-end to meet a covenant," particularly the loan covenant reflecting debt to EBIDTA, the covenant which "gave us ... the most difficulty." (*Id.*) The first part of this statement reflects what has already been well-established-that the Company and Defendants knew the implications of taking on heavy debt in order to pursue its acquisitions plan. But both that debt and the implications thereof were revealed to the public. (*See, e.g.,* Becker Decl., Exhibit G, at 19-20, discussing the Company's substantial leverage and ability to service debt; and at 40-41 discussing liquidity). The second part of the allegation regarding the need to "manage the payables" is too vague as to time, source or circumstances to establish scienter on the part of any Defendant.

***22** Once again, Plaintiff resorts to generalizations and relies on events which occurred well after the Class Period. For instance, in discussing the practice of paying down the revolving loan in order to create the false impression that the Company had access to a greater amount of credit than it did, Plaintiff argues that both Soose and DeLuca received the memos reflecting Soose's inception of the scheme and the operation of the scheme. (*See* AC Exhibit F, PL 2-10, a series of three memos which discuss financial projections in 2000). A review of Exhibit F at PL 2-3 shows the first memo to Soose and DeLuca was dated July 14, 2000, almost five months after the end of the Class Period. The memo presents two cash flow forecasts prepared by Conte, not Soose, described as "calculations of requirements to keep A/P [accounts payable] from further deterioration from the current situation."There are no references to paying down the revolving loan at the end of any quarter; in fact, the memo focuses on anticipated accounts receivable, presumably the source for covering accounts payable. There is nothing in this first memo from which one may infer that Soose initiated the so-called scheme. The second memo, dated August 3, 2000, is addressed only to Soose and includes a statement from which one could infer that he proposed "managing" accounts payable, *i.e.,* a reference to a cash forecast entitled "Harry Soose '$710' Managed A/P."(AC, Exhibit F, at PL 4-9). Conte wrote "in [that] forecast, we managed A/P in the September and December time periods ... to deal with Total Debt Outstanding Goals of $709 million at September 30 and $615 million at December 31, 2000."The final memo in this group (AC, Exhibit F, at PL 10) shows only that as of November 13, 2000, the Company anticipated falling some $26.4 million short of its goal of paying down the debt to $635 million as of the end of the year.

Based on the foregoing memoranda, the most that reasonably may be inferred is that to the extent there was a "scheme" to create the false impression that the Company had greater credit than it truly did by manipulating accounts payable, Soose did not play any role in that scheme until mid-July 2000 at the earliest, well after the end of the Class Period.

Plaintiff also alleges that Defendants Soose and DeLuca knew, not later than November 13, 2000, that the Company had begun withholding payments to vendors from July 11, 2000.[FN39](*See* AC Exhibit F at PL-10). But there is no allegation that this activity occurred during the Class Period or that Defend-

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ants had concocted a plan to do so during that time.

> FN39. The Court finds that this may be an over-generalization of the content of this memo which states “we have not moved general A/P date beyond 7/11/00 (applies only to CEC and SGA expenses.)”Not knowing what the parenthetical expression denotes, however, the Court will accept Plaintiff's assertion that the Company withheld payment on payables in general from July 11 onward.

Even accepting Plaintiff's contention that Soose instituted a practice of deliberately paying down the credit line at the end of each quarter, he has failed to establish why this practice constitutes fraud, violated the terms of the loan agreements, GAAP, or any SEC regulation, or why it should have been disclosed to the market. As noted in *Payne,* the practice of writing checks to vendors in one quarter but not sending them out until the next would have the effect of increasing actual cash on hand at the end of the quarter, but the Company's accounts payable total would have decreased concomitantly. There are no allegations that the Company was keeping two sets of books to hide these actions. Also, the Court determined in *Payne* that the lending banks received not only the Monthly Compliance Letter Packages which Plaintiff contends show the true amount of the Revolver balance, but also the quarterly reports to the SEC. The banks therefore easily could have detected the pattern of paying down the Revolver at the end of each quarter only to borrow again immediately thereafter. *See Payne,* 433 F.Supp.2d at 585. In order to accept Plaintiff's theory that paying down the credit line at the end of each quarter was fraudulent, one also must infer that the banks fostered this fraud by ignoring the fact that the SEC filings were materially different from the reports provided only to them.

***23** Finally, Plaintiff argues that evidence of scienter on the part of all Defendants regarding manipulation of the revolving credit line is well established by the fact that the Company's bankruptcy trustee and creditors committee filed complaints against all Defendants alleging that the Company was insolvent in 1998, Defendants knew this, and failed to address the insolvency. (AC, ¶ 95). The Court declines to accept as evidence of scienter an allegation made in a separate lawsuit in another forum.

The Court concludes that none of the new allegations establish scienter on the part of Defendants DeLuca or Soose with regard to misrepresentations about the Company's revolving credit line. As the court held in *Kushner v. Beverly Enterprises, Inc.,* 317 F.3d 820, 827-28 (8th Cir.2003), allegations that defendants “designed and implemented” improper accounting practices fail to state a claim for securities fraud in the absence of “allegations of particular facts demonstrating how the defendants knew of the scheme at the time they made their statements, that they knew the financial statements over-represented the company's true earnings, or that they were aware of a GAAP violation and disregarded it.”*See also In re Alpharma,* 372 F.3d at 150 (*citing Kushner.*)

b. Violation of loan covenants:[FN40] Based largely on Soose's deposition testimony in the Company's bankruptcy proceedings, Plaintiff alleges that “the company knew and it was widely understood” that cash flow at the end of quarters was critical to achieve loan covenant compliance. (AC, ¶ 120). Therefore, as discussed *supra,* cash flow was managed so the Company could meet its loan covenants. Plaintiff alleges the Company should have disclosed that absent the scheme to manipulate the revolving credit line balance, the Company was in violation of those covenants. (AC, ¶ 449).

> FN40. The Court will address only new factual allegations pertaining to events during the Class Period or those which shed light on the scienter of Defendants at that time. The Court has not addressed the argument in this section regarding presentations made by Confidential Witness 3 to the Board in 1999, 2000 and March 2001

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regarding the “Company's problems” with liquidity and working capital issues (*see, e.g.,*AC, ¶ 312) or the conclusions of the bankruptcy examiner's report regarding an actual or expected covenant default in the spring of 2000 (AC, ¶ 101) because these were addressed in *Payne.*Similarly, the Court is not considering the allegations concerning the “scheme and policy to manipulate the level of the revolver” carried out at the end of the first quarter of 2001 so that the Company could meet the debt leverage loan covenants (AC, ¶ 133) or DeLuca's sale of his Company stock in October-November 2001 (AC, ¶ 460), because these events occurred well after the Class Period and Plaintiff has made no allegations which tie those events to Defendants' knowledge at an earlier time.

Plaintiff further contends that the Board of Directors had to be aware of these facts. For instance, the minutes of the Board meeting of December 17, 1999 (attended by all Individual Defendants), state that DeLuca and Soose “emphasized the goal of reducing debt by approximately $100 million to achieve compliance with the company's credit agreement loan covenants.”(AC, ¶ 122).[FN41] Only three months later, however, the Company increased its debt by $100 million rather than decreasing it by that amount. Plaintiff concludes that “only willful blindness could obscure [the fact] that the Company was not in compliance with its loan covenants according to its true financial condition in the ordinary course of business.”(*Id.*) The fact that the Board discussed the requirements of meeting loan covenants in December 1999, then increased its debt in March 2000 does not necessarily lead to Plaintiff's conclusion. That is, although each of the factual allegations may be true, his conclusion that the Individual Defendants must have known that the Company was in violation of its loan covenants simply because the Board members discussed the goal of meeting those covenants does not follow necessarily.

FN41. The Court is unable to identify these minutes within the exhibits provided by the parties. In his brief, Plaintiff attempts to rely on a memorandum from DeLuca to the Board members dated January 31, 2000, referring to the discussion at the December 17, 1999 meeting. (Declaration of Robert M. Zabb in Opposition to Motion to Dismiss First Amended Complaint, Docket No. 64, Zabb Decl., Exhibit C.) The memorandum states: “As discussed at the last Board meeting, the Company needed to pursue a near-term financing alternative to address liquidity and existing loan covenant constraints.... The new term debt will primarily be used to pay down the revolver and provide additional capacity for working capital purposes.”The Court declines to draw any inferences from this memorandum inasmuch as the January 31, 2000, memo is not mentioned in the Amended Complaint and was improperly submitted in response to the motion to dismiss. *In re Burlington,* 114 F.3d at 1426 (the court may not consider documents extraneous to the pleadings except those which are “integral to or explicitly relied upon in the complaint”). As any arguments based on these exhibits are improperly raised in Plaintiff's brief in opposition, the Court will disregard them for purposes of deciding the motion to dismiss. *See In re PDI Sec. Litig.,* CA No. 02-211, 2005 U.S. Dist. LEXIS 18145, *48 (D.N.J. Aug. 17, 2005).

***24** Plaintiff alleges that if the Company had used its average Revolver usage during each reporting period, it would have violated its loan covenants on a regular basis. For instance, in the fourth quarter of 1999, the report to lenders stated that the Company-with a 4.32 leverage ratio [FN42]-was in compliance with its 4.5 loan covenant. However, had the calculation been made using the quarterly average Revolver usage, rather than the artificially paid down

balance, the leverage ratio would have been 4.52. (AC, ¶ 148). Building on this reasoning, Plaintiff further alleges that such a violation would have caused the Company to default on its loans. (AC, ¶ 31). That default in turn would have caused the principal of the loans to become immediately due. Consequently, the SEC filings violated GAAP because ITG failed to report its indebtedness as a current instead of a non-current liability on its balance sheets.

FN42. The leverage ratio is calculated by dividing total debt by EBITDA for the period.

The Court finds these allegations insufficient to establish either misrepresentations or scienter on the part of any Defendant because the loan covenant violations alleged by Plaintiff are entirely hypothetical. The fact that the Board of Directors knew loan covenant violations were an ongoing *possibility* does not mean such violations *actually occurred.* There is no allegation that the lenders were unaware of or willfully ignored violations or failed to recognize that compliance was achieved only by accounting legerdemain. When the Company was in potential default of its loan covenants in December 2000 (eleven months after the end of the Class Period), it was forced to renegotiate the loan terms, a fact which was disclosed to the public in the Form 10-K issued on March 20, 2001. (Becker Decl., Exhibit K, at 17). As discussed in *Payne,* Plaintiff has not shown that the terms of any credit agreement required (or even permitted) loan covenant calculations to be made using the average Revolver usage rather than the amount outstanding at the end of the last day of the reporting period. (Becker Decl., Exhibit K, Form 10-K for 2000, Exhibit 10.11.2, Amendment No. 1 to the Second Amended and Restated Credit Agreement, December 21, 2000, at 6-8). Consequently, the alleged GAAP violations for reporting indebtedness as a current rather than non-current liability in the SEC filings are even more hypothetical.

3. *Misleading statements about the Company's financial condition in SEC filings and press releases:* Plaintiff contends that every SEC filing and press release issued during the Class Period was false and misleading because they incorporated the aforementioned accounting manipulations, or failed to disclose the Company's liquidity issues, thereby presenting a false picture of the Company's financial condition.

a. Statements in SEC filings: Plaintiff's claims regarding false and misleading statements in the SEC filings issued between November 1998 when the Form 10-Q for the third quarter of 1998 was filed and February 23, 2000, the end of the Class Period, are exact duplicates of the claims made in *Payne.*FN43 For instance, Plaintiff contends that the Company's Form 10-Q for the third quarter of 1998, filed with the SEC on November 9, 1998, misrepresented the proportion of billed receivables to unbilled receivables and violated GAAP by including within accounts receivable some $18 million of claims and unapproved change orders that management believed were "probable of realization." According to Plaintiff, ITG should have disclosed to the investing public-as it did to its banks in the Monthly Compliance Letter Packages-(1) that its total receivables were not more than $230.6 million, (2) that the proportion of billed to unbilled receivables was heavily skewed toward the less collectible unbilled receivables, (3) that of the claimed receivables, $45 million consisted of unapproved change orders, (4) that the total receivables were "highly impaired" because of the Company's violation of pay-when-paid requirements, and (5) that the receivables were overstated because the amounts improperly included purchase price adjustments recorded during acquisitions as well as non-reimbursed cost overruns. (AC, ¶¶ 187, 339-342).FN44 The Court need not revisit these arguments which were addressed throughout the *Payne* Opinion and differ only as to the period in which the SEC filings were made.

FN43. Plaintiff also claims that the SEC filings violated 17 C.F.R. § 229.303 and

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SEC Regulation S-K. *See Payne,* 433 F.Supp.2d at 574 n. 25.

FN44. Other allegations of discrepancies between SEC filings and the Monthly Compliance Letter Packages are essentially the same as in *Payne. See, e.g.,* allegations that the difference between total receivables reported in the 1998 Form 10-K and the total receivables reported in the Monthly Compliance Letter Package for the fourth quarter of 1998 included $55 million in unapproved change orders, therefore misleading investors not only as to quantity of receivables, but as to their quality inasmuch as billed receivables were overstated and unbilled receivables understated. (AC, ¶ 171; *see also* ¶ 173, making the same claim with regard to the Form 10-Q for the first quarter of 1999 and the April 28, 1999 Monthly Compliance Letter Package). As stated above, there is no need to reconsider these allegations simply using data from the earlier period.

***25** One matter not addressed in *Payne,* however, which Plaintiff contends is an example of improper accounting for accounts receivables, leading in turn to false and misleading information in the SEC filings, requires some discussion. Plaintiff claims that the Fernald project, part of the GTI Fluor Daniel acquisition in December 1998, "was known by Defendants to be a fiasco during the Class Period."(AC, ¶ 244). David Hill objected to the Company's recognition of revenues from the Fernald project, apparently in part because the customer had denied a $12.9 million change order in October 1998. Ernst & Young reported to the Audit Review Committee on October 20, 1999, that there was "still uncertainty" as to whether a revised change order would be accepted by the client. (AC, ¶ 242). As late as September 12, 2000, receivables on the Fernald project were still questionable and Plaintiff claims that until December 2000, the Company reported Fernald receivables separately from other billed receivables "because of their uncertain collectibility." (AC, ¶ 244.)A quarterly management package dated June 29, 2001, showed that all accounts receivable not categorized as "disputed" or from the Fernald project were included in billed accounts receivable in the SEC filings. (AC, ¶ 185, and Exhibit N). In December 2001, Defendants wrote off $1 million of Fernald receivables. Plaintiff claims that the magnitude of this write-off, "which [was] improperly delayed despite Defendants' close scrutiny of the situation, indicates scienter."(AC, ¶ 274 and Exhibit HH, noting that Fernald was written off as part of "cash acceleration strategy/timing of revenue recognition").

All that may be reasonably inferred from these allegations is that Fernald was a problem project and that Defendants were aware of that fact. Plaintiff's conclusion that the Company separately identified Fernald receivables because of "their uncertain collectibility" is sheer speculation because Plaintiff provides no factual support such as a statement by a confidential witness who was familiar with the Company's accounting practices. It is not even clear to the Court what fraudulent activity is being alleged in connection with the Fernald project, other than a delay in writing off the receivables. Although Plaintiff asserts that Fernald receivables totaled $33.2 million as of December 1999, $32.4 million as of March 2000, $28.7 million as of June 2000, and $27.9 million as of September 2000, there is no allegation as to what part of those receivables should have been written down at a particular time. "[E]ven a delinquent write-down of the impaired assets, without anything more, does not state a claim of securities fraud, stating at best a bad business decision." *In re ICN Pharms., Inc. Sec. Litig.,* 299 F.Supp.2d 1055, 1065 (C.D.Cal.2004). It appears that Plaintiff has simply identified a project with accounts receivable problems and set forth numerous financial facts about it, including internal reports that categorize its receivables in a way which differs from how those receivables are reported in the SEC filings. Although a plaintiff need not allege every individual improper

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transaction when stating a fraudulent accounting claim, the complaint must set forth enough information to allow the Court to determine if the alleged violations "affected the company's financial statements and whether they were material in light of the company's overall financial position." *Sparling v. Daou (In re Daou Sys. Sec. Litig.),* 411 F.3d 1006, 1018 (9th Cir.2005). Simply alleging that Fernald was a known fiasco does not state a claim for securities fraud.

***26** For the reasons discussed in *Payne,* 433 F.Supp.2d at 590-597, the Court concludes that Plaintiff has failed to establish that any SEC filing prior to or during the Class Period contained material misrepresentations about the Company's financial condition.

b. Statements in press releases: Plaintiff contends that press releases issued on October 21 and October 28, 1998, and on February 23, March 3, April 12, April 21, May 11, May 17, May 27, July 21, and October 26, 1999, were all false and misleading for two reasons. First, they failed to disclose the problems with the acquisition program, namely, that the Company was having trouble covering the increased debt, the acquired companies were not producing adequate revenues and efficiencies, and the Company had violated GAAP by failing to make price adjustments at the time of acquisitions which should have resulted in write-downs of the receivables from the acquired companies. Second, the press releases were false and misleading because they failed to disclose the Company's ever-increasing liquidity crisis. (*See*AC, ¶¶ 333-338, 347-353, 368-369; 373-374; 384-391 and 412-414).[FN45]

> FN45. Plaintiff also refers to false and misleading press releases from February 24, 2000, through October 30, 2001; these have already been addressed in the *Payne* Opinion. The Court has declined to consider allegations based on certain press releases issued by Donaldson Lufkin & Jenrette on September 23, 1998, April 22, 1999, and August 26, 1999 (AC, ¶¶ 322, 370-372 and 402, respectively), CIBC World Markets Corp. on May 3, 1999 (AC, ¶ 375), and Salomon Smith Barney on November 4 and November 10, 1999 (AC, ¶¶ 415 and 428-429, respectively) because there is no allegation that any Defendant authorized these statements. *See Payne,* 433 F.Supp.2d at 588, n. 38.

As a specific example, Plaintiff refers to the first of the press releases, dated October 21, 1998. He claims that the statement "an increase in the Company's revolving credit line of just $35 million [will] be sufficient to finance the Company's acquisition plans" was false and misleading "because the increase was due to IT Group's liquidity shortage, not merely to fund future cash needs."(AC, ¶¶ 333, 335-336). The press release actually stated:

> During the current quarter, the IT Group's bank syndicate increased the Company's Revolving Credit Facility by $35 million which, combined with management's ongoing working capital focus, is providing the Company with the liquidity needed to finance our growth and diversification plans in the near term.

(AC, ¶ 333).

Plaintiff has misstated the content of the press release by omitting the reference to "management's ongoing working capital focus" and the limitation of the increase to finance growth "in the [undefined] near term." Moreover, Plaintiff has failed to offer any factual allegation which would show that when DeLuca stated that the increase in the Revolver would be sufficient to provide the necessary "liquidity to finance our growth and diversification plans in the near term," he knew that statement was false. The revolving credit line had just been increased from $150 million to $185 million, the level at which it remained until the Company's bankruptcy in January 2002, more than three years after this statement was made. The Term C Loan was not acquired until March 2000, more than

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15 months later, a time lapse that would put it outside "the near term." Even the fact that six months later, the Company issued $225 million of senior subordinated notes in order to finance two additional acquisitions can give rise only to a weak inference that DeLuca knew what he said was false because Plaintiff fails to show that those acquisitions were part of the Company's plans in late October 1998 or that the Company planned to issue the notes at the time the statement was made.

***27** Plaintiff makes other unfounded leaps in basing certain allegations on these press releases. Referring to a press release dated February 23, 1999, he states: "[t]he claim that the Company had healthy liquidity based on free cash flow was false because the starting point for that measurement was earnings which included inflated receivables and various disputed claims for job change orders which were later written down by the Company."(AC, ¶¶ 347-351). However, a careful reading of that press release shows no reference to the Company's liquidity, healthy or otherwise. References to "a substantial growth in revenues and earnings" explicitly attributes that growth to the OHM and GTI acquisitions in 1998. Plaintiff's claim that these statements were false because earnings included "inflated receivables" and "various disputed claims for job change orders" does not satisfy the particularity requirement of the PSLRA inasmuch as he fails to offer even an estimate of the degree to which receivables were inflated at that time, the materiality of the disputed claims, or the source of these conclusions.

Another allegation, however, bears closer scrutiny. Plaintiff claims that in "approximately December 1999," DeLuca held a conference call with CIBC analysts in which he pointed to an "imminent" debt paydown, stating that the Company would reduce debt in the fourth quarter by $25 to $30 million.[FN46] Plaintiff describes this as a "complete fabrication," because DeLuca failed to disclose that he personally gave instructions to withhold cash payments due to vendors in the amount of $53 million. (AC, ¶¶ 430-431). This claim is directly supported by Confidential Witness 1 (CW 1) who was responsible for making payments by the Company. CW 1 stated that at the end of 1999, "as the situation became more desperate," he was given "strict instructions" by Defendants Soose and DeLuca to withhold $53 million in payments that were "supposed to be in the hands of vendors and subcontractors before the end of December. The checks were cut and placed in a drawer of the accounts payable department, but they were deliberately held back from going out before year's end."(AC, ¶ 146). Based on these allegations, one could reasonably infer that when DeLuca stated that the 1999 debt reduction would come from "free cash flow" in a "very high revenue quarter," he knew the paydown could only be accomplished by withholding payments to vendors. However, the inference cannot be considered strong because "in approximately December" is too vague to establish whether the statement was made before or after DeLuca told CW 1 to withhold payments. If, for instance, the statement was made before DeLuca realized that withholding payments was the only way to achieve the paydown, it would not have been false when made. And, as the Court noted in *Payne,* there is no allegation that the Company did not actually pay down its debt or that the Company did not generate sufficient operating cash flow to make such a reduction.[FN47]

FN46. In full, DeLuca is quoted as saying, "[w]hat I said in October is that our net debt pay down position in this quarter will be in the range of $25 to $30 million. That's from the free cash flow that we've produced in our business. It's also a combination of taking a very high revenue quarter and in some cases collecting the working capital investment we made in the quarter. But, we feel quite confident that we'll [produce] a new debt reduction ... of $25 to $30 million in the quarter."(AC, ¶ 430). Plaintiff claims DeLuca had been promising investors that debt would be

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paid down in 1999, but although the Court can identify such puffing "promises" made in 2000 (*e.g.,* the Form 10-K for 2000 states, "[w]e are focusing on reducing our leverage, and expect that during 2001 we will be able to reduce our total debt by $90-$100 million from our December 29, 2000 levels"), the Court has been unable to identify such a promise in any of the 1999 press releases and SEC filings provided by the parties. Neither paragraph 82 nor 142 of the Amended Complaint on which Plaintiff bases this statement in his brief in opposition to the motion to dismiss identifies such promises. In fact, as Plaintiff points out, the market reacted negatively to the announcement in March 1999 that the Company would acquire additional debt by issuing $225 million in unsecured notes and using the proceeds for more acquisitions and to refinance-not reduce-outstanding indebtedness, an action which would contradict any alleged "promise." (AC, ¶¶ 366-368).

FN47. Operating cash flow for 1999 was $47 million, an increase of $62 million "principally due to improved operating results in 1999 and ... also due to a $17 million net change in discontinued operations cash flow as a result of the 1999 release of previously restricted trust fund assets of discontinued operations."(Becker Decl., Form 10-K for 1999, Exhibit F at 22). Thus, it appears the Company had adequate cash flow to make the debt reduction. However, for purposes of deciding the motion to dismiss, the Court will accept Plaintiff's allegations that the reduction was achieved by delaying payments to vendors at the end of the year.

***28** 4. *Failure to pay subcontractors and vendors on a timely basis and the Company's inability to abide by pay-when-paid regulations:*[FN48] As in *Payne,* Plaintiff argues that ITG misled investors and lulled them into complacency by failing to disclose the impact of the pay-when-paid regulations or their potential to impair government receivables, particularly because Defendants failed to disclose that a substantial portion of "cost-reimbursable projects unbilled" amounts included in billed receivables were subject to the pay-when-paid regulations.

FN48. Plaintiff's argument that the Company failed to advise investors of the existence and consequences of the federal government's pay-when-paid regulations was addressed at length in *Payne,* 433 F.Supp.2d at 600-603.

Plaintiff argues that Defendants knew as early as March 1999 that vendors were not being paid. The failure to pay vendors in a timely manner, in turn, suppressed credit line usage, understated payables because checks recorded as paid were not sent to vendors, and hid the Company's liquidity problems from investors. To substantiate this allegation, Plaintiff relies on memoranda from March and October 1999, referring to contractors walking off the job as a result of not being paid.[FN49] These memos were addressed to the ITG Controller and Vice President of Procurement, who was a direct subordinate of Soose. (AC, ¶¶ 308-309 and Exhibits JJ and KK). The Court finds these documents do not lead to a strong inference of scienter on the part of any Defendant, even Soose. First, knowledge of a subordinate cannot, without more, be imputed to a securities fraud defendant. *In re Bio-Technology Gen.,* 380 F.Supp.2d at 596. Second, in the October 26, 1999 memorandum, the Vice President of Procurement assures the writer of the complaint that he will copy the memo to "senior managers," stating, "I think it will be helpful for them to see this message."(AC, Exhibit KK). Significantly, however, the list of recipients does not include any Defendant; therefore, there is no evidence that any of them was aware of its content, even if their subordinates received it.

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FN49. Plaintiff has also offered as evidence that all Defendants knew about the failure to pay vendors a March 9, 2001, memorandum from DeLuca to members of the Board of Directors which states in relevant part that $34 million of a $57 million increase in net debt between December 2000 and February 2, 2001, was “primarily related to the use of cash for vendor payments which had been delayed to 2001.”(AC, ¶ 121 and Exhibit E). The reasonable inference to be drawn from this memo is that to the extent this delay in payments to vendors was somehow fraudulent, the fraud occurred in the fourth quarter of 2000. That is, this memo is not evidence that any Defendant, including DeLuca, was aware that vendor payments were being delayed within the Class Period which ended almost eleven months before. Similarly, the statement by Confidential Witness 3 that during “the last six months before Shaw took over the Company's businesses,” all of his time was spent “fending off unpaid vendors, collecting cash, setting up accounts with customers to get cash, and bringing in new vendors to replace those who had walked off the job” (AC, ¶ 310), would have applied to events in late 2001. His comment that nonpayment of vendors was “an ongoing problem while [he] was at IT Group” is too vague to give rise to an inference of scienter on the part of any Defendant. The November 13, 2000, memorandum from Conte to Defendants DeLuca and Soose noting that accounts payable after July 11, 2000, had not been paid (AC, ¶ 130 and Exhibit F at PL 10) does not lead to an inference that during the Class Period, such a practice had occurred or that Defendants knew about it.

Plaintiff's claims that the Board members knew about non-payment of vendors rest largely on events which occurred well after the Class Period. One exception-a memorandum from DeLuca to the Board dated April 19, 1999, referring to “our tight liquidity plan which delayed vendor payments and related billing on federal government contracts”-will not be considered by the Court because the Amended Complaint does not mention or rely on this document or DeLuca's statement. (*See* note 40, *supra*). Nor do the allegations based on statements by Confidential Witness 3 regarding presentations to the Board “from 2000 on” in which he “laid out the Company's problems,” including “subcontractors walking off the job, ... unpaid vendors filing liens, ... problems with getting bonding for the Company's projects due to its negative history with respect to late payment of vendors” (AC, ¶¶ 310-316) establish scienter. Again, accepting the vague allegation that “from 2000 on” means that Defendants were aware of the non-payment problem during the Class Period herein, that does not necessarily lead to the inference that this information was fraudulently withheld from the public. “Except for specific periodic reporting requirements ... there is no general duty on the part of a company to provide the public with all material information.” *In re Burlington,* 114 F.3d at 1432. In fact, a defendant is not required “to disclose a fact merely because a reasonable investor would like to know that fact.”*Id., quoting In re Time Warner Inc. Sec. Litig.,* 9 F.3d 259, 267 (2d Cir.1993); *see also Basic, Inc.,* 485 U.S. at 239, n. 17 (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5”). Plaintiff has cited no support for his contention that these problems should have been disclosed to the public.

***29** Another new allegation on this topic which did not appear in the *Payne* SAC is based on a January 2002 report by Conway, Del Genio, Gries & Co., LLC, entitled “Draft Report to the Senior Secured Lenders of the IT Group, Inc.” The report sets out the “extreme problems” which would result if the company violated the pay-when-paid rules. Plaintiff alleges that the report FN50 states the following material facts which were not disclosed by ITG:

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> FN50. Neither party provides a copy of the full report; the Court therefore accepts as accurate the excerpts provided by Plaintiff.

- IT was operating under a compliance program as a result of OHM's pre-acquisition violation of billing/payment practices;

- "Compliance matters" included ITG's pay-when-paid status with its subcontractors on government work; and

- Potential penalties for violation of the pay-when-paid regulations include (1) a significant increase in working capital requirements because the Company would need to fund payment to subcontractors prior to collection of the related government receivable and (2) suspension of new work being awarded to ITG.

(AC, ¶ 209).

As discussed in *Payne,* 433 F.Supp.2d at 602-603, investors would have been aware of the pay-when-paid regulations and the implications of failing to comply with them because such government regulations were in the public domain and the Company was under no obligation to provide investors with information about the regulations because they were not "firm specific." *See Epstein v. Washington Energy Co.,* 83 F.3d 1136, 1143 (9th Cir.1996). Moreover, this excerpt from a report by an external analyst issued in January 2002 sheds no light on what any Individual Defendant may have known about alleged pay-when-paid violations between July 1999 and February 2000.

Embedded within the above-cited report, however, is an allegation which was not addressed in the previous analysis of the pay-when-paid regulations. That is, Plaintiff alleges the Company failed to disclose that it was operating under a compliance program as a result of OHM's pre-acquisition violation of billing/payment practices.FN51(AC, ¶ 209). The fact that the Company was operating under such a program would be a firm-specific aspect of the regulations which, pursuant to *Epstein, supra,* it was obliged to disclose.

> FN51. Since this allegation appears in a section of the Amended Complaint which addresses only the pay-when-paid regulations and there are no allegations elsewhere concerning violation of other government "billing/payment practices," the Court assumes that the violation in question is associated with the pay-when-paid regulations.

A review of the Form 10-K for 1998, released on March 22, 1999, shows it simply is not true, however, that ITG failed to disclose this information to investors. The Company stated the following in the section addressing risks associated with its role as a government contractor:

> On or about September 2, 1998, OHM Corporation, one of its subsidiaries, and The IT Group entered into a Compliance Agreement with the EPA to address alleged past practices by OHM that, according to the EPA, may constitute a basis for our suspension and/or debarment. A breach of the Compliance Agreement by us or any of our subsidiaries is potentially cause for our immediate suspension from work and/or debarment.

(Becker Decl., Exhibit G, at 17-18).

***30** The same statement is made in the 10-K for 1999, with the additional information that "[w]e have not received any notice of noncompliance regarding the September 2, 1998 Compliance Agreement and believe OHM and The IT Group have been compliant."(Becker Decl., Exhibit F, at 11). A similar notice appears in the 10-K for 2000. (Becker Decl., Exhibit K, at 9). Thus, the allegation that ITG failed to disclose an aspect of the pay-when-paid regulations which was particular to itself is unfounded.

Finally, Conte stated that Messrs. DeLuca and Soose knew about the pay-when-paid regulations

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and "expressed concern about the Company's compliance with those rules."When asked what they had said on the subject, Conte testified, "[t]hey were very concerned. They knew what the rules were. They knew that they had to try to live with them."(AC,¶ 210). Similarly, CW1 said that the daily liquidity position memos provided to Defendants Soose and DeLuca included information about payments necessitated by the regulations and that weekly cash flow projections prepared by the finance department in which CW1 worked identified amounts which had to be paid under the regulations. (AC, ¶ 211). Plaintiff alleges that the members of the Board of Directors knew ITG was required to comply with the pay-when-paid requirements and discussed this issue at Board meetings. For instance, a financial report provided to the Board at its meeting of June 8, 2000, mentions that "an emphasis on reducing working capital includes a pay when paid initiative."(AC, ¶ 213).

The Court accepts all of Plaintiff's allegations as true. However, neither the fact that Messrs. Soose and DeLuca knew the effect of violating the pay-when-paid regulations and how much was needed on a weekly basis to satisfy them, nor the fact that the members of the Board discussed the regulations, suggests that the regulations were violated during the Class Period. The bankruptcy examiner's report on which Plaintiff relies FN52 states that "during the last quarter of 2001, [ITG was] no longer able to invoice the federal government on a significant portion of contract work because [it] could not certify that the subcontractors were current with respect to all prior payments due."(AC, ¶ 205). Because it identifies a time period in which the Company "no longer" met the regulation, this allegation leads to the reasonable inference that during the Class Period, which ended almost two years before, ITG had been able to satisfy those requirements.

FN52.*See, e.g.,*AC, ¶¶ 17, 21, 90, 98, 101, 104-105, 204-205, 221, 229, and Becker Decl., Exhibit J, First Report of R. Todd Neilson, as Examiner for the IT Group, Inc., *et al.,* Pursuant to Order of Appointment, dated March 11, 2002.

5. *Misrepresentations as to the value and reliability of the ITG contract backlog:* Plaintiff makes essentially the same claims and arguments as those in *Payne* with regard to the Company's contract backlog, *i.e.,* that Defendants misrepresented or failed to disclose to investors that: (1) a substantial part of its backlog of government contracts was known to be unprofitable and/or would be realized only five or more years in the future; (2) contrary to statements in its SEC filings, the Company did not "bid selectively on new work," but instead "accepted a number of projects which were either low margin or unprofitable;" and (3) ITG was not always the sole successful bidder on indefinite delivery order ("IDO") contracts awarded by the federal government, but rather, multiple contractors, each of whom could do the work required, were typically identified as successful bidders. (AC, ¶¶ 277-280).FN53

FN53. Other new allegations of misrepresentations concerning the Company's contract backlog appear at AC, ¶¶ 344, 350, 362, 374, 381, 391, 399, 408, 414, and 425.

***31** Plaintiff raises very few new substantive issues about the contract backlog and the alleged misrepresentations on this subject which were not previously considered in the *Payne* Opinion.FN54 Plaintiff notes that on September 23, 1998, Donaldson, Lufkin & Jenrette (DLJ) issued an analyst's report, raising its rating on IT Group to "buy," based in part on the Company's purported backlog. Consequently, the Company's misrepresentations on this subject were material and served to materially artificially inflate the price of IT stock. (AC, ¶ 332). He claims that the Company's press releases during the Class Period also presented false and misleading information about the backlog. For instance, the October 21, 1998, press release included false reassurances that investors

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could rely on the Company's large contract backlog. (AC, ¶ 333). Plaintiff claims the press release failed to disclose that the purported backlog was not exclusive to ITG and could be assigned to other vendors. (AC, ¶ 335; *see also*¶ 350, alleging that a press release regarding 1998 results, issued on February 23, 1999, contained the same false and misleading omissions). The Company's SEC filings during the Class Period were similarly false and misleading because they failed to disclose the quality of backlog revenues, the likelihood of losses from low-margin or unprofitable backlog projects, the time lag in receiving backlog revenues, and the potential for parts of the claimed backlog to be transferred to other contractors. (*See, e.g.,*AC, ¶ 344, discussing Form 10-Q for the third quarter of 1998).[FN55]

FN54. Plaintiff reiterates the same allegations which were made in *Payne* regarding a presentation made by DeLuca on April 14-15, 1999, press releases issued during the Class Period herein, SEC filings, and statements by confidential witnesses. *See, e.g.,*AC, ¶¶ 296, 324, 328, 370-371, 435, and 453-455.

FN55. Plaintiff also alleges that additional facts about IDO contracts and the backlog were confirmed in the report prepared in January 2002 by Conway *et al.* for the Company's senior secured lenders in the bankruptcy process. The report, which relied on unaudited financial information, Company records and forecasts, and discussions with its management, indicated that approximately 38% of projected 2002 revenue was related to funded backlog, 52% to unfunded backlog, and 11% to anticipated new work. It also noted the tenuous nature of IDO projects. (AC, ¶ 281). The Court need not consider this allegation further because it addresses events which occurred some two years after the end of the Class Period and relates to projected backlog revenues for 2002 which is not relevant to the claim that information about the backlog provided in the past was false and misleading.

In short, the Court concludes-for the reasons discussed at length in *Payne*-that Defendants adequately distinguished between funded and unfunded portions of the backlog in the Company's SEC filings, that the market would have known how IDO contracts are awarded, and that statements about the reliability of the backlog were either forward-looking statements protected by the Reform Act's safe harbor provision or inactionable puffery. *Payne,* 433 F.Supp.2d at 603-606. Plaintiff has failed to show that the statements made by DLJ in September 1998 can be attributed to any Defendant. (*Id.* at 588, n. 38). Thus, claims of securities fraud resting on purported misrepresentations about the Company's backlog must be dismissed.

D. *Loss Causation*[FN56]

FN56.*See Payne* at 433 F.Supp.2d at 606-611 for a summary of the Supreme Court's analysis in *Dura,* as well as a discussion of the ITG announcements made between October 30 and December 27, 2001, which were analyzed pursuant to the “corrective disclosure” paradigm of alleging loss causation.

Pursuant to *Dura,* plaintiffs in a securities fraud case brought under Section 10b(5) must allege both economic loss and “a causal connection between the material misrepresentation and the loss.” *Dura,* 544 U.S. at 342. As noted in *Payne,* the allegations regarding loss causation therein reflected almost exactly the language the Supreme Court rejected in *Dura*[FN57] where the plaintiffs had alleged “the following (and nothing significantly more than the following) about economic losses attributable to the ... misstatement: ‘In reliance on the integrity of the market, [the plaintiffs] paid artificially inflated prices for Dura securities' and the plaintiffs suffered

damage[s] thereby."' *Dura,* 544 U.S. at 339-340. The Supreme Court held that to successfully allege a cause of action in a fraud-on-the market case, a plaintiff must allege that the share price fell significantly after the truth about the misstatement or omission became known, which the *Dura* plaintiffs had failed to do. *Id.* at 347.

FN57. In *Dura,* the plaintiffs alleged that the defendant pharmaceutical company misrepresented the company's profitability and the expected approval of its new asthmatic spray device by the FDA. In reliance on those statements, plaintiffs purchased Dura stock, only to learn, first, that earnings would be lower than expected due in part to slow drug sales, and second, that the FDA would not approve the device. *Dura,* 544 U.S. at 339. Plaintiffs sued Dura, its managers and directors under the PSLRA, invoking the fraud-on-the-market doctrine. The District Court dismissed the case, finding that the complaint failed to adequately allege scienter or loss causation. *Id.* at 340.The Ninth Circuit Court of Appeals held that because the injury occurred when the plaintiffs purchased their stock at prices which were inflated by the corporation's misrepresentations, the plaintiffs had satisfied the loss causation requirement. The Supreme Court reversed, finding that the plaintiffs failed to adequately allege proximate cause. *Dura,* 544 U.S. at 346. Specifically, the Supreme Court held that a plaintiff cannot satisfy the loss causation requirement of Section 10(b) by simply alleging that the purchase price of the security on the date of purchase was inflated because of the misrepresentation. *Id.* at 342.The Court reasoned that when the plaintiffs purchased Dura's shares, they did not immediately suffer a loss because they could have sold the shares at an equally inflated price any time before the truth became known. That is, an inflated purchase price "will not itself constitute or proximately cause the relevant economic loss.... [I]f the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."In a fraud-on-the-market situation, the loss does not occur until the truth becomes known to the public, causing the share value to drop and preventing the plaintiffs from recouping the purchase value by re-selling the shares. *Id.* at 342-343.Thus, to successfully allege a cause of action, a plaintiff must allege that the share price fell significantly after the truth about the misstatement or omission became known. *Id.* at 347.

***32** Here, Plaintiff alleges that he "purchased shares of [ITG] common stock during the Class Period and was damaged thereby."(AC, ¶ 42). He further alleges:

> In ignorance of the adverse facts concerning [ITG's] business operations and earnings, and in reliance on the integrity of the market, plaintiffs [sic] and the members of the Class acquired [ITG] common stock at artificially inflated prices and were damaged thereby.
>
> Had plaintiffs [sic] and the members of the Class known of the materially adverse information not disclosed by the Defendants, they would not have purchased [ITG's] common's stock at all or not at the inflated prices paid.

(AC, ¶¶ 480-481).FN58

FN58. While these allegations may support the reliance or transaction causation element of a securities fraud claim, they do not satisfy the loss causation element. *See* *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 259 F.3d 154, 172 (3d Cir.2001) (associating transaction causation with the idea that "but for the fraudulent misrepresentation, the investor would

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not have purchased or sold the security.")

These allegations are a verbatim duplication of the language used in the Second Amended Complaint in *Payne.*FN59 Moreover, there is no mention of those members of the putative class who purchased the senior subordinated notes, not common stock. Loss causation is never explicitly mentioned in the Amended Complaint, although it was filed well after the Supreme Court's opinion in *Dura,* which clearly states that loss causation is one of the "basic elements" to be alleged in securities fraud cases. *Dura,* 544 U.S. at 341. Plaintiff does not even make a generic allegation that Defendants' misrepresentations "directly or proximately caused, or were a substantial contributing cause of, the damages [he] sustained."*See* *Semerenko v. Cendant Corp.,* 223 F.3d 165, 186 (3d Cir.2000). However, Plaintiff does allege:

> FN59. The Second Amended Complaint in *Payne* was filed before the Supreme Court decided in *Dura,* but before the parties had completed briefing the issues raised in the motion to dismiss. Neither party, however, addressed the loss causation element in their pleadings despite the obvious applicability of that case, nor did the plaintiffs seek to amend the complaint to satisfy the pleading requirements of *Dura.*However, the Court analyzed the Second Amended Complaint in light of *Dura,* and found that the plaintiffs had failed to adequately plead loss causation. In short, the Court concluded that although the plaintiffs had alleged the price of ITG stock fell severely between October 30, 2001, and January 16, 2002, as the Company released its dismal results for the third quarter of 2001, announced that it would suspend payment of its dividend on preferred shares, alerted the market that it expected to file for bankruptcy, and eventually did so, none of these announcements revealed any part of Defendants' fraudulent actions, but instead perpetrated the cover-up. Moreover, the *Payne* plaintiffs had clearly alleged that they first learned of the defendants' wrongdoing from documents filed in ITG's bankruptcy proceeding "no earlier than March 2002" and that further facts were revealed in a bankruptcy examiner's report filed in the same proceedings "on or about April 2002." The Court concluded that if the *Payne* defendants' wrongdoing was not disclosed until March 2002 at the earliest, the plaintiffs had failed to satisfy the *Dura* requirement of pleading that the decline in the price of ITG stock was the result of the truth surrounding the defendants' fraud becoming known to the public.

The market experienced a severe reaction to the adverse developments between October 30, 2001 and January 16, 2002. The value of IT Group stock evaporated. In trading on October 30, 2001, when the news release on third quarter results was dated, the price of IT shares dropped from \$4.77 to \$3.48, a 27.04% loss. As the company held its corresponding conference call on that release and the Salomon Smith Barney analyst's report on that release occurred, the stock dropped from a \$3.50 close on November 2, 2001 to a close of \$1.65 on November 8, an additional 53% plunge.FN60 When IT announced the suspension of its dividend on its preferred shares, the price resumed its drop from a close of \$1.73 on November 29, 2001 to a closing price of \$.81 on December 3, 2001, a loss of over 50%. By December 27, 2001, when the Company announced it expected to file for bankruptcy, IT [Group] lost almost all value, plummeting again from a December 26 closing price of \$.38 to a price of \$.05 at the market close on December 28, 2001, when the Company said they may be forced to file bankruptcy.

> FN60. The contents of the press release of October 30, 2001, and the Salomon Smith Barney analyst's report issued on Novem-

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ber 3, 2001, are not alleged in the Amended Complaint.

Similarly, IT Group's $225 million notes were downgraded at the end of the Class Period as the bad news emerged about IT Group's financial condition. Standard & Poor's downgraded its rating on the bonds from B+ at time of issuance to B as of November 20, 2001, B as of December 3, 2001, CCC+ as of December 14, 2001, C as of December 27, 2001, D as of January 16, 2002 and not rated as of February 10, 2002. Moody's downgraded the bonds from B3 as of date of issuance to Caa3 as of December 13, 2001 to withdraw rating as of January 18, 2002. As the bad news emerged and these bonds were downgraded, their market price declined, causing damages to members of the Class.
***33** (AC, ¶¶ 469-470).

Defendants argue that Plaintiff has not adequately pled loss causation for two reasons. First, he cannot establish a causal connection between a purported misrepresentation and his loss inasmuch as ITG's stock price declined before any alleged misrepresentations were disclosed. Second, the disclosures which did take place between October 2001 and February 2002 related to ITG's worsening financial condition and eventual bankruptcy, but did not reveal that any statements made during the Class Period were false. In short, Defendants argue that Plaintiff has failed to identify a "corrective disclosure" which brought to light the alleged fraudulent activities and caused a drop in the value of the securities.

Plaintiff argues that he has adequately pled loss causation not by alleging a corrective disclosure, but by pointing to the materialization of a concealed risk. That is, throughout the Class Period and thereafter until the last quarter of 2001, Defendants successfully hid the Company's lack of liquidity from the investing public. This chronic liquidity crisis put the Company at risk of bankruptcy and/or inability to service its debt. In late 2001, the Company was forced to concede that it had massive amounts of uncollectible accounts receivable which finally had to be written-off and had run out of borrowing capacity to supplement its rapidly declining revenues. Defendants could no longer keep the Company afloat by dishonestly suppressing the balance on the revolving loan in order to meet loan covenants, delaying payments to vendors, and engaging in other accounting manipulations. Thus, the risks associated with the concealed chronic liquidity crisis materialized and the Company stock lost its all its value. The Court disagrees.

Although the Third Circuit has held that loss causation is a fact-intensive inquiry best resolved by the trier of fact (*see* *EP Medsystems, Inc. v. EchoCath, Inc.,* 235 F.3d 865, 884 (3d Cir.2000)), the plaintiff must provide the defendant "with some indication of the loss and the causal connection that he has in mind." *Dura,* 544 U.S. at 347;*see also* *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.,* 343 F.3d 189, 198 (2d Cir.2003) ("the very question" the loss causation allegation must answer is why plaintiffs lost money on the purchase).

In making his argument that he has properly pled loss causation through allegations showing that the risks associated with the prolonged liquidity crisis materialized and caused his loss, Plaintiff relies almost entirely on cases from the Second Circuit.[FN61] To date, the Third Circuit has not explicitly addressed the materialization of the risk method of pleading loss causation,[FN62] nor has it analyzed the language in *Dura* requiring a plaintiff to allege that "the share price fell significantly after the truth about the misstatement or omission became known." *Dura,* 544 U.S. at 347. However, accepting Plaintiff's contention that materialization of the risk is an acceptable alternative means to plead loss causation in this Circuit, the Court finds that he has failed to meet the standards set out in the cases on which he relies.

FN61.*See* *Lentell v. Merrill Lynch & Co., Inc.,* 396 F.3d 161, 174 (2d Cir.2005); *Emergent Capital,* 343 F.3d at 197; *Suez*

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Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 98, n. 1 (2d Cir.2001); *Catton v. Defense Tech. Sys., Inc.,* CA No. 05-6954, 2006 U.S. Dist. LEXIS 205, *20-*22 (S.D.N.Y. Jan. 3, 2006); *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* CA No. 05-1898, 2005 U.S. Dist. LEXIS 19506, *57-*58 (S.D.N.Y. Sept.6, 2005); *In re Initial Public Offering Sec. Litig.,* 399 F.Supp.2d 298, 307 (S.D.N.Y.2005); and *In re NTL, Inc. Sec. Litig.,* CA No. 02-3013, 2006 U.S. Dist. LEXIS 5346, *30-*33 (S.D.N.Y. Feb. 14, 2006).

FN62. The Third Circuit Court of Appeals has addressed the Second Circuit standard for alleging loss causation on at least one occasion, albeit in dicta. In *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 259 F.3d 154, 181, n. 24 (3d Cir.2001), the plaintiffs, relying on *AUSA Life Ins. Co. v. Ernst & Young,* 206 F.3d 202 (2d Cir.2000), argued that they had established loss causation because it was foreseeable the defendants' trading practices would cause economic harm to class members. The Third Circuit Court of Appeals explained that the Second Circuit's definition of loss causation "examines how directly ... [the fraudulent conduct] caused the loss, and whether the resulting loss was a foreseeable outcome of the fraudulent [conduct]."*Newton, id., also citing* *Suez Equity Investors,* 250 F.3d at 96. The Court went on to state:

> Our test for loss causation is framed somewhat differently.... [A] a viable Rule 10b-5 securities claim must show a "sufficient causal nexus between the loss and the alleged [nondisclosure]." *Semerenko,* 223 F.3d at 184. In other words, to establish loss causation, a claim must demonstrate that the fraudulent conduct proximately caused or substantially contributed to causing plaintiff's economic loss. Whether there are differences between these standards for loss causation, it is far from certain in this case that each plaintiff has sustained a loss, unlike the insurance companies in AUSA.
>
> *Newton, id.*(other internal citations omitted.)

***34** There are two methods of establishing loss causation, which have been distinguished as follows:

> Where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff's loss, it is the materialization of the undisclosed condition or event that causes the loss. By contrast, where the alleged misstatement is an intentionally false opinion, the market will not respond to the truth until the falsity is revealed, i.e, a corrective disclosure.

In re Initial Public Offering Securities Litig., 399 F.Supp.2d 298, 307 (S.D.N.Y.2005).

Relying on *In re Parmalat Sec. Litig.,* 375 F.Supp.2d 278, 307 (S.D.N.Y.2005), Plaintiff argues that even though the true extent of the fraud was not disclosed until two months after the ITG stock price plummeted in late 2001 and the notes were downgraded, that disclosure is immaterial where the risk concealed by Defendants materialized and caused the decline in the value of the securities. As was the case in *In re Parmalat,*[FN63] Plaintiff claims that lack of liquidity caused ITG to file for bankruptcy and the Company's bonds were downgraded when the details of the Company's perilous financial condition were revealed beginning in late 2001. Thus, he contends, he has satisfied the loss causation requirement under the materialization of the risk theory.

FN63.*In re Parmalat* involved claims

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against auditing company defendants who concealed the Italian dairy conglomerate's massive undisclosed debt, its inability to service that debt, and its reliance on non-existent bank accounts to bolster its reported assets. *Id.,* 375 F.Supp.2d at 307.

According to the Second Circuit's decision in *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161 (2d Cir.), *cert. denied,* --- U.S. ----, 126 S.Ct. 421, 163 L.Ed.2d 321 (2005), a plaintiff relying on the materialization of the risk method must allege several things.[FN64] First, he must establish that the misstatement or omission was the proximate cause of his loss by alleging that the loss "was within the zone of risk concealed by the misrepresentations and omissions."He must further allege "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. Otherwise the loss in question was not foreseeable."Third, he must assert "that the subject of the fraudulent statement or omission was the cause of the actual loss suffered." *Lentell,* 396 F.3d at 172-73. If the relationship between his investment loss and the information misstated or concealed by the defendant is sufficiently direct, he has satisfied the element of loss causation for purposes of withstanding a motion to dismiss. *Id.* at 174.

FN64. The Second Circuit's decision in *Lentell* was issued on January 20, 2005, shortly before the Supreme Court's decision in *Dura* on April 19, 2005. In denying the petition for writ of certiorari on October 25, 2005, the Supreme Court did not offer any comment on the analysis in *Lentell* vis-a-vis its holding in *Dura,* nor did it remand *Lentell* for further consideration in light of *Dura.*

The first step, therefore, in analyzing whether a plaintiff alleging securities fraud has adequately pled loss causation "is to identify the subject of the misrepresentations or omission that allegedly caused plaintiff's loss, i.e., the risk concealed by the defendant's fraud."*Leykin v. AT & T Corp.,* 423 F.Supp.2d 299, 240 (S.D.N.Y.2006); *see also* *Halperin v. Ebanker Usa.com,* 295 F.3d 352, 359 (2d Cir.2002). The second step "is to determine whether the complaint alleges that the concealed risk led to plaintiff's loss.... If the plaintiff fails to demonstrate a causal connection between the content of the alleged misstatements or omissions and the harm actually suffered, a fraud claim will not lie."*Leykin, id.*(internal quotation omitted).

***35** The threshold problem with Plaintiff's argument that the undisclosed risk was the Company's chronic liquidity crisis is that herein, unlike *In re Parmalat,* contemporaneous public statements repeatedly revealed the Company's liquidity situation. In its 1998 Form 10-K, for example, the Company advised investors of its intent to issue $200 million in senior subordinated notes in order to finance two imminent acquisitions (Note Offering) (Becker Decl., Exhibit G, at 6-7). The Form 10-K later reported in a section entitled "Substantial Leverage" that total indebtedness as of December 25, 1998 was $422,662,000. The statement continued, "we have now and, after the Note Offering, will continue to have a significant amount of indebtedness."(*Id.* at 19). This section continued:

Our substantial indebtedness could have important consequences. For example, it could:

- increase our vulnerability to general adverse economic conditions;

- limit our ability to pursue our acquisition business strategy;

- limit our ability to obtain necessary financing or bonding, fund future working capital, capital expenditures and other general corporate requirements

- require us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital ex-

penditures and other general corporate purposes;

- limit our flexibility in planning for, or reacting to, changes in our business and the environmental services industry;

- place us at a competitive disadvantage compared to our competitors that have less debt; and

- limit, along with the financial and other restrictive covenants in our indebtedness, our ability to borrow additional funds. And, failing to comply with those covenants could result in an events of default which, if not cured or waived, could have a material adverse effect on us.

We may be able to incur substantial additional indebtedness in the future. During 1998, we amended and restated our credit facilities so that they now provide for a $228.0 million eight-year term loan and a $185.0 million six-year revolving credit facility. At December 25, 1998, we had outstanding $225.8 million of borrowings under the term loan and $143.0 million under the revolving credit facility. If new debt is added to our current debt levels, the related risks that we now face could increase.

(Becker Decl., Exhibit G, at 20, emphasis added).

As if the foregoing were not warning enough, the Form 10-K continued in a section entitled "Ability to Service Debt:"

Our ability to make payments on and to refinance our indebtedness and to fund planned capital expenditures and any future acquisitions will depend on our ability to generate cash in the future. Our success is dependent upon our results of operations, which are heavily dependent on various factors, including managing utilization of our professional staff, properly executing projects and successfully bidding new contracts at adequate margin levels....

***36** Based on our current level of operations and anticipated costs savings and operating improvements, we believe our cash flow from operations, available cash and available borrowings under our credit facilities will be adequate to meet our future liquidity needs, excluding acquisitions, for the next twelve months.

We can make no assurance, however, that our business will generate sufficient cash flow from operations or that future borrowings will be available to us under our credit facilities in an amount sufficient to enable us to pay our Indebtedness or to fund our other liquidity needs.

(Becker Decl., Exhibit G, at 20, emphasis added).FN65

FN65. The foregoing caveats cited as appearing in the Form 10-K for 1998 were repeated, essentially verbatim, in the Form 10-K for 1999, Becker Decl., Exhibit F, at 8-9, released on March 30, 2000.

In the Form 10-K for 2000, released on March 20, 2001, the Company stated that in December 2000,

we requested ... an amendment to the credit agreement for the exclusion of the special charge from our covenant ratio calculations and revisions to the financial covenants which included, among other items, the deferral of more restrictive future financial covenants for maximum EBITDA, minimum interest coverage and minimum fixed charge coverage, as defined, to later quarters over the next two years. As amended, we were compliant with the covenants and all other limitations of our credit agreement at December 29, 2000.

(Becker Decl., Exhibit K, at 17).

Such requests, coming only nine months after the Company had taken on an additional $100 million loan, alerted the market that ITG must have experienced difficulty meeting its loan covenants during the last quarter of 2000 if not before and that the Company would have failed to comply with its loan covenants had the credit agreement not been

amended.

The Company revealed in its Form 10-Q for the third quarter of 2001 that it anticipated it would not meet the more restrictive covenants in effect as of September 2001 and again sought modification of those covenants. (Becker Decl., Exhibit N, at 11). It also warned investors that it expected to negotiate a third amendment during the first quarter of 2002, another sign that the Company did not expect its liquidity situation to improve in the near future. *Id.*

Apparently recognizing that these disclosures hamper his materialization of the risk argument, Plaintiff asserts that the materiality of Defendants' concealment of this long-term, pervasive liquidity problem is overwhelming and cannot be dispelled by indirect or partial disclosures. Relying on *In re Stone & Webster, Inc. Sec. Litig.,* 414 F.3d 187, 209 (1st Cir.2005), Plaintiff argues that even honest disclosures of liquidity problems cannot necessarily, as a matter of law, redress earlier false claims of adequate liquidity, since pervasive liquidity problems are qualitatively different from a sudden temporary reversal. Moreover, no "honest disclosures" were ever made regarding ITG's long-term liquidity problem.

It is undoubtedly true that cautionary language in securities publications, such as those which appear in the Company's SEC filings, "is just about universal." *Halperin,* 295 F.3d at 359. To overcome the effect of such general language, the plaintiff may show that the "cautionary language did not expressly warn of or did not directly relate to the risk that brought about [his] loss."*Id.* But other than the blanket argument just above, Plaintiff never explains why the cautionary language in the SEC filings did not constitute "honest disclosures" of the Company's "long-term, pervasive liquidity problem." FN66

FN66. In *Payne,* the plaintiffs claimed that ITG became secretly insolvent in February 2000. The Court noted that because the Company continued to operate until February 2002 without seeking bankruptcy protection, it was reasonable to infer that although for most of that time liquidity was a problem, there was no "crisis" to disclose. *Payne,* 433 F.Supp.2d at 592-593,*citing In re Ultrafem Sec. Litig.,* 91 F.Supp.2d 678, 700 (S.D.N.Y.2000). Since Plaintiff here alleges that the crisis began in 1998 with the acquisition of OHM, that conclusion is reinforced since under Plaintiff's timetable, ITG managed its liquidity problem for almost four years.

***37** Furthermore, the Court finds the disclosures herein were neither indirect nor partial. Unless investors expected the Company to announce explicitly in every public statement that it might, someday, declare bankruptcy, it is difficult to imagine what more it could have done to alert the market to its ongoing liquidity situation and the consequences thereof. As noted previously, at the same time the Company advised investors that if it took on additional debt, the associated risks could increase, it stated that it was about to do just that. Within a year of issuing $225 million in notes and borrowing another $100 million on the Term C Loan, the Company had to amend its credit agreements in order to comply with its then-current loan covenants and request postponement of more onerous covenants. As Plaintiff points out, the Company was unable to make appreciable progress in reducing its total debt. The situation never significantly improved and Defendants never asserted to investors that it had. In stark contrast to the facts of *In re Parmalat,* this "massive" debt and the Company's potential inability to effectively service it were repeatedly disclosed.

As the Second Circuit stated in *Lentell:*

> where (as here) substantial indicia of the risk that materialized are unambiguously apparent on the face of the disclosures alleged to conceal the very same risk, a plaintiff must allege (i) facts sufficient to support an inference that it was defendant's fraud-rather than other salient factors-that

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proximately caused plaintiff's loss; or (ii) facts sufficient to apportion the losses between the disclosed and concealed portions of the risk that ultimately destroyed an investment.

Lentell, 396 F.3d at 177.

The Court finds that Plaintiff has failed to state allegations in the Amended Complaint that would satisfy either of these *Lentell* criteria.[FN67] There are no allegations that Defendants' fraudulent concealment of the Company's liquidity crisis proximately caused his loss. The closest Plaintiff comes to such a statement is the allegation that his "case is based upon the concealment of the Company's liquidity and related problems, and the means utilized by Defendants to artificially prop up the failing Company."(AC, ¶ 8). Elsewhere, he states: "In fact, the Company was suffering from a prolonged liquidity crisis, and had virtually exhausted its available credit line for a substantial portion of the Class Period-a sure sign that bankruptcy was an imminent threat."(AC, ¶ 29). The statement of the cause of action in Count I (AC, ¶ ¶ 477-482) makes no reference to Plaintiff's theory of loss causation. *See Porter v. Conseco, Inc.,* 2005 U.S. Dist. LEXIS 15466, *13-*14 (S.D.Ind. July 14, 2005)(*Dura*"makes clear that a plaintiff must give a defendant fair notice of his loss causation theory in the complaint"); *see also D.E. & J. Ltd. P'ship v. Conaway,* CA Nos. 03-2334 and 03-2417, 2005 U.S.App. LEXIS 11267, *16 (6th Cir. June 10, 2005), affirming dismissal of the complaint for failure to plead loss causation, in part because the plaintiff did not give fair notice of the relevant economic loss or the causal connection between the loss and the misrepresentation. On the other hand, the Amended Complaint contains no allegations which allow the Court to apportion Plaintiff's losses between the concealed and disclosed portions of the risk that materialized-in fact, even the magnitude of the loss is unclear.[FN68] *See In re Gilead Sciences Sec. Litig.,* CA No. No. 03-4999 *et al.,*2006 U.S. Dist. LEXIS 32893, *12-*13 (N.D.Cal. May 12, 2006), referring to an earlier unpublished opinion in which the court had dismissed the third amended complaint because plaintiffs had inadequately pled loss causation in part because the court was "left to speculate as to what portion, if any, of [the] decrease should be attributed to the alleged misconduct or whether the loss was caused by other factors."

FN67. Contrary to Plaintiff's argument that one reason Defendants' motion to dismiss should be denied is their failure offer evidence that intervening events were at least partially responsible for the decrease in value of ITG securities, *Lentell* makes clear that the burden is on the plaintiff to plead that its loss was caused by fraud and not intervening events. "When the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases, and a plaintiff's claim fails when it has not adequately [pled] facts which, if proven, would show that its loss was caused by the alleged misstatements as opposed to intervening events." *Lentell,* 396 F.3d at 174 (internal quotations omitted). In addition to the impact of September 11, 200, on the financial markets, "[as] is obvious to anyone familiar with recent history, America's economy underwent a recession and the U.S. stock market suffered a substantial decline during [2001.]"*In re Sawtek Inc. Sec. Litig.,* CA No. 03-294, 2005 U.S. Dist. LEXIS 39223 at *43 and n. 5 (M.D.Fla. Oct. 6, 2005), noting that during 2001, the broad U.S. stock market declined 11.46%.

FN68. Since the value of ITG stock was $4.77 per share at the time Plaintiff asserts effects of the Company's liquidity crisis began to materialize, it logically follows that any decrease between a purchase price greater than $4.77 per share and $4.77

> would have been caused by other factors and not by materialization of the risks associated with lack of liquidity. Moreover, because there are absolutely no allegations as to the monetary losses incurred by members of the Class who purchased the unsecured notes, the Court cannot begin to allocate their losses between the alleged fraudulent and non-fraudulent causes of the decline in value.

***38** While the Supreme Court in *Dura* assumed "at least for argument's sake," that neither the Rules of Civil Procedure nor the securities statutes impose a heightened pleading standard on the element of loss causation,

> it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and causal connection that the plaintiff has in mind. At the same time, allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about the harm of the very sort the statutes seek to avoid.

Dura, 544 U.S. at 347.

Plaintiff has not argued in the alternative that a corrective disclosure occurred which alerted the market to Defendants' fraud; in fact, he appears entirely to reject that argument. Accordingly, the Court concludes that: (1) he has not satisfactorily established a materialization of the risk argument as set out by courts which have recognized this as an alternate way of pleading loss causation, and (2) he did not give Defendants fair notice of his economic loss and proximate cause in the Amended Complaint. Therefore, failure to plead loss causation is yet another reason why the Amended Complaint must be dismissed.

IV. COUNT II-VIOLATION OF SECTION 20(a) OF THE 1934 ACT

In Count II of the Amended Complaint, Plaintiff asserts that the Individual Defendants and Carlyle are liable as "controlling persons" of the Company which violated the securities laws. Specifically, he alleges:

> The Individual Defendants and the Carlyle Group, by virtue of their offices, directorships, stock ownership and specific acts were, at the time of the wrongs alleged herein and as set forth in Count I, controlling persons of [ITG] within the meaning of Section 20(a) of the 1934 Act. The Individual Defendants and the Carlyle Group had the power and influence and exercised the same to cause [ITG] to engage in the illegal conduct and practices complained of herein by causing the Company to disseminate the false and misleading information referred to above. The Individual Defendants' positions made the Individual Defendants and the Carlyle Group privy to and provided them with actual knowledge of the material facts concealed from plaintiffs and the Class. By virtue of the conduct alleged herein, the Individual Defendants and the Carlyle Group are liable for the aforesaid wrongful conduct and are liable to plaintiff and the Class for damages suffered.

(AC, ¶¶ 485-486).

As noted in *Payne,* liability under Section 20(a) of the 1934 Act [FN69] is predicated on an underlying violation by a person or entity controlled by the defendant. *Payne,* 433 F.Supp.2d at 611-12. If no controlled person is liable, there can be no controlling person liability. *In re Alpharma,* 372 F.3d at 153. Because Plaintiff fails to successfully allege that the controlled entity, ITG, violated Section 10(b) or Rule 10b-5, his Section 20(a) claims against The Carlyle Group and the Individual Defendants must fail as well.*In re Alpharma, id.*Accordingly, the Court need not address the arguments raised by the parties in their supplemental briefs on this subject. (*See*Docket Nos. 59 and 62).

FN69. In full, Section 20(a) provides:

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> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a).

V. CONCLUSION

***39** Dismissal with prejudice is warranted in this case. The Amended Complaint, although only the second version, essentially duplicates the allegations made in three iterations of *Payne v. DeLuca* and the arguments offered by Plaintiff here are largely the same as those the Court rejected in that case. Plaintiff has failed to establish scienter by any Defendant, despite access to voluminous documents gleaned from ITG's bankruptcy proceedings. This case is based on the entirely speculative view that since the Company was forced to declare bankruptcy, there "must have been" fraudulent activity on someone's part. The allegations against the members of the Board of Directors are particularly weak and rely entirely on the unsupported speculation that they deliberately or recklessly ignored the Company's financial condition for more than four years. The failure to establish scienter on the part of any Defendant is sufficient alone to require dismissal.

One objective of the PSLRA is "to provide a filter at the earliest stage (the pleading stage) to screen out lawsuits that have no factual basis." *GSC Partners,* 368 F.3d 228 at 246,*quoting* *In re NAHC Inc. Sec. Litig.,* 306 F.3d 1314, 1332 (3d Cir.2002). As the Court of Appeals noted, "[t]his objective would be frustrated where there is a stark absence of any suggestion by the plaintiffs that they have developed any facts since the action was commenced which would, if true, cure the defects in the pleadings under the heightened requirements of the PSLRA."*GSC Partners, id.*(internal quotation omitted.) Moreover, "the Third Circuit has made clear, that in actions filed under the PSLRA, leave to amend should not be granted in a fashion that would frustrate the heightened pleading requirements of the statute."*In re Bristol-Myers Squibb Sec. Litig.,* CA No. 00-1990, 2005 U.S. Dist. LEXIS 18448, *28 (D.N.J. Aug. 17, 2005), *citing* *Chubb,* 394 F.3d at 164. Therefore, the Amended Complaint will be dismissed with prejudice.

An appropriate Order follows.

W.D.Pa.,2006.
Glover v. DeLuca
Not Reported in F.Supp.2d, 2006 WL 2850448 (W.D.Pa.)

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TAB 20

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.

Jack E. GRANT, Plaintiff,
v.
CHEMREX, INC., Defendant.

No. 93 C 0350.

April 28, 1997.

MEMORANDUM OPINION AND ORDER

MAROVICH, District Judge.

***1** Plaintiff Jack Grant ("Grant") filed a three-count Complaint against Chemrex, Inc. ("Chemrex") alleging injuries to his liver, heart and lungs from an exposure to Chemrex's product, Kure-N-Seal, and seeking $4.5 million in damages. Grant's Complaint presents three legal theories for recovery based upon negligence (Count I), breach of implied warranty of merchantability (Count II) and strict product liability (Count III). Chemrex has moved for summary judgment on all three counts asserting that Grant cannot establish that Chemrex's product caused his injuries. In conjunction with this motion, Chemrex has moved to strike the testimony of Grant's treating physicians and expert witness. As set forth below, the Court grants Chemrex's motions to strike. As a result, the Court also grants Chemrex's motion for summary judgment.

BACKGROUND

Grant worked for Pacific Fasteners Corporation ("Pacific") as a warehouse manager. In March 1991, Pacific moved into a new warehouse in Lincolnshire. In June 1991, as part of an attempt to "spruce up" the warehouse for the upcoming visit of the company chairman, Grant along with a co-worker, Jim Ringman ("Ringman"), was asked to seal the warehouse floor. Grant's supervisor purchased paint rollers and several five gallon drums of Chemrex's Kure-N-Seal Gray. Kure-N-Seal Gray is a pigmented ready-to-use acrylic curing and sealing system specifically designed for interior and exterior concrete masonry floors. The solvents in the Kure-N-Seal produce an odor.

One of the employees of the hardware store came to the warehouse and instructed Grant as to how to apply the sealant using a paint roller. The paint store employee recommended that they keep the loading dock doors open for ventilation while applying the Kure-N-Seal. Before he began using Kure-N-Seal, Grant read the label which he recalls warned him to keep the area ventilated to avoid fumes. The warning label for the Kure-N-Seal used by Grant read as follows:

WARNING-COMBUSTIBLE

CONTAINS: MINERAL SPIRITS, AROMATIC 100

May cause skin irritation. Prolonged contact of liquid or vapor with eyes may cause injury. Prevent contact with skin and eyes. If contact occurs, flush affected area(s) thoroughly with plenty of water. May cause respiratory irritation or intoxication with headaches, nausea, and central nervous system depression. Repeated or prolonged overexposure may cause injury to the kidneys, central nervous system, or formed elements of the blood. Avoid breathing vapor/mist. If inhaled, remove to fresh air. If breathing is difficult, give oxygen. If not breathing administer artificial respiration. May cause irritation if ingested. DO NOT take internally. If ingested, DO NOT induce vomiting. Small amounts of liquid aspirated into lungs may cause serious pulmonary injury. SEEK MEDICAL ATTENTION FOR ALL OVEREXPOSURES.

Use only with adequate ventilation. Keep containers closed.

Keep away from sources of ignition.

***2** KEEP OUT OF REACH OF CHILDREN

RECOMMENDED SAFETY EQUIPMENT Use impervious gloves, goggles, and if applied in areas of poor or inadequate ventilation, use NIOSH/MSHA approved organic vapor respirator.

While he applied the sealant, Grant made sure that the dock doors, which are eight feet by eight feet, and

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the bay door, which is ten feet by twelve feet, remained open and that the dock area exhaust fan was running. In addition, Grant used two large floor fans to push the fumes out of the warehouse. The Pacific warehouse is about 200 feet long by approximately 100 feet wide. Working normal hours of 8:00 a.m. to 5:00 p.m., it took Grant and Ringer three full days and a part of a fourth day to complete the project. While he was applying the sealant, Grant had headaches, but experienced no other problems. According to Grant, Ringer did not have a headache or experience any other problems.

Approximately two weeks later, on June 28, 1991, Grant went to the emergency room of Sherman hospital complaining of right side chest pain. Dr. Mohammad Zahid ("Dr.Zahid"), an emergency room physician, admitted him to the hospital. Grant was also examined by a number of other physicians. Dr. Deepak Khurana ("Dr.Khurana"), a gastroenterologist, was consulted because Grant's liver function test results were abnormal. After examining Grant, Dr. Khurana opined that he doubted that Grant suffered from toxic hepatitis, based upon the type of exposure and time frame of response, but instead opined that Grant suffered from a viral illness.

Dr. Lee Lichtenberg ("Dr.Lichtenberg"), who is board certified in rheumatology and internal medicine, was consulted because Grant had inflammation of the pleural cavity and pericardial cavity and at least one abnormal blood test for rheumatic disease. Dr. Lichtenberg was asked to determine if there was a medical causation between the toxic exposure and Grant's condition. Dr. Lichtenberg opined that if this was Grant's first exposure to Kure-N-Seal, then it was an unlikely cause of his medical symptoms.

Dr. Zahid, who is board certified in internal medicine, was not able to make any specific diagnosis of Grant's condition, but was willing to consider a toxic nature to his illness. Dr. Zahid indicated that he would rely upon the opinion of Dr. Zubair Ahmad ("Dr.Ahmad") as a pulmonary specialist, who also treated Grant during his stay at Sherman hospital. According to Dr. Zahid, Dr. Ahmad ruled out the possibility of Kure-N-Seal exposure as a cause of Grant's injury due to the presence of pleural pericardial effusion (fluid around the heart)

Dr. Ahmad, who is board certified in pulmonary and critical care, was asked to consult on Grant's case because of his pulmonary problems. At the time he treated Grant during Grant's hospitalization, Dr. Ahmad opined that chemical exposure was not the cause of Grant's medical problems. Later, at his deposition, Dr. Ahmad testified that he found, to a reasonable degree of medical certainty, that the pleural thickening in just one lung was not caused by an inhalation of hydrocarbons, but that further study would be required to completely rule out inhalation as the cause of Grant's condition.

***3** Grant was also under the care of his treating physician, Dr. Irving Bush ("Dr.Bush"). Dr. Bush, a professor of surgery in the field of urology at Chicago Medical School and an adjunct professor of biology at Northern Illinois University, opined that Grant had a fibrous reaction and pleurisy from the Kure-N-Seal exposure which led to the decortification of Grant's lungs in 1993. Dr. Bush further found that Grant suffered from liver toxicity from inhaling the Kure-N-Seal fumes.

Expert Testimony

Chemrex offered the following expert testimony from John Bederka, Ph.D. and David Cugell, M.D. Dr. Bederka, a toxicologist, chemist and pharmacologist, reviewed Grant's records from Sherman hospital, Dr. Bush's medical records, the Kure-N-Seal label provided by Grant, the Material Safety Data Sheet ("MSDS") for Kure-N-Seal, the construction handbook and other material related to the product and produced by Chemrex, the Complaint, the depositions of Grant, Dr. Bush, Dr. Lichtenberg, Dr. Ahmad, Dr. Zahid, and Dr. Khurana. Dr. Bederka also inspected the Pacific warehouse, measuring its dimensions and the area that was sealed and the dock doors that were used for ventilation, and performed calculations of the amount of product that Grant was exposed to during his work day based on his visit to the warehouse, Grant's deposition testimony, and the Kure-N-Seal Gray specification sheet. Based on his review of the information, and his experience and training, Dr. Bederka concluded "that the product, Kure-N-Seal concrete sealer, is safe; the labeling is appropriate; the material data safety sheets are appropriate; and there is no probable connection between Mr. Grant's exposure to this product and his subsequent medical problems." Dr. Bederka noted that Grant had a history of an abnormal left lung and

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found that Grant's lung problems "had nothing to do with any exposure to a chemical." In addition, Dr. Bederka concluded that the "two week interval between exposure and the hospital admission make it highly unlikely that the chemicals are a cause."

Dr. Cugell, a professor of pulmonary diseases at Northwestern University, after examining the same materials as Dr. Bederka, concluded as follows:

I do not believe that there is any connection between the application of Kure-N-Seal sealer to a cement floor in June 1991 and Mr. Grant's multiple medical problems that occurred thereafter for the following reasons:

a. According to his deposition, Mr. Grant used large, mobile fans in the area where he was applying the sealer and the overhead doors to the warehouse were kept open to enhance ventilation.

b. According to the material safety data sheets, this concrete sealer can exert an irritant effect on the eyes, skin and respiratory tract. If so, adverse effects would be maximal at the time of the exposure and diminish thereafter. Mr. Grant did not experience any symptoms at the time he was handling the floor sealer.

c. Although no definite diagnosis was established during the June 1991 admission to Sherman Hospital, neither the pattern of complaints nor the pattern of abnormal laboratory tests, or the gradual resolution of many of the abnormal findings is consistent with a prior exposure to injurious chemicals. An infectious cause for his symptoms seems most probable, particularly in view of the blood oxygen values that were significantly reduced when he was admitted to the hospital, and had returned to normal by the time of discharge. In July 1993 Mr. Grant underwent surgery for removal of scar tissue surrounding his left lung. His prior medical records indicate that he sustained a left lung collapse in conjunction with an appendectomy done many years previously. The 1993 chest surgery was the result of this prior left lung injury or collapse that occurred many years earlier and the fluid or pneumonia in 1991.[FN1]

FN1. Neither Dr. Bederka nor Dr. Cugell was deposed by Grant's counsel during discovery.

***4** In rebuttal, Grant offers the opinions of his treating physicians-Drs. Bush, Lichtenberg, Khurana, Ahmad and Zahid-and though belatedly, Dr. Samuel Epstein ("Dr.Epstein"). Dr. Epstein, a medical doctor with expertise in the field of cancer, opines that Kure-N-Seal was defective and unreasonably dangerous because it failed to list hazardous components in its MSDS, misrepresented Threshold Limit Values ("TLV") (maximum safe exposure) of its various components and was never tested to determine the synergistic effects of mixing its individual components; Dr. Epstein opined that these product defects caused Grant's injuries. In addition, Dr. Epstein opined that the warnings on Kure-N-Seal failed to disclose the hazards of using the product or the conditions under which it could be safely used-it misleadingly implied that one could apply the product without breathing vapors and failed to make clear that normal ventilation would be inadequate. Dr. Epstein attaches to his his report and opinion the report of Alan Todd ("Todd"), an industrial hygienist retained to provide an estimate of the levels of exposure to the chemicals contained in Kure-N-Seal. As Dr. Epstein stated, ascertaining the level of exposure (along with the product ingredients) was a "prerequisite to my being able to develop a position on causation." In addition, Dr. Epstein reviewed the depositions of Grant, Dr. Ahmad, Dr. Bush, Dr. Khurana, Dr. Zahid, and the records from Sherman hospital. Dr. Epstein did not visit the Pacific warehouse.

Procedural History

This case has a rather tortured history that is important to recount because it serves, at least in part, as a basis for the Court's decision. Grant's Complaint was filed on January 20, 1993 and, after several status conferences, this Court ordered Grant to disclose any medical experts by September 7, 1993. Because of various failures of the discovery process, this goal was not met, resulting in the following court-ordered schedule: Chemrex was to respond to all outstanding discovery requests within thirty days; the parties were to depose Dr. Bush by February 10, 1994 and all treating physicians and occurrence witnesses by May 12, 1994. The Court also referred further discovery issues to Magistrate Judge Guzman.

On March 11, 1994, Magistrate Judge Guzman entered the following discovery schedule: "all written

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discovery to be completed by 7/15/94. Non-expert depositions to be completed by 10/15/94. Rule 26(a)(2)(B) reports to be exchanged by the parties by 11/15/94 and all expert depositions to be taken by 12/15/94." These deadlines came and went without Grant ever disclosing his expert witnesses or deposing Chemrex's properly-disclosed expert witnesses. In addition, Grant did not seek an extension of time or seek to compel any outstanding discovery from Chemrex. On December 19, 1994, with discovery closed, Magistrate Judge Guzman ordered all dispositive motions to be brought by January 13, 1995.

***5** Chemrex filed its motion for summary judgment on December 20, 1994, alleging that Grant could not establish causation because he had no expert testimony. Grant did not respond to the motion directly, but instead moved the Court to compel Chemrex to disclose the specific percentages of Kure-N-Seal ingredients, something he had been seeking from Chemrex since April 1994. Grant claimed that his expert could not provide any opinion without the specific chemical make-up of Kure-N-Seal. The Court again referred the matter to Magistrate Judge Guzman who denied the motion to compel without prejudice.

Grant then filed a partial response to the motion for summary judgment, but moved the Court to reopen discovery to allow him to disclose his expert witness, Dr. Epstein. On March 10, 1995, Magistrate Judge Guzman granted Grant's motion. Because discovery had been reopened, the motion for summary judgment was withdrawn on March 21, 1995.

On May 23, 1995, Magistrate Judge Guzman ordered Chemrex to produce the MSDSs for Kure-N-Seal. The Court also advised Grant that if he needed any more information to notify Chemrex by June 2, 1995. No such notification was made, nor were any motions to extend discovery brought. After several status hearings, on September 21, 1995, Magistrate Judge Guzman ordered Grant to disclose Todd's report by October 3, 1995 and to take Dr. Epstein's deposition by October 31, 1995. Finally, the Magistrate Judge ordered Chemrex to file its summary judgment motion by November 3, 1995.

Chemrex filed its summary judgment motion as directed. Thereafter, Grant filed his opposition to the motion, relying principally on the opinion of Dr. Epstein who, in turn, relied on Todd's findings. Grant, however, never disclosed Todd as an expert witness and, thus, Todd was never deposed by Chemrex. It is for these reasons that Chemrex moved for leave to file several motions to strike the expert testimony that Grant offered in his response to the motion for summary judgment. This Court, after a pretrial conference with the parties, granted Chemrex the requested leave and allowed Grant an opportunity to respond to the motions.

DISCUSSION

I. *Summary Judgment Standards*

Summary judgment is appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law. Fed.R.Civ.P. 56(c); *Serfecz v. Jewel Food Stores,* 67 F.3d 591, 596 (7th Cir.1995). A material fact is one that may affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Once the moving party has shown that no issue of material fact exists, the opposing party must come forward with specific evidence showing that there is a genuine issue for trial. *Celotex Corp. v. Catrett,* 477 U.S. 317, 324, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). The nonmovant may not rest upon mere allegations in the pleadings or upon conclusory statements in affidavits; rather he must go beyond the pleadings and support his contentions with proper documentary evidence. All reasonable inferences must be made in favor of the nonmoving party. *McCoy v. WGN Continental Broadcasting Co.,* 957 F.2d 368, 371 (7th Cir.1992).

***6** The plain language of Rule 56(c) mandates the entry of summary judgment against a party who fails to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex,* 477 U.S. at 322. In such a situation there can be no genuine issue as to any material fact, since a complete failure of proof concerning an essential element of the nonmoving party's case necessarily renders all other facts immaterial. *Id.* at 323.

Chemrex contends that it is entitled to summary

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judgment because Plaintiff cannot show causation. In addition, Chemrex has moved to (1) bar the expert opinions of Todd; (2) strike those opinions of Dr. Epstein which rely on the evidence supplied by Todd; (3) strike the testimonies of Grant's treating physicians regarding medical causation; (4) strike the testimony of Dr. Epstein regarding medical causation; and (5) strike the opinions of Dr. Epstein regarding product defect. As these motions to strike impact the summary judgment motion, they are considered first.

II. *Motions to Strike*

A. *Motion to Bar the Opinions of Todd*

Todd is an industrial hygienist hired by Grant after the close of discovery to render opinions on the chemical composition of Kure-N-Seal, the adequacy of the warnings and the MSDSs, and Grant's level of exposure to those chemicals. His report, which is included only as an appendix to Dr. Epstein's report, comments on the product, its warning label, and its MSDS. The report also estimates the levels of Grant's exposure, both as a whole, and with regard to the product's individual components.

Chemrex moves to strike Todd's report, arguing that Todd's report constitutes expert testimony that should have been disclosed to the opposing party as part of the discovery process pursuant to Rule 26(a)(2) of the Federal Rules of Civil Procedure. Rule 26(a)(2) also requires that this disclosure be accompanied by a written report prepared and signed by the witness. Moreover, Chemrex claims that to allow Grant to rely upon Todd's opinion without timely disclosure would prejudice Chemrex because Todd has not been deposed. Rule 26(b)(4) provides that "A party may depose a person who has been identified as an expert whose opinions may be presented at trial." Without a chance to depose Todd, Chemrex argues, the bases for his opinions and conclusions would be left unexamined.

The Court may exclude the testimony of witnesses who were not disclosed in a timely manner. *See Hill v. Porter Memor'l Hosp.,* 90 F.3d 220, 224 (7th Cir.1996); In re *Maurice,* 21 F.3d 767, 773 (7th Cir.1994). Here, Grant failed to disclose *any* experts, much less Todd, by the deadline imposed by the Court. Yet, after failing to meet this initial discovery deadline, Grant did manage to successfully petition the Court for another chance to disclose Dr. Epstein and thus, allow Chemrex to depose him. Grant neglected to do the same for Todd, however, despite being given lengthy discovery extensions and an opportunity in open court. To admit Todd's testimony without providing Chemrex the opportunity to examine Todd on the basis of his opinions would be unfair and prejudicial.

***7** Grant's counsel admits that Plaintiff "dropped the ball" in failing to properly disclose Todd as an expert but contends that this mistake was the product of Chemrex's belligerence and, thus, should be excused. Specifically, Grant claims that he repeatedly requested that Chemrex disclose the specific ingredients of Kure-N-Seal and that Todd could not render an opinion without such data. While this delay might excuse Grant's failure to offer Todd's report at the initial discovery deadline, it does not excuse his failure to file a timely petition with this Court or the Magistrate Judge seeking an extension of time to disclose Todd. Moreover, Plaintiff's excuse for his failure to disclose Todd is particularly unpersuasive when one considers that Dr. Epstein refers to and relies on Todd's report in forming his own opinion. As such, Todd's report must have been completed before Dr. Epstein's, and therefore, could have been disclosed at the same time as Dr. Epstein's, if not sooner. In short, if Grant intended to rely upon Todd's opinion, he had at least as much time to disclose Todd as a testifying expert, following whatever delays Chemrex may have caused, as he had for Dr. Epstein. Given the many opportunities Grant was given to present this issue to the Court, and his failure to do so, Grant must now proceed without Todd's input.

"Adherence to established deadlines is essential if all parties are to have a fair opportunity to present their positions." Hill, 90 F.3d at 224. Without such compliance, the decision-making process is severely hindered. Indeed, this case provides a clear example of the problems attendant to failure to adhere to court imposed deadlines. As Judge Easterbrook warned,

Ignoring deadlines is the surest way to lose a case. Time limits coordinate and expedite a complex process; they pervade the legal system, starting with the statute of limitations.... "Lawyers and litigants who decide to play by rules of their own invention will find that the game cannot be won."

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United States v. Golden Elevator, Inc., 27 F.3d 301, 302 (7th Cir.1994) (quoting *Northwestern Nat'l Ins. Co. v. Baltes,* 15 F.3d 660, 663 (7th Cir.1994)).

For the above reasons, Chemrex's motion to bar the expert opinion testimony of Todd is granted.

B. Motion to *Strike Dr. Epstein's Opinions Which Rely on Todd*

Chemrex also moves to strike the opinions of Dr. Epstein which rely upon Todd's report, arguing that Plaintiff should not be able to present the hearsay opinions of Todd-an undisclosed expert-on the chemical composition of Kure-N-Seal and the amount of Grant's exposure to the chemicals through Dr. Epstein.

Hearsay is defined as an out-of-court statement offered for the truth of the matter asserted. Todd's report certainly falls within this definition and thus, standing alone is inadmissible. Expert witnesses, however, are allowed to rely on hearsay in forming their opinions, as long as their opinions are based on the type of evidence reasonably relied on by experts in that particular field. Fed.R.Evid. 703 [FN2]; *see, e.g., AMPAT/Midwest, Inc. v. Illinois Tool Works, Inc.,* 896 F.2d 1035, 1045 (7th Cir.1990); *Janopoulos v. Harvey L. Walner & Assocs., LTD.,* 866 F.Supp. 1086, 1095 (N.D.Ill.1994); Weinstein & Margaret A. Berger, 3 Weinstein's Evidence § 703 [03] at 703-18 (1993).

> FN2. Federal Rule of Evidence 703 provides:
>
> > The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences on the subject, the facts or data need not be admissible in evidence.

***8** As the Seventh Circuit has instructed:

An expert is of course permitted to testify to an opinion formed on the basis of information that is handed to rather than developed by him-information of which he lacks first-hand knowledge and which might not be admissible in evidence no matter by whom presented. Fed.R.Evid. 703. And in explaining his opinion an expert witness normally is allowed to explain the facts underlying it, even if they would not be independently admissible.

In re James Wilson Assocs., 965 F.2d 160, 172 (7th Cir.1992). Nonetheless, "[t]he fact that inadmissible evidence is the (permissible) premise of the expert's opinion does not make that evidence admissible for other purposes, purposes independent of the opinion." *Id.* at 173. An expert may not be used "as a vehicle for circumventing the rules of evidence" to introduce inadmissible evidence for its own sake. *Id.* Thus, while Dr. Epstein could use the information contained in the industrial hygienist report to offer an opinion within Dr. Epstein's "domain of expertise", if possible, he could not testify for the purpose of "vouching for the truth of what [Todd] told him-of becoming in short [Todd's] spokesperson." *See id.*

Here, Chemrex argues that Dr. Epstein should not be allowed to rely on Todd's estimated levels of exposure as a basis for his own expert opinion because Dr. Epstein, as medical doctor, does not have the ability to evaluate the truth of Todd's conclusions. This Court agrees. Dr. Epstein is not an industrial hygienist, he did not perform any of his own studies regarding the Kure-N-Seal product, and he lacks the "technical expertise to determine the volume of the chemical components of Kure-N-Seal" and "arrive at a reasoned estimate of exposure" to the chemicals. (Dep. of Dr. Epstein, p. 60). Moreover, by his own admission, Dr. Epstein's "professional knowledge and ability" do not permit him to evaluate Todd's calculations and opinions regarding Grant's exposure levels. (Dep. of Dr. Epstein, p. 66).

An "expert witness must rely on his own expertise in reaching his opinion and may not simply repeat the opinions of others." *Faulkner v. Markkay of Ind., Inc.,* 663 N.E.2d 798, 801 (Ind.Ct.App.1996). To allow Dr. Epstein to introduce the findings of Todd as true, and rely on those findings in forming his own opinion on causation would allow the plaintiff to circumvent the rules of evidence by admitting Todd's conclusions-conclusions Dr. Epstein is unable to evaluate the accuracy and reliability of-through the

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back door; in effect, this would permit Dr. Epstein to become "[Todd's] spokesperson." *See James Wilson,* 965 F.2d at 173; *Gong v. Hirsch,* 913 F.2d 1269, 1272-73 (7th Cir.1990); *cf Janopoulos,* 866 F.Supp. at 1095.

Therefore, Dr. Epstein's testimony which relies upon Todd's report is hereby stricken.

C. *Treating Physicians' Opinions on Medical Causation*

Chemrex has moved to strike the opinions regarding causation of the physicians who treated Grant, arguing that such testimony is insufficient to establish medical causation and/or unacceptable under the standard set forth in *Daubert v. Merrell Dow Pharmaceutical, Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993).

***9** The admissibility of expert testimony in federal court proceedings is governed by Federal Rule 702, as interpreted by the Supreme Court in *Daubert.* In Daubert, the Supreme Court held that Rule 702 requires the trial judge to "ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable." 113 S.Ct. at 2795. The Seventh Circuit, interpreting *Daubert,* has established that when evaluating the admissibility of proffered testimony, district courts are to undertake a two-step inquiry:

Daubert first "directs the district court to determine whether the expert's testimony pertains to scientific knowledge. This task requires that the district court consider whether the testimony has been subjected to the scientific method; it must rule out 'subjective belief or unsupported speculation.' " Second, the district court must "determine whether the evidence or testimony assists the trier of fact in understanding the evidence or in determining a fact in issue. That is, the suggested scientific testimony must 'fit' the issue to which the expert is testifying."

O'Connor v. Commonwealth Edison Co., 13 F.3d 1090, 1106 (7th Cir.1994) (quoting *Porter v. Whitehall Labs., Inc.,* 9 F.3d 607, 613 (7th Cir.1993) (citations omitted)). The party who proffers an expert's testimony bears the burden of establishing its admissibility by a preponderance of proof. *Dukes v. Illinois Central R.R. Co.,* 934 F.Supp. 939, 946 (N.D.1996) (citations omitted)

Furthermore, the Seventh Circuit has offered the following admonition regarding expert testimony on medical causation:

An expert witness cannot guess or base an opinion on surmise or conjecture,.... Moreover, courts must be particularly wary of unfounded expert opinion testimony when medical causation is the issue. As we have previously noted, "There is not much difficulty in finding a medical expert witness to testify to virtually any theory of medical causation short of the fantastic."

Cella v. United States, 998 F.2d 418, 423 (7th Cir.1993) (citations omitted). With these standards in mind, the Court turns first to the physicians who treated Grant at Sherman Hospital, and then to his regular physician, Dr. Bush.

To begin, the medical causation testimonies of Grant's treating physicians are unavailing because none of them even offer an opinion as to the medical cause of Grant's injuries.[FN3] Drs. Ahmad (Pulmonary and Critical Care), Khurana (Gastroenterology), and Lichtenberg (Rheumatology) each testified that they had no opinion relating to medical causation between a toxic exposure and Grant's symptoms or had insufficient information to render a competent medical opinion. In addition, Dr. Zahid, Grant's attending physician, admitted that he was not capable of making a specific diagnosis because he was neither a toxicologist nor a pulmonary specialist.[FN4]

FN3. The Court does not distinguish the treating physician from other experts when the treating physical is offering expert testimony regarding medical causation. *O'Connor,* 13 F.3d at 1105 n. 14.

FN4. Furthermore, Plaintiff's Response refers solely to Dr. Bush's medical opinions and does not object to Chemrex's motion to strike the medical causation testimony of Dr. Lichtenberg, Dr. Khurana and Dr. Ahmad.

On the other hand, Dr. Bush, Grant's general physician and a urologist, opines that the combination of the exposure, temporally connected to symptoms

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provides a sufficient basis for causation when other causes or contributing factors have been eliminated. (Dep. of Dr. Bush, pp. 41, 76). The Court rejects Dr. Bush's testimony as to medical causation, however, because it finds that his methodology was not sufficiently scientific in nature to render such an opinion and he lacks the expertise to assist the trier of fact in understanding the evidence. *See Wintz v. Northrop,* 110 F.3d 508, 1997 WL 155272, at *5 (7th Cir. Apr.4, 1997).

***10** There is no evidence that Dr. Bush's testimony is based on sound scientific methodology. He arrived at his opinion by treating Plaintiff, and reviewing Plaintiff's medical records, the MSDS and the reports of the other treating physicians. Dr. Bush testified that he did not perform any independent studies, or review any research for the purpose of reaching his opinion. (Dep. of Dr. Bush, pp. 13, 50-51). Dr. Bush has not presented any technique or methodology by which his conclusions can be scientifically and objectively tested. Further, despite the fact that Plaintiff's treating physicians and hired experts agree that information regarding the level of chemical exposure is necessary to render a competent medical opinion, Dr. Bush lacked this information. (Dep. of Dr. Bush, pp. 8, 24). Dr. Bush is unable to meet the Daubert requirements because he has no factual or scientific basis or empirical data to support his opinions, but rather his conclusions are based on his own subjective observations. *See Dukes,* 934 F.Supp. at *949; O'Connor* 13 F.3d at 1106-07; *Deimer v. Cincinnati Sub-Zero Prods. Inc.,* 58 F.3d 341, 341 (7th Cir.1994) (affirming exclusion of doctor's testimony regarding causation because doctor did not conduct any studies or analysis to substantiate his opinion or provide any supporting methodology or protocol).

Even assuming that Dr. Bush's methodology was sufficiently grounded in scientific methodology to be admissible, the Court does not believe that Dr. Bush's testimony would be helpful to the trier of fact. “Whether a witness is qualified as an expert can only be determined by comparing the area in which the witness has superior knowledge, skill, experience, or education with the subject matter of the witness's testimony.” *Carroll v. Otis Elevator Co.,* 896 F.2d 210, 212 (7th Cir.1990). Indeed, “[a] medical degree ‘alone does not qualify [an expert] to give an opinion on every conceivable medical question.’ ” *O'Connor v. Commonwealth Edison Co.,* 807 F.Supp. 1376, 1390 (C.D.Ill.1992) (citation omitted), aff'd, 13 F.3d 1090 (7th Cir.1994)).

Dr. Bush is a specialist in urology, not pulmonary medicine, or gastroenterology. Although Dr. Bush's claims experience and/or expertise based on the fact that he did a rotation through pulmonary medicine during his residency and has participated in an advisory committee on gastroenterology, in comparison to the other specialist in the fields of rheumatology, gastroenterology, pulmonary and critical care who could not reach an opinion regarding the medical cause of Grant's symptoms within a reasonable degree of medical certainty, the Court does not find that someone with Dr. Bush's knowledge on the relevant subject matter would assist the trier of fact.

Accordingly, for the above reasons, Bush's testimony is inadmissible.

D. *Dr. Epstein's Opinions on Medical Causation*

Similarly, the Court finds that Dr. Epstein's opinions regarding causation are speculative and inadmissible and that, even if admissible, they are insufficient to create a genuine issue of fact regarding causation. According to Dr. Epstein himself, evidence regarding the amount of chemicals that Plaintiff was exposed to is “critical” to his ability to express a valid position on causality. In fact, as he admits, evidence of chemical exposure was “a prerequisite to [his] being able to develop a position on causality.” Specifically, Dr. Epstein states in his deposition:

***11** A: As soon as I got involved in the case *I emphasized that there were two pieces of information which were critical [ ] to be able to express a scientifically valid position on causality.*

One was the ingredients in the Gray Kure-N-Seal. And it was clear to me that the M.S.D.S. which I'd been provided was not, to say the least candid, on this. The second is estimated levels of exposure, which is a specialty of industrial hygienists, and after a time, Mr. Todd on my recommendation was brought in to provide advice and guidance on these matters.

Q: When did you first express the need to have the two components of that analysis looked at?

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A: Almost immediately .... it's a routine prerequisite to find out what chemicals you're dealing with and roughly ballpark levels of exposure....

And almost, I would say, within a month or so of getting involved in the case *I stressed that these were a prerequisite to my being able to develop a position on causation.*

(Dep. of Dr. Epstein, p. 62) (emphasis added).[FN5]

> FN5. In addition, "the Federal Judicial Center's Reference Manual on Scientific Evidence (1994) notes that the following three 'preliminary assessments' should be made by an expert toxicologist as premises for an opinion:
>
> > First, the toxicologist should analyze whether the disease can be related to chemical exposure by a biologically plausible theory. Second, the expert should examine if the plaintiff was exposed to the chemical in a manner that can lead to absorption into the body. Finally, the expert should offer an opinion as to whether the dose to which the plaintiff was exposed to is sufficient to cause the disease."
> >
> > *Wintz,* 110 F.3d 508, 1997 WL 155272, at *5.

Unfortunately for Plaintiff, however, Dr. Epstein has not conducted any studies of the Kure-N-Seal product or the levels of Grant's exposure himself (nor does he have the expertise to do so). Moreover, as discussed above, he is barred from accepting Todd's estimates of chemical exposure as true in offering his opinion. Thus, as a result, Dr. Epstein, by his own admission, lacks information "critical" to his opinion of medical causation and cannot "express a scientifically valid position on causality."

Furthermore, although Plaintiff argues that Dr. Epstein's opinions do not stand or fall on Todd's report, Dr. Epstein's deposition testimony, considered in its entirety, belies that argument. Despite Dr. Epstein's grasp of the scientific knowledge regarding chemicals and adverse toxic reactions, he refers to and relies on Todd's exposure calculations, as he must, in forming his opinion. It is true that Dr. Epstein also opines that there was a "direct temporal relationship" between the unknown level of exposure and Plaintiff's medical symptoms, and "no other known [cause] in [Grant's] medical records." (Dep. of Dr. Epstein, pp. 170, 183). Yet, regardless of the strength of these conclusions, before Dr. Epstein actually reaches his opinions regarding causation, he considers Todd's estimates of exposure.[FN6] Epstein notes that "the Todd estimates of exposure, [ ] make it clear that on a quantitative level [Plaintiff's] exposures were extremely high," (Dep. of Dr. Epstein, pp. 183-84), and he relies on this information in his analysis. As Dr. Epstein admits, without scientific facts regarding the exposure level, he is unable to establish the necessary causal link between the Kure-N-Seal Product and Plaintiff's injuries. See *Waldridge v. American Hoechst Corp.,* 1992 WL 612252, at *9-10 (S.D.Ind. Oct.6, 1992)(expert "did not possess sufficient information regarding the particular facts of Plaintiff's exposure to render a probative, admissible opinion that [ ] [chemical] exposure caused her injuries"), *aff'd,*24 F.3d 918 (7th Cir.1994); *Wintz,* 110 F.3d 508, 1997 WL 155272, at *4-6.

> FN6. Further, to the extent that Plaintiff relies on Dr. Epstein's opinion that there is a direct temporal relationship between Plaintiff's exposure and his medical symptoms to establish causation, Chemrex correctly notes that "it is well settled that a causation opinion based solely on a temporal relationship is not derived from scientific method and is therefore insufficient to satisfy the requirements of Fed.R.Evid. 702." *Schmaltz v. Norfolk & W. Ry.,* 878 F.Supp. 1119, 1122 (N.D.Ill.1995); *see also Porter, 9 F.3d at 611;* In re "Agent Orange" Prod. Liab. Litig., 611 F.Supp. 1223, 1248 (E.D.N.Y.1985) (finding Dr. Samuel Epstein's testimony to be inadmissible and insufficient as a basis for a finding of causality), *aff'd,*818 F.2d 187 (2d Cir.1987).

III. *Absence of a Genuine Issue of Fact Regarding Causation*

***12** Grant seeks to recover against Chemrex on claims of claims of negligence, strict product liability and breach of warranty. Although the elements in

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each of the three theories are somewhat different, in order to recover under any of these theories, Plaintiff must show that the product is unreasonably dangerous and there is a causal relationship between his injury and the defective product.[FN7]

> FN7. In a product liability cause of action based on negligence, a plaintiff must establish: the existence of a legal duty owed to the plaintiff by the defendant; a breach of that duty; a resulting compensable injury to the plaintiff; and the breach must have been the proximate cause of the plaintiff's injury. *Miller v. Dvornik,* 149 Ill.App.3d 883, 890, 501 N.E.2d 683, 687 (1st Dist.1986). To recover under strict product liability, a plaintiff must plead and prove: 1) a manufacturing defect in the product that renders it unreasonably dangerous; 2) the presence of the defect in the product at the time the product left the manufacture's control; and 3) that the defective condition of the product was the cause of the injury. *Cozzi v. North Palos Elementary Sch. Dist. No. 117,* 232 Ill.App.3d 379, 384-85, 173 Ill.Dec. 709, 597 N.E.2d 683, 687 (1st Dist.1992). As to the breach of warranty claim, there is considerable similarity in analysis in evaluating a strict liability claim and a warranty claim. *Roback v. V.I.P. Transp., Inc.,* 1994 WL 327414 (N.D.Ill. Jul.6, 1994), *aff'd,*90 F.3d 1207 (7th Cir.1996). In fact, "[b]reach of implied warranty and strict liability are nearly identical; the distinguishing feature is that warranty is based on contract and strict liability is based on tort." *Id.* (citing *Garcia v. Edgewater Hosp.,* 244 Ill.App.3d 894, 184 Ill.Dec. 651, 613 N.E.2d 1243 (1st Dist.1993)).

A causal relationship is more than the mere possibility that the product caused the injury; there must be evidence justifying an inference of probability that the product caused the injury. *Tragarz v. Keene Corp.,* 980 E.2d 411, 418 (7th Cir.1992). The plaintiff must introduce evidence with reasonable probative force as to this probability, as juries will not be permitted to engage in "mere speculation or imagination." *Parker v. Freightliner Corp.,* 940 F.2d 1019, 1026 (7th Cir.1991); *see Tragarz,* 980 F.2d at 418. Moreover, expert testimony usually is necessary to establish a causal connection between an injury and its source "unless the connection is a kind that would be obvious to laymen, such as a broken leg from being struck by an automobile." *Schmaltz v. Norfolk & Western Ry. Co.,* 896 F.Supp. 180, 182 (N.D.Ill.1995).

In this case, Chemrex has presented the affidavits of two experts which sufficiently counter the allegations set forth in Grant's Complaint. Dr. Bederka, an expert in toxicology, pharmacology and chemistry, performed an inspection of the premises and scientific calculations of Grant's exposure and concluded that Kure-N-Seal is safe as manufactured, that the information contained on the label and MSDSs are appropriate indicators of the product's hazards, and that Grant's injuries were not caused by Kure-N-Seal. Dr. Cugell, a specialist in pulmonary medicine, reviewed the relevant medical records, Grant's medical history, and the depositions of all the parties involved, and concluded that Grant's lung problems were the likely result of an infection stemming from a collapsed lung injury which occurred many years earlier. Thus, through Drs. Bederka and Cugell, Chemrex has offered evidence that Grant's medical problems were not the result of his exposure to the Chemrex product.

Plaintiff's ability to establish an issue of fact of whether his injuries were caused by exposure to Chemrex's Kure-N-Seal, however, has been detrimentally affected by his failure to properly disclose an expert necessary to prevail. Todd's conclusions as an industrial hygienist were critical to Plaintiff's demonstration of a causation, yet he was never disclosed as an expert and his deposition was never taken. Grant, who must prove causation, has presented no admissible evidence regarding his exposure, and thus is unable to establish a causal link between his use of the Kure-N-Seal product and his subsequent medical problems. Such opinion testimony which is scientifically non-founded is insufficient to controvert the defenses of Chemrex and its experts. Accordingly, Chemrex's motion for summary judgment is granted.

CONCLUSION

***13** For the reasons set forth above, the Court grants Chemrex's motions to exclude the opinions of Todd, to strike the opinions of Dr. Epstein which rely on Todd, and to strike Plaintiff's expert testimony re-

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garding causation.[FN8] Thus, because Plaintiff is unable to demonstrate any issue of material fact on the causation issue, Chemrex's motion for summary judgment is granted.

FN8. As the issue of causation is dispositive, Chemrex's motion regarding product defect is rendered moot.

N.D.Ill.,1997.
Grant v. Chemrex, Inc.
Not Reported in F.Supp., 1997 WL 223071 (N.D.Ill.)

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TAB 21

United States District Court, N.D. Illinois, Eastern Division.
HEIDELBERG HARRIS, INC., Plaintiff,
v.
MITSUBISHI HEAVY INDUSTRIES, LTD. and MLP U.S.A., Inc., Defendants.
No. 95 C 0673.

Nov. 21, 1996.

Alan N. Salpeter, Javier H. Rubinstein, Mayer, Brown & Platt, Chicago, IL, Richard L. Mayer, Richard L. DeLucia, Richard S. Gresalfi, Michael D. Loughnane, Kenyon & Kenyon, New York City, for Plaintiff.
Harry J. Roper, William P. Oberhardt, John E. Titus, George S. Bosy, Roper & Quigg, Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER

ASHMAN, United States Magistrate Judge.
***1** This case was brought by Heidelberg Harris, Inc. ("Harris"), charging Defendants, Mitsubishi Heavy Industries, Ltd. and Mitsubishi Lithographic Presses, U.S.A., Inc. ("Mitsubishi"), with the infringement of three patents owned by Harris, all of which involve offset printing presses that are used in the printing of newspapers, magazines and other publications. Mitsubishi denies the infringement of any Harris owned patents and further claims that the patents are invalid and unenforceable. In their answers, Defendants presented several affirmative defenses, including the defense that Patent Nos. '267, '048 and '981 are unenforceable and invalid because the alleged inventions failed to meet one or more of the conditions of patentability set out in Title 35 U.S.C. §§ 102, 103 and 112.

After the close of fact discovery on May 17, 1996, the parties exchanged expert reports. As a result of information contained in these reports, Plaintiff claims it became aware for the first time of Defendants' intention to raise the defense of inequitable conduct in connection with the prosecution of the '048 and '981 Patents, in addition to Defendants' intention to raise a Section 112 "best mode" defense. Consequently, Plaintiff filed these two motions *in limine* to prevent Defendant from introducing any evidence with respect to these defenses at trial. In response to Plaintiff's inequitable conduct motion *in limine,* Defendants filed a motion to amend their answer.

The Court will first address Plaintiff's inequitable conduct motion *in limine* in conjunction with the Defendants' motion to amend their answer and will then turn to the Plaintiff's second motion *in limine* concerning the Section 112 "best mode" defense.

I. Plaintiff's Motion *In Limine* To Preclude the Introduction of Evidence Related To the Inequitable Conduct Defense and Defendants' Motion To Amend Their Answer To the Complaint.

Plaintiff advances three arguments in favor of its first motion *in limine:* (A) Defendants failed to raise the affirmative defense of inequitable conduct in their answers and additionally failed to plead that defense with the particularity required by FED. R. CIV. P. 9(b); (B) Defendants should be barred from amending their answer to include this affirmative defense because such an amendment would be unfair and prejudicial; and (C) such an amendment should be barred because Mitsubishi's allegations are futile. The Court will address each argument in turn.

A. Defendants' Failure To Plead The Inequitable Conduct Defense

Plaintiff first argues that Defendants did not plead inequitable conduct as an affirmative defense in any of their answers and further never indicated through interrogatory answers that they had any intention of raising this defense. Plaintiff not only argues that

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this defense should have been pled, but further contends that it should have been pled with sufficient particularity to satisfy the requirements of FED. R. CIV. P. 9(b) ("Rule 9(b)"), which Plaintiff argues applies to claims of inequitable conduct.

***2** Defendants contend that their answer sufficiently pleads the affirmative defense of inequitable conduct. However, no citation to a paragraph in the answer is given to support this proposition. Additionally, Defendants allege that claims of inequitable conduct need not be pled with the particularity required by Rule 9(b). Despite the above argument, Mitsubishi moves to amend its answer to conform to the requirements set out by Rule 9(b) regarding specificity in pleading claims involving fraud.

FED. R. CIV. P. 9(b) requires: "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."FED. R. CIV. P. 9(b). One of the rule's purposes in requiring particularity in the pleadings is "to deter the filing of charges of fraud as a pretext for discovery of unknown wrongs." *Solarex Corp v. Arco Solar, Inc.,* 121 F.R.D. 163, 178 (E.D. N.Y. 1988). Although the Federal Circuit has not directly addressed the need to plead inequitable conduct claims with specificity, the general trend, including that in this district, requires that inequitable conduct be pled in accordance with the specificity requirements of Rule 9(b).*Northern Eng'g & Plastics Corp. v. Blackhawk Molding Co.,* 205 U.S.P.Q. 609, 610 (N.D. Ill. 1979); *Solarex Corp. v. Arco Solar, Inc.,* 121 F.R.D. 163, 178 (E.D. N.Y. 1988), *aff'd,* 870 F.2d 642 (Fed. Cir. 1989); *Sunflex Co. v. Softview Computer Prods.,* 18 U.S.P.Q.2d 1171, 1172 (N.D. Ill. 1990); *Energy Absorption Sys. v. Roadway Safety Servs. Inc.,* 28 U.S.P.Q.2d 1717, 1718-19 (N.D. Ill. 1993). This Court agrees that claims of fraud, including claims of inequitable conduct, should be supported by specific allegations as mandated by Rule 9(b). Such a requirement prevents claims of fraud from being used to impugn the integrity of attorneys involved in patent prosecutions without sufficient evidence that wrongdoing has in fact occurred and constrains the utilization of such claims to redressing wrongs committed, rather than to uncovering wrongs merely suspected.

Defendants have failed to plead their inequitable conduct defense with sufficient particularity to satisfy the dictates of Rule 9(b). Nowhere in Defendants' answers does this Court find any allegations which demonstrate that the inequitable conduct defense was ever pled, much less pled with any specificity. Only in the broadest terms is it possible to infer that the allegations regarding the unenforceability of the '048 and '981 Patents under 35 U.S.C. §§ 102 and 103 might encompassed facts which would support an inequitable conduct defense.

As a result of Defendants' failure to adequately plead the inequitable conduct defense, the Plaintiff's motion *in limine* will be granted unless the Court allows the Defendants to amend their answer. Consequently, the Court next turns to the arguments advanced by both sides on Defendants' motion to amend the answer.

B. The Plaintiff Will Suffer Undue Prejudice If the Defendants' Motion To Amend Is Granted.

***3** Defendants move for leave to amend their answer to add more specific allegations on their inequitable conduct defense in the event the Court determines that such specificity is required. Plaintiff, however, contends that Mitsubishi should be prevented from amending its answer after the close of fact discovery because such an amendment would be would be prejudicial.

Leave to amend may be denied where it would either prejudice the opposing party or result in the addition of a futile allegation. *Foman v. Davis,* 371 U.S. 178, 182 (1962). Plaintiff alleges that it would be prejudiced by the proposed amendment because it had no notice that inequitable conduct would be at issue until after fact discovery was closed. Therefore, Plaintiff argues that it has been deprived of

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the opportunity to explore the basis for the Defendants' claim. Plaintiff further alleges that to reopen discovery would prejudice Plaintiff by causing undue delay of the trial. However, the Court notes that a trial date has yet to be set in this case.

Defendants claim that Plaintiff will not suffer any prejudice as a result of the delay. Defendants claim that the only Mitsubishi witness Plaintiff will have to depose on this issue is Mitsubishi's expert and expert depositions have not yet begun. Defendants further contend that any other information related to this claim would be in Plaintiff's possession,[FN1] thereby eliminating any real need for further discovery by Plaintiff. Thus, Defendants claim that Plaintiff would suffer no prejudice as a result of allowing Defendants' amendments on this issue.

> FN1. Examples of information in Plaintiff's possession includes information known by Plaintiff's employees and documents produced by Plaintiff related to this defense.

While Plaintiff may suffer some prejudice as a result of allowing this amendment, the Plaintiff was unable to articulate any specific examples of how it would be prejudiced or what it would have done differently had it been made aware of this defense earlier. The Court finds that the Plaintiff's general allegations of prejudice regarding delay and additional expense do not rise to a level sufficient to override, on their own, the liberal right to amend embodied by FED. R. CIV. P. 15(a). Therefore, the Court is unwilling to deny the Defendants' motion for leave to amend based on this ground alone.

C. The Defendants' Proposed Amendment Is Futile.

Plaintiff's final contention is that the amendment should not be allowed because Defendants' inequitable conduct claim is futile. Plaintiffs argue that a proposed amendment is futile if it could not survive a motion for summary judgment. Citing *CBS., Inc. v. Ahern,* 108 F.R.D. 14, 18 (S.D. N.Y. 1985), Defendants, on the other hand, contend that the proper standard for deciding whether a motion to amend should be denied for futility is whether the amendment would survive a motion to strike under Fed. R. Civ. P. 12(f). To survive a motion to strike, Defendants argue they need only present facts which, if proven, would constitute a valid defense.

A proposed amendment is futile if it could not withstand a motion for summary judgment. *Porter v. State of Illinois,* 36 F.3d 684, 690 (7th Cir. 1994). Although some courts base their futility determination on whether the amendment would survive a motion to dismiss, the parties here have appended substantial evidence to their memoranda for the Court's consideration. When evidence is attached to a motion to dismiss under FED. R. CIV. P. 12(b)(6) and is not excluded from consideration, the motion is treated as one for summary judgment. FED. R. CIV. P. 12(b). Because the Court will be going beyond the scope of the complaint and proposed answer to reach its conclusion, the Court finds the standard used in analyzing motions for summary judgment appropriate here. Consequently, the Court must determine whether each allegation of inequitable conduct proposed in the amendment to the answer could survive a motion for summary judgment.

***4** To establish inequitable conduct, clear and convincing proof of each of the following is required: (1) that the applicant or one substantially involved with the prosecution of a patent omitted or misrepresented material prior art or information; (2) that such person knew of the materiality of the prior art; and (3) intended to deceive the Patent Office by deliberately withholding the prior art or information. *Kingsdown Medical Consultants, Ltd. v. Hollister, Inc.,* 863 F.2d 867,872 (Fed. Cir. 1988), *cert. denied,* 490 U.S. 1067 (1989).

Plaintiff asserts that there are two basic inequitable conduct allegations in Defendants' expert's report and that neither is sufficient to support a charge of inequitable conduct. The first claim of inequitable conduct centers around Defendants' claims that Mr.

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Hobby made untrue statements in the affidavit he submitted to the Patent Examiner in connection with the '048 Patent prosecution. Defendant claims that Mr. Hobby made three material misrepresentations about the commercial success and performance of the '048 patented presses including: (1) that the presses cost approximately $12 million dollars each; (2) that the presses operated with good print quality at speeds up to 3000 feet per minute and (3) that the presses were regarded as a commercial success by the industry. Defendants claim that these allegations were made to overcome the Patent Examiner's prior rejection of Plaintiff's patent application on the grounds of obviousness under 35 U.S.C. § 103.

With respect to the first contention, Defendants claim that Mr Hobby grossly inflated the selling price of the presses by claiming that they sold for $12 million each when, in fact, only three of the presses sold for $12 million and over half generated net revenues of less than $10 million.

Plaintiff responds that Mr. Hobby's statement was not false. In his affidavit, Mr. Hobby stated that "while prices vary, each Sunday Press costs about $12 million dollars."Plaintiff argues that the average list price at the time Mr. Hobby gave his affidavit was $12,614,922 and the average net price was $11,459,208. Additionally, Plaintiff points out that rebates given to some customers after the date of Mr. Hobby's affidavit can hardly be used as evidence of dishonesty on Mr. Hobby's behalf.

Defendant never establishes how the difference in price it alleges is material. However, even assuming the materiality of this fact, there is insufficient evidence to support Defendants' contentions. Plaintiff's price chart establishes that, as of August 10, 1994, the average cost was about $12 million per machine. (Exhibit 37 of Plaintiff's Reply Brief). Mr. Hobby gave his affidavit on August 11, 1994. Defendants' price chart, on the other hand, covers fiscal years 1993 to 1996 and therefore covers periods extending far beyond the period relevant to a determination of the veracity of Mr. Hobby's affidavit statements. Additionally, the Defendants' own price chart establishes that the average gross sales price was around $11 million. Mr. Hobby's affidavit stated the average cost of a press, not the average revenue generated by the sale of a press. Consequently, Mr. Hobby's failure to figure in the effect of any rebates, allowances, and commissions does not constitute a misrepresentation on his behalf. The evidence presented supports Plaintiff's claim that Mr. Hobby's affidavit was factually correct at the time. Therefore, not only is the materiality of the presses' cost questionable, but Defendants have also failed to establish that Mr. Hobby's statements regarding the cost of the presses were, in fact, misrepresentations.

***5** In addressing the second and third contentions, Defendants claim that Plaintiff misrepresented the performance capabilities and the commercial success of the press. Defendants contend that several of Plaintiff's customers were complaining about the performance of the presses in that they were not performing at the promised 3000 feet per minute rate with acceptable print quality. Defendants argue that these complaints refute Plaintiff's claim that the industry considered the presses to be a commercial success, since the people most familiar with the presses, namely the customers, were dissatisfied. Defendants contend that, not only does the dissatisfaction of these customers contradict Plaintiff's claim of commercial success, they also demonstrate that the presses did not produce good print quality at speeds of 3000 feet per minute, as stated by Mr. Hobby in his affidavit.

Based on the evidence presented, the Defendants' motion to amend the answer to include Paragraph 38(a) is denied. First, Mr. Hobby never stated that there were no problems or complaints with the presses in his affidavit. At the time the affidavit was given, the only complaints Plaintiff had received were from R. R. Donnelley regarding six of the early presses. The only other complaint was received after Mr. Hobby made his affidavit.[FN2]The Court does not find that the failure to reveal one

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customer's complaints makes Mr. Hobby's statements about the commercial success or the performance abilities of the presses misleading or deceptive, especially when viewed in light of evidence existing at the time, which supported Plaintiff's and Mr. Hobby's statements that the press operated with good print quality at speeds of up to 3000 feet per minute. (Exhibits 38 and 39 of Plaintiff's Reply Brief). Consequently, the Court does not find that the Defendants have presented sufficient evidence to raise a genuine issue of material fact as to Plaintiff's intent to mislead or as to Plaintiff's alleged submission of false information to the Patent Examiner and therefore, the Court denies the Defendants' motion to amend its answer to add Paragraph 38(a).

> FN2. Perry Printing's complaints regarding the performance of on of the Harris' presses was dated December 7, 1994 -- nearly four months after Mr. Hobby gave his affidavit to the Patent Office.

The Defendants' second inequitable conduct allegation is based on the Defendants' contentions that Plaintiff and its attorneys never revealed the existence of the Vanguard Press or Ghormley '851 Patent to the patent examiner, even thought Mr. Hobby, Plaintiff's Vice President of Marketing, was aware of the existence of the press and of its acquisition by Plaintiff, many years before, when he gave his affidavit to the Patent Office during the prosecution of the '048 Patent. Defendants contend that this information was relevant as prior art, which Plaintiff had a duty to disclose.

Plaintiff argues that the evidence uncovered through discovery shows that no one knew of the features Defendants claim the press had, which would make it relevant as prior art, nor of the Ghormley '851 Patent, and thus, there was no intent to deceive or withholding of information from the Patent Office.[FN3]

> FN3. Additionally, the Plaintiff argues that there is no disagreement that the Vanguard press was different from the press patented under the '048 Patent in that the Vanguard press did not contain a removable gapless blanket, while the blanket on the '048 patented press was both removable and gapless. Plaintiff appears to be contending that the Vanguard press would not have been relevant as prior art, even if Mr. Hobby or the others had sufficient knowledge of the Vanguard press. (Footnote 4 of Plaintiff's Motion *In Limine*).

***6** In response, Defendants claim that this press was on display at a plant that was visited by many Harris employees, including Hobby, and that Mr. Hobby attempted to locate an old Vanguard press, thereby establishing Mr. Hobby's familiarity with the press. Plaintiff, however, argues that neither Mr. Hobby nor any of the inventors ever saw the press allegedly kept at the Texas plant as a museum piece, and that Mr. Hobby was only trying to obtain an old press, not necessarily a Vanguard press.

The Defendants' motion to amend the answer is denied as to the inclusion of proposed Paragraph 38(b)(i) and (ii). The evidence supports the Plaintiff's contention that Mr. Hobby did not know anything substantive about the Vanguard press and was not even aware of the fact that Harris had purchased the Vanguard technology. Conversely, there is no evidence that any of the inventors of the press at issue (the '048 patented press) or Mr. Hobby every saw the Vanguard press and no evidence that any of the inventors even knew what the features of the press were. Two of the inventors and Mr. Hobby had heard the term "Vanguard press" before, but there is insufficient evidence to establish that any of the inventors or Mr. Hobby had enough knowledge about the press to know that it might be relevant as prior art. Consequently, there is no evidence to support the conclusion that these individuals withheld prior art with the intent to mislead the Patent Examiner.

The final inequitable conduct contention submitted by Defendants centers around Plaintiff's alleged

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failure to disclose the existence of the "Speedwell Sleeve System," a flexographic printing sleeve that Defendants claim is relevant as prior art. Plaintiff, however, contends that the patents on the "Speedwell Sleeves" were disclosed to the Patent Office. Plaintiff states that the patents covering this invention were listed as cited references on a document given to the Patent Office in connection with the prosecution of the '048 Patent.

Defendants' motion to amend the answer to include the allegations contained in Paragraph 39 is denied. Defendants have provided no proof, other than their unsupported allegations, that Plaintiff ever withheld this information from the Patent Office. Furthermore, Plaintiff has provided evidence that the patents which covered the Speedwell Sleeves were included as cited references in another document which was given to the Patent Office in connection with the prosecution of the '048 Patent (Exhibits 34, 40, 41, 42 of Plaintiff's Reply Brief). The evidence refutes Defendants' unsupported allegations of inequitable conduct with respect to the Plaintiff's alleged failure to notify the Patent Office of the Speedwell Sleeve System and the Defendants' motion to amend their answer to add Paragraph 39 is therefore denied.

This Court finds that, for the above reasons, none of Defendants' claims of inequitable conduct could survive a motion for summary judgement, thereby establishing the futility of the claims Defendants seek to add. The Defendants' motion to amend is therefore denied and Plaintiff's motion *in limine* as to the Defendants' inequitable conduct defense is granted.

II. Plaintiff's Motion *In Limine* to Preclude the Introduction of Evidence On the Defendants' "Best Mode" Defense

***7** The Plaintiff's second motion *in limine* is directed at precluding the introduction of any evidence regarding a violation of 35 U.S.C. § 112, specifically regarding Defendant's contention that Plaintiff's inventors violated the "best mode" requirement of Section 112 by concealing as proprietary one of the key ingredients used to make the rubber in the print blanket. Plaintiff, on the other hand, contends that its motion *in limine* should be granted because Defendants failed to timely notify Plaintiff of the defense and failed to supplement their interrogatories with respect to this defense. Consequently, Plaintiff contends it will be prejudiced by the Defendants' introduction of any evidence of this issue at trial.

Plaintiff contends that, although Defendants made broad allegations in their answer that the patents at issue were invalid under 35 U.S.C. § 112, when asked about the nature of their Section 112 defense in subsequent interrogatory questions, Defendants failed to set forth any grounds upon which they were going to challenge the validity of the asserted claims under Section 112. Plaintiff contends that Defendants revealed the basis of their Section 112 defense for the first time in their expert reports, after fact discovery had closed, thereby failing to comply with their duty to supplement information contained in interrogatory responses under FED. R. CIV. P. 26(e)(2). Consequently, Plaintiff argues that Defendants should be precluded from presenting evidence on this issue at trial for failing to supplement the interrogatory answers.

Plaintiff finally contends that allowing Defendant to raise this defense now, after fact discovery has closed, would be prejudicial because Plaintiff will have been denied its opportunity to investigate the underlying facts and develop a response. Plaintiff alleges that, had it know of the details of Defendants' Section 112 defense, it would have modified its approach in deposing Sumitomo and Mitsubishi representatives. Plaintiff claims that it cannot redepose 50 witnesses or afford the expense of investigating this new defense.

While the Plaintiff was given general notice of Defendants' intent to assert a Section 112 defense, both through the Defendants' answer and its responses to interrogatories,[FN4] the details of and the

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basis for that defense were never fleshed out until after fact discovery closed and the Defendants' expert reports were disclosed. The Defendants imply that they were unable to provide the specifics of their Section 112 defense until after they deposed Harris' named inventors on the subject. These depositions took place one month before the Defendant provided the Plaintiff with the expert reports. However, after reviewing the deposition testimony provided, there is no indication that the depositions did anything to enhance the Defendants' understanding of this defense or provide the Defendants with any of the facts they needed to flesh out this defense.

FN4. The Defendants' answer included the following allegations:

> The claims of the [patents in suit] are invalid and/or unenforceable because the alleged inventions purported to be claimed therein fail to meet one or more of the conditions for patentability specified in Title 35, United States Code, specifically sections 102, 103, and 112.
>
> To the extent that plaintiff alleges that any asserted claim of the [[[patents in suit] allegedly is of a scope sufficient to cover any activity by defendants, each such claim is invalid and/or unenforceable because each such claim fails to meet one or more of the conditions for patentability specified in Title 35, United States Code, specifically sections 102, 103, and 112.
>
> Additionally, in response to Plaintiff's interrogatory and supplemental interrogatory questions regarding the basis and factual grounds for the Section 112 defense, Defendants stated:
>
> To the extent that plaintiff seeks to ignore limiting elements of the as yet unasserted claims of the patents at issue, and attempts to broadly construe the claims of patents at issue to cover the accused press, blanket, and/or method, Mitsubishi states that one or more of the following prior art references (copies of which have been or are being produced by plaintiff to Mitsubishi), alone or in combination, would render the claims of the patents invalid under 35 U.S.C. §§ 102, 103 and/or unenforceable. Furthermore, any such broad interpretation of the claims would lack support in the patent specification under 35 U.S.C. § 112.

The Defendants base their “best mode” defense on the phrase “proprietary curative in nitrile polymer” which appears in the text of both the blanket method and the August patents. Mitsubishi had notice that the August patent was at issue on November 13, 1995, when Plaintiff filed its Second Amended Complaint, and that the blanket method patent was at issue on February 2, 1995, when the Plaintiff filed this suit. Additionally, other documents establishing that the Harris inventors knew the exact formula for the best printing rubber were disclosed to Defendant in June and July of 1995.[FN5] Consequently, the Court finds that Defendants' had notice of the facts that form the basis of their Section 112 defense well before the close of fact discovery on May 17, 1996.

FN5. Documents DX-120, DX-136 and DX-55 (Exhibits 6 and 7 of Mitsubishi's Reply to Harris' § 112 Motion *In Limine* and Exhibit 5 of Harris' Response to Mitsubishi's' Reply) establish that Harris' inventors obtained the exact formula for the best printing rubber from American Roller Company. In its Response to Harris' Motion *In Limine,* Mitsubishi refers to these documents to support its assertion that Harris violated Section 112's best mode requirement because it obtained the formula for the printing rubber, but nevertheless, concealed the formula as proprietary. Con-

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sequently, it is clear that, at a minimum, Mitsubishi was aware of the substance of its Section 112 defense in July of 1995, when these documents were produced.

***8** Under FED. R. CIV. P. 26(e)(2)

a party is under a duty seasonably to amend a prior response to an interrogatory ... if the party learns that the response is in some material respect incomplete or incorrect and if the additional or corrective information has not otherwise been made known to the other parties during the discovery process or in writing.

“The [ ] Court has broad discretion in determining whether to impose sanctions, including the exclusion of evidence, for discovery violations.” *Boynton v. Monarch,* 1994 WL 463905, *1, 1994 U.S. Dist. LEXIS 11967, *1 (N.D. Ill. 1994) (citing *Scaggs v. Consolidated Rail Corp.,* 6 F.3d 1290, 1295 (7th Cir. 1993)). Consequently, failure to supplement interrogatory responses under Rule 26(e)(2) may, at the Court's election, result in the exclusion of all evidence related to the non-supplemented subject.[FN6] *Holiday Inn, Inc. v. Robertshaw Controls Co.,* 560 F.2d 856, 858 (7th Cir. 1977).

FN6. Defendants contend that the Plaintiff's motion *in limine* is nothing more than an attempted end run around Rule 37(b)(2)(B) which requires the party seeking a more complete discovery response to obtain a court order compelling further discovery, the violation of which may result in sanctions, including the exclusion of the relevant evidence. While this may have been one option open to Plaintiff, had it been able to determine that the Defendants were still intending to assert the Section 112 defense, the Court, at its discretion, is empowered to order sanctions without resort to Rule 37. *See* *Holiday Inn v. Robertshaw Controls Co.,* 560 F.2d 856 (7th Cir. 1977); *Jefferson v. Davis,* 131 F.R.D. 522 (N.D. Ill. 1990); *Boynton v. Monarch,* 1994 WL 463905, 1994 U.S. Dist. LEXIS 11967 (N.D. Ill. 1994).

Defendants here do not contend that they were unable to produce the supplemental information at an earlier date, but rather, rely on the argument that, by providing the information in their expert reports, they have satisfied their duty to seasonable supplement their interrogatory responses under Rule 26(e)(2).[FN7] Defendants contend that their duty to supplement under Rule 26(e)(2) is satisfied because they informed Plaintiff of the details of their Section 112 defense via their experts' reports, thereby making the updated information known to the Plaintiff during the discovery process. Defendants apparently contend that, since expert discovery has not concluded, the discovery process is not yet over.

FN7. Defendants contend that Rule 26(e) simply requires the supplementation to occur “at appropriate intervals.” Mitsubishi contends that it provided the supplemental information only four months after answering the interrogatories, and since no trial date is pending, it has updated its interrogatory answers within an appropriate interval.

However, the Court finds that this type of supplementation was not what the drafters of Rule 26(e)(2) envisioned. “The purpose of [Rule 26(e)(2)] is to prevent trial by ambush.” *Gorman v. Chicago Housing Authority,* 1991 WL 10893 *2 (N.D. Ill. 1991). If a party is allowed to withhold the supplementation of its discovery responses until after fact discovery is closed, the purpose of the Rule is effectively frustrated because the opposing party is denied the opportunity to conduct discovery on the supplemented responses.

As the Court has concluded that Defendants have failed to supplement their interrogatory responses as required by Rule 26(e)(2), the relevant inquiry now becomes whether the opposing party was “prejudicially surprised.” *Gorman,* 1991 WL

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10893 at *2 (citations omitted). Harris alleges that it was completely unaware of Mitsubishi's intention to assert this defense until after discovery was closed and the expert reports were exchanged. Conversely, Mitsubishi contends that Harris was fully aware of their intention to assert this defense as a result of Mitsubishi's answer and interrogatory responses. The Court finds that, while the Defendants' answer and nebulous interrogatory responses[FN8] may have served to put Harris on notice as to the possibility of a Section 112 defense being raised,[FN9] they failed to apprise Harris of the substance and basis for that defense. Consequently, the Court finds that Harris was surprised as to the factual basis and substance of Defendants' §112 defense.

FN8.*See* footnote 2 for the substance of Mitsubishi's answer and interrogatory responses on this issue.

FN9. The Court uses the term "may have" here because the Defendants' interrogatory responses were vague as to the Defendants' intention to assert a Section 112 defense, thus lending credibility to the Plaintiff's claim that it was under the impression that Defendants were no longer planning to pursue this defense unless other patent claims were asserted by the Plaintiff.

***9** As to the prejudice element, Defendants' claim that Plaintiff will suffer no prejudice as a result of Mitsubishi's method of disclosing its Section 112 defense. Defendants contend that the only Mitsubishi witnesses Harris will have to depose are the two experts and expert depositions have not yet begun. Furthermore, Defendants claim Plaintiff is free to examine its own inventors on this subject at any time it chooses.

Contrary to Defendants' assertions, this Court finds that Plaintiffs were prejudiced by Mitsubishi's failure to timely supplement its interrogatory responses. Had Plaintiff been aware of Defendants' intention to raise this defense, it would have altered the way it conducted discovery. Specifically, Plaintiff would have deposed Sumitomo personnel[FN10] on the issue of whether, based on the specifications given in Harris' patents, they would know how to cure the rubber and whether undue experimentation would be necessary to carry out the best mode. Additionally, Plaintiff would have deposed two inventors of the print rubber formula used by Harris, both of whom work for American Roller, to determine whether they knew of a better curative and whether they hid that curative.

FN10. Sumitomo, a Japanese Corporation, was responsible for the formulation and manufacture of the rubber print layer used by Mitsubishi in the presses which Harris alleges are infringing on its patents.

The above information is highly relevant for two reasons. First, to prevail on its "best mode" defense, Mitsubishi must show by clear and convincing evidence that the co-inventors "knew of and concealed a better mode of carrying out the claimed invention than was set forth in the specifications." *Minco, Inc. v. Combustion Eng'g,* 1996 WL 511532 at *5 (Fed Cir. 1996). Consequently, the inventors' intent controls the outcome of this issue. *Glaxo Inc. v. Novopharm Ltd.,* 52 F.3d 1043, 1050 (Fed. Cir.), *cert. denied,* 116 S. Ct. 516 (1995). It was therefore critical for Harris to depose the two inventors from American Roller to ascertain their knowledge and intent with respect to this issue in order to prepare to refute this defense at trial.

Additionally, to prevail on its best mode defense, Mitsubishi must show that Harris' use of the phrase "proprietary curative in nitrite polymer" prevents one skilled in the art from practicing the best mode. The best mode disclosure requirement is satisfied when patentees disclose the best mode contemplated by the inventor in carrying out the invention.[FN11] *Glaxo Inc. v. Novopharm Ltd.,* 52 F.3d 1043, 1050 (Fed. Cir. 1995). Consequently, disclosure of the preferred embodiment must be sufficiently specific to enable one skilled in the art

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to practice what the inventors believed to be the best mode. *Glaxo,* 52 F.3d at 1055. The disclosure is sufficiently specific if one skilled in the art could practice the best mode, as described in the patent, without undue experimentation. Therefore, Harris' ability to depose Sumitomo personnel, who represent persons skilled in the art, on the issue of whether, based on the specifications given in Harris' patents, they would know how to cure the printing rubber and whether undue experimentation would be necessary to carry out the best mode as provided in the specifications was important to Harris' ability to respond to the Defendants' claims at trial.

FN11. This requirement is intended to prevent inventors from concealing, intentionally or unintentionally, the preferred embodiment of the invention while at the same time, obtaining a patent which confers the right to exclude others from practicing the invention. *Spectra-Physics, Inc. v. Coherent, Inc.,* 827 F.2d 1524, 1532 (Fed. Cir. 1987).

***10** Plaintiff cannot now go back and depose the two American Roller inventors, nor, it contends, can it afford the expense of flying to Japan yet again to depose Sumitomo personnel. In fact, Plaintiff did not question a single witness on this subject in any of its depositions and is being denied the opportunity to do so now because fact discovery has closed. Additionally, Plaintiff contends that it would have modified its questioning of Mitsubishi witnesses and would have prepared its own witnesses differently had it been aware of the Defendants' intention to assert a Section 112 defense and of the basis of that defense.

This Court finds that, based on the above considerations, the Plaintiff has been denied the opportunity to conduct any discovery on the issue of the best mode defense and has therefore been prejudiced by the Defendants' failure to timely supplement their interrogatory responses prior to the close of fact discovery. The Court therefore grants the Plaintiff's motion *in limine* and precludes the Defendants from introducing any evidence concerning the Defendants' Section 112 “best mode” defense at trial.

N.D.Ill.,1996.
Heidelberg Harris, Inc. v. Mitsubishi Heavy Industries, Ltd.
Not Reported in F.Supp., 1996 WL 680243 (N.D.Ill.), 42 U.S.P.Q.2d 1369

END OF DOCUMENT

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TAB 22

LEXSEE 2004 U.S. DIST. LEXIS 4659

LAWRENCE E. JAFFE PENSION PLAN, on Behalf of Itself and All Others Similarly Situated, Plaintiff, v. HOUSEHOLD INTERNATIONAL, INC., MERRILL LYNCH, PIERCE, FENNER, & SMITH, INC., GOLDMAN SACHS & CO., INC., ARTHUR ANDERSEN, L.L.P., WILLIAM F. ALDINGER, DAVID A. SCHOENHOLZ, GARY GILMER, J.A. VOZAR, ROBERT J. DARNALL, GARY G. DILLON, JOHN A. EDWARDSON, MARY JOHNSTON EVANS, J. DUDLEY FISHBURN, CYRUS F. FREIDHEIM, LOUIS E. LEVY, GEORGE A. LORCH, JOHN D. NICHOLS, JAMES B. PITBLADO, S. JAY STEWART, and LOUIS W. SULLIVAN, Defendants.

02 C 5893 (Consolidated)

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

2004 U.S. Dist. LEXIS 4659*; *Fed. Sec. L. Rep. (CCH) P92,713

March 19, 2004, Decided
March 22, 2004, Docketed

SUBSEQUENT HISTORY: Motion granted by, in part, Motion denied by, in part *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 2004 U.S. Dist. LEXIS 18993 (N.D. Ill., Sept. 20, 2004)*

PRIOR HISTORY: *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 2003 U.S. Dist. LEXIS 7466 (N.D. Ill., May 2, 2003)*

DISPOSITION: [*1] Defendants' motions to dismiss ruled upon. Defendant Andersen's motion to strike denied.

COUNSEL: For THE GLICKENHAUS GROUP, LAWRENCE E JAFFE, Pension Plan, on behalf of itself and all others similary situated, plaintiff: Patrick J. Coughlin, Esq., Azra Z. Mehdi, Esq., Luke O. Brooks, Esq., Milberg Weiss Bershad Hynes & Lerach, LLP, San Francisco, CA. Marvin Miller, Esq., Miller Faucher and Cafferty, LLP, Chicago, IL. Frederic S Fox, Kaplan, Kilsheimer & Fox LLP, New York, NY. Gary L. Specks, Kaplan, Fox & Kilsheimer LLP, Chicago, IL.

For HOUSEHOLD INTERNATIONAL INC., W F ALDINGER, defendants: Warren Roger Stern, Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen & Katz, New York, HY. Nathan P. Eimer, Adam B. Deutsch, Eimer Stahl Klevorn & Solberg, LLP, Chicago, IL.

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For D A SCHOENHOLD, defendant: Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen & Katz, New York, HY. Nathan P. Eimer, Adam B. Deutsch, Eimer Stahl Klevorn & Solberg, LLP, Chicago, IL.

JUDGES: HON. RONALD A. GUZMAN, United States Judge.

OPINION BY: RONALD A. GUZMAN

OPINION

MEMORANDUM OPINION AND ORDER

Plaintiff Lawrence E. Jaffe Pension Plan, on behalf of itself and all others similarly situated, brought this suit alleging violations of *15 U.S.C. § 78(j)(b)* ("*§ 10(b)*" of the *Exchange Act of 1934* ("1934 Act")) and *17 C.F.R. § 240.10b-5* ("*Rule 10b-5*") against Household, Household Officers, identified as Aldinger, Schoenholz, and Gilmer, and Arthur Andersen ("Andersen") in Count I; violation of *15 U.S.C. § 78(t)(a)* ("*§ 20(a)*" of the 1934 Act) by Household, and Household Officers in Count II; violations of *15 U.S.C. §§ 77k,77l(a)(2),* and*77o* ("*§§ 11, 12(a)(2), and 15*" of the Securities Act of 1933 ("1933 Act")) by Household, [*3] Household Officers, Household Directors, Andersen, Goldman Sachs & Co., Inc. ("Goldman Sachs"), and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") in Count III, and violations of *15 U.S.C. §§ 77k,77o* ("*§§ 11, 15*" of the 1933 Act) by Household, Household Directors and Andersen in Count IV. Glickenhaus & Co. has been named lead plaintiff in this case, which is a consolidation of a number of cases.

Household, Officer Defendants, Individual Defendants and Andersen have moved to dismiss Counts I and II under *Fed. R. Civ. P. ("Rule") 9(b)* and *12(b)(6)*. Household Officers, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch have moved to dismiss Counts III and IV under *Rule 12(b)(6)*. In addition, Andersen has moved to strike two paragraphs in the Amended Complaint pursuant to *Rule 12(f)*. For the reasons set forth in this Memorandum Opinion and Order, the Court: (1) denies Household's, Household Officers' and Andersen's motion to dismiss Count I; (2) denies Household's, and Household Officers' motion to dismiss Count II; (3) grants Household's, Household Officers', [*4] Household Directors', Andersen's, Goldman Sachs', and Merrill Lynch's motions to dismiss Counts III; (4) denies in part and grants in part Household's, Household Directors' and Andersen's motions to dismiss Count IV; and (4) denies Andersen's motion to strike.

FACTS

The complaint at issue relates to violations of *Sections 11, 12(a)(2)and 15* of the Securities Act of 1933, *Sections 10(b)and 20(a)* of the Exchange Act of 1934 and *17 C.F.R. § 240.10b-5.*

Lead plaintiff Glickenhaus & Company and the other proposed class members purchased shares of Household common stock, preferred stock, bonds, notes, InterNotes(SM) and Trust indentures between October 23, 1997 and October 11, 2002 ("Class Period"). Defendant Household International, Inc. is engaged primarily in consumer lending.

During the Class Period, Household reported continuous and dramatic growth in income and net earnings. On the basis of quarterly earning statements, meetings, conference calls with analysts and other publication of data, stock analysts from a variety of respected firms issued "buy" reports with respect to Household offerings. Also during this period, Household filed a [*5] number of required forms and statements with the Securities and Exchange Commission ("SEC") with the inclusion of reports from various named directors and officers as well as audit reports generated by Andersen and stock analysis reports by Goldman Sachs and Merrill Lynch. On the basis of these statements and assurances, plaintiff purchased Household securities.

During the Class Period, allegations of predatory lending and improper "reaging" of loans began to surface from a variety of sources. These included allegations in Washington and California that ultimately resulted in the filing of lawsuits during the Class Period. During the Class Period Household entered into a settlement agreement regarding Household's lending practices with the Attorneys General of several states. Also during the Class Period, Washington published the Washington Department of Financial Institutions Expanded Report of Examination of Household Finance Corporation III (April 30, 2002) ("Washington Report"). All of these allegations arose from what plaintiff characterizes as Household's predatory lending practices as outlined in what Household had named the "EZ Pay Plan," wherein Household allegedly loaned [*6] money to high-risk consumers and home owners, employing a variety of tactics intended to boost the fees and costs associated with the loans. In order to assist in the overall management of Household, during this period Household perfected what it called the "Vision System" that the Officer Defendants publicly praised as making company-wide data available to them and allowing them to engage in proactive management of lending practices at all of the branch offices. In addition, plaintiff alleges

Household engaged in "reaging" loans, whereby delinquent loans were reclassified as still current by the addition of the delinquent payments onto the end of the loan term, thereby lengthening the loan term and reducing the appearance of default loans on Household's books.

Although both Household and Andersen argue that Household's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP") and generally accepted accounting standards ("GAAS"), this was not true according to plaintiff. Under these principles, "reaging" of loans in the manner Household used is strongly recommended against because it fails to indicate whether the accounts may ultimately [*7] be collectable. This results in the diminution of the reliability of aging scales and, practically speaking, obscures the risk of delinquency associated with the outstanding loans.

Throughout most of the Class Period, Household securities generally increased in value, ultimately rising to over $ 63.25. This began to change, though. On August 14, 2002 Household announced that its new auditors KPMG had recommended a substantial restatement of earnings for a period including the Class Period. The ultimate result was a lowering of net income and equity by $ 386 million for the period from 1994 to the second quarter 2002. Additionally, with the circulation of rumors about a pending California class action legal settlement that would restrict Household's lending practices and result in a multi-million settlement, there was a dramatic fall in stock price to around $ 28 a share in less than three months.

Each of the proposed class members purchased Household securities during the Class Period at allegedly artificially inflated prices, relying on the integrity of the market price and market information. Each has been damaged as a result of defendants' misrepresentations.

Officer Defendants [*8] participated directly in the day-to-day operations of Household and were instrumental in the development and execution of the practices and programs plaintiff alleges led to the instant complaint. Each had access to confidential information about the company's business and operations. Each directly and indirectly controlled the conduct of the company's business, the information contained in its filings with the SEC, and public statements about its business and financial results. Officer and Director Defendants were signatories on the Registration Statements that resulted in the issuance of further Household securities. Auditor defendant, Andersen, performed independent audits and provided accounting, management consulting, and tax services for Household during the Class Period. It reviewed financial data used in a variety of SEC filings, *e.g.*, debt registration statements and audit reports included as attachments to various SEC filings. Andersen was intimately involved in Household's confidential corporate financial and business operations. Household Director Defendants were all Household directors during the Class Period. Merrill Lynch and Goldman Sachs both provided stock analysis [*9] services in connection with the merger between Beneficial and Household.

DISCUSSION

Each defendant has moved to dismiss various counts of the Amended Complaint. Household, Officer Defendants, Individual Defendants and Arthur Andersen have moved to dismiss Counts I and II. Household, Officer Defendants, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch have moved to dismiss Counts III and IV. Additionally, Andersen has moved to strike paragraphs 180 and 181 of the Amended Complaint as prejudicial and irrelevant. The Court addresses each of these arguments in turn.

A *Rule 12(b)(6)* motion to dismiss does not test the merits of the case and merely attacks the sufficiency of the complaint. *Fishman v. Meinen, 2003 U.S. Dist. LEXIS 2527, No. 02 C 3433, 2003 WL 444223, at *4 (N.D. Ill. Feb. 24, 2003)*. A court may only dismiss a complaint for failure to state a claim upon which relief may be granted if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding, 467 U.S. 69, 73, 81 L. Ed. 2d 59, 104 S. Ct. 2229 (1984)*; *see Ledford v. Sullivan, 105 F.3d 354, 356 (7th Cir. 1997)*. [*10] A court must accept all well pleaded allegations of the complaint as true, and must view those allegations in the light most favorable to plaintiff. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *4*. The Court need not accept as true legal conclusions alleged in the complaint, though a plaintiff may plead conclusions if they "provide the defendant with at least minimal notice of the claim." *Jackson v. Marion County, 66 F.3d 151, 154 (7th Cir. 1995)*.

I. Fraud Claims: *Section 10(b)* and *Section 20(a)*

of the 1934 Act and *Rule 10b-5*

Plaintiff seeks relief against Household, Officer Defendants and Andersen for fraud under *Section 10(b)* of the 1934 Act and *Rule 10b-5* in Count I and *Section 20(a)* in Count II. Defendants contend that plaintiff has insufficiently pleaded according to the standards for fraudulent averments under *Rule 9(b)*, or according to the standards of the Private Securities Litigation Reform Act ("PSLRA"). *15 U.S.C. § 78u-4*. (Household Mot. Dismiss at 22-24; Andersen Mot. Dismiss at 1-2.)

It is well settled that "*Rule 9(b) [of the Federal Rules of Civil Procedure*] governs claims [*11] based on fraud and made pursuant to the federal securities laws." *Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990)* (alteration in original, quotations omitted). "Circumstances constituting fraud ... shall be stated with particularity," which has been interpreted as requiring inclusion of "'the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff'" in fraud allegations. *Fed. R. Civ. P. 9(b)*; *Uni*Quality, Inc. v. Infotronx, Inc., 974 F.2d 918, 923 (7th Cir. 1992)* (quoting *Bankers Tr. Co. v. Old Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992))*. In essence, the complaint must specify the "who, what, when, where, and how" of the allegedly fraudulent acts. *DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990)*. The purpose of this "is to force the plaintiff to do more than the usual investigation before filing his complaint." *Ackerman v. Northwestern Mut. Life Ins. Co., 172 F.3d 467, 469 (7th Cir. 1999)*. The rule serves to [*12] (1) protect defendants' reputations from harm, (2) minimize 'strike suits' and 'fishing expeditions', and (3) provide notice of claims to adverse parties. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *5* (citing *Vicom, Inc. v. Harbridge Merch. Servs., Inc., 20 F.3d 771, 777 (7th Cir. 1994))*.

In addition, a complaint of securities fraud under the 1934 Act is subject to the PSLRA. *15 U.S.C. § 78u-4(a)(1)*. Under the PSLRA, a plaintiff must allege a defendant "made an untrue statement of a material fact" or "omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading." *15 U.S.C. § 78u-4(b)(1)*. In either case, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* Further, plaintiff must "state with particularity facts giving rise to a strong inference that the defendant [*13] acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2)*. If these requirements are not met, the Court shall dismiss the complaint. *15 U.S.C. § 78u-4(b)(3)*.

Together, the overlapping pleading requirements of *Rule 9(b)* and the PSLRA make it clear that a plaintiff must aver which defendants said what, to whom, and when. *Ackerman, 172 F.3d at 471*; *Fishman, 2003 U.S. Dist. LEXIS2527, 2003 WL 444223, at *5*; *see also Sears, 912 F.2d at 893*. "Where a plaintiff alleges that a group of individuals is part of a fraudulent scheme, he or she must put each defendant on notice of his or her alleged role." *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *5*; *see Vicom, 20 F.3d at 777-78*. In addition, a plaintiff must show a "strong inference" of scienter, whether through a showing of "motive and opportunity to commit fraud" or through a showing of "conscious misbehavior or recklessness." *Johnson v. Tellabs, Inc., 303 F. Supp. 2d 941, 2004 U.S. Dist. LEXIS 2617, No. 02 C 4356, 2004 WL 324752, at *18 (N.D. Ill. Feb. 19, 2004)*.

A. *§ 10(b)* and *Rule 10b-5*

In pertinent part *Section 10(b)* and *Rule 10b-5* provide that it is unlawful [*14] for any person in connection with a securities sale or purchase "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *17 C.F.R. § 240.10b-5(b), (c)*; *see 15 U.S.C. § 78j(b)*.

To state a claim for a violation under *Section 10(b)* or *Rule 10b-5*, a plaintiff must allege that (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages. *Otto v. Variable Annuity Life Ins. Co., 134 F.3d 841, 851 (7th Cir. 1998)*; *Caremark, Inc. v. Coram Healthcare Corp.,*

113 F.3d 645, 648 (7th Cir. 1997). Plaintiff must establish that defendants had a duty to disclose [*15] the omitted information. *Basic Inc. v. Levinson, 485 U.S. 224, 239, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988)*.

1. Alleged false and misleading statements

The first requirement of the PSLRA is to identify each statement alleged to be misleading. For the most part, plaintiff has done this, identifying who made particular statements, when, how they were misleading, and the results of the statements. They point to the following representations as false and misleading.

a. Household

Throughout the Class Period Household published quarterly financial data, usually accompanied by statements from one or more directors. (Am. Compl. at PP192, 214, 218, 230, 233, 237, 243, 252, 258, 263, 272, 285, 289, 298, 311, 333.) These statements included net income and earnings per share information, giving both dollar amounts and various comparative statistics with respect to earlier quarters. In each case, the income and earnings per share information increased by double digit percentages over earlier quarters. Plaintiff contends these quarterly statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the [*16] inclusion in the statements of what it alleges were the knowingly inaccurate financial representations, as well as its assertion that Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at PP126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) Plaintiff contends the result of these quarterly releases was the republication of the Household data in a variety of respected analyst reports accompanied by "buy" recommendations and immediately subsequent share price rises based on both Household's and the analysts' reports. (*Id.* at PP193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

Further, Household filed Form 10-K SEC filings signed by Aldinger, Schoenholz and Director Defendants that asserted Household was in compliance with SEC Regulations S-X and S-K. (*Id.* at PP200, 225, 246-48, 277, 313.) This was supported by Andersen's audit opinion of the data incorporated by reference in the filing. (*Id.* at PP202, 227, 249, 279, 316.) In the audit opinions Andersen asserted "that it had audited Household's financial statements and Schedule [*17] 14(d) for [the respective years] in accordance with GAAS and opined that it 'fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.'" (*Id.*) The March 28, 2000 filing contained assertions related to how Household had increased in various indices of operating net income. (*Id.* at P246.) It also stated that risk-based pricing and effective collection efforts for its loans resulted in effective management of credit losses. (*Id.* at P247.) Household also stated that it had shifted its credit card receivables to its subsidiary HFC, according to plaintiff, for the purpose of avoiding newly enacted federal banking regulations that significantly altered reporting requirements. (*Id.* at P250.) The March 28, 2001 filing stated that Household "continue[s] using risk-based pricing and effective collection efforts for each loan. We have a process that gives us a reasonable basis for predicting the asset quality of new accounts." (*Id.* at P278.) The March 13, 2002 filing reiterated this language. (*Id.* at P315.) It additionally stated in the "Management Report" signed by Aldinger [*18] and Schoenholz that "the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards." (*Id.* at P314.) Plaintiff contends Household through the agency of its officers, directors and auditor based these filings on knowingly false and misleading financial data. (*Id.* at PP126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) As a result of the successful filings, Household was able to maintain what plaintiff contends was its false financial position which misled analysts and investors. (*Id.* at PP200, 225, 246-48, 277, 313.)

b. Aldinger

In addition to Aldinger's signatures on the above-mentioned SEC filings, plaintiff alleges Aldinger repeatedly made materially misleading statements during the Class Period. Many of these statements were included in Household's quarterly releases of its financial results. (*Id.* at PP192, 197, 209, 214, 218, 229, 233.) Aldinger repeatedly made statements included in these releases concerning Household's financial status and the alleged means used to reach the published results. These statements included ones such as (1) "wider margins, higher average [*19] managed receivables, and a continued focus on efficiency []more than offset the impact of higher credit losses"; (2) "we grew revenues 18

percent and kept expenses essentially flat. We absorbed increased chargeoffs consistent with industry-wide trends and further strengthened our credit loss reserves. We also improved our return on managed assets. Our return on equity exceeded 18 percent, even though we significantly increased our capital levels"; (3) "our tight focus on our core markets, our conservative capital base and our disciplined approach to funding and liquidity management enabled Household to achieve record earnings for the quarter"; (4) "the company's operating results were solid with 6 percent annualized receivable growth, margin expansion and improving efficiency . . . . reserve coverage remains conservative"; (5) reporting net income increases in excess of 70%, resulting in part from "higher yields on unsecured products and lower funding costs, partially offset by the effect of a shift in mix toward secured products"; and (6) "strong loan growth in our consumer finance business, improved efficiency and higher income from our tax refund loan business" as the underlying [*20] causes for increases. (*Id.* at PP192, 197, 214, 218, 229.)

In response to analyst questions on February 7, 2002 concerning rumors that Household might change its accounting policies, thereby affecting stock value, Aldinger and Schoenholz made various statements indicating that Household would not change its accounting policies. (*Id.* at P320.) These included statements such as "Household has had no problems with its commercial paper funding and the costs of that funding has not increased," "Arthur Andersen has always been aggressive with HI. There are no accounting changes being discussed and there are to be no surprises in the 10K. HI's board of directors has had long conversations about Arthur Andersen and they plan to watch to see if a change has to be made but none is anticipated at this point." (*Id.*)

Plaintiff contends the statements made by Aldinger were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on what it asserts was Aldinger's knowledge of Household's improper business and accounting practices. The result of Aldinger's alleged concealment of Household's true financial state resulted in the re-publication [*21] of the Household data along with Aldinger's statements and paraphrases of Aldinger's statements in a variety of respected analyst reports, causing immediately subsequent share price rises and "buy" recommendations. (*Id.* at PP193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

c. Schoenholz

In addition to Schoenholz's signatures on the above-mentioned SEC filings, plaintiff alleges Schoenholz authorized, signed and caused to be filed multiple SEC Form 10-Q's. Each filing stated it was prepared in accordance with GAAP procedures and that it included, "in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation." (*Id.* at PP194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.) Plaintiff contends that both statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the inclusion in the 10-Qs of what it alleges were the knowingly inaccurate financial representations published in Household's quarterly corporate financial reports, as well as its assertion that [*22] Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at PP126, 142-47, 194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.)

Schoenholz, in particular, is cited by plaintiff for having made misleading public statements about the restatement resulting from the KPMG audit. (*Id.* at PP146-47.) Plaintiff contends that the financial reports included in the 10Qs materially misrepresented Household's true financial condition because they failed to disclose losses and the ephemeral nature of claimed assets. (*Id.* at PP196, 217, 242, 271, 302, 308, 332, 342.)

d. Gilmer

Plaintiff contends that Gilmer oversaw a sales training manual update project that featured the "EZ Pay Plan." (*Id.* at P96.) The subsequent nationwide distribution of this manual to Household offices and its use as the basis of sales training programs resulted in the nationalization of practices previously confined to the Washington State area. (*Id.* at PP94-96.) Plaintiff alleges the distribution and training authorized by Gilmer directly resulted in company-wide predatory lending practices [*23] and subsequent accounting irregularities, ultimately resulting in the misrepresentation of Household's financial status. (*Id.* at PP26, 102.) Despite the allegedly unethical nature of the "EZ Pay Plan," the Origination News quoted Gilmer as stating that

"unethical lending practices of any type are abhorrent to our company, our employees and most importantly customers." (*Id.* at P280.) Thus, Gilmer reassured the market and contributed to analyst optimism, "buy" recommendations, and increasing share prices.

e. Andersen

In addition to the inclusion of Andersen's audit reports and opinions in the above-mentioned SEC filings, plaintiff alleges Andersen failed to conduct its audits of Household in compliance with GAAS and GAAP standards, or even to conduct proper audits at all, despite asserting the contrary. Specifically, Andersen stated in a report to Household's shareholders:

> We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, [*24] on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

(*Id.* at P174.)

Plaintiff alleges this, and similar statements, are untrue and resulted in false and misleading audit reports of Household's financials. This further resulted in the allegedly false SEC filings noted above. (*Id.* at P176.) Additionally, plaintiff alleges that Andersen "knew its reports would be relied upon by potential investors in Household securities," whether they appeared in the SEC filings or the quarterly Household financial data releases. (*Id.* at P176.)

The Court concludes that each of these statements satisfies *Rule 9(b)* and the PSLRA's requirement for particularly pointing out misleading statements related to securities sales, indicating why it is material, and relating how the statements caused plaintiff's damages. Accordingly, the Court holds that plaintiff has articulated the who, what, when, where, [*25] and how of the fraud with sufficient particularity.

2. Scienter

The only remaining question is whether plaintiff has pleaded sufficiently that defendants Household, Officer Defendants and Andersen acted with the requisite scienter to meet PSLRA standards. While the Seventh Circuit has yet to address precisely how rigorously the PSLRA's pleading standards must be applied to plead the "requisite state of mind," cases in the Northern District of Illinois have generally followed the Second Circuit's pleading standard. Thus, plaintiff must allege facts either (1) showing that the defendant had both motive and opportunity to commit fraud; or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. *See Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 100 (2d Cir. 2001)*; *see, e.g., In re Hartmarx Secs. Litig., 2002 U.S. Dist. LEXIS 6983, No. 01 C 7832, 2002 WL 653892, at *2 (N.D. Ill. Apr. 19, 2002)* (collecting cases); *Beedie v. Battelle Mem'l Inst., 2002 U.S. Dist. LEXIS 171, No. 01 C 6740, 2002 WL 22012, at *2 (N.D. Ill. Jan. 7, 2002)* (collecting cases).

Officer Defendants Aldinger, Schoenholz and Gilmer contend they did not knowingly [*26] publish inaccurate or misleading statements on behalf of Household. They also contend that plaintiff has failed to "state with particularity facts giving rise to a strong inference" that defendants acted with the required state of mind, or knew of the predatory lending and "reaging" practices or knew that such practices were material. (Mem. Supp. Household's Mot. Dismiss at 18, 23-25.) Further, Officer Defendants argue that the tie between compensation and company performance is insufficient to establish scienter. (*Id.* at 20.)

Defendants are correct that the tie between compensation and company performance without more is not sufficient. *Tricontinental Indus. v. Anixter, 215 F. Supp. 2d 942, 950 (N.D. Ill. 2002)*; *Chu v. Sabratek Corp., 100 F. Supp. 2d 827, 837 (N.D. Ill. 2000)*. However, "it is well established in this Circuit that a party may be excused from *Rule 9(b)*'s requirement of pleading with particularity if the information that he is required to plead rests exclusively within the defendants' control or is otherwise unavailable to him." *In re NeoPharm, Inc. Sec. Litig., 2003 U.S. Dist. LEXIS 1862, No. 02 C 2976, 2003 WL 262369, at *11 (N.D. Ill. Feb. 7, 2003)* [*27] (citing

*In re Newell Rubbermaid Sec. Litig., 2000 U.S. Dist. LEXIS 15190, No. 99 C 6853, 2000 WL 1705279, at *14 (N.D. Ill. Nov. 14, 2000))*. As a result, it is necessary to consider if plaintiff has sufficiently pleaded facts indicating strong circumstantial evidence of defendants' awareness and direction of the allegedly predatory pricing and "reaging" programs.

Officer Defendants Aldinger, Schoenholz and Gilmer are characterized by plaintiff as "hands-on" managers of Household and its subsidiaries, with access to and control over the daily operations of Household, including the programs that resulted in predatory lending and in "reaging" of loans. (*Id.* at P165.) As such the Officer Defendants were in possession of non-public information "based on their review of Household's internal operating data, including information provided to them by Household's Vision system," directly contradicting their public statements on behalf of the company about Household's financial dealings. (*Id.* at PP155-56, 196, 217, 242, 271, 302, 308, 332, 342.) As a result, plaintiff alleges Officer Defendants in their individual capacities and as representatives of Household either knew or were grossly reckless [*28] in not knowing that the public statements and omissions regarding Household's financial status, and business and accounting practices were false or misleading when made. (*Id.*)

Plaintiff asserts the Officer Defendants Aldinger, Schoenholz and Gilmer had motive and opportunity to commit fraud, and further, acted with conscious recklessness. Household's "pay-for-performance" policy tied executive compensation to company performance, both economic and non-economic. (*Id.* at PP157-64.) Targeted earnings per share, targeted return on equity, targeted operating efficiency ratios, targeted reserve to charge-off ratios and targeted equity to managed asset ratios all played a role in determining the officer defendants' compensation. (*Id.* at PP160-62.) Thus, plaintiff assert that "without the boost provided by defendant's improper accounting, Household would likely not have had a single quarter of meeting or exceeding analysts' expectations," nor as a result would Officer Defendants have garnered the bonuses they did. (*Id.* at P163.)

With respect to Andersen, plaintiff asserts it had motive and opportunity to make misrepresentations as well. Plaintiff alleges Andersen partners [*29] "were under enormous pressure" to increase its Household billing. (*Id.* at P177.) In addition to its auditing fees, Andersen sought and gained further extensive, non-auditing consulting service work and fees from Household. (*Id.* at P178.) By involving itself closely in Household's various business ventures, it abrogated its independent status as an auditor, thereby compromising its independence. (*Id.* at P179.) As a result, plaintiff alleges Andersen had a vested interest in going along with Household's allegedly improper accounting practices and supporting Household's misrepresentations and material misstatements. (*Id.* at P177.)

The Court concludes that plaintiff has sufficiently pleaded the requisite state of mind for each defendant from the information currently available to it. As a result, the heightened pleading requirements for *§ 10(b)* and *Rule 10b-5* have been met and the defendants' motions to dismiss Count I are denied.

B. *§ 20(a)*

Section 20(a) of the 1934 Act imposes liability on anyone "who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder." *15 U.S.C. § 78t(a)* [*30] . It is a predicate offense, requiring a violation of some other section of the 1934 Act in order to be applicable. *Id.* That threshold requirement has been met via the *§ 10(a)* and *Rule 10b-5* allegations. Additionally, *§ 20(a)* does not have a scienter requirement or a heightened pleading standard. Accordingly, liberal pleading requirements apply. *In re Anicom, Inc., 2001 U.S. Dist. LEXIS 6607, No. 00 C 4391, 2001 WL 536066, at *6 (N.D. Ill. May 18, 2001)*; *Chu, 100 F. Supp. 2d at 843*.

"To plead control person liability, the plaintiff[] must adequately allege that each 'control person' participated in or exercised control over the company in general and that he or she possessed the 'power or ability to control [the specific] transactions upon which the primary violation was predicated,' whether or not that power was exercised." *Nanophase Techs. Corp. Secs. Litig., 2000 U.S. Dist. LEXIS 11744, Nos. 98 C 3450, 98 C 7447, 2000 WL 1154631, at *7 (N.D. Ill. Aug. 14, 2000)* (citing *Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992))*. Plaintiff alleges that the Officer Defendants, Aldinger, Schoenholz and Gilmer, exercised "hands on" management, involving [*31] themselves in all aspects of Household's activities. (Am. Compl. at P165.) Further, plaintiff alleges Officer Defendants had

control over the content and issuance of public statements "issued by or on behalf of Household," *e.g.*, quarterly and annual reports, press releases and SEC filings. (*Id.* at P166.) Plaintiff alleges these defendants had the requisite knowledge, the opportunity, and the power to correct any misstatements prior to publication. (*Id.*) This is sufficient for the purposes of a *§ 20(a)* claim. *Chu, 100 F. Supp. 2d at 843*; *Nanophase, 2000 U.S. Dist. LEXIS 11744, 2000 WL 1154631, at *7*. As a result, defendants' motions to dismiss Count II are denied.

II. Strict Liability under the 1933 Act

Plaintiff also seeks relief against Household, Officer Defendants, Director Defendants, Andersen, Goldman Sachs and Merrill Lynch under *§§ 11, 12(a)(2)and 15* of 1933 Act in Counts III, and against Household, Director Defendants and Andersen under *§§ 11and 15* of 1933 Act in Count IV. Defendants contend that plaintiff has failed to state a claim upon which relief can be granted on two grounds. They primarily contend that the statute of limitations has passed. [*32] Even if it has not, they contend the claims lack sufficient particularity, fail to give notice, or otherwise are improperly pleaded.

A. Statute of Limitations

In stating its claims, plaintiff has asserted that the Sarbanes-Oxley Act (2002) applies to *§§ 11, 12(a)(2)and 15* of 1933 Act. Defendants contest this.

In 2002, prior to the original filing of this suit, Congress prospectively lengthened the statute of limitations in federal securities fraud suits from a one-year/three-year arrangement to a two-year/five-year arrangement. *28 U.S.C. § 1658(b)*. As amended in 2002, *28 U.S.C. § 1658* provides:

> (b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in *section 3(a)(47) of the Securities Exchange Act of 1934* (*15 U.S.C. 78c(a)(47)*, may be brought not later than the earlier of--
>
> (1) 2 years after the discovery of the facts constituting the violation; or
>
> (2) 5 years after such violation.

28 U.S.C. § 1658(b) [*33] .

A statute of limitations begins to run on either actual or inquiry notice of facts constituting fraud. *See Tregenza v. Great Am. Communications Co., 12 F.3d 717, 722 (7th Cir. 1993)*. The Seventh Circuit employs an objective inquiry notice test:

> The one-year [now two-year] statute of limitations applicable to suits under *Rule 10b-5* begins to run not when the fraud occurs, and not when the fraud is discovered, but when (often between the date of occurrence and the date of the discovery of the fraud) the plaintiff learns, or should have learned through the exercise of ordinary diligence in the protection of one's legal rights, enough facts to enable him by such further investigation as the facts would induce in a reasonable person to sue within a year [now two years].

Fujisawa Pharm. Co., Ltd. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997); *see Law v. Medco Research, Inc., 113 F.3d 781, 786 (7th Cir. 1997)*. The ease of access to evidence that would trigger an appropriate inquiry is an important factor in determining when the statute of limitations begins running. *Fujisawa, 115 F.3d at 1334*. Further, [*34] "there must also be a suspicious circumstance to trigger a duty to exploit the access; an open door is not by itself a reason to enter the room.... *How* suspicious the circumstance need be to set the statute of limitations running ... will depend on how easy it is to obtain the necessary proof by a diligent investigation aimed at confirming or dispelling the suspicion." *Id. at 1335* (emphasis in original).

Defendants make two arguments. First, defendants argue that the lengthened statute of limitations period granted by Sarbanes-Oxley is not applicable, and rather a shorter one-year/three-year statute of limitation applies to *§§ 11, 12(a)and 15* violations because they do not sound in fraud. Second, even if some other alleged wrongdoing occurred, plaintiff's Complaint is untimely as not having been filed the earlier of five years after the occurrence or two years after notice. The Seventh Circuit has stated that, if a "plaintiff pleads facts that show its suit [is]

barred by a statute of limitations, it may plead itself out of court under a *Rule 12(b)(6)* analysis." *See Whirlpool Fin. Corp. v. GN Holdings, Inc., 67 F.3d 605, 608 (7th Cir. 1995)* [*35] (affirming district court's dismissal of federal securities fraud claim on inquiry notice issue). Each of these arguments will be addressed in turn.

1. Applicability of the Sarbanes-Oxley Act to the 1933 Act

Defendants have individually moved to dismiss all claims brought under the 1933 Act as time barred by the statute of limitations period contained in *15 U.S.C. § 77m* ("*§ 13*"). *Section 13* requires a claim to be

> brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.... In no event shall any such action be brought to enforce a liability ... more than three years after the security was bona fide offered to the public, or ... more than three years after the sale.

15 U.S.C. § 77m.

In response, plaintiff contends that Section 804 of the Sarbanes-Oxley Act governs and that it had until the earlier of five years from the event or two years from the date of notice to bring their action. *28 U.S.C. § 1658(b).* This raises the question of whether Sarbanes-Oxley applies to *Section 11, 12(a)(2)* [*36] *and 15* claims, which the plaintiff properly asserts require only strict liability or negligence. (Am. Compl. PP136, 147.)

"Interpretation of a statute must begin with the statute's language." *Mallard v. U.S. Dist. Court for So. Dist. of Iowa, 490 U.S. 296, 300, 104 L. Ed. 2d 318, 109 S. Ct. 1814 (1989).* A court may look beyond "the express language of a statute only where that statutory language is ambiguous or a literal interpretation would lead to an absurd result or thwart the purpose of the overall statutory scheme." *Nauheim v. Interpublic Group of Cos. Inc., 2003 U.S. Dist. LEXIS 6266, No. 02 C 9211, 2003 WL 1888843, at *3 (N.D. Ill. Apr. 16, 2003).* The language of the statute itself, both in terms of the words used themselves and within the context of the statute, determines whether the meaning is plain or ambiguous. *Robinson v. Shell Oil Co., 519 U.S. 337, 341, 136 L. Ed. 2d 808, 117 S. Ct. 843 (1997).* A court must endeavor to give effect to the plain language of the statute. *Mallard, 490 U.S. at 300.* Where there is no ambiguity in the statute, there is "'no occasion to look to the legislative history.'" *T.D. v. La Grange Sch. Dist. No. 102, 349 F.3d 469, 482 (7th Cir. 2003)* [*37] (quoting *Neosho R-V Sch. Dist. v. Clark, 315 F.3d 1022, 1032 (8th Cir. 2003)).*

The Sarbanes-Oxley Act provides:

> (b) Notwithstanding subsection (a), *a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance* in contravention of a regulatory requirement concerning the securities laws, as defined in *section 3(a)(47) of the Securities Exchange Act of 1934* (*15 U.S.C. § 78c(a)(47)*), may be brought not later than the earlier of--
>
> > (1) 2 years after the discovery of the facts constituting the violation; or
> >
> > (2) 5 years after such violation.

28 U.S.C. § 1658(b) (emphasis added).

While *15 U.S.C. § 78c(a)(47)* provides:

> (47) The term "securities laws" means the Securities Act of 1933 (*15 U.S.C. § 77a et seq.*), the Securities Exchange Act of 1934 (*15 U.S.C. § 78a et seq.*), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (*15 U.S.C. § 79a et seq.*), the Trust Indenture Act of 1939 (*15 U.S.C. § 77aaa et seq.*), the Investment [*38] Company Act of 1940 (*15 U.S.C. § 80a-1 et seq.*), the Investment Advisers Act of 1940 (*15 U.S.C. § 80b-1 et seq.*), and the Securities Investor Protection Act of 1970 (*15 U.S.C. § 78aaa et seq.*).

15 U.S.C. § 78c(a)(47).

While it is true that sections of the Securities Act of 1933 fall under Sarbanes-Oxley, the plain language of the Sarbanes-Oxley Act only applies to claims including "fraud, deceit, manipulation, or contrivance." *28 U.S.C. § 1658(b)*. It does not apply to non-fraud based claims brought under the 1933 Act. While relatively few courts have had opportunity to consider this question, each court has come to the same conclusion. *See Friedman v. Rayovac Corp., 295 F. Supp. 2d 957, 975 (W.D. Wis. 2003)*; *In re Merrill Lynch & Co. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003)*; *In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 2003 U.S. Dist. LEXIS 20955, Nos. 02 Civ. 3288 (DLC), 03 Civ. 6592, 2003 WL 22738546, at *9 (S.D.N.Y. Nov. 21, 2003)*. Hence, plaintiff's strict liability claims brought under *Sections 11, 12(a)(2)and* [*39] *15* claims of the 1933 Act are not covered by the Sarbanes-Oxley Act. [1]

1 To state a claim for violation of *§§ 11, 12(a)(2)and 15*, plaintiff need only allege that "material facts have been omitted" from a registration statement or "presented in such a way as to obscure or distort their significance." *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co., 936 F.2d 759, 761 (2d Cir. 1991)* (quotation omitted). These minimal proof requirements create extensive liability for issuers and those involved in the preparation and dissemination of the registration statements filed in the context of a public offering. *WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *7*. *Section 11, 12(a)(2)and 15* claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by *Rule 9(b)* and PSLRA. *See In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 423 (S.D.N.Y. 2003)*. Plaintiff clearly understands this because it has disavowed that its *§§ 11, 12(a)(2)and 15* claims are anything other than strict liability or negligence claims. (Am. Compl. at PP354, 383.)

[*40] Plaintiff's alternate contentions supporting its position are, likewise, without merit. Plaintiff's contention that Sarbanes-Oxley pertains to all sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 because Congress failed to explicitly exclude any sections of either invites the Court to step into the role of legislator, which is inappropriate.

Plaintiff also contends that a more inclusive meaning must be given to the terms "manipulation" and "contrivance," such that they cover any "vehicle through which the fraud is achieved" whether falling under the definition of fraud or not. (Pl's Resp. Household's Mot. Dismiss at 48.) Plaintiff's reliance on case law and legislative history to support this position is also misplaced. In *Ernst & Ernst v. Hochfelder*, the Supreme Court distinguished between intentional and negligent behavior in the context of securities fraud. *425 U.S. 185, 199, 47 L. Ed. 2d 668, 96 S. Ct. 1375 (1976)*. In particular, the Court held that the "use of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud [*41] investors by controlling or artificially affecting the price of securities." *Id.* Intent to deceive is a necessary element of "manipulation" or "contrivance," making these terms ones of scienter, not negligence or strict liability. BLACK'S LAW DICTIONARY 741, 846, 1081 (7th ed. 2000).

Plaintiff's attempt to bolster this position through reference to the legislative history of the Sarbanes-Oxley Act is not well founded. The argument presented is nearly identical to the one presented, and rejected, in *WorldCom*. *WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *9*. In *WorldCom* the court stated that the legislative record shows that while the senators involved were greatly concerned with contemporaneous business frauds, they had no intention of conflating fraud with strict liability or negligence. *WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *8-9*.

The Court holds that the language of *28 U.S.C. § 1658(b)* is unambiguous and does not apply to strict liability or negligence claims. As a result, the one-year/three-year statute of limitations in *Section 13 of the 1933 Act* applies to *§§ 11, 12(a)(2)and 15*. *15 U.S.C. § 77m*.

2. Timing [*42] **of the Claims**

Because the Amended Complaint arose from the consolidation of multiple suits, it is necessary to determine the date of the earliest original pleading. *Rule 15 of the Federal Rules of Civil Procedure* provides that an amended pleading relates back to the date of the original timely pleading when "the claim or defense asserted in the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted

to be set forth in the original pleading." *Fed. R. Civ. P. 15(c)(2)*. The earliest of the consolidated suits was filed August 19, 2002, hence that is the correct date for calculating notice.

Plaintiff bases its *Section 11, 12(a)(2)and 15* claims on various SEC filings and associated statements and publications. Count III is based on a June 1, 1998 Form S-4 Registration and Joint Proxy Statement-Prospectus. (Am. Compl. at P357.) Applying the one year/three year statute of limitations, there is some question as to when plaintiff should first have been on inquiry notice. Plaintiff cites both the letter to Aldinger and the publication of the Washington Report as key indications [*43] that something was possibly not right with Household's financials, providing the "suspicious circumstance." *Fujisawa, 115 F.3d at 1335*. But the ability to pursue a diligent inquiry also plays a role in determining when inquiry notice should have begun. *Id.* Plaintiff would like to argue that inquiry notice should not have begun until the release of the Restatement by Household on August 14, 2002 made the recalculations of profits and losses accessible to the public, all other meaningful data having been sealed by settlement agreements. However, to assume that would mean that inquiry notice would have arisen more than three years after the complained of violation, the filing of the S-4 Registration. Because *Section 13* requires claims to be filed the earlier of three years after the occurrence or one year after plaintiff is on actual or constructive notice, three years after the alleged violation, June 30, 2001, is the earliest date in this case. *15 U.S.C. § 77m*. As a result, the claims in Count III filed on August 19, 2002 against Household, Officer Defendants, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch are untimely.

[*44] Count IV is based on a series of Form S-3 debt registration statements. The dates of these SEC filings were on or about June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am. Compl. P384.) The same circumstances for inquiry notice apply for Count IV claims as the Count III claims. If the one year inquiry notice period could not have begun until the publication of the Restatement on August 14, 2002, the earliest *Section 13* dates for the June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000 filings are three years after each filing, respectively June 30, 2001, February 16, 2002, July 1, 2002, March 24, 2003. The earliest *Section 13* dates for the remainder of the filings, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002, is one year after inquiry notice should have begun, August 14, 2003, which plaintiff's August 19, 2002 filing satisfies. As a result, only the allegations arising out of the March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and [*45] April 9, 2002 Debt Registration Statements against Household, Officer Defendants, Individual Defendants and Andersen are timely. [2]

2 Neither equitable tolling nor estoppel are appropriate in securities cases. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 363, 115 L. Ed. 2d 321, 111 S. Ct. 2773 (1991)*; *Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1391 (7th Cir. 1990)*. The holdings in both cases have subsequently been modified with respect to retroactivity, but the tolling and estoppel holdings have been upheld. *Klehr v. A.O. Smith Corp., 521 U.S. 179, 200-01, 138 L. Ed. 2d 373, 117 S. Ct. 1984 (1997)*; *Plaut v. Spendthrift Farm, 514 U.S. 211, 217, 131 L. Ed. 2d 328, 115 S. Ct. 1447 (1995)*; *Lewis v. Long Grove Trading Co., 13 F.3d 1028, 1029 (7th Cir. 1994)*; *Cortes v. Gratkowski, 795 F. Supp. 248, 249 (N.D. Ill. 1992)*; *Cont'l Assurance Co. v. Geothermal Res. Int'l, Inc., 1991 U.S. Dist. LEXIS 13925, No. 89 C 8858, 1991 WL 202378, at *2 (N.D. Ill. Sept. 30, 1991)*; *see also* ABA COMMITTEE ON FEDERAL REGULATION OF SECURITIES, REPORT OF THE TASK FORCE ON STATUTE OF LIMITATIONS FOR IMPLIED ACTIONS 645, 655 (1986) (advancing "the inescapable conclusion that Congress did not intend equitable tolling to apply in actions under the securities laws").

[*46] **B. Sufficiency of the Pleadings**

1. *§§ 11, 12(a) & 15*

To establish a violation of *§ 11*, plaintiff must prove that a defendant's registration statement "contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." *15 U.S.C. § 77k(a)*. The statute sets forth five groups of people who may be liable for the misrepresentation: (1) anyone who signed the registration statement; (2) anyone who was a

director or partner in the issuer at the time of the filing; (3) anyone who is named in the registration statement as being a director or partner; (4) anyone who has certified any part of the registration statement; and (5) any underwriter of the security. *Id.*

To establish a violation of *§ 12(a)(2)*, plaintiff must show that defendants offered or sold a security to the plaintiff by means of a prospectus or oral communication that was false or misleading with respect to material facts. *15 U.S.C. § 77l*. Defendants may avoid liability by proving that plaintiff knew the statement was false when made. Additionally, under [*47] *§ 12(a)(2)*, a defendant is not liable if he or she can prove that he did not know and could not have reasonably discovered that the statement was false. *Friedman, 295 F. Supp. 2d 979*.

Section 15 imposes liability on those who "control" persons liable under other provisions of the 1933 Act.

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under *sections 77kor 77l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77.

2. Standard of Pleading

Section 11, 12(a)(2)and 15 claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by *Rule 9(b)* and [*48] PSLRA. *See In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d at 423*; *Friedman, 295 F. Supp. 2d at 977*. Plaintiff's allegations only need satisfy the liberal notice pleading requirements of *Fed. R. Civ. P. 8*. *Hoskins v. Poelstra, 320 F.3d 761, 764 (7th Cir. 2003)*. The complaint need not contain "all of the facts that will be necessary to prevail." *Id.* So long as the complaint gives defendant sufficient notice of the claim to file an answer, it "cannot be dismissed on the ground that it is conclusory or fails to allege facts." *Higgs v. Carver, 286 F.3d 437, 439 (7th Cir. 2002)*.

3. Materiality and Sufficiency

Defendants contend that plaintiff has insufficiently pleaded *§§ 11and 12(a)(2)* claims by failing to establish that any of the SEC statements contained misstatements and by failing to show a traceable loss to plaintiff arising from any of the alleged misstatements.

A misstatement or omission is material if there is a substantial likelihood that the disclosure of the misstatement or omitted fact "would have been viewed by the reasonable investor as having significantly [*49] altered the total mix of information." *Friedman, 295 F. Supp. 2d at 981* (citing *Basic, Inc., 485 U.S. at 231*).

Defendants assert plaintiff failed to plead contemporary facts, relying instead on hindsight, something that is disallowed under PSLRA. (Household Mot. Dismiss at 39; Andersen Mot. Dismiss at 1.) As a result, defendants urge that no material misstatement or omission was made because plaintiff could not have construed any of the debt registrations statements as containing misstatements or omissions until later events transpired. (Household Mot. Dismiss at 39; Memo Supp. Andersen Mot. Dismiss at 11.)

However, plaintiff has pleaded sufficient facts to make a colorable inference that defendants did know, and failed to disclose, or misrepresented material information at the time the debt registration statements were filed with the SEC. Plaintiff alleges defendants made materially and deliberately false statements in SEC filing on September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am. Compl. at P384.) Plaintiff alleges essentially the same grounds in each case, that the ratio of earnings [*50] to fixed charges was deliberately falsified. (*Id.* at PP390-91.) Earnings were over reported and losses were not reported. The basis for plaintiff's statements about defendant Household's earnings are related primarily to Household's allegedly engaging in a variety of predatory lending schemes in order to conceal the true value of the loans held. (*Id.* at PP51-54.) Plaintiff primarily cites details of lending settlements Household reached with a variety of State Attorneys General and bank regulators, exposure of Household's "Vision" system and practice of

"reaging" loans by a Washington state investigation, and the publication of the Washington Report as foundation. (*Id.* at PP51-99, 110-24.) Plaintiff claims Household's 2002 $ 600 million restatement of earnings was the direct result of these activities. (*Id.* at P135.) Andersen's role in assisting Household with its regular accounting and management and, most importantly, its consent to the inclusion of its own statements about Household's financial status in the SEC statements at issue establish its culpability, according to plaintiff. (*Id.* at PP171-79, 185-91, 388.)

Plaintiff's allegations are detailed and voluminous, [*51] more than sufficient to put defendants on notice. Accordingly, plaintiff's claims under the 1933 Act cannot be dismissed for failing to allege sufficient facts.

Defendants further allege that members of the class did not have losses as the result of the activities plaintiff complains of, hence plaintiff has no grounds for complaint. (Household Mot. Dismiss at 43.) Defendants argue that if disclosure of negative information does not "move the market" (that is, if the price of shares does not go down), the omission is immaterial as a matter of law. However, there may be reasons unrelated to the restatement that initially insulated the stock price from adverse effects. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 935 (9th Cir.), cert. denied, 157 L. Ed. 2d 311, 124 S. Ct. 433 (2003)* (concluding that information was material even though disclosure had no immediate effect on market price); *see also Folger Adam Co. v. PMI Indus., Inc., 938 F.2d 1529, 1533 (2d Cir. 1991)* ("It is well-established that a material fact need not be outcome-determinative.").

This Court cannot conclude as [*52] a matter of law that defendants' alleged omissions and misstatements were immaterial. Assuming the truth of plaintiff's allegations as the Court must, there is a colorable argument that a reasonable investor would view the defendants' actions as material, which is all that is required. Therefore, plaintiff has sufficiently pleaded *Section 11and 12(a)(2)* claims to raise questions of fact and to place defendants on notice. As a result, these claims cannot be dismissed.

4. Predicate Claims

Defendants also urge that no *§ 15* violation can be alleged without first establishing a predicate violation. (Household Mot. Dismiss at 44.) And, that even if such is found, the group pleading doctrine is no longer good law, thereby limiting the individuals who can be considered "control" personnel. (*Id.* at 45.) The purpose of a complaint is to plead allegations, not to prove them. Plaintiff has sufficiently pleaded *Section 11and 12(a)(2)* allegations. As a result, there is no bar to plaintiff likewise pleading a *Section 15* allegation.

As for the group pleading doctrine, "the Seventh Circuit has not ruled on the applicability of the group pleading doctrine following the enactment [*53] of the PSLRA." *Tricontinental, 215 F. Supp. 2d at 947*. This Court, as well as others in the district, continue to recognize it. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *6*; *Friedman, 295 F. Supp. 2d at 991-93*. As a result, plaintiff's *Section 15* claims cannot be dismissed.

C. Conclusion

As a result of the foregoing, Count III is dismissed for untimeliness. The motions to dismiss Count IV is granted with regard to the June 30, 2001, February 2002, July 2002 SEC Debt Registration Statements, but denied with regard to the March 2000, September 2000, February 2001, May 2001, November 2001, December 2001 and April 2002 SEC Debt Registration Statements.

III. Andersen's Motion to Strike

Defendant Andersen has moved to strike paragraphs 180 and 181 of the Amended Complaint as prejudicial and irrelevant. (Andersen Mot. to Strike at 1.) Andersen brings this motion pursuant to *Rule 12(f)*. *Rule 12(f)* provides that "upon motion made by a party within 20 days after the service of the pleading upon the party or upon the court's own initiative at any time, the court may order stricken from any pleading any insufficient defense or any redundant, [*54] immaterial, impertinent, or scandalous matter." *Fed. R. Civ. P. 12(f)*. Motions to strike are disfavored and usually denied. *Spearman Indus., Inc. v. St. Paul Fire & Marine Ins. Co., 109 F. Supp. 2d 905, 907 (N.D. Ill. 2000)*. Courts will strike portions of a complaint if the challenged allegations are so unrelated to the present claims as to be void of merit and unworthy of consideration and if the allegations are unduly prejudicial. *Kies v. City of Aurora, 149 F. Supp. 2d 421, 427 (N.D. Ill. 2001)*; *Robinson v. City of Harvey, 1999 U.S. Dist. LEXIS 12478, No. 99 C 3696, 1999 WL 617655, at *1-2 (N.D. Ill. Aug. 11, 1999)*. "Prejudice

results when the challenged allegation has the effect of confusing the issues or is so lengthy and complex that it places an undue burden on the responding party." *Cumis Ins. Soc'y Inc. v. Peters, 983 F. Supp. 787, 798 (N.D. Ill. 1997).*

Andersen questions whether material from other litigation and accounting scandals cited by plaintiff is discoverable for the purposes of this litigation. It also asserts that material contained in paragraphs 180 and 181 is misleading, inflammatory, [*55] inaccurate, prejudicial and irrelevant. Andersen does little to convince this court to strike these paragraphs. Whether any particular allegation is admissible will be dealt with more appropriately at a later time. The motion to strike is denied.

CONCLUSION

For the reasons set forth above, the Court denies Household, Household Officers, and Andersen's motion to dismiss Count I [88-1, 94-1, 97-1]; denies Household and Household Officers' motion to dismiss Count II [88-1]; grants Household, Household Officers, Household Directors, Andersen, Goldman Sachs, and Merrill Lynch's motions to dismiss Count III [88-1, 94-1, 95-1, 97-1]; grants in part and denies in part Household, Household Directors, and Andersen's motions to dismiss Count IV [88-1, 94-1, 97-1] and denies Andersen's motion to strike [93-1]. Goldman Sachs and Merrill Lynch are hereby terminated as parties.

SO ORDERED

ENTERED: 3/19/04

HON. RONALD A. GUZMAN

United States Judge

TAB 23

LEXSEE 2005 U.S. DIST. LEXIS 13607

JOHN KLACZAK and JEFF SHARP, individually and as ex rel. UNITED STATES OF AMERICA, Relators, v. CONSOLIDATED MEDICAL TRANSPORT INC., d/b/a COMED TRANSPORT, INC. TOWER AMBULANCE SERVICE, INC., DALEY'S AMBULANCE SERVICE, LTD., ESTATE OF JOHN W. DALEY, JR., JOHN W. DALEY, III, BRIAN T. WITEK, RICHARD S. WITEK, TOM WAPPEL, ST. BERNARD HOSPITAL, MT. SINAI HOSPITAL MEDICAL CENTER OF CHICAGO, JACKSON PARK HOSPITAL, TRINITY HOSPITAL, SOUTH SHORE HOSPITAL, SOUTH SUBURBAN HOSPITAL, HOLY CROSS HOSPITAL, BETHANY HOSPITAL, ST. JAMES HOSPITAL, LORETTO HOSPITAL, and "JOHN DOE" MEDICAL PROVIDERS, Defendants.

Case No. 96 C 6502

UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

2005 U.S. Dist. LEXIS 13607

May 26, 2005, Decided
May 26, 2005, Filed

SUBSEQUENT HISTORY: Summary judgment granted by, Motion granted by *Klaczak ex rel. United States v. Consol. Med. Transp., 2006 U.S. Dist. LEXIS 76100 (N.D. Ill., Sept. 30, 2006)*

PRIOR HISTORY: *Klaczak v. Consol. Med. Transp., Inc., 2002 U.S. Dist. LEXIS 16824 (N.D. Ill., Sept. 6, 2002)*

COUNSEL: [*1] For John Klaczak, Jeff Sharp, individually, Plaintiffs: Sidney R. Berger, Attorney at Law, Chicago, IL; Brian Richard Holman, Holman & Stefanowicz, LLC, Chicago, IL; Jeffrey Mark Friedman, Law Office of Jeffrey Friedman, PC, Chicago, IL.

For United States of America, Plaintiff: AUSA, Daniel Edward May, Kurt N. Lindland, United States Attorney's Office, NDIL, Chicago, IL.

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For John W Daley, Jr, Defendant: Daniel M. Purdom, Hinshaw & Culbertson, Lisle, IL; J David Dillner, Hiskes, Dillner, O'Donnell, Marovich & Lapp, Ltd, Timothy Charles Lapp, South Holland, IL.

For Richard S Witek, Defendant: Daniel M. Purdom, Joseph Henry McMahon, Hinshaw & Culbertson, Lisle, IL.

For St. Bernard Hospital, Defendant: Clare E. Connor, Frances Wiet Makuch, Tom H. Luetkemeyer, Hinshaw & Culbertson, Chicago, IL.

For Mt Sinai Hospotal Medical Center of Chicago, Defendant: Patrick Sean Coffey, Antonio DeBlasio, Donna J. Rolf, Gardner Carton & Douglas LLP, Chicago, IL; William M. Ejzak, [*2] Schuyler, Roche & Zwirner, Chicago, IL.

For Jackson Park Hospital, Defendant: Timothy F. Haley, Emily M Maki-Rusk, Scott A. Carlson, Seyfarth Shaw, Chicago, IL.

For Trinity Hospital, South Suburban Hospital, Bethany Hospital, Defendants: Clare E. Connor, Tom H. Luetkemeyer, Hinshaw & Culbertson, Chicago, IL.

For South Shore Hospital, Defendant: Clare E. Connor, Hinshaw & Culbertson, Chicago, IL.

For Holy Cross Hospital, Defendant: Patrick Edward Deady, John Michael Tecson, Laura Cha-Yu Liu, Matthew James Cleveland, Hogan Marren, Ltd., Chicago, IL.

For St. James, Defendant: Patrick J. Galvin, Hammond, IN; Bradford D. Roth, Cassiday, Schade & Gloor, Chicago, IL; Robert A Anderson, Krieg Devault Galvin, Hammond, IN.

For Loretto Hospital, Defendant: Patrick Edward Deady, John Michael Tecson, Laura Cha-Yu Liu, Timothy Brennan Caprez, Hogan Marren, Ltd., Chicago, IL.

JUDGES: Hon. Mark Filip.

OPINION BY: Mark Filip

OPINION

MEMORANDUM AND OPINION

In this *qui tam* action, plaintiffs John Klaczak and Jeff Sharp ("Relators"), individually and on behalf of the United States, are suing Consolidated Medical Transport ("CoMed"), as well as the various other defendants named [*3] in the caption of this case. [1] The United States partially intervened in this matter, and declined to intervene in other aspects of the Relators' claims. (D.E. 15). (In this regard, for example, it appears that the United States declined to intervene in the claims against the Defendant hospitals. (*See id.*)) The Relators allege, among other things, that certain defendants violated the *False Claims Act* ("FCA") by entering into agreements for ambulance services, which agreements constituted a kickback scheme in violation of the Medicare Anti-Kickback Statute, *42 U.S.C. § 1320a-7b et seq.* Count V of Relators' Second Amended Complaint is an FCA claim brought against St. Bernard Hospital, Mt. Sinai Hospital, Jackson Park Hospital, Trinity Hospital, South Shore Hospital, South Suburban Hospital, Holy Cross Hospital, Bethany Hospital, St. James Hospital, Loretto Hospital (collectively, "Defendants"), and "John Doe" Medical Providers. Relators allege that, in violation of the Anti-Kickback Statute, Defendants have "knowingly and willfully accepted illegal remunerations offered to them by CoMed in the form of drastically reduced rates for their Part A transports [*4] in exchange for which they referred to CoMed their Part B transports." (Second Am. Compl. (D.E. 85) P 81.) Before the Court is the Defendants' Motion (D.E. 180) in Limine to Exclude the Expert Testimony of Frank W. Nagorka and Eva Jo Sparks under *Federal Rules of Evidence 104* and *702*. [2] For the following reasons, the motion is granted in part and denied in part.

1 The Court assumes that the reader has a certain degree of familiarity with the history of this case, particularly that history which is not relevant to the disposition of this motion. Judge Andersen has issued two opinions detailing the background of this case. *See Klaczak v. Consol. Med. Transp., Inc., 2002 U.S. Dist. LEXIS 16824, No. 96-6502, 2002 WL 31010850, at *1-3 (N.D. Ill. Sept. 9, 2002)*; *United States ex rel. Sharp v. Consol. Med. Transp., Inc., 2001 U.S. Dist. LEXIS 13923, No. 96-6502, 2001 WL 1035720, at *1-3 (N.D. Ill. Sept. 4, 2001).*

2 The individual defendants in this case orally moved to join this motion. (*See* D.E. 181). As a practical matter, their motion may be moot, as the individual defendants (who were the subject of the intervention of the United States) have settled with the government. As a result, the claims that the government is pursuing, at least on its own behalf, as well as the claims against the individual defendants, are now resolved.

[*5] BACKGROUND

This suit was filed in October 1996, and in the years since then, this case has produced a long and relatively complex procedural history, much of which is not relevant to the resolution of Defendants' Motion. [3] What is relevant, however, is that during 2004, this Court set a disclosure and report schedule for experts in this matter. The Realtors disclosed Frank W. Nagorka ("Nagorka") and Eva Jo Sparks ("Sparks") as their experts and provided Defendants with copies of Sparks's and Nagorka's expert reports. Defendants have moved to exclude Sparks's and Nagorka's testimony and reports, arguing that their testimony generally (and their expert reports specifically) fail to meet the required standards for admissibility and would fail to assist the jury in understanding the facts of this case. (D.E. 180 at 2.) Defendants also contend that Sparks's and Nagorka's testimony is "inadmissible and inappropriate as a matter of law and . . . that neither [Sparks nor Nagorka] is qualified to testify as to the opinions that they ultimately offer." [4] (*Id.*)

3 This Court received this case via reassignment upon taking the bench in 2004.

[*6]

4 The Court makes no finding at this time that Realtors' experts are qualified to offer any of the testimony identified in their reports. The reports did not contain *curriculum vitae* and the issue of qualification was not addressed in any meaningful way in the parties' briefs. Defendants may raise qualification challenges as this matter approaches trial, if appropriate, and the parties are

free to request a *Daubert* hearing at that later juncture if one is appropriate.

Before reaching the merits of Defendants' Motion, a brief review of an opinion and order that Judge Andersen issued in this case on September 4, 2001, is necessary to put Defendants' Motion in context. *See United States ex rel. Sharp v. Consol. Med. Transp., Inc., 2001 U.S. Dist. LEXIS 13923, No. 96-6502, 2001 WL 1035720 (N.D. Ill. Sept. 4, 2001)*. In that opinion, Judge Andersen ruled that "if the Relators can show that the alleged scheme is in fact an illegal kickback scheme [in violation of the Anti-Kickback statute], and that the government would have barred claims had it known of the existence of the underlying scheme, a violation [*7] of the FCA would be proven." *2001 U.S. Dist. LEXIS 13923, [WL] at *10*. Judge Andersen found that "under these circumstances, the alleged facts would constitute a fraudulent scheme materially bearing on the government's decision to pay the claims submitted to it." *Id.* The Relators must prove that "had the government known about the kickback scheme, it would have refused payment of the claims, and, further, that the defendants were aware that this was the case when they engaged in their fraudulent conduct." *Id.* The Relators have apparently endeavored to follow Judge Andersen's directions, with their expert reports taking a marked shortcut (producing, as discussed below, proffered expert testimony in the form of various inappropriate legal conclusions) on the issue of Defendants' liability.

With respect to the Relators' proffered experts, Mr. Nagorka is a paramedic and lawyer whose report ultimately concludes that "the ambulance provider agreements . . . constituted a kickback scheme in violation of the Anti-Kickback Statute." (D.E. 180, Ex. A ("Nagorka Report") at 1, 44.) In reaching this conclusion, Nagorka's report, which reads more like a legal brief than an expert report, sets forth numerous assertions [*8] about the applicable law, reviews various agreements between the Defendants and defendant ambulance companies, and asserts that the Defendants and their agreements violated the Anti-Kickback Statute. (*See id.* at 14 ("The ambulance provider agreements entered into by Bethany Hospital and Consolidated Medical Transport violate the Anti-Kickback Statute (*42 U.S.C. § 1320a-7b(b)*).").) Nagorka also asserts that the Defendants and their agreements are not protected by any laws concerning safe harbor protections (*see, e.g., id.* at 2 (stating that the agreements "fail to meet the 'safe harbor" requirements")), and Nagorka further asserts that discounts received by the Defendants from CoMed were "illegal remunerations." (*See, e.g., id.* at 15 ("The rates provided to Bethany Hospital by CoMed are illegal remunerations under the Anti-Kickback Statute."); *see also, e.g.,* ("The discounts that Bethany Hospital received from CoMed on transports that Bethany Hospital was financially responsible for (e.g., DRGs, Medicare Part A transports, in-patient transports) are illegal remunerations.").)

Ms. Sparks is a Certified Fraud Examiner (D.E. 180, Ex. B ("Sparks [*9] Report") at 1), who, according to her report, the Relators expect to "testify relating to the application of Medicare rules and regulations as applied to" this case. (*Id.;* D.E. 182 at 10.) Sparks's report begins by discussing the Medicare system. (D.E. 180, Ex. B at 1-6). Her ultimate opinion is that, among other things, the Defendants and defendant ambulance companies "knowingly entered into a kickback scheme" and "knowingly filed Cost Reports with Medicare containing false certifications and statements." (*Id.* at 21.) She opines that each claim presented to Medicare and Medicaid by the Defendants and the defendant ambulance companies "which were provided or procured through the underlying kickback scheme . . . is a fraudulent claim on the Government." (*Id.*) Of particular relevance to Defendants' Motion is Sparks's conclusion that Defendants "knowingly concealed from Medicare the improper kickback schemes" and that Defendants "knew that any disclosure . . . would result in denial of all claims made to Medicare." (*Id.* at 10.)

ANALYSIS

A district court must exercise its informed discretion to determine whether to admit expert testimony or not. *See, e.g., Good Shepherd Manor Found., Inc. v. City of Momence, 323 F.3d 557, 564 (7th Cir. 2003).* [*10] After reviewing the proffered expert reports, and after reviewing applicable precedent, the Court finds that much of the testimony of the Relators' proffered experts, and particularly much of the testimony of attorney Nagorka, should not be admitted at trial. The legal conclusions offered by Relators' experts will not assist the jury in understanding the evidence or in determining the facts at issue. Independently, such testimony presents an impermissible risk of usurping the role of the Court as it relates to the jury. In addition, and independently, the potential for jury confusion attendant to such testimony warrants exclusion pursuant to *Federal Rule of Evidence 403*. The Court also, as explained below, excludes various purported expert testimony from Sparks and Nagorka as to what the Defendants purportedly knew or whether the Defendants intended to commit fraud. Such testimony is not helpful to the jury, as the jury is well positioned to make this type of assessment in the absence of a battle of expert testimony about what parties knew or did not know, or did or did not subjectively intend to do. In addition, such testimony is independently excluded [*11] pursuant to *Rule 403*.

Federal Rule of Evidence 702 provides that an expert witness may testify as to "scientific, technical, or

other specialized knowledge" where such testimony "will assist the trier of fact to understand the evidence or to determine a fact in issue." *Fed. R. Evid. 702*. Seventh Circuit precedent, however, prohibits expert witnesses from offering opinions or legal conclusions on issues that will determine the outcome of a case. *See, e.g., Good Shepherd, 323 F.3d at 564* ("The district court correctly ruled that expert testimony as to legal conclusions that will determine the outcome of the case is inadmissible.") (citing *United States v. Sinclair, 74 F.3d 753, 758 n.1 (7th Cir. 1996))*; *accord, e.g., Hygh v. Jacobs, 961 F.2d 359, 363 (2d Cir. 1992)* ("This circuit is in accord with other circuits in requiring exclusion of expert testimony that expresses a legal conclusion."); *Niebur v. Town of Cicero, 136 F. Supp. 2d. 915, 920 (N.D. Ill. 2001)* ("The Court of Appeals is crystal clear that an expert may not 'improperly tell[] the jury [*12] why [a party's] conduct was illegal.' Expert witnesses are not allowed to draw legal conclusions' . . . .") (quoting, first, *Haley v. Gross, 86 F.3d 630, 645 (7th Cir. 1996)*, and second, *West v. Waymire, 114 F.3d 646, 652 (7th Cir. 1997))*; *In re Initial Public Offering Servs. Litig., 174 F. Supp. 2d 61, 64 (S.D.N.Y. 2001)* ("In fact, every circuit has explicitly held that experts may not invade the court's province by testifying on issues of law.") (collecting numerous cases); *id.* ("While an expert may provide an opinion to help a judge or jury understand a particular fact, 'he may not give testimony stating ultimate legal conclusions based on those facts.'") (quoting *United States v. Bilzerian, 926 F.2d 1285, 1294 (2d Cir. 1991)).*

Precedent teaches that one reason for these rules is to prevent the situation where the expert usurps or infringes upon the role of the judge. *See Panter v. Marshall Field & Co., 646 F.2d 271, 294 n.6 (7th Cir. 1981)* ("It is not for witnesses to instruct the jury as to applicable principles of law, but the judge."); *accord, e.g., Burkhart v. Wash. Metro. Area Transit Auth., 324 U.S. App. D.C. 241, 112 F.3d 1207, 1213 (D.C. Cir. 1997)* [*13] ("Each courtroom comes equipped with a legal expert,' called a judge, and it is his or her province alone to instruct the jury on the relevant legal standards."). The Seventh Circuit has noted that, if a court would admit such expert testimony, a court would improperly signal to the jury that it is appropriate to look to the parties' experts for legal guidance. *See Harbor Ins. Co. v. Cont'l Bank Corp., 922 F.2d 357, 366 (7th Cir. 1990).*

The Court need not decide at this time (nor have the parties asked for) the precise language of the instructions that the Court will give to the jury at the conclusion of any trial in this case. [5] Even a rough sketch of what those instructions may look like (in light of the relevant law and Judge Andersen's prior rulings), however, reveals the many material legal conclusions and assertions contained in the Nagorka and Sparks reports. Judge Andersen "recognized that a violation of the Anti-Kickback Statute may form the basis of an FCA claim." *Sharp, 2001 U.S. Dist. LEXIS 13923, 2001 WL 1035720, at *1*; *2001 U.S. Dist. LEXIS 13923, [WL] at *8* ("Courts recognize that FCA liability may be premised on the violation of a different federal statute that otherwise lacks a private [*14] cause of action."). The Anti-Kickback Statute, *42 U.S.C. § 1320a-7b(b)* makes it a felony to:

> knowingly and willfully solicit[] or receiver any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind--(A) in return for referring an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in part under a Federal health care program, or (B) in return for purchasing, leasing, ordering, or arranging for or recommending purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under a Federal health care program.

42 U.S.C. § 1320a-7b(b). As explained above, Judge Andersen held that "if the Relators can show that the alleged scheme is in fact an illegal kickback scheme [in violation of the Anti-Kickback statute], and that the government would have barred claims had it known of the existence of the underlying scheme, a violation of the FCA would be proven." *Sharp, 2001 U.S. Dist. LEXIS 13923, 2001 WL 1035720, at *10*. Under [*15] Judge Andersen's ruling, the issue of whether Defendants violated the Anti-Kickback Statute is outcome determinative and will be the subject of a jury instruction at trial.

> 5 A trial date has not been set in this case, and the parties have not submitted proposed jury instructions. Judge Andersen stated that "this is a case of first impression in [the Seventh Circuit] and . . . [that] there is a dearth of case law relevant to the issue from any court." *Sharp, 2001 U.S. Dist. LEXIS 13923, 2001 WL 1035720, at *4*. The time that has passed since Judge Andersen's ruling has not added any definitive level of clarity to what jury instructions might look like, although the Court's research uncovered cases addressing use of the Anti-Kickback Statute to attempt to establish a violation of the FCA, which cases were not available to Judge Andersen. *See, e.g., United States ex rel. Bidani v. Lewis, 264 F. Supp. 2d 612 (N.D. Ill. 2003)* (holding that viola-

tion of Anti-Kickback statute can be basis for False Claims Act violation); *United States ex rel. Barrett v. Columbia/HCA Health Care Corp., 251 F. Supp. 2d 28 (D.D.C. 2003)* (similar).

[*16] Moreover, established Seventh Circuit precedent, as well as case law from this district, specifically teaches that an expert may not offer opinion testimony as to whether a defendant violated a statute or regulation, at least where that statute or regulation is at issue in the case. *See Good Shepherd, 323 F.3d at 564* (holding that expert testimony that included "conclusions that the [defendants] violated the [*Fair Housing Amendments Act*]" was properly excluded) (citing *Sinclair, 74 F.3d at 757 n. 1*); *McCabe v. Crawford & Co., 272 F. Supp. 2d 736, 740 (N.D. Ill. 2003)* (holding that plaintiff's expert, a law professor who specialized in consumer law, "may not expound on what complies and does not comply with the [*Fair Debt Collection Practices Act*]; these are inappropriate legal conclusions"); *Cent. Die Casting and Mfg. Co., Inc. v. Tokheim Corp., 1998 U.S. Dist. LEXIS 18472, No. 93-7692, 1998 WL 812558, at *9 (N.D. Ill. Nov. 19, 1998)* ("The Court agrees that an expert's opinion concerning whether a statute or regulation was violated is likely an inadmissible legal conclusion . . . ."). Accordingly, any opinion as to whether Defendants violated [*17] the Anti-Kickback Statute, or met (or did not meet) with the safe harbor strictures, or whether any discounts received were illegal remunerations, is improper. *See, e.g., Good Shepherd, 323 F.3d at 564*; *Sinclair, 74 F.3d at 758 n.1*; *McCabe, 272 F. Supp. 2d at 740*.

The Relators' briefing, with all respect, is not particularly helpful. The Relators "do not contest the proposition that experts cannot render impermissible legal conclusions." (D.E. 182 at 2.) But rather than explain which, if any, of the specific legal conclusions contained in their experts' reports is a "permissible" legal conclusion (whether any actually would be is suspect, given the precedent cited above), Relators advance, as best the Court can tell, three general arguments. First, Relators argue that "as a practical matter not all opinions can be easily identified as permissible factual conclusions or impermissible legal conclusions." (*Id.*) Second, Relators argue that "courts have admitted testimony that clearly sets forth a legal conclusion[,] and *Rule 704 of the Federal Rules of Evidence* permits opinions on the ultimate issue. [*18] " (*Id.*) Third, Relators argue that, even if the Court excludes certain of Sparks's and Nagorka's testimony, that exclusion does not mandate that they should be excluded from testifying at trial. (*Id.* at 2, 4.) The Court addresses these arguments in turn.

Realtors begin with the proposition that certain words have both legal and non-legal or lay meanings. According to the Relators, an expert opinion may encompass the lay meaning of such a word, and (given the potential dual meaning of certain words) what appears to be a legal conclusion on its face may actually not be one. By way of illustration, the Realtors point to Defendants' objection that "Sparks even goes as far as to affirmatively state that the Defendants committed fraud, an ultimate legal conclusion that directly invades the province of this Court." (*Id.* at 3 (quoting D.E. 180 at 7).) In support of what appears to be Relators' implicit argument that Sparks's opinion that the Defendants committed fraud is not an improper legal conclusion, Relators cite *In re Air Crash Disaster at Lockerbie Scotland on December 2, 1988 ("Lockerbie "), 37 F.3d 804 (2d Cir. 1994)*. In that case, the Second Circuit stated, [*19] in analyzing a fairly peripheral issue within a lengthy appeal, that it was not an abuse of discretion for the district court to admit testimony of one of the plaintiffs' expert witnesses who testified that he thought that the defendant had "engaged in 'fraud' and 'deceit.'" *Id. at 826*. The court went on to explain that "it was clear from the . . . [the expert witness's] direct and cross examination that he used those terms in a nonlegal sense." *Id.*

The *Lockerbie* case does not assist the Relators. *Lockerbie* did not question "the general rule" "that an expert may not testify as to what the law is, because such testimony would impinge on the trial court's function." *Id. at 826-27* (collecting cases). *Lockerbie* also cautioned that "permitting an expert to give a legal conclusion" may often be improper because it "implicitly provide[s] a legal standard to the jury." *Id. at 827* (collecting cases). "Thus, expert testimony expressing a legal conclusion should ordinarily be excluded . . . ." *Id.*

More specifically, given the context and matters at issue in this case, Relators cannot credibly argue that Sparks is using [*20] the term "fraud" in a nonlegal sense. Relators are claiming that Defendants committed fraud within the meaning of one or both of the False Claims Act and the Anti-Kickback Statute. Nor can Relators credibly argue that the passage of time will somehow reveal that Sparks's report uses the term fraud in a nonlegal sense. Realtors are suing Defendants under the FCA, and the issues of whether Defendants committed fraud and subjectively intended to commit fraud are material to establishing Defendants' potential legal liability--liability, incidentally, under federal statutory regimes and related precedent that are, at least at times, arguably byzantine. Abundant caselaw confirms the impropriety of such purported expert testimony. *See, e.g., Steadfast Ins. Co. v. Auto Mktg. Network, Inc., 2004 U.S. Dist. LEXIS 6938, No. 97 C 5696, 2004 WL 783356, *6 (N.D. Ill. Jan. 28, 2004)* (barring experts from testifying as to whether an insurance claim was filed in bad faith, as the "experts are in no better position than the jury to assess Steadfast's subjective intent"; allowing such experts to testify about intent would be improper because it "would

be little more than 'telling the jury what result to reach'") [*21] (quoting *Woods v. Lecureux, 110 F.3d 1215, 1221 (6th Cir. 1997))*; *Dahlin v. Evangelical Child and Family Agency, 2002 U.S. Dist. LEXIS 24558, No. 01 C 1182, 2002 WL 31834881, at *3 (N.D. Ill. Dec. 18, 2002)* (holding that an expert cannot testify that certain actions constituted fraud because it "is a quintessential jury determination on which the Court will instruct a jury concerning the factors it is to consider" and because the expert is no "more qualified than an ordinary juror" to determine intent) (collecting cases); *Isom v. Howmedica, Inc., 2002 U.S. Dist. LEXIS 9116, No. 00 C 5872, 2002 WL 1052030, *1-2 (N.D. Ill. May 22, 2002)* (barring proposed expert testimony concerning opposing party's intent because expert is no more qualified than jury to assess party's intent); *see also Woods, 110 F.3d at 1221* (affirming district court's decision to preclude plaintiff's expert from testifying about whether defendants were "deliberately indifferent" in prison civil rights case, because such testimony gives "the false impression that . . . [the expert] knows the answer to this inquiry"; such testimony improperly "runs the risk of interfering with a district court's jury instructions" [*22] and "hardly can be viewed as being helpful to the jury"). Sparks's testimony, by her own admission, is directed, in part, at Medicare Fraud and Abuse Rules and Regulations, and she opines that "each claim presented to Medicare and Medicaid by the Defendant[s] . . . is a fraudulent claim on the Government." (Sparks Report at 21.) This is precisely the sort of testimony--about fraud in the legal sense, as well as about a party's subjective state of mind, a subject on which the expert is no better qualified than a jury--that precedent forbids.

Relators also implicitly suggest that the legal conclusions in Sparks's and Nagorka's reports are permissible because courts have admitted testimony that sets forth legal conclusions and *Federal Rules of Evidence 704* "permits an expert to express an opinion that embraces an ultimate issue to be decided by the trier of fact." (D.E. 182 at 4.) In support, Plaintiffs cite *Miksis v. Howard, 106 F.3d 754, 762 (7th Cir. 1997). Miksis,* however, does not support Relators' argument that either Sparks or Nagorka are permitted to proffer legal conclusions in this case. *Miksis* distinguished factual versus legal causation, [*23] *see id. at 762*, holding that admission of the expert's opinion at issue in that case (which was directed at factual, not legal, causation) was not "manifestly erroneous" or an abuse of discretion. *Miksis* did not (as Relators appear to suggest), hold that a legal conclusion on the ultimate issue of causation was the proper subject of admissible expert testimony, much less that it was required to be admitted. Indeed, other caselaw teaches that such testimony is properly excluded. *See, e.g., Good Shepherd, 323 F.3d at 564*; *McCabe, 272 F. Supp. 2d at 740*; *Isom, 2002 U.S. Dist. LEXIS 9116, 2002 WL 1052030, at *3*.

Relators also proffer various "examples of cases in which the courts allowed expert testimony/opinions that the opposing party argued were impermissible legal conclusions." (D.E. 182 at 6.) Realtors contend that what is "clear from these cases is that one cannot assume [that] the Court will disallow expert testimony simply because the opposing party classifies it as a legal conclusion." (*Id.* at 7.) This Court takes no issue with this unobjectionable generality. However, to the extent Relators cite these cases in support of some sort [*24] of implied argument that the various legal conclusions offered by Relators' proposed experts are admissible, the Court finds that, after reviewing these cases and the proposed testimony, such an argument is unpersuasive.

Indeed, *West v. Waymire, 114 F.3d 646 (7th Cir. 1997)*, a case cited by the Realtors, actually undermines such a conclusion. *West* noted that the plaintiff's expert's affidavit was "admissible to show . . . [negligent supervision], [but] was not admissible to show . . . a municipal policy . . . [of refusing to protect against certain dangers for purposes of *Monell* liability under *42 U.S.C. § 1983*]," which was a "legal conclusion that an expert witness is not allowed to draw." *West, 114 F.3d at 652* (collecting cases). *West,* therefore, actually supports the position (which is consistent with the Seventh Circuit's holdings in *Sinclair* and *Good Shepherd*) that, as a general rule, an expert may not testify as to a legal conclusion. And, notably, courts within this district have cited *West* in support of this very proposition. *See Dahlin, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881, at *3 n.2*; [*25] *Isom, 2002 U.S. Dist. LEXIS 9116, 2002 WL 1052030, at *2 n.1 (N.D. Ill. May 22, 2002)*; *Niebur, 136 F. Supp. 2d at 920*.

Moreover, in many of the cases cited by Relators, the court determined, based on the specific facts of the respective case, that the proffered opinion was, in fact, *not* a legal conclusion. *See United States v. Brown, 7 F.3d 648, 651, 653-54 (7th Cir. 1993)*(finding that district court committed no "clear abuse of discretion" in admitting testimony of prosecution's expert concerning whether amount of drugs was consistent with user or distributor status, because the expert's testimony "merely assisted the jury in interpreting the significance of the evidence by comparing [the defendant's] activities to typical behavior patterns of crack users and distributors" and "did not interfere with the jury's exclusive role") [6]; *United States v. Oles, 994 F.2d 1519, 1523 (10th Cir. 1993)*(reviewing for plain error only, as there was no trial objection, and holding that witnesses' reference to the legal term "kiting," where those "witnesses neither attempted to legally define check kiting nor explained the elements of a check kiting offense," was not plain

error); *Heflin v. Stewart County, Tenn., 958 F.2d 709, 715 (6th Cir. 1992)* [*26] (holding, over a dissent, that trial court did not abuse its discretion concerning expert, who testified as an expert concerning correctional institutions and did not claim to have any expertise on the legal requirements for recovery from jail officials for dereliction of duty, that defendants were deliberately indifferent because expert simply used the term in "the way an ordinary layman would"). [7] The fact that other courts have failed to find an abuse of discretion concerning admitted testimony, after determining that often belated and untimely objections were unfounded on factual grounds, does not change the nature of the Realtors' expert testimony here. In addition, none of the Relators' cases casts meaningful doubt on the well-established principles outlined at length above that demonstrate the impropriety of much of the testimony of the proffered experts of the Relators here.

6 *See also United States v. Brown, 7 F.3d 648, 654 n.3 (7th Cir. 1993)*(noting that such testimony is always potentially excludable, if warranted, pursuant to *Fed. R. Evid. 403*).

[*27]

7 *But see Woods, 110 F.3d at 1221* (affirming district court's decision to preclude plaintiff's expert from testifying about whether defendants were "deliberately indifferent" in civil rights case, because such testimony gives "the false impression that . . . [the expert] knows the answer to this inquiry"); *id.* (teaching that admission of such testimony "hardly can be viewed as . . . being helpful to the jury").

In sum, none of the cases Relators cite support the conclusion that Nagorka and Sparks should be permitted to offer opinion testimony on ultimate issues of law in this case. For instance, this is not a case, as in some of the other cases Relators cite, where the proposed experts are testifying as a means to assist in determining the frequency with which certain contractual language is used in an industry. *See WH Smith Hotel Servs. v. Wendy's Int'l, Inc., 25 F.3d 422, 429 (7th Cir. 1994)*(holding that the district court, in bench trial, properly admitted expert testimony regarding custom and usage in connection with interpretation of an ambiguous [*28] provision of an operating agreement); *Huddleston v. Herman & MacLean, 640 F.2d 534, 552 (5th Cir. 1981)*(holding that the district court properly admitted expert testimony that boilerplate language in prospectus "was standard language for a prospectus used in connection with the issuance of a new security" and thus was unlikely to have been viewed as negating the effect of other misleading statements in prospectus). And in some of the cases cited by Realtors, there is no indication that either party objected to the introduction of expert testimony involving legal conclusions. *See e.g., Autoskill Inc. v. Nat'l Educ. Supp. Sys., 994 F.2d 1476, 1493 (10th Cir. 1993)*(noting that judge, at a bench trial, considered expert testimony regarding what aspects of a computer program were protectable under copyright law) [8]; *Whittaker Corp. v. Edgar, 535 F. Supp. 933, 943 (N.D. Ill. 1982)*(reflecting that experts testified regarding whether a transaction would be taxable; admissibility does not seem to have been litigated).

8 *See also Autoskill Inc., 994 F.2d at 1497 n.25* (noting that trial judge explained that he was not relying on purported expert's legal assertions and conclusions).

[*29] Relators' reliance on the text of *Federal Rule of Evidence 704* is also misplaced. Legal conclusions, of course, depending on the particular posture of a case, may be "ultimate issues." That said, the Court notes that *Federal Rule of Evidence 704*, which abolished the "ultimate issue" rule, does not function in isolation. *See Fed. R. Evid. 704* Advisory Committee Notes ("The abolition of the ultimate issue rule does not lower the bars so as to admit all opinions. Under *Rules 701* and *702*, opinions must be helpful to the trier of fact, and *Rule 403* provides for exclusion of evidence which wastes time.")

Moreover, Seventh Circuit precedent teaches that "that *Federal Rules of Evidence 702 and 704* prohibit experts from offering opinions about legal issues that will determine the outcome of a case." *Sinclair, 74 F.3d at 758 n.1* (emphasis added); *accord Good Shepherd 323 F.3d at 564*. Indeed, the plain text of *Federal Rule of Evidence 704* requires [*30] that an expert opinion, notwithstanding that it may reach an "ultimate issue," must be "otherwise admissible." *Fed. R. Evid. 704*. In this regard, an expert's opinion must, among other things, "assist the trier of fact to understand the evidence or to determine a fact in issue," within the meaning of *Federal Rule of Evidence 702*. *Fed. R. Evid. 702*. The Seventh Circuit instructs that "expert testimony is helpful to the jury if it concerns a matter beyond the understanding of the average person, assists the jury in understanding facts at issue, or puts the facts in context." *United States v. Welch, 368 F.3d 970, 974 (7th Cir. 2004)*(citing *Fed. R. Evid. 702*). Legal conclusions as to ultimate issues generally do not assist the trier of fact because they simply tell the trier of fact what result to reach. *See, e.g., United States v. Duncan, 42 F.3d 97, 101 (2d Cir. 1994)*("Generally, the use of expert testimony is not permitted if it will usurp either the role of the trial judge in instructing the jury as to the applicable [*31] law or the role of the jury in applying that law to the facts before it. When an expert undertakes to tell the jury what result to reach, this does not *aid* the jury in making a decision, but rather attempts to substitute the expert's

judgment for the jury.") (collecting numerous circuit court authorities; internal quotation marks omitted; emphasis in original); *Woods, 110 F.3d at 1220-21*; *Paradigm Sales, Inc. v. Weber Marking Sys., Inc., 880 F. Supp. 1247, 1255 (N.D. Ind. 1995)*("*Fed. R. Evid. 704(a)* provides that 'otherwise admissible' opinion testimony is not rendered inadmissible because it embraces an ultimate issue, but legal conclusions are not 'otherwise admissible' under Rule[] . . . 702 because they are not helpful to the trier of fact."). Relatedly, precedent teaches that proffered expert assertions about another's subjective intent or knowledge are not helpful to the jury, which is equally if not much better suited to make these assessments than the parties' competing paid experts. *See Isom v. Howmedica, Inc., 2002 U.S. Dist. LEXIS 9116, No. 00 C 5872, 2002 WL 1052030, *1 (N.D. Ill. May 22, 2002)*(barring proffered [*32] expert testimony concerning party's intent, and stating that "even though *Federal Rule of Evidence 704(a)* abrogates the common-law rule barring expert opinions on an 'ultimate issue,' we must nonetheless analyze whether an 'expert' opinion on this topic would assist the jury and if so, whether its probative value is outweighed by its danger for unfair prejudice"); *Dahlin v. Evangelical Child and Family Agency, 2002 U.S. Dist. LEXIS 24558, No. 01-1182, 2002 WL 31834881, at *3 (N.D. Ill. Dec. 18, 2002)*(same quote, and barring proffered expert testimony of clinical psychologist as to whether the defendant committed fraud); *accord, e.g., Woods, 110 F.3d at 1220-21*. As a result, *Federal Rules of Evidence 702* and *704*, along with *Federal Rule of Evidence 403* and the precedent interpreting and applying those rules, are consonant with the Court's ruling and do not counsel in favor of admission of the Relators' suspect testimony.

With the aforementioned principles in mind, the Court turns to the substance of the two proffered expert reports.

A. Nagorka's [*33] Report Is Stricken In Substantial Part

Nagorka's report is comprised almost entirely of impermissible legal conclusions. The gist of his opinion is succinctly stated in the "Overview and Opinions" section of the report. In that section, Nagorka states that "in my opinion . . . the ambulance provider agreements entered into by the Defendants Hospitals . . . constituted a kickback scheme in violation of the Anti-Kickback statute (*42 U.S.C. § 1320a-7b(b)*)"). (Nagorka Report at 1.) In support of this conclusion, Nagorka's report recites what he views as the applicable law and reaches the conclusion that the each of the Defendants has violated a federal criminal statute and various federal regulations. While this may be the proper subject of a brief, or perhaps a closing argument, it is not the proper subject of an expert opinion. *See, e.g., Good Shepherd, 323 F.3d at 564* ("The district court correctly ruled that expert testimony as to legal conclusions that will determine the outcome of the case is inadmissible.") (citing *United States v. Sinclair, 74 F.3d 753, 758 n.1 (7th Cir. 1996))*; *accord, e.g., Hygh v. Jacobs, 961 F.2d 359, 363 (2d Cir. 1992)* [*34] ("This circuit is in accord with other circuits in requiring exclusion of expert testimony that expresses a legal conclusion."). Such an assertion (and many similar ones, discussed further below) invades the province of this Court and the province of the jury and will not assist the jury as contemplated by *Federal Rule of Evidence 702*.

In the wake of the broad legal conclusion stated in the overview, Nagorka's report continues into an extended legal discussion of the Anti-Kickback statute. (Nagorka Report at 1-2.) The report continues into an even longer legal discussion of the purported inapplicability of any "safe harbor" provision--at least as Nagorka would define the "safe harbor" protections based on his extended assertions concerning the content, meaning and proper interpretation of, *inter alia,* federal statutory and regulatory provisions, the preamble to a federal regulation, and an Inspector General Advisory Opinion. (*Id.* at 2-14.) The report then proceeds to a review of various purported provider agreement between the Defendant hospitals and the Defendant ambulance companies. (*Id.* at 15-44.)

After carefully reviewing the Nagorka [*35] report, the Court exercises its discretion to exclude most of it. The aforementioned major sections are replete with numerous legal assertions. (*See, e.g.,* Nagorka Report at 2 ("*Section 1320a-7b(b)(1)* is the mirror image of *Section 1320a-7b(b)(2)*, thereby making the party giving the remuneration (the ambulance companies) in the same legal position as the party receiving the remuneration (the Defendant hospitals")); *id.* ("The discounts that the Defendant hospitals received . . . are illegal remunerations"); *id.* ("The ambulance service agreements . . . fail to meet the safe harbor requirements.") [9] *id.* at 14 ("The ambulance provider agreements entered into by Bethany Hospital and Consolidated Medical Transport violate the Anti-Kickback Statute (*42 U.S.C. § 1320a-7b(b)*).") [10] ; *id.* (opining that various discounts do not qualify under purported safe harbor parameters as delimited by Nagorka); *id.* at 16 ("The rates provided to Bethany Hospital . . . are illegal remunerations under the Anti-Kickback statute."). [11]) They also contain block quotations from purported applicable statutory and regulatory regimes (Nagorka Report at 1-2, 3, [*36] 4, 5, 6, 11-13), which invade the province of the Court in defining that relevant law, which are unhelpful to the jury, and which create an unacceptable risk on balance of jury confusion given their limited utility as offered in the form of expert testimony. *Accord Fed. R. Evid. 403*. [12] The report also con-

tains extended discussions and extrapolations of certain potentially relevant legal material, such as an Inspector General Advisory Opinion (Nagorka Report at 6-10). [13] These discussions are not helpful to the jury and invade the province of the Court in defining the relevant law. In this latter regard, the Nagorka report also often elides from its legal conclusions, interpretations, and assertions concerning the applicable legal rules to legal assertions about the ultimate issues in the case. *See, e.g.,* footnotes 9-11, *supra.* This sort of testimony is not helpful to the jury. *See, e.g., Good Shepherd, 323 F.3d at 564* (citing *Sinclair, 74 F.3d at 757 n.1*); *McCabe v. Crawford & Co., 272 F. Supp. 2d at 740*. It also is subject to exclusion under *Rule 403* because Nagorka's assertions about [*37] the ultimate legality of various challenged practices contain various implicit legal determinations that invade the province of the Court. *See, e.g., Torres v. County of Oakland, 758 F.2d 147, 150 (6th Cir. 1985)* ("The problem with testimony containing a legal conclusion is in conveying the witness' [sic] unexpressed, and perhaps erroneous, legal standards to the jury. This invades the province of the court to determine the applicable law and to instruct the jury as to that law.") (internal quotation and citations omitted); *McCabe v. Crawford & Co., 272 F. Supp. 2d 736, 740 (N.D. Ill. 2003)* (discussing court's gatekeeper obligations).

9 *See also, e.g.,* Nagorka Report at 15, 17, 18, 20, 21, 23, 24, 26, 27, 29, 30, 32, 33, 35, 36, 38, 38, 41, 42, 44 (all substantially identical).

10 *See also, e.g.,* Nagorka Report at 15, 16, 18, 20, 21, 23, 24, 26, 27, 28, 30, 31, 33, 34, 36, 37, 39, 40, 42 (all substantially identical).

11 *See also, e.g.,* Nagorka Report at 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33, 34, 35, 36, 37, 39, 40, 41, 42, 43 (all similar).

[*38]

12 Given the lack of clarity in the Nagorka report and the report's repeated practice of intertwining improper assertions about governing law and improper assertions about whether such legal regimes were violated, the Court also excludes as unhelpful and as potentially confusing to the jury testimony about the nature of the provider agreements. *See, e.g.* Nagorka Report at 10 ("Even a cursory review of the ambulance provider agreements . . . demonstrate that the contracts were 'exclusive supplier agreements.'"). *Accord Torres v. County of Oakland, 758 F.2d 147, 150-51 (6th Cir. 1985)*; *McCabe v. Crawford & Co., 272 F. Supp. 2d 736, 740 (N.D. Ill. 2003)* ("Because expert testimony can be powerful and misleading, judges must act as gatekeepers and exclude expert testimony where the possible prejudice of the testimony outweighs its probative force.") (citations omitted). (Incidentally, if the matter is as obvious as Nagorka contends, a properly-instructed jury will not need Nagorka's assistance in this regard.) Nagorka's conclusions and assertions about the contracts present an unacceptable risk of presenting the jury with Nagorka's extensive (and often, at least in this section of the report, implicit) testimony concerning applicable legal rules of decision.

[*39]

13 *See, e.g.,* Nagorka Report at 6 ("The comments provided in the above-listed portions of the preamble to the "safe harbor" regulations (*42 C.F.R. § 1001.952*), demonstrate that the discounts provided to and received by the Defendant hospitals . . . do not comply with the requirements of the discount exception to the Anti-Kickback Statute.").

Nagorka's report is not excluded in its entirety. In limited portions of his report, Nagorka opines concerning market conditions in the ambulance services industry and whether, for example, the rates provided to the Defendant hospitals are commercially reasonable. *See, e.g.,* Nagorka Report at 15 ("The rates provided to Bethany Hospital by CoMed are not commercially reasonable in the absence of CoMed receiving Bethany Hospital's referrals of Medicare Part B transports and Medicaid transports."); *id.* ("A BLS round trip transport for $ 68.25 plus mileage at $ 2.95 is below CoMed's actual cost for such transport."); *id.* at 17 ("P 4.2(b) establishes that the rates being charged to Holy Cross Hospital were below the [*40] 'retail rates.'"); *id.* at 43 (discussing testimony concerning invoices and admissions concerning payments to St. James Hospital). Mr. Nagorka can testify to such matters without invading the province of the Court, invading the province of the jury, creating an imprudent risk of jury confusion and waste of time, and without violating the extensive precedent developed in this area. Mr. Nagorka will be able to testify in such a limited capacity at trial--subject to any further *Daubert* challenges or other evidentiary or substantive rulings that may affect the scope of the trial or his role in it.

B. Sparks's Report Is Stricken In Part

Relators contend that "Sparks'[s] proposed testimony would be helpful to the jury because the Medicare system is clearly beyond the common knowledge of the jury." (D.E. 182 at 10.) Defendants acknowledge that Sparks's report does provide background information "as to the Medicare System and provider reimbursement and hospital cost reports" (D.E. 180 at 6) as well as Medicaid (D.E. 183 at 4). After reviewing Sparks's report, the Court makes the preliminary conclusion that such testi-

mony may be helpful to the trier of fact, and the Court declines [*41] to admit or exclude such testimony in its entirety as this time. If Defendants have specific objections to this type of testimony, they may move to exclude it at trial. [14]

14 Any objections based on a lack of foundation for Sparks's opinions are more properly addressed at trial. The Court declines to exclude or admit any opinion that may be subject to a foundation objection at this time. Similarly, the Court did not consider Defendants' arguments regarding Sparks's damage calculations, as these arguments were raised for the first time in Defendants' reply brief. In addition, this opinion is certainly not a blanket ruling that all of Sparks's putative testimony is admissible under *Fed. R. Evid. 403*. Such objections can be addressed at trial or in the period immediately preceding it.

In this regard, for example, the Sparks report begins with an extended overview of the Medicare System and its operation. Although this section of the report relates, at least tangentially, to some [*42] statutory and legal rules, that is not the essence of the testimony, which presents an overview about the general programs that have been created within Medicare and the payment mechanisms that exist within them. (*See, e.g.,* Sparks Report at 1-2). Sparks's report also discusses various forms, certifications, and documentation required by the Medicare oversight systems. (*See id.* at 6-7).

The Court does, however, strike portions of Sparks's report that are improper under the principles outlined above and holds that she may not testify to these matters at trial. Specifically, the Court strikes portions of her report that opine as to the Defendants' states of mind. She may not testify as to any of the Defendants' respective states of mind at a trial in this matter. [15] There is no indication (her certification as a fraud examiner notwithstanding) that she is any more qualified than the average juror to make such a determination. *See, e.g., Woods, 110 F.3d at 1221*; *Steadfast Ins. Co. v. Auto Marketing Network, Inc., 2004 U.S. Dist. LEXIS 6938, No. 97-5696, 2004 WL 783356, at *6 (N.D. Ill. Jan. 26, 2004)*; *Dahlin, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881, at *3*. The Court similarly [*43] strikes her report to the extent that it opines that the Defendants committed fraud within the meaning of the operative statutes and holds that she may not testify as to whether any of the Defendants intended to and did commit fraud at a trial in this matter. *See Dahlin, 2002 U.S. Dist. LEXIS 24558, 2002 WL 31834881, at *3*. [16]

15 *See, e.g.,* Sparks Report at 8 ("In knowing violation of the Anti-Kickback Statute, Defendants COMED, Tower and Daley's **knowingly and willfully offered illegal remunerations** to the Defendant Hospitals . . . .") (emphasis in original); *id.* at 9 ("Violation of the *State of Illinois Whistleblower Reward and Protection Act*: Defendants . . . knowingly concealed from Medicaid the improper kickback schemes that they had with the Defendant Hospitals knowing that any disclosure of said schemes would result in denial of all of the claims . . . ."); *id.* at 10 (stating that Defendants "knowingly concealed from Medicaid the improper kickback schemes"); *id.* at 17 ("The Defendant Hospitals knew that their arrangements with the Defendant Ambulance Companies were kickback schemes . . . ."); *id.* at 19 ("Defendant Hospital Officers knowingly and willingly participated in Medicare Fraud . . . because of the existence of the kickback scheme which the Defendant Hospitals knowingly entered into with the Defendant ambulance companies."); *id.* at 21 ("The Defendant Hospitals and Defendant Ambulance Companies knowingly entered into a kickback scheme . . . ."); *id.* ("The Defendant hospitals knowingly filed Cost Reports with Medicare containing false certifications and statements."); *see also id.* at 6 ("Defendant Hospitals received discounts on Part A ambulance transports in return for Part B referrals to COMED Transport, Inc.") (emphases omitted). Sparks also cannot testify as to the state of mind of regulators. *See, e.g.,* Sparks Report at 19-20 (opining, without apparent foundation, about the beliefs of the CMS).

[*44]

16 Nagorka's report contains improper assertions of the same general variety. *See, e.g.,* Nagorka Report at 2 ("Clearly, the remunerations . . . were offered and received to induce or in return for the exclusive agreement for the referral of business reimbursed under Medicare and Medicaid.").

C. The Experts Will Be Expected to Testify Within The Confines of The Permissible Testimony in Their Reports.

Defendants ask the Court to exclude not only Nagorka's and Sparks's expert reports, but also their testimony. The Relators argue that, even if the Court excludes portions of Nagorka's and Sparks's expert reports, the Court should not preclude them from testifying at all. The Relators suggest that Nagorka could testify as to the ambulance services industry and that Sparks could testify as to the Medicare system generally. Defendants respond that the experts' reports do not contain such testimony and that the Relators should not be allowed to rewrite the reports at this juncture. Given that the Court has not

completely excluded the testimony of either putative expert, the Court need not address [*45] whether either should be entirely barred from testifying. However, the Court will not permit either individual to testify as to subjects that are not fairly encompassed within or relate to the portions of their reports that are appropriate under the law. As a result, neither expert (nor any expert that the Defendants may ultimately offer) will be able to opine about subjects that are not encompassed within properly disclosed expert reports.

In support of their position, the Relators rely on *McCabe v. Crawford & Co., 272 F. Supp. 2d 736, 740-41 (N.D. Ill. 2003)*, for the proposition that "it would be improper to exclude the testimony of an expert witness because his or her expert report contains legal conclusions." (D.E. 182 at 4.) *McCabe* does not, however, help the Relators here. In *McCabe,* the court found, like the Court in the instant case, that a purported expert had offered improper legal conclusions in his expert report and subsequently granted a motion to exclude that report. *McCabe, 272 F. Supp. 2d at 740-41*. The court then held that the expert was not barred from testifying at trial because the expert "may offer something of value [*46] in regards to industry standards and practice." *Id.* Before the party could offer that expert at trial, however, the court held that the party would have to submit another expert report that complied with *Federal Rule of Civil Procedure 26(a)(2).* [17] *Id. at 741*. Thus, *McCabe* cannot be read to have allowed an expert to testify outside the confines of his report. Rather, the court in *McCabe* simply extended expert discovery to allow the expert to submit a report disclosing the opinions, if any, to which he would ultimately testify.

17 *Rule 26(a)(2)* requires a party to disclose, via written report, "a complete statement of all opinions to be expressed [by the purported expert] and the basis and reasons therefore." *Fed. R. Civ. P. 26(a)(2)(B).*

Here, by contrast, the Relators at least suggest that they should be able to circumvent the entire expert discovery regime set up by *Rule 26* by attempting to recast [*47] the content of Nagorka's and Sparks's reports in order to allow them to testify to opinions not timely disclosed. The Court will not allow such maneuvering and will, instead, hold Nagorka and Sparks to any disclosed opinions that have not been excluded by this Order. *See generally Salgado v. Gen. Motors Corp., 150 F.3d 735, 742 n.6 (7th Cir. 1998)* ("If the expert's report contains only incomplete opinions, the court may choose to restrict the expert's testimony to those opinions alone."). The Court notes that the Relators have not asked the Court to extend discovery in order to submit an additional report by either witness, [18] and given that they have been given a full and fair opportunity to submit expert reports in the course of extensive discovery, the Court would refuse any such request. Thus, to the extent that the Relators have tendered a valid report by Nagorka or Sparks, and only to that extent, the Relators' experts will be allowed to testify to the opinions contained in or that reasonably grow out of those limited portions of the report.

18 The Court notes that such additional reports would almost certainly not constitute supplementation of previously disclosed opinions as the Relators have not indicated that anything contained in the initial expert reports was "incomplete or incorrect." *See Fed. R. Civ. P. 26(e)(1).*

[*48] CONCLUSION

For the foregoing reasons, Defendants' motion is granted in part and denied in part.

So ordered.

Mark Filip

United States District Judge

Northern District of Illinois

Dated: May 26, 2005