**UNITED STATES DISTRICT COURT**

**NORTHERN DISTRICT OF ILLINOIS**

**EASTERN DIVISION**

| | |
|---|---|
| LAWRENCE E. JAFFE PENSION PLAN, ON BEHALF OF ITSELF AND ALL OTHERS SIMILARLY SITUATED,<br><br>Plaintiffs,<br><br>*- against -*<br><br>HOUSEHOLD INTERNATIONAL, INC., ET AL.,<br><br>Defendants. | Lead Case No. 02-C-5893<br>(Consolidated)<br><br>CLASS ACTION<br><br>Judge Ronald A. Guzmán |

**APPENDIX B: UNREPORTED AUTHORITIES IN SUPPORT OF DEFENDANTS' MOTION FOR JUDGMENT AS A MATTER OF LAW PURSUANT TO RULE 50(A) AFTER PLAINTIFFS HAVE BEEN FULLY HEARD**

CAHILL GORDON & REINDEL LLP
80 Pine Street
New York, New York 10005
(212) 701-3000

EIMER STAHL KLEVORN & SOLBERG LLP
224 South Michigan Ave.
Suite 1100
Chicago, Illinois 60604
(312) 660-7600

*Attorneys for Defendants Household International, Inc., William F. Aldinger, David A. Schoenholz and Gary Gilmer*

# APPENDIX B

**Table of Contents for Appendix B: Unreported Authorities**


**Cases** **Tab**

*In re Allscripts, Inc. Securities Litigation*, No. 00 C6 796, 2001 WL 743411 (N.D. Ill. June 29, 2001) .......... B-1

*Antell* v. *Arthur Andersen LLP*, No. 97 C 3456, 1998 WL 245878 (N.D. Ill May 4, 1998) .......... B-2

*Ariel (UK) Ltd.* v. *Reuters Group, PLC*, No. 06 5533 CV, 277 2008 WL 1984270 (2d Cir. May 6, 2008) .......... B-3

*In re Bally Total Fitness Securities Litigation*, No. 04 C 3530, 2006 WL 3714708 (N.D. Ill. July 12, 2006) .......... B-4

*In re Ditech Networks, Inc. Derivative Litigation*, No. C 06-5157, 2007 WL 2070300 (N.D. Cal. July 16, 2007) .......... B-5

*In re Glaxo Smithkline PLC Securities Litigation*, No. 05 Civ. 3571, 2006 WL 2871968 (S.D.N.Y. Oct. 6, 2006) .......... B-6

*Grant v. Chemrex, Inc.*, No. 93C0350, 1997 WL 223071 (N.D. Ill. Apr. 28, 1997) .......... B-7

*In re Impax Laboratories, Inc. Securities Litigation*, No. C 04-04802 JW, 2007 WL 5076983 (N.D. Cal. Jan. 3, 2007).......... B-8

*Kaufman* v. *Motorola, Inc.*, No. 95 C 1069, 2000 WL 1506892 (N.D. Ill. Sept. 21, 2000) .......... B-9

*Mathews* v. *Centex Telemanagement, Inc.*, No. C-92-1837-CAL, 1994 WL 269734 (N.D. Cal. June 8, 1994) .......... B-10

*Premier Capital Management, LLC* v. *Cohen*, No. 02 C 5638, 2008 WL 4378300 (N.D. Ill. Mar. 28, 2008) .......... B-11

*Pro Bono Investments Inc.* v. *Gerry*, No. 03 Civ. 4347, 2005 WL 2429787 (S.D.N.Y. Sept. 30, 2005) .......... B-12

*Pullins* v. *Klimley*, No. 3:05 CV 082, 2008 WL 8587 (S.D. Ohio Jan. 7, 2008) .... B-13

*Stark Trading* v. *Falconbridge Ltd.*, No. 08 1327, 2009 WL 18140 (7th Cir. Jan. 5, 2009) ........ B-14

*In re System Software Assocs. Securities Litigation*, No. 97C177, 2000 WL 283099 (N.D. Ill. Mar. 8, 2000) ........ B-15

# TAB B-1

United States District Court, N.D. Illinois, Eastern Division.
In re ALLSCRIPTS, INC. SECURITIES LITIGATION
**No. 00 C 6796.**

June 29, 2001.

*MEMORANDUM OPINION*

KOCORAS, J.
***1** Before the Court is the Motion to Dismiss of Defendants Allscripts Healthcare Solutions, Inc., David B. Mullen, Glen E. Tullman, J. Peter Geerlofs, and Phillip J. Langley. For the following reasons, we grant the Motion.

BACKGROUND

This case arises from the sale of the common stock of Defendant Allscripts Inc. ("Allscripts" or the "Company") on the open market. Plaintiffs are a class of persons and entities who purchased the common stock of Allscripts on the open market during the period of March 6, 2000 through and including February 27, 2001 (the "Class Period"). Plaintiffs named Allscripts as a Defendant as well as four individual officers of the Company. Defendant Glen E. Tullman ("Tullman") served as Chairman of the Board of Allscripts since May 1999 and Chief Executive Officer since August 1997. Defendant David B. Mullen ("Mullen") was Allscripts' President and Chief Financial Officer since August 1997. Defendant J. Peter Geerlofs ("Geerlofs") served as Allscripts' Chief Medical Officer since April 2000. Defendant Phil Langley ("Langley") was Allscripts' Senior Vice President of Business Development/Field Services.[FN1]

FN1. On occasion this Opinion refers to Defendants Tullman, Mullen, Geerlofs and Langley collectively as the "Individual Defendants."

For purposes of a motion to dismiss, we are obligated to accept as true all well-pled allegations. Founded in 1986, Allscripts was originally a drug wholesaler that provided prepackaged medicines to certain dispensing physicians. The Company later shifted its focus toward software sales and e-commerce. It developed and began marketing an "electronic prescribing solution" software package to doctors called the TouchScript ® Personal Prescriber ™ ("TouchScript"). Available on both palm-top and wall-mount computers, TouchScript used the Internet to route drug prescriptions to pharmacies and purported to provide "connectivity" to managed care and other organizations.

Defendants promoted the many purported benefits of TouchScript. For instance, TouchScript would allow physicians to save time, because typing prescriptions is faster than writing them down. Furthermore, the software could limit malpractice liability because the system was designed to avoid errors and detect harmful drug interactions. Finally, TouchScript would enable physicians to generate greater revenues by dispensing certain medications directly from their offices.

Not surprisingly, Allscripts also emphasized to the investing public the revenues flowing from TouchScript. Physicians paid Allscripts an initial implementation fee of up to $6,000 depending on the length of the patient list in any given office. This fee covered the installation of TouchScript by an Allscripts technician. In addition, Allscripts collected a monthly subscription of $250 from each TouchScript user. Prior to and throughout the Class Period, Defendants continually highlighted these amounts. Furthermore, Defendants emphasized that physicians actually paid for TouchScript, unlike many other e-commerce products which were given away without charge.

***2** Despite these promotions, Defendants were also realistic about the potential shortcomings of the product. In their Form 10-K disclosure for 1999, [FN2] filed on March 30, 2000, the Company conceded that

FN2. The Court may take judicial notice of documents filed with the Securities and Exchange Commission without converting a motion to dismiss into a motion for sum-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

mary judgment. *See* *Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1276-81 (11 th Cir.1999). Moreover, the Complaint specifically refers to the Form 10-K filing, so we may properly refer to that document. *See* *Wright v. Associated Ins. Cos.,* 29 F.3d 1244, 1248 (7 th Cir.1994) (stating that documents attached to a motion to dismiss are part of the pleadings if they are referred to in the plaintiff's complaint and are central to the claim").

Our business model depends on our ability to sell our TouchScript system to physicians and other healthcare providers and to generate usage by a large number of physicians. We have not achieved this goal with previously or currently available versions of our software.

(Allscripts Form 10-K, 3/30/00, at 23.) The Company also warned potential investors about the potential obstacle of convincing doctors to abandon traditional methods of writing prescriptions in favor of new technological opportunities:

We cannot assure you that physicians will integrate our products and services into their office work flow or that participants in the pharmaceutical healthcare market will accept our products and services as a replacement for traditional methods of conducting pharmaceutical healthcare transactions.

(*Id.*) In addition, the 10-K Form warned of the risk of errors or defects in the technology:

[E]arly releases of software often contain errors or defects. We cannot assure you that, despite our extensive testing, errors will not be found in our new product releases and services before or after commercial release, which would result in product redevelopment costs and loss of, or delay in, market acceptance.

(*Id.* at 24.)Furthermore, the 10-K Form contained a frank conclusion about the risk of failure:

If we fail to achieve broad acceptance of our products and services by physicians and other healthcare participants or to position our services as a preferred method for pharmaceutical healthcare delivery, our prospects for growth will be diminished.

(*Id.* at 23.)Thus, the Form 10-K disclosed that TouchScript was a new product, not yet adopted by a large number of doctors, that could contain bugs or defects that would preclude market acceptance. Because the Form 10-K is a public filing, these disclosures and warnings were available to all investors.

TouchScript turned out to be a hard sell. Physicians were reluctant to use, let alone pay for, new technology unless it added to their practice. However, TouchScript did not add to many practices because the system proved to be more time consuming and costly than prescribing in the traditional manner. The system frequently took as long as thirty minutes to process a single prescription and sometimes it failed to work at all. Additionally, the system required physicians to enter a patient's diagnostic code in order to call up a list of appropriate medications. Because TouchScript's list of diagnostic codes was limited, however, physicians frequently had to look up codes for similar ailments in the Physician's Desk Reference, enter them, and choose from the lists of medications that appeared, thereby consuming additional time. Moreover, the system was often busy and unable to communicate with the insurer. Thus, even those practices that could afford TouchScript ultimately lost money with the product due to fundamental flaws in the system.

***3** Despite these problems, in late 1999 Allscripts allegedly began to reduce the implementation fee for TouchScript. In some cases, the Company eliminated the fee altogether. In addition, the Company began waiving the monthly subscription fee. In one instance, DeerPath Medical Associates did not pay installation or set-up charges for TouchScript. In another instance, in response to Dr. Howard Baker's expression of dissatisfaction with TouchScript, the Company waived the monthly fee. Allscripts continued to represent to the public that customers paid for the product.

Realizing that TouchScript was encountering difficulty penetrating the market, Allscripts decided to purchase existing sales channels and couple TouchScript with products already being sold to doctors through those channels. Consequently, Allscripts purchased three companies with well-established sales channels in order to access physicians. Throughout this period of acquisitions, according to Plaintiffs, Allscripts was highly motivated to keep the price of its common stock high. Moreover, the Com-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

pany needed to offset public shareholder concerns about dilution.

Notwithstanding these problems, Plaintiffs claim that Defendants made false and misleading statements regarding TouchScript during the Class Period. The allegedly false and misleading statements are as follows:

• March 6, 2000: Defendant Langley told *The Pink Sheet* that "one hundred percent of our clients have to pay" for TouchScript.

• March 30, 2000: In its Form 10-K for Year 1999, Allscripts made numerous representations regarding TouchScript, such as:

• TouchScript is "easy to use, enabling a physician to complete a prescription in as little as 20 seconds";

• TouchScript provides "valuable, objective information prior to and during the prescribing process";

• TouchScript offers physicians a "significant financial opportunity through better management of pharmacy risk."

• July 27, 2000: Allscripts issued a press release announcing its financial results from the second quarter of fiscal year 2000. These results included revenues of $500,000 which were improperly recognized.

• August 2000: Allscripts filed Form 10Q which also reflected the improperly recognized $500,000.

• August 2000: Defendant Geerlofs comments to *Modern Physician* magazine that "[o]ther companies are trying other ways to penetrate the market, often by giving products away, and they are frequently subsidized by pharmaceutical companies. We don't need to do that."

• December 19, 2000: Defendant Mullen states to *Business Wire* that Allscripts has "multiple recurring revenue streams. Beginning with the physician, we earn revenue from the TouchScript software fees that are charged to the physician for using the product, which is typically received on a monthly subscription basis. We also earn revenue from the physician from the sale of the prepackaged medication."

***4** • January 2001: Defendant Mullen tells *Drug Topics* magazine that "the idea that a patient, at least for the first fill, can pick up the prescription right in the physician's office is a huge convenience. Convenience is also manifest when the physician is able to electronically send the prescription straight from his handheld computer to the pharmacy so that the medication could actually be waiting by the time the patient gets there."At another point in the interview, Mullen says that the monthly fee for TouchScript was $200.

Plaintiffs believe that these statements made during the Class Period were false and misleading. As a result of the statements, Allscripts' common stock traded at artificially inflated prices during the Class Period but ultimately plummeted.

Plaintiffs assert that Defendants were highly motivated to exaggerate sales of TouchScript because they had allocated "an extravagant amount of Allscripts' cash and resources to market the system, and it simply was not selling."An additional motivation was the three acquisitions Allscripts had made. As Plaintiffs contend, "the higher the share price, the more buying power each share had."Furthermore, Defendants were motivated to keep the stock price as high as possible to offset shareholder concerns about dilution. Last, the individual Defendants had motive to exaggerate Allscripts' performance because their annual bonuses and incentives depended on it.

On March 12, 2001, Defendants filed this two-count Complaint against Allscripts and the Individual Defendants. Count I alleges violations of section 10(b) of the Securities Exchange Act of 1934 ("the '34 Act") and Rule 10b-5 of the Securities Exchange Commission. Count II alleges control person liability pursuant to section 20(a) of the '34 Act. Defendants have moved to dismiss the Complaint in its entirety.

STANDARD OF REVIEW

Plaintiffs based this action on sections 10(b) and 20(a) of the '34 Act and Rule 10b-5. Federal Rule of Civil Procedure 12(b)(6) governs all of these claims.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

In addition, the claims implicate Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 ("PSLRA").*See Rehm v. Eagle Fin. Corp.,* 954 F.Supp. 1246, 1250 (N.D.Ill.1997).

A motion to dismiss pursuant to Rule 12(b)(6) tests whether the plaintiff has properly stated a claim for which relief may be granted. *See Pickrel v. City of Springfield, Ill.,* 45 F.3d 1115, 1118 (7th Cir.1995). The court must accept as true all of the plaintiff's well-pled factual allegations as well as all reasonable inferences. *See Coates v. Illinois State Bd. of Ed.,* 559 F.2d 445, 447 (7th Cir.1977). However, the court need "not strain to find inferences favorable to the plaintiffs" which are not apparent on the face of the complaint. *Id.* The court will dismiss a complaint under Rule 12(b)(6) only if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Ledford v. Sullivan,* 105 F.3d 354, 356 (7th Cir.1997) (quoting *Hishon v. King & Spalding,* 467 U.S. 69, 73, 104 S.Ct. 2229, 2232, 81 L.Ed.2d 59 (1984)).

***5** Rule 9(b) states that "[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). The rule requires plaintiffs to allege the "identity of the person who made the misrepresentation, the time, place and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff." *Vicom, Inc. v. Harbridge Merchant Svcs., Inc.,* 20 F.3d 771, 777 (7th Cir.1994) (quoting *Bankers Trust Co. v. Old World Republic Ins. Co.,* 959 F.2d 677, 683 (7th Cir.1992)). In other words, pleading with particularity means stating "the who, what, when, where, and how: the first paragraph of any news story." *DiLeo,* 901 F.2d 624, 627 (7th Cir.1990).

Reflecting the heightened pleading requirements of Rule 9(b), the PSLRA requires complaints to "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."15 U.S.C. § 78u-4(b)(1). Furthermore, with respect to scienter, complaints must "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 Seventh Circuit has not yet addressed the question whether the PSLRA standard displaces past case law regarding pleading standards in private securities litigation. Until the Seventh Circuit does so, we shall concur with other courts in this District who have adopted the Second Circuit's pleading standard but declined to bind courts to the Second Circuit's interpretation of that standard. *See Retsky Family Ltd. P'ship v. Price Waterhouse,* No. 97 C 7694, 1998 WL 774678 at *1 (N.D.Ill. Oct. 21, 1998); *Rehm,* 954 F.Supp. at 1252; *Fugman v. Aprogenex, Inc.,* 961 F.Supp. 1190, 1195 (N.D.Ill.1997). That standard requires plaintiffs to "allege facts that give rise to a strong inference of fraudulent intent." *Retsky,* 1998 WL 774678 at *1.

DISCUSSION

Defendants contend that Plaintiffs have failed to state a claim under section 10(b) of the '34 Act and Rule 10b-5. In order to state a claim under these provisions, Plaintiffs must allege that Defendants made: (1) a false representation or an omission; (2) of a material fact; (3) with scienter; (4) in connection with the purchase or sale of securities; (5) upon which the claimant justifiably relied; and (6) that the false representation or omission was the proximate cause of claimant's damages. *See In re Healthcare Compare Corp. Sec. Litig.,* 75 F.3d 276, 280 (7th Cir.1996). Defendants argue that Plaintiffs cannot establish the requisite elements of a false representation or omission and scienter.

I. Count One: Securities Fraud

A. Alleged Omissions and False Representations

***6** Plaintiffs identify a handful of statements they believe are false and misleading and endeavor to explain the grounds for these allegations. We find none of the allegations supportable, especially in light of the numerous frank disclosures that appear in Defendants' SEC filings. These filings announce the risks of this e-commercial venture that any reasonable investor would have spotted on his or her own. Significantly, Plaintiffs have not challenged the veracity and forthrightness of those SEC filings. The primary purpose of these filings is, after all, to guide the decisions of the investing public. *See,e.g., United States v. Arthur Young & Co.,* 465 U.S. 805, 810, 104 S.Ct. 1495, 79 L.Ed.2d 826 (1984).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Instead, Plaintiffs contend that the Individual Defendants behaved fraudulently because they told falsehoods and made omissions about the products to newspapers and other media. The statements upon which they rely, however, cannot support such a conclusion. As we shall explain in greater detail, many of the statements rely on subjective determinations not susceptible to an assessment of truth or falsity. Rather, the statements amount to the kind of touting that shareholders would expect of, indeed demand of, senior officers. In the words of the Seventh Circuit, the comments are mere "puffery" lacking the "requisite specificity to be considered anything but optimistic rhetoric." *Searls v. Glasser,* 64 F.3d 1061, 1066 (7 th Cir.1995). The statements do not convey any "useful information upon which a reasonable investor would base a decision to invest,"*id.,* particularly when they appear in a venue directed toward potential customers, rather than shareholders.

In addition, Plaintiffs appear to argue that Defendants failed to divulge problems with TouchScript's technology and declines in customer satisfaction. However, Plaintiffs have failed to allege the existence of a duty to make such disclosures, and we find none in the case law. Such a duty would not comport with the way the business world works. Markets are wont to ebb and flow. The securities laws do not require management to apprise the public of each and every move the market may make. Nor should management "bury the shareholders in an avalanche of trivial information-a result that is hardly conducive to informed decisionmaking." *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 448-49, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). As a practical matter, such a scheme would saturate the business wires and confuse investors.

Having summarized why the case at bar cannot pass muster, we now turn to a careful analysis of each of the alleged misstatements before us.

1. Statements Regarding TouchScript and Its Customers

On March 6, 2000, *The Pink Sheet* published Defendant Langley's statement that "one hundred percent of our clients have to pay" for TouchScript. Later that month, on March 30, Allscripts submitted its Form 10-K for Year 1999. In the Form 10-K, Allscript represented that TouchScript is "easy to use, enabling a physician to complete a prescription in as little as 20 seconds," and that it provides "valuable, objective information prior to and during the prescribing process."Furthermore, the Form states that TouchScript offers physicians a "significant financial opportunity through better management of pharmacy risk."

***7** Later, in August 2000, Defendant Geerlofs commented to *Modern Physician* magazine that "[o]ther companies are trying other ways to penetrate the market, often by giving products away, and they are frequently subsidized by pharmaceutical companies. We don't need to do that."Then on December 19, 2000, an interview with Defendant David Mullen appeared in *Business Wire.*In the interview, Mullen stated that Allscripts has "multiple recurring revenue streams. Beginning with the physician, we earn revenue from the TouchScript software fees that are charged to the physician for using the product, which is typically received on a monthly subscription basis. We also earn revenue from the physician from the sale of the pre-packaged medication."Then in an interview in January 2001 in *Drug Topics,* Mullen stated that "the idea that a patient, at least for the first fill, can pick up the prescription right in the physician's office is a huge convenience. Convenience is also manifest when the physician is able to electronically send the prescription straight from his handheld computer to the pharmacy so that the medication could actually be waiting by the time the patient gets there."At another point in the interview, Mullen said that the monthly fee for TouchScript was $200.

Plaintiffs offer several explanations for why these statements were false and misleading. First, Allscripts waived and/or reduced fees for two resisting physicians. Specifically, DeerPath Medical Associates did not pay installation or set-up charges in late 1999. Then in September 2000, Allscripts' sales representatives offered to waive the monthly fee for Dr. Howard Baker to induce him not to cancel the service. Second, Allscripts failed to disclose that TouchScript was not credentialed with many insurance companies, meaning that patients could not be reimbursed for obtaining their prescriptions through the physician. Third, pharmacies had difficulties in deciphering prescriptions. Fourth, TouchScript had a limited list of diagnostic codes. Last, according to Plaintiffs, Allscripts experienced an average return rate of 50%.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

We find these reasons unavailing. That the Company waived the installation charge in one instance and the monthly fee in another does not amount to "giving away TouchScript" as Plaintiffs assert. Plaintiffs have not alleged that DeerPath Medical Association paid no money for TouchScript; instead, the allegation is limited to nonpayment of the installation fee but is notably silent as to the monthly subscription fee. The same is true of the allegation regarding Dr. Baker, which speaks to waiver of the monthly fee but is silent to the installation fee. Neither allegation suggests that the Company gave away TouchScript without receiving any payment. Thus, these allegations do not render false or misleading the statement that one hundred percent of customers pay for TouchScript.

Nor do we accept Plaintiffs' assertion that Allscripts failed to disclose that TouchScript was not credentialed with many insurance companies. As an initial matter, Plaintiffs have failed to plead this allegation with the requisite particularity. Under the PSLRA, complaints must "specify 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). At the pleading stage, a plaintiff may satisfy this requirement by referring to internal memoranda or other documents, press releases, news articles and government-mandated filings. *See In re Theragenics Corp. Sec. Litig.,* 137 F.Supp.2d 1339, 1345 (N.D.Ga.2001) (relying on *Novak v. Kasaks,* 216 F.3d 300 (2d Cir.2000)). Because the instant allegation identifies no source for the information, it cannot meet this threshold requirement.

***8** Furthermore, even if properly pled, the Form 10-K disclosures belie this allegation. In the section outlining risks related to the Company, the Form 10-K states that "[a]chieving market acceptance for our products and services will require substantial marketing efforts.... If we fail to achieve broad acceptance of our products and services by physicians *and other healthcare participants*... our prospects for growth will be diminished."(Form 10-K at 23; emphasis added.) Insurance companies are precisely those "other healthcare participants" on whose participation the success of TouchScript turned. Their participation comprised a risk which the Form 10-K clearly spelled out. Thus, even if many insurance companies balked at the idea of participating in TouchScript, Allscripts adequately disclosed this possibility. That this possibility actually arose did not trigger a duty to disclose on the part of Defendants. *See Wielgos v. Commonwealth Edison Co.,* 892 F.2d 509, 515 (7 th Cir.1989) (stating that "[J]ust as a firm needn't disclose that 50% of all new products vanish from the market within a short time, so Commonwealth Edison needn't disclose the hazards of its business, hazards apparent to all serious observers and most casual ones").

Plaintiffs next contend that pharmacies "had great difficulties in deciphering prescriptions sent by TouchScript."We presume that Plaintiffs are alleging that Defendants failed to disclose these problems. This allegation, like the prior one, fails to meet the PSLRA's pleading requirements because of the dearth of information as to its source. Moreover, even if the allegation were properly pled, the Form 10-K disclosures again betray this supposition. If the alleged problems were attributable to technological glitches, the disclosures addressed such risks. If the problems stemmed from the reluctance of pharmacists to learn how to use TouchScript, this possibility too was addressed by the disclosures. That the possibility of problems later materialized does not make a claim of omission actionable. Furthermore, it does not render false some of the Individual Defendants' statements as to the quality of the TouchScript. Such statements are nothing more than the " '[s]oft, puffing' statements" that representatives make to sell their products but upon which reasonable investors know not to rely. *Raab v. General Physics Corp.,* 4 F.3d 286, 289-90 (4 th Cir.1993); *Shaw v. Digital Equip. Corp.,* 82 F.3d 1194, 1217 (1 st Cir.1996) (stating that "courts have demonstrated a willingness to find immaterial as a matter of law a certain kind of rosy affirmation commonly heard from corporate managers and numbingly familiar to the marketplace-loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor could find them important to the total mix of information available") (superseded by statute on other grounds); *Eisenstadt v. Centel Corp.,* 113 F.3d 738, 744 (7 th Cir.1997) (noting that general statements of customer satisfaction should not make the "heart of a reasonable investor ... begin to flutter" because "[e]veryone knows that someone trying to sell something is going to look ... on the bright side"). This point is especially worthy given that many of the alleged statements

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

were made to magazines and trade publications directed at TouchScript customers, rather than investors or stockholders.

***9** Plaintiffs' fourth ground goes to the quality of the design of TouchScript. When a physician prescribed medication using TouchScript, (s)he had to enter the diagnostic code for the particular ailment. Because TouchScript had a limited list of diagnostic codes, however, physicians were often unable to find applicable code in the software. Instead, they resorted to looking up codes for similar ailments in the Physician's Desk Reference, then finding a code that TouchScript recognized to produce a list containing the desired medication. According to Plaintiffs, this time-consuming process deterred physicians from using TouchScript. Even if this were the case, however, it does not mean that Defendants omitted any material information about TouchScript. Defendants disclosed in the Form 10-K that early versions of TouchScript were susceptible to technological errors. If this later proved to be the case, Plaintiffs had already been put on notice as to the potential for errors and cannot recover against Defendants for alleged omissions or affirmative misrepresentations. *See Gart v. Electroscope, Inc.,* 24 F.Supp.2d 969, 975 (D.Minn.1998) (stating that in a fledgling enterprise, "it is obvious to any reasonable investor that [the defendant] anticipated the continuing evolution of its products, and that any particular enhancement or new product carried with it certain risks").

Finally, Plaintiffs allege that Allscripts experienced an average return rate of 50% for TouchScript due to numerous technical problems. This allegation, too, is pled in a conclusory fashion that is ill suited to securities fraud pleadings. Plaintiffs have furnished no particularized statements of fact to support the allegation. Even assuming it were properly pled, the allegation does not present an actionable claim because Plaintiffs have not directed us to any cases establishing that Defendants had a duty to disclose the average return rate of the product. Corporate executives have no general duty to disclose every problem that arises in selling a Company's products. Indeed, if they did, the daily business news would be saturated with reports of rises and falls in corporate revenues. What matters is that investors were made aware of the potential for such technical problems. As we have stated, a reasonable investor would have recognized immediately the risks of e-commerce. In light of these considerations, Defendants had no additional duty to disclose the peaks and valleys of TouchScript's sales pattern.

In sum, we do not find any of the aforementioned conduct to be actionable as omissions or false statements. Where a company is candid about the risks it faces in selling its product, it has no companion duty to report every glitch that arises. This is especially true in a high-risk industry such as e-commerce, where even the most casual investor could recognize the risks without significant investigation. Allscripts confronted squarely in its Form 10-K the risks of its endeavor. These statements, as well as common sense, should have put Plaintiffs on notice as to the risks involved in this e-commercial endeavor. That some of the Individual Defendants made statements to magazines and trade publications painting the product in a positive light does not rise to the level of misstatements. In short, none of the aforementioned statements forms an actionable basis for a claim of securities fraud.

2. Statements Regarding Recognition of $500,000

***10** On October 26, 2000, Allscripts issued a press release announcing its financial results for the third quarter ending September 30, 2000. The press release revealed that during the quarter ending June 30, 2000 (the second quarter), Allscripts improperly recognized $500,000 in revenue flowing from an agreement with IMS Health Incorporated ("IMS"). The revision adjusted previously reported revenues for the second quarter from $12.6 million to $12.1 million, and adjusted previously reported revenues for the first six months of the year from $22.2 million to $21.7 million. The revisions increased Allscripts' net loss for the second quarter of 2000 from $24.3 million to $24.8 million and net loss for the first six months of 2000 from $26.3 million to $26.8 million.

Plaintiffs believe these statements were false and misleading. Even if this were true, however, the alleged misstatement of earnings are immaterial in light of the total amount of Allscripts' earnings and losses. The allegedly improperly recognized sum reflects a mere 4% of the Company's revenues for that quarter and just over 2% of the Company's six-month revenues. It adjusted the Company's quarterly losses by a mere 2%. Given these modest numbers, the alleged improperly recognized sum cannot as a matter of law

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

be material. *See* Glassman v. Computervision Corp., 90 F.3d 617, 633 (1 st Cir.1996) (affirming conclusion that a minor drop of a few percentage points is inadequate to support a claim of material difference for purposes of Rule 10b-5); *In re First Union Corp. Sec. Litig.,* 128 F.Supp.2d 871, 895 (D.N.C.2001) (dismissing as immaterial an alleged misstatement of earnings of $79 million which amounted to a mere 2.1% of operating earnings and 2.8% of earnings); *In re Newell Rubbermaid Inc. Sec. Litig.,* 2000 WL 1705279, at *8 (N.D.Ill. Nov. 14, 2000) (deeming immaterial allegedly undisclosed expenses that amounted to 1% of the overall expense budget as "nothing more than pocket change"). Because the alleged misstatement in the case at bar cannot satisfy the materiality element, Plaintiffs' claim under section 10(b) and Rule 10b-5 cannot survive.

B. Scienter

Plaintiffs' failure adequately to allege scienter provides an entirely independent basis to dismiss the Complaint. The PSLRA requires Plaintiffs to plead facts giving rise to a "strong inference" that a particular defendant made a specific statement with knowledge of its falsity. 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit has not yet ruled on the question of the what constitutes a "strong inference" of such knowledge. In some circuits, the plaintiff must allege specific, detailed facts demonstrating the defendant's contemporaneous knowledge of falsity. *See* *Bryant v.. Avado Brands, Inc.,* 187 F.3d 1271, 1286-87 (11 th Cir.1999); *In re Silicon Graphics, Inc. Sec. Litig.,* 183 F.3d 970, 979 (9 th Cir.1999). In other circuits, allegations of "motive and opportunity" to commit fraud will give rise to a "strong inference" of scienter. *See* *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 534-35 (3d Cir.1999); *Novak v. Kasaks,* 216 F.3d 300, 310-11 (2d Cir.2000). Under either pleading standard, Plaintiffs cannot proceed.

***11** As we have already discussed, Defendants' Form 10-K disclosures were issued toward the beginning of the Class Period on March 30, 2000. These disclosures highlighted the risks surrounding TouchScript, particularly with respect to acceptance in the medical community and problems with the technology. Significantly, Plaintiffs have *not* alleged that Defendants ever furnished inaccurate numbers as to the Company's sales, margins and customers. Rather, Plaintiffs offer broad, unspecified allegations insinuating Defendants had "access to adverse, non-public information" about the Company, had "conducted extensive market research" on TouchScript, "received constant feedback" from salespeople and "paid close attention to sales trends" for the product. These allegations paint with too broad a brush and cannot satisfy the PSLRA's pleading standards. Without a clearer idea as to what the allegedly adverse, nonpublic information was, it is impossible for us to determine whether the allegedly undisclosed information could have rendered Defendants' subsequent statements untrue. So too are we unable to measure the timing of the allegedly adverse information against the public representations made by Defendants. It is axiomatic that Defendants could not intentionally have made false statements without previous access to accurate information.

Plaintiffs did plead with specificity regarding the two medical practices that allegedly received rebates for using TouchScript. However, these allegations cannot carry the day for Plaintiffs. In the first place, many of the allegedly false statements occurred *before* the two medical practices received the alleged rebates. Second, Plaintiffs have pointed merely to two instances among at least several hundred customers. We cannot reasonably infer from two instances the existence of "widespread problems."

Last, with respect to the improperly recognized revenue, we have already noted that the amount of the revenue is modest in comparison to the Company's total revenue. Even assuming that this accounting decision violated GAAP, merely establishing GAAP violations is not tantamount to scienter. *See* *Chu v. Sabratek Corp.,* 100 F.Supp.2d 815, 823-24 (N.D.Ill.2000). In fact, it is difficult to build inferences of scienter upon accounting errors because such errors often involve complex calculations about which reasonable people can differ in opinion. The small magnitude of the error, the Company's prompt acknowledgement of the error, and the fact that the revenue was ultimately realized all militate against an inference of scienter in this case.

Plaintiffs also appear to raise allegations going to Defendants' "general motive" to commit fraud. Plaintiffs suggest that the Individual Defendants had motive to commit fraud because they stood to benefit through their salaries and benefits. Moreover, Plaintiffs claim that the Company's recent acquisitions

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

supplied Defendants with a motive to inflate the price of the Company's stock. These unsupported, generalized allegations of motive are insufficient as a matter of law. With respect to the Individual Defendants' salary and benefit incentives, that allegation is too general to satisfy the scienter requirement. Under Plaintiffs' argument, virtually any corporate executive would have the requisite intent to defraud, since most salaries and benefit packages have some incentive-based dimension. Moreover, with respect to the motive to inflate stock price, that too is vague. *See,e.g., Coates v. Heartland Wireless Comm., Inc.,* 26 F.Supp.2d 910, 918 (N.D.Tex.1998) (dismissing allegation of motive to conceal overstatements during public offering); *Novak v. Kasaks,* 997 F.Supp. 425, 430 n.5 (S.D.N.Y.1998) (concluding that allegations of motive to "raise capital" were insufficient as a matter of law to allege scienter); *Glickman v. Alexander & Alexander Servs., Inc.,* 1996 WL 88570, at *5 (S.D.N.Y. Feb. 29, 1996) (holding that vague allegations of motive, like "desire to raise much needed capital," are too general to satisfy scienter requirement). Without more particularized allegations, Plaintiffs cannot satisfy the scienter requirement by alleging motive.

II. Count Two: Control Group Liability

***12** Plaintiffs have also raised a claim pursuant to section 20(a) of the '34 Act. Section 20(a) imposes civil liability upon persons who control others who are directly liable under the Act. 15 U.S.C. § 78t. If a Complaint does not adequately allege an underlying violation of the securities laws, however, the district court must dismiss the section 20(a) claim. *See Greebel v. FTP Software, Inc.,* 194 F.3d 185, 207 (1st Cir.1999). Because Plaintiffs have failed to state a claim under section 10(b) of the '34 Act, they cannot assert the underlying claim required by section 20(a). Thus, their section 20(a) claim must fail.

CONCLUSION

For the foregoing reasons, we dismiss Plaintiffs' complaint in its entirety.

N.D.Ill.,2001.
In re Allscripts, Inc. Securities Litigation
Not Reported in F.Supp.2d, 2001 WL 743411 (N.D.Ill.), Fed. Sec. L. Rep. P 91,481

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-2

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois.
James B. ANTELL, III, Nick Pino, Anthony Dicamillo, and Ralph Corigliano Plaintiffs
v.
Arthur ANDERSEN LLP., Defendant.
**No. 97 C 3456.**

May 4, 1998.

MEMORANDUM OPINION AND ORDER

ANDERSEN, District J.

***1** On February 20, 1998, Magistrate Judge Martin C. Ashman filed and served upon the parties his report and recommendation concerning the motion of Defendant, Arthur Andersen LLP ("Arthur Andersen"), to dismiss the instant complaint pursuant to Fed.R.Civ.P. 12(b)(6). Judge Ashman recommends that Arthur Andersen's motion be granted in part and denied in part.

After a careful consideration of the above-referenced motion, the applicable memoranda of law, other relevant pleadings, Judge Ashman's report, and the parties' objections, the Court hereby adopts in full the report and recommendation.

## I. BACKGROUND

For purposes of a motion to dismiss, the allegations in the complaint are presumed true. The Discovery Zone, Inc. (the "Discovery Zone") owns, operates, and franchises children's indoor recreational centers. In June 1993, the Discovery Zone offered its stock to the public for the first time.

Each of the four named Plaintiffs purchased Discovery Zone stock in the pertinent time period. According to Plaintiffs, between March 31, 1994 and September 15, 1995, the officers and directors of the Discovery Zone inflated the price of the company's stock by using false and misleading financial statements in the company's annual Form 10-K Securities and Exchange Commission ("SEC") filings for the years ending 1993 and 1994. Plaintiffs further allege that Arthur Andersen, an independent accounting firm, audited these financial statements and issued unqualified or "clean" audit opinions. Additionally, Plaintiffs contend that the officers and directors of the Discovery Zone and Arthur Andersen engaged in various accounting improprieties which converted normal operating expenses to capital thereby masking operational loses. Accordingly, Plaintiffs allege that these accounting manipulations and other misrepresentations deceived the public into believing that the Discovery Zone was profitable and well positioned for dramatic future growth.

The Discovery Zone filed the pertinent Form 10-Ks and audit reports prepared by Arthur Andersen with the SEC on March 31, 1994 and March 31, 1995.

On November 9, 1994, the Discovery Zone reported a substantial operating loss for the third quarter of 1994. On November 28, 1994, the first putative class action was filed against the Discovery Zone and certain officers and directors alleging that these defendants improperly inflated the price of Discovery Zone stock in violation of §§ 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and 78t, and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5.

Several other putative class actions were also filed against the Discovery Zone and certain officers and directors. All of the separate lawsuits were consolidated in front of Judge Ruben Castillo (the "Related Action"). On January 31, 1995, James B. Antell, III ("Antell") filed a consolidated putative class action complaint in the Related Action and later amended that pleading on April 25, 1995 and November 16, 1995. Antell purchased Discovery Zone stock on December 7, 1994.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

***2** In the Related Action, Antell asserted a fraud-on-the-market theory on behalf of a class of shareholders who purchased Discovery Zone stock during the period that the price of the stock was purportedly inflated due to the defendants' alleged manipulations and misrepresentations.

As part of the Related Action, on September 5, 1995 Arthur Andersen was served with a subpoena seeking its work papers from its 1993 and 1994 audits of the Discovery Zone's financial statements. In December 1996 and January 1997, Arthur Andersen produced documents which allegedly demonstrated, for the first time, that Arthur Andersen acted with scienter in the alleged accounting manipulations. Based on this information, on March 28, 1997, Antell sought leave to file a third amended complaint in the Related Action asserting similar fraud-on-the-market claims against Arthur Andersen. Judge Castillo denied the motion on the grounds that the addition of Arthur Andersen would delay discovery and prejudice the defendants. Nonetheless, Judge Castillo's order did not preclude the filing of a separate lawsuit against Arthur Andersen.

On May 9, 1997, Antell filed a putative class action against Arthur Andersen. Antell seeks damages on behalf of the class of shareholders who purchased Discovery Zone stock between March 31, 1994 and September 15, 1995. Antell claims that Arthur Andersen's audit reports either intentionally or recklessly failed to disclose that the Discovery Zone's financial statements were materially misstated and not in compliance with Generally Accepted Accounting Principles and General Accepted Auditing Standards. Antell brings claims under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, (Count I) and common law fraud (Count II).

On August 6, 1997, Judge Ashman granted the motion of class members Nick Pino ("Pino"), Anthony DiCamillo ("DiCamillo"), and Ralph Corigliano ("Corigliano") for appointment as lead plaintiffs. Corigliano purchased Discovery Zone stock on March 24, 1995. DiCamillo and Pino purchased the stock on September 13, 1995 and September 14, 1995, respectively.

Arthur Andersen filed a motion to dismiss Plaintiffs' claims on July 21, 1997. In its motion to dismiss, Arthur Andersen argues that Plaintiffs' federal securities claim (Count I) is barred by the applicable statutes of limitations and repose. Arthur Andersen further asserts that the Court should decline to exercise supplemental jurisdiction over Plaintiffs' state law claim for common law fraud (Count II). Plaintiffs contend that their claims are not time barred.

Judge Ashman issued his report and recommendation on February 20, 1998 recommending that Arthur Andersen's motion to dismiss based on the one-year statute of limitations be denied and that the motion be granted based on the applicable three-year statute of repose. Accordingly, Judge Ashman recommends that all claims for purchases made in reliance on the March 31, 1994 Form 10-K and the accompanying supplemental claims for common law fraud be dismissed. The Plaintiffs and Arthur Andersen each filed and briefed their objections in March 1998.

## II. DISCUSSION

***3** A motion to dismiss a complaint pursuant to Fed.R.Civ.P. 12(b)(6) does not test whether the plaintiff will prevail on the merits but instead whether the claimant has properly stated a claim. *Triad Assoc. v. Chicago Housing Auth.,* 892 F.2d 583, 586 (7th Cir.1989), *cert. denied,* 498 U.S. 845, 111 S.Ct. 129, 112 L.Ed.2d 97 (1990). The court must accept as true all well-pleaded factual allegations and draw all reasonable inferences in favor of the plaintiff. *Chaney v. Suburban Bus Div. of Reg'l Transp. Auth.,* 52 F.3d 623, 626-627 (7th Cir.1995) (citations omitted). Dismissal is proper only if it appears beyond doubt that the plaintiff cannot prove any of the facts in support of her claim that would

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

entitle her to the requested relief. *Hughes v. Rowe,* 449 U.S. 5, 9-10, 101 S.Ct. 173, 66 L.Ed.2d 163 (1980).

With these standards in mind, we now turn to the report and recommendation. In doing so, we must "make a de novo determination upon the record, or after additional evidence, of any portion of the magistrate judge's disposition to which a specific written objection has been made."Fed.R.Civ.P. 72(b). This "de novo determination" does not require a new hearing, but simply means that we must give "fresh consideration to those issues to which specific objections have been made." *Rajaratnam v. Moyer,* 47 F.3d 922, 925 n. 8 (7th Cir.1995) (*quoting*12 Charles A. Wright et al., *Federal Practice and Procedure* § 3076.8 (Supp.1994)).

An action claiming a violation of Section 10(b) or Rule 10b-5 must be brought "within 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); 15 U.S.C. § 78i(e). The statue of limitations is an affirmative defense. In the context of a motion to dismiss, a plaintiff is not required to negate an affirmative defense in his complaint. *Fugman v. Aprogenex, Inc.,* 961 F.Supp. 1190, 1198 (N.D.Ill.1997). Nonetheless, if the plaintiff pleads facts that establish that his suit is time barred, he pleads himself out of court. *Tregenza v. Great American Communications Co.,* 12 F.3d 717, 718 (7th Cir.1993), *cert. denied,* 511 U.S. 1085, 114 S.Ct. 1837, 128 L.Ed.2d 465 (1994).

A. One-Year Statute of Limitations

The one-year limitations period begins to run when a plaintiff has "inquiry notice" of the alleged fraud rather than when a plaintiff actually discovers the fraud. *Id.* at 722.The test is an objective one. *Law v. Medco Research, Inc.,* 113 F.3d 781, 786 (7th Cir.1997). A person is charged with "inquiry notice" when she becomes aware of facts that would lead a reasonable person to investigate whether she has a claim under Section 10(b) or Rule 10b-5. *Marks v. CDW Computer Centers, Inc.,* 122 F.3d 363, 367 (7th Cir.1997)." 'Suspicious circumstances, coupled with ease of discovering, without the use of legal process, whether the suspicion is well grounded, may cause the statute of limitations to start to run before the plaintiffs discover the actual fraud." ' *Fujisawa Pharm. Co., Ltd. v. Kapoor,* 115 F.3d 1332, 1335 (7th Cir.1997) (citing *Law,* 113 F.3d at 786).

***4** Judge Ashman recommends that Arthur Andersen's motion to dismiss based on the one-year limitations period be denied. Arthur Andersen objects to Judge Ashman's conclusion that Plaintiffs did not have "inquiry notice" of their claim more than one year before the action was commenced. Plaintiffs offer no objection on this point. For the following reasons, we agree with Judge Ashman and overrule Arthur Andersen's objection.

Plaintiffs filed the instant action against Arthur Andersen on May 9, 1997. Arthur Andersen contends that Plaintiffs had inquiry notice of this claim on November 28, 1994, the day the original complaint in the Related Action was filed. Arthur Andersen asserts that the Related Action complaint proclaimed to the world that Discovery Zone shareholders asserted fraud based on the same type of accounting manipulations and practices that Plaintiffs claim in the instant lawsuit. Thus, Arthur Andersen concludes that Plaintiffs were sufficiently alerted that Arthur Andersen, the auditor of the purported fraudulent financial statements, may have participated in the alleged fraud.

A "reasonable investor is presumed to have information available in the public domain, and therefore [a plaintiff] is imputed with constructive knowledge of this information." *Whirlpool Fin. Corp. v. GN Holdings, Inc.,* 67 F.3d 605, 610 (7th Cir.1995). Arthur Andersen correctly states that pleadings in a lawsuit can provide inquiry notice of a claim. *See Astor Chauffeured Limousine Co. v. Runnfeld Inv. Corp.,* 910 F.2d 1540, 1544 (7th Cir.1990); *Cash-*

*man v. Coopers & Lybrand,* 877 F.Supp. 425, 436-437, n. 14 (N.D.Ill.1995). Nonetheless, Plaintiffs are not charged with inquiry notice until they knew or should have known Arthur Andersen acted with scienter. *Law,* 113 F.3d at 786.

Plaintiffs contend that they could not have known that Arthur Andersen may have joined in the alleged fraudulent accounting treatment until Arthur Andersen produced its work papers in the Related Action in late 1996 and early 1997. Specifically, in ¶ 80 of the complaint Plaintiffs allege that:

> Beginning in December 1996 and continuing in January 1997, as a result of discovery in the action against the Related Action Defendants, which discovery had previously been stayed, plaintiffs received work papers of Arthur Andersen relating to the 1993 and 1994 audits. Included in the Administration Binder produced by Arthur Andersen, contained as part of the 1993 work papers, were Audit Issue Control Documents dated February 7, 1994. These documents and related documents revealed for the first time, that Arthur Andersen knew or recklessly disregarded that the public financial statements for the years ended December 31, 1993, and December 31, 1994, issued or disseminated in the name of [the Discovery Zone], were materially false and misleading and that Arthur Andersen's audits did not conform with GAAS.

Although the pleadings filed in the Related Action and the disclosures in the Form 10-K filings may have created suspicious circumstances as to Arthur Andersen's knowledge and activities, we cannot accept Arthur Andersen's assertion that these documents conclusively provided inquiry notice of Arthur Andersen's supposed recklessness or intentional misconduct. In order to make the inference Arthur Andersen requires, the Court must ignore the equally reasonable inference that the Related Action pleadings and the SEC filings merely put Plaintiffs on notice that Arthur Andersen acted only in a negligent manner.

***5** Whether a plaintiff has inquiry notice of a claim under Section 10(b) or Rule 10b-5 is a question of fact and, as such, is often inappropriate for resolution of a motion to dismiss. *Marks,* 122 F.3d at 366. At this stage of the proceedings, we must assume the truth of Plaintiffs' allegations and draw all reasonable inferences in their favor. Thus, for purposes of the motion to dismiss we find that Plaintiff had inquiry notice of the instant claim against Arthur Andersen when it received Arthur Andersen's work papers in December 1996 or January 1997. Arthur Andersen's motion to dismiss based on the one-year statue of limitations is, therefore, denied.

B. Three-Year Statute of Repose

In *Lampf,* the Supreme Court adopted a three-year statute of repose for claims brought under Section 10(b) and Rule 10b-5. The Supreme Court, however, did not specifically define the "violation" that triggers the repose period. Plaintiffs assert that a plaintiff's purchase of a security triggers the repose period. Judge Ashman and Arthur Andersen both suggest that the alleged misrepresentation is the "violation" contemplated by the statute of repose.

Based on the statute of repose, Judge Ashman recommends that Arthur Andersen's motion to dismiss be granted for all claims for purchases made in reliance on the Discovery Zone's March 31, 1994 Form 10-K filing, namely all purchases made prior to March 31, 1995. Plaintiffs object to Judge Ashman's recommendation. Defendant offers no objection on this point. For the following reasons, we agree with Judge Ashman and overrule Plaintiffs' objection.

Whether Plaintiffs' claims are time-barred under the statute of repose depends on when the repose period began to run. Although the Seventh Circuit has not yet determined the triggering event in the Section 10(b) or Rule 10b-5 context, the court has held that a period of repose bars a suit a fixed number of years after an action by a defendant, even if this

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

period ends before a plaintiff suffers any injury. *Beard v. J.I. Case Co.,* 823 F.2d 1095, 1097 n. 1 (7th Cir.1987).*Accord Lampf,* 501 U.S. at 363 (stating “the purpose of the 3-year [statute of repose] is clearly to serve as a cutoff....”); *Law,* 113 F.3d at 786 (noting that “the three-year statute of repose gives defendants a definite limit beyond which they needn't fear being sued”). For the following reasons, we hold that the repose period is triggered by the alleged misrepresentation rather than by a plaintiff's purchase of a security.

An examination of the language of 15 U.S.C. § 78i(e), § 9(e) of the of the 1933 Security and Exchange Act, the rule adopted by the Supreme Court in *Lampf,* is instructive. Pursuant to § 78i(e), claims must be “brought within one year after the discovery of the facts constituting the *violation* and within three years after such *violation.*” The employment of the term “violation” for purposes of both the one-year statute of limitations period and the three-year repose period demonstrates that a “violation” occurs at the time of the alleged fraudulent conduct. As discussed above, *see supra* Section A, a party must commence a Section 10(b) or Rule 10b-5 claim within one-year after discovery of the facts constituting the alleged fraudulent conduct. If we held that the repose period begins when a plaintiff purchased the Discovery Zone stock, “violation” would have two different meanings in the same sentence.

***6** Additionally, although the *Lampf* opinion did not specifically decide what constitutes a triggering event for the repose period, the Court stated:

> As there is no dispute that the earliest of plaintiffs-respondent's complaints was filed *more than three years after petitioner's alleged misrepresentations,* plaintiffs-respondent's claims were untimely.

*Lampf,* 501 U.S. at 364 (emphasis added). Furthermore, the Ninth Circuit and the SEC agree that a “violation” of Section 10(b) or Rule 10b-5 does not depend on a sale or purchase of a security. *E.g.* *S.E.C. v. Rana Research, Inc.,* 8 F.3d 1358, 1364 (9th Cir.1993); *In re Cambridge Biotech Corp.,* Exch. Act. Rel. No. 33-7358, 1996 WL 595674 (Oct. 17, 1996).

Thus, we find that the three-year repose period for Section 10(b) and Rule 10b-5 claims begins to run when a defendant makes an affirmative misrepresentation. *Accord In re Prudential Ins. Co. of America Sales Practices Litigation,* 975 F.Supp. 584, 603-604 (D.N.J.1997) (holding that the alleged misrepresentation rather than the sale or purchase of a security triggers the three-year repose period); *In re Phar-Mor, Inc. Securities Litigation,* 892 F.Supp. 676, 687-688 (W.D.Pa.1995) (same); *Continental Bank, Nat'l Assoc.,* 777 F.Supp. 92, 102 (D.Mass.1991) (same); *Greenberg v.. Boettcher & Co.,* 755 F.Supp. 776, 784-785 (N.D.Ill.1991) (same); *c.f., Otto v. Variable Annuity Life Ins. Co.,* 816 F.Supp. 458, 461 (N.D.Ill.1991) (declining to select a triggering date for affirmative misrepresentation cases and noting in *dicta* that “a violation of § 10(b) and Rule 10b-5 is comprised not only of a misrepresentation or omission of material fact, but also includes the purchase or sale of any security”).

In their objection, Plaintiffs assert that Judge Ashman's conclusion that the misrepresentation triggers the repose period is contrary to law. We have already rejected this argument and agree with Judge Ashman's analysis. Furthermore, Plaintiffs' reliance on *Kleban v. S.Y.S. Restaurant Management, Inc.,* 912 F.Supp. 361 (N.D.Ill.1995), is misplaced. In *Kleban,* the court held that the sale of the security triggers the repose period. *Id.* at 367.We are not bound by this decision and for the reasons stated above we disagree with its reasoning.

Likewise, *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975), offers Plaintiffs no assistance. In *Blue Chip Stamps,* the Supreme Court held only that actual purchasers and sellers of securities have standing to pursue a claim under the anti-fraud provisions of the Security and Exchange Act of 1934. The Court

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

did not decide when the repose period begins to run or define "violation" in the repose context. Therefore, Plaintiffs' objection is denied.

In sum, all claims for purchases made in reliance on the Discovery Zone's March 31, 1994 Form 10-K filing, namely all purchases made prior to March 31, 1995, are time bared by the statute of repose. Because Antell and Corigliano purchased the stock before March 31, 1995, their federal claims are time-barred. Generally, when federal claims are dismissed, the court should decline to exercise jurisdiction over supplemental state law claims. *United Mine Workers of America v. Gibbus,* 383 U.S. 715, 726-727, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966). Accordingly, the Court will not exercise supplemental jurisdiction over the state law claims based on purchases made before March 31, 1995. Thus, the claims of Antell and Corigliano are dismissed.

***7** Additionally, in his report, Judge Ashman overlooked the purchase dates of Plaintiffs DiCamillo and Pino which occurred on September 13, 1995 and September 14, 1995. Because DiCamillo and Pino relied on the alleged misrepresentations contained in the March 31, 1995 Form 10-K filing, the repose period for their claims had not expired when the instant action was filed on May 9, 1997. Thus, Plaintiffs DiCamillo and Pino may pursue the federal and state law claims in Counts I and II for purchases made in reliance on the Discovery Zone's March 31, 1995 Form 10-K, namely all purchases made between March 31, 1995 and September 15, 1995.

### C. Tolling Of The Three-Year Statue Of Repose

Plaintiffs also contend that the statue of repose was tolled on March 28, 1997, three days before the anniversary of the initial Form 10-K filing. On that date, Plaintiffs filed their motion to amend the complaint in the Related Action to add Arthur Andersen as a defendant. Plaintiffs, thus, argue that the repose period was tolled during the pendency of their motion. Judge Ashman rejected Plaintiffs' assertion and we agree with Judge Ashman.

In *Lampf,* the Supreme Court squarely rejected the doctrine of equitable tolling in securities fraud cases. The Court held that "it is evident that the equitable tolling doctrine is fundamentally inconsistent with the 1-and 3-year [limitations] structure." *Lampf,* 501 U.S. at 363.

Moreover, even if the clock stopped running while Judge Castillo decided Plaintiffs' motion to amend, from March 28, 1997 to May 2, 1997, the repose period would only be extend by three days. Plaintiffs, however, waited four days before filing the instant suit. Thus, we reject Plaintiffs' equitable tolling argument.

## III. CONCLUSION

For the foregoing reasons, we adopt Magistrate Judge Ashman's report and recommendation. Arthur Andersen's motion to dismiss the complaint pursuant to Fed.R.Civ.P. 12(b)(6) based on the one-year statute of limitations is denied. The motion to dismiss based on the three-year statute of repose is granted in part and denied in part.

Claims for purchases made in reliance on the Discovery Zone's March 31, 1994 Form 10-K filing are time barred under the statute of repose, namely purchases made prior to March 31, 1995. The claims of Plaintiffs Antell and Corigliano are, thus, dismissed. Accordingly, we decline to exercise supplemental jurisdiction of their state law claims. Claims for purchases made in reliance on the Discovery Zone's March 31, 1995 Form 10-K filing are timely. Therefore, Arthur Andersen's motion to dismiss is denied as to Plaintiffs DiCamillo and Pino. Plaintiffs DiCamillo and Pino may pursue the federal and state law claims in Counts I and II for purchases made in reliance on the Discovery Zone's March 31, 1995 Form 10-K, namely all purchases made between March 31, 1995 and September 15, 1995.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

The objections to the report and recommendation of Plaintiffs and Arthur Andersen are hereby overruled.

***8** It is so ordered.

N.D.Ill.,1998.
Antell v. Arthur Andersen LLP
Not Reported in F.Supp., 1998 WL 245878 (N.D.Ill.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-3

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

United States Court of Appeals,
Second Circuit.
**ARIEL** (UK) LIMITED, Plaintiff-Appellant,
v.
**REUTERS** GROUP, PLC, **Reuters** C, LLC, **Reuters** Transaction Services Limited, Instinet Group Incorporated, The NASDAQ Stock Market, Inc., Silver Lake Partners II, LP, Inet Ats Inc., Instinet Holdings Incorporated, formerly known as Iceland Acquisitions Corp., Instinet Incorporated and Norway Acquisition Corp., Defendants-Appellees.
**No. 06-5533-cv.**

May 6, 2008.

**Background:** Copyright owner brought action against business competitor for infringement, breach of contract, and state law claims. The United States District Court for the Southern District of New York, John F. Keenan, J., 2006 WL 3161467, dismissed the copyright claim with prejudice, dismissed the breach of contract claim without prejudice, and declined to exercise pendent jurisdiction over the state law claims. Plaintiff appealed.

**Holdings:** The Court of Appeals held that:
(1) competitor was valid licensee of copyrighted works and thus not liable for infringement;
(2) rescission of contract was not warranted absent allegation of fundamental breach, or breach of condition precedent; and
(3) district court was not required to sua sponte grant leave to amend complaint.

Affirmed.

West Headnotes

**[1] Copyrights and Intellectual Property 99 ⚷ 77**

99 Copyrights and Intellectual Property
99I Copyrights
99I(J) Infringement
99I(J)2 Remedies
99k72 Actions for Infringement
99k77 k. Persons Liable. Most Cited Cases
Successor of valid licensee of copyrighted works was not liable for infringement.

**[2] Contracts 95 ⚷ 261(1)**

95 Contracts
95IV Rescission and Abandonment
95k257 Grounds for Rescission by Party
95k261 Failure of Performance or Breach
95k261(1) k. In General. Most Cited Cases

**Contracts 95 ⚷ 261(2)**

95 Contracts
95IV Rescission and Abandonment
95k257 Grounds for Rescission by Party
95k261 Failure of Performance or Breach
95k261(2) k. What Breach Will Authorize Rescission in General. Most Cited Cases
Rescission of contract was not warranted absent allegation of fundamental breach, or breach of a condition precedent.

**[3] Copyrights and Intellectual Property 99 ⚷ 82**

99 Copyrights and Intellectual Property
99I Copyrights
99I(J) Infringement
99I(J)2 Remedies
99k72 Actions for Infringement
99k82 k. Pleading. Most Cited Cases
District court was not required to sua sponte grant leave to amend complaint in copyright infringement action, where plaintiff had already amended the complaint once and any additional amendment

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

would have been futile.

***44** UPON DUE CONSIDERATION it is hereby ORDERED, ADJUDGED, and DECREED that the judgment of the District Court is AFFIRMED.J. Joseph Bainton (Michael J. Cohen, of counsel), Bainton McCarthy LLC, New York, NY, for Plaintiff-Appellant.

David L. Yohai (Alan R. Feigenbaum, on the brief), Weil Gotshal & Manges LLP, New York, NY, for Defendants-Appellees Reuters Group PLC, Reuters C LLC, and Reuters Transaction Services Limited.

William I. Sussman, Ropes & Gray LLP, New York, NY, for Defendants-Appellees Silver Lake Partners II, L.P., Instinet Holdings Incorporated, Instinet Incorporated, and Instinet LLC.

Douglass B. Maynard (Michael D. Lockard, on the brief), Akin Gump Strauss Hauer & Feld LLP, New York, NY, for Defendants-Appellees The NASDAQ Stock Market, Inc., Norway Acquisition Corp., and Instinet Group Incorporated.

PRESENT: Hon. CHESTER J. STRAUB, Hon. REENA RAGGI, Circuit Judges, and Hon. SIDNEY H. STEIN, District Judge.[FN1]

FN1. Honorable Sidney H. Stein, of the United States District Court for the Southern District of New York, sitting by designation.

***SUMMARY ORDER***

****1** Ariel (UK) Limited ("Ariel") appeals from the judgment of the District Court for the Southern District of New York (John F. Keenan, *Judge* ) granting defendants' motion to dismiss Ariel's copyright claim with prejudice, dismissing Ariel's claims for breach of contract and declaratory relief, without prejudice, and declining to exercise pendent jurisdiction over Ariel's state law claims, entered on November 2, 2006. We assume the parties' familiarity with the procedural history, arguments on appeal, and the underlying facts, which are laid out in detail in the ***45** opinion of the District Court. *See Ariel (UK) Ltd. v. Reuters Group PLC,* No. 05 Civ. 9646, 2006 WL 3161467 (S.D.N.Y. Oct. 31, 2006).

"We review the district court's grant of a Rule 12(b)(6) motion *de novo,* drawing all reasonable inferences in plaintiffs' favor, and accepting as true all the factual allegations in the complaint." *Transhorn, Ltd. v. United Techs. Corp. (In re Elevator Antitrust Litig.),* 502 F.3d 47, 50 (2d Cir.2007) (internal quotation marks, alteration, and citations omitted); *see also Bell Atl. Corp. v. Twombly,* --- U.S. ----, 127 S.Ct. 1955, 1965, 167 L.Ed.2d 929 (2007). Our review is limited to the complaint and any undisputed documents attached as exhibits to it. *See*Fed.R.Civ.P. 10(c). We affirm for substantially the reasons given in the District Court's thorough and well-reasoned opinion.

[1] Ariel's pleadings and the 1975 agreement between Ariel and Institutional Networks Corporation ("Instinet"), predecessor to defendants, upon which Ariel bases its contract claims, demonstrate that defendants are valid licensees of the works Ariel claims defendants infringed. As the pleadings and 1975 agreement demonstrate, Ariel and Instinet were subject to a license agreement that granted each of them a perpetual, royalty free, worldwide, non-exclusive license to exploit the works at issue in Ariel's copyright claim. As the District Court found, the 1975 agreement also demonstrates that Instinet was free to operate and license others to operate the works Ariel claims were infringed. The District Court properly relied on Ariel's allegations to determine that defendants were licensees. *See Official Comm. of Unsecured Creditors of Color Tile, Inc. v. Coopers & Lybrand, LLP,* 322 F.3d 147, 167 (2d Cir.2003) (holding that allegations in the complaint are judicial admissions that bind a party "throughout the course of the proceeding" (internal quotation marks omitted)). Thus, we find no error in the District Court's holding that, as a

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

matter of law, the defendants could not be sued for copyright infringement. *See Davis v. Blige,* 505 F.3d 90, 100 (2d Cir.2007) (noting that a valid exclusive or non-exclusive license "immunizes the licensee from a charge of copyright infringement, provided that the licensee uses the copyright as agreed with the licensor"). Ariel's argument on appeal that it alleged, in the alternative, that defendants were not licensed is belied by the record. Ariel consistently argued that defendants were licensees, and any argument to the contrary amounted to nothing more than a late-breaking claim that it was entitled to rescission.

****2** [2] As to Ariel's potential rescission claim, assuming, *arguendo,* that Ariel was entitled to make the claim, the District Court did not err in finding that it was not justified because Ariel had not pled a breach of a condition precedent or one that was so fundamental, that, if proven, would trigger a rescission right. *See Septembertide Publ'g., B.V. v. Stein & Day, Inc.,* 884 F.2d 675, 678 (2d Cir.1989) ("[B]efore rescission will be permitted the breach must be material and willful, or, if not willful, so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract."(internal quotation marks omitted)). While we have cautioned that district courts are ill-equipped to make judgments regarding rescission at the early stages of litigation, *see Bassett v. Mashantucket Pequot Tribe,* 204 F.3d 343, 356 n. 14 (2d Cir.2000), here the claim of rescission was not "plausible" on its face, and the District Court did not err in dismissing it, *see Iqbal v. Hasty,* 490 F.3d 143, 157-58 (2d Cir.2007).

[3] Finally, the District Court did not exceed its allowable discretion in not *sua* ****46*** *sponte* granting Ariel leave to amend. Ariel had already amended its complaint once, and any amendment would have been futile. *See Pani v. Empire Blue Cross Blue Shield,* 152 F.3d 67, 76 (2d Cir.1998), *cert. denied,* 525 U.S. 1103, 119 S.Ct. 868, 142 L.Ed.2d 770 (1999). Ariel's allusion to new facts that it submitted in response to defendants' motion below for attorneys' fees and costs is unavailing. We note that, on a motion to dismiss, "our review is limited to undisputed documents, such as a written contract attached to, or incorporated by reference in, the complaint." *Official Comm. of Unsecured Creditors of Color Tile,* 322 F.3d at 160 n. 7. However, even if we were to consider the facts Ariel alludes to, Ariel fails to show how those facts could not have been pled originally, or how new facts or allegations could salvage Ariel's copyright claim. *See Bellikoff v. Eaton Vance Corp.,* 481 F.3d 110, 118 (2d Cir.2007) (explaining that "[w]hen a moving party has had an opportunity to assert the amendment earlier, but has waited until after judgment before requesting leave, a court may exercise its discretion more exactingly"); *In re Am. Express Co. S'holder Litig.,* 39 F.3d 395, 402 (2d Cir.1994) (affirming district court's dismissal without leave to replead and noting that appellants had not indicated how they could transform the facts pleaded into a sufficient allegation).

We have considered all of Ariel's arguments and find them to be without merit. For the reasons set forth above, the judgment of the District Court is hereby AFFIRMED.

C.A.2 (N.Y.),2008.
Ariel (UK) Ltd. v. Reuters Group, PLC
277 Fed.Appx. 43, 2008 WL 1984270 (C.A.2 (N.Y.)), 2008 Copr.L.Dec. P 29,558

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-4

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

- 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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

> 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).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

("[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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

***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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-5

Westlaw.

United States District Court, N.D. California,
San Jose Division.
In re DITECH NETWORKS, INC. DERIVATIVE LITIGATION.
**No. C 06-5157 JF.**

July 16, 2007.

Darryl Paul Rains, Morrison & Foerster, LLP, Palo Alto, CA, Diane Elizabeth Pritchard, Morrison & Foerster, LLP, San Francisco, CA, for Defendants.

ORDER FN1 GRANTING MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM UPON WHICH RELIEF CAN BE GRANTED WITH LEAVE TO AMEND; DEFERRING MOTION TO DISMISS FOR FAILURE TO MAKE DEMAND

FN1. This disposition is not designated for publication and may not be cited.

JEREMY FOGEL, United States District Judge.

## I. BACKGROUND

### 1. Procedural Background

***1** This derivative action arises from the alleged backdating and springloading of stock options by directors and officers of nominal defendant Ditech Networks, Inc. ("Ditech" or "the Company"). Plaintiff Donald W. Newman filed the initial complaint on August 23, 2006. The Court has consolidated the Newman action and two other actions under the caption of the instant case. On March 2, 2007, Plaintiffs filed an amended consolidated complaint ("the Complaint"). The Complaint asserts claims against the following individuals ("the Individual Defendants").

| Defendant | Role at the Company |
| --- | --- |
| Timothy K. Montgomery | President, CEO, and director, September 1998 to present. |
| | Chairman of the Board of Directors ("the Board"), October 1999 to present. |
| | Senior Vice President of Sales and Marketing, November 1997 to September 1998. |
| Gregory M. Avis | Director, February 1997 to present. |
| | Member, Compensation Committee, 1999 to present. |
| William A. Hasler | Director, May 1997 to present. |
| | Member, Compensation Committee, at least 1999 to present. |
| | Member, Audit Committee, at least 1999 to present. |
| Andrei M. Manoliu | Director, June 2000 to present. |
| | Member, Audit Committee, 2003 to present. |
| Edwin L. Harper | Director, December 2002 to present. |
| David M. Sugishita | Director, February 2003 to present. |

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

| | |
|---|---|
| | Member, Audit Committee, 2003 to present; Chair of Audit Committee, 2004 to present. |
| Serge Stepanoff | Vice President of Engineering & Development for Echo Cancellation Products, September 1996 to May 2002. |
| William J. Tamblyn | Chief Financial Officer, June 1997 to present.<br>Executive Vice President, May 2005 to present.<br>Vice President, June 1997 to May 2005. |
| Toni M. Bellin | Vice President of Operations, December 1998 to July 2001. |
| Robert T. DeVincenzi | Senior Vice President of Sales for Altamar Networks, July 2000 to June 2003. |
| Lowell B. Transgrud | Vice President, Operations, July 2001 to present. |
| James H. Grady | Vice President, Business Development, 2005 to present.<br>Vice President, Worldwide Sales, July 2003 to 2005. |
| Lee H. House | Vice President, Echo Engineering, May 2002 to present. |
| Ian M. Wright | Senior Vice President of Engineering for Optical Networking Products, February 2000 to present. |
| Chalan M. Aras | Vice President of Marketing, May 2004 to present.<br>Senior Director of Product Management, October 2003 to May 2004. |

Complaint ¶¶ 14-30. The Complaint describes Montgomery, Stepanoff, Tamblyn, Bellin, DeVincenzi, Transgrud, Grady, House, Wright, and Aras as "the Officer Defendants;" Avis and Hasler as "the Committee Defendants;" and Montgomery, Tamblyn, Transgrud, House, Avis, Hasler, Manoliu, Sugishita, and Grady as "the Insider Selling Defendants." Complaint ¶¶ 24, 27.

The Complaint asserts nine claims: (1) violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder, against the Individual Defendants; (2) violation of Section 14(a) of the Securities Exchange Act and Rule 14a-9 promulgated thereunder, against the Individual Defendants; (3) violation of Section 20(a) of the Securities Exchange Act, against defendants Montgomery, Tamblyn, Avis, Hasler, Sugishita, Harper, and Manoliu; (4) accounting, against the Individual Defendants; (5) breach of fiduciary duty and/or aiding and abetting, against the Individual Defendants; (6) unjust enrichment, against the Individual Defendants; (7) rescission, against the Officer Defendants; (8) insider selling and misappropriation of information, against the Insider Selling Defendants; and (9) breach of fiduciary duty and/or aiding and abetting relating to the May 18, 2004 option grants, against the Individual Defendants.

***2** On April 2, 2007, the Individual Defendants moved to dismiss the Complaint for failure to state a claim upon which relief can be granted ("Motion One"), and Ditech moved to dismiss the Complaint for failure to make demand ("Motion Two"). Plaintiffs oppose both motions. The Court heard oral argument on June 8, 2007.

**2. Allegations Made in the Complaint**

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Pursuant to the Company's shareholder-approved stock option plans, the exercise price of options may not be less than the fair market value of the stock on the date the option is granted. Complaint ¶ 38. However, the Complaint alleges that

> [t]he Compensation Committee, with the knowledge and approval of the other members of the Board, knowingly and deliberately violated the terms of the [Company's stock option] Plans ... by knowingly and deliberately backdating grants of stock options to make it appear as though the grants were made on dates when the market price of Ditech stock was lower than the market price on the actual grant dates, thereby benefitting the recipients of the backdated options.

Complaint ¶ 37; *see also* Complaint ¶ 46. Nine stock option grants allegedly were backdated:

| Purported Date | Recipient | Number of Options | Exercise Price |
|---|---|---|---|
| 8/10/1999 | Montgomery | 253,888 | $ 9.00 |
| 8/10/1999 | Stepanoff | 125,020 | $ 9.00 |
| 8/10/1999 | Tamblyn | 149,586 | $ 9.00 |
| 10/4/1999 | Bellin | 50,000 | $24.69 |
| 8/1/2000 | DeVincenzi | 133,934 | $22.50 |
| 1/10/2001 | Montgomery | 400,000 | $ 7.19 |
| 1/10/2001 | DeVincenzi | 160,000 | $ 7.19 |
| 1/10/2001 | Tamblyn | 145,000 | $ 7.19 |
| 1/10/2001 | Wright | 300,000 | $ 7.19 |

Complaint ¶ 41.[FN2] The grants dated August 10, 1999 coincided with the second-lowest quarterly price, those dated October 4, 1999 and August 1, 2000 coincided with the lowest price of their respective months, and those dated January 10, 2001 coincided with the second-lowest price of the six-month period ending on April 30, 2001. Complaint ¶¶ 43-45.[FN3]

> FN2. Two further alleged backdated grants were made on July 6, 2000, but were cancelled on March 19, 2003. Complaint ¶ 41 n.3.

> FN3. The Complaint includes no allegations regarding the actual date of the option grants, of any public announcement by the Company of options backdating or the need to restate earnings, or of any investigation by the Company or by the SEC.

Defendants allegedly engaged in option springloading in 2004. This is a practice "when directors grant options at the market value on the date of grant, at a time the directors know that the shares are actually worth more than the market value because the directors possess material non-public information."Complaint ¶ 48. Three springloaded stock option grants allegedly were made on May 18, 2004.

| Purported Date | Recipient | Number of Options | Exercise Price |
|---|---|---|---|
| 5/18/04 | Tamblyn | 125,000 | $13.37 |

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

| | | | |
|---|---|---|---|
| 5/18/04 | Transgrud | 125,000 | $13.37 |
| 5/18/04 | Aras | 100,000 | $13.37 |

Complaint ¶ 49. The grant price coincided with the third lowest price of 2004. *Id.* The Company announced positive results on May 27, 2004, and Ditech shares closed at $20.61 per share on May 28, 2004. Complaint ¶ 51.

As alleged in the Complaint, two proxy statements, filed on August 18, 2000 and August 8, 2001, respectively, falsely reported the backdated option grants. Complaint ¶ 61. Defendants also are alleged to have disseminated false financial reports, Complaint ¶¶ 54-61, concealed their misconduct, Complaint ¶¶ 62-63, and violated GAAP accounting principles, SEC regulations, and IRS rules and regulations. Complaint ¶¶ 64-86. During the period from October 5, 1999 to December 9, 2004, the Individual Selling Defendants are alleged to have sold over $100 million in Ditech stock while in the possession of materially adverse non-public information regarding the backdating of stock options. Complaint ¶ 87. These alleged actions of the Individual Defendants constituted breaches of their fiduciary duties and were not, and could not have been, products of the exercise of good faith business judgment. Complaint ¶¶ 88-89.

***3** Plaintiffs claim that they have not made a demand on the Board because "demand would be a futile and useless act because the Board is incapable of making an independent and disinterested decision to institute and vigorously prosecute this action."Complaint ¶ 94. At the time that this action was commenced, the Board consisted of six directors: Montgomery, Avis, Hasler, Manoliu, Sugishita, and Harper. Complaint ¶ 95. According to Plaintiffs, five directors are incapable of considering independently and disinterestedly a demand to commence and prosecute this action vigorously. *Id.* The reasons for each director's alleged incapacity to do so are summarized in the table below:

| Director | Reasons for Lack of Independence and Disinterestedness |
|---|---|
| Montgomery | • Received backdated stock options.<br>• Sold Ditech stock for proceeds in excess of $39 million on the basis of inside information. |
| Avis | • Sold Ditech stock for proceeds in excess of $43 million on the basis of inside information.<br>• Knowingly and deliberately backdated stock option grants as a member of the Compensation Committee, and is substantially likely to be held liable for breaching his fiduciary duties.<br>• Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently.<br>• Has served as Managing Partner of Summit, a venture capital and private firm, since 1990. Summit invested in Ditech in 1997 and is still listed as a Summit portfolio company. |
| Hasler | • Sold Ditech stock for proceeds in excess of $4.4 million on the basis of inside information.<br>• Knowingly and deliberately backdated stock option grants and approved, signed, and disseminated false financial statements |

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

| | |
|---|---|
| | and other false SEC filings as a member of the Audit and Compensation Committees, and is substantially likely to be held liable for breaching his fiduciary duties.<br>• Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently. |
| Manoliu | • Sold Ditech stock for proceeds in excess of $441,000 on the basis of inside information.<br>• Knowingly and deliberately approved, signed, and disseminated false financial statements and other false SEC filings as a member of the Audit Committee, and is substantially likely to be held likely for breaching his fiduciary duties.<br>• Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently. |
| Sugishita | • Sold Ditech stock for proceeds in excess of $516,000 on the basis of inside information.<br>• Knowingly and deliberately approved, signed, and disseminated false financial statements and other false SEC filings as a member and Chair of the Audit Committee, and is substantially likely to be held liable for breaching his fiduciary duty.<br>• Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently. |

***4** *Id.*

## II. LEGAL STANDARD

### 1. Motion to Dismiss

For purposes of a motion to dismiss, the plaintiff's allegations are taken as true, and the Court must construe the complaint in the light most favorable to the plaintiff. *Jenkins v. McKeithen,* 395 U.S. 411, 421, 89 S.Ct. 1843, 23 L.Ed.2d 404 (1969). However, the court is not required "to accept legal conclusions case in the form of factual allegations if those conclusions cannot reasonably be drawn from the facts alleged." *Clegg v. Cult Awareness Network,* 18 F.3d 752, 754-55 (9th Cir.1994). Leave to amend must be granted unless it is clear that the complaint's deficiencies cannot be cured by amendment. *Lucas v. Department of Corrections,* 66 F.3d 245, 248 (9th Cir.1995). When amendment would be futile, however, dismissal may be ordered with prejudice. *Dumas v. Kipp,* 90 F.3d 386, 393 (9th Cir.1996). Leave to amend is to be granted with extreme liberality in securities fraud cases, because the heightened pleading requirements imposed by the PSLRA are so difficult to meet. *See Eminence Capital, LLC v. Aspeon, Inc.,* 316 F.3d 1048, 1052 (9th Cir.2003).

On a motion to dismiss, the Court's review is limited to the face of the complaint and matters judicially noticeable. *North Star International v. Arizona Corporation Commission,* 720 F.2d 578, 581 (9th Cir.1983); *MGIC Indemnity Corp. v. Weisman,* 803 F.2d 500, 504 (9th Cir.1986); *Beliveau v. Caras,* 873 F.Supp. 1393, 1395 (C.D.Cal.1995). However, under the "incorporation by reference" doctrine, the Court also may consider documents that are referenced extensively in the complaint and are accepted by all parties as authentic, even though the documents are not physically attached to the complaint. *In re Silicon Graphics, Inc. Securities Litigation,* 183 F.3d 970 (9th Cir.1999).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

**2. The Demand Requirement**

A derivative complaint must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Fed.R.Civ.P. 23.1. The existence and satisfaction of a demand requirement is a substantive issue governed by state law. *See Kamen v. Kemper Financial Services, Inc.,* 500 U.S. 90, 96-97, 111 S.Ct. 1711, 114 L.Ed.2d 152 (1991).[FN4] When the challenged decision is that of the board in place at the time of the filing of the complaint, failure to make demand may be excused if a plaintiff can raise a reason to doubt that a majority of the board is disinterested or independent or that the challenged acts were the product of the board's valid exercise of business judgment. *Aronson v. Lewis,* 473 A.2d 805, 812 (Del.1984); *see also Ryan v. Gifford,* 918 A.2d 341, 352 (Del.Ch.2007) (discussing *Aronson* ). However, "[w]here there is no conscious decision by the corporate board of directors to act or refrain from acting, the business judgment rule has no application." *Rales v. Blasband,* 634 A.2d 927, 933 (Del.1993); *see also Ryan,* 918 A.2d at 352 (discussing *Rales* ). In such a situation, demand may be excused only if a plaintiff "can create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." *Id.* at 353 (citing *Rales,* 634 A.3d 933-34).

FN4. The parties agree that Delaware law applies to the instant action because Ditech is incorporated in Delaware.

## III. DISCUSSION

### 1. Motion to Dismiss for Failure to State a Claim Upon Which Relief Can Be Granted

a. *Claim One: Violation of Section 10(b) and Rule 10b-5*

i. Sufficiency of the Allegations

***5** Plaintiffs allege securities fraud in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. Complaint ¶ 99. Plaintiffs summarize their claim as follows:

Plaintiffs allege that (1) Defendants committed a variety of manipulative and deceptive acts, including backdating stock option grants and producing and disseminating false financial statements, false proxy statements, and false Form 4s, ¶¶ 54-63; (2) Defendants' misconduct was in furtherance of their scheme to defraud the Company, ¶¶ 88-90, 98-103; (3) Defendants engaged in their fraudulent scheme knowingly and deliberately, i.e., with scienter, ¶¶ 54-59, 61-63; and (4) the Company relied on Defendants' fraud in granting the Officer Defendants options to purchase Ditech common stock, ¶¶ 37-38, 41, 46-49-53.

Opposition to Motion One 18.[FN5]

FN5. Plaintiffs do not assert that springloading supports liability under the federal claims.

Section 10(b) makes it unlawful

[t]o 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

(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 cases involving publicly-traded securities and purchases or sales in public securities markets, the elements of an action under Section 10(b) and Rule 10b-5 are: (1) a material misrepresentation or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

Plaintiffs must meet two heightened pleading standards. Fed.R.Civ.P. 9(b) requires that "the circumstances constituting fraud ... be stated with particularity."The Ninth Circuit has explained that a "plaintiff must include statements regarding the time, place, and nature of the alleged fraudulent activities, and that mere conclusory allegations of fraud are insufficient." *In re GlenFed, Inc. Securities Litigation,* 42 F.3d 1541, 1548 (9th Cir.1994). A plaintiff asserting fraud "must set forth an explanation as to why the statement or omission complained of was false or misleading."*Id.* (internal quotation marks omitted); *see also Yourish v. California Amplifier,* 191 F.3d 983, 992-93 (9th Cir.1999). The Private Securities Litigation Reform Act ("PSLRA") raises the pleading standard further:

***6** (1) Misleading statements and omissions

In any private action arising under this chapter in which the plaintiff alleges that the defendant-

(A) made an untrue statement of a material fact; or

(B) 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; 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.

(2) Required state of mind

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-4b(1)-(2).

Plaintiffs assert that they "undeniably plead all of the elements necessary to state a claim for "scheme liability." The Court disagrees. The Complaint alleges a very limited number of facts that pertain to a subset of the defendants, but then attempts to impose liability on all the Individual Defendants. In addition to this global deficiency, at least two major inadequacies require dismissal.[FN6]

FN6. In dismissing this claim on these grounds, the Court expresses no opinion as to other argued grounds for dismissal forwarded by the Individual Defendants, such as the sufficiency of the pleading of damage to Ditech or causation. Nor does the Court deem it necessary to discuss arguments it does not reach as to the other claims.

First, Plaintiffs assert that their claim is for violation of Rule 10b-5(a) and (c), not for violation of Rule 10b-5(b), which pertains to material untrue statements or omissions. *Id.* This assertion is confusing given Plaintiffs' emphasis on the alleged production and dissemination of false financial statements, proxy statements, and Form 4's. In light of this ambiguity, while Plaintiffs may have stated with particularity some portion of the supposed universe of Defendants' fraudulent conduct, the extent of this alleged fraudulent conduct remains unclear. Not only must Plaintiffs give Defendants notice of what acts constitute the alleged violations, but, as discussed below, the nature of the viola-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

tion is relevant to the statute of limitations analysis. Accordingly, Plaintiffs may not proceed with this claim as presently stated.

Second, the Complaint fails to allege scienter sufficiently. The Complaint alleges no *facts* that give rise to a strong inference that the non-director defendants knew that the options they received were backdated or that the directors who joined after the final alleged backdated grant participated in the backdating scheme. Even the participation and knowledge of the remaining members of the board during the time of the options grants is pled without factual particularity. Instead, the Complaint alleges generically that the Compensation Committee acted "with the knowledge and approval of the other members of the Board."Complaint ¶¶ 37, 40, 42. The high rank of various Defendants within the Company is insufficient, without more, to impose liability, and the conclusory allegation that each individual defendant had knowledge or acted with reckless disregard of the truth is insufficient to state a claim even under the more liberal Rule 12(b)(6) standard. *See e.g. Assoc. Gen. Contractors, Inc. v. Metro. Water Dist. of So. Cal.,* 159 F.3d 1178, 1181 (9th Cir.1998); *see also Bell Atlantic v. Twombly,* ---U.S. ----, ---- - ----, 127 S.Ct. 1955, 1964-65, 167 L.Ed.2d 929, ---- - ---- (May 21, 2007) (explaining that a plaintiff's obligation to state the ground for relief "requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do") (citations omitted).

***7** Other courts within this district have considered the presence or absence of a pattern of backdating, primarily in the context of the demand futility requirement. *See e.g. In re CNET Networks, Inc. Deriv. Litig.,* 483 F.Supp.2d 947 (N.D.Cal.2007); *In re Zoran Corp. Deriv. Litig.,* 2007 WL 1650948 (N.D.Cal. June 5, 2007); *In re Openwave Systems Inc. Deriv. Litig.,* 2007 WL 1456039 (N.D.Cal., May 17, 2007); *In re Linear Tech. Corp. Deriv. Litig.,* 2006 WL 3533024 (N.D.Cal. Dec.7, 2006). As currently pled, the Complaint alleges fraudulent conduct by labeling various grants as backdated and describing them as having been made at low points within certain defined periods. *See e.g.* Complaint ¶¶ 37, 42-46. While counsel for Plaintiffs represented at oral argument that the statistical likelihood of the options having been granted properly is very low, that theory is not alleged in the Complaint or in a document that the Court may consider on this motion. Even assuming that the *factual* allegations of the Complaint are true, many explanations other than options backdating exist for the coincidence of the grants and a low share price.[FN7] The following factual detail likely would strengthen the Complaint: the degree to which the options were granted at the discretion of the compensation committee or the board, versus at fixed, preestablished times; the actual grant dates of the options and the appropriate price of the options; the date that the options were exercised; whether required performance goals were met before the options were granted; the presence or absence of other major corporate events, such as an acquisition, at the time of the grants; and the results of any requests by Plaintiff for information.

> FN7. The Court does not hold that a plaintiff must allege a pattern of backdating in order to state a claim under Section 10(b), to establish demand futility, or to state a claim for breach of fiduciary duty. *See CNET,* 483 F.Supp.2d at 956-58 (describing analytical methods as one way to support an inference of illegal conduct when "direct evidence is rare and difficult to uncover"). For example, a plaintiff likely could proceed past the pleading stage by alleging sufficient factual detail as to the mechanics of an option backdating scheme, including the specific roles and mental states of the various participants. In such a case, the fact that the defendants only backdated one option grant or did not grant themselves the largest possible benefit (and thus failed to generate a statistically implausible pattern) would not be an automatic bar to liability.

ii. Statute of Limitations

[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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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); *see e.g. In re Heritage Bond Litig.,* 289 F.Supp.2d 1132, 1147-48 (C.D.Cal.2003). This statute of limitations is not subject to equitable tolling. *Durning v. Citibank, In'l,* 990 F.2d 1133, 1136-37 (9th Cir.1993). Claim one, asserting a violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act, alleges and involves fraud. *See* Complaint ¶ 99. Accordingly, Section 1658 applies to this claim. Because the practice of backdating options came to light in 2005, the Court concludes that the two-year discovery period does not bar the instant action. Accordingly, the applicable period for this analysis is the five-year period of repose.[FN8]

FN8.“A statute of repose is a fixed, statutory cutoff date, usually independent of any variable, such as claimant's awareness of a violation.” *Munoz v. Ashcroft,* 339 F.3d 950, 957 (9th Cir.2003) (citing *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 501 U.S. 350, 363, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991)).

In light of the statute's focus on the “violation,” the Court first must decide what comprises the alleged violation. The primary focus of the claim appears to be on the backdating of options.[FN9] To the extent that the claim is based upon the backdating itself, the period of repose starts on the date that the option grant was made. *See Durning,* 990 F.2d at 1136 (noting that the federal rule is that a cause of action accrues at the completion of the sale of the instrument); *Falkowski v. Imation Corp.,* 309 F.3d 1123, 1130 (9th Cir.2002) (describing the grant of an option as “a purchase or sale” under the Securities Litigation Uniform Standards Act). The last alleged purported date of a backdated option is January 10, 2001. This option was reported in a proxy statement filed with the SEC on August 8, 2001, so even though the actual date of the options grant is not alleged, it could not have been granted after that date. Because the initial complaint was filed on August 23, 2006, any improper transaction under Section 10(b) must have occurred after August 23, 2001. Accordingly, this claim is time-barred to the extent that it is based upon the actual backdated grants.

FN9. Plaintiffs do not argue that option spring-loading would support a claim under the federal securities laws.

***8** Plaintiffs also appear to suggest that the Individual Defendants violated Section 10(b) by disseminating false financial statements. However, as noted above, Plaintiffs state in opposition to the instant motion that they do not assert a claim under Rule 10b-5(b), which makes it unlawful to make an untrue statement or to omit a material fact. Opposition to Motion One 18. Consequently, it is by no means clear how the alleged fraudulent financial statements fit into the first claim. Plaintiffs have not pled them as an independent violation of Section 10(b); indeed, they appear to acknowledge their failure to do so by disclaiming any need to plead the elements of a violation of Rule 10b-5(b).*See* Opposition to Motion One 18. While Plaintiffs refer to a fraudulent scheme in the Complaint, *see e.g.* Complaint ¶¶ 2-4, they do not allege such a scheme with any particularity and, as noted above, fail to allege with any factual detail the involvement of a large number of the Individual Defendants. In light of these inadequacies, the Court concludes that it is premature to rule out the possibility that Plaintiffs will be able to plead a violation of Section 10(b) based upon fraudulent financial statements that is not time-barred. In reaching this conclusion, the Court notes the Individual Defendants' argument that the period of repose starts when the misrepresentation is made for the first time. At least one court in this district has accepted this argument, *see Zoran,* 2007 WL 1650948 *21(citing *Asdar Group v. Pillsbury, Madison, and Sutro,* 99 F.3d 289, 294-95 (9th Cir.1996) (“[A] statute of limitations [for a Section 10(b) claim] ordinarily begins to run when an act occurs that gives rise to liability ....”))[FN10] As it indicated at oral argument, the Court is highly skeptical of a continuing

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

wrong theory FN11 that would allow the revival of a time-barred claim under Section 10(b) upon the issuance of a further financial statement that failed to correct the prior false statement. Such a theory appears to approximate the effects of the fraudulent concealment doctrine of equitable tolling, a doctrine that does not apply in the Section 10(b) context.

FN10. The court explained in *In re Dynex Capital, Inc. Sec. Litig.,* 2006 WL 314524 *5 (S.D.N.Y. Feb 10, 2006) that while it concluded that a series of misrepresentations were not barred by the period of repose when the alleged securities transaction fell within the five-year period, it had held in a previous case that a claim was time-barred when the underlying securities transaction fell outside the five-year period. *Dynex,* 2006 WL 314524 at n. 4 (citing *Shalam v. KPMG, L.L.P.,* 2005 WL 2139928 *2 (S.D.N.Y. Sept.6, 2005)). Thus, even if *Dynex* were binding authority, which it is not, it would not necessarily dictate the outcome suggested by Plaintiffs.

FN11. Any such theory would be distinct from the continuing wrong exception, recognized by other courts, *see e.g. Bateson v. Magna Oil Corp.,* 414 F.2d 128, 130 (5th Cir.1969), to the continuous ownership requirement of Rule 23.1 that allows standing to maintain a claim for an entire course of a continuing wrong even if a portion of those events occurred prior to the plaintiff's acquisition of stock in the nominal defendant.

iii. Leave to Amend

Counsel for Plaintiffs represented at oral argument that he believed that Plaintiffs could allege further facts that would allow them to address both the time-bar and the current lack of particularity in the Complaint. Accordingly, this claim will be dismissed with leave to amend.

b. *Claim Two: Violation of Section 14(a)*

Rule 14a-9 provides:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

***9** 17 C.F.R. § 240.14a-9(a). To state a claim under Rule 14a-9 and Section 14(a), a plaintiff must allege a false or misleading statement or omission of material fact; that the misstatement or omission was made with the requisite level of culpability; and that it was an essential link in the accomplishment of the transaction. *Desaigoudar v. Meyercord,* 223 F.3d 1020, 1022 (9th Cir.2000).

The Individual Defendants argue that the extended limitations period under 28 U.S.C. § 1658 does not apply to actions under Section 14(a), and that a Section 14(a) claim must be filed one year after discovery of the facts constituting the violation, and in no event more than three years following publication of the false statement. Individual Defendants' Motion 8 (citing *In re Exxon Mobil Corp. Sec. Litig.,* 387 F.Supp.2d 407, 424 (D.N.J.2005); *In re Global Crossing, Ltd. Sec. Litig.,* 313 F.Supp.2d 189, 196-97 (S.D.N.Y.2003). Plaintiffs do not respond to this argument, and the Court concludes that it should apply the one/three-year limitations period. *Accord Zoran,* 2007 WL 1650948 * 24. The last proxy statement containing an allegedly false statement was filed on August 8, 2001, Complaint ¶ 61, and the initial complaint was filed on August 23, 2006. Plaintiffs provide no specific argument explaining why the Section 14(a) claim is not time-barred, but they appear to imply that it survives under a continuing wrong theory. However, nothing is pled that would support such a theory, as even the part of the fraudulent scheme pled with respect to that claim apparently ends in 2001, outside the three-year period of repose. *See* Complaint ¶

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

106. Moreover, it is unclear how false statements in financial filings other than proxy statements (such as Form 4's) could revive a claim under Section 14(a), which pertains to proxy statements. Accordingly, the Court concludes that claim two is time-barred as currently pled and should be dismissed with leave to amend.

The Individual Defendants also argue that Plaintiffs fail to allege which Defendants made the false statements, specific facts that support a strong inference of negligence, and specific facts supporting causation. The Court does not reach the Individual Defendants' challenges to the sufficiency of the allegations, but notes that, assuming without deciding that the PSLRA also applies to Section 14(a) claims, *see e.g. In re Textainer Partnership Securities Litig.,* 2005 WL 3801596 (N.D.Cal. March 8, 2005), *In re McKesson HBOC, Inc. Sec. Litig.,* 126 F.Supp.2d 1248, 1267 (N.D.Cal.2000), greater specificity likely would strengthen this claim considerably.[FN12]

> FN12. This Court has held in another action that the PSLRA has foreclosed the application of the "group published pleading" doctrine, which provides that when false or misleading information is conveyed in group published statements, it is reasonable to presume that the statements are the result of the collective actions of the company's officers. *In re Nextcard, Inc. Sec. Litig.,* 2006 WL 708663 *2-3 (N.D.Cal. March 20, 2006). Since it is not clear to what extent the first claim is based upon false statements made by the defendants, *see* Opposition to Motion One 18, that holding may not be relevant to the first claim. However, it likely will be relevant to the sufficiency of any amended claim under Section 14(a).

c. *Claim Three: Violation of Section 20(a)*

To state a claim under Section 20(a), a plaintiff must allege (1) a primary violation of federal securities laws; and (2) that the defendant exercised actual power or control over the primary violator. *Howard v. Everex Systems, Inc.,* 228 F.3d 1057, 1065 (9th Cir.2000). As discussed above, Plaintiffs have failed to state a claim for a primary violation of the securities laws. The statute of limitations analysis pertaining to the Section 10(b) claim applies equally to the Section 20(a) claim. *See e.g. In re Heritage Bond Litigation,* 289 F.Supp.2d at 1148. Accordingly, this claim also will be dismissed with leave to amend.

d. *Claims Four to Nine: Violations of Delaware Law*

i. Statute of Limitations

***10** The parties agree that a three-year statute of limitations applies to the claims asserted under Delaware law. Plaintiffs argue that the running of this period was tolled because the injury was inherently unknowable, because the defendants engaged in fraudulent concealment, and because Plaintiffs relied on the competence and good faith of a fiduciary. "[P]laintiffs bear the burden of pleading specific facts to demonstrate that the statute of limitations was, in fact, tolled." *In re Dean Witter P'Ship Litig.,* 1998 WL 442456 *6 (Del.Ch. July 17, 1998). The Complaint alleges that the Individual Defendants colluded with one another to "conceal[ ] the improper backdating of stock options."Complaint ¶ 6(d); *see also* Complaint ¶¶ 57, 114, 120. It also identifies the signatories to seven Form 10-K filings that disseminated false financial statements. Complaint ¶ 55. Under Delaware law, if a plaintiff "alleges that defendants intentionally falsified public disclosures, defendants may not rely on the statute of limitations as a defense until plaintiff is placed on inquiry notice that such filings were fraudulent." *Ryan,* 918 A.2d at 360. The Court concludes that Plaintiffs have pled intentional falsification of proxy statements and other public disclosures sufficiently to toll the statue of limitations under the fraudulent concealment doctrine. The Individual Defendants do not argue that the claims would be time-barred even if the statute of limitations was tolled until the Plaintiffs were put on inquiry notice. Accordingly, the Court concludes that the state law claims are not time-barred.

ii. Sufficiency of the Claims

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

(1) Claims Four and Seven: Accounting and Rescission

The Individual Defendants argue that the fourth and seventh claims in the Complaint should be included as remedies, not as independent claims. Plaintiffs do not respond to this argument in their opposition. The Court agrees with Defendants that Plaintiffs should include accounting and rescission as remedies in any amended complaint.

(2) Claim Five: Breach of Fiduciary Duty

As discussed above, the Complaint contains no factual allegations as to the knowledge of the options recipients and instead makes only conclusory allegations that do not satisfy Rule 12(b)(6). While the PSLRA does not apply to this claim or the other claims under Delaware law, because the options backdating sounds in fraud, *see* Complaint ¶ 99, Plaintiffs also must plead the circumstances of the fraud with particularity. Fed.R.Civ.P. 9(b); *Atlantis Plastic Corp. v. Sammons,* 558 A.2d 1062, 1066 (Del.Ch.1989) (stating same rule under Delaware law). Plaintiffs fail to do so. Accordingly, this claim will be dismissed with leave to amend.

(3) Claim Six: Unjust Enrichment

The Individual Defendants argue that the Complaint fails to state a claim for unjust enrichment because Plaintiffs fail to allege that other adequate remedies are not provided by law or that the options recipients were enriched unjustly. Individual Defendants' Motion 25. Plaintiffs do not respond to these arguments in their opposition. Plaintiffs asserted the validity of this claim at oral argument, however, and at least one Delaware case suggests that option backdating will support a claim for unjust enrichment. *Ryan,* 918 A.2d at 361. Accordingly, while the Court concludes that the unjust enrichment claim should be dismissed, leave to amend will be granted.

(4) Claim Eight: Insider Selling

***11** The Complaint alleges that the Insider Selling Defendants breached their fiduciary duties of loyalty and good faith by selling stock when in possession of material, non-public information. Complaint ¶¶ 115-18. To determine the sufficiency of insider selling allegations, Delaware courts look to whether a complaint contains "particularized facts providing an inference of insider trading." *Guttman v. Huang,* 823 A.2d 492, 503 (Del.Ch.2003). The Complaint alleges that the Insider Selling Defendants sold a certain amount of shares for a certain amount of "proceeds garnered" within a range of dates. Complaint ¶ 87. For example, it alleges that Montgomery sold 1,163,200 shares between the dates of October 5, 1999 and December 16, 2004, for proceeds garnered of $39,188,259. *Id.* It does not identify the date or amount of individual transactions; instead, it provides only aggregate totals by defendant. Accordingly, the Complaint fails to allege particularized facts sufficient to state a claim for insider selling. The eighth claim will be dismissed with leave to amend.[FN13]

FN13. Plaintiffs do not respond to the Individual Defendants' argument that the Complaint fails to state a claim for insider selling due to the lack of such specificity and appear to have abandoned this claim. However, in light of the statements made by counsel for Plaintiffs and the grant of leave to amend the rest of the Complaint, leave to amend is also appropriate as to this claim.

(5) Claim Nine: Breach of Fiduciary Duty by Options Springloading

The Complaint alleges that the Individual Defendants "breached their fiduciary duties by ... engaging in a scheme to grant spring-loaded stock options to themselves and/or certain other officers and directors of the Company and cover up their misconduct."Complaint ¶ 122.[FN14]The Complaint alleges that Tamblyn, Transgrud, and Aras received springloaded options on May 18, 2004. Complaint ¶ 49. The Complaint also alleges that "the Individual Defendants agreed to and did participate with and/or aided and abetted one another in a deliberate cause of action designed to divert corporate assets to themselves and/or other Company in-

siders."Complaint ¶ 123.[FN15] However, the Complaint does not allege which defendants authorized the grants, approved the grants, or intended or had knowledge that the grants were springloaded. Nor does the Complaint allege the specific material information that had not been made public previously. As is the case with the fifth claim, because the springloading claim sounds in fraud, *see* Complaint ¶ 128 (describing stock option grants in the relevant period as obtained by fraud), Plaintiffs must plead the circumstances of the fraud with particularity. Fed.R.Civ.P. 9(b); *see also Atlantis Plastics Corp.,* 558 A.2d at 1066 (stating same rule under Delaware law). Plaintiffs fail to do so here. While it is not clear that Plaintiff will be able to state a claim for breach of fiduciary duty by identifying only one allegedly improper grant date, the law in this area is still developing and the Delaware Chancery has permitted at least one claim for breach of the duty of loyalty and good faith to proceed on a springloading theory. *See In re Tyson Foods,* 919 A.2d 563, 593 (Del.Ch.2007). Accordingly, the claim will be dismissed with leave to amend.

FN14. The Complaint repeats certain paragraph numbers. This cite refers to the paragraph bearing this number that appears under the heading "Count IX," not that which appears under the heading "Count V."

FN15. In a portion of a recent decision concluding that plaintiffs had failed to allege sufficient facts to establish demand futility, the Delaware Court of Chancery observed that a "spineless 'and/or' is a telling concession that [plaintiff] cannot cross even the minimal Rule 11 threshold."Order Dismissing Complaint 51, *Desimone v. Barrows,* Case No. 2210-VCS (Del.Ch., June 7, 2007). While not directly applicable to the instant motion, this reference to Rule 11 bears notice as it reminds Plaintiffs that any amended complaint must be based upon appropriate investigation.

> While the Court appreciates the efforts of counsel for each side to bring to its attention new cases in this rapidly developing area of law, it concludes that it should defer a detailed discussion of *Desimone.*Its distinction of *In re Tyson Foods,* 919 A.2d 563, 593 (Del.Ch.2007) and its discussion of demand futility likely will provide guidance to the Court in subsequent motion practice. However, the Complaint's lack of detail makes a similar analysis premature in the instant action.

**2. Motion to Dismiss for Failure to Make Demand**

a. *Standing Under Rule 23.1*

***12** Ditech argues that Plaintiffs lack standing because they allege only that they have held stock in Ditech at all relevant periods. *See* Complaint ¶¶ 10-12. Ditech cites a number of non-binding cases from other districts in support of this proposition. Because the Court will dismiss the Complaint with leave to amend on other grounds, it need not decide the appropriate level of detail in the pleading of share ownership. Nonetheless, it recommends that Plaintiffs amend this aspect of the Complaint.

b. *Disinterestedness and Independence*

Ditech argues that Plaintiffs have failed to allege sufficient facts to raise a reasonable doubt as to the disinterestedness and independence of a majority of the present Board. Ditech concedes that Montgomery is not independent or impartial, and Plaintiffs do not argue that Harper cannot act independently or impartially. Accordingly, the question as to the independence and disinterestedness of the Board revolves around four members: Avis, Hasler, Manoliu, and Sugishita. Hasler and Avis were on the Board during the entire period of alleged backdating. Complaint ¶¶ 25-26. Manoliu joined the Board prior to the final alleged backdated grant. Complaint ¶ 28. Sugishita joined the Board prior to the alleged springloaded grant. Complaint ¶ 29. Ditech points out that the Company's policy that the compensation committee makes option grant decisions would limit the challenged decisions to a subset of the existing Board. Motion Two 22. However, Plaintiffs allege that this

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

policy was not followed in multiple respects and that, while the Compensation Committee backdated the grants, the other members of the Board had knowledge and approved of the backdating. Complaint ¶ 37. Accordingly, assuming that an amended complaint alleges with sufficient particularity that each of these directors approved the option grants or otherwise participated in wrongful conduct, Plaintiffs may be able to plead demand futility on the basis of an insufficient number of disinterested and independent directors. However, the Court concludes that it is premature to make such a determination because Plaintiffs have failed to allege with sufficient particularity that any options backdating or other actionable misconduct occurred at Ditech.

c. *The Business Judgment Rule*

Ditech argues that the second prong of the *Aronson* demand futility test, which inquires whether a plaintiff can identify a reason to doubt that the challenged acts were the product of the board's valid exercise of business judgment, does not apply because the "board that would be considering the demand did not make a business decision which is being challenged in the derivative suit." *Rales,* 634 A.2d at 933-34. As discussed above, the threshold question is the role of the members of the board when the Complaint was filed. "Where at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, the *Aronson* test applies." *Ryan,* 918 A.2d at 353. As with the disinterestedness and independence inquiry, assuming that Plaintiffs can amend to add sufficient particularity, it appears possible that this aspect of the *Aronson* test applies to some or all of the surviving claims. However, the Court also concludes that it is premature to determine the presence or absence of a valid business judgment behind the decision to engage in the alleged misconduct.

**IV. ORDER**

***13** Good cause therefor appearing, IT IS HEREBY ORDERED that the motion to dismiss for failure to state a claim upon which relief can be granted is GRANTED WITH LEAVE TO AMEND and the motion to dismiss for failure to make demand is DEFERRED. Any amended complaint shall be filed within thirty days of the date of this order.

N.D.Cal.,2007.
In re Ditech Networks, Inc. Derivative Litigation
Not Reported in F.Supp.2d, 2007 WL 2070300 (N.D.Cal.), Fed. Sec. L. Rep. P 94,440

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-6

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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 over-charging 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-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-7

Westlaw.



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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 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*

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 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 indi-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

vidual 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 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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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."

*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

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 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.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

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 physi-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

cian and a urologist, opines that the combination of the exposure, temporally connected to symptoms 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?

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 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 alleg-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

ations 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 regarding 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.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-8

H
Only the Westlaw citation is currently available.

United States District Court, N.D. California,
San Jose Division.
In re IMPAX LABORATORIES, INC. SECURITIES LITIGATION.
**No. C 04-04802 JW.**

Jan. 3, 2007.

Patrick J. Coughlin, Darren Jay Robbins, Willow E. Radcliffe, Coughlin Stoia Geller Rudman & Robbins LLP, San Francisco, CA, William S. Lerach, Lerach Coughlin Stoia Geller Rudman & Robbins LLP, San Diego, CA, for Plainfiffs.

Dale E. Barnes, Jr., Bingham McCutchen LLP, San Francisco, CA, Joseph Otto Click, Blank Rome LLP, Kerry Brainard, Michael Joseph, Washington, DC, for Defendants.

Monique C. Winkler, Coughlin Stoia Geller Rudman & Robbins LLP, San Francisco, CA, Shana E. Scarlett, Hagens Berman Sobol Shapiro LLP, Berkeley, CA, Tricia Lynn Mccormick, Coughlin Stoia Geller Rudman & Robbins LLP, San Diego, CA, Elizabeth Pei Lin, Milberg Weiss & Bershad LLP, Los Angeles, CA, for Movant.

Azra Z. Mehdi, Daniel Jacob Pfefferbaum, Coughlin Stoia Geller Rudman & Robbins LLP, Robert S. Green, Green Welling LLP, San Francisco, CA, for Plainfiffs/Movant.

**ORDER GRANTING DEFENDANTS' MOTION TO DISMISS SECOND AMENDED CONSOLIDATED COMPLAINT WITH LEAVE TO AMEND**

JAMES WARE, District Judge.

***I. INTRODUCTION***

***1** This is a securities fraud class action suit brought on behalf of investors who acquired Impax Laboratories, Inc. ("Impax") securities between May 5, 2004 and November 3, 2004 (the "Class Period") against Impax and certain of Impax's senior officers and directors (collectively, "Defendants"). Impax is a specialty pharmaceutical company that develops, sells, and markets generic pharmaceuticals, including generic equivalents of drugs Wellbutrin and Zyban. Plaintiffs allege violations of Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act"). Before the Court is Defendants' Motion to Dismiss the Second Amended Consolidated Complaint. The Court conducted a hearing on November 8, 2006. Based upon the papers submitted to date and the oral arguments of counsel, the Court GRANTS Defendants' Motion to Dismiss with leave to amend.

***II. BACKGROUND***

Plaintiffs filed this suit on behalf of all persons who purchased Impax securities during the Class Period. Plaintiffs allege the following:

> Plaintiffs purchased Impax securities during the Class Period and suffered losses as a result of Defendants' actions. (Second Amended Consolidated Complaint for Violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 ¶¶ 12-13, hereafter, "SAC," Docket Item No. 83.) Defendant Impax is a pharmaceutical company that develops, sells, and markets generic pharmaceuticals, including variations of bupropion hydrochloride ("bupropion"), the generic version of Wellbutrin and Zyban. (SAC ¶ 2.) Individual Defendants Barry R. Edwards, Dr. Charles Hsiao, Dr. Larry Hsu, Cornel C. Spiegler, David S. Doll, and David J. Edwards were directors, officers, or high-ranking employees of Impax during the Class Period. (SAC ¶¶ 15-20.)

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Non-party Teva Pharmaceuticals Industries, Ltd. ("Teva") is a global pharmaceutical company that specializes in the production of generic versions of branded pharmaceuticals. Teva entered into a Strategic Alliance Agreement ("SAA") with Impax in June 2001. The SAA granted Teva exclusive U.S. prescription-marketing rights for six Impax products, including Wellbutrin and Zyban generics, and provided for the two companies to share profits. (SAC ¶¶ 39-41.) Non-party Andrx Corporation ("Andrx") was also a signatory to the SAA. (SAC ¶ 6.)

On May 5, 2004, Impax announced its first profitable quarter, 1Q04. (SAC ¶ 51.) In response, Impax stock increased $3.70 on a trading volume of almost 3.7 million shares. (SAC ¶ 2.) The increase was primarily due to sales of bupropion products. *Id.* On August 4, 2004, Impax announced a second profitable quarter, 2Q04. (SAC ¶ 4.) On November 3, 2004, Impax announced a delay in the release of 3Q04 financial results in order for it to review customer credits on bupropion products. (SAC ¶ 63.) Also on November 3, Andrx announced that customer credits granted by Teva would result in a $9 million decrease in Andrx revenues and operating income. (SAC ¶ 6.) These two announcements caused Impax's share price to fall from $13.00 to $10.07, a one-day decline of 23 percent on a trading volume of 6.77 million shares. *Id.* On November 9, 2004, Impax announced that it was restating its financial results for 1Q04 and 2Q04 due to adjustments made as a result of March 2004 customer credits granted by Teva on sale of Impax bupropion products. (SAC ¶ 7.) Impax simultaneously announced positive news regarding the FDA's approval of two new drug applications and the submission of a new drug application for the generic version of Concerta. *Id.* Impax's stock increased to $13 .30 on November 11, 2004. *Id.*

***2** Plaintiffs' Second Amended Complaint alleges two causes of action against Impax: (1) Claim 1, for violation of Section 10(b) of the Exchange Act and Rule 10b-5, by issuing false or misleading statements about Impax's reserves, revenues, and income, and (2) Claim 2, for violation of Section 20(a) of the Exchange Act, for control person liability. Presently before the Court is Defendants' Motion to Dismiss pursuant to the Private Securities Litigation Reform Act of 1995 ("PSLRA") and Federal Rules of Civil Procedure 9(b) and 12(b)(6).[FN1] Defendants contend that Plaintiffs have failed adequately to allege loss causation and scienter.

FN1. Plaintiffs filed a Motion to Strike and Opposition to Defendants' Request for Judicial Notice in Support of Defendants' Motion to Dismiss (hereafter, "Motion to Strike," Docket Item No. 96.) Plaintiffs oppose judicial notice of Defendants' Exhibits P-U (analysts' reports), Y (website), and Z (report) and move to strike Defendants' arguments based on these materials. (Motion to Strike at 1-2.) Since the Court's Order does not reference any of these exhibits, Plaintiffs' Motion to Strike is denied as moot.

### *III. STANDARDS*

A court may dismiss a complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for pleading "insufficient facts under a cognizable legal theory." *Robertson v. Dean Witter Reynolds Co.,* 749 F.2d 530, 534 (9th Cir.1984). When deciding a motion to dismiss a complaint under Rule 12(b)(6), the court takes all material allegations in the complaint as true and construes those material allegations in the light most favorable to the non-moving party. *Sanders v. Kennedy,* 794 F.2d 478, 481 (9th Cir.1986); *NL Indus., Inc. v. Kaplan,* 792 F.2d 896, 898 (9th Cir.1986). However, the court need not accept wholly conclusory allegations. *Western Mining Council v. Watt,* 643 F.2d 618, 624 (9th Cir.1981), cert. denied, 454 U.S. 1031, 102 S.Ct. 567, 70 L.Ed.2d 474 (1981); *Kennedy v. H & M Landing, Inc.,* 529 F.2d 987, 989 (9th Cir.1976).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Claims brought under Section 10(b) of the Exchange Act and Rule 10b-5 must meet the particularity requirements of Federal Rule of Civil Procedure 9(b). *In re Daou Sys., Inc. Sec. Litig.,* 411 F.3d 1006, 1014 (9th Cir.2005).Rule 9(b) requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."

Moreover, claims brought under Section 10(b) and Rule 10b-5 must also meet the stringent pleading standards of the Private Securities Litigation Reform Act of 1995. To plead a violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, a plaintiff must allege (1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss. *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005). The PSLRA amends the Exchange Act to require that a private securities fraud litigation complaint "plead with particularity both falsity and scienter." *In re Daou,* 411 F.3d at 1014.Specifically, a complaint alleging securities fraud 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, the complaint shall state with particularity all facts on which that belief is formed."15 U.S.C. § 78u-4(b) (1); *In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1085 (9th Cir.2002).

### *IV. DISCUSSION*

***3** Defendants challenge the particularity and sufficiency of Plaintiffs' pleadings with respect to scienter and loss causation.

#### A. *Loss Causation*

Defendants contend that the Second Amended Complaint does not sufficiently allege the causal connection between a misrepresentation and a loss that is required to satisfy Rule 10b-5's pleading requirements. (Defendants' Notice of Motion and Motion to Dismiss Second Amended Consolidated Complaint and Memorandum of Points and Authorities in Support Thereof at 17-18, hereafter, "Motion," Docket Item No. 90.) Plaintiffs contend that they have satisfied the loss causation pleading requirement of Federal Rule of Civil Procedure 8(a)(2) by describing the relevant economic loss and providing an indication of the causal connection between their loss and Defendants' misconduct. (Plaintiffs' Opposition to Defendants' Motion to Dismiss Second Amended Consolidated Complaint at 21, hereafter, "Opposition," Docket Item No. 94.)

To plead loss causation adequately, a plaintiff must allege a causal connection between the defendant's material misrepresentation and the plaintiff's loss; that is, the "misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security."15 U.S.C. § 78u-4(b)(4); *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005); *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 173 (2nd Cir.2005). The plaintiff "must allege ... that the *subject* of the fraudulent statement or omission was the cause of the actual loss." *Lentell,* 396 F.3d at 173 (quoting *Suez Equity Investors, L.P. v. Toronto Dominion Bank,* 250 F.3d 87, 95 (2nd Cir.2001) (emphasis in original.)) If a plaintiff alleges a fraud on the market, a mere allegation of an inflated purchase price does not constitute or proximately cause a relevant economic loss, because:

> [A]t the moment that the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if,

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price might mean a later loss. But this is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, or other events, which taken separately or together account for some or all of that lower price.

*Id.* at 342-43.

The Ninth Circuit considered loss causation under the *Dura* framework in the case of *In re Daou Systems, Inc.,* 411 F.3d 1006, 1014 (9th Cir.2005). The court held that the *Daou* complaint adequately pled loss causation by alleging that "the drop in Daou's stock price was causally related to Daou's financial misstatements reflecting its practice of prematurely recognizing revenue before it was earned."*Id.* at 1026.The complaint alleged that the defendants' belated revelation of the company's true financial condition "led to a 'dramatic, negative effect on the market, causing Daou's stock to decline to $3.25 per share, a staggering 90% drop from the Class Period high of $34.375 and *a $17 per share drop from early August 1998.' " Id.* (emphasis in original.) Lastly, the complaint alleged that "Daou's stock price has never recovered and the Company has never been able to match the artificially inflated revenues reported during the Class Period." *Id.* The *Daou* court found these allegations sufficient to plead loss causation.

***4** In this case, whether Plaintiffs have adequately pled loss causation is grounded on four events that allegedly occurred between November 3 and November 9, 2004. First, Impax publically announced on November 3 that it was delaying the release of 3Q04 financials to allow its independent auditors more time to complete their review. Second, Andrx, one of Impax's partners, disclosed on November 3 that it was reducing its revenue for sales generated through its agreements with Impax and Teva by $9 million. Third, Impax announced on November 9 that it was restating its 1Q04 and 2Q04 financial results due to customer credits granted by Teva on sales of Impax's bupropion products. Fourth, Impax also disclosed on November 9 that it had submitted a new drug application for the generic version of Concerta to the FDA and that it had received approval for drugs during the third quarter, including a 500 mg generic version of Wellbutrin SR. The Court considers the sufficiency of each allegation for loss causation purposes.

**1. Impax's November 3 Press Release**

Plaintiffs allege that Impax's November 3, 2004 Press Release entitled, "IMPAX Laboratories Postpones Third Quarter 2004 Financial Results Conference Call to Tuesday, November 9, 2004," stated as follows:

IMPAX Laboratories, Inc.... today announced that the Company has postponed its release of 2004 third quarter financial results to Tuesday, November 9, 2004 in order to allow its independent auditors more time to complete their review of the Company's third quarter financial statements, including the timing of certain customer credits on bupropion products marketed by a strategic partner. Results were originally scheduled to be announced on Thursday, November 4, 2004.

(SAC ¶ 161.) Plaintiffs further allege, "On this news, the Company's shares plummeted from $13.00 to $10.07, a one-day decline of 23% on volume of 6.77 million shares."(SAC ¶ 162.)

Applying *Dura,* the Court finds that it is the content of the November 3 press release, rather than its mere issuance, that is critical to the loss-causation analysis. Impax's November 3 announcement concerned only the release of 3Q04 results. The November 3 announcement did not indicate that the

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

1Q04 or 2Q04 financial statements or revenues would be altered. However, Plaintiffs' Second Amended Complaint only alleges material misstatements or omissions with respect to Impax's 1Q04 and 2Q04 financial results. Since Impax's November 3 press release does not address these financial results, the Court finds that it did not disclose a previously made misstatement or omission. Thus, Plaintiffs' allegations that the value of Impax's securities was negatively affected by the November 3 press release are insufficient to allege loss causation under *Dura.*

**2. Andrx's November 3 Disclosure**

Plaintiffs allege that the 23 percent decline in the value of Impax stock on November 3 was also due to information provided to the market by Impax's partner, Andrx:

***5** In its 3Q04 Report on Form 10-Q, issued November 3, 2004, Andrx announced to the market that sales generated through its agreements with Teva and Impax were "significantly impacted by shelf-stock adjustments granted by Teva for generic Wellbutrin SR 150 mg." According to statements made by Andrx's CEO in a press release issued to the market on November 3, 2004, Andrx's share of the customer credits equaled an approximate $9 million decrease in revenues and operating income. This $9 million revenue reduction was a significant portion of the $35.4 million in revenue generated year-to-date for Andrx through bupropion products. This information, released to the market on the same day as Impax's announcement of its own difficulties with customer credits, shed light for investors on the significant impact of Impax's fraud on Impax's revenue restatement and overall financial health.

(SAC ¶¶ 202-03.)

Andrx's announcement of a $9 million decrease in revenues and operating income for 3Q04 suggested, at most, that Impax's *third quarter* results might disappoint investors. However, Andrx's announcement cannot be construed to mean that Impax's first and second quarter financial statements were incorrect or would be restated. Andrx's statements, then, did not represent a public disclosure of the truth with respect to Impax's alleged material misstatements in its 1Q04 and 2Q04 financial statements, as *Dura* requires.[FN2] The Court finds that whether taken separately or together with Impax's November 3 announcement, Plaintiffs' allegations concerning Andrx's statement are insufficient to establish loss causation under *Dura.*

FN2. In finding that the *Dura* plaintiffs had insufficiently pled loss causation, the Supreme Court cited their failure "to claim that Dura's share price fell significantly after the truth became known." *Dura,* 544 U.S. at 347.

**3. Impax's November 9 Announcement Re: Financial Restatements**

Plaintiffs allege that on November 9, Defendants made additional misrepresentations when they disclosed their restatement of first and second quarter results:

[D]efendants revealed that [Impax's] strategic alliance partner, Teva, had accepted large returns from its customers and Impax was forced to announce a restatement of its financial statements for the first and second quarters of 2004. The restatement reduced total revenues for 1Q04 by $4,308,000, from $38,853,000 to $34,545,000. Total revenues for 2Q04 were reduced by $281,000, from $30,845,000 to $30,564,000. On November 9, 2004 defendants issued a press release describing, in part, the details of their restatement of first and second quarter results. In addition, on November 9, 2004, defendants held a conference call to discuss Impax's third quarter financial results. As a part of this conference call, defendants discussed the restatement due to

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

bupropion and made several false representations that suggested the restatement of the bupropion credits was a historical event with a level of certainty and finality.

(SAC ¶¶ 204-05.)

Impax's November 9 disclosure was the first time that the truth about Impax's 1 Q04 and 2Q04 financial results was disclosed to the market. However, Impax's stock value increased by sixty cents on November 9, closing at $11.85. (Defendants' Request for Judicial Notice in Support of Defendants' Motion to Dismiss, hereafter, "RJN," Ex. N, Docket Item No. 92.) FN3 On November 10, Impax's stock again closed up at $12.73. *Id.* On November 11, Impax's stock again closed up at $13.30. *Id.* The November 11 closing price was also an increase over the November 3 closing price of $13.00. FN4 The Court finds that Plaintiffs have not alleged loss causation under *Dura* based on Impax's November 9 disclosure that it would be restating its 1 Q04 and 2Q04 revenues.

FN3. The Court takes judicial notice of Impax's closing stock prices on November 9-11, 2004 pursuant to Federal Rule of Evidence 201.

FN4. The November 3 closing price was the stock price immediately prior to Impax's press release on the evening of November 3, which announced that 3Q04 financial results would be delayed.

**4. Impax's Other Announcements on November 9**

***6** Plaintiffs allege that in Defendants' November 9 conference call, they released positive news to the market that accounts, at least partially, for the increases in Impax's stock price between November 9 and November 11, 2004:

In the November 9, 2004 conference call, defendants disclosed for the first time that it [sic] had submitted an ANDA [abbreviated New Drug Application] for the generic version of Concerta to the FDA. Impax also confirmed that it had received ANDA approval for two drugs during the third quarter, the 500 mg version of Wellbutrin SR and a generic version of 80 mg Oxycontin. By revealing these positive milestones for the Company on November 9, 2004, defendants offset the negative news of their restatement. Analysts confirmed the importance of these additions to Impax's forecasts. On November 9, 2004, Credit Suisse First Boston issued an analyst report that confirming [sic] the importance of this announcement, stating that "[a]lthough we had previously highlighted that Impax was likely developing a generic Concerta, we are now formally adding the product to our Impax forecasts."Similarly, Smith Barney Citigroup explained its valuation of Impax on November 9, 2005, "Although the company has only recently transitioned into profitability, we believe the successful launch of generic Wellbutrin SR [500 mg strength] and the upcoming launch of generic Oxycontin will quickly provide Impax with an earnings base that allows it to be compared with its generic peers."As a result of these additions to Impax's generic drug portfolio and defendants' misrepresentations regarding the finality and certainty of its restatement of bupropion credits, the stock increased in value over the next two days from $11.85 on November 9, 2004 to $13.30 on November 11, 2004.

(SAC ¶¶ 206-07.) The parties dispute, *inter alia,* whether stock analysts had previously considered this positive news in their previous coverage of Impax stock. However, for purposes of this motion, the Court need not resolve any factual dispute with respect to this positive news. Impax's November 9 disclosure of positive news does not alter a simple reality: there was no loss associated with Impax's announcement that it would restate its 1 Q04 and 2Q04 revenues, because the stock price increased after the truth was disclosed.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

The Court dismisses Plaintiffs' First Cause of Action for violation of Section 10(b) of the Exchange Act and Rule 10b-5, for failure to allege loss causation, with leave to amend.

**B.** ***Scienter***

Since the Court finds that Plaintiffs have inadequately alleged loss causation, it does not consider whether the Second Amended Complaint adequately alleges scienter.

**C.** ***Control Person Liability***

To allege a Section 20(a) violation adequately, a plaintiff must prove (1) a primary violation of federal securities law and (2) that the defendant exercised actual power or control over the primary violator. *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1065 (9th Cir.2000). To establish a prima facie case, the plaintiff need not show the defendant's actual participation or exercise of power. Moreover, a defendant is entitled to a good faith defense if he or she can show no scienter and an effective lack of participation. *Id.* The Court has already found that Plaintiffs have not adequately pled a primary violation of a federal securities law under the PSLRA. Accordingly, the Court dismisses Plaintiffs' Second Cause of Action for violation of Section 20(a) of the Exchange Act for control person liability, with leave to amend.

***V. CONCLUSION***

***7** The Court dismisses Plaintiffs' Second Amended Complaint without prejudice. If Plaintiffs wish to file a Third Amended Complaint consistent with this Order, Plaintiffs shall file and serve the amended complaint no later than **February 5, 2007.**The Third Amended Complaint, if filed, shall strictly follow the format in the Court's subsequent Order Regarding Structure of Complaint Governed by Private Securities Litigation Reform Act.

N.D.Cal.,2007.
In re Impax Laboratories, Inc. Securities Litigation
Not Reported in F.Supp.2d, 2007 WL 5076983 (N.D.Cal.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-9

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
Richard KAUFMAN, et al., individually and on behalf of all those similarly situated, Plaintiff,
v.
MOTOROLA, INC., Christopher B. Galvin and Gary Tooker, Defendants.
**No. 95 C 1069.**

Sept. 21, 2000.

ORDER

GETTLEMAN, District J.

***1** This matter is before the court on defendants' motion in limine to preclude the expert testimony of Dr. Gregg A. Jarrell in this securities fraud class action litigation. Specifically, defendants challenge Dr. Jarrell's application of a damage model known as the "proportional trading model" to determine aggregate damages in this action.[FN1] The court has conducted several evidentiary hearings, heard extensive argument, and considered extensive briefing by the parties on this issue.

> FN1. Defendants also challenge Dr. Jarrell's computation of the inflation factor (the amount each share has been damaged), arguing that the evidence does not support Dr. Jarrell's basic assumption that defendants could have made the February 17, 1995, announcement on November 4, 1994. The court defers ruling on this aspect of defendant's motion until the evidence is presented at trial.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.,* 509 U.S. 579 (1993), the Supreme Court directed district courts to perform a "gatekeeping" function in determining the reliability of expert testimony offered under Federal Rule of Evidence 702. In making that determination, district courts were directed to consider four factors: (1) whether the theory or technique can be and has been tested; (2) whether the technique or theory has been subjected to peer review and publication; (3) the known or potential rate of error, and (4) the "general acceptance" of the theory. *See Bradley v. Brown,* 42 F.3d 434, 437 (7th Cir.1994). In *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137 (1999), the Court noted that in determining reliability of expert opinion, district courts should apply the four factors set forth above flexibly.

Dr. Jarrell employed the proportional trading model to determine aggregate damages to the class in this case by multiplying the alleged per share price differential by the aggregate number of shares that were "damaged" by the alleged fraud. Thus, Dr. Jarrell attempted to calculate the number of shares that were purchased during the class period, that is after the date on which the disclosure of the "truth" about Motorola's inventories should have been made and the date on which it was actually made, a period of approximately three and one half months. Any shares purchased during the class period and sold afterwards were considered by Dr. Jarrell to be "damaged shares."

According to Dr. Jarrell, because the actual number of such shares cannot be computed empirically, a model is required to estimate the number in order to determine aggregate damages to the class. This is so because, although the actual number of shares purchased during the class period can be ascertained, a number of those purchases are not made for shareholders as such, but are purchased, for example, by specialists, for short sales and the like. Thus, as both sides agree, in determining the number of "damaged shares" purchased during the class period and sold thereafter to compute aggregate damages, one must eliminate such shares not purchased for actual investment.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

There is no question that Dr. Jarrell is a highly qualified economist, a fact acknowledged by defendants' expert, Dr. Robert Stillman. Dr. Jarrell's expertise was also clearly demonstrated to the court by his cogent explanation of the proportional trading model and its application to the facts of this case, many of which (such as liability) were assumed by him in applying the model.

***2** The proportional trading model does not meet any of the *Daubert* standards. Indeed, Dr. Jarrell candidly admitted that it did not. In his testimony, Dr. Stillman noted a test of reliability first articulated by Nobel Prize winning economist Milton Friedman: the reliability of an economic theory is tested by comparing it to reality. Dr. Jarrell agreed that this was an appropriate test, and indeed it matches the first of the four *Daubert* factors. Dr. Jarrell also admitted that the proportional trading model has never been tested against reality.

In addition, it was clearly established from the evidentiary hearing and the voluminous materials submitted by the parties that the proportional trading model has never been accepted by professional economists. It seems to be a theory developed more for securities litigation than anything else. Although it may be correct to conclude that some type of model is needed in order to compute aggregate damages to the class, this does not mean that absent such a computation any alleged securities law violation would go unremedied. Indeed, under the case law governing § 10(b)(5) securities actions such as this, only "actual damages" may be awarded to each shareholder. *Affiliated Ute Citizens of Utah v. United States,* 406 U.S. 128, 155 (1972); *Rowe v. Maremont Corp.,* 850 F.2d 1226, 1240 (7th Cir.1988); 15 U.S.C. § 78bb(a). Therefore, assuming liability, an adequate remedy may be fashioned by having the jury determine a per share damage loss and requiring the filing of claims by each shareholder who claims that he, she or it has been damaged.

At first blush, the conclusion that the proportional trading model does not pass *Daubert* muster may appear to implicate the "flat earth" theory, under which one could assume that the first person to conclude that the world was round would have been considered heretically unscientific. The difference, of course, is that the "round earth" theory was subject to testing, and proven correct. Perhaps without such proof, the first person to conclude that the world was round would not have been allowed to so testify before a jury if *Daubert* had been the law of what ever land that person lived in.

In the instant case, Dr. Jarrell testified that there was no way to actually test the reliability of the proportional trading model. Whether this is correct or not, in absence of such testing and in absence of any acceptance by the professional economists of the theory, it simply does not pass *Daubert* muster.

Defendants' motion in limine to preclude Dr. Jarrell's testimony is granted as to his opinion on aggregate damages, and denied without prejudice as to his computation of the inflation factor.

N.D.Ill.,2000.
Kaufman v. Motorola, Inc.
Not Reported in F.Supp.2d, 2000 WL 1506892 (N.D.Ill.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-10

United States District Court, N.D. California.
Carol MATHEWS, on behalf of herself and all others similarly situated, Plaintiffs,
v.
CENTEX TELEMANAGEMENT, INC., Peter A. Howley and Henry P. Huff, III, Defendants.
**No. C-92-1837-CAL.**

June 8, 1994.

*ORDER FOR SUMMARY JUDGMENT*

LEGGE, District Judge.
***1** The case is now before this court on defendants' motion for summary judgment. The motion was opposed, briefed, argued and submitted for decision. The court has reviewed the moving and opposing papers, the arguments of counsel, the voluminous record of the motion and opposition, and the applicable authorities. For the reasons stated below, the court concludes that there are no genuine issues of material fact and that defendants' summary judgment motion should be granted.

I.

A brief recitation of the history of the case, leading to this motion and decision, is appropriate in order to define the present record.

The action was filed May 19, 1992. In September 1992, there was a hearing on defendants' motion to dismiss, which raised many of the same issues which defendants urge in this summary judgment motion. The motion to dismiss was denied without prejudice. At the same time, the court attempted to identify the key issues in the case and direct discovery on those issues.

Following that discovery, defendants made this summary judgment motion, which was opposed and set for hearing in July 1993. After reviewing the moving and opposing papers at that time, this court continued defendants' motion. The court was concerned that its earlier attempt to manage the discovery might have had the result of precluding plaintiffs from obtaining discovery which might be necessary for them to resist the summary judgment motion. The court therefore set another date for the completion of discovery, the filing of supplemental material in connection with this motion, and the hearing of the motion. The parties then completed that discovery, filed supplemental material, and the motion was argued and submitted for decision. All other proceedings in the case have been stayed pending the court's resolution of this motion.

II.

This is a securities action brought under Rule 10b-5 of the Securities and Exchange Act of 1934, and state common law fraud claims. The allegations are that Centex failed to adequately account for uncollectible receivables in its financial statements.

Plaintiffs also allege that defendants made false and misleading statements in a press release on October 21, 1991, commenting on Centex's third quarter results, and in its annual report for 1991, issued on March 30, 1992. Plaintiffs allege generally that defendants painted a falsely optimistic picture by indicating that Centex was a growth company which could withstand recession. However, that claim is too general and amorphous to base a cause of action upon, and is answered by the actual statements which Centex made in its releases and filings.

The real claim is that Centex had increasing difficulty in collecting its accounts receivable during the period October 31, 1991 to May 1, 1992, and that Centex did not record adequate reserves for its bad debts during the third and fourth quarters of 1991. Plaintiffs claim that this had the effect of artificially inflating the company's income and net worth until a May 1, 1992 press release. At that time, Centex announced that it would write off $850,000 of its earnings to a reserve for bad debts. Centex also announced relatively flat earnings for the first quarter of 1992. Centex's stock prices fell from $13.75 on May 1 to $12 on May 2, on trading of over two million shares.

***2** It is obvious from Centex's public filings during late 1991 and early 1992 that there were disclosures

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

made to the public of collection and bad debt problems, and that increases were made by Centex to its reserves for bad debts. The central issues are therefore the adequacy of the bad debt reserves-a subject on which reasonable business, accounting and legal minds differ constantly-and the adequacy of Centex's disclosures about its collection and bad debt problems.

III.

Defendants' summary judgment motion is based upon the following assertions from the record: Defendants disclosed the material information. Any statements that were allegedly misstatements were not material. There is insufficient evidence to show that defendants' setting of Centex's reserves for bad debts was fraudulent or was with scienter, but rather the reserves were good faith efforts by management to maintain adequate reserves based on Centex's prior collection experience. There is no other evidence of scienter, because defendants relied in good faith on their accountants in setting the reserves and they purchased more stock than they sold during the relevant time period. There is no showing of loss causation. And plaintiffs' state law claims do not show the reliance and *scienter* required by the recent California Supreme Court case Mirkin v. Wasserman, 23 Cal.Rptr.2d 101 (1993).

IV.

Having reviewed the extensive record and briefs, the court concludes that there are no genuine issues about the material facts. Those facts, together with the applicable law, compel that judgment be entered in favor of defendants.

In summary, the major points are: Debt collection problems and the increases of bad debt reserves were disclosed in Centex's 10Q report for the third quarter of 1991 and in its 1991 year end reports. The necessity for an even larger increase in the bad debt reserves was not known until April 1992, in response to 1992 events. There is not evidence sufficient to create a genuine issue of fact on misrepresentation, omission, materiality, scienter, fraud or loss causation.

The record of what was done and what was not done is not really in dispute. The issues raised by plaintiffs are claims about what defendants *should* have done. They do not establish anything more than differences in judgment and criticism by hindsight. The court does not believe that plaintiffs' contentions are enough to create genuine issues of material fact, particularly in the face of the record of the undisputed facts.

V.

Because of the nature of plaintiffs' claims, the defenses, and this court's conclusions, it is necessary to recite the record in some detail:

Defendant Centex offers telecommunications management and services to other companies. It is a service business and it bills its customers for its services.

As stated, plaintiffs allege that defendants touted Centex as a growth company which would continue to grow despite a bad economy. The complaint cites statements dated August 1, 1991, February 7, 1991, and October 31, 1991 in which defendant Howley proclaimed that the company was doing well "particularly in light of the weakness in the national economy" or "despite the poor national economy." However, these statements made no commitments for the future, and were in any event before the debt collection problems of 1992. While such statements may form a general background for plaintiffs' specific claims, they are not themselves actionable as misstatements or omissions of material facts. Plaintiffs' real claims are based upon Centex's receivables and reserves for bad debts.

***3** The declaration of defendant Huff, the former Chief Financial Officer of Centex, defined Centex's billing and collection procedures: Centex generally billed customers 15-20 days after the end of each month. Billings were recognized as revenue in the month in which Centex had a non-contingent right to receive the money. Because Centex knew that not all bills would be paid, each month Centex provided for possible bad debts with a monthly bad debt expense (an addition to its doubtful accounts reserve), which was an estimate of the amount that would turn out to be uncollectible. When a particular receivable was determined to be uncollectible, it was written off against the reserve, and that write-off did not itself affect net income during that month.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Huff stated that the monthly bad debt reserve was an estimate of future uncollectible invoices, which was based on business judgment and was necessarily subjective. He based his reserve decisions on Centex's past collection history, the aging of the accounts receivable, and general business conditions. An important factor was the "days outstanding;" that is, the ratio of total accounts receivable to average billings per day.

The declaration of defendant Howley explained how bad debts were written off. When a collector believed that a receivable was uncollectible, he proposed the write-off. Various management levels had to review the proposed write-off; and Howley himself had to approve amounts over $5000.

In the third quarter of 1991, a sluggish economy made collections more difficult. Huff therefore decided to increase the bad debt reserve for Centex's third quarter to $516,000-a 249% increase over the third quarter of 1990, and a 145% increase over the second quarter of 1991. This information was disclosed in the 10-Q report filed with the Securities and Exchange Commission on November 14, 1991. The report specifically stated that, "The Company increased its bad debt expenses to $516 as compared to $148 for the corresponding period of 1990. These increases are due to increased write-offs of doubtful receivables reflecting the current recessionary forces in the national economy." The report also stated that "The national economy has resulted in increases in the Company's receivables days outstanding."

KPMG Peat Marwick served as Centex's independent auditor. Huff and KPMG decided together that the reserve balance at the end of the third quarter of 1991 was adequate. KPMG did not advise him that reserves needed to be greater to comply with Generally Accepted Accounting Principles, even if KPMG might have initially believed that some higher reserve was warranted. Huff decided not to increase reserves further because Centex's aging of accounts receivable over 90 days had improved, from 8.02% in the second quarter to 6.89% in the third quarter. Although Huff knew that as a percentage of accounts receivable the reserve had decreased from 1.35% during the second quarter of 1991 to 1.01% in the third quarter, he considered that adequate because Centex normally had higher reserves than necessary and usually had uncollectibles of only .6% to .7%. Huff also believed that unpaid receivables on September 30, 1991 were higher than normal because Centex's bills had gone out late in the past two months as a result of technical problems.

***4** At year end, the level of accounts receivable over 90 days increased from 6.89% in the third quarter to 7.22% in the fourth quarter. Huff then increased bad debt expenses to $688,000, 33% more than in the third quarter. This was disclosed in the 10-K report filed with the SEC on March 30, 1992. Centex also set up a new reserve of $225,000 for disputed billings, so the total addition to the company's reserves was $913,000.

In February 1992, KPMG conducted its year end audit of Centex's financial statements. Although KPMG did some original test work which suggested that the reserve levels might be higher, it later agreed with Huff that the company's reserves were adequate. KPMG's original tests were conservative, because it recommended reserves between 3 and 4% of accounts receivable (rather than Centex's historical 1-2%), and because Huff had already increased reserves to 2.43% of accounts receivable.

KPMG finally recommended that the reserve should be increased by $100,180 pre-tax. The KPMG representative stated in his deposition that the $100,000 change was not material, because it was such a small percentage of billings (less than one percent), and also less than one percent of after-tax income. Huff relied on KPMG's opinion that the financial statements were fair and accurate, and if KPMG had concluded that the reserves were inadequate Huff would have raised them.

In the first quarter of 1992, there was a substantial increase in bankruptcies and delinquencies among Centex's clients. The company was adversely impacted because many of its clients were in California, which had a particularly bad economy. The aging of its accounts receivable deteriorated rapidly. By the end of the first quarter, March 1992, the percentage of accounts receivable over 90 days old was 11.54% compared to an average in the prior quarter of 7.22%.

In response to those events, a finance group within Centex performed a detailed review of each of Centex's accounts receivable, to decide if the doubtful accounts reserve was adequate. As a result of that

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

research and in consultation with KPMG, the reserve was increased by $853,000. That more than doubled the then existing reserve of $779,000. The increase was necessary because of events of which Centex became aware in the first quarter of 1992, and there is not sufficient evidence to create a genuine issue of fact that such an increase was necessary earlier. The increased reserve was announced in a press release dated May 1, 1992. The release also announced that earnings were reduced by over $500,000 and that earnings per share were 14 cents, a two cent decrease from the previous quarter.

VI.

Plaintiffs contend that Centex's collections did not suddenly deteriorate in first quarter of 1992, but that the large increase then was due to the failure to maintain adequate reserves in the last two quarters of 1991. But plaintiffs' contentions only show a difference in judgment, and not misstatements or material omissions. Plaintiffs point to certain evidence in the record, and to certain discussions within the company and with KPMG, which could lead to a conclusion that the reserves might have been higher. And plaintiffs point to certain write-off requests that were not acted upon immediately and to changes in the aging of certain of the receivables. While plaintiffs may be correct as a matter of hindsight-that is, that the receivable reserve might have been increased earlier-those differences of opinion do not rise to the level of misstatements or material omissions, for the reasons discussed in Section VII below.

***5** Plaintiffs' expert, Mr. Gavron, explained how he arrived at a higher calculation of reserve requirements. First, he stated that defendants should have written off certain accounts receivable as uncollectible much earlier. Because the write-offs would have been against the reserve, the reserve would have had to correspondingly increase. He based his determination of which accounts should have been written off sooner on certain accounts which were disconnected. He assumed in his analysis that these bills were probably already 30 days old on the date of disconnection. Second, he also stated that Centex did not adequately account for "credits in the pipeline;" that is, amounts which defendants improperly charged to customers and which would have to be credited to them. He also stated that management delayed writing off bad debts which had been approved by regional directors. Defendants contend that Mr. Gavron relied on faulty assumptions. Specifically (1) not all disconnected lines are disconnected for failure to pay (*e.g.,* a customer may go out of business or switch to a competitor), and even as to those lines, not all accounts were uncollectible; (2) the decision to issue business credits also takes a long time, and might not have been determined at the end of 1991, even if it resulted from a 1991 transaction. And two documents on which Mr. Gavron relied (Exhibits F and H), were prepared in April 1992 and contained information not known earlier to Centex. This court need not reconcile those differences of opinion, because they are just that; that is, differences of opinion. They are not evidence of misstatements or material omissions.

VII.

To establish a Rule 10b-5 claim, plaintiffs must prove (1) a false statement or an omission that rendered another statement misleading; (2) materiality; (3) scienter; and (4) loss causation. *In re Apple Computer Security Litigation,* 886 F.2d 1109, 1113 (9th Cir.1989); *McGonigle v. Combs,* 968 F.2d 810, 817, 819 (9th Cir.1992).

A.

The company's collection problems, and the necessity for increases to its reserves, were publicly disclosed as they became apparent. Defendants did increase Centex's bad debt reserves in late 1991, and stated in public filings that the company was having increasing difficulty in collections. The 10-Q for the third quarter, filed with the SEC on November 14, 1991 and quoted above, stated that the company had increased its bad debt expenses and that the increases were due to increased write-offs because of the current state of the national economy and to increased aging of receivables. Additionally, a table in the allegedly misleading year end reports disclosed that the provision for bad debts had increased from $951,000 in 1990 to $1,678,000 for 1991. The necessity for larger reserves and write offs of accounts did not become known to defendants until 1992.

Plaintiffs' arguments about what should have been known or done in 1991 are only differences in business judgment viewed from hindsight, and do not demonstrate knowingly false statements or omissions. Inadequate loss reserves *can* be the basis for a

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Rule 10b-5 suit if the necessary elements of such a cause of action are present. *See* In re Wells Fargo Securities Litigation, 12 F.3d 922, 926 (9th Cir.1993) (reviewing dismissal under F.R.C.P. 12(b)(6), and not a summary judgment based on a fact record). But the necessary elements are not present here.

***6** Reserves for bad debts are essentially predictions about the future. The fact that a future prediction turns out to be wrong does not mean it was fraudulent when made. *Marx v. Computer Sciences Corp.,* 507 F.2d 485, 489, 490 (9th Cir.1974). Because reserves are meant to be estimates or predictions of collectibility, they are fraudulent only "if, when they were established, the responsible parties knew or should have known that they were derived in a manner inconsistent with reasonable accounting practices." *Christidis v. First Pennsylvania Mortg. Trust,* 717 F.2d 96, 100 (3rd Cir.1983); *see also* *DiLeo v. Ernst & Young,* 901 F.2d 624 (7th Cir.1990) and *In re Convergent Technologies Second Half 1984 Securities Litigation,* No. C-85-20130-SW, 1988 WL 215412, at *1-2, 1988 U.S.Dist Lexis 18658, AT *5 (N.D.Cal. May 23, 1988). In *In re Adobe Systems, Inc. Securities Litigation,* 787 F.Supp. 912, 919 (N.D.Cal.1992), the court held that if the defendants' method of projection was reasonable, summary judgment is appropriate. The jury need not be given the task of deciding whose proffered method is more reasonable. *Adobe* at 920.

It is also obvious that a dramatic change occurred in the first quarter of 1992. The number of accounts receivable over 90 days old went up from the 7-8% range to 11.54% at the end of the first quarter of 1992. In that same quarter, California bankruptcies were up 37%. This lends credence to defendants' contention that the 1992 increase in reserves was due to newly changed circumstances, not to prior fraudulent understatements.

There is simply not sufficient evidence of any misstatement or material omission.

B.

Plaintiffs' 10b-5 claim also fails for lack of materiality and lack of loss causation. Even if the company had increased its reserves as contended by plaintiffs, such increases would not have had a material impact on Centex's financial statements, and are therefore not actionable.

Revenues, as defined by billings in accrual accounting, would not have changed at all had the reserves been increased. If the reserves had been increased by $382,000 in the third quarter, net income would have been $2,647,000 rather than $2,888,000, resulting in earnings per share of 14 rather than 15 cents. If the reserves had been increased by $277,000 in the fourth quarter, net income would have been $2,514,000 rather than $2,682,000, and earnings per share would have been 13 rather than 14 cents. If the reserves had been increased by $100,180 (the final difference between defendants' reserves and those recommended by KPMG), the difference in income would have been only $60,642. Net income figures fluctuated in 1990 and 1991 from $2,055,000 in the first quarter of 1990 to a high of 2,944,000 in the second quarter of 1991.

Materiality in the context of a false proxy statement under the 1934 Act has been defined by the U.S. Supreme Court as "a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976). Courts can and do grant summary judgment on the grounds that a given statement or omission was not material. *E.g.* *Apple,* 886 F.2d at 1116.

***7** Courts have also found that allegedly fraudulent transactions which are under one or two percent of net operating revenues are immaterial. *See In re Convergent Technologies Second Half 1984 Sec. Litig.,* No. C-85-20130-SW, slip op. at 22-23 (N.D.Cal. Jan. 10, 1990). In *Convergent,* the court held that "in this context of meeting net current operations well above market expectations and then recognizing a huge one time loss, a difference of a cent or two per share is not material." Thus, transactions amounting to $1.2 million, but which accounted for one and one half percent of revenue, were not material. In considering whether a proxy statement was false or misleading, another district court held that a failure to disclose an increase in revenue of less than 1% was immaterial. *Pavlidis v. New England*

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Patriots Football Club, 675 F.Supp. 688, 692 (D.Mass.1986).

Plaintiffs argue that the drop in stock price on May 2, 1991 indicates materiality. When defendants announced flat earnings for the first quarter of 1992 and the $853,000 increase in the bad debt reserve, the stock price fell $1.75, from $13.75 to $12. Stock prices may sometimes indicate materiality, depending on the circumstances of a particular case. *Apple,* 886 F.2d at 1116. However, three days later the price of the stock rebounded to $13.75, suggesting that investors did not believe the change was really material. And investors were also reacting to the first quarter 1992 addition of $853,000 to reserves; not to the proposed addition of $100,000 to $300,000 for the fourth quarter of 1991.

Looking at the total mix of information available to investors, the increase in reserves would not have been material. Earnings per share and net income was basically flat through 1990-91, so that one cent would not have made a material difference.

C.

Plaintiffs have also failed to show *scienter,* which is a necessary element in any 10b-5 claim. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). *Scienter* is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst,* 425 U.S. at 1993-94 n. 12. To prove *scienter,* plaintiffs must show, at the least, that defendants acted recklessly, as defined by the Ninth Circuit: "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 actors must have been aware of it. [citations omitted]." *Hollinger v. Titan Capital,* 914 F.2d 1564 (9th Cir.1990). A defendant may not be found liable under 10b-5 unless he acted other than in good faith. *Ernst,* 425 U.S. at 206. Although *scienter* often is a fact specific issue to be determined by the trier of fact, in appropriate cases it can be decided on summary judgment. *Apple,* 886 F.2d at 1113. Here, plaintiffs have shown no more than a difference in the business judgment exercised by the defendants. Defendants also conferred with and relied in good faith on their outside auditor.

***8** Further, Centex bought 209,500 shares of its own stock in the open market, at a total price of almost four million dollars. It would have made no sense to purchase that stock if defendants knew the prices to be inflated.

Defendants' overall conduct shows no intent to defraud. In late 1991 Centex's reserves were increased and the company disclosed its collection problems. In the first quarter of 1992, voluntarily and on its own initiative, Centex began reviewing all of its accounts receivable to insure that its reserves were adequate. When it discovered that the accounts were inadequate it immediately raised reserves and announced this in a press release.

Plaintiffs appear to have abandoned their claim of scienter based on the individual defendants' selling Centex stock. This is because defendants had a consistent pattern of selling stock for several years: Since the company went public in 1987, Huff had a practice of selling Centex stock to diversify his stock into cash. He sold about 20,000 shares each in 1989 and 1990. In the second quarter of 1991 he sold 135,888 shares; in the third quarter 1991 sold 5,600 shares, and in the fourth quarter 1991 9,400 shares. Howley sold some stock each quarter, depending on the amount of money he needed. He sold about 73,000 shares held by himself and his children in 1989 and 115,600 shares in 1990. In 1991 he sold 16,000 shares the first quarter, 6,000 the second, 8,000 the third, and 19,175 shares the fourth quarter. In the first quarter of 1992 he sold 18,333 shares.

VIII.

Plaintiffs' claims under California law also fail for two reasons. First is the absence of *scienter,* as discussed above. Second, the California Supreme Court has recently held that the "fraud on the market" theory does not apply to common law fraud claims. *Mirkin,* 23 Cal.Rptr.2d at 101. Plaintiffs must prove actual reliance on the allegedly misleading statement. In this case, the class representative has not submitted a declaration or other showing that she read the allegedly false materials and relied upon them. And under *Mirkin* even her reliance would not establish reliance by the class.

IT IS THEREFORE ORDERED that defendants'

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

motion for summary judgment is granted.

*JUDGMENT*

For the reasons set forth in the Order for Summary Judgment signed and filed this date, judgment is hereby entered in favor of defendants Centex Telemanagement, Inc., Peter A. Howley, and Henry P. Huff III, and against Carol Mathews, on behalf of herself and all others similarly situated.

N.D.Cal.,1994.
Mathews v. Centex Telemanagement, Inc.
Not Reported in F.Supp., 1994 WL 269734 (N.D.Cal.), Fed. Sec. L. Rep. P 98,440

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-11

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois, Eastern Division.
PREMIER CAPITAL MANAGEMENT, L.L.C., a Virginia Limited Liability Company, et al., Plaintiffs,
v.
Larry COHEN, Individually, Brian Flanagan, Individually, Wan Hee Kim, Individually, Jung Koh, Individually., et al., Defendants.
**No. 02 C 5368.**

Aug. 15, 2003.

*MEMORANDUM OPINION & ORDER*

GOTTSCHALL, J.

***1** Plaintiffs Premier Capital Management, LLC ("Premier Capital"), TMB, LLC and Xen Investors, LLC have sued defendants Xentex Technologies ("Xentex"), Xentex's officers and/or directors Larry Cohen, Brian Flanagan, Wan Hee Kim and Michael Turcotte, Ron Falese, a Xentex shareholder, Northview Bank and Trust, and the bank's president Blair Robinson, claiming that defendants violated federal and state securities laws, as well as several state statutory and common laws. Before the court are two motions to dismiss: the motion of defendants Xentex, Cohen, Kim, Turcotte and Falese (the "Xentex defendants") to dismiss the federal claims raised against them in the second amended complaint ("complaint" or "SAC"), and defendant Flanagan's motion to dismiss the federal claims against him. Although both Flanagan and the Xentex defendants have moved to dismiss all claims against them, this order pertains only to the federal claims raised in Counts 1-3, 8-10, and 24-26 against Xentex, Turcotte and Kim, respectively,[FN1] and the federal claims against Flanagan in Counts 17-19. Plaintiffs seek relief under both § 10(b) of the Exchange Act of 1934, 15 U.S.C. 78j(b), and § 12(a)(2) of the Securities Act of 1933, 15 U.S.C. 77l(a)(2). For example, plaintiffs bring a claim against Xentex for allegedly violating § 12(a)(2) in Count 1 and for violating § 10(b) in Counts 2 and 3.[FN2] Plaintiffs follow the same pattern in their claims against Turcotte, Kim, and Flanagan. Plaintiffs also seek to impose control-person liability against Turcotte, Kim, and Flanagan.[FN3] The court assumes they bring their control-person liability claims under both § 15 of the Securities Act, 15 U.S.C. § 77o, and § 20 of the Exchange Act, 15 U.S.C. § 78t. The Xentex defendants and Flanagan seek dismissal of all the federal securities claims under Fed.R.Civ.P. 12(b)(6), asserting primarily that plaintiffs failed to satisfy the heightened pleading requirements imposed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4, as well as the requirements of Fed.R.Civ.P. 9(b). They also argue that § 12(a)(2) is inapplicable to the securities offering at issue. Additionally, Flanagan argues that plaintiffs fail to plead violations of either § 12(a)(2) or § 15 against him.

FN1. At the Xentex defendants' request, the court allowed them to bifurcate briefing and address first the counts alleging violations of the federal securities laws. Of the Xentex defendants, only Xentex, Turcotte, and Kim face claims for violations of the federal securities laws.

FN2. Actually, plaintiffs' complaint states only that Count 1 asserts a violation of the Securities Act whereas Counts 2 and 3 asserted violations of the Exchange Act-they do not specifically refer to Section 12(a)(2) or Section 10(b) anywhere in the pleading.

FN3. Plaintiffs do not raise the control-person liability claims in separate counts. Additionally, as with the other federal securities claims, plaintiffs do not specifically refer to the section number that was al-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

legedly violated.

For the reasons explained below, the claims against Xentex, Turcotte, Kim, and Flanagan under § 10(b) and § 20 of the Exchange Act are hereby dismissed, as is the § 12(a)(2) claim against Flanagan. The § 12(a)(2) claims against Xentex, Turcotte and Kim survive, however, as do the control-person liability claims against Turcotte, Kim and Flanagan under § 15.

*Background*

According to the complaint, plaintiffs made two investments in Xentex, the first through a stock purchase, the second in the form of a promissory note. Xentex, through its CEO Jeff Batio and its Vice Chairman and Executive Vice President Douglas Tucker, presented plaintiffs with an opportunity to invest at a meeting on November 1, 2000. At that time, Xentex was in the process of developing and launching a flip-pad computer known as the Voyager. During that meeting, plaintiffs received an Information Statement dated November 1, 2000 ("Information Statement"), which contained numerous representations relating to Xentex, the Voyager computer, and Xentex's plans for launching the Voyager into the market. In reliance on the representations made in the Information Statement, as well as certain oral representations made by Batio and Tucker at the November 1st meeting, plaintiffs invested more than $3.3 million in Xentex stock. Subsequently, on June 4, 2001, after certain additional representations by various members of Xentex's Board of Directors, plaintiffs loaned Xentex $650,000 in return for a promissory note. Plaintiffs now claim that the representations made in the Information Statement, the oral representations made at the November 1st meeting, and the representations made in connection with the execution of the promissory note were false, and that as a result, defendants have violated federal securities laws as well as numerous state statutory and common laws. Flanagan and the Xentex defendants have moved to dismiss.

*Analysis*

***2** In evaluating the motions to dismiss, the court accepts all of plaintiffs' well-pled allegations in the complaint as true and draws all reasonable inferences in plaintiffs' favor. *Stachon v. United Consumers Club, Inc.,* 229 F.3d 673, 675 (7th Cir.2000). The court need " 'not strain to find inferences favorable to the plaintiffs' which are not apparent on the face of the complaint," however. *In re Allscripts, Inc. Secs. Litig.,* No. 00 C 6796, 2001 WL 743411, *4 (N.D. Ill. June 29, 2001) (quoting *Coates v. Ill. State Bd. of Ed.,* 559 F.2d 445, 447 (7th Cir.1977)). To the extent plaintiffs raise securities fraud claims under § 10(b), they must meet the heightened pleading requirements of Rule 9(b) as well as § 78u-4(b) in order to state a claim for fraud. Under Rule 9(b), a plaintiff must plead "the circumstances constituting fraud ... with particularity." *In re HealthCare Compare Corp. Secs. Litig.,* 75 F.3d 276, 281 (7th Cir.1996). In other words, a plaintiff must allege "the who, what, when, where and how" of the fraud. *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir.1990). Since the enactment of the PSLRA in 1995, the pleading requirements for claims under the Exchange Act are now even higher: the complaint must "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)(B). Additionally, with respect to each alleged misrepresentation or omission, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."*Id.* at § 78u-4(b)(2). These two requirements are closely related. The PSLRA requires, in the absence of direct evidence of falseness and scienter, the pleading of facts which justify a strong inference of both elements. *See In re Navarre Corp. Secs. Litig.,* 299 F.3d 735, 744 (8th Cir.2002).

The heightened pleading requirements imposed by the PSLRA do not apply to plaintiffs' claims under § 12(a)(2), however. Although the PSLRA amended both the Securities Act and the Exchange

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Act, the heightened pleading requirements imposed by § 78u-4(b) apply only to claims brought under the Exchange Act. *In re Adams Golf, Inc. Secs. Litig.,* 176 F.Supp.2d 216, 230 (D.Del.2001); 15 U.S.C. § 78u-4(b).

With these pleading requirements in mind, the court turns to the counts at issue.

I. *Claims Under Section 10(b) and Section 20 of the Exchange Act of 1934*

A. § 10(b) Claims Against Xentex: Counts 2 and 3

1. For Claims under § 10(b), Plaintiffs Must Identify Specific False Statements and Provide the Reasons Why Each Statement is Misleading.

To state a claim under § 10(b) of the Exchange Act for a violation of Rule 10b-5, 17 C.F.R. § 24010b-5, a plaintiff must plead that "the defendant (1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which plaintiff has relied, and (6) that reliance proximately caused plaintiff's injuries." *HealthCare,* 75 F.3d at 280. Moreover, as explained above, plaintiffs must satisfy the pleading requirements imposed by the PSLRA: they must not only specify each statement they claim was misleading, they must also allege "the reason or reasons why [each] statement is misleading."15 U.S.C.A. § 78u-4(b)(1)(B). Claiming that a particular statement was untrue is not enough-plaintiffs must explain, with particularity, the factual basis for their assertion that the statement was untrue. *Clark v. TRO Learning, Inc.,* No. 97 C 8683, 1998 WL 292382, at *4 (N.D.Ill. May 20, 1998).

***3** Plaintiffs in this case fail to state claims under § 10(b) against Xentex because the complaint is woefully deficient under the PSLRA.FN4 Although plaintiffs identify numerous specific statements that they believe were misleading, they repeatedly fail to provide "the reason or reasons why [each] statement is misleading."15 U.S.C.A. § 78u-4(b)(1)(B). Further, in the few instances where plaintiffs provide the reasons why a particular statement was false, they fail to plead scienter adequately.

> FN4. The court need not address whether plaintiffs satisfied Rule 9(b). The PSLRA requires at least as much and more.

Plaintiffs specifically identify the following representations from the Information Statement as false:

(1) Xentex had $5.3 million in assets, including $4.25 million in tooling;

(2) Korean Data Systems ("KDS") had agreed to open a service center for warranty & repair services;

(3) Xentex expected to launch the Voyager in fourth quarter of 2000; FN5

> FN5. This representation is a forward-looking statement. Such a prediction is not actionable unless plaintiffs alleged that Xentex lacked a reasonable basis for making it. *Zoghlin v. Renaissance Worldwide, Inc.,* No. 99 C 1965, 1999 WL 1004624, at *6 (N.D.Ill. Nov. 4, 1999).

(4) KDS had provided approximately $40 million for product financing; and

(5) KDS had agreed to pay for all further product development and tooling costs.

(SAC at ¶ 20(a-e)). According to plaintiffs, the first statement was false because Xentex never had those assets, and the third statement was false because at the time, "Defendant was in a position wherein said launch was impossible,"(*id.* ¶ 23). These are not adequate allegations of *why* the subject statements were false: plaintiffs merely allege that the statements were false because the opposite was true. These are conclusory allegations, not facts. As for statements 2, 4, and 5, plaintiffs offer no reasons

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

whatsoever explaining why those representations were false.[FN6] Plaintiffs have failed to state a securities fraud claim based on the representations in the Information Statement.

FN6. Indeed, with respect to statement 4, there is not even an allegation that the statement was false, let alone an explanation of why it was false.

Plaintiffs also allege that Batio and Tucker made oral misrepresentations during the November 1st meeting. The purported oral misrepresentations were that:

(1) Xentex had made all necessary production arrangements with KDS for mass production;

(2) KDS had completed the tooling required to mass produce;

(3) all conditions precedent for production of the computers had been completed and any money sought was for marketing;

(4) the computer presented at the meeting was manufactured and produced by KDS; and

(5) there were no lawsuits pending against Xentex.

(SAC ¶¶ 34(a-e).) For present purposes, the court assumes each of these statements would be actionable if properly pled. But neither of the first two statements is properly pled. According to plaintiffs, the first statement was false because the arrangements have never been completed and the computers have never been mass-produced, again nothing more than the conclusion that the the opposite of the statements was true. Moreover, the fact that the computers have never been mass produced does not mean that the necessary production arrangements were never made. As for the second oral statement, plaintiffs claim it was false, but offer no reason why, again failing to satisfy the PSLRA requirements.

***4** Plaintiffs' pleading marginally improves with respect to the remaining three oral statements. They allege the third oral statement was false because the funds plaintiffs invested were not used for marketing, but rather were used "to pay off unrelated past debt and to purchase automobiles for Mr. Batio, pay his rent, fund his vacations and for other inappropriate purposes," (SAC ¶ 37). These allegations, which purport to be based on direct knowledge,[FN7] are suspiciously vague; if plaintiffs have such evidence, one would think they would describe with some particularity what debt, what automobiles, what vacations, and what "other inappropriate purposes" they are referring to. In any event, even if the alleged "facts" are specific enough to show why the representation was false, they do not provide a basis for inferring that the representation was false at the time it was made. " '[O]ften there is no reason to assume that what is true at the moment plaintiff discovers it was also true at the moment of the alleged misrepresentation, and that therefore simply because the alleged misrepresentation conflicts with the current state of facts, the charged statement must have been false." ' *City of Philadelphia v. Fleming Cos., Inc.,* 264 F.3d 1245, 1260 (10th Cir.2001) (quoting *In re GlenFed Sec. Litig.,* 42 F.3d 1541, 1548-49 (9th Cir.1994)). As for the statements concerning the origin of the computer and the lack of any pending lawsuits, plaintiffs probably adequately allege the falsity of those statements. However, for reasons explained below, even if the allegations regarding each of the last three oral statements satisfy the "why" requirement of the PSLRA, they fail to satisfy the Act's scienter prong.

FN7. If these allegations are based on information and belief rather than direct knowledge, plaintiffs have failed set out "with particularity all facts on which that belief is formed" as required by the PSLRA. 15 U.S.C. § 78u-4(b)(1)(B).

Additionally, plaintiffs raise a claim against Xentex under § 10(b) based on allegedly untrue representations made to induce plaintiffs to loan Xentex

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

$650,000 in June 2001 pursuant to a promissory note.[FN8] Plaintiffs plead that:

> FN8. Plaintiffs allege, and defendants at this stage do not contest, that this loan constituted a sale of securities within the meaning of the Exchange Act.

(1) Kim tendered a production schedule dated March 21, 2001, which represented that Xentex had the ability to mass produce Voyager computers at that time;

(2) Xentex, through Tucker, tendered a memo dated April 5, 2001 to plaintiffs representing that Xentex had made all arrangements to possess seventy prototypes from Asia within 3 weeks from the date of the memo;

(3) Xentex, through Batio, informed plaintiffs in May 2001 that the Voyager computers were essentially complete and assembled;

(4) Xentex, through defendant Brian Flanagan, advised the plaintiff that the company was able to pay its bills and was not financially depleted;

(5) Xentex, through Flanagan, advised plaintiff that no engineering or mechanical defects existed regarding the computers and that Xentex was being properly managed; and

(6) Xentex, through Batio, advised plaintiffs that the money tendered pursuant to the promissory note would be used for marketing purposes only, as the computers were assembled and complete.

***5** (SAC ¶¶ 53-59.) Plaintiffs' allegations regarding statements 2, 3 and 4 are deficient under the PSLRA's pleading requirements because they failed to plead any specific facts showing the falsity of those statements at the time they were made.

As for the first statement, plaintiffs allege that the statement that Xentex was capable of mass producing Voyager computers was false because Xentex, to date, has never mass-produced the computers. *Id.* ¶ 61.)As explained above, the fact that Xentex has not mass-produced the computers does not mean that it was never capable of doing so, and thus does not support the inference that the statement was false when made. Plaintiffs also attempt to show the falsity of the first statement by alleging that the production schedule Kim gave them "failed to accurately disclose Xentex['s] ability to mass-produce the Voyager computers." (*Id.* at 62.) Plaintiffs have again merely stated that the production memo was untrue, without providing facts showing why it was untrue.

The allegations regarding the falsity of the fourth statement also falter. According to the complaint, Flanagan's statement that the company was able to pay its bills and was not financially depleted was false because in fact, Xentex was deeply in debt, underfunded, and a defendant in numerous lawsuits based on its failure to pay its bills. (*Id.* ¶ 60.)The allegation that Xentex was deeply in debt and underfunded is conclusory. The allegation that Xentex was a defendant in numerous lawsuits based on its failure to pay its bills is more specific, but the court cannot infer from this allegation that the company was underfunded. Plaintiffs give no information about the lawsuits in question.[FN9] For that matter, a claim for $1000 or even $100,000, without more, does not show that a company is underfunded.

> FN9. It seems odd that plaintiffs know enough to allege that two lawsuits were pending, yet entirely fail to identify or describe them.

According to plaintiffs, the sixth statement, Batio's representation that the money loaned pursuant to the promissory note would be used only for marketing purposes, was false because Xentex actually used the money to pay past due bills and to pay for Batio's living expenses, car payments, and vacations. Those vague allegations do not provide any basis for inferring that the sixth statement was false at the time it was made. *City of Philadelphia,* 264 F.3d at 1260. Whether the sixth statement adequately explains why the statement was false when

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

made is therefore questionable. But even assuming the complaint adequately alleges why the fourth and sixth statements were false, plaintiffs have failed to satisfy the PSLRA's requirements for pleading scienter in connection with those statements.

2. *The Complaint Lacks Facts Giving Rise to a Strong Inference that Xentex Acted with Scienter in Violation of § 10(b).*

To satisfy the PSLRA's heightened pleading requirements for scienter, plaintiffs must "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). For a claim under § 10(b), the requisite scienter is "a mental state embracing the intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976)."[R]eckless disregard for the truth counts as intent" for purposes of § 10(b).[FN10] *Chu v. Sabratek Corp.,* 100 F.Supp.2d 815, 822 (N.D.Ill.2000) (quoting *SEC v. Jakubowski,* 150 F.3d 675, 681 (7th Cir.1998)). Conclusory allegations that defendants acted with knowledge that the representations were false and misleading do not satisfy the PSLRA's pleading requirements. Plaintiffs "must do more than speculate as to defendants' motives or make conclusory allegations of scienter; [they] must allege specific facts." *Rehm v. Eagle Fin. Corp.,* 954 F.Supp. 1246, 1255 (N.D.Ill.1997). The facts alleged must be sufficient to strongly support the inference that at the time the statements were made, defendants knew, or were reckless in not knowing, that the statements were false.

FN10. Recklessness requires, at minimum, "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care ... to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Fin. Corp.,* 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

***6** Even if, as explained above in Section I.A.1, plaintiffs adequately allege the reasons why three of the oral statements made at the November 1st meeting and two of the oral statements relating to the promissory note were false, they have failed to allege facts giving rise to a strong inference that defendants made those purported misrepresentations knowingly or recklessly. With respect to the statements at the November 1st meeting [FN11] and the statements relating to the promissory note,[FN12] plaintiffs plead that "Xentex, through its Board of Directors and corporate officers, made the above-referenced false and misleading statements and/or omissions, although the Board of Directors and said corporate officers knew them to be false, untrue and misleading."(SAC ¶¶ 46, 70.) This is merely a conclusion and therefore is inadequate to satisfy the heightened pleading standards of the PSLRA.

FN11.*I.e.,* Batio's and Tucker's statements that the money would be used for marketing, that KDS manufactured the computer displayed at the meeting, and that there were no lawsuits pending against Xentex.

FN12.*I.e.,* Flanagan's statement that the company was able to pay its bills and was not financially depleted and Batio's representation that the money loaned pursuant to the promissory note would be used only for marketing purposes.

Plaintiffs also allege that defendants made the misrepresentations because Xentex had "misappropriated and squandered the corporation[']s money," "needed to alleviate the corporation's extreme financial difficulties," and sought to enable Xentex's Board of Directors, corporate officers, and employees to "loot the corporation for their personal gain."(*Id.* ¶¶ 43-44; 71-72.) These allegations similarly are devoid of the level of factual specificity required to satisfy the PSLRA. Plaintiffs "must do more than speculate as to defendants' motives or make conclusory allegations of scienter;

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

[they] must allege specific facts." *Rehm,* 954 F.Supp. at 1255;*see also* *Shields v. Citytrust Bancorp, Inc.,* 25 F.3d 1124, 1129 (2d Cir.1994) (requiring particularized facts under Rule 9(b) pre-PSLRA). Plaintiffs allege no specific facts to show that Xentex was experiencing extreme financial difficulties at the time the representations were made.[FN13] Bare allegations that a company has cash flow problems, without factual support, are insufficient to support a finding of scienter. *Rehm,* 954 F.Supp. at 1254 n. 4. Nor do plaintiffs plead facts supporting their vague allegations that Xentex's Board, officers, and employees were misappropriating, squandering, and looting Xentex's money. The most they allege, in highly general and hence inadequate form, is that at some *later* time the money they invested was used to pay Batio's personal expenses. Such an allegation, even if factually specific enough (which the court doubts) does not support a strong inference that at the time of the November 1st meeting, looting and misappropriation of corporate funds was occurring at Xentex, and that Xentex thus made fraudulent misrepresentations in order to continue the looting and misappropriation.

FN13. In their briefs opposing the motion to dismiss, plaintiffs argue that Xentex owed defendant Flanagan $500,000 pursuant to a promissory note, and that he ultimately (*i.e.,* at a later time) called that note and forced Xentex into bankruptcy. Notably, the allegations concerning Flanagan were not incorporated into the allegations against Xentex and have therefore not been raised against Xentex. In any event, the fact that a start-up company like Xentex owed $500,000 under a promissory note is far from remarkable; indeed, Xentex owed plaintiffs $650,000 pursuant to another promissory note.

Plaintiffs have failed to set forth facts demonstrating why most of the misrepresentations they allege were false. In the few instances where some "why" information is provided, plaintiffs have not set forth facts sufficient to give rise to a strong inference that Xentex (through its Board and/or corporate officers) knew the statements were false and acted knowingly or recklessly in making the misstatements. For these reasons, plaintiffs have failed to plead securities fraud claims against Xentex under § 10(b). Counts 2 and 3 are dismissed.

B. § 10(b) Claims Against Turcotte: Counts 9 and 10

***7** Plaintiffs also claim that Michael Turcotte, Xentex's Vice President of Accounting and Control, committed securities fraud in violation of § 10(b) by making misrepresentations in financial statements distributed prior to the initial stock purchase (Count 9) and prior to the execution of the promissory note (Count 10).

Specifically, plaintiffs allege that the Information Statement they received included financial statements prepared by Turcotte which falsely represented that Xentex owned tooling worth more than $4.25 million and total assets exceeding $5.3 million. A subsequent financial statement prepared by Turcotte dated December 31, 2000, less than two months after plaintiffs invested in Xentex, represented that Xentex had just $4.3 million in assets, including only $1.5 million in tooling. Plaintiffs claim they relied on the original financial statement when they invested $3.3 million in Xentex. Turcotte then allegedly prepared another financial statement, dated March 15, 2001, in which the value of tooling was raised back to $4.25 million. Plaintiffs plead that this March 15th representation induced them to execute the promissory note and loan Xentex an additional $650,000. Plaintiffs further allege that in preparing the financial statements, Turcotte violated Generally Accepted Accounting Procedures ("GAAP").

Plaintiffs rely on the variations between the financial statements to support their allegations of fraud. But plaintiffs may not rest a securities fraud claim

on the differences between financial statements. *DiLeo,* 901 F.2d at 627. Rather, "[i]nvestors must point to some facts suggesting that the difference is attributable to fraud...."*Id.*Moreover, the allegations against Turcotte fail to give rise to a strong inference that he knew the statements were false and acted knowingly or recklessly in making the misstatements. For the most part, plaintiffs make the same scienter allegations against Turcotte that they alleged against Xentex; that Turcotte, according to the complaint, made misrepresentations and omissions because Xentex "had misappropriated and squandered money tendered by previous investors,""was unable to pay its bills and drastically needed funding so that individuals on the Board of Directors could continue to loot the company."(SAC ¶¶ 179-80, 196-97.) The court has already addressed the deficiencies of these allegations above.

Plaintiffs also allege that Turcotte made misrepresentations in the financial statements "to properly secure his inflated salary and ensure he was compensated by other [unspecified] means"(*Id.* ¶¶ 181, 198), and that he committed various GAAP violations. Plaintiffs' allegation regarding Turcotte's desire to maintain his inflated salary, obviously aimed at establishing his motive to commit fraud, fails to establish a strong inference of scienter. There is disagreement among the courts of appeals which have addressed the issue as to the adequacy of allegations of motive and opportunity, standing alone, to create the necessary strong inference of scienter. *See Goldstein v. MCI WorldCom,* __ F.3d __, Nos. 02-60322, 03-60248, 2003 WL 21738963, at *6 (5th Cir. July 28, 2003). But this court agrees with the Eighth Circuit's observation that "having the motive and opportunity to do wrong are certainly not the same as having the intent to do it," and that generally alleging greed as a motive fails even to establish motive, led alone scienter. *Florida State Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 655 (8th Cir.2001). To establish motive, "a plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold." *Shields,* 25 F.3d at 1130. Further, alleged GAAP violations, without more, have consistently been held insufficient to give rise to a strong inference of scienter. *In re K-Tel Int'l, Inc. Secs. Litig.,* 300 F.3d 881, 890 (8th Cir.2002); *Riggs Partners, LLC v. Hub Group, Inc.,* No. 02 C 1188, 2002 WL 31415721, *5 (N.D.Ill. Oct. 25, 2002); *Rehm,* 954 F.Supp. at 1255.

***8** Counts 9 and 10 fail to meet the PSLRA's pleading standards and are therefore dismissed to the extent they raise claims under § 10(b) of the Exchange Act.

C. § 10(b) Claims Against Kim: Counts 25 and 26

Plaintiffs also claim that Dr. Wan Hee Kim, a member of Xentex's Board of Directors and chairman of its Executive Committee, committed securities fraud in violation of § 10(b) by making misrepresentations to them prior to the initial stock purchase (Count 25) and prior to the execution of the promissory note (Count 26).

To the extent plaintiffs seek to hold Kim directly responsible for misrepresentations made in the Information Statement, their claim is based on the same flawed allegations that form the basis of the deficient claim against Xentex, and thus fails for the same reasons the claim against Xentex fails. But plaintiffs also allege that Kim had a direct conversation with them in early November 2000 in which Kim "failed to disclose the fact that Xentex was drastically underfunded, was incapable of producing Voyager computers and was the subject of several lawsuits for failure to pay its bills."(SAC ¶ 425-26.) These allegations suffer from the same lack of factual specificity that afflicted the allegations discussed above, and thus cannot sustain a § 10(b) claim. Plaintiffs offer no facts showing that Xentex was underfunded or incapable of producing the computers. Further, plaintiff's conclusory allegations that Kim knew the representations were false and made them in order to induce plaintiffs to invest are wholly inadequate, for the reasons re-

peatedly rehearsed above, to constitute facts giving rise to a strong inference of scienter.

Nor have plaintiffs stated a claim in Count 26 against Kim for misrepresentations relating to the promissory note. Count 26, like Count 25, is premised on Kim's failure to disclose that Xentex was underfunded, incapable of producing Voyager computers, and involved in several lawsuits due to its failure to pay bills. Plaintiffs do not allege that Kim had a duty to disclose, or that he ever even discussed with them, pending lawsuits. They do, however, allege that he made representations about Xentex's ability to produce Voyager computers, and thus should have disclosed that Xentex was incapable of doing so. They claim that in March 2001, Kim learned that a design problem was holding up production of the computers, and that he proceeded to give them a production schedule dated March 21, 2001 "which represented [Xentex's] present position and ability to mass produce Voyager computers, stat[ing] that Voyager computers would start to be produced in October, 2001."(SAC ¶ 441.) But Kim's representation that production of the Voyager computers would start in October was a projection or a forward-looking statement. "[P]redictions of future performance are inevitably inaccurate because things almost never go exactly as planned." *Zoghlin v. Renaissance Worldwide, Inc.,* No. 99 C 1965, 1999 WL 1004624, at *6 (N.D.Ill. Nov. 4, 1999) (quoting *Arazie v. Mullane,* 2 F.3d 1456, 1468 (7th Cir.1993)). Forward-looking statements are therefore not actionable unless plaintiffs allege "specific facts which illustrate that [the defendant's] predictions lacked a reasonable basis." *Arazie,* 2 F.3d at 1468. The mere allegation that there were design problems in March 2001 does not support the inference that there was no reasonable basis for Kim to represent that production would begin nearly seven months later.

***9** To the extent Counts 25 and 26 seek to hold Kim liable under § 10(b), they are dismissed for failure to state a claim.

D. § 10(b) Claims Against Flanagan: Counts 18 and 19

Plaintiffs sue Flanagan, a member of Xentex's Board of Directors, for misrepresentations purportedly made in connection with their initial stock purchase (Count 18) and the execution of the promissory note (Count 19). Neither of these claims satisfy the PSLRA's heightened pleading requirements.

With respect to the initial stock purchase, plaintiffs do not allege any direct contact with Flanagan. Rather, they claim Flanagan is liable for misrepresentations in the Information Statement because he "played a role in the preparation of said information sheet and/or had reviewed said Information [Statement] in his capacity as a member of the Xentex Board of Directors with a substantial financial interest in said corporation."(SAC ¶ 303.) In other words, they seek to hold him liable for a "group-published" document. "The group pleading doctrine is generally construed as applying only to high-level corporate officers and directors with direct involvement in the day-to-day business of the company." *Sutton v. Bernard,* No. 00 C 6676, 2001 WL 897593, at *5 (N.D.Ill. Aug. 9, 2001). Assuming plaintiffs' allegations are adequate under the group pleading doctrine and that the doctrine is applicable to Flanagan, plaintiffs' § 10(b) claim against Flanagan nevertheless fails for their failure to comply with the PSLRA's requirements that they allege facts indicating why the purported misrepresentations were false and facts giving rise to a strong inference of scienter.

Likewise, the § 10(b) claim against Flanagan based on misrepresentations relating to the promissory note is deficient. Plaintiffs allege that before they executed the promissory note, their principals had a telephone conversation with Flanagan during which he represented that "Xentex management was stable and effective, production of the Voyager computers were [sic] on schedule, [Xentex] was not under funded and he did not know the reason that the CEO of [Xentex] had quit."(SAC ¶ 320.) Plaintiffs, as is

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

their wont, fail to offer any specific facts indicating that any of these representations were false. They merely allege that Flanagan, as a Board member, attended Board meetings, had frequent conversations with the former CEO, had reviewed documentation, and "otherwise knew" the representations were false. (SAC ¶ 320.) Such vague allegations are not nearly factually specific enough to satisfy the PSLRA's pleading standards.

Given the aforementioned deficiencies, the court need not address the sufficiency of plaintiffs' allegations regarding Flanagan's scienter. To the extent Counts 18 and 19 raise claims against Flanagan under § 10(b), they are dismissed.

E. Control Person Claims Under § 20 Against Turcotte, Kim & Flanagan

Plaintiffs also sue Turcotte, Kim, and Flanagan as control persons under § 20 of the Exchange Act based on misrepresentations relating to plaintiffs' initial stock purchase and their subsequent loan pursuant to the promissory note.[FN14] Plaintiffs' control-person claims under § 20 are derivative claims, and thus are actionable only if plaintiffs adequately allege a primary violation under § 10(b). *Heartland Fin. USA, Inc. v. Fin. Insts. Capital Appreciation Partners I, L.P.,* No. 02 CV 3982, 2002 WL 31819008, at * 8 (N.D.Ill.Dec. 12, 2002). Because plaintiffs here failed to state a claim under § 10(b) against any of the defendants, plaintiffs' claims under § 20 must be dismissed as well. *Id.*

FN14. As noted earlier, plaintiffs did not bring the control-person liability claims under § 20 in counts separate from the direct liability claims under § 10(b). The § 20 claims are raised against Turcotte in Counts 9 and 10, against Kim in Counts 24 and 25, and against Flanagan in Counts 18 and 19.

II. *Claims Under Section 12(a)(2) and Section 15 of the Securities Act of 1933*

***10** Plaintiffs also bring claims against Xentex, Turcotte, Kim and Flanagan under § 12(a)(2) of the Securities Act relating to their initial stock purchase. The PSLRA's heightened pleading requirements do not apply to claims under the Securities Act. *Adams Golf,* 176 F.Supp.2d at 230. Likewise, neither fraud nor scienter are elements of a Section 12(a)(2) claim. *In re Nationsmart Corp. Secs. Litig.,* 130 F.3d 309, 318 (8th Cir.1997). Nor need plaintiffs satisfy Rule 9(b), as long as they are not making allegations of fraud. Flanagan and the Xentex defendants, however, argue that plaintiffs have no cause of action under § 12(a)(2) because plaintiffs purchased stock through a private placement, not a public offering. Plaintiffs disagree.

Section 12(a)(2) applies only to public offerings, not private placements. Liability under § 12(a)(2) extends to any person who "offers or sells a security ... by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements ... not misleading...."15 U.S.C. § 77*l* (a)(2). As the Supreme Court explained in *Gustafson v. Alloyd Co., Inc.,* 513 U.S. 561, 567-68, 571 (1995), § 12(a)(2) provides for liability only for misstatements in prospectuses or false oral communications relating to such prospectuses. Further, the term "prospectus" is "confined to documents related to public offerings by an issuer or its controlling shareholders." *Id.* at 569.[FN15] Accordingly, causes of action brought under § 12(a)(2), where the transaction at issue was a private placement rather than a public offering, are subject to dismissal. *See, e.g., Abbell Credit Corp. v. Banc of Am. Secs., L.L.C.,* No. 01 C 2227, 2001 WL 1104601, at *3 (N.D.Ill. Sept. 17, 2001) (dismissing § 12(a)(2) claims pursuant to Rule 12(b)(6)); *Liberty Ridge LLC v. Realtech Sys. Corp.,* 173 F.Supp.2d 129, 135 (S.D.N.Y.2001) (same).

FN15.*Gustafson* addressed Section 12(2), which by amendment in 2000 became Section 12(a)(2).

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Plaintiffs allege that they made their initial stock purchase in a public offering. That allegation, however, is contradicted by the offering document for plaintiffs' initial investment. "It is a well-settled rule that when a written instrument [properly before the court as an exhibit] contradicts allegations in the complaint, ... the exhibit trumps the allegations."*N. Ind. Gun & Outdoor Shows, Inc. v. City of South Bend,* 163 F.3d 449, 454 (7th Cir.1998).FN16 The Information Statement plainly states that the offering was a "private placement," that was "being made pursuant to Regulation D of the Securities Act of 1933," that "investors must be 'accredited investors' under Regulation D," and that no public trading market existed for the shares offered. (Information Statement at unnumbered p. 2.) Sales of securities made pursuant to Regulation D, 17 C.F.R. § 230.506, are not public offerings.

FN16. In determining whether to grant the motion to dismiss, the court may properly consider the Information Statement, which the Xentex defendants submitted as an exhibit to their brief in support of their motion to dismiss, because plaintiffs referred to the Information Statement in their complaint and the document is central to plaintiffs' claims. *Wright v. Assoc. Ins. Cos. Inc.,* 29 F.3d 1244, 1248 (7th Cir.1994). For the same reasons, the court will consider the Promissory Note and the Amendment to that note. The court will not, however, consider any of the other documents submitted by the Xentex defendants, *i.e.,* the Worldwide Manufacturing Agreement, the Sales and Distribution Licensing Agreement, the list of Due Diligence Documents Delivered to Copeland Family, or the Subscription Agreement. Although those documents may well be central to resolution of plaintiffs' claims, none of those documents were referenced in the complaint. The exception allowing a court to consider documents referenced in a complaint, and central to the claims, is a narrow one. "It is not intended to grant litigants license to ignore the distinction between motions to dismiss and motions for summary judgment...." *Levenstein v. Salafasky,* 164 F.3d 345, 347 (7th Cir.1998).

But despite what the Information Statement says, plaintiffs argue that Xentex's sale of securities does not qualify as a private placement under Regulation D. Regulation D applies only if certain conditions are met, one of which requires that the number of purchasers not exceed thirty-five. 17 C.F.R. § 230.506(b)(2)(i). Regulation D also places restrictions on investments by purchasers who are not accredited investors. *See id.* at § 230.506(b)(2)(ii). According to plaintiffs, "there were over 300 investors in [Xentex] and a large percentage of the investors were unaccredited."(Pls.' Surreply at 9.) FN17 If these assertions are true, the offering by which plaintiffs acquired their Xentex stock would not qualify as a private placement and would have to satisfy the requirements for a public offering. At this stage, the court must accept their truth. Consistent with these assertions, plaintiffs could prove that they acquired their stock in a public offering, subject to the requirements of § 12(a)(2).FN18 The Xentex defendants and Flanagan bear the burden of proving that the private placement exemption applies to the stock sale at issue. *UBS Asset Mgmt. (N.Y.) Inc. v. Wood Gundy Corp.,* 914 F.Supp. 66, 68 (S.D.N.Y.1996) (burden of showing exemption falls on person claiming it).

FN17. Even though these allegations are not in the complaint, the court may consider them. In opposing dismissal, a plaintiff is allowed to assert additional facts that are consistent with the complaint to show facts which, if proved, would entitle him to judgment. *Early v. Bankers Life & Cas. Co.,* 959 F.2d 75, 79 (7th Cir.1992).

FN18. These assertions are not necessarily inconsistent with a private placement,

however. For example, Xentex could have achieved 300 investors by means of multiple private placements with no more than 35 investors per offering.

***11** The Xentex defendants raise no other challenges to plaintiffs' § 12(a)(2) claims against Xentex (Count 1), Turcotte (Count 8), and Kim (Count 24). Accordingly, those counts survive the motion to dismiss. Counts 8 and 24 also sought to impose control-person liability under § 15 against Turcotte and Kim, respectively. Claims under § 15 are derivative claims, seeking to impose joint and several liability against control persons for others' primary violations of § 12(a)(2). Because the Xentex defendants' only challenge to the § 15 claims was that plaintiffs failed to allege a primary violation under § 12(a)(2), the control-person claims against Turcotte and Kim also survive.

Flanagan, on the other hand, raises two additional arguments for dismissal of the claims against him under the Securities Act. He argues first that plaintiffs failed to properly state a claim against him under § 12(a)(2) because they do not allege that Flanagan was a seller within the meaning of the statute. Liability under § 12(a)(2) is limited to "those who pass title of securities or solicit their sale." *Danis v. USN Communications, Inc.,* 73 F.Supp.2d 923, 936 (N.D.Ill.1999) (citing *Pinter v. Dahl,* 486 U.S. 622 (1988)). Thus, individual officers and directors are not liable "absent allegations that they actually promoted or solicited the sale of [Xentex's] securities."[FN19] *Maton v. Arthur Andersen & Co.,* No. 91 C 1885, 1991 WL 131184, at *3 (N.D.Ill. July 5, 1991). Here, plaintiffs effectively concede that Flanagan is not liable under § 12(a)(2). They argue that as a control person under § 15, Flanagan can be liable for another person's primary violation of § 12(a)(2). That is true, but as a control person, he would be liable only under § 15, not under both § 15 and § 12(a)(2). Plaintiffs' § 12(a)(2) claim against Flanagan is therefore dismissed.

FN19. At the November 1st meeting, it was Batio and Tucker, not Flanagan, who met with plaintiffs and presented them with the opportunity to invest in Xentex.

Flanagan also asserts that plaintiffs have not adequately pled control-person liability under § 15. In the Seventh Circuit, plaintiffs seeking to establish control-person liability must plead two clements: "(1) that the defendant actually exercised general control over the operations of the entity [that is liable for a primary violation]; and (2) that the defendant had the power or ability to control the specific acts constituting the primary violation." *Lindelow v. Hill,* No. 00 C 3727, 2001 WL 830956, at *9 (N.D.Ill. July 20, 2001) (citing *Donohoe v. Consol. Operating & Prod. Corp.,* 982 F.2d 1130, 1138-39 (7th Cir.1992)).[FN20] Simply relying on Flanagan's status as a member of the Board of Directors is insufficient to state a control person claim. *See, e.g., Donovan v. ABC-NACO, Inc.,* No. 02 C 1951, 2002 WL 1553259, at *6 (N.D.Ill. July 15, 2002) (fact that defendants were directors insufficient to support control-person liability). But here, plaintiffs allege a bit more. They contend that Flanagan "actively participated in and controlled decisions of the Board of Directors" (general control), that he helped prepare and/or review the Information Statement (control over specific acts) and that he held a security interest in all of Xentex's assets. These allegations are enough to survive a motion to dismiss. Claims under § 15 need only satisfy federal notice pleading standards. Moreover, "[o]rdinarily, whether a defendant is a 'controlling person' ... is a question of fact that cannot be determined at the pleading stage." *Lindelow,* 2001 WL 830956, at *9.

FN20. Both *Lindelow* and *Donohoe* involved control person liability under § 20, not § 15, but the same standards apply to both. *See In re VMS Secs. Litig.,* 752 F.Supp. 1373, 1402 (N.D.Ill.1990).

*Conclusion*

***12** Both Flanagan's and the Xentex defendants' motions to dismiss the federal claims against them

in the Second Amended Complaint are granted in part and denied in part. As explained above, the claims against Xentex, Turcotte, Kim, and Flanagan under § 10(b) and § 20 of the Exchange Act are hereby dismissed, as is the § 12(a)(2) claim against Flanagan. The claims against Xentex, Turcotte and Kim under § 12(a)(2) survive, however, as do the control-person liability claims against Turcotte, Kim and Flanagan under § 15.

N.D.Ill.,2003.
Premier Capital Management, L.L.C. v. Cohen
Not Reported in F.Supp.2d, 2003 WL 21960357 (N.D.Ill.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-12

Westlaw



H
Only the Westlaw citation is currently available.

United States District Court,
S.D. New York.
**PRO BONO INVESTMENTS**, INC., Plaintiff,
v.
Christina Green GERRY, and Abraham Goldner and Joan Fisher, Executors of the Estate of Judith H. Green, Defendants.
Christina Green GERRY, and Abraham Goldner and Joan Fisher, Executors of the Estate of Judith H. Green, Counterclaim Plaintiffs,
v.
**PRO BONO INVESTMENTS**, INC.; **Pro Bono**, LLC; Lawrence Bishop; John Dockery; Bishop & Co.; Faith Conger; Richard Conger; Gray Seifert & Co., LLC, f/k/a Gray, Seifert & Co., Inc.; and Legg Mason, Counterclaim Defendants.
**No. 03 Civ. 4347(JGK).**

Sept. 30, 2005.

*OPINION AND ORDER*

KOELTL, J.

***1** The plaintiff, Pro Bono Investments, Inc., ("Pro Bono"), originally brought an action against defendants, Christina Green Gerry, daughter of the late Judith H. Green, and Abraham Goldner and Joan Fisher, Executors of the Estate of Judith H. Green (the "Estate"), for payment on a promissory note allegedly executed by Green on July 12, 2001 (the "Note"), and payable to the plaintiff as a successor-in-interest to a nominee partnership, Bishop & Co. In its Second Amended Complaint, Pro Bono asserted claims for (1) payment on the Note, (2) breach of contract for failure to repay the amounts allegedly loaned, and (3) unjust enrichment.[FN1]

> FN1. The plaintiff filed a motion for partial summary judgment and the defendants have cross-moved for summary judgment. These motions for summary judgment are the subject of a separate Opinion and Order issued by this Court.

Gerry, Goldner, and Fisher (the "counter-plaintiffs") have filed counterclaims against Pro Bono Investments, Inc.; Pro Bono Investments, LLC; Lawrence Bishop ("Bishop"); John Dockery; Bishop & Co.; Faith Conger; Richard Conger; Gray, Seifert & Co., LLC, f/k/a Gray, Seifert & Co., Inc. ("Gray Seifert"); and Legg Mason, Inc. ("Legg Mason") (collectively, "the counter-defendants"). The counter-plaintiffs assert fifteen counterclaims. The First Counterclaim is for a declaratory judgment that the Note is void and unenforceable. The Second Counterclaim is based on promissory estoppel against the individual defendant Bishop, based on alleged misrepresentations made by Bishop in connection with Green's down payment on property in Bridgehampton, New York. The Third Counterclaim seeks an accounting from Bishop, Bishop & Co., and Gray Seifert of all holdings and transactions by Green and Gerry during the period from 1980 to 2001. The Fourth Counterclaim alleges securities fraud against all of the counter-defendants pursuant to Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 CFR § 240.10b-5, promulgated thereunder. The counter-plaintiffs also assert a claim for control person liability under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), against Gray Seifert and Legg Mason. The Fifth Counterclaim is for breach of contract against Bishop and Gray Seifert. The Sixth Counterclaim is asserted pursuant to the Investment Advisors Act of 1940, 15 U.S.C. § 80b-1*etseq.,* against Grey Seifert and Legg Mason as registered investment advisors. The Seventh Counterclaim asserts common law fraud against all of the counter-defendants. The Eighth Counterclaim alleges a breach of fiduciary duty by Bishop and Gray Seifert. The Ninth Counterclaim is based on alleged conversion and is asserted against all the

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

counter-defendants. The Tenth Counterclaim asserts unjust enrichment against all of the counter-defendants. The Eleventh Counterclaim alleges negligence by Bishop and Gray Seifert. The Twelfth Counterclaim alleges gross negligence against Bishop and Gray Seifert. The Thirteenth Counterclaim alleges negligent misrepresentation, which was allegedly committed by Bishop, Bishop & Co., and Gray Seifert. The Fourteenth Counterclaim seeks indemnification from Bishop, Bishop & Co., and Gray Seifert. The Fifteenth Counterclaim requests that the Court impress a constructive trust on the funds allegedly retained by Bishop and Gray Seifert.

***2** The counter-defendants move to dismiss the counterclaims pursuant to Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure arguing, among other things, that the securities fraud claim under § 10(b) is time-barred under the applicable statutes of limitations, that it fails to state a claim upon which relief can be granted pursuant to Federal Rule of Civil Procedure 12(b)(6), and that the Second Amended Complaint fails to allege fraud with particularity as required by Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b). In addition, Gray Seifert and Legg Mason argue that the Section 20(a) claim for control person liability fails to state a claim and is improperly pleaded. All of the counter-defendants urge the Court to decline supplemental jurisdiction over the state law claims in the event that the counterclaims based on federal law are dismissed.[FN2]

> FN2. The counter-defendants also dispute additional elements of § 10(b) and Rule 10b-5 liability, namely the counter-plaintiffs' scienter and reliance required for Section 10(b) and Rule 10b-5 claims. In light of the result here, there is no need to reach these additional arguments relating to the § 10(b) and Rule 10b-5 claims or the issue of § 20(a) control person liability against any of the counter-defendants. *See* *Salinger v. Projectavision,* 934 F.Supp. 1402, 1404 n. 2 (S.D.N.Y.1996).

I.

On a motion to dismiss a counterclaim, the allegations in the counterclaim are accepted as true. *See* *Universal Acupuncture Pain Servs., P.C. v. State Farm Mutual Auto. Ins. Co.,* 196 F.Supp.2d 378, 382 (S.D.N.Y.2002); *Grandon v. Merrill Lynch & Co.,* 147 F.3d 184, 188 (2d Cir.1998). All reasonable inferences are thus drawn in the counter-plaintiffs' favor. *See* *Universal Acupuncture,* 196 F.Supp.2d at 382; *Gant v. Wallingford Bd. of Educ.,* 69 F.3d 669, 673 (2d Cir.1995); *Cosmas v. Hassett,* 886 F.2d 8, 11 (2d Cir.1989). The Court's function on a motion to dismiss is "not to weigh the evidence that might be presented at trial but merely to determine whether the complaint itself is legally sufficient." *Goldman v. Belden,* 754 F.2d 1059, 1067 (2d Cir.1985). Therefore, the counter-defendants' motion to dismiss should only be granted if it appears that the counter-plaintiffs can prove no set of facts in support of their claims that would entitle them to relief. *See* *Swierkiewicz v. Sorema, N.A.,* 534 U.S. 506 (2002); *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957); *Grandon,* 147 F.3d at 188; *Goldman,* 754 F.2d at 1065.

In deciding the motion, the Court may consider documents that are referenced in the counterclaims, documents that the counter-plaintiffs relied on in bringing suit and that are either in the counter-plaintiffs' possession or the counter-plaintiffs knew of when bringing suit, or matters of which judicial notice may be taken. *Chambers v. Time Warner, Inc.,* 282 F.3d 147, 153 (2d Cir.2002); *seealso* *Brass v. Am. Film Techs., Inc.,* 987 F.2d 142, 150 (2d Cir.1993); *Cortec Indus., Inc. v. Sum Holding L.P.,* 949 F.2d 42, 47-48 (2d Cir.1991); *I. Meyer Pincus & Assoc ., P.C. v. Oppenheimer & Co., Inc.,* 936 F.2d 759, 762 (2d Cir.1991); *Skeete v. IVF America, Inc.,* 972 F.Supp. 206, 208 (S.D.N .Y.1997); *VTech Holdings Ltd. v. Lucent Techs., Inc.,* 172 F.Supp.2d 435, 437 (S.D.N.Y.2001);

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

*also* *N.Y. Mercantile Exch. v. Intercont'l Exch., Inc.,* 323 F.Supp.2d 559, 561 (S.D.N.Y.2004).

II.

***3** The counter-plaintiffs allege the following relevant facts in the Amended Answer to the Second Amended Complaint.

Christina Green Gerry is a citizen of New York, the daughter of the decedent Judith H. Green, and a residuary beneficiary of the Green Estate. (Counterclaim ("CC") ¶ 61.) Abraham Goldner and Joan Fisher are co-executors of the Estate, and are both citizens of and reside in New York. (CC ¶¶ 62-63.) Pro Bono Investments, Inc. is a corporation organized and existing under the laws of Nevada and has its principal place of business in Arizona. (CC ¶ 64.) Pro Bono LLC is a Nevada limited liability company to which the assets of Bishop & Co. purportedly were assigned, transferred, and conveyed on or about February 12, 2003. (CC ¶ 65.) Lawrence Bishop is an Indiana citizen who currently resides in New York State. (CC ¶ 66.) Bishop was a founder and partner of Gray Seifert and the managing partner of Bishop & Co. (*Id.*) Bishop & Co. is a nominee partnership formed on or about November 1, 1986, with its principal place of business in New York. (CC ¶ 68.) As the managing partner of Bishop & Co., Bishop was allegedly responsible for implementing decisions of the partners pursuant to the instructions from the principals of Bishop & Co., Faith and Richard Conger. (CC ¶ 66.) John Dockery, a New York resident, is a lawyer, accountant, and general partner of Bishop & Co., which he served as a bookkeeper and tax advisor. (CC ¶ 67.)

At all relevant times, Bishop & Co. was a client of its managing partner, Lawrence Bishop, and of Gray Seifert, and was controlled by its owners and principals, Richard and Faith Conger. (CC ¶ 68.) The Congers are citizens of and reside in New Jersey. (CC ¶ 69.) At all relevant times, the Congers were clients of Gray Seifert and, according to the counter-plaintiffs, are allegedly responsible for Bishop's acts and omissions based on principles of agency, vicarious liability, respondeat superior, and control person liability under 15 U.S.C. § 78t(a). (*Id.*)

Gray, Seifert & Co., LLC is the successor-in-interest to Gray, Seifert & Co., Inc. (collectively, "Gray Seifert"), which was a New York corporation with its principal offices in New York at the time of the acts complained of in this action. (CC ¶ 70.) At present, Gray Seifert is a limited liability company organized and existing under Delaware law with its principal offices located in Baltimore, Maryland. Gray Seifert was at all relevant times a registered investment advisor and is alleged to be responsible for Bishop's acts and omissions based on principles of agency, vicarious liability, respondeat superior, and control person liability under 15 U.S.C. § 78t(a). (*Id.*) Legg Mason is a corporation organized and existing under Maryland law with its principal offices in Baltimore, Maryland. (CC ¶ 71.)

The counter-plaintiffs allege that Lawrence Bishop, a former officer of Gray Seifert, mismanaged assets of the late Judith Green before and after he became an officer of Grey Seifert. When Green's husband, William, died in 1979, he left his widow in excess of $5,000,000, including more than $1,000,000 in cash and cash equivalents, and also a collection of valuable artwork. The residue of his estate, in excess of $1,600,000, was divided equally between two separate trusts created in 1987 for the benefit of each of the couple's children, Christina and Nicholas. (CC ¶ 75.)

***4** In 1980, Green was introduced to Bishop, who offered his services and those of Gray Seifert, to manage the money and assets bequeathed to Green by her late husband. (CC ¶ 76.) On or about October 27, 1980, Green executed an agreement with Gray Seifert (the "Agreement") pursuant to which she opened an investment account (the "Investment Account") under the management of Gray Seifert and Bishop. Under the second paragraph of the Agreement, Gray Seifert was permitted to "arrange

custody of the Investment Account in any bank, trust company, brokerage firm or other custodial facility (the "Custodian") as [it] shall select."Under the fourth paragraph of the Agreement, Gray Seifert agreed to ensure that either it or the Custodian "will provide ... quarterly appraisals of securities in the Investment Account and monthly cash statements."Under the fifth paragraph, Gray Seifert "will have complete and unrestricted ability with respect to the investments of the Investment Account and can trade securities in [its] sole discretion."(CC ¶ 77.) Green made an initial deposit of $1,000,000 to open her Investment Account. (CC ¶ 78.) Pursuant to the Agreement, Gray Seifert thereafter designated Neuberger Berman, Ltd. ("Neuberger Berman") as one of the custodians of Green's investments (the "Neuberger Account"). Over the next twenty years Green deposited in excess of $11 million of her funds into the account. (CC ¶ 79.) The value of the Neuberger Account had been reduced to zero by the date of Green's death on September 14, 2001. (*Id.*)

Over the course of his stewardship and management of Green's assets, Bishop allegedly claimed that, in addition to her investments in publicly-traded securities, Bishop was investing her money in what he called "special situation" investments (the "Special Situation Securities"), which were not held in the Neuberger Account, but rather, were held by other repositories in other accounts under Bishop's control, including Bishop & Co. Bishop & Co. was formed for the benefit of Richard and Faith Conger, who were defined in the partnership agreement dated November 1, 1986 (the "Partnership Agreement") as the "Principals." Bishop and Dockery were named as the two general partners of Bishop & Co. and each became liable individually and jointly and severally, for damages arising from the acts or misconduct of the other and the partnership. (CC ¶ 81.) As the managing partner of Bishop & Co., Bishop was also required pursuant to paragraph 6(a) of the Partnership Agreement to maintain the books and records of the partnership. (CC ¶ 82.)

The counter-plaintiffs allege that, in connection with the purchases and sales of Special Situation Securities, Bishop and Gray Seifert made materially false and misleading statements, including that these securities were low risk, especially lucrative, and reserved for preferred clients of Bishop and Gray Seifert. (CC ¶ 83.) Bishop and Gray Seifert allegedly failed to disclose material facts regarding these Securities, including that they were high-risk private investments not permissible under Gray Seifert's internal rules and regulations and that in some cases, Bishop had a personal financial interest in the investment which precluded him from recommending certain investments under applicable conflict of interest prohibitions, including Gray Seifert's internal guidelines and 15 U.S.C. § 80b-6(3). (CC ¶ 84.) Moreover, Bishop allegedly made materially false and misleading statements and omissions in his capacity as an officer of Gray Seifert and managing partner of Bishop & Co. (CC ¶ 85.) In reliance on Bishop's misrepresentations and omissions, Green allegedly liquidated her entire art collection and other investments to provide funding for the purchase of Special Situation Securities and other investments. (CC ¶ 87.) Except for a brief eighteen-month period in 1993 and 1994, Green allegedly held an equity interest in only one publicly-traded company, American Business Computers Corporation ("ABCC"), and two private companies with unpriced shares and no ready market, Harris Acquisition Corp. and Wind Baron Corp. (CC ¶ 89.) In connection with the purchases of these securities, Bishop, Bishop & Co, and Gray Seifert allegedly failed to disclose that these were penny stock companies, all with financial difficulties. Bishop allegedly failed to disclose that he was a director of ABCC, that he knew that the company was facing bankruptcy and de-listing from NASDAQ, and that Green's holdings in ABCC were therefore worthless. (CC ¶¶ 99-101.)

***5** On January 25, 1998, Gerry and her mother met with Bishop at the Gray Seifert offices in New York, New York. Gerry secretly tape-recorded the meeting, where Bishop allegedly made false state-

ments to persuade Green and Gerry that his management of Green's funds had been profitable and that he had invaded Green's principal for her benefit, that he had made millions of dollars investing the proceeds from the sale of her artwork, and that Green should invest more money with Bishop. (CC ¶ 91.) At the meeting, Bishop allegedly made false and fraudulent misrepresentations and material omissions in furtherance of a fraud that allegedly continued up to and including the date of Green's death, and these statements and omissions "were designed to bilk Mrs. Green of her assets through investments in Special Situation Securities."(CC ¶ 92.) Bishop allegedly falsely represented that Bishop & Co was a partnership that he owned with two other families and that Green's participation in Bishop & Co.'s investments would be limited to those investments that were profitable. Bishop allegedly could make this decision because he was the general partner in charge of the money. (CC ¶ 93.) According to Bishop, Green's investments through Bishop & Co. had already generated her more than $500,000 in annual returns. Bishop also told Green that she had invested $300,000 in real estate ventures that had yielded more than $1.2 million per year; had received $100,000 from an investment in a latex glove company and $150,000 through another venture that Green had invested $15,000 in during 1996 and 1997. (CC ¶ 94.)

During the January 25, 1998 meeting, Bishop also allegedly represented that he had two deals, LB/JG Partnership ("LB/JG") and Second Time Out Partnership ("Second Time Out"), which involved music products sold in television infomercials. Bishop allegedly asked Green for a $100,000 investment in these ventures, which Green provided through the sale of artwork. (CC ¶ 95.) Bishop allegedly failed to disclose that LB/JG was a high-risk, speculative venture and that, because of his personal investment in LB/JG and a friendship with LB/JG partner Joseph Gabriel, Bishop was prohibited from soliciting such investments under Gray Seifert's internal guidelines and the conflict of interest prohibitions of 15 U.S.C. § 80b-6(3). (CC ¶ 97.)

At the January 1998 meeting, Green also expressed concern about her investment in ABCC, a stock that had not performed well in the eight years that it had been in her portfolio. (CC ¶ 99.)Bishop, a member of the ABCC board of directors, allegedly directed Green to continue to hold her ABCC stock even though he knew the company was in danger of collapse. (CC ¶ 100.) In October 1998, ABCC was delisted from the NASDAQ. In 2000 or early 2001, ABCC declared bankruptcy and its shares were worthless on the date of Green's death. (CC ¶ 101.)

At the January 1998 meeting, Green asked Bishop for an accounting of all her past and present investments in private equities. Green subsequently made a written request to Bishop. In that letter, Green indicated that although Bishop had asked Green to disregard her Neuberger Account statements because they did not reflect her Special Situation Security holdings, Green wanted Bishop to provide an accounting of the Special Situation Securities. (CC ¶ 103.) Bishop responded with a memorandum dated December 14, 1998 in which he stated that Green had a 10% interest in Bishop's 30% interest in LB/JG Partnership, a 50% interest in Bishop's 50% interest in Second Time Out Partnership, and 290,000 shares of ABCC held for her in Bishop & Co. (CC ¶ 104.)

***6** On July 12, 2001, Bishop claims that he obtained Green's signature on a promissory note (the "Note") pledging as collateral all securities and cash in the Neuberger Account as well as the shares in her cooperative Park Avenue apartment and proprietary lease. Bishop drafted the Note (CC ¶ 107), which was allegedly requested by Christopher J. ("Kim") Elliman ("Elliman"), a Gray Seifert partner and Legg Mason employee. Bishop allegedly brought the Note to Green to sign based upon instructions of Legg Mason and Gray Seifert. (CC ¶ 109.) At the time Green signed the Note, Bishop allegedly failed to disclose that Green had received money from and was allegedly indebted to Bishop & Co. for amounts that Bishop had transferred. Bishop also failed to disclose that the Note might

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

be used as evidence that Green had an obligation to repay funds to Bishop & Co. (CC ¶ 110.) Green's signature is not notarized. Although Green's assistant, Marina Lakner, was present in Green's apartment where the Note was allegedly signed, there were no witnesses to the signing other than Bishop. (CC ¶ 111.) The counter-plaintiffs allege that Bishop, Gray Seifert, and Legg Mason all misrepresented or failed to disclose material facts in connection with the procurement of the purported Note, including the fact that transfers in excess of $1 million had been made from Bishop & Co.'s Neuberger account to Green's Neuberger Account, that Bishop & Co. intended to claim that these transfers were loans, and that Bishop & Co.'s books and records did not record any loans to Green. The counter-plaintiffs claim that Green was deceived and did not know she was subject to any claims of indebtedness when she allegedly signed the Note. (CC ¶ 114.)

Shortly after the Note was allegedly signed, Bishop's employment with Gray Seifert ended. (CC ¶ 112.) The counter-plaintiffs allege that Bishop was either fired or forced to resign from Gray Seifert because Gray Seifert and Legg Mason knew of Bishop's alleged malfeasance and fraud in connection with the Special Situation Securities in which other Gray Seifert clients, in addition to Green, held interests. (*Id.*)

On November 19, 2001, one of the Congers allegedly wrote a letter to Elliman at Gray Seifert. The letter states that Bishop's transactions "were made with my full consent and knowledge and are affirmed by me in all respects."(CC ¶ 116.)

In or about April 2002, Bishop went to the offices of co-executor Goldner and informed him that Green owed Bishop & Co. $1,088,000. Bishop did not mention the Note. Rather, Bishop showed Goldner a list of transactions indicating that Bishop & Co. had allegedly loaned money to Green. Goldner made inquiries and reviewed documents, including statements from Green's Neuberger Account, but could not find evidence of indebtedness or investments. (CC ¶ 118.) By letter dated January 14, 2003, Bishop informed Goldner that Bishop and Bishop & Co. were seeking approximately $1.2 million in funds advanced to Green from Bishop & Co., which were purportedly secured by securities in Green's Neuberger Account and shares in her cooperative apartment. Bishop and Bishop & Co. sought to prevent a sale of the apartment, arguing that the shares could not be tendered without the permission of Larry Bishop or Bishop & Co. (CC ¶ 119.)

***7** Bishop & Co.'s legal advisors, Gary Yanker and Logan Fulrath, Jr., subsequently executed assignments purporting to transfer the assets, but not liabilities, of Bishop & Co. The assignments ran first to a Nevada limited liability company named Pro Bono, LLC and from Pro Bono, LLC to Pro Bono Investments, Inc.[FN3] (CC ¶ 120.) Pro Bono Investments, Inc. is allegedly the successor-in-interest to Bishop & Co. and acts in place of Bishop & Co. in asserting claims against the Estate under the Note. (CC ¶ 121.)

FN3. Pro Bono Investments, Inc. and Pro Bono, LLC are referred to throughout this Opinion and Order as "Pro Bono," which refers to whichever entity held assignments from Bishop & Co. at the time.

III.

In their Fourth Counterclaim, the counter-plaintiffs allege federal securities fraud in violation of Section 10(b) and Rule 10b-5. There are two separate sets of alleged misrepresentations and omissions: (1) statements associated with Green's security investments, including statements allegedly made by Bishop on January 25, 1998 in connection with the LB/JG Partnership, Second Time Out, and ABCC stock, and (2) statements associated with the Note allegedly signed by Green on July 12, 2001. The counter-defendants move pursuant to Rule 12(b)(6) to dismiss the plaintiffs' § 10(b) and Rule 10b-5 claims on the grounds that the first set of alleged

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

misrepresentations and omissions are time-barred, and that the second set of alleged misrepresentations and omissions were not made "in connection with" the purchase or sale of securities.

A.

The Fourth Counterclaim brought pursuant to § 10(b) and Rule 10b-5 is plainly time-barred with respect to alleged securities transactions occurring between 1980 and 1998.[FN4] Litigation instituted pursuant to § 10(b) and Rule 10b-5 "must be commenced within 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 (1991); *seealso Dodds v. Cigna Secs., Inc.,* 12 F.3d 346, 349 (2d Cir.1993). The one-year prong of the statute of limitations on § 10(b) and Rule 10b-5 claims begins to run when the plaintiffs have either actual or constructive notice of the alleged fraud. *See Dodds,* 12 F.3d at 350;*seealso Salinger,* 934 F.Supp. at 1408. "[W]hen the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded, a duty of inquiry arises, and knowledge will be imputed to the investor who does not make such an inquiry. Such circumstances are often analogized to 'storm warnings." ' *Dodds,* 12 F.3d at 350 (citations omitted).[FN5]

FN4. The only transaction alleged to occur after 1998 concerns the execution of the Note, which, for reasons to be described in this Opinion, provides no basis for a federal securities law claim.

FN5. Rather than follow the applicable limitations period established in *Lampf,* the counter-plaintiffs urge the Court to rely on the limitations period established by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), Pub.L. No. 107-204, § 804, 116 Stat. 745, 801 (2002) codified in part at 28 U.S.C. § 1658(b). Under the Sarbanes-Oxley Act, claims brought under § 10(b) and § 20(a) of the Exchange Act may be brought no later than the earlier of: (1) two years after the discovery of the facts constituting the alleged fraud, or (2) five years after such fraud. 28 U.S.C. § 1658(b). However, the counter-defendants are correct that the period provided by *Lampf* applies to this case and that the longer statute of limitations period provided by Sarbanes-Oxley does not. For reasons to be explained above, these claims were already time-barred at the time that the Sarbanes-Oxley Act was enacted on July 30, 2002 and that statute did not revive claims that were already time-barred. *See,e.g., In Re Enter. Mortgage Acceptance Co. LLC, Sec. Litig.,* 391 F.3d 401, 403-04 (2d Cir.2004); *In re Worldcom, Inc. Sec. Litig.,* Nos. 02 Civ. 3288 & 03 Civ. 9499, 2004 WL 1435356, at *7 (S.D.N.Y. June 28, 2004) ("Sarbanes-Oxley does not revive previously time barred private securities fraud claims.").

The question of constructive knowledge and inquiry notice may be one for the trier of fact and therefore ill-suited for determination on a motion to dismiss. *SeeVassilatos v. Ceram Tech Int'l, Ltd.,* No. 92 Civ. 4574, 1993 WL 177780, at *4 (S.D.N.Y. May 19, 1993) (dismissal not appropriate where discovery might yield facts to support or refute plaintiffs' constructive knowledge); *Siebert v. Nives,* 871 F.Supp. 110, 116 (D.Conn.1994) (noting that not every case is susceptible to determination of inquiry notice as a matter of law); *seealso Salinger,* 934 F.Supp. at 1408-09. Nonetheless, the test is an objective one and dismissal is appropriate when the facts from which knowledge may be imputed are clear from the pleadings and the public disclosures themselves. *See Dodds,* 12 F.3d at 352 n. 3 ("Where ... the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of fraud can be gleaned from

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

the complaint and papers such as the prospectuses and disclosure forms that are integral to the complaint, resolution of the issue on a motion to dismiss is appropriate."); *In re Integrated Res. Real Estate Ltd. P'ships Sec. Litig.,* 850 F.Supp. 1105, 1132-33 (S.D.N.Y.1993) ("Integrated I"); *Lenz v. Assoc'd Inns & Rests. Co. of Am.,* 833 F.Supp. 362, 370 & n. 7 (S.D.N.Y.1993); *seealso Menowitz v. Brown,* 991 F.2d 36, 42 (2d Cir.1993) (affirming dismissal based on finding that plaintiffs were placed on inquiry notice based on SEC filings). The plaintiffs need not be able to learn the precise details of the fraud, but they must be capable of perceiving the general fraudulent scheme based on the information available to them. *See Dodds,* 12 F.3d at 352 ("An investor does not have to have notice of the entire fraud being perpetrated to be on inquiry notice."); *In re Integrated Resources Real Estate Sec. Litig.,* 815 F.Supp. 620, 637 (S.D.N.Y.1993) (*"Integrated II"* ) ("[T]he statute is not tolled for a plaintiff's leisurely discovery of the full details of the alleged scheme. Instead, the period runs from the time at which a plaintiff should have discovered the general fraudulent scheme."(citations and internal quotations omitted)). The available facts must establish the probability of fraud, however, and not merely the possibility of fraud. *See Lenz,* 833 F.Supp. at 373 & n. 10; *Integrated II,* 815 F.Supp. at 638;*see also Salinger,* 934 F.Supp. at 1408-09.

***8** This action was originally commenced by Pro Bono against the Estate as part of an effort to recover money allegedly loaned to Green pursuant to the Note. Pro Bono amended its complaint to add Gerry as an additional defendant. On March 30, 2004, the Estate and Gerry filed counterclaims against Pro Bono and added Gray Seifert and Legg Mason, among others, as additional counter-defendants.[FN6] The Fourth Counterclaim based on securities transactions that allegedly occurred between 1980 and 1998 is therefore time-barred because the counterclaims were filed on March 30, 2004, more than six years after the counter-plaintiffs knew or should have known the facts surrounding the transactions alleged to be fraudulent.[FN7] The most recent securities transactions alleged in this action all occurred in early 1998 or before; thus, if measured by three years after the date of the last alleged violation, these counterclaims were time-barred by early 2001 at the latest. Gerry was also on notice of possible fraud with respect to her mother's securities portfolio at least as of January 25, 1998, when Gerry, suspecting Bishop of committing fraud in connection with her mother's accounts, secretly tape-recorded a meeting with Bishop. The counter-plaintiffs therefore discovered or at least should have discovered the facts constituting the alleged violation prior to January 25, 1998. One year after the discovery of the facts constituting the alleged violation would have been January 25, 1999, more than five years before the counterclaims alleging federal securities fraud were filed.

FN6. The counter-plaintiffs originally asserted counterclaims against Pro Bono and Bishop on September 19, 2003, seeking a judgment that they did not owe Pro Bono on the alleged Note. They filed an Amended Answer on March 30, 2004 that asserted counterclaims relating to the investment relationship between Green and Gerry and Bishop, Bishop & Co., and Gray Seifert (including the counterclaims against the additional counter-defendants) for the first time. In July 2004, the counter-defendants all moved to dismiss the counterclaims. After a court conference on October 6, 2004, the counter-defendants filed an Amended Answer to the Second Amended Complaint with Counterclaims. Those counterclaims not directly related to the alleged Note do not relate back to the September 19, 2003 date.

FN7. Even under the longer statute of limitations provided by Sarbanes-Oxley, the counter-plaintiffs were on inquiry notice of the facts constituting the alleged fraud at

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

> the time that the alleged fraudulent statements were made, which was more than two years before the complaint was filed.

The counter-plaintiffs argue that these securities counterclaims are timely under principles of equitable tolling and the continuing wrong doctrine. Under the counter-plaintiffs' theory of the case, the securities transactions beginning in 1980 are related to and part of the fraud that continued up to and including Bishop's alleged procurement of the Note. Both arguments are without merit. The three-year statute of limitations period established for securities claims is measured from the date of the alleged securities transaction, and the Supreme Court instructs that equitable tolling is unavailable in § 10(b) actions because "the three-year limit is a period of repose inconsistent with tolling." *Lampf,* 501 U.S. at 363;*seealsoCSI Inv. Partners II, L.P. v. Cedant Corp.,* 18C F.Supp.2d 444, 462 (S.D.N.Y.2001); *Friedman v. Wheat First Sec.,* 64 F.Supp.2d 338, 344-45 (S.D.N.Y.1999).

The continuing wrong doctrine is also inapplicable. Each of the cases relied on by the counter-plaintiffs involve SEC enforcement actions that are governed by a different statute of limitations than private securities actions brought by investors, and one of the cases relied on by the counter-plaintiffs explicitly acknowledges that the continuing wrong doctrine may not apply to securities fraud actions. *See SEC v. Caserta,* 75 F.Supp.2d 79, 89 (E.D.N.Y.1999) (noting "it is not at all certain that the continuing violation doctrine applies in securities fraud litigation."); *accord De La Fuente v. DCI Telecom, Inc.,* 206 F.R.D. 369, 385-86 (S.D.N.Y.2002). In any event, even if the continuing wrong doctrine were applied to this case, no securities transactions occurred within the three-year limitations period. The counter-plaintiffs do not allege that the securities transactions allegedly occurring between 1980 and 1998 have any connection to the securities pledged under the Note. For the reasons explained below, the Note executed by Green was not a securities transaction and there is no allegation that the Note was in any way related to the transactions that occurred between 1980 and 1998. The execution of the Note was therefore not "so closely related" to the time-barred claims of stock allegedly purchased between 1980 and 1998 "as to be viewed as part of a continuing practice for which recovery should be had for all violations."*See Caserta,* 75 F.Supp.2d at 89.

***9** With respect to the amended counterclaims asserted against Grey Seifert and Legg Mason filed on March 30, 2004, those counter-defendants have an additional argument why the § 10(b) and Rule 10b-5 counterclaims are time-barred. The counter-plaintiffs attempt to "relate back" their claims to original counterclaims filed on September 19, 2003, in which neither Gray Seifert nor Legg Mason were named as parties. The relation back argument is without merit. Federal Rule of Civil Procedure 15(c) provides that a claim in an amended pleading relates back to the date of the original pleading if it arose out of the "conduct, transaction or occurrence set forth or attempted to be set forth in the original pleading."When new parties are added to an amended pleading, the pleading relates back to the original pleading date only if the new party "knew or should have known that, but for a mistake concerning the identity of the proper party, the action would have been brought against the party."Fed.R.Civ.P. 15(c)(3); *seealso Enter. Mortgage Acceptance Co., LLC, Sec. Litig.,* 391 F.3d 401, 405 n. 2 (2d Cir.2004) (citing *Cornwell v. Robinson,* 23 F.3d 694, 705 (2d Cir.1994))."If the reason for not naming the party is anything other than a mistake of identity, then the relation back doctrine is unavailable." *Nordco, A.S. v. Ledes,* No. 95 Civ. 7753, 1999 WL 1243883, at *3 (S.D.N.Y. Dec. 21, 1999) (citations omitted). In this case, Gray Seifert and Legg Mason were not named in the original counterclaims and the counter-plaintiffs have not alleged that there was any mistake in identity in not naming these parties. The counter-plaintiffs' attempt to revive their time-barred claims against Gray Seifert and Legg Mason through the relation back doctrine fails.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Finally, the counter-plaintiffs cannot rely on the absence of documents to overcome the time bar. The counter-plaintiffs should be able to plead its amended counterclaims without the benefit of discovery and must at least identify the transactions at issue. In this case, Gray Seifert points out that significant disclosures were already made, including over six thousand pages of documents making up the whole of Green's account records (with the exception of the year 1990) and all of the recorded correspondence between Green and Gray Seifert from 1980 to 2001. (*See* Decl. of Lauren C. Gould dated Mar. 4, 2005 ¶ 10.) Accordingly, the counter-defendants' motion to dismiss the fourth counterclaim brought pursuant to § 10(b) and Rule 10b-5 as time-barred is granted with respect to the allegations of securities fraud associated with Green's alleged securities transactions occurring between 1980 and 1998.

B.

The counter-defendants acknowledge that the securities fraud claim based upon the promissory Note allegedly signed by Green on July 12, 2001 is not time-barred by the statute of limitations because the counterclaims were brought within three-years of the procurement of the Note. However, it is clear that the fraud alleged in connection with the procurement of the Note was not "in connection with" the "purchase" or "sale" of "securities" as required by § 10(b) and Rule 10b-5.

***10** The Note consisted of a pledge of stocks in Green's Neuberger Account and the shares in her cooperative apartment. The parties dispute whether the pledge of securities in the Neuberger Account constitutes the purchase or sale of a security for purposes of the antifraud provisions of the federal securities laws. According to the counter-plaintiffs, if the Note was actually signed by Green, then it must have been fraudulently obtained because Bishop did not disclose either the fact that Bishop & Co. had allegedly loaned $1,000,000 to Green, or the fact that Bishop & Co. would use the Note to secure the return of the money.[FN8] *See,e.g., Mallis v. Fed. Deposit Ins. Corp.,* 568 F.2d 824, 830 (2d Cir.1977); *United States v. Gentile,* 520 F.2d 461, 466-67 (2d Cir.1975). The counter-defendants respond that although the pledge of a security can, under some circumstances, constitute a "purchase or sale" of securities for purposes of § 10b, "[m]isrepresentations involved in a securities transaction but not pertaining to the securities themselves cannot form the basis of a violation of § 10(b) or Rule 10b-5." *Citibank v. K-H Corp.,* No. 89 Civ. 3609, 1991 WL 35951, at *3-*4 (S.D.N.Y. Mar. 14, 1991) (citations omitted), *aff'd* 968 F.2d 1489, 1495 (2d Cir.1992). In this case, the alleged misrepresentations about the Note were not in any way connected with the collateral. Rather, Bishop's alleged misrepresentations and omissions concerned the issue of whether Green owed money to Bishop & Co. as a result of alleged loans. There is no allegation that Bishop's alleged misrepresentations and omissions-assuming that representations were even made and that the Note was signed at all-had any bearing on the nature or value of the securities underlying the Note. The counter-plaintiffs' have therefore failed to state a valid claim that the alleged misrepresentations concerning the Note were in connection with the purchase or sale of securities. Accordingly, the counter-defendants' motion to dismiss the § 10(b) and Rule 10b-5 claims must be granted.

FN8. There is an obvious tension between the counter-plaintiffs' theory, on the one hand, that Green never signed the Note, and on the other, that Green was fraudulently induced, based on Bishop's alleged misrepresentations and omissions, to sign such a pledge. Assuming that the Note was actually executed, the counter-plaintiffs argue that Green's pledge of shares in her cooperative apartment and stock in her Neuberger Account constitutes both a purchase and a sale of securities within the scope of § 10(b) and would therefore be sufficient to trigger liability under § 10(b)

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

and Rule 10b-5.

Even assuming that the counter-plaintiffs' allegations satisfied the "in connection with" requirement, the counter-plaintiffs have plainly failed to allege loss causation with respect to the Note. A securities fraud plaintiff must plead and prove a causal connection between the content of the alleged misstatements or omissions and the harm actually suffered. *See Dura Pharm., Inc. v. Broudo,* 125 S.Ct. 1627, 1633 (2005); *Emergent Capital Inc. Mgmt., LLC v. Stonepath Group,* 343 F.3d 189, 198-99 (2d Cir.2003). To plead causation sufficiently under Section 10(b) "a plaintiff must allege both transaction causation, *i.e.*[,] that *butfor* the fraudulent statement or omission, the plaintiff would not have entered into the transaction; and loss causation, *i.e.,* that the subject of the fraudulent statement or omission was the cause of the actual loss suffered."*In re Parmalat Sec. Litig.,* 378 F.Supp.2d 278, 302 (S.D.N.Y.2005) (footnote omitted). Loss causation is established by pleading that (1) the misrepresentation artificially inflated the value of the security, or otherwise misrepresented its investment quality, and (2) the subject of the misrepresentation caused the decline in the value of the security. *Fogarazzo v. Lehman Bros., Inc.,* 341 F.Supp.2d 274, 289 (S.D.N.Y.2004) (interpreting requirements for pleading loss causation in *Suez Equity* and *Emergent Capital* ). The Supreme Court instructs that a plaintiff must allege that a "defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss."*SeeParmalat,* 378 F.Supp.2d at 305 (quoting *Dura Pharm., Inc.,* 125 S.Ct. at 1633)."To plead loss causation, the complaint must allege facts that support an inference that [the defendant's] misstatements and omissions concealed the circumstances that bear upon the loss suffered such that plaintiffs would have been spared all or an ascertainable portion of that loss absent the fraud."*Id.* (quoting *Lentell v. Merrill Lynch & Co ., Inc.,* 396 F.3d 161, 175 (2d Cir.2005)). In short, "the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission."*Id.* (quoting *Emergent Capital,* 343 F.3d at 197.); *seealso Citibank,* 1991 WL 35951, at *4.

***11** In this case, the losses allegedly sustained by the counter-plaintiffs in connection with the Note have nothing to do with any misrepresentations regarding the value of the securities that collateralized the Note. Rather, the counter-plaintiffs merely allege that they have incurred attorneys' fees and costs in defending against the enforcement of the Note and in removing a lien on the sale of Green's apartment. (*See* Counterclaimants' Omnibus Mem. in Opp'n to Mots. to Dismiss Counterclaims at 26.) These losses have nothing to do with the value of the securities allegedly pledged by Green.[FN9] Because the counter-plaintiffs have not suffered a loss related to any alleged misrepresentations about the value of the securities underlying the Note, the counter-defendants' motion to dismiss the counter-plaintiffs' Fourth Counterclaim alleging securities fraud in violation of § 10(b) and Rule 10b-5 claims must be granted.

FN9. Because the counter-plaintiffs' fourth cause of action is dismissed because it is time-barred and for failure to plead loss causation, it is not necessary to reach the counter-defendants' additional arguments that the counter-plaintiffs have failed to plead securities fraud with particularity as required under Federal Rule of Civil Procedure 9(b) and the PSLRA.

IV.

The counter-plaintiffs, in their Sixth Counterclaim, argue that under the Advisers Act, Gray Seifert and Legg Mason, as registered investment advisers, had fiduciary duties to Green and Gerry. The counter-defendants correctly argue that this federal claim, seeking restitution, jointly and severally, from Gray Seifert and Legg Mason for alleged violations of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1*etseq.,* is also time-barred.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

The Supreme Court has recognized that the only private remedy under the Advisors Act is an action for rescission and restitution. *See Transamerica Mortgage Advisers, Inc., (TAMA) v. Lewis,* 444 U.S. 11, 24 & n. 14 (1979). No specific statute of limitations is provided for such an action in the Advisers Act itself. *Kahn v. Kohlberg, Kravis, Roberts & Co.,* 970 F.2d 1030, 1033 (2d Cir.1992). Before Sarbanes-Oxley, courts applied in Advisors Act cases the same one-year/three-year statute of limitations period that applies to other federal securities claims. *Id.* Therefore, under the statute, the claims in this case-which do not allege any securities-related misstatements or omissions occurring after 1998-were time-barred no later than January 2001, three years after the last alleged transaction. The counter-defendants' motion to dismiss the Sixth Counterclaim is granted.[FN10]

FN10. There is no basis for the argument that Sarbanes-Oxley's two-year inquiry notice/five-year statute of limitations should apply because the Investment Advisers Act claim was already time-barred when the Sarbanes-Oxley Act was enacted and that statute did not revive time-barred claims. *See In re Enter. Mortgage Acceptance Co. Sec. Litig.,* 391 F.3d at 403-04.

V.

The counter-defendants urge the Court to decline to exercise supplemental jurisdiction over the remaining counterclaims, all of which arise under state law.

In this case, there is no diversity of citizenship jurisdiction over the state law counterclaims because counter-defendant John Dockery ("Dockery") is a citizen of New York, as are the counter-plaintiffs. *See*28 U.S.C. § 1332; *Owen Equip. & Erection Co. v. Kroger,* 437 U.S. 365, 373-74 (1978).

Thus, the only basis for subject matter jurisdiction over the state law counterclaims is supplemental jurisdiction under 28 U.S.C. § 1367.Section 1367(a) provides that

> "... in any civil action of which the district courts have original jurisdiction, the district courts shall have supplemental jurisdiction over all other claims that are so related to claims in the action within such original jurisdiction that they form part of the same case or controversy under Article III of the United States Constitution. Such supplemental jurisdiction shall include claims that involve the joinder or intervention of additional parties."

***12** 28 U.S.C. § 1367(a).

The Supreme Court and the Court of Appeals for the Second Circuit have held that claims form part of the same case or controversy as the claims over which the court has original jurisdiction within the meaning of Article III, and thus within the meaning of Section 1367(a), if they "derive from a common nucleus of operative facts." *City of Chicago v. Int'l Coll. of Surgeons,* 522 U.S. 156, 165 (1997) (*quoting United Mine Workers v. Gibbs,* 383 U .S. 715, 725 (1966)); *Briarpatch Ltd., L.P. v. Phoenix Pictures, Inc.,* 373 F.3d 296, 308 (2d Cir.2004). Supplemental jurisdiction therefore exists where the original and supplemental claims arise from the same basic facts, but does not where they rest "on essentially unrelated facts." *Lyndonville Sav. Bank & Trust Co. v. Lussier,* 211 F.3d 697, 704 (2d Cir.2000).

In this case Section 1367(a) confers supplemental jurisdiction over those counterclaims that fall within the same case or controversy as either (1) the plaintiff's original claims or (2) the counterclaims asserted under federal law, because all of these claims are "within [the Court's] original jurisdiction." 28 U.S.C. § 1367(a).

The counter-plaintiffs' First Counterclaim (for a declaratory judgment that the promissory note is not enforceable) and Fourteenth Counterclaim (for indemnification for any liability defendants/

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

counter-plaintiffs might have to Pro Bono) form part of the same case or controversy as the plaintiff's original claims. Among the plaintiff's original claims were a claim to enforce the alleged Note and a claim for breach of contract, with the alleged Note being the contract in question, and a claim for indemnification of any liability to plaintiff on the original claims falls within the same case or controversy. These counterclaims thus share "a common nucleus of facts" with the original claims. *See Kristensons-Petroleum, Inc. v. Sealock Tanker Co., Ltd.,* 304 F.Supp.2d 584, 588 (S.D.N.Y.2004). Indeed, these counterclaims "arise[ ] out of the same transaction or occurrence that is the subject matter of the opposing party's claim" such that they are compulsory counterclaims within the meaning of Federal Rule of Civil Procedure 13(a). Compulsory counterclaims fall within the same "case or controversy" as the original claims and supplemental jurisdiction over them exists. *Jones v. Ford Motor Credit Co.,* 358 F.3d 205, 212-213 (2d Cir.2004).

The Court also has supplemental jurisdiction over the remaining state law counterclaims, with the exception of the Second Counterclaim, because they relate to Bishop and Gray Seifert's handling of Green and Gerry's investments and thus share a "common nucleus of facts" with the federal securities law claims.[FN11] These counterclaims are sufficiently related to counter-plaintiffs' federal securities claims to confer supplemental jurisdiction and the Court's dismissal of the related federal claims does not deprive it of the power to exercise that jurisdiction. *See Nowak v. Ironworkers Local 6 Pension Fund,* 81 F.3d 1182, 1187 (2d Cir.1996).

FN11. The Third Counterclaim seeks an accounting of all holdings, transactions, and dispositions of assets of Green from 1980 to 2001, and of the Christina Green Trust and Gerry from 1987 through 2001. The Fifth Counterclaim alleges that Bishop and Gray Seifert breached a valid investment advisory contract with Green and Gerry. The Seventh Counterclaim alleges that all counter-defendants are liable to Goldner and Fisher for fraud because of Bishop's alleged misrepresentations to Green in connection with her investments made through Bishop & Co. The Eighth Counterclaim alleges that Bishop and Gray Seifert are liable to counter-plaintiffs for breach of the fiduciary duty allegedly owed to Green and Gerry as their investment advisors. The Ninth Counterclaim alleges that all counter-defendants are liable to counter-plaintiffs for Bishop, Bishop & Co., and Gray Seifert's alleged conversion of Green and Gerry's funds to their own use. The Tenth Counterclaim alleges that Bishop and Gray Seifert were unjustly enriched because they retained fees paid by Green, Gerry, and the Christina Green Trust to cover Bishop's personal investment losses and those of his principals. The Eleventh, Twelfth, and Thirteenth Counterclaims allege, respectively, that Bishop and Gray Seifert were negligent and grossly negligent in the conduct of, and negligently misrepresented the performance of, their investment activities on behalf of Green, Gerry, and the Christina Green Trust. Bishop & Co. is also a defendant in the Thirteenth Counterclaim. The Fifteenth Counterclaim requests that, in the event an adequate remedy at law does not exist, the Court impose a constructive trust in favor of counter-plaintiffs on the funds allegedly wrongfully detained by Bishop and Gray Seifert.

***13** On the other hand, the counter-plaintiffs' Second Counterclaim, to recover damages from Bishop on a theory of promissory estoppel because he allegedly represented to Green that he would guarantee the purchase price on property in Bridgehampton, New York, falls wholly outside the "common nucleus of operative fact" required to confer supplemental jurisdiction under Section

1367(a). There is no relation between Pro Bono's claims for repayment of the funds allegedly advanced to Green by Bishop & Co., or between the alleged violations of federal securities laws, and alleged promises by Bishop to guarantee the purchase price of this property, and therefore the Court lacks supplemental jurisdiction over this counterclaim.

The counter-plaintiffs assert that their Twelfth Affirmative Defense to Pro Bono's claims, seeking "a setoff" of their potential liability to plaintiff for, among other things, money due them because of Bishop's alleged failure to keep his promise to finance the purchase of the Bridgehampton property, brings this counterclaim within the reach of 28 U.S.C. § 1367(a). (*See* Counterclaimants' Omnibus Memorandum in Opposition to Motions to Dismiss Counterclaims, at 37.) This assertion is without merit. If merely requesting a setoff of potential liability on the original claims is sufficient to bring a claim within Section 1367(a), a counter-plaintiff could plead such an affirmative defense in every case and thereby render meaningless Section 1367(a)'s limitation of supplemental jurisdiction to "claims that are so related to claims in the action within such original jurisdiction that they form part of the same case or controversy under Article III of the United States Constitution."It is well established that courts should, if possible, give effect to every clause and word in a statute. *Duncan v. Walker,* 533 U.S. 167, 174 (2001); *Cal. Pub. Employees' Ret. Sys. v. WorldCom, Inc.,* 368 F.3d 86, 106 (2d Cir.2004). The counter-plaintiffs have cited no case where a claim was held to fall within Section 1367(a)'s jurisdictional grant solely because a setoff of the counter-plaintiffs' potential liability on the original claims was sought.[FN12] The counter-plaintiffs' Second Counterclaim is therefore dismissed for lack of subject matter jurisdiction.

FN12. There was a connection between supplemental jurisdiction and the concept of setoff predating Section 1367's enactment in 1990. Prior caselaw drew a distinction between compulsory counterclaims, over which federal courts could exercise ancillary (now supplemental) jurisdiction, and permissive counterclaims, over which an independent basis of federal jurisdiction was required. *See,e.g., O'Connell v. Erie Lackawanna R.R.,* 391 F.2d 156, 163 (2d Cir.1968). At times courts would, however, exercise ancillary jurisdiction over permissive counterclaims where a purely defensive setoff of liability was sought. *See Ambromovage v. United Mine Workers of Am.,* 726 F.2d 972, 988 n. 47 (3d Cir.1984); *seealso Marks v. Spitz,* 4 F.R.D. 348, 350 (D.Mass.1945). The Court of Appeals has made clear, however, that Section 1367 displaced the prior, judge-made, jurisdictional standards. *Jones v.. Ford Motor Credit Co.,* 358 F.3d 205, 212-213 (2d Cir.2004). Under Section 1367, supplemental jurisdiction exists over permissive counterclaims only so long as they satisfy Section 1367(a)'s "case or controversy" test, irrespective of whether or not a setoff is requested. *Seeid.*

B.

While the Court has supplemental jurisdiction over all counterclaims except the Second, Section 1367(c) affords a district court discretion, where certain conditions have been satisfied, to decline to exercise such jurisdiction if doing so promotes " 'economy, convenience, fairness, and comity." ' *Itar-Tass Russian News Agency v. Russian Kurier, Inc.,* 140 F.3d 442, 446-48 (2d Cir.1998) (quotation omitted); 28 U.S.C. § 1367(c).

Section 1367(c) provides four specific bases for declining supplemental jurisdiction over a claim.[FN13] The Court of Appeals has held that, as a precondition to declining supplemental jurisdiction, a district court must identify a factual predicate corresponding to one of Section 1367(c)'s four enumerated categories. Where the bases for declining supplemental jurisdiction do not exist, the Court

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

must exercise that jurisdiction. *Itar-Tass,* 140 F.3d at 446-47. The only arguable bases to decline jurisdiction here are Sections 1367(c)(3) and (c)(2). As explained below, neither Section 1367(c)(3) nor Section 1367(c)(2), the two possibly applicable bases, provides a basis to decline supplemental jurisdiction.

FN13.28 U.S.C. § 1367(c) provides:

> The district courts may decline to exercise supplemental jurisdiction over a claim under subsection (a) if-
>
> (1) the claim raises a novel or complex issue of State law,
>
> (2) the claim substantially predominates over the claim or claims over which the district court has original jurisdiction,
>
> (3) the district court has dismissed all claims over which it has original jurisdiction, or
>
> (4) in exceptional circumstances, there are other compelling reasons for declining jurisdiction.

***14** Section 1367(c)(3) authorizes district courts to decline supplemental jurisdiction where the court "has dismissed all claims over which it has original jurisdiction."In this case, however, although the Court has dismissed, pursuant to Federal Rule of Civil Procedure 12(b)(6), the Fourth and Sixth Counterclaims, over which the Court had original jurisdiction because they arise under federal law, the Court has not dismissed all of the plaintiff's original claims. By separate Opinion and Order, the Court granted the defendants' cross-motion for summary judgment on plaintiffs' breach of contract claim and claim for payment on an alleged promissory note, but denied the defendants' cross-motion for summary judgment on plaintiff's unjust enrichment claim. This claim, over which the Court has original jurisdiction pursuant to 28 U.S.C. § 1332(a)(1), remains in the case. The Court cannot, therefore, properly decline supplemental jurisdiction under Section 1367(c)(3).*See Jones,* 358 F.3d at 214.

A district court may also decline supplemental jurisdiction over a claim that "substantially predominates over the claim or claims over which the district court has original jurisdiction."28 U.S.C. § 1367(c)(2). The inquiry under Section 1367(c)(2) turns on whether the supplemental claims "are more complex or require more judicial resources or are more salient in the case as a whole" than the claims over which the court has original jurisdiction. *Luongo v. National Mut. Ins. Co.,* No. 95 Civ. 3190, 1996 WL 445365 at *5 (S.D.N.Y. Aug. 7, 1996). The sole remaining claim in this case over which the Court has original jurisdiction is the plaintiff's unjust enrichment claim. Two of the twelve remaining counterclaims, the First and the Fourteenth Counterclaims, address substantially the same issues that will be litigated in connection with that claim, and cannot be dismissed on this basis.

With respect to the other ten state law counterclaims, the relationship between these counterclaims and Pro Bono's unjust enrichment claim is sufficiently close that the Court cannot decline supplemental jurisdiction over them; the counterplaintiffs' defense to the unjust enrichment claim will require litigation concerning the investment relationship Green had with Bishop, Bishop & Co., and Gray Seifert. Accordingly, the Court will exercise supplemental jurisdiction over those counterclaims as well.

VI.

Even though supplemental jurisdiction exists over twelve of the thirteen state law counterclaims, the counter-defendants have moved to dismiss these counterclaims on the merits.

The First Counterclaim seeks a declaratory judgment that the alleged Note is invalid. Because the Court has, by separate Opinion and Order, granted

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

summary judgment in favor of the defendants-counter-plaintiffs on both of Pro Bono's original claims based upon the alleged Note, this counter-claim is dismissed as moot.

The Third Counterclaim seeks an accounting of all holdings, transactions, and dispositions of assets of Green from 1980 to 2001, and of the Christina Green Trust and Gerry from 1987 through 2001. Bishop & Co. argues that this claim is time-barred under a three-year statute of limitations because it is only incidental to claims for money damages for breach of fiduciary duty. Counter-plaintiffs argue that the six-year statute of limitations for fraud applies.N.Y. C.P.L.R. § 213(8). Even for a breach of fiduciary duty claim, the statute of limitations for an equitable remedy such as an accounting is six years. N.Y. C.P.L.R. § 213(1). Where, as here, the breach of fiduciary duty involves allegations of actual fraud, the statute of limitations is six years regardless of the remedy sought. *Kaufman v. Cohen,* 760 N.Y.S.2d 157, 164 (1st Dep't 2003). Because alleged covered transactions occurred as late as 2001, the claim is not time-barred.

***15** Under New York law a party may obtain an accounting when four factors exist: "(1) a fiduciary relationship (2) entrustment of money or property (3) no other remedy and (4) a demand and refusal of an accounting." *In re Guardianship of Kent,* 729 N.Y.S.2d 352, 353 (Sup.Ct.2001). The counter-defendants argue that there was no demand and refusal because documents were produced in response to the counter-plaintiffs's subpoenas. The counter-plaintiffs, however, have alleged that they have not received all the documentation they requested. This is an issue of fact that cannot be decided on a motion to dismiss. Accordingly, the Court declines to dismiss the Third Counterclaim.

The Fifth Counterclaim alleges that Bishop and Gray Seifert breached a valid investment advisory contract with Green and Gerry. Although the parties dispute the relevant statute of limitations, it is well established that the statute of limitations for a breach of contract claims under New York law is six years. *See*N.Y. C.P.L.R. § 213(2). There is no reason to apply the three-year statute of limitation for breach of fiduciary duty to this counterclaim because the counter-plaintiffs have alleged the existence of valid contracts with both Gray Seifert and Bishop and the material breach of those contracts.[FN14](CC ¶ 149-50.) This counterclaim is therefore distinct from the counterclaim for breach of fiduciary duty and, under the liberal pleading standard of Federal Rule of Civil Procedure 8, it is sufficient to survive a motion to dismiss. *Conley,* 355 U.S. at 47-48. Accordingly, while any alleged breach prior to March 30, 1998, six years before the counterclaims were first filed, is time-barred, this counterclaim cannot be dismissed to the extent a breach of contract after March 30, 1998 is alleged.[FN15]

FN14. Bishop's argument that he is not liable on the contracts of his corporation is unavailing for the same reason: the counter-plaintiffs have alleged contracts with Bishop and with Gray Seifert, not merely Gray Seifert. (CC ¶ 149-150.)

FN15. The Fifth Counterclaim, as well as the Seventh Counterclaim, was asserted for the first time on March 30, 2004, and does not related back to September 19, 2003, the date of the counter-plaintiffs' original answer with counterclaims against Pro Bono and Bishop seeking a judgment that they did not owe Pro Bono on the alleged Note.

The Seventh Counterclaim alleges that all counter-defendants are liable to Goldner and Fisher for fraud because of Bishop's alleged misrepresentations to Green in connection with her investments made through Bishop & Co. This claim is also time-barred to the extent that it alleges fraud prior to March 30, 1998. The counter-plaintiffs, however, have alleged fraud up to July 2001, and did plead fraud in connection with Bishop's procurement of the alleged Note with the particularity required by Federal Rule of Civil Procedure 9(b). (CC ¶¶

106-15, 156-60.) The counter-defendants' motion to dismiss the Seventh Counterclaim is therefore granted to the extent the counter-plaintiffs alleged fraud prior to March 30, 1998.

The Seventh Counterclaim further alleges that Pro Bono, Bishop, the Congers, Dockery, Gray Seifert and Legg Mason are jointly and severally liable for the alleged fraud. (CC ¶ 160.) Resolution of these issues requires factual determinations and the allegations therefore cannot be disposed of on a motion to dismiss, which accepts the facts alleged as true and tests only the legal sufficiency of the complaint. *Cooper v. Parsky,* 140 F.3d 133, 140 (2d Cir.1998). The same is true for the allegations that Pro Bono, Dockery, Gray Seifert, and Legg Mason are liable for Bishop's alleged fraud. (*See* CC ¶¶ 70-71, 81, 160).

***16** The Eighth through Thirteenth Counterclaims, as well as the Fifteenth Counterclaim, are preempted by New York's Martin Act. *See*N.Y. Gen. Bus. L. §§ 352*etseq*. The New York Court of Appeals has held that there is no private right of action under the Martin Act and that the Attorney General's enforcement rights are exclusive. *CPC Int'l Inc. v. McKesson Corp.,* 514 N.E.2d 116, 118-19 (N.Y.1987). Most New York courts have further held that the act precludes a private right of action for common law claims the subject matter of which is covered by the Martin Act, as is the case with these counterclaims. *See Rego Park Gardens Owners Ass'n v. Rego Park Gardens Assocs.,* 595 N.Y.S.2d 492, 494 (2d Dep't 1993); *Eagle Tenants Corp. v. Fishbein,* 582 N.Y.S.2d 218, 219 (2d Dep't 1992); *Horn v. 440 E. 57th Co.,* 547 N.Y.S.2d 1, 5 (2d Dep't 1989). The federal courts have, almost without exception, adopted the same position. *See,e.g., Marcus v. Frome,* 329 F.Supp.2d 464, 475-76 (S.D.N.Y.2004); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC,* No. 02 Civ. 0767, 2003 WL 22052894 at *3 (S.D.N.Y. Sept. 2, 2003) (collecting cases).

The counter-plaintiffs cite *Scalp & Blade, Inc. v. Advest, Inc.,* 722 N.Y.S.2d 639 (4th Dep't 2001), and *Cromer Fin. Ltd. V. Berger,* No. 00 Civ. 2498, 2001 WL 1112548 (S.D.N.Y. Sept. 19, 2001), for the proposition that the Martin Act does not preclude common law rights of action. These cases, however, "stand as solitary islands in a stream of contrary opinion," *Nanopierce Techs.,* 2003 WL 22052894 at *4, and are not persuasive because allowing a private cause of action for common law wrongs within the Martin Act's purview is inconsistent with the Attorney General's exclusive enforcement powers in this realm.[FN16] *See Castellano v. Young & Rubicam, Inc.,* 257 F.3d 171, 190-91 (2d Cir.2001); *Marcus,* 329 F.Supp.2d at 476 n. 4; *Nanopierce Techs.,* 2003 WL 22052894 at *3-4; *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.,* 17 F.Supp.2d 275, 291-92 (S.D.N.Y.1998). The Eighth through Thirteenth and Fifteenth Counterclaims are therefore dismissed for failure to state a claim upon which relief can be granted pursuant to Federal Rule of Civil Procedure 12(b)(6).

FN16. Unlike Counterclaims Eight through Thirteen and Fifteen, the common law fraud alleged in the Seventh Counterclaim is not "covered" by the Martin Act because it requires an additional element of deceitful intent. *See Horn,* 547 N.Y.S.2d at 5.

In the Fourteenth Counterclaim the counter-plaintiffs seek indemnification from Bishop, Bishop & Co., and Gray Seifert for any liability they might have to Pro Bono. In the absence of an express agreement to indemnify, there are only two grounds for indemnification under New York law. *People's Democratic Republic of Yemen v. Goodpasture, Inc.,* 782 F.2d 346, 351 (2d Cir.1986). "Implied in law" indemnity applies "when there is a great disparity in the fault of two tortfeasors and one of the tortfeasors has paid for a loss that was primarily the responsibility of the other,"*Id.*That ground is not available in this case because there has been no suggestion that the counter-plaintiffs and the counter-defendants are joint tortfeasors. The counter-plaintiffs urge that they are entitled to

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

"implied in fact" indemnification, which arises out of "the special nature of a contractual relationship between parties."*Id.* Implied in fact indemnification, however, applies where "the proposed indemnitee holds a non-delegable duty to the plaintiff, the responsibility for which he transfers to the proposed indemnitor by agreement."*In the Matter of Poling Transp. Corp.,* 784 F.Supp. 1045, 1048 (S.D.N . Y.1992) Thus, " '[a] person who, in whole or in part, has discharged a duty which is owed by him but which as between himself and another should have been discharged by the other, is entitled to indemnity." ' *State v. Stewart's Ice Cream Co., Inc.,* 473 N.E.2d 1184, 1186 (N.Y.1984) (quoting Restatement, Restitution, § 76).

***17** "No right to implied indemnification exists when the proposed indemnitee retains a duty it owes directly to the plaintiff." *Poling Transp. Corp.,* 784 F.Supp. at 1048 (citing *Rosado v. Proctor & Schwartz, Inc.,* 484 N.E.2d 1354, 1355 (N.Y.1985), and *Guzman v. Haven Plaza Housing Dev. Fund Co.,* 509 N.E.2d 51, 55 (N.Y.1987)). In the absence of an express contract so providing, it cannot be maintained that the counter-plaintiffs fully transferred any liability they might have to plaintiffs to Bishop, Bishop & Co., and Gray Seifert. *Id.*

Moreover, the relationship the counter-plaintiffs had with Bishop, Bishop & Co., and Gray Seifert is not the kind that gives rise to an implied contract for indemnification under New York law. "Relationships that support implied indemnification include employer/negligent employee, building owner/independent contractor, and motor vehicle owner/negligent driver." *In re Del-Val Fin. Corp. Securities Litig.,* 868 F.Supp. 547, 553 (S.D.N.Y.1994) (citing *D'Ambrosio v. City of New York,* 435 N.E.2d 366, 369 (N.Y.1982)).

The relationship between these parties is of an entirely different nature. Bishop, Bishop & Co., and Gray Seifert cannot be said to have contracted with the counter-plaintiffs to assume full responsibility for a duty the counter-plaintiffs owed to Pro Bono. Indeed, it is from Bishop & Co. that Pro Bono alleges the counter-plaintiffs were unjustly enriched. It is only because Bishop & Co. assigned its assets to Pro Bono that Pro Bono has standing to prosecute its action against the counter-plaintiffs. Under these circumstances it cannot be concluded that Bishop, Bishop & Co., or Gray Seifert impliedly agreed to indemnify the counter-plaintiffs should they be held liable for a breach of a duty they owed to Bishop & Co. The Fourteenth Counterclaim is therefore dismissed.

## CONCLUSION

The counter-defendants' motions to dismiss the amended counterclaims are granted in part and denied in part: The First Counterclaim is dismissed as moot. The Second Counterclaim is dismissed without prejudice for lack of subject matter jurisdiction. The Fourth, Sixth, Eighth, Ninth, Tenth, Eleventh, Twelfth, Thirteenth, Fourteenth, and Fifteenth Counterclaims are dismissed for failure to state a claim upon which relief can be granted. The Fifth Counterclaim is dismissed to the extent it alleges breach of contract prior to March 30, 1998. The Seventh Counterclaim is dismissed to the extent it alleges fraud prior to March 30, 1998.

SO ORDERED.

S.D.N.Y.,2005.
Pro Bono Investments, Inc. v. Gerry
Not Reported in F.Supp.2d, 2005 WL 2429787 (S.D.N.Y.)

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-13

H

United States District Court,
S.D. Ohio,
Western Division.
Wayne E. **PULLINS**, et al., Plaintiffs,
v.
Laura **KLIMLEY**, et al., Defendants.
**No. 3:05-CV-082.**

Jan. 7, 2008.

Richard B. Reiling, Richard Reiling, Esq., Loveland, OH, for Plaintiffs.

Stephen M. Kindseth, Zeisler & Zeisler PC, Bridgeport, CT, James Eugene Burke, Jennifer J. Morales, Michael L. Scheier, Keating Muething & Klekamp, PLL, Jean R. Robertson, McDonald Hopkins, Cincinnati, OH, Vincent James Nardone, McDonald Hopkins CO LPA, Columbus, OH, for Defendants.

**ENTRY AND ORDER GRANTING IN PART AND OVERRULING IN PART BROOKS KLIMLEY'S MOTION FOR SUMMARY JUDGMENT (Doc. # 106); GRANTING IN PART AND OVERRULING IN PART LAURA KLIMLEY'S MOTION FOR SUMMARY JUDGMENT (Doc. # 108); AND OVERRULING PLAINTIFFS' MOTION FOR ORAL ARGUMENT (Doc. # 154)**

THOMAS M. ROSE, District Judge.

***1** The Plaintiffs in this matter are Wayne E. Pullins ("Ed"), his wife Dianne H. Pullins ("Dianne") and their son David E. Pullins ("David"). Robert Howard is also a named Plaintiff. The Defendants are Laura Klimley ("Laura") and her husband Brooks Klimley ("Brooks").

Plaintiffs' original Complaint was filed in the Court of Common Pleas for Clark County, Ohio on January 26, 2005, and was subsequently removed to this Court by Laura. Erma A. Houser was a named Plaintiff in the original Complaint and Alicia Eimicke ("Alicia"), Maxine Eimicke ("Maxine"), and John Palmero were named Defendants in addition to Laura. Brooks was not identified as a Defendant in the original Complaint. The original Complaint included causes of action for engaging in a pattern of corrupt activity under Ohio law, fraud, civil conspiracy, and violation of Ohio's Blue Sky laws.

On July 22, 2005, the Plaintiffs filed an Amended Complaint which added claims of violation of Sections 12(a)(1) and 12(a)(2) of the Securities Act of 1933 and violation of Section 10b of the Securities Exchange Act of 1934. The Amended Complaint also brought the claim of engaging in a pattern of corrupt activity under federal law instead of state law.

On November 2, 2005, the Plaintiffs again amended their Complaint. The Second Amended Complaint includes the same Parties and causes of action as the First Amended Complaint and indicates that it was filed pursuant to the instructions of the United States Bankruptcy Court for the Southern District of New York.

Following and pursuant to this Court's ruling on Defendants' Motion To Dismiss the Second Amended Complaint, the Third Amended Complaint (the "TAC") was filed on April 6, 2006. The TAC does not include Erma A. Houser as a Plaintiff. The TAC also adds Brooks as a Defendant and does not name Alicia, Maxine, and John Palmero as Defendants. Finally, the TAC includes the particulars of the allegations of fraud. It is the TAC that is now before the Court.

Plaintiffs' First Cause of Action in the TAC is a claim brought pursuant to Section 12(a)(1) of the Securities Act of 1933, 15 U.S.C. § 771(a)(1), which prohibits selling unregistered securities. The

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

First Cause of Action also includes a claim brought pursuant to Section 12(a)(2) of the Securities Act of 1933 which prohibits the offer or sale of securities through a "prospectus or oral communication" that contains misrepresentations or omissions. 15 U . S.C. § 771(a)(2).

Plaintiffs' Second Cause of Action is a claim brought pursuant to the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. This claim is brought specifically pursuant to 15 U.S.C. § 78j and the associated regulation, 17 C.F.R. § 240.10b-5 (the "10b-5 claim"). Together, this code and regulation prohibit making material misstatements in connection with the purchase or sale of securities.

Plaintiffs' Third Cause of Action is for violation of Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o, and Plaintiffs' Fourth Cause of Action is for violation of Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t. In these Causes of Action, Plaintiffs claim that Laura and Brooks were control persons and therefore secondarily liable for any misrepresentations and/or omissions.

***2** Plaintiffs' Fifth Cause of Action is an common law fraud claim and the Sixth Cause of Action is a common law civil conspiracy claim. Finally, Plaintiffs' Seventh Cause of Action is for violation of the Ohio Securities Act, Ohio Rev.Code § 1707.44(B), (C)(1), (D), (F) and (G).

Now before the Court are Motions for Summary Judgment filed by Laura (doc. # 108) and Brooks (doc. # 106). Both of these Motions are now fully briefed and ripe for decision. A factual background will first be set forth followed by the standard of review for motions for summary judgment and an analysis of the Motions.

## I. FACTUAL SUMMARY[FN1]

FN1. When contested, the facts herein are presented, as they must be, in a light most favorable to the Plaintiffs who are the non-moving parties.

This matter arises from the purchase of Debenture Notes by the Plaintiffs. The Debenture Notes were issued by VWE Group, Inc. dba V .W. Eimicke Associates, Inc. (hereinafter "VWE").

### A. The Company

VWE was a New York company founded by Victor W. Eimicke ("Victor") in 1958. (TAC ¶ 16.)Initially VWE produced and sold forms and other materials used by companies in the hiring, firing and motivation of employees (the "HR Business").(*Id.*) Several years ago VWE began selling holiday greeting cards (the "Greeting Card Business") in addition to its HR Business. (*Id.*¶ 17.)

Victor served as VWE's President and managed all of its operations until he passed away on September 4, 2000. (TAC ¶ 14; Deposition of Loretta Buscarino ("Buscarino Dep.") 9-10 May 22, 2007.) Victor and his wife Maxine had two daughters, Alicia and Laura. (Affidavit of Laura E. Klimley ("Laura Aff.") ¶ 4 Sept. 3, 2007.) At some point during the 1990s, Victor gifted all of his stock in VWE to Laura and Alicia, giving them each a 50% share of the company.(*Id.*¶ 5.)

By 2003, the Greeting Card Business surpassed the HR Business and accounted for 75% of VWE's revenues. (TAC ¶ 17.)In December of 2003, VWE sold its Greeting Card Business to an entity known as the Taylor Group. (*Id.*)

Following the sale of the Greeting Card Business, VWE filed for relief pursuant to Chapter 11 of the United States Bankruptcy Code. (TAC ¶ 18.)VWE's bankruptcy petition was filed on June 1, 2004, and is currently pending in the United States Bankruptcy Court for the Southern District of New York, case number 04-20308. (*Id.*) VWE ceased operations as a company in July of 2006. (Deposition of Elizabeth Longinetti ("Longinetti Dep.") 8 May 22, 2007.) During its operation, VWE had an official policy of not giving out any financial information to its investors or to anyone else. (Deposition of

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Brooks J. Klimley ("Brooks Dep.") 97 Mar. 9, 2007.)

**B. The Debenture Notes**[FN2]

FN2. A debenture is a debt secured only by the debtor's earning power and not by a lien on specific assets. *Black's Law Dictionary* (8th ed.2004). A debenture note is an instrument acknowledging such a debt. *Id.*

From its inception, VWE offered Debenture Notes with terms from 90 days to 5 years, interim maturity periods of between 1 and 3 years and interest rates from 10 to 23%. (TAC ¶ 19.)At first the Debenture Notes were issued to "very close friends and family" of the Eimickes. (Deposition of Barbara DeMuth ("DeMuth Dep.") 55 May 22, 2007.) Over the years, the Debenture Notes program was expanded as VWE began to issue Debenture Notes to individuals and entities "all over the country." (*Id.*)

***3** There is no evidence that the Debenture Notes issued by VWE were registered with the Securities and Exchange Commission or any state in which they were offered. When VWE filed for bankruptcy, the outstanding principal amount of the Debenture Notes issued by VWE was more than $26 million. (TAC ¶ 20.)

Ed originally invested in VWE Debenture Notes when he received a call at his home in Ohio from Victor in 1988. (Deposition of Wayne E. Pullins ("Ed Dep.") 19-20, 26 Feb. 22 and 23, 2007.) At that time, Victor stated that, as a "favor" to Ed, he would permit Ed to invest in the family business which he had specifically designed to make money for the family. (*Id.* 20.)Ed acknowledges that he never saw a financial statement prior to purchasing a Debenture Note. (*Id.* 201.)

Following this initial investment, Ed and his family continued to invest throughout the nineties in response to telephone calls and written solicitations from VWE. (*Id.* 56-60.)In addition to investing new money, Ed and his family reinvested interest that they received on the Debenture Notes and reinvested principal when a Debenture Note became due. (Affidavit of Wayne E. Pullins ("Ed Aff .") ¶¶ 2-6 Sept. 26, 2007.)

For 15 years from 1989 until just prior to VWE's bankruptcy, the Plaintiffs have presented evidence that they made investments totaling $1,389,982 in VWE's Debenture Notes [FN3] and were paid or accrued 15% per year interest. (See Ed Dep. 208-13; Ed Aff. ¶ 2-6 .) Over 100 other individuals or entities also invested in VWE's Debenture Notes. (Brooks Klimley Mem. In Supp. of Mot. Summ. J. 1.) These investors cannot recover their investments from VWE which filed bankruptcy, from Victor who is deceased or from Maxine or Alicia who have either filed for personal bankruptcy or have no assets from which to collect.(*Id.*)

FN3. VWE admitted in its bankruptcy filing that it owed this amount or something close to this amount to the Pullins.

**C. Laura Klimley**

Laura Eimicke married Brooks in 1981 and currently resides in Bronxville, New York. (Deposition of Laura E. Klimley ("Laura Dep.") 6-7 Mar. 8, 2007.) Laura studied dance in college and graduate school and, after marrying Brooks in 1981, took a job teaching dance at a preparatory school. (Laura Aff. ¶ 6.) At some point, Laura was appointed a Vice-President of VWE and a member of VWE's Board of Directors. (*Id.*)

When she became tired of teaching dance in 1985, Laura went to work for VWE.(*Id.* ¶ 7.) Her responsibilities at the time included writing copy for the catalogs and brochures, working in the direct mail customer list rental division and dealing with personnel issues at the plant. (*Id.* ¶ 8.)

Laura was employed full-time at VWE until 1996 when she gave birth to triplets. (*Id.* ¶ 7.) She then began working part-time. (*Id.*) After 1999, Laura no

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

longer worked at VWE as an employee of VWE and stayed home with her children. (*Id.* ¶ 9 .)

Laura held the title of Vice-President and was a director of VWE up to the date of the bankruptcy in 2004. (Laura Dep. 38-40.) In addition to 50% of the voting shares in VWE, Laura held 1046.5 of a total of 2093 Common B non-voting shares of VWE, 111 of 189 Preferred A non-voting shares of VWE and 814 of 15978 Preferred B non-voting shares of VWE. (*Id.* 74-75.)Laura testified that she does not know how much she received in salary for VWE and does not recall receiving a dividend. (*Id.* 121-22.)

**D. Brooks Klimley**

***4** Brooks Klimley met Laura Eimicke in 1977 during his sophomore year at Columbia University. (Affidavit of Brooks Klimley ("Brooks Aff.") ¶ 3 Sept. 3, 2007.) At the time, Laura was a freshman at Barnard College studying dance.(*Id.*)

Brooks graduated magna cum laude from Columbia University in New York with a degree in economics. (Brooks Dep. 18-19.) He then went on to obtain a degree in jurisprudence from Oxford University in Oxford, England. (*Id.* 19.)

After marrying Laura in 1981, Brooks worked full time as an investment banker for Chemical Bank (1981-1984), Kidder Peabody (1984-1994), Bear Stearns (1998-2001) and Citigroup (2001-2004) and, at the time of his deposition, was the President of CIT Energy. (Brooks Aff ¶ 4; Brooks Dep. 22.) Brooks holds series 7, series 24 and series 63 certifications from the National Association of Security Dealers. (Answers To Requests for Admissions of B. Klimley .) In a recent deposition in another lawsuit against Brooks, he testified that, at Bear Stearns, he was known as "Dr. Value" for his creativity in complex investment banking transactions. (Deposition of Brooks Klimley ("Brooks Dec. Dep.") 241-42 Dec. 7, 2007.) There is no evidence that Brooks was ever an officer, director, shareholder or employee of VWE.

Beginning in the 1990s, Brooks purchased VWE Debenture Notes for himself and his children and continued to do so until 2004. (Brooks Aff. ¶ 7.) Brooks claims that he did not ask to see any financial records in connection with VWE when he purchased the Debenture Notes and relied upon the representations of Victor that he would be repaid. (Brooks Dep. 60-61.) When VWE declared bankruptcy, the company owed Brooks, Laura, their children and The Klimley Foundation $2,085,003.05. (Brooks Aff. ¶ 7.)

**E. Alicia Eimicke**

Alicia consistently played an active role in VWE's business activities. She joined VWE after graduating from Harvard University. (Laura Aff. ¶ 10.) Alicia worked with Victor to manage VWE's day-to-day operation. (Longinetti Dep. 17; DeMuth Dep. 13-15.) After Victor's death in 2000, Alicia became President of VWE and managed the day-to-day operation of the business. (Longinetti Dep. 13-15.)

**F. Plaintiffs' Familial Relationships**

Ed is a resident of the State of Ohio. (TAC ¶ 6.) Dianne is Ed's wife and David is Ed's son. (Ed Dep. 6.) Victor was Ed's uncle. (*Id.* 26.)

Plaintiff Robert Howard is also Ed's uncle. (*Id.* 7.) Ed has testified that Robert Howard is no longer interested in proceeding in this litigation (*id.*) but Robert Howard remains a named Plaintiff. Finally, Ed's mother, now deceased, was Maxine's sister. (Ed Dep. 26.)

**II. SPOILATION OF EVIDENCE**

Brooks and Laura argue that Plaintiffs claims should be dismissed because they have intentionally "spoiled" evidence. Specifically, according to the Defendants, Ed admits that he destroyed a tape

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

recording of a meeting, destroyed notes that he took regarding telephone conversations with potential witnesses and destroyed executed affidavits and statements that would either corroborate or undermine the potential testimony of these witnesses.

***5** In addition, the Plaintiffs argue that VWE engaged in the spoliation of evidence and the Court should infer that each document that was destroyed contained concrete evidence that Brooks and Laura were heavily involved in the operations of VWE and the sale of Debenture Notes. Brooks and Laura respond that there is no evidence that they were involved in the shredding or that the shredding was improper.

**A. Relevant Law Regarding Spoliation of Evidence**

"Spoliation is the intentional destruction of evidence that is presumed to be unfavorable to the party responsible for the destruction." *In re Smartalk Teleservices, Inc. Securities Litigation,* 487 F.Supp.2d 947, 949 (S.D.Ohio 2007)(quoting *Beck v. Haik,* 377 F.3d 624, 641 (6th Cir.2004). Further, "the rules that apply to an alleged spoliation of evidence and the appropriate sanctions are defined by state law."*Id.*

In this case, this Court sits in Ohio, the Defendants provide legal argument based upon Ohio law and the Plaintiffs do not argue otherwise. Therefore, Ohio spoliation law will be used.

Ohio recognizes the spoliation of evidence as an independent cause of action.*Id.* However, spoliation may also be raised as an affirmative defense, in a motion for summary judgment, in a motion to dismiss or in a Rule 37 motion for sanctions. *Loukinas v. Roto-Rooter Services Co.,* 167 Ohio App.3d 559, 855 N.E.2d 1272, 1278 (Ohio Ct.App.2006). If not pursued as a independent cause of action, which is the case here, the elements of a spoliation claim are nonetheless instructive in considering whether the imposition of sanctions is proper. *In re Smartalk,* 487 F.Supp.2d at 949.

The elements of a spoliation claim, as they would be applied to this case, are: (1) there is a pending or probable litigation involving the non-offending party; (2) knowledge on the part of the offending party that the litigation exists or is probable; (3) wilful destruction of the evidence by the offending party designed to disrupt the non-offending party's case; (4) disruption of the non-offending party's case; and (5) damages proximately caused by the offending party's actions. *In re Smartalk,* 487 F.Supp.2d at 949;*see also Herlik v. Continental Airlines, Inc.,* No. 04-3790, 2005 WL 2445947 at *6 (6th Cir. Oct.4, 2005). Finally, even if the evidence was not deliberately destroyed, negligent or inadvertent destruction of evidence is sufficient to trigger sanctions.*In re Smartalk,* 487 F.Supp.2d 950.

If relevant evidence was indeed destroyed, a court has the power to fashion a just remedy. *Id.* In fashioning a just remedy, the court must balance the intent of the offending party, the level of prejudice, and the reasonableness of the offending party's action. *Id.*"The test for prejudice is where there is a reasonable possibility, based on concrete evidence, that access to the evidence which was destroyed or altered, and which was not otherwise obtainable, would produce evidence favorable to the objecting [non-offending] party." *Loukinas,* 855 N.E.2d at 1278.

***6** The least severe sanction should be imposed-a sanction that is proportionate to the seriousness of the infraction under the facts of the particular case. *In re Smartalk,* 487 F.Supp.2d 950.Said another way, the sanction imposed must be commensurate with the degree of prejudice. *Loukinas,* 855 N.E.2d at 1278.

**B. Spoliation By Ed**

In this case, Ed testifies that he invited creditors to attend two meetings in December of 2005. (Ed Dep.

220.) Only one of the meetings was held. (*Id.* 223, 855 N.E.2d 1272.) He tape recorded the meeting and threw the tape away afterwards because "there wasn't any information on it" and it was useless to him. (*Id.* 224-25, 855 N.E.2d 1272.) Further, when Ed sent out the invitation to the meetings, he invited those who could not attend to send a letter relating their experiences with VWE. (*Id.* 229, 855 N.E.2d 1272.) The written statements that he received were read at the meeting and later thrown away by Ed because they were repetitive of what was being said at the meeting. (*Id.* 229-30, 855 N.E.2d 1272.)

Ed also testifies that he contacted potential witnesses by telephone. (*Id.* 243, 855 N.E.2d 1272.) He would ask the potential witness if it was okay to prepare an affidavit for them to sign. (*Id.*) If so, Ed would prepare and forward an affidavit for signature. (*Id.* 244, 855 N.E.2d 1272.) Ed remembers sending "two or three" affidavits for signature. (*Id.* 243, 855 N.E.2d 1272.) Ed took notes of the telephone conversations and testifies that he later threw the notes away. (*Id.* 244, 855 N.E.2d 1272.) He also destroyed draft affidavits that were not sent to potential witnesses. (*Id.* 246, 855 N.E.2d 1272.)

The Plaintiffs first argue that Ed did not destroy his personal notes. (Pullins Sur-Reply to Mots, for Summ. J 15.) According to the Plaintiffs, Ed kept his notes on VWE's Schedule F to VWE's bankruptcy filing and these notes have been provided to the Defendants. (*Id.*)

Plaintiffs also argue that, while Ed did not keep the tape of the December 2005 meeting, he did provide Defendants with a list of those in attendance.(*Id.*) And, since the list was provided, the Defendants have deposed some of the individuals in attendance. (*Id.*) Further, the Defendants have a copy of one of the unsigned affidavits sent out by Ed and have taken the deposition of the individual who received and refused to sign this affidavit. (Deposition of Michelle Bronski ("Bronski Dep.") Ex. 1 May 2, 2007 .)

Based upon the information presented to the Court, some, but not all of the elements of a spoliation claim exist in this case. Ed knew that there was pending or probable litigation against the Defendants. He also testified that he destroyed personal notes, a tape recording and draft affidavits that were not forwarded for signature. However, the Defendants cannot be said to have been harmed. They allegedly have copies of Ed's notes, they have a list of attendees at the meeting and presumably have deposed at least some of those individuals and they have deposed at least one individual who received and refused to sign an affidavit drafted by Ed. Further, there is not a reasonable probability, based on concrete evidence, that access to the evidence which was destroyed or altered, and which was not otherwise obtainable, would produce evidence favorable to Brooks and Laura, particularly since Brooks and Laura have access to most, if not all of the evidence destroyed by Ed. Therefore, since the Defendants cannot be said to have been prejudiced, sanctions are not appropriate.

**C. Spoliation By Brooks and Laura**

***7** Laura Pignone was VWE's Telemarketing Manager from 1997 until she voluntarily left in 2004. (Deposition of Laura Pignone ("Pignone Dep.") 8 June 26, 2007.) She reported directly to Alicia and was located in VWE's main office on Grassy Spring Road. (*Id.* 10-11, 855 N.E.2d 1272.)

Between the filing of VWE's Bankruptcy in June of 2004 and September of 2004, Laura Pignone observed a "tremendous amount of shredding being done" off site by a contractor. (*Id.* 53-55, 855 N.E.2d 1272.) VWE had always shredded unneeded documents but the shredding took place in house prior to the Bankruptcy filing. (*Id.*) Also, the volume of documents being shredded increased after the Bankruptcy filing. (*Id.*) Laura Pignone, however, does not know what was being shredded. (*Id.*)

Laura Pignone's observations, alone, are not enough

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

to satisfy a spoliation claim. She does not know what documents were being shredded, who was responsible for shredding them or why. The analysis next turns to the standard of review for motions for summary judgment.

**III. STANDARD OF REVIEW**

The standard of review applicable to motions for summary judgment is established by Federal Rule of Civil Procedure 56 and the associated caselaw. Rule 56 provides that summary judgment "shall be rendered forthwith 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 a judgment as a matter of law."Fed.RCiv.P. 56(c).

Alternatively, summary judgment is denied "[i]f there are any genuine factual issues that properly can be resolved only by a finder of fact because they may reasonably be resolved in favor of either party." *Hancock v. Dodson,* 958 F.2d 1367, 1374 (6th Cir.1992)(quoting *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 250, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986)). Thus, summary judgment must be entered "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 party seeking summary judgment has the initial burden of informing the court of the basis for its motion and identifying those portions of the pleadings, depositions, answers to interrogatories, and admissions on file together with the affidavits which it believes demonstrate the absence of a genuine issue of material fact. *Id.* at 323.The burden then shifts to the nonmoving party who "must set forth specific facts showing that there is a genuine issue for trial." *Anderson,* 477 U.S. at 250 (quoting Fed.R.Civ.P. 56(e)).

Once the burden of production has shifted, the party opposing summary judgment cannot rest on its pleadings or merely reassert its previous allegations. It is not sufficient to "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, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986).Rule 56"requires the nonmoving party to go beyond the [unverified] pleadings" and present some type of evidentiary material in support of its position. *Celotex Corp.,* 477 U.S. at 324.

***8** In determining whether a genuine issue of material fact exists, a court must assume as true the evidence of the non-moving party and draw all reasonable inferences in the favor of that party. *Anderson,* 477 U.S. at 255. If the parties present conflicting evidence, a court may not decide which evidence to believe by determining which parties' affiants are more credible. 10A Wright & Miller, *Federal Practice and Procedure,* § 2726. Rather, credibility determinations must be left to the factfinder. *Id.*

However, the mere existence of a scintilla of evidence in support of the non-moving party is not sufficient to avoid summary judgment. *Anderson,* 477 U.S. at 252. "There must be evidence on which the jury could reasonably find for the plaintiff."*Id.* The inquiry, then, is whether reasonable jurors could find by a preponderance of the evidence that the non-moving party is entitled to a verdict. *Id.*

Finally, in ruling on a motion for summary judgment, "[a] district court is not ... obligated to wade through and search the entire record for some specific facts that might support the nonmoving party's claim." *InterRoyal Corp. v. Sponseller,* 889 F.2d 108, 111 (6th Cir.1989), *cert. denied,* 494 U.S. 1091, 110 S.Ct. 1839, 108 L.Ed.2d 967 (1990). Thus, in determining whether a genuine issue of material fact exists on a particular issue, the court is entitled to rely upon the Rule 56 evidence specifically called to its attention by the parties. The Rule 56 evidence includes the verified pleadings, depos-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

itions, answers to interrogatories and admissions on file, together with any affidavits submitted. Fed.R.Civ.P. 56(c).

The Plaintiffs' causes of action in this case include claims brought pursuant to Ohio law and issues interpreted under Ohio law. In reviewing an Ohio claim or an issue under Ohio law, this Court must apply the law of Ohio, as interpreted by the Supreme Court of Ohio. *Northland Ins. Co. v. Guardsman Prods. Inc.,* 141 F.3d 612, 617 (6th Cir.1998). Specifically, this Court must apply the substantive law of Ohio " 'in accordance with the then-controlling decision of the highest court of the state.'" *Imperial Hotels Corp. v. Dore,* 257 F.3d 615, 620 (6th Cir.2001)(quoting *Pedigo v. UNUM Life Ins. Co.,* 145 F.3d 804, 808 (6th Cir.1998)). Also, to the extent that the highest court in Ohio has not addressed the issue presented, this Court must anticipate how Ohio's highest court would rule. *Id.* (quoting *Bailey Farms. Inc. v. NOR-AM Chem. Co. .,* 27 F.3d 188, 191 (6th Cir.1994)).

In this case, Brooks and Laura seek summary judgment on each of Plaintiffs' claims and seek a ruling that the Plaintiffs are not entitled to punitive damages. Brooks' and Laura's arguments regarding each of Plaintiffs' claims will be addressed followed by an analysis of the availability of punitive damages.

## IV. FIRST CAUSE OF ACTION: SECTION 12(a)(1) AND 12(a)(2) CLAIMS

Plaintiffs first assert that Brooks and Laura sold unregistered securities. Plaintiffs also assert that Brooks and Laura sold those securities through a prospectus or oral communication that contained misrepresentations or omissions.

***9** Under Section 12(a)(1) of the Securities Act of 1933, the seller of a security is liable to a purchaser if the sale violates the registration provisions of the Securities Act of 1933 unless exempted. *Cook v. Avien, Inc.,* 573 F.2d 685, 691 (1st Cir.1978). Further, if securities are sold without full disclosure or effective access to significant information, there is no exemption to the registration requirement. *Id.*

Liability attaches under Section 12(a)(2) if: (1) the defendant made a false or misleading statement of material fact or failed to state a material fact necessary in order to make the statement not misleading; (2) the plaintiff did not know of the untruth or omission; and (3) the defendant knew, or in the exercise of reasonable diligence, could have known of the untruth or omission.*Id.* (citing *Alton Box Board Co. v. Goldman, Sachs & Co.,* 560 F.2d 916 (8th Cir.1977).

Brooks and Laura argue that these claims are time-barred, that neither of them solicited or sold securities and that the statements they allegedly made are not material. The Plaintiffs respond that their claims are not time-barred, that both Brooks and Laura are "sellers" for purposes of the Section 12(a)(1) and 12(a)(2) claims and that the statements made were material.

### A. Timeliness of Section 12(a)(1) and 12(a)(2) Claims

The law regarding the timeliness of Plaintiffs' Section 12(a)(1) and 12(a)(2) claims will first be set forth. This is followed by a determination of the relevant dates and an analysis of the timeliness of Plaintiffs' Section 12(a)(1) and 12(a)(2) Claims.

#### 1. Applicable Statues of Limitation and Repose

Section 13 of the Securities Act of 1933 provides that no action shall be maintained under Section 12(a)(1) "unless brought within one year after the violation upon which it is based."15 U.S.C. § 77m. It further provides that no action shall be maintained under Section 12(a)(2) "unless brought within one year after discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence."*Id.*

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Section 13 also provides a period of repose. A Section 12(a)(1) claim cannot be brought "more than three years after the security was bona fide offered to the public."*Id.* A Section 12(a)(2) claim cannot be brought "more than three years after the sale."*Id.*

The Plaintiffs have the burden of pleading facts that show compliance with Section 13's limitation periods. *In re National Mortgage Equity Corp. Mortgage Pool Certificates Securities Litigation,* 636 F.Supp. 1138, 1166 (C.D.Cal.1986)(citing *Toombs v. Leone,* 777 F.2d 465, 468 (9th Cir.1985)). The Plaintiffs must demonstrate compliance with both the statute of limitations and the statute of repose. *Id.* (citing *Morley v. Cohen,* 610 F.Supp. 798, 815 (D.Md.1985)).

The Plaintiffs urge the Court to apply a different statute of limitations and statute of repose to their Section 12(b)(1) and 12(b)(2) claims. They urge the Court to apply the statute of limitations and statue of repose found in the Sarbanes-Oxley Act (the "SOA").

***10** Enacted on July 30, 2002, the SOA provides a two-year statute of limitations and a five year statute of repose to "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 ..." *Lieberman v. Cambridge Partners, L.L .C.,* 432 F.3d 482, 486 (3d Cir.2005) (citing SOA, Pub.L. No. 107-204 § 804, 116 Stat. 745, 801, codified in part at 28 U.S.C. § 1658(b)). However, while the caselaw is limited, those courts that have considered the issue have determined that the SOA time limitations do not apply to claims that are based upon negligence or strict liability and do not require a showing of fraudulent intent. *See In re Enron Corporation Securities, Derivative and "ERISA" Litigation,* No. H-01-3624, 2004 U.S. Dist. Lexis 8158 at * 51, 2004 WL 405886 (S.D .Tex. Feb. 25, 2004)(SOA time limitations do not apply to Section 12(a)(2) claims); *In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation,* 289 F.Supp.2d 416, 423 15 U.S.C. § 77m applies to Section 12(a)(2) claims and the SOA applies to 10-b5 claims); *Friedman v. Rayovac Corp.,* 295 F.Supp.2d 957, 974-75 (W.D.Wis.2003)(SOA does not apply to claims brought under the Securities Act of 1933).

While Plaintiffs may have alleged fraud in connection with their Section 12(a)(1) and 12(a)(2) claims, these two alleged violations of the Securities Act of 1933 do not require a showing of fraud. Therefore, the one-year statute of limitations and three-year statute of repose found in 15 U.S.C. § 77m will be applied to Plaintiffs' Section 12(a)(1) and 12(a)(2) claims.

**2. Relevant Dates**

To apply the one-year statute of limitations to the Section 12(a)(1) claims, the date the claim was filed and date of the violation must be determined. To apply the one-year statute of limitations to the Section 12(a)(2) claims, the date the claim was filed and the date when the untrue statement was discovered or should have been discovered by the exercise of reasonable diligence must be determined.

To apply the three-year statute of repose to the Section 12(a)(1) claims, the date the claim was filed and the date the security was first bona fide offered to the public must be determined. To apply the three-year statute of repose to the Section 12(a)(2) claims, the date the action was filed and the date the security was sold must be determined.

**a. Date When the Claim Was Filed**

Plaintiffs' original Complaint was filed in the Court of Common Pleas for Clark County, Ohio on January 26, 2005, and was subsequently removed to this Court. The original Complaint included causes of action for engaging in a pattern of corrupt activity under Ohio law, fraud, civil conspiracy, and violation of Ohio's Blue Sky laws.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

On July 22, 2005, the Plaintiffs filed an Amended Complaint which added claims of violation of Sections 12(a)(1) and 12(a)(2) of the Securities Act of 1933 and violation of Rule 10b of the Security Exchange Act of 1934. The Amended Complaint also brought the action of engaging in a pattern of corrupt activity under federal law instead of state law.

***11** On November 2, 2005, the Plaintiffs again amended their Complaint. The Second Amended Complaint includes the same Parties and causes of action as the First Amended Complaint and indicates that it was filed pursuant to the instructions of the United States Bankruptcy Court for the Southern District of New York.

Following and pursuant to this Court's ruling on Defendants' Motion To Dismiss the Second Amended Complaint, the TAC was filed on April 6, 2006. The TAC adds Brooks Klimley as a Defendant and includes the particulars of the allegations of fraud.

The Defendants argue that the Plaintiffs did not file any claim against Laura until January 26, 2005 and did not file the Section 12(a)(1) and 12(a)(2) claims, or any federal securities claims, against Laura until July 22, 2005. They also argue that the first claim against Brooks was filed on January 18, 2006. The Plaintiffs respond that their first claim was filed on January 26, 2005, and that the subsequent claims against both Laura and Brooks relate back to that claim. The Defendants do not dispute that the claims against Laura relate back to the filing of the original complaint on January 26, 2005, but argue that the TAC against Brooks does not relate back .[FN4]

FN4. Brooks Klimley was first named as a defendant in the TAC which was filed on April 6, 2006.

**i. Relevant "Relate Back" Law**

The Plaintiffs ground their argument that the claim set forth in the TAC relates back to the filing of the original complaint on Fed.R.Civ.P. 15(c)(3). However, Fed.R.Civ.P. 15(c)(3) no longer exists. Fed.R.Civ.P. 15 was amended effective December 1, 2007, as part of the "general restyling of the civil rules to make them more easily understood" and these 2007 "changes are intended to be stylistic only."(2007 Amendment Note to Fed.R.Civ.P. 15.) Since the 2007 changes are intended to be stylistic only and the caselaw refers to and interprets the prior Rule 15(c)(3), the prior Rule 15(c)(3) will be used herein.

When a complaint is amended to add a defendant, Rule 15(c)(3) controls whether the amended complaint may relate back to the filing of the original complaint for purposes of the running of a statute of limitations. *Pompey v. Lumpkin,* 321 F.Supp.2d 1254, 1258 (M.D.Ala.2004)(citing *Powers v. Graf,* 148 F.3d 1223, 1225 (11th Cir.1998)), *aff'd* 127 F. App'x 473 (11th Cir.2005). Further, Rule 15(c) is liberally construed by federal courts. *Snoqualmie Tribe of Indians v. United States,* 178 Ct.Cl. 570, 372 F.2d 951 n. 5 (Cl.Ct.1967). It assures that the rights of the parties to a transaction or occurrence can be determined on the merits rather than on procedural difficulties. *Id.*

Pursuant to Rule 15(c)(3), an amendment that adds a party relates back when (1) the claim or defense asserted in the amended complaint arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading; (2) when the party being added has received notice of the complaint within the period provided by Rule 4(m) for service of the summons and complaint; and (3) when the party being added knew or should have known that, but for a mistake concerning the identity of the proper party, the action would have been brought against the party. *Pompey,* 321 F.Supp.2d at 1258 (citing Rule 15(c)(3)). A mistake occurs where the wrong party is blamed while the real culprit remains unknown and also where the plaintiff has full knowledge of all relevant actors but lists the technically incorrect parties. *Kinnally v. Bell of Pennsylvania,* 748 F.Supp. 1136, 1142

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

(E.D.Pa.1990).

***12** Courts impute the notice of a lawsuit, termed “constructive notice,” when there is sufficient “identity of interests” between the original and new parties. *Id.* at 1263 (citing *Jacobsen v. Osborne,* 133 F.3d 315, 320 (5th Cir.1998). Constructive notice can exist when the original and added parties are a parent corporation and its wholly owned subsidiary, when the original party and the added party are co-executors of an estate and when the original party and new party share counsel. *Id.* Further, constructive notice may exist when the original and added parties are so closely related in business or other activities that it is fair to presume the added parties learned of the institution of the action shortly after it was commenced. *Wine v. EMSA Limited Partnership,* 167 F.R.D. 34, 38 (E.D.Pa.996)(citing *Advanced Power Systems, Inc. v. Hi-Tech Systems, Inc.,* 801 F.Supp. 1450, 1456 (E.D.Pa.1992)); *In re Integrated Resources Real Estate Limited Partnerships Securities Litigation,* 815 F.Supp. 620, 647 (S.D.N.Y.1993)(a growing number of courts and commentators have concluded that sufficient notice exists when a party who has some reason to expect his potential involvement as a defendant hears of the commencement of litigation through some informal means). Finally, the plaintiff has the burden of showing that the added party received constructive notice.*Id.*

**ii. “Relate Back” Analysis**

In this case, the claims asserted in the TAC arose out of the conduct, transactions and occurrences set forth in the original complaint. Further, Brooks received constructive notice of the original complaint when it was filed against Laura and should have expected that, while his involvement may have been unknown by others at the time, he might ultimately be included as a Defendant.

Brooks had constructive knowledge of the original complaint because it was brought against his spouse with whom he presumably had an informal relationship. Also, based upon Plaintiffs' factual allegations, Brooks had reason to believe that he would be named as a party because he was involved in VWE. (Deposition of Dianne Pullins (“Dianne Dep.”) 16-17, 77, 107-08 Mar. 22, 2007); Deposition of David Pullins (“David Dep.) 82-83, 102-04 Mar. 23, 2007); Affidavit of Thomas Romo (“Romo Aff.”) ¶¶ 1-3 Feb. 26, 2007.) Finally, both Brooks and Laura have been jointly represented by Mr. Kindseth's office in connection with matters concerning VWE.[FN5]

FN5. The record in VWE's bankruptcy case indicates that Mr. Kindseth and his partners have represented Brooks and Laura in connection with the VWE bankruptcy and the various claims asserted against them by the Creditors Committee since at least December of 2004.

Therefore, for purposes of the Section 12(a)(1) and 12(a)(2) claims against both Brooks and Laura, January 26, 2005, the date the Plaintiffs original complaint was filed, is the date the claims were filed for purposes of statute-of-limitation analysis. Laura was a named Defendant in the original Complaint and the Amended Complaint arose out of the same conduct, transactions and occurrences set forth in the original Complaint. Brooks had constructive notice of the original Complaint and the claims set forth in the TAC, which first named Brooks as a Defendant, arose out of the conduct, transactions and occurrences set forth in the original Complaint. The analysis next turns to the date of the alleged Section 12(a)(1) violations.

**b. Date of the Alleged Section 12(a)(1) Violations**

***13** Section 13 provides that a 12(a)(1) claim must be brought within one year after the sale upon which it is based. 17 U.S.C. § 77m. In this case, Brooks and Laura argue and the Plaintiffs agree that the Plaintiffs last purchased debenture notes from VWE on January 1, 2004.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

**c. Date When the Alleged Section 12(a)(2) Untrue Statement Was Or Should Have Been Discovered**

Brooks and Laura argue that the Plaintiffs were on inquiry notice about the alleged true state of affairs by at least June 2, 2004, when VWE filed for Bankruptcy. The Plaintiffs agree that they were on inquiry notice when the Bankruptcy was filed on June 2, 2004.

**d. Date When the Security Was First Bona Fide Offered To the Public for Purposes of the Section 12(a)(1) Claims**

Brooks and Laura argue that the Plaintiffs, as they allege, were first offered Debenture Notes in 1989. The Plaintiffs respond that Ed purchased securities from VWE's I-1, I-4, 1-7, I-13 and I-15 offerings, that Dianne purchased securities from VWE's I-7, I-9 and I-13 offerings and that David purchased securities from VWE's I-9, I-12, I-13 and I-15 offerings and that, based upon VWE's records, each offer is separate and distinct and each was made available at a different time.

The Plaintiffs further argue that Brooks and Laura have failed to identify the date that each of these offerings was first offered to the public and cannot prove their statute of limitations defense without this information. Brooks and Laura reply by identifying evidence that offering I1 was first sold to Plaintiffs on January 1, 1989, I-4 on September 22, 1992, I-7 on November 12, 1998, I-9 on February 17, 1998, I-12 on December 12, 2000, I-13 on October 1, 2001, and I-15 on October 1, 2003. (Laura Mem. Ex. G.)

A stock, even if unregistered, is bone fide offered when it is genuinely offered to the public. *P. Stolz Family Partnership L.P. v. Daum,* 355 F.3d 92 (2d Cir.2004)(citing *Kubic v. Goldfield,* 479 F.2d 472, 475 (3d Cir.1973)). Further, the majority of courts have found that the three-year period begins when the security is first bona fide offered and not when last bona fide offered. *Id.* at 100;*but see In re National Mortgage,* 636 F.Supp. at 1166 (the statute begins to run from that date of defendant's last sales-related activity, i.e., offer, sale or delivery of the security).

In this case, there were several offerings of debenture notes. Each offering was made at a different time, the offerings had different term periods, the offerings had different interim maturity periods, the offerings had different interest rates, and each offering became due at a different date. Therefore, each of the offerings will be considered to be a bona fide offering and the dates that each offering was sold will be when each of the Debenture Notes was first bona fide offered.

**e. Date the Security Was Sold for Purposes of the Section 12(a)(2) Claims**

Courts generally consider the date of sale relating to Section 12(a)(2) claims as the last of three occurrences: the date the security was first offered for sale, the date it was sold or the date it was delivered. *In re Enron,* 2004 U.S. Dist. LEXIS 8158 at *77, 2004 WL 405886.In this case, since each of the offerings will be considered as a sale of a security, the date each of the offerings was sold will be the date of sale.

**3. Timeliness Analysis**

***14** The statute of limitations that applies to Plaintiffs' 12(a)(1) claims requires that Plaintiffs' Complaint be brought within one year after the violation upon which it is based *and* not later than three years after the security was bona fide offered to the public. 15 U.S.C. § 77m. In this case, Plaintiffs' 12(a)(1) claims were brought on January 26, 2005 and the most recent alleged violation occurred on January 1, 2004 when the I-19 offering was purchased.

The Plaintiffs suggest that their Section 12(a)(1) claim is timely because of equitable tolling. Some

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

courts have found that equitable tolling does not apply to Section 12(a)(1) claims. *In re Colonial Ltd. Partnership Litigation,* 854 F.Supp. 64, 86 (D.Conn.1994). Those courts that have considered equitable tolling have either considered it with regard to the service requirement found in Rule 4(m), *Pompey,* 321 F.Supp.2d at 1265, or with regard to cases where there was concealment of the fact that the securities were not registered. *Katz v. Amos Treat & Co.,* 411 F.2d 1046, 1055 (2d Cir.1969); *In re Colonial,* 854 F.Supp. at 86; *Jones v. Lewis,* No. 86-1547-T, 1988 WL 163026 at *2 (D.Kan. June 13, 1988); *In re Gas Reclamation, Inc. Securities Litigation,* 659 F.Supp. 493, 507 (S.D.N.Y.1987); *In re National Mortgage,* 636 F.Supp. at 1166-67.

In this case, the Plaintiffs make no allegations regarding service of their Complaint or no allegations that Brooks and Laura made fraudulent misrepresentations about the registration of the Debenture Notes. Therefore, the doctrine of equitable estoppel does not apply to Plaintiffs' 12(a)(1) claims.

The one-year requirement is not satisfied by any of Plaintiffs' 12(a)(1) claims. Since both the one-year and three-year requirements must be satisfied, Plaintiffs' 12(a)(1) claims against both Laura and Brooks are barred and must be dismissed.

The statute of limitations that applies to Plaintiffs' 12(a)(2) claims requires that Plaintiffs' Complaint be brought within one year after the discovery of the untrue statement or omission *and* not later than three years after the sale. In this case, Plaintiffs' 12(a)(2) claims were brought on January 26, 2005, and the untrue statements or omissions were discovered on June 2, 2004. Therefore, Plaintiffs' 12(a)(2) claims are not barred by the one-year limit.

One of Plaintiffs' 12(a)(2) claims is also not barred by the three-year limit. Plaintiffs' 12(a)(2) claims were brought on January 26, 2005, and the sale of the I-15 offering occurred on October 1, 2003. The sale of the other offerings about which Plaintiffs complain occurred outside of the three year limit and causes of action regarding these sales are barred by the three-year limit.

Plaintiffs' 12(a)(2) claim regarding the purchase of the I-15 offering is not time barred. Further, the doctrine of equitable estoppel does not apply to the other offerings. *In re Enron,* 2004 U.S. Dist. LEXIS 8158 at *77, 2004 WL 405886 (courts have almost uniformly agreed that the three-year time limit is absolute and thus equitable tolling principles are not applied to further extend the three years). In this case, the Plaintiffs do not argue otherwise regarding equitable tolling.

**B. Sale of Securities**

***15** The elements of a Section 12(a)(2) claim [FN6] are: (1) the defendants offered and sold a security; (2) by the use of any means of communication in interstate commerce; (3) through a prospectus or oral communication; (4) by making a false or misleading statement of material fact or by omitting to state a material fact; (5) plaintiff did not know of the untruth or omission; and (6) defendants knew, or in the exercise of reasonable care, should have known of the untruth or omission. *Wright v. National Warranty Company,* L.P., 953 F.2d 256, n. 3 (6th Cir.1992); *Wuliger v. Mann,* No. 3:03 CV 1531, 2005 WL 1566751 at *5 (N.D.Ohio July 1, 2005).

> FN6. Since Plaintiffs' Section 12(a)(1) claims are time-barred, only the remaining Section 12(a)(2) claim will be considered.

Therefore, to make a Section 12(a)(2) claim, the Plaintiffs must show that Brooks and Laura offered and sold them the debenture notes that are not barred by the statute of limitations through an oral communication.[FN7] Where the defendant is not a direct seller, direct and active participation in the solicitation of the sale must be shown. *Maker v. Durango Metals, Inc.,* 144 F.3d 1302, 1307 (10th cir.1998). Liability extends “to the person [non owner] who successfully solicits the purchase, motivated at least in part by a desire to serve his own

financial interests or those of the securities owner."FN8 *Shaw v. Digital Equipment Corp.,* 82 F.3d 1194, 1214-15 (1st Cir.1996); *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.,* 940 F.Supp. 1101, 1132 (W.D.Mich.1996)(quoting, *Pinter v. Dahl,* 486 U.S. 622, 647, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988)).

FN7. There is no evidence that a prospectus was involved in the sale of the Debenture Notes.

FN8. The definition of seller set forth in *Pinter* was in the context of a Section 12(a)(1) claim but it is well established that this same definition applies to a Section 12(a)(2) claim. *Shaw,* 82 F.3d at 1214; *Picard,* 940 F.Supp. at 1132.

To establish liability as a seller, a plaintiff must demonstrate direct and active participation in the solicitation of the immediate sale. *Picard,* 940 F.Supp. at 1132-33;*see also Shaw,* 82 F.3d at 1215. In other words, a statutory seller must engage in activity which could be considered an offer.FN9 *Id.* (citing *PPM America, Inc. v. Marriott Corp.,* 853 F.Supp. 860, 873 (D.Md.1994)). A non-owner seller must urge a prospective purchaser to buy. *Smith v. American National Bank and Trust Co.,* 982 F.2d 936, 941 (6th Cir.1992). However, participation in activities relating to the sale of securities, standing alone, does not demonstrate statutory seller status nor does the fact that statements by a defendant were a substantial factor in the purchase demonstrate seller status. *Shaw,* 82 F.3d at 1216.

FN9. An offer is "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value." *Picard,* 940 F.Supp. at 1132-33 (quoting 15 U.S.C. § 77b(3)).

**1. Sales By Brooks for Purposes of Section 12(a)(2) Claims**

Turning then to this case, Brooks testifies that he has "never solicited or sold any investments in VWE to Plaintiffs or to anyone else. (Brooks Aff. ¶ 11.) Also, Laura testified that she "did not authorize or participate in, and have no knowledge of my father's, mother's and sister's solicitations of Plaintiffs' investments in VWE."(Laura Aff. ¶ 12.) Brooks and Laura also point to Ed's testimony that Victor, Maxine and Alicia solicited him and David to purchase the debenture notes. (Ed. Dep.15, 39, 59.) This was confirmed by Dianne. (Dianne Dep. 21, 58, 90.)

***16** The Plaintiffs respond by arguing that Brooks made numerous false statements in connection with the financial status of VWE. For example, Brooks allegedly said that the company had plenty of assets to cover the notes outstanding. (Ed Dep. 118.) In another example, Brooks was part of a group sitting around a table who agreed that VWE was doing very well and everyone should do all they can to relieve the anxiety of the shareholders. (*Id.* 122-25.)At another time, Brooks indicated that Alicia was doing a great job at VWE and "launched" into a dialogue about VWE's financials. (*Id.* 160, 169-70.)

Dianne testified that Brooks was indirectly involved in the solicitations by Victor because Victor always said that, if anything happened to him [Victor] that Brooks was going to take over and that "Brooks had his eye on everything."(Dianne Dep. 16-17.) She further testified that, on many social occasions, she was told by Brooks and Victor "what a great company it is and we should invest."(*Id.*) Finally, David testified that, on one occasion, Brooks "had no problem rattling off numbers, saying "I've seen the numbers. They're good. They're strong and profitable. Don't worry ."(David Dep. 102-03.)

The Plaintiffs also direct attention to a conflict in Brooks' testimony between what he testified in this lawsuit and what he testified at a recent deposition taken in another lawsuit brought against him. Here, he said he never solicited or sold VWE Debenture Notes to anyone. In the other lawsuit, he testified

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

that Alicia asked him to talk to other potential investors and he specifically remembers talking to at least one. (Brooks Dec. Dep. 166-68) He said, however, that he does not remember talking to Ed. (*Id.*)

While Brooks may have made statements regarding the financial status of VWE, none of the statements identified demonstrate direct and active participation in the solicitation of the immediate sale of any Debenture Note to the Plaintiffs. Therefore, Brooks was not a "seller" of the Debenture Notes to the Plaintiffs.

**2. Sales By Laura for Purposes of Section 12(a)(2) Claim**

The Plaintiffs do not identify any specific statements that Laura made regarding sale of the Debenture Notes, and, instead argue that she is liable as a senior officer of VWE, as a director of VWE and as one who held 50% of the voting shares of VWE. In support of this argument, the Plaintiffs cite *Maywalt v. Parker & Parsley Petroleum Co.,* 808 F.Supp. 1037, 1053 (S.D.N.Y.1992). In *Maywalt,* a group of managers who published a proxy solicitation for a merger and ended up as directors of the resulting company and a group of officers and directors of one of the entities being merged that provided a written recommendation of approval of the merger were found to be sellers for Section 12(a)(2) purposes. 808 F.Supp. at 1053.

However, the situation in *Maywalt* is considerably different from the situation here. In *Maywalt,* there were written publications and here there are no written publications. Here, the only misstatement allegations regarding the sale of Debenture Notes are oral representations by Maxine and Alicia.[FN10] Since there can be no inference that oral statements of one officer represent the "collective action" of others, Laura can hardly be held liable for the oral statements made by the others. *See In re Smartalk Teleservices, Inc. Securities Litigation,* 124 F.Supp.2d 527, (S.D.Ohio 2000)(there can be no inference that an oral statement of one officer represents the "collective action" of others).

> FN10. Victor was deceased at the time of the sale of the Debenture Notes actionable under Section 12(a)(2) and there is no evidence of written communications after that time.

***17** The Plaintiffs have not presented evidence that Laura directly and actively participated in the solicitation of the immediate sale of any debenture notes. Therefore, Laura was not a "seller" of the Debenture Notes.

**C. Conclusion On Section 12(a)(1) and Section 12(a)(2) Claims**

There are no genuine issues of material fact and both Brooks and Laura are entitled to judgment as a matter of law on Plaintiffs' Section 12(a)(1) and Section 12(a)(2) claims against them. Action on all of Plaintiffs' Section 12(a)(1) claims is time-barred. Action on all but one of Plaintiffs' Section 12(a)(2) claims is time-barred. Finally, the Plaintiffs have presented no evidence that either Brooks or Laura sold or solicited the sale of the Debenture Note to them upon which action is not time-barred.

Since summary judgment has been granted based upon the statute of limitations and the requirement that the defendant be a seller of the actionable security to the purchaser, the materiality of the alleged statements need not be addressed for purposes of the Section 12(a)(1) and 12(a)(2) claims. The analysis next turns to Plaintiffs' Second Cause of Action.

**V. SECOND CAUSE OF ACTION: 10b-5 CLAIMS**

Plaintiffs' Second Cause of Action asserts that Brooks and Laura violated Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 which prohibit making material misstatements in

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

connection with the purchase or sale of securities. To be actionable, the conduct giving rise to the 10b-5 claim must be more than negligent. *Cook,* 573 F.2d at 692.

Section 10(b) of the Securities Exchange Act of 1934 was designed as a "catchall clause to prevent fraudulent practices." *Picard,* 940 F.Supp. at 1119 (quoting *Chiarella v. United States,* 445 U.S. 222, 226, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980)). Section 10(b) makes it unlawful to employ, in connection with the purchase or sale of securities, any "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe ..."*Id.*(quoting *Chiarella,* 455 U.S. at 226). Rule 10b-5 promulgated by the Securities and Exchange Commission makes it unlawful in connection with the purchase or sale of any security "(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."*Id.* (quoting 17 C.F.R. 240, 10b-5). Section 10(b) and Rule 10b-5 reach beyond statements and omissions that are made in registration statements and that are actionable under Sections 12(a)(1) and 12(a)(2) to create liability for false or misleading statements or omissions of material fact in connection with trading in the secondary market. *Shaw,* 82 F.3d at 1216-17.

***18** The elements of a 10b-5 claim are: (1) scienter on the part of the defendant; (2) materiality of the alleged misrepresentations or omissions by the defendant; (3) actual reliance by plaintiff upon the defendant's misstatements or omissions; and (4) justifiable reliance. *Wright,* 953 F.2d at n. 1 (citing *Cavalier Carpets, Inc. v. Caylor,* 746 F.2d 749, n. 16 (11th Cir.1984)).

The alleged violator need not directly communicate with the plaintiff for primary liability for a 10b-5 claim to attach. *Picard,* 940 F.Supp. at 1120. A third-party defendant may be liable as a primary violator where the third-party defendant controlled the content of the misleading statement.[FN11] *Id.*

> FN11. The control over a specific third-party statement needed to establish primary 10b-5 liability is not the equivalent of the degree of control over an actor needed to establish a "control person" liability under Section 15 of the Securities Act of 1933 or Section 20(a) of the Securities Exchange Act of 1934. *Picard,* 940 F.Supp. at n. 13.

Brooks and Laura argue that Plaintiffs' 10b-5 claims are time-barred, that the statements allegedly made by them are not actionable and that there is no evidence that either of them acted with scienter. The Plaintiffs respond that their claims are not time-barred, that both Brooks and Laura are "sellers" for purposes of the 10b-5 claims and that the statements made were actionable.

**A. Timeliness of 10b-5 Claims**

The Sarbanes-Oxley Act of 2002 extended the statute of limitations on 10b-5 claims from a one-year/three-year scheme to a two-year/five year scheme. *Taylor v. Prudential Insurance Company of America,* No. l:02-cv-1462, 2003 WL 21314254 at *4 (S.D.Ind. May 7, 2003). The two-year/five-year scheme currently in effect is found at 28 U.S.C. § 1658. *Id.*

Section 1658 provides that "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 ... 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."*Id.* (citing 28 U.S.C. § 1658). The limitations period is not subject to equitable tolling and the statute of limita-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

tions begins to run on either actual or inquiry notice of the facts constituting the fraud. *Id.*

To apply the two-year limitation, the date the complaint was filed and the date that the facts constituting the violation was or should have been discovered must be determined. To apply the five-year limitation, the date of the violation must be determined.

**1. Date When the 10b-5 Claim Was Filed**

Plaintiffs' original Complaint was filed in the Court of Common Pleas for Clark County, Ohio on January 26, 2005, and was subsequently removed to this Court. On July 22, 2005, the Plaintiffs filed an Amended Complaint which added claims of violation of Sections 12(a)(1) and 12(a)(2) of the Securities Act of 1933 and violation of Rule 10b-5 of the Securities Exchange Act of 1934. On November 2, 2005, the Plaintiffs again amended their Complaint. Following and pursuant to this Court's ruling on Defendants' Motion To Dismiss the Second Amended Complaint, the TAC was filed on April 6, 2006. The TAC adds Brooks as a Defendant and includes the particulars of the allegations of fraud.

***19** Brooks and Laura now argue that the 10b-5 claim was first filed against Laura on July 22, 2005 when this claim was amended to the original Complaint. They also argue that the 10b-5 claim against Brooks was brought on January 18, 2006, when Plaintiffs filed their motion to file the TAC.[FN12] The Plaintiffs respond that the 10b-5 claim filed against Laura on July 22, 2005, and the TAC which first named Brooks relate back to the original claim filed on January 26, 2005.

> FN12. The TAC first added Brooks as a Defendant.

The law regarding an amendment relating back to an original claim is as set forth above. In this case, Laura was named in the original Complaint and the Amended Complaint adding the 10b-5 claim against Laura arose out of the conduct, transaction and occurrences set forth in the original Complaint. Therefore, the Amended Complaint that adds a 10b-5 claim against Laura relates back to the original Complaint filed on January 26, 2005. Also, for the reasons stated above regarding the Section 12(a)(1) and 12(a)(2) claims, the 10b-5 claim against Brooks relates back to the original Complaint.

Therefore, for purposes of the 10b-5 claims against both Brooks and Laura, January 26, 2005, the date the Plaintiffs original Complaint was filed, is the date the claims were filed for purposes of 10b-5 statute-of-limitation analysis. Laura was a named Defendant in the original Complaint and the Amended Complaint which first includes a 10b-5 claim against Laura relates back to the original Complaint. Also, Brooks had constructive notice of the original Complaint and the TAC which first named Brooks as a Defendant arose out of the conduct, transactions and occurrences set forth in the original Complaint. The analysis next turns to the date that the facts constituting the 10b-5 violation were or should have been discovered.

**2. Date When the Alleged 10b-5 Untrue Statements Were Or Should Have Been Discovered**

As with the Section 12(a)(1) and 12(a)(2) claims, Brooks and Laura argue that the Plaintiffs were on inquiry notice about the alleged true state of affairs by at least June 2, 2004, when VWE filed for bankruptcy. The Plaintiffs agree that they were on inquiry notice when the Bankruptcy was filed on June 2, 2004. The analysis next turns to when the alleged 10b-5 violations occurred.

**3. Date When the Alleged 10b-5 Violations Occurred**

The alleged 10b-5 violations are misstatements allegedly made by Brooks and Laura in connection with the purchase of Debenture Notes by the Plaintiffs. There are factual allegations that the alleged misstatements by Brooks and/or Laura were

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

made as early as "during the 90s" and continued until VWE filed bankruptcy. (Ed Dep. 41, 61-62, 125-26, 154, 168-70, 190-96; Dianne Dep. 17-18, 75-77, 143; David Dep. 82-85.) There are also factual allegations that the sales to the Plaintiffs that resulted from alleged misrepresentations were made on January 1, 1989, September 22, 1992, November 12, 1998, February 17, 1998, December 12, 2000, October 1, 2001 and October 1, 2003. Therefore, the alleged sales were made after the alleged misrepresentations and, as determined above, each of the sales is an alleged violation.

**4. Analysis of Timeliness of 10b-5 Claims**

***20** In this case, the discovery of the facts constituting the alleged violations was made on June 2, 2004. Two years after this date is June 2, 2006 and the Complaint was filed on January 26, 2005. Therefore, the Complaint was filed within two years of when the facts constituting the alleged violations were discovered and the two-year limitation is satisfied.

The five-year limitation must also be considered. The dates of the alleged violations range from January 1, 1989, to October 1, 2003. Five years after the alleged violations is a range from January 1, 2004, to October 1, 2008.

The claim was filed on January 26, 2005. Therefore, any sales that occurred on or after January 26, 2000, are not subject to the five-year limitation. This includes sales made on December 12, 2000, October 1, 2001 and October 1, 2003. The five-year limitation bars claims for sales made prior to January 26, 2000. This includes the sales made on January 1, 1989, September 22, 1992, November 12, 1998, and February 17, 1998. The analysis next turns to the actionability of the alleged statements made by Brooks and Laura.

**B. Actionability as 10b-5 Claims**

To be actionable as 10b-5 claims, the Plaintiffs must show that the statements made by Brooks and/or Laura Klimley were material. *City of Monroe Employees Retirement System v. Bridgestone Corp.,* 399 F.3d 651, 669 (6th Cir.2005), *cert. denied,* 546 U.S. 936 (2005). Plaintiffs must also show that Brooks and/or Laura had a duty to disclose. *Id.*

The analysis next turns to a determination of whether the alleged statements or omissions were material. This is followed by an analysis of whether Brooks and/or Laura had a duty to disclose.

**1. Relevant Law On Materiality**

A *statement* is material only if there is a substantial likelihood that "a reasonable investor would have viewed the misrepresentation as 'having significantly altered the total mix of information made available.' " *In re Ford Motor Company Securities Litigation,* 381 F.3d 563, 570 (6th Cir.2004)(quoting *In re Sofamor Danek Group, Inc.,* 123 F.3d 394, 400 (6th Cir.1997), *cert. denied,* 523 U.S. 1106, 118 S.Ct. 1675, 140 L.Ed.2d 813 (1998)). Likewise, an *omission* is material if there is "a substantial likelihood that the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available." *Stavroff v. Meyo,* No. 95-4118, 1997 WL 720475 at *4 (6th Cir. Nov.12, 1997).

Alleged misrepresentations are immaterial "only if they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *In re Ford Motor Company,* 381 F.3d at 570 (citing *Helwig v. Vencor, Inc.,* 251 F.3d 540, 563 (6th Cir.2001)). Misrepresentations are also immaterial if the investors have knowledge of the truth. *Picard,* 940 F.Supp. at 1123 (citing *Basic Inc. v. Levinson,* 485 U.S. 224, 231-32, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988)).

***21** The materiality requirement does not require proof of a substantial likelihood that proper disclosure would have caused an investor to change a de-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

cision. *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). Proof that the proper disclosure would have significantly altered the "total mix" of available information is all that is necessary. *Id.*

Whether or not a statement is material turns upon a "fact-intensive test." *City of Monroe,* 399 F.3d at 669 (citing *Helwig,* 251 F.3d at 555). Therefore, materiality is a mixed question of law and fact and is decided as a matter of law only if reasonable minds could not differ on the issue. *Picard,* 940 F.Supp. at 1122. However, in most instances, disputes over the materiality of allegedly false or misleading statements are determined by the trier of fact. *Shaw,* 82 F.3d at 1217.

Regarding materiality, the Sixth Circuit has distinguished between "hard" and "soft" information. *Picard,* 940 F.Supp. at 1122. Hard information is usually historical information or other factual information that is objectively verifiable. *Id.* Publicly-disclosed hard information is actionable if false and material. *Id.*

Soft information includes predictions and matter of opinions. *Id.* Soft information that is not actionable includes vague, puffing statements or obvious hyperbole upon which a reasonable investor would not rely. *In re Ford Motor,* 381 F.3d at 570. Statements that are "mere puffing" or "corporate optimism" may be forward-looking or generalized statements of optimism that are not capable of objective verification. *Id.*

Soft information is actionable only if it is virtually as certain as hard facts. *City of Monroe,* 399 F.3d at 669. Opinions may be deemed false or misleading under the securities laws if proof of their falsity can be established "through the orthodox evidentiary process." *Id.* (citing *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083, 1090-93, 111 S.Ct. 2749, 115 L.Ed.2d 929 (1991)).

**2. Relevant Law On Duty To Disclose**

In addition to being material, to be actionable, a misrepresentation or omission must pertain to information that the defendant had a duty to disclose. *City of Monroe,* 399 F.3d at 669. A duty to disclose may arise where there is an incomplete or misleading prior disclosure. *Id.* Also, a duty to disclose may arise from a relationship of trust and confidence between the parties to a transaction. *Chiarella,* 445 U.S. at 230; *State v. Warner,* 55 Ohio St.3d 31, 564 N.E.2d 18, 40 (Ohio 1990), *cert. denied,* 499 U.S. 961, 111 S.Ct. 1584, 113 L.Ed.2d 649 (1991).

For example, "[a] duty to disclose and corresponding liability for failure to disclose arises when the party fails to exercise reasonable care to disclose a material fact which may justifiably induce another party to act or refrain from acting, and the non-disclosing party knows that the failure to disclose such information to the other party will render a prior statement or representation untrue or misleading. *Glassner v. R.J. Reynolds Tobacco Company,* 223 F.3d 343, 352 (6th Cir.2000). In another example, a duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. *Warner,* 564 N.E.2d at 40.

***22** As an example of a fiduciary duty, the officers and directors of a corporation that is insolvent or is on the brink of insolvency owe a fiduciary duty to the corporation itself and to its creditors not to waste corporate assets which otherwise could be used to pay corporate debts. *DeNune v. Consolidated Capital of North America, Inc.,* 288 F.Supp.2d 844, 859 (N.D.Ohio 2003). In another example, directors of a corporation owe a fiduciary duty to the corporation and its shareholders to perform their duties in good faith and in a manner not opposed to the best interests of the corporation. *Thomas v. Matthews,* 94 Ohio St. 32, 113 N.E. 669, 671 (Ohio 1916); *Geygan v. Queen City Grain Co.,* 71 Ohio App.3d 185, 593 N.E.2d 328, 331 (Ohio Ct.App.1991).

Directors are held strictly accountable and liable if

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

corporate funds or property are wasted or mismanaged due to the director's inattention. *Biggins v. Garvey,* 90 Ohio App.3d 584, 630 N.E.2d 44, 52 (Ohio Ct.App.1993); *Geygan,* 593 N.E.2d at 333. However, a fiduciary duty does not exist when a bank and a prospective borrower are dealing at arm's length unless special circumstances are present. *Groob v. Keybank,* 108 Ohio St.3d 348, 843 N.E.2d 1170, 1176 (Ohio 2006).

**3. Alleged Fraudulent Statements**

The allegedly fraudulent statements or omissions attributed to Brooks and Laura in the TAC are:

¶ 35.In October of 2000 at the Dutch Reformed Church in Bronxville, New York, after the funeral service of Victor Eimicke, Alicia and Maxine Eimicke and Laura Klimley assured Wayne, Dianne and David Pullins that Alicia Eimicke would run the Company and that the Company was strong financially. At the time that said statements were made, Alicia, Maxine Eimicke and Laura Klimley knew these statements to be false. (See also Ed's deposition where he remembers that a group, including Brooks, discussed that VWE was doing well and he remembers this conversation being at a dinner following Victor's funeral. (Ed. Dep.122-25.); In her deposition, Dianne remembers that on many social occasions “we” were told by Victor and Brooks “what a great company it is and we should invest.”(Dianne Dep. 16-18; David Dep. 82-83.))

¶ 43.On Thursday-Sunday, October 11-14, 2001 at Baker Field, Columbia University, New York City, Brooks and Laura Klimley took Wayne, Dianne and David Pullins to a Columbia University football game. Brooks and Laura Klimley told the Pullins Family that all was well with the company and everything was running as usual although they knew that said representations were false. (See also Ed Dep. 137-39; Dianne Dep. 16-18, 76-78; David Dep. 100-03.)

¶ 61.On Friday, July 4, 2003, at the Siwanoy Country Club in Bronxville, New York, Laura and Brooks Klimley, along with Maxine Eimicke, indicated to Wayne Pullins that the Company was doing better than ever before and Alicia was doing a great job although they knew this not to be the case. (See also Ed Dep. 164; Dianne Dep. 16-18.)

¶ 68.On Tuesday-Friday, April 20-23, 2004, Wayne Pullins was in Columbus, Ohio at Riverside Methodist Hospital for a heart operation. He received separate calls from both Maxine Eimicke and Laura Klimley, wishing him well and not to worry about the money with them, it was safe for his wife and son although they knew that this was not true and in fact that Company was preparing a bankruptcy filing. (See also Dianne Dep. 16-18.)

***23** ¶ 70.On Saturday, May 29, 2004, at 5 Oakledge Road (Klimley family residence), Bronxville, New York, the Klimleys held a barbeque at their home, attended by Brooks and Laura Klimley, their three children (Zoe, Spencer, Graham), Beth Duval and Wayne, Dianne and David Pullins. Wayne Pullins asked about the company (because they were behind in payment to the Pullins family for about $17,000). Laura Klimley referred questions to Brooks who said things were “going on as usual.” Wayne Pullins asked where Alicia Eimicke was and was told by Laura that she was unable to attend because of conflicting weekend plans. The guests were shown in detail their $8 million home, acting as if they (Maxine Eimicke and Brooks and Laura Klimley) were entirely secure. In front of Brooks and Laura Klimley, Maxine Eimicke advised the Pullins family to reserve rooms at the Plaza Hotel for David Pullins' upcoming graduation from Columbia University, suggesting money issues were secure. At the time that these representations were made Brooks Klimley, Laura Klimley and Maxine Eimicke knew that the Company was insolvent and had authorized the filing of a bankruptcy petition.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

(See also Ed. Dep. 168-70; Dianne Dep. 16-18.)

¶ 71.On Sunday, May 30, 2004, in the Bronxville area, to see the Klimley's two sons play baseball, Wayne Pullins asked again about Alicia and the Company. Again, Brooks spoke for Laura Klimley and himself saying, “Alicia runs the company for us and she plays her cards close to the vest.”This statement was made although Brooks Klimley was actively involved in the note program and had knowledge of the Company's insolvency and bankruptcy filing. (See also Dianne Dep. 16-18.)

¶ 79.Defendants knew or in the alternative recklessly disregarded the adverse information in connection with the Company's losses, excessive officers salaries and compensation; failure to register the subject Notes and make the required disclosures; inability to service the Notes and the insolvency of the Company as described above and purposely failed to disclose this information to Plaintiffs and the other investors in the Note Program although Defendants had a clear duty to do so.

In addition to the specific instances identified in the TAC, Ed remembers that, during the time prior to Victor's death, Brooks represented to him that VWE was doing well. (Ed Dep. 62.) Ed does not identify when this particular statement may have been made.

Ed also testified that Brooks confirmed with Maxine that there were $4 million in notes outstanding and VWE had plenty of assets to cover that. (*Id.* 118, 843 N.E.2d 1170.) Ed does not testify as to when this particular statement was made. (*Id.*)

**4. Analysis of Actionability of Fraudulent Statements**

As an initial matter, the alleged general representations made by Brooks and identified in Ed's deposition at pages 62 and 118 will not be considered to be material because Ed does not identify the statements with specificity. Remaining to be considered are the specific statements and omissions alleged in the TAC and confirmed in the Depositions of Ed, Dianne and David.

***24** This analysis is undertaken based upon factual allegations that both Laura and Brooks knew or should have know the true financial status of VWE. Laura was a 50% owner, a Vice President of VWE, a Director of VWE and worked in the business every day for a period of time. (See Dianne Dep. 107-08.)

Leo Kirby, a VWE employee from May of 1993 to July of 2000, testifies that, as part of his job duties, he delivered business items, including interoffice envelopes and mail messages, to Laura's home and that he saw an office in her home in which she did VWE business-related work. (Deposition of Leo Kirby (“Leo Kirby Dep.”) 64 May 1, 2007.) He, however, does not know the contents of the materials that he delivered. (*Id.* 42, 843 N.E.2d 1170.) He also recalls occasionally discussing business matters with Laura in VWE's office after she ceased working full time there. (*Id.* 34-35, 843 N.E.2d 1170) Dianne also recalls seeing the office in Laura's home and financial documents on Laura's desk. (Dianne Dep. 73-74.) Finally, David recalls seeing the office that Laura had in her home and describes it as a “business-like” office with a fax machine and computer and as “not an office for writing thank you notes.”(David Dep. 117.)

Further, in a recent deposition in an different lawsuit, Laura acknowledges that she was consulted by Alicia in connection with issues involving VWE's business affairs in the 1998 to 2004 time period. (Deposition of Laura Klimley (“Laura Dec. Dep.”) 34 Dec. 5, 2007.) She also admits that she had signatory power on VWE accounts after Victor's death and that, in October of 2000, she actually signed checks to holders of the Debenture Notes. (*Id.* 223-25, 843 N.E.2d 1170.) Laura also admits that, in mid-2003 she attended at least one meeting regarding the sale of VWE's Holiday Greeting Card business. (*Id.* 205, 276, 843 N.E.2d 1170.) Finally,

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Laura admits that, up until VWE's bankruptcy was filed, she was receiving a weekly check from VWE for $600. (*Id.* 41, 843 N.E.2d 1170.) She does not think this money was a salary but was money VWE owed her for something other than a Debenture Note. (*Id.* 41-42, 843 N.E.2d 1170)

Further, regarding Laura, there is evidence that she was told by lawyers in the firm of Hall Dickler Kent Goldstein & Wood that, as of August 27, 2001, VWE had significant net operating losses of approximately $8.6 million, a book value of approximately $11 million and outstanding liabilities of approximately $24 million.. (Affidavit of Michael Meyers ("Meyers Aff.") ¶¶ 3-4, Ex.1 Nov. 9, 2007). This information was presented as part of a response to a request from VWE, half-owned at the time by Laura, to present the most tax efficient business structure under which VWE could achieve certain goals in the event it became profitable and/or was later sold at a substantial gain.(*Id.*)

There are also factual allegations that Brooks was knowledgeable in general about financial matters and heavily involved in and knowledgeable of VWE financial matters. (Dianne Dep. 16-17, 77, 107-08; David Dep. 82-83, 102-04; Romo Aff. ¶¶ 3-4.)

***25** Because Laura and Brooks knew or should have known about VWE's poor financial conditions, their statements identified in paragraphs 35, 43, 61, 68, 70 and 71 of the TAC are misrepresentations. While in one context, these statements may be mere "rosy affirmations," in the context of a family business where no financial information is officially disclosed and where the alleged misstatements are made by those close to the family who knew or should have known the actual financial conditions, there are not mere "rosy affirmations." Also, while the majority of the alleged misrepresentations were made by Victor, Maxine and Alicia, there are factual allegations that Laura and Brooks knew or should have known that they were misrepresentations and either supported or failed to correct them. Finally, proper disclosure of the financial status of VWE would have significantly altered the total mix of information available to Ed, Dianne and David upon which to base their decisions regarding purchase and/or renewal of the Debenture Notes. Finally, failure to disclose the true financial picture when given many opportunities to do so is a material omission.

Regarding duty, both Brooks and Laura had a duty to disclose VWE's true financial status to the Plaintiffs because they had made alleged misleading prior disclosures regarding the financial status of VWE. Both Brooks and Laura also had a duty to disclose arising from the relationship of trust that they created due to their close family relationship with the Plaintiffs, Plaintiffs continuing purchase of Debenture Notes and Brooks' and Laura's prior affirmations of VWE's financial well-being. Further, both Brooks and Laura, as control persons of a insolvent company, had a fiduciary relationship with Plaintiffs as creditors and, therefore, had a duty to disclose. Finally, Laura had a duty to disclose that arose from the positions that she held at VWE and the fact that the Plaintiffs were both investors and close family members.

**5. Conclusion On Actionability**

There are genuine issues of material fact as to whether the alleged misstatements and omissions made by Brooks and Laura are actionable. There are genuine issues of material fact as to whether the statements were material and genuine issues of material fact as to whether Brooks and/or Laura had a duty to disclose the true financial status of VWE.

**C. Scienter Regarding the 10b-5 Claims**

To prove their 10b-5 claim, Plaintiffs must show that Brooks and/or Laura acted with the requisite scienter. Scienter is defined as "a mental state embracing intent to deceive, manipulate or defraud." *Brown v. Earthboard Sports USA, Inc.,* 481 F.3d 901, 917 (6th Cir.2007); *Picard,* 940 F.Supp. at 1125. For 10b-5 claims based on statements of

present or historical fact, scienter consists of knowledge or recklessness. *PR Diamonds v. Chandler,* 364 F.3d 671, 681 (6th Cir.2004). Recklessness is akin to conscious disregard and is defined as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Id.* at 684.While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it." *Id.* at 681 (quoting *Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1025 (6th Cir.1979)). For forward-looking statements that are not accompanied by meaningful cautionary language, the required state of mind is actual knowledge of the statement's false or misleading nature. *Id.* at n. 3.

***26** A "totality of the circumstances" test is used to determine whether scienter is adequately shown. *Brown,* 481 F.3d at 917. Among the factors that have been considered to determine if scienter was present are: divergence between internal reports and external statements on the same subject; closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; disregard of the most current factual information before making statements; and the self-interested motivation of the defendants in the form of saving their salaries or jobs. *Id.* at 917.

Scienter must be shown for each of the statements allegedly made by Brooks and Laura. *City of Monroe,* 399 F.3d at 682. The Plaintiffs must allege facts that, if true, form the basis for a strong inference that Brooks and/or Laura knew a statement was false or misleading.

In this case, the Plaintiffs have alleged facts that both Laura and Brooks knew or should have known that their statements regarding the financial health of VWE were false and that both Brooks and Laura may have been motivated to make the false statements. This same reasoning applies to the alleged omissions.

First, there is evidence that Brooks knew or should have known about the actual financial condition of VWE. There is evidence that, in 1994 at a party at Maxine's home, the group present "toasted" to the "handing of the guard over to Brooks and the girls."[FN13] (Dianne Dep. 107-08.) The Eimickes, the Pullins and Brooks Klimley were in attendance. (*Id.*)

> FN13. The Defendants argue that this testimony should not be considered because it is hearsay. However, it is not hearsay because Dianne Pullins did not identify who, if anyone, made a statement.

Dianne testified that, on social occasions, Brooks and Victor discussed the financial aspects of VWE and said what a great company it was. (Dianne Dep. 16-17.) Dianne also testified that, after Victor's death, Brooks told her and others not to worry that he would take care of the family's money and that he had it right under his thumb. (Dianne Dep. 108; David Dep. 82-83.)

Ed testified that, on one occasion, Brooks told him that VWE was "running fine." (Ed Dep. 41.) On other occasions, Brooks told Ed that VWE was a great business and highly profitable. (*Id.* 62.)On other occasions, Brooks launched into a dialogue about VWE's financials. (Ed Dep. 160-61, 170; Dianne Dep. 77; David Dep. 102-04 .) In addition to evidence recalled by Ed, Dianne and David, Brooks allegedly told Terence Cyran that VWE was a "pioneer" in the direct mail industry with "huge" margins and had been highly and consistently profitable for many years. (Verified Comp. of Terence Cyran ¶ 12.) Brooks also told Terence Cyran that the lack of financial disclosure regarding VWE should not be a concern given the long profitable history of the business. (*Id.* ¶ 21.)In addition, Brooks told Thomas Romo that VWE had been highly and consistently profitable for many years. (Verified Compl. of Thomas Romo ¶ 7.)

Laura also knew or should have known about the financial condition of VWE. There is evidence that she owned 50% of VWE, she was a Director of VWE, she was a Vice President of VWE and, for a

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

period of time, she worked at VWE on a daily basis. There is also evidence that, after Laura ceased working full-time, she continued to be involved in the operation of VWE.

***27** There is also evidence that both Brooks and Laura had financial motivation to make misrepresentations or fail to provide material information. Laura was half-owner of VWE and received a regular payment and other benefits from VWE. Both Brooks and Laura owned several of the Debenture Notes and benefitted from continuing to receive interest payments on the notes. (Plts.' Mem. In Opposition To Brooks Klimley Mot. for Summ. J. Exs. A, B.) Finally, as Laura's spouse, Brooks would indirectly benefit from the income and profits she received from VWE.

**D. Conclusion Regarding 10b-5 Claims**

The five-year statute of limitations bars Plaintiffs' 10b-5 claims for Debenture Notes purchased prior to January 26, 2000. However, action on the Debenture Notes purchased by the Plaintiffs on or after January 26, 2000, is not barred by the statute of limitations. This includes purchases made on December 12, 2000, October 1, 2001 and October 1, 2003.

With regard to the Debenture Notes purchased on or after January 26, 2000, the Plaintiffs have presented evidence the misrepresentations and/or omissions made by both Brooks and Laura are material and that Brooks and Laura owed them a duty to disclose the actual financial condition of VWE. The Plaintiffs have also presented evidence that both Brooks and Laura may have acted with a mental state embracing an intent to deceive, manipulate or defraud with regard to these misrepresentations and/or omissions and that Brooks and Laura had the financial incentive to do so. Therefore, there are genuine issues of material facts and Brooks and Laura are not entitled to judgment as a matter of law on Plaintiffs' Second Cause of Action for violation of Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5.

**VI. THIRD CAUSE OF ACTION: VIOLATION OF SECTION 15 OF THE SECURITIES ACT OF 1933**

In Plaintiffs' Third Cause of Action, they allege that Brooks and Laura were control persons of VWE and therefore secondarily liable for any misrepresentations made by Victor, Maxine or Alicia. The Defendants argue that neither Brooks nor Laura were control persons.

Section 15 applies to violations of Section 12 of the Securities Act of 1933.*Herm v. Stafford,* 663 F.3d 669, 679 (6th Cir.1981). In this case, Brooks and Laura Klimley have been granted summary judgment on the Section 12 claims brought directly against them. However, Brooks and Laura may be liable as control persons for the Section 12 claim that is not time-barred.

Courts analyze control-person-liability claims brought under Section 15 of the Securities Act of 1933 and control-person-liability claims brought under Section 20(a) of the Securities Exchange Act of 1934 using the same legal standards. *See Maker,* 144 F.3d at 1304-05; *In re Enron Corporation Securities, Derivative & "ERISA" Litigation,* Nos. MDL-1446 and Civ.A. H-01-3624, 2003 WL 230688 at * 12 (S.D.Tex. Jan.28, 2003)(the Fifth Circuit has held that Section 15 and Section 20(a) are analogous and should be interpreted in the same manner); *Picard,* 940 F.Supp. at 1133-34; *Maywalt,* 808 F.Supp. at 1053-54. Also, the Parties in this case have not argued otherwise. Therefore the law regarding Section 15 and Section 20(a) claims will be set forth and applied to both Plaintiffs' Section 15 and Section 20(a) claims.

**A. Relevant Law On Control Person Liability**

***28** Under Section 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934, a person who controls a party that commits a

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

violation of the securities laws may be held jointly and severally liable with the primary violator. *Maher,* 144 F.3d at 1304-05.[FN14] To state a prima facie case of control person liability, the plaintiff must establish (1) a primary violation of the securities laws and (2) "control" over the primary violator by the alleged controlling person. *Id.* (citing *First Interstate Bank v. Pring,* 969 F.2d 891, 897 (10th Cir.1992)); *see also PR Diamonds v. Chandler,* 364 F.3d 671, 696-97 (6th Cir.2004).

> FN14. Section 15 and Section 20(a) are remedial and thus construed liberally. *Maher,* 144 F.3d at 1305.

A plaintiff is not required to show that the defendant "acted or culpably participated in the primary violation." *Maher,* 144 F.3d at 1305. Only some indirect means of discipline or influence short of actual direction is required to hold a controlling person liable. *Id.* Further, status as a control person is normally a question of fact unless the allegations are unusually explicit and the court can determine that the plaintiff could not plead or prove sufficient facts to support control-person liability. *Sanders Confectionery Products v. Heller Financial, Inc.,* 973 F.2d 474, 485-86 (6th Cir.1992).

Having set forth the standard for control person liability, the analysis turns a determination of who is liable as a control person. "Control" has been defined by the Securities and Exchange Commission as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. *PR Diamonds,* 364 F.3d at 696-97 (citing 17 C.F.R. § 230.405). "Control," therefore, is the practical ability to direct the actions of the individuals who committed the primary violation. *In re National Century Financial Enterprises, Inc. Investment Litigation,* 504 F.Supp.2d 287, 30 (S.D.Ohio 2007)(citing *Stavrof,* 1997 WL 720475 at n. 5.)

The Sixth Circuit has not adopted a test for control-person liability but has applied the test set forth in *Metge v. Baehler,* 762 F.2d 621 (8th Cir.1987) because it was the least rigorous standard used at that time. *Sanders,* 973 F.3d at 486.*Metge* established a two-pronged test for control person liability. *Id.* The plaintiff must show that the defendant "actually participated in (i.e. exercised control over) the operations" in general and "that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated."*Id.* (quoting *Metge,* 762 F.2d at 631.)

"To establish the first prong of the test, the plaintiff must show that the defendant had some indirect means of discipline or influence, even if short of actual directions, over the corporation."[FN15] *Picard,* 940 F.Supp. at 1134 (citing *Myzel v. Fields,* 386 F.2d 718, 738 (8th Cir.1967), *cert. denied,* 390 U.S. 951, 88 S.Ct. 1043, 19 L.Ed.2d 1143 (1968)). In short, there must be some showing of actual participation or some influence before control may be imposed. *Id.*

> FN15. The Defendants cite *Herm v. Stafford,* 663 F.2d 669 (6th Cir.1981) for the proposition that allegations of an actual exercise of control are necessary to survive a motion for summary judgment. However, in *Herm,* the court granted a motion for summary judgment against a Section 20(a) claim because the plaintiff failed to present evidence of the defendant's "influence" or "actual participation in the corporation's operations."*Id.* at 684.

***29** The Plaintiffs cite *In re National Century,* 504 F.Supp.2d 287,[FN16] for the proposition that it is not necessary to show actual participation or the exercise of actual power to prove control person liability. However, this particular argument is not persuasive. The *National Century* court was identifying a pleading standard relative to a motion to dismiss. *Id.* at 303.The *National Century* court did, however, acknowledge that *Herm* required evidence of "influence or actual participation in the corporation's operation" in order to survive a motion for

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

summary judgment.*Id.* at n. 3.

> FN16. The Plaintiffs actually cite *In Re National Century Financial Enterprise, Inc.,* 2006 U.S. Dist. LEXIS 72154 (S.D.Ohio 2006) but this case says nothing about control person liability and it appears that Plaintiffs may have intended to cite *In re National Century Financial Enterprises, Inc.,* 504 F.Supp.2d 287 (S.D.Ohio 2007).

**B. Primary Violation**

The Plaintiffs have presented factual allegations that Victor, Maxine and Alicia violated Section 12(a)(2) of the Securities Act of 1933 by making material misstatements or omissions regarding the sale of the Debenture Notes. These allegations are not disputed by the Defendants. Therefore, for purposes of the Defendants' Motions for Summary Judgment, a primary violation of Section 12(a)(2) will be assumed to have occurred. The analysis next turns to whether Brooks and/or Laura had control over Victor, Maxine and Alicia Eimicke.

To survive a motion for summary judgment regarding control person liability, the Plaintiffs must present evidence that Brooks and/or Laura actually participated in or had some involvement in the operations of VWE in general and that Brooks and/or Laura possessed the power to control Victor, Maxine and Alicia's misstatements and/or omissions regarding sale of the Debenture Notes.

**C. Brooks as a Control Person**

Brooks argues that he did not act in any capacity for VWE, and that his only relationship to VWE was by being married to Laura. The Plaintiffs respond that Brooks was in charge of overseeing VWE's financial affairs and represented to the Plaintiffs and others that he was doing so.

First, there is evidence that Brooks was involved in the financial affairs of VWE. There is evidence that, in 1994 at a party at Maxine's home, the group present "toasted" to the "handing of the guard over to Brooks and the girls."(Dianne Dep. 107-08.) The Eimickes, the Pullins and Brooks Klimley were in attendance. (*Id.*) In addition, Dianne testifies that, on social occasions, Brooks and Victor discussed the financial aspects of VWE and said what a great company it was. (Dianne Dep. 16-17.) Dianne Pullins also testifies that, after Victor's death, Brooks told her and others not to worry that he would take care of the family's money and that he had it right under his thumb. (Dianne Dep. 108; David Dep. 82-83.)

Ed testifies that, on one occasion, Brooks told him that VWE was "running fine." (Ed Dep. 41.) On other occasions, Brooks told Ed that VWE was a great business and highly profitable. (*Id.* 62.)On other occasions, Brooks launched into a dialogue about VWE's financials. (Ed Dep. 160-61, 170; Dianne Dep. 77; David Dep. 102-04 .)

In addition to evidence recalled by Ed, Dianne and David, Brooks allegedly told Terence Cyran that VWE was a "pioneer" in the direct mail industry with "huge" margins and had been highly and consistently profitable for many years. (Verified Comp. of Terence Cyran ¶ 12.) Brooks also told Terence Cyran that the lack of financial disclosure regarding VWE should not be a concern given the long profitable history of the business. (*Id.* ¶ 21.)In addition, Brooks told Thomas Romo that VWE had been highly and consistently profitable for many years. (Verified Compl. of Thomas Romo ¶ 7.) Finally, Brooks has testified that, on at least one occasion, he, at Alicia's request, discussed VWE with a potential buyer of VWE's Debenture Notes. (Brooks Dec. Dep. 166-68.)

***30** In addition to the above deposition testimony, the Plaintiffs have identified evidence that Brooks was involved in the operation of VWE in the form of nineteen VWE quarterly interest checks written to various debenture holders that are allegedly signed by Brooks. (Affidavit of Barbara DeMuth

("DeMuth Aff.") Ex. 14 Oct. 11, 2007; Ed Aff.") ¶ 7.) Brooks' signature on the checks is identified by Ed. (Ed. Aff.¶ 7.) Barbara DeMuth also attests that she recognizes the signatures on the checks in Ex. 14 to her Affidavit as the signatures of Alicia Eimicke, John Palmero, Laura Klimley and that these checks were signed at a time when Brooks Klimley, "who likewise appears to have signed these checks," was in VWE's offices. (DeMuth Aff. ¶ 18.)

Brooks testified that he did not sign the checks attached to DeMuth's Affidavit and Laura affirms that she did. (Supplemental Affidavit of Brooks Klimley ("Brooks Supp. Aff.") ¶ 7 Nov. 13, 2007; Supplemental Affidavit of Laura Klimley ("Laura Supp. Aff.") ¶ 3 Nov. 13, 2007.) In addition to arguing that he did not sign the checks, Brooks argues to disregard Ed's Affidavit wherein he identifies Brooks' signature. This Affidavit should be disregarded according to Brooks, because it was untimely, it is not signed or notarized and because Ed Pullins did not establish the foundation necessary for him to conclude that the signature belonged to Brooks.

As to timeliness, signature and notarization, the first page of Ed's Affidavit was filed on October 22, 2007, along with Plaintiffs' responses to Defendants' Motions for Summary Judgment. (Doc. # 132.) A complete Affidavit was then filed on November 5, 2007, but included typed rather than original affiant and notary signatures. (Doc. # 139.) On November 21, 2007, a complete Affidavit was filed that was notarized and included an original signature. (Doc. # 155.) The manner in which Ed's Affidavit was filed is not necessarily acceptable to this Court. However, the Defendants are obviously aware of, and therefore, not prejudiced by the late filing of the complete Affidavit and the interests of justice demand that the Affidavit not be disregarded based upon the manner in which is was filed.

As to the foundation for Ed's Affidavit, a nonexpert may be permitted to state an opinion as to the authenticity of handwriting with which he or she is familiar provided that the familiarity is not acquired for the purpose of litigation. *United States v. Binzel,* 907 F.2d 746, 749 (7th Cir.1990). The extent of the witnesses' familiarity generally goes to the weight to be given to the testimony but there must be a minimal factual basis from which the familiarity might reasonably have been obtained. *Id.* Finally, the nonexpert witness must identify with particularity any documents that are relied upon to establish familiarity. *Hall v. United Insurance Company of America,* 367 F.3d 1255, 1261 (11th Cir.2004).

In his Affidavit, Ed affirms that Laura is his niece and Brooks her husband and that he is familiar with their signatures because he has received correspondence from both for many years prior to filing this lawsuit. This is enough foundation. Ed indicates that he is familiar with Brooks' and Laura's signatures and identifies the documents that he relied upon to establish the familiarity. Any further familiarity issues go to the weight to be given to Ed's testimony and are not properly determined at summary judgment.

***31** Brooks argues that former VWE employees who were actually present at VWE testified that they almost never saw Brooks at VWE and that they had no knowledge of Brooks having involvement in or responsibility for VWE. However, this, of course, is not conclusive proof that Brooks was not a control person, particularly when faced with evidence to the contrary.

The Plaintiffs have presented evidence that Brooks participated in or had some involvement in the operation of VWE in general and that Brooks had the power to control Victor, Maxine and Alicia's misstatements and/or omissions regarding sale of the Debenture Notes. There is evidence that "Brooks and the girls" were running VWE and that Brooks held himself out to others as knowledgeable about the financial status of VWE. Further, there is evidence that, on at least one occasion, Brooks discussed VWE with a potential buyer of VWE Debenture Notes. Finally, there is evidence that Brooks signed checks on VWE accounts issued to

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

holders of VWE Debenture Notes. Therefore, there are genuine issues of material facts and Brooks is not entitled to judgment as a matter of law on Plaintiffs' claim that he was a control person pursuant to Section 15.

**D. Laura as a Control Person**

Laura argues that she is not a control person of VWE because, at all relevant times, she did not participate in the management and operations of VWE. However, the Plaintiffs have presented evidence otherwise.

Laura owned half of VWE. She also was a Director of VWE until she resigned in a letter dated September 9, 2004 (Laura Dep. Ex. 1.) and a Vice President of VWE until she resigned in a letter date September 28, 2004 (*Id.*Ex. 2.).

Laura affirms that she worked full-time at VWE from 1985 until 1996 and worked part time thereafter until 1999. (Laura Aff. ¶ 7.) She recalls very little regarding her involvement in VWE after 1999. She admits that she was a Vice President of VWE but doesn't recall who appointed her, why she was appointed or what her duties were. (Laura Dep. 39.) She also admits that she was a director of VWE but she claims that she did not know what her duties were and had no idea how VWE's Directors were appointed. (*Id.* 78, 122.)Finally, she acknowledged that she was the owner of VWE common and preferred stock but does not know how she acquired the stock. (*Id* . 74-75.)

Documents submitted by the Plaintiffs describe more involvement in VWE by Laura after 1999 than she remembers. She allegedly received business correspondence at an office that she had at her home, she allegedly signed checks to Debenture Note holders, she allegedly participated in the sale of the Greeting Card Business and she allegedly received a weekly check from VWE after 1999.

In addition, Minutes of Annual Meetings of Stockholders for the years 2000, 2001, 2002 and 2003 indicate that Laura was present for each, that Laura was an officer and employee of VWE, that Laura was elected a director for the next year and that she reviewed and approved the Financial Report for the preceding fiscal year. (DeMuth Aff. Ex. 16.) Minutes of the Annual Meeting of Directors for the years 2000, 2001, 2002 and 2003 indicate that Laura was present, that she was elected as Vice President for the following year, that she reported on "list management and organizational structure/ personnel" and that she reviewed and approved VWE's Financial Statements for the previous fiscal year. (*Id.*) The Minutes of the Shareholder and Director annual meetings are signed by Alicia (Barbieri) Klimley and Maxine Klimley. (*Id.*) Included in the records submitted by the Plaintiffs are "Waiver of Notice" forms waiving notice of the 2000, 2001, 2002, and 2003 Stockholders and Directors annual meetings. (*Id.*) Each of the waivers is signed by Laura.[FN17] (*Id.;* see also Laura Supp. Aff. 6 Nov. 13, 2007.)

FN17. The signature on the waiver for the 43rd Annual Meeting of the Directors appears to be different from the signature on the other waivers.

***32** In addition to the documents regarding VWE annual shareholder and director meetings, the Plaintiffs have submitted VWE's Federal Income Tax Returns for the years 2002 and 2003. (Demuth Aff. Ex. 12, 13.) These tax returns are signed by Alicia Eimicke as President of VWE and report to the Government that Laura was an officer of VWE and devoted 100% of her time to the business.

**1. Objection To Barbara DeMuth's Affidavit**

The meeting minutes and waivers and the tax returns were submitted as attachments to Barbara DeMuth's Affidavit. The Defendants object to Barbara DeMuth's Affidavit arguing that it fails to establish her competency to attest to the elements of the business-records exception and because she does not affirm that the minutes were created by a person

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

with knowledge of the transaction or from information transmitted by a person with knowledge.

Records prepared in the course of regularly conducted business are particularly reliable because the person preparing the record has an incentive to be accurate. *United States v. Weinstock,* 153 F.3d 272, 276 (6th Cir.1998). Therefore, the Federal Rules of Evidence provide an exception to the inadmissibility of hearsay for business records.

The business record exception sets forth the following four requirements for admissibility of documents that are otherwise hearsay: (1) the document must have been made in the course of a regularly conducted business activity; (2) the document must have been kept in the regular course of that business; (3) the regular practice of that business must have been to have made the document; and (4) the document must have been made by a person with knowledge of the transaction or from information transmitted by a person with knowledge. *United States v. Jenkins,* 345 F.3d 928, 935 (6th Cir.2004)(citing Fed.R.Evid. 803(b)). Also, the document must be presented through "the testimony of the custodian or other qualified witness[.]"*Id.*(quoting Fed.R.Evid. 803(6)). The "other qualified witness," if applicable, is not required to have control of the record or personal knowledge of the preparation of the record but is required to be familiar with the record keeping procedures of the organization. *Id.* (citing *Dyno Construction Co. v. McWane, Inc.,* 198 F.3d 567, 575-76 (6th Cir.1999)); *Weinstock,* 153 F.3d at 276.

Business records meeting the criteria set forth in Fed.R.Evid. 803(6) are admissible "unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness."*Id.* (quoting Fed.R.Evid. 803(6)). The trial court is given "great latitude" on evidentiary rulings regarding trustworthiness and federal law favors the admission of evidence which has any probative value. *United States v. Hathaway,* 798 F.2d 902, 906 (6th Cir.1986).

**2. Analysis of the Admissibility of Barbara DeMuth's Affidavit**

A review of the Affidavit of Barbara DeMuth indicates a sufficient basis to qualify the meeting minutes, waivers and income tax returns as business records. Barbara DeMuth affirms that she was employed by VWE from 1979 until 2004 as the accounts receivable supervisor and that she worked with John Palmero and Alicia Eimicke on a daily basis. (DeMuth Aff. ¶ 2.) She affirms that she became "intimately" familiar and has extensive knowledge of the creation and maintenance of VWE's banking records, accounts receivable records, records in connection with VWE's sale of unregistered debentures, sales reports and other like general business records. (*Id.* ¶ 3.) She affirms that she viewed numerous documents hand-written and/or signed by John Palmero, Maxine Eimicke, Alicia Eimicke and Laura Klimley and "is very familiar with and recognizes on sight, their handwriting and signature."*Id.* ¶ 4. She then identifies the 2003 and 2004 VWE tax returns as documents prepared by John Palmero in the regular performance of his job duties. (*Id.* ¶¶ 16, 17.)She also identifies the signatures on the 2000, 2001, 2002 and 2003 Shareholders and Directors Meeting Minutes and waivers as those of John Palmero, Maxine Eimicke, Alicia Eimicke and Laura Klimley. (*Id.* ¶ 20.)She further affirms that these records were prepared by Loretta Buscarino, VWE's secretary, in the regular performance of her job duties at or near the dates set forth and were kept in the course of the regularly conducted activity of VWE.(*Id.*) Loretta Buscarino confirms that, although she did not attend the meetings, she typed the minutes based upon notes given to her by those who did attend. (Buscarino Dep. 33-39, 74-75.)

***33** As an "other qualified witness," Barbara DeMuth presents evidence that she is familiar with the record keeping procedures of VWE. Further, she affirms that the documents in question were made in the course of a regularly conducted business activity and were kept in the regular course of that busi-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

ness. Further, Barbara DeMuth's recognition of the signatures on the documents is but one indication that the regular practice of VWE must have been to have made the documents. The signatures on the documents and the affirmation that VWE's secretary prepared the documents indicate that the documents were made by a person with knowledge of the transaction or from information transmitted by a person with knowledge.

The Defendants attempt to discredit DeMuth's Affidavit by identifying testimony that she gave at an examination conducted by the Official Committee of Unsecured Creditors in *In re VWE Group, Inc.,* (DeMuth Dep. Ex. C 37.) In response to the question, “Do you know if the company kept corporate books and minutes,” DeMuth responded, “I don't know.” She was then asked, “You don't know,” to which she responded, “Not that I know of.” (*Id.*) This general line of questions without any signed documents to view is far different from the specific documents that DeMuth identifies in her Affidavit and does not serve to discredit DeMuth's identification of the meeting minutes, waivers and tax returns.

The Defendants continue to attempt to discredit DeMuth's Affidavit by discussing what DeMuth actually did for VWE, who actually typed minutes, and DeMuth's alleged recantation of allegations that she had made in another affidavit. However, rather than going to the trustworthiness of the Affidavit in question, these arguments go to the weight to be given the evidence and can be made, if appropriate, in cross examination.

### 3. Analysis of Laura's Control Person Liability

Minutes of the Shareholders and Directors Meetings from 2000 to 2003, waivers for these meetings from 2000 to 2003, and the federal income tax returns for 2002 and 2003 will be considered. These documents along with Laura's 50% ownership, Directorship, Vice-Presidency and participation in VWE's business affairs during this same time period are evidence that Laura participated in the operations of VWE and possessed the power to control what was said or unsaid with regard to sale of the Debenture Notes. There is, therefore, evidence that Laura is subject to control person liability.

In moving for summary judgment, the Defendants present evidence that Laura did not actively participate in the operation of VWE at times relevant to the actionable Section 12(a)(2) claims. Resolving this dispute of fact is for the trier of fact. Therefore, there are genuine issues of material fact and Laura is not entitled to judgment as a matter of law on Plaintiffs claim that she was a control person pursuant to Section 15.

### E. Conclusion On Section 15 Control Person Claim

***34** There are genuine issues of material fact as to whether Brooks and/or Laura were control persons pursuant to Section 15. Therefore, Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Third Cause of Action for violation of Section 15 of the Securities Act of 1933 is OVERRULED.

## VII. FOURTH CAUSE OF ACTION: VIOLATION OF SECTION 20(a) OF THE SECURITIES EXCHANGE ACT OF 1934

In Plaintiffs' Fourth Cause of Action, they allege that Brooks and Laura were control persons of VWE and therefore secondarily liable for any misrepresentations made by Victor, Maxine or Alicia with regard to their 10b-5 Claims. The Defendants argue that neither Brooks nor Laura were control persons and the Plaintiffs respond that they were.

Section 20(a) applies to claims brought under the Securities Exchange Act of 1934 such as Plaintiffs 10b-5 claims. *Herm,* 663 F.2d at 679. Plaintiffs' 10b-5 claims against both Brooks and Laura have survived summary judgment and the Sixth Circuit has observed without deciding that there is some

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

authority that a plaintiff may not be able to simultaneously assert both 10b-5 claims and Section 20(a) claims. *PR Diamonds,* 364 F.3d at n. 4. However, since this is a summary judgment proceeding and not a trial, whether Brooks and Laura are liable, if at all, directly under Section 10b-5 or as control persons under Section 20(a) will be left for a jury to decide.

As set forth above, courts analyze control-person-liability claims brought under Section 15 of the Securities Act of 1933 and control-person-liability claims brought under Section 20(a) of the Securities Exchange Act of 1934 using the same legal standards and the Parties in this case have not argued otherwise. Therefore, the law and conclusions set forth above with regard to Plaintiffs' Section 15 claims apply to Plaintiffs' Section 20(a) claims.

There are genuine issues of material fact as to whether Brooks and/or Laura were control persons under Section 20(a) of the Securities Exchange Act of 1934. Therefore, Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Fourth Cause of Action for violation of Section 20(a) of the Securities Exchange Act of 1934 is OVERRULED.

## VIII. FIFTH CAUSE OF ACTION: FRAUD

In Plaintiffs' Fifth Cause of Action, they allege that Brooks and Laura made material misrepresentations and/or omissions in an attempt to induce them to invest in VWE in violation of common law. The Defendants argue that neither Brooks nor Laura had a duty to disclose, that the statements attributed to Brooks and Laura were not material and that there is no evidence that either Brooks or Laura acted with the required scienter. The Plaintiffs respond that both Brooks and Laura had a duty to disclose, that the statements by both Brooks and Laura were material and that they both acted with the required scienter.

The elements of a common law fraud claim are:

(1) a representation or, where there is a duty to disclose, concealment of a fact,

***35** (2) which is material to the transaction at hand,

(3) made falsely, with knowledge of its falsity, or with such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred,

(4) with the intent of misleading another into relying upon it,

(5) justifiable reliance upon the representation or concealment, and

(6) a resulting injury proximately caused by the reliance.

*Glassner,* 223 F.3d at 352; *Russ v. TRW, Inc.,* 59 Ohio St.3d 42, 570 N.E.2d 1076, 1083 (Ohio 1991). Further, a representation which may serve as a basis for common-law fraud includes spoken or written words and conduct that amounts to an assertion not in accordance with the truth. *Russ,* 570 N.E.2d at 1084.

As determined above, there are questions of fact regarding whether the oral statements and omissions attributed to Brooks and Laura were material. Also, as determined above, there are questions of fact as to whether Brooks and Laura had a duty to disclose VWE's true financial condition to the Plaintiffs. Also, as determined above, there are questions of fact as to whether Brooks and Laura acted with the requisite scienter. Finally, Brooks and Laura do not dispute, for purposes of their Motions for Summary Judgment, that the remaining elements of a common law fraud claim are satisfied. Therefore, there are genuine issues of material fact and Brooks and Laura are not entitled to judgment as a matter of law on Plaintiffs' common law fraud claim.

## IX. SIXTH CAUSE OF ACTION: CIVIL CONSPIRACY

In Plaintiffs' Sixth Cause of Action, they allege that

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Brooks and Laura engaged in a conspiracy to illegally deprive them of their property through a pattern of fraud and corrupt activity. Brooks and Laura argue that the Plaintiffs cannot establish their conspiracy claims.

**A. Relevant Law Regarding Civil Conspiracy**

A civil conspiracy claim serves to enlarge the pool of potential defendants from whom a plaintiff may recover. *Gosden v. Louis,* 116 Ohio App.3d 195, 687 N.E.2d 481, 497-98 (Ohio Ct.App.1996). Also, a civil conspiracy claim may constitute an aggravation which may tend to increase the amount of damages available to the plaintiff. *Id.*

A civil conspiracy is "a malicious combination of two or more persons to injure another in person or property, in a way not competent for one alone, resulting in actual damages." *Aetna Casualty and Surety Company v. Leahey Construction Company, Inc.,* 219 F.3d 519, 534 (6th Cir.2000)(quoting *Kenty v. Transamerica Premium Insurance Company,* 72 Ohio St.3d 415, 650 N.E.2d 863, 866 (Ohio 1995)). Thus, the elements of a civil conspiracy claim are: (1) a malicious combination; (2) two or more persons; (3) injury to person or property; and (4) existence of an unlawful act independent from the actual conspiracy." *Id.* (quoting *Universal Coach, Inc. v. New York City Transit Authority, Inc.,* 90 Ohio App.3d 284, 629 N.E.2d 28, 33 (Ohio Ct.App.1993)). Finally, knowledge of a wrongful purpose is a crucial element in conspiracy cases. *Id.*

***36** To satisfy the "malicious combination" element, actual knowledge must be shown and may be shown by circumstantial evidence. *Aetna,* 219 F.3d at 536. As a result, evidence showing that a defendant should have known is not enough. *Id.* However, only a common understanding or design or shared conspiratorial objective need be shown. *Aetna,* 219 F.3d at 538. Finally, the malice may be imputed to a common design by two or more persons to harm another and need not be proved separately. *Gosden,* 687 N.E.2d at 496.

The fourth element, "[i]n a way not competent for one alone" means that, if one person could lawfully commit an act, then that act, if committed by two or more persons cannot support a conspiracy claim. *Gosden,* 687 N.E.2d at 497. Said another way, if the claim regarding the underlying unlawful act fails, the conspiracy claim must also fail. *Wolfer Enterprises, Inc. v. Overbrook Development Corp.,* 132 Ohio App.3d 353, 724 N.E.2d 1251, 1255 (Ohio App.Ct.1999).

**B. Analysis of Conspiracy Claim**

In this case, the Plaintiffs have presented evidence that satisfies the second, third and fourth elements of a conspiracy claim. Brooks and Laura do not argue otherwise regarding second and third elements for purposes of their Motions for Summary Judgment.

Brooks and Laura do, however, argue that the Plaintiffs have no evidence that Brooks and Laura participated in a "malicious combination" to defraud the Plaintiffs However, there is evidence to the contrary.

As determined above, there are questions of material fact as to whether Brooks and Laura are primarily liable for alleged securities fraud and there are questions of material fact as to whether Brooks and Laura are liable for the alleged securities fraud as control persons. Further, there is evidence that Brooks and Laura were spouses and that they both had financial interests in the success of VWE. From these alleged facts, a reasonable juror could conclude that Brooks and Laura had a common understanding or design or shared conspirational objective to defraud the Plaintiffs. Therefore, there are questions of fact as to whether the Plaintiffs can satisfy the "malicious combination" element of a civil conspiracy claim.

Brooks and Laura also argue that they are entitled to summary judgment on the civil conspiracy claim because they are entitled to summary judgment on

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

the underlying claims. Yet, as determined above, Brooks and Laura are not entitled to summary judgment on Plaintiffs' 10b-5 and fraud claims. Therefore, there are genuine issues of material fact and Brooks and Laura are not entitled to judgment as a matter of law on Plaintiffs' Sixth Cause of Action for civil conspiracy.

**X. SEVENTH CAUSE OF ACTION: VIOLATION OF OHIO SECURITIES ACT**

In Plaintiffs' Seventh Cause of Action, they alleged that Brooks and Laura violated the Ohio Securities Act, Ohio Rev.Code § 1707.44(B), (C)(1), (D), (F) and (G). Ohio securities laws are evidence of Ohio's interest in protecting its citizens by making certain requirements of investment arrangements before and when they are distributed in Ohio. *Bernie v. Waterfront Limited Dividend Housing Association,* 614 F.Supp. 651, 655 (S.D.Ohio 1985).

***37** The relevant portions of Ohio securities law prohibit making or causing to be made any false representation concerning a material and relevant fact in any oral statement for the purpose of selling any securities in Ohio. Ohio Rev.Code § 1707.44(B). This law also prohibits knowingly selling or causing to be sold any security which has not been registered and is not exempt from registration. Ohio Rev.Code § 1707.44(C)(1). In addition, Ohio securities law prohibits a person who is an officer, director or trustee of an issuer and who knows the issuer to be insolvent from selling any of the issuer's securities without disclosing the fact that the issuer is insolvent. Ohio Rev.Code § 1707.44(D). Finally, this law prohibits a person from selling the securities of an insolvent issuer with knowledge that the issuer is insolvent and with intent to deceive. Ohio Rev.Code § 1707.44(F).

Brooks and Laura argue that Plaintiffs' Ohio securities claims cannot be applied to them and, in the alternative, that these claims are time-barred. The Plaintiffs respond that this Court has personal jurisdiction over both Brooks and Laura and that Plaintiffs' Ohio securities claims are not time-barred. The existence of personal jurisdiction must first be determined.

**A. Relevant Law On Personal Jurisdiction**

Federal courts apply the law of the forum state when determining whether personal jurisdiction exists. *Burnshire Development, LLC v. Cliffs Reduced Iron Corp.,* 198 F. App'x 425, 429 (6th Cir.2006). The federal court must first determine if the law of the forum state, Ohio in this case, provides personal jurisdiction. *Id.* If so, the federal court must then determine if exercising personal jurisdiction comports with the Due Process Clause of the U.S. Constitution. *Id.*

When there is no evidentiary hearing, as is the case here, the plaintiff must make only a prima facie showing. *Id.* The evidence, when in conflict, is viewed in a light most favorable to the plaintiff. *Id.*

Brooks and Laura do not dispute whether Ohio law provides for personal jurisdiction over them. The analysis, therefore, becomes whether personal jurisdiction over Brooks and Laura on Ohio securities claims comports with the Due Process Clause.

For purposes of the Due Process analysis, there is a distinction between general and specific jurisdiction. *Youn v. Track, Inc.,* 324 F.3d 409, 417 (6th Cir.2003). However, either one is an adequate basis for personal jurisdiction. *Id.*

General jurisdiction exists where the defendant's contacts with the forum state are “substantial” and “continuous and systematic” so that the state may exercise personal jurisdiction even if the action does not relate to the defendant's contacts with the state. *Id.* at 418.Specific jurisdiction exists when the contacts giving rise to the jurisdiction relate to the claim that is before the court. *Id.*

The constitutional touchstone for specific jurisdiction is whether the non resident defendant purposefully established minimum contacts in the forum

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

state such that he or she should reasonably anticipate being haled into court there. *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 474, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985). Jurisdiction comports with the Due Process Clause where the contacts proximately result from actions by the defendant himself or herself that create a substantial connection with the forum. *Id.* Jurisdiction does not comport with the Due Process Clause when the contacts are random, fortuitous or attenuated or where they result from the unilateral activity of a third party. *Id.*

***38** The Sixth Circuit has established a three part test for determining whether specific personal jurisdiction exists. *Id.* For specific personal jurisdiction to exist: (1) a defendant must purposefully avail itself of the privilege of acting in the forum state; (2) the cause of action must arise from the defendant's activities in the forum state; and (3) the acts of the defendant or consequences caused by the defendant must have a substantial enough connection with the forum state to make the exercise of personal jurisdiction over the defendant reasonable. *Morel Acoustics, LTD. v. Morel Acoustics USA, Inc.,* No. 3:04-CV-348, 2005 WL 2211306 at *5 (S.D.Ohio Sept.7, 2005)(citing *Southern Machine Co. v. Mohasco Industries, Inc.,* 401 F.2d 374, 381 (6th Cir.1968)).

The first prong of the *Southern Machine* test, termed the "purposeful availment requirement," ensures that a defendant will not be haled into a jurisdiction solely as a result of "random," "fortuitous" or "attenuated" contacts. *Burger King,* 471 U.S. at 475. However, physical contacts are not necessary so long as a commercial actor's efforts are "purposely directed" toward a resident of the forum state. *Ricker v. Fraza/Forklifts of Detroit,* 160 Ohio App.3d 634, 828 N.E.2d 205, 211 (Ohio Ct.App.2005). For example, the soliciting of insurance by mail, the transmission of radio broadcasts into the forum state and the sending of magazines and newspapers into the forum state to be sold there have all been considered to be an availment of the privilege to do business in the forum state. *Southern Machine,* 401 F.2d at 382. Yet, the existence of a contract, such as a debenture note, is not purposeful availment. *Healthcare Capital, LLC v. Healthmed, Inc.,* 213 F.Supp.2d 850, 860 (S.D.Ohio 2002.)Prior negotiations and contemplated future consequences along with the terms of the contract and the parties' actual course of dealing must be evaluated. *Healthcare Capital,* 213 F.Supp.2d at 860 (citing *Nationwide Mutual Insurance Co. v. Tryg International Insurance Co., Ltd.,* 91 F.3d 790, 795 (6th Cir.1996)).

The second prong of the *Southern Machine* test is satisfied when the defendant's contacts are related to the operative facts of the case. *Bird v. Parsons,* 289 F.3d 865, 875 (6th Cir.2002). Further, contacts include only those activities purposefully sought or initiated by the defendant. *World-Wide Volkswagen Corp. v. Woodson,* 444 U.S. 286, 297-98, 100 S.Ct. 559, 62 L.Ed.2d 490 (1980).

The third prong of the *Southern Machine* test is satisfied when the defendants have sufficient contacts with the forum state and the wrongs of which the plaintiff complains arise out of those contacts. *See Cole v. Mileti,* 133 F.3d 433, 436 (6th Cir.1998), *cert. denied,* 525 U.S. 810, 119 S.Ct. 42, 142 L.Ed.2d 32 (1998); *CompuServe, Inc. v. Patterson,* 89 F.3d 1257, 1268 (6th Cir.1996). In other words, a court may infer that the third prong of the *Southern Machine* test has been satisfied and the exercise of personal jurisdiction over the defendant is reasonable if the first two prongs are satisfied. *Id.*

***39** The Parties here cite several cases in support of their arguments. In one example, Due Process was not offended when jurisdiction was found to exist over a non resident defendant who was conducting a mail order business in the forum state and had issued insurance to a resident of the forum state. *Travelers Health Association v. Commonwealth of Virginia,* 339 U.S. 643, 649, 70 S.Ct. 927, 94 L.Ed. 1154 (1950). In another example, Due Process was not offended when jurisdiction was found to exist over claims brought by non resident plaintiffs pursuant to Ohio security laws against a non resident

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

securities underwriting firm that sold securities of an Ohio company and had visited the Ohio company several times in the process. *Corporate Partners, L.P. v. National Westminster Bank PLC,* 126 Ohio App.3d 516, 710 N.E.2d 1144, 1150 (Ohio Ct.App.1998). In another example, Due Process was not offended when jurisdiction was found to exist in a securities case over a non resident defendant who had contacted the Ohio plaintiff several times by phone and mail. *Bernie,* 614 F.Supp. at 654-55.[FN18] In yet another example, subjecting a non resident seller of securities to Ohio securities law did not offend Due Process where the only contacts with Ohio were the mailing of two letters and a subscription agreement to an Ohio resident. *Martin v. Steubner,* 485 F.Supp. 88, 100 (S.D.Ohio 1979), *aff'd* 652 F.2d 652 (6th Cir.1981), *cert. denied,* 454 U.S. 1148, 102 S.Ct. 1013, 71 L.Ed.2d 302 (1982). However, Due Process was offended and jurisdiction not permitted over a non resident bank whose only contact with Ohio was the mailing of loan documentation to an Ohio resident. *First National Bank of Mt. Prospect v. Shenk,* Nos. 91 C 5736 and 91 C 5753, 1993 U.S. Dist. LEXIS 1172 at *13 (N.D.Ill. Feb. 2, 1993). While these cases are instructive, none are on point and the course of dealing and contemplated future consequences in this case must be analyzed.

> FN18. The *Bernie* court based its decision upon how the securities were marketed to an Ohio resident and on Ohio's interest in protecting its citizens with regard to the sale of securities in Ohio. *Bernie,* 614 F.Supp. at 654-55.

**B. Analysis of Personal Jurisdiction**

In this case, Brooks and Laura argue that they did not have contacts with Ohio and did not purposefully avail themselves of the benefits of Ohio and are, therefore, not subject to Ohio securities laws. The Plaintiffs respond that Brooks and Laura knew that Ohio residents were solicited to buy the debenture notes and that they both actively assisted VWE in selling the debenture notes to residents of Ohio.

As for general jurisdiction, the Plaintiffs identify various social visits to Ohio made by Brooks and Laura. However, social visits do not rise to the level of business contacts necessary to invoke general jurisdiction.[FN19] The analysis, therefore, turns to specific personal jurisdiction.

> FN19. Ohio does not recognize general jurisdiction over non residents. *Signom v. Schenck Fuels, Inc.,* No. C-3-07-037, 2007 WL 1726492 at *3 (S.D.Ohio June 13, 2007).

In this case, the Plaintiffs are residents of Ohio and Brooks and Laura are residents of New York. Further, the Plaintiffs were contacted in Ohio at various times by Victor, Maxine and Alicia via telephone and written communications, and there is no evidence that either Brooks or Laura visited Ohio with regard to the sale of the Debenture Notes to the Plaintiffs. (Ed. Dep.19-20, 26, 56-57.)

***40** The contacts with Brooks and Laura identified by the Plaintiffs took place outside of Ohio. However, there are factual allegations that these contacts regarding the Debenture Notes were directed toward Plaintiffs and are part of alleged course of dealing involving Brooks, Laura and the Plaintiffs and the Debenture Notes.

Also, Brooks and Laura were aware that the Plaintiffs owned Debenture Notes and were residents of Ohio. They should have anticipated that making the alleged misrepresentations and/or omissions regarding the Debenture Notes might cause them to be haled into court in Ohio. The first prong of the *Southern Machine* test is satisfied.

The contacts with Brooks and Laura identified by the Plaintiffs are related to Plaintiffs' Ohio securities claim. While these contacts may have been initiated by the Plaintiffs, the responses allegedly given were not. Therefore, the second prong of the *Southern Machine* test is satisfied.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Plaintiffs have presented evidence that Brooks and Laura had sufficient contacts with Ohio and the wrongs of which the Plaintiffs complain arise out of those contacts. Further, Ohio has a significant interest in protecting its citizens by making certain requirements of investment arrangements before and when they are distributed in Ohio. Therefore, the third prong of the *Southern Machine* test has been satisfied and the exercise of personal jurisdiction over Brooks and Laura in this case is reasonable. Since Plaintiffs have made a prima facie showing regarding all three prongs of the *Southern Machine* test, the exercise of personal jurisdiction over Brooks and Laura on Plaintiffs' Ohio securities claims does not offend the Due Process Clause of the U.S. Constitution.

**C. Time Limitations Under Ohio Securities Law**

Brooks and Laura next argue that Plaintiffs' Ohio securities claims are time barred. The Plaintiffs respond that they are not.

Ohio securities laws provide that no action based upon or arising out of a sale may be brought more than two years after the plaintiff knew, or had reason to know, of the facts by reason of which the actions of the defendants were unlawful or more than five years from the date of such sale, whichever is the shorter period. Ohio Rev.Code § 1707.43. "The two-year provision is based on notice and is an actual statute of limitations while the five-year provision is a statute of repose. *Cain v. Mid-Ohio Securities, Inc.,* Nos. 06CA008933 and 06CA008932, 2007 WL 2080553 at *2 (Ohio Ct.App. July 23, 2007). Ohio courts have interpreted the phrase "whichever is the shorter period" to mean whichever period expires first. *Cain,* 2007 WL 2080553 at *3; *Goldberg v. Cohen,* No. 01 CA 49, 2002 WL 1371031 at *6 (Ohio Ct.App. June 13, 2002); *Kondrat v. Morris,* 118 Ohio App.3d 198, 692 N.E.2d 246, 250 (Ohio Ct.App.1997).

**1. Statute of Limitations**

The discovery of the facts constituting the alleged violations in this case was made on June 2, 2004 and the Complaint was filed on January 26, 2005. Therefore, the complaint was filed within two years after Plaintiffs knew, or had reason to know, of the facts by reason of which the actions of Brooks and Laura were allegedly unlawful. The two-year statute of limitations is satisfied for Plaintiffs' Ohio securities claims.

**2. Statute of Repose**

***41** The dates of the alleged sales in this case range from January 1, 1989, to October 1, 2003. The claim was filed on January 26, 2005. Therefore, any sales that occurred on or after January 26, 2000, are not subject to the statute of repose. This includes sales made on December 12, 2000, October 1, 2001 and October 1, 2003. The five-year statute of repose bars claims for sales made prior to January 26, 2000. This includes the sales made on January 1, 1989, September 22, 1992, November 12, 1998, and February 17, 1998.

**3. Statute of Limitations Conclusion**

None of Plaintiffs' Ohio securities claims against Brooks and Laura are barred by Ohio's two-year statute of limitations for bringing such claims. However, the claims regarding several of the sales of Debenture Notes are barred by Ohio's statute of repose for securities claims.

Sales of Debenture Notes that occurred on or after January 26, 2000, are not time-barred. These include sales made on December 12, 2000, October 1, 2001 and October 1, 2003. Having determined that some of Plaintiffs' Ohio securities claims are not time barred, the analysis turns to whether Plaintiffs have presented evidence that Brooks and/or Laura are liable under Ohio security laws.

**D. Liability Under Ohio Security Laws**

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

Brooks' and Laura's final argument regarding Plaintiffs' Ohio securities claims is that they were not "sellers" of the Debenture Notes and are, therefore, not liable. Ohio securities law makes directors of a corporation liable for violations of the corporation unless the director had just and reasonable grounds to believe that the alleged statements to be true or the omissions of facts to not be material. *In re National Century Financial Enterprises, Inc.,* 504 F.Supp.2d 287, (S.D.Ohio 2007)(citing Ohio Rev.Code § 1707.41(B)(1)). Further, Ohio securities law makes liable every person that has participated in or aided the seller in any way in making a sale. *Id.* (citing Ohio Rev.Code § 1707.43(A)). Liability extends to any person who participates or aids the sale of a security in any way, including "inducing the purchaser to invest." *Id.* (citing *Federated Management Co. v. Coopers & Lybrand,* 137 Ohio App.3d 366, 738 N.E.2d 842, 860 (Ohio Ct.App.2000)).

The arguments presented and discussed above regarding Brooks and/or Laura as sellers are based upon the Securities Act of 1933. However, the determination of who is a seller for purposes of Ohio securities law is different.

The Plaintiffs have presented evidence from which a reasonable juror could conclude that Brooks and Laura aided in the sale of the Debenture Notes, including inducing the Plaintiffs to continue to invest in the Debenture Notes. The Plaintiffs have presented evidence that Brooks and Laura aided the sale of the Debenture Notes by making the alleged misstatements and/or material omissions regarding the financial health of VWE which induced the Plaintiffs to continue to hold the Debenture Notes. In addition, Laura was a Director of VWE who allegedly knew that the statements and/or omissions were allegedly material and misleading.

**E. Conclusion Regarding Plaintiffs' Ohio Securities Law Claims**

***42** Applying Ohio securities laws to Brooks and Laura does not offend the Due Process Clause of the U.S. Constitution. Further, the Debenture Notes sold after January 26, 2000, including the Debenture Notes sold on December 12, 2000, October 1, 2001 and October 1, 2003, are not time barred by the statute of limitations or the statute of repose set forth in Ohio securities law. Finally, there are genuine issues of material fact as to whether Brooks and/or Laura were sellers under Ohio securities law. Therefore, Brooks and Laura are not entitled to summary judgment on Plaintiffs Seventh Cause of Action for violation of Ohio securities law.

**XI. PUNITIVE DAMAGES**

The relief prayed for in the TAC includes punitive damages. However, punitive damages are not available for the alleged violations of the Security Act of 1933 (Section 12(a)(1) and 12(a)(2) and Section 15 claims), the Security Exchange Act of 1934 (10b-5 and Section 20 claims) and Ohio securities law. *Burkhart v. Alison Realty Trust,* 363 F.Supp. 1286, 1290 (N.D.Ill.1973); *Byrley v. Nationwide Life Insurance Co.,* 94 Ohio App.3d 1, 640 N.E.2d 187, 200 (Ohio Ct.App.1994).

Punitive damages are, however, available for common law tort claims such as fraud and conspiracy. *Motorists Mutual Insurance Co. v. Said,* 63 Ohio St.3d 690, 590 N.E.2d 1228, 1234(Ohio 1992); *Preston v. Murty,* 32 Ohio St.3d 334, 512 N.E.2d 1174, 1175 (Ohio 1987). Plaintiffs' fraud and conspiracy claims have survived summary judgment so further consideration is necessary.

To establish a claim for punitive damages, the plaintiff must show, in addition to proving the elements of the tort itself, that the tort was aggravated by the existence of malice or ill will or must show that the wrongdoing is particularly gross or egregious. *Davis v. Sun Refining and Marketing Co.,* 109 Ohio App.3d 42, 671 N.E.2d 1049, 1060 (Ohio Ct.App.1996). The Ohio Supreme Court has defined actual malice as:

(1) that state of mind under which a person's conduct is characterized by hatred, ill will or a spirit of revenge, or (2) a conscious disregard for the rights and safety of other persons that has a great probability of causing substantial harm.

*Motorists Mutual,* 590 N.E.2d at 1234. To obtain punitive damages, the probability of harm occurring must be great and the possible harm must be substantial. *Id.*

The amount of punitive damages to be awarded, if any, rests largely within the determination of the trier of fact. *Zoppo v. Homestead Insurance Co.,* 71 Ohio St.3d 552, 644 N.E.2d 397, 401 (Ohio 1994); *Roar v. Rydell,* Nos. C-061090 and C-070032, 2007 WL 4463965 at *9 (Ohio Ct.App. Dec.21, 2007). The Ohio Supreme Court has also noted that "it is rarely possible to prove actual malice otherwise than by conduct and surrounding circumstances." *Villella v. Waikem Motors, Inc.,* 45 Ohio St.3d 36, 543 N.E.2d 464, 466-67 (Ohio 1989) (citing *Davis v. Tunison,* 168 Ohio St. 471, 155 N.E.2d 904, 907 (Ohio 1959), overruled on other grounds in *Moskovitz v. Mt. Sinai Medical Center,* 69 Ohio St.3d 638, 635 N.E.2d 331 (Ohio 1994))

***43** "[A]ctual malice may be inferred from conduct and surrounding circumstances which may be characterized as reckless, wanton, willful or gross." *Id.* at 467, 635 N.E.2d 331. Even if actual malice is not shown, actions that are particularly gross or egregious, such as intentionally made misrepresentations, may support an award of punitive damages. *Smith v. General Motors Corp.,* 168 Ohio App.3d 336, 859 N.E.2d 1035, 1042 (Ohio Ct.App.2006).

For example, an insured may maintain an action for punitive damages if the insured shows that the insurer's bad faith was accompanied by a dishonest purpose, actual intent to mislead or deceive the insured, or a calculated scheme to defeat the insured's action. *Motorists Mutual,* 590 N.E.2d at 1235. In another example, punitive damages may be awarded where evidence established that the non removal of potentially contaminated piping displayed a conscious disregard for the safety of others. *Davis,* 671 N.E.2d at 1060.

In this case, Brooks and Laura argue that there is no basis for a recovery of punitive damages. The Plaintiffs do not offer legal argument otherwise but do offer facts from which a juror could reasonably conclude that Brooks and/or Laura consciously disregarded Plaintiffs' rights to know the actual financial status of VWE and actually intended to mislead or deceive the Plaintiffs with regard to the actual financial status of VWE.

Plaintiffs are not entitled to punitive damages on their alleged violations of the Security Act of 1933 (Section 12(a)(1) and 12(a)(2) and Section 15 claims), the Security Exchange Act of 1934 (10b-5 and Section 20 claims) and Ohio securities law as a matter of law. However, the factual allegations set forth by the Plaintiffs combined with the axiom that it is generally for the finder of fact to determine the amount, if any, of a punitive damage award leads to the conclusion that there are genuine issues of material fact with regard to whether Plaintiffs are entitled to damages on their fraud and conspiracy claims.

**XII SUMMARY**

Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' First Claim for Relief for violation of Sections 12(a)(1) and 12(a)(2) of the Securities Act of 1933 is GRANTED. Plaintiffs' Section 12(a)(1) claims and all but one of Plaintiffs' Section 12(a)(2) claims are time barred. Also, there are no genuine issues of material fact and Plaintiffs have not shown that either Brooks or Laura were "sellers" in accordance with the law regarding Section 12(a)(1) and 12(a)(2) claims.

Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Second Claim for Relief for violation of Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 is GRANTED IN PART and OVERRULED IN PART. Sales made

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

before January 26, 2000, are timed barred and sales that occurred on or after January 26, 2000, are not. Further, there are genuine issues of material fact as to whether the statements made by Brooks and/or Laura are actionable and as to whether Brooks and/or Laura acted with the requisite scienter.

***44** Brooks' and Laura's Motions for Summary Judgment on Plaintiffs Third and Fourth Claims for Relief for violation of Section 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934 are OVERRULED. There are genuine issues of material facts as to whether Brooks and/or Laura were control persons under the applicable law.

Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Fifth Cause of Action for fraud are OVERRULED. There are genuine issues of material fact as to whether the oral statements and omissions attributed to Brooks and Laura were material, as to whether Brooks and/or Laura had a duty to disclose and as to whether Brooks and/or Laura acted with the requisite scienter.

Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Sixth Cause of Action for civil conspiracy are OVERRULED. There are genuine issues of material fact as to whether the Plaintiffs can satisfy the "malicious combination" element of a civil conspiracy claim and Brooks and Laura are not entitled to summary judgment on the remaining underlying claims.

Brooks' and Laura's Motions for Summary Judgment on Plaintiffs' Seventh Cause of Action for violation of Ohio securities laws is OVERRULED. Application of Ohio securities law to Brooks and Laura in this case is not offended by the Due Process Clause of the U.S. Constitution. Further, Debenture Notes sold after January 26, 2000, including those sold on December 12, 2000, October 1, 2001 and October 1, 2003, are not time barred. Finally, there are genuine issues of material fact as to whether Brooks and/or Laura were sellers under Ohio securities law.

Finally, Brooks' and Laura's Motion for Summary Judgment on Plaintiffs' prayer for punitive damages is GRANTED IN PART and OVERRULED IN PART. Plaintiffs are not entitled to punitive damages on their alleged violations of the Security Act of 1933 (Section 12(a)(1) and 12(a)(2) and Section 15 claims), the Security Exchange Act of 1934 (10b-5 and Section 20 claims) and Ohio securities law as a matter of law. However, there are genuine issues of material fact as to whether Plaintiffs are entitled to punitive damages on the remaining fraud and civil conspiracy claims.

Plaintiffs' 10b-5, control person liability and Ohio securities law claims on sales of Debenture Notes that occurred on or after January 26, 2000 remain to be adjudicated. Plaintiffs common law fraud and civil conspiracy claims also remain to be adjudicated.

Finally, Plaintiffs have moved for oral argument on Brooks' and Laura's Motions for Summary Judgment. (Doc. # 154.) However, the Court has been able to review the thousands of pages of argument and evidence submitted by the Parties and can fairly resolve the Motions based upon these submissions without oral argument. Therefore, Plaintiffs' Motion for Oral Argument is OVERRULED.

**DONE** and **ORDERED.**

S.D.Ohio,2008.
Pullins v. Klimley
Not Reported in F.Supp.2d, 2008 WL 85871 (S.D.Ohio), Fed. Sec. L. Rep. P 94,551

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-14

Only the Westlaw citation is currently available.
United States Court of Appeals, Seventh Circuit.
STARK TRADING and Shepherd Investments International Ltd., Plaintiffs-Appellants,
v.
FALCONBRIDGE LIMITED and Brascan Corporation, Defendants-Appellees.
**No. 08-1327.**

Argued Sept. 8, 2008.
Decided Jan. 5, 2009.

**Background:** Hedge fund investors filed action against corporations alleging securities fraud in violation of federal law. Parties consented to final disposition by magistrate judge. The United States District Court for the Eastern District of Wisconsin, Aaron E. Goodstein, United States Magistrate Judge, 2008 WL 153542, dismissed action. Funds appealed.

**Holdings:** The Court of Appeals, Posner, Circuit Judge, held that:
(1) investors, as minority shareholders, who were aware of alleged fraud as it was being perpetrated by controlling shareholder with regard to tender offer, did not rely on that fraud in their subsequent tender of shares, and
(2) investors had to allege that they sold their shares at loss, among other elements, in order to state claim that registration statement was false.

Affirmed.

West Headnotes

**[1] Securities Regulation 349B 60.48(1)**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(1) k. In General. Most Cited Cases
Sophisticated hedge fund investors, as minority shareholders, who were aware of alleged fraud as it was being perpetrated by controlling shareholder with regard to tender offer, did not rely on that fraud in their subsequent tender of shares, as required for federal securities fraud claim. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

**[2] Securities Regulation 349B 60.19**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.19 k. Particular Conduct. Most Cited Cases
Federal securities fraud does not include the oppression of minority shareholders. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

**[3] Securities Regulation 349B 60.22**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.22 k. Mergers, Reorganizations or Tender Offers. Most Cited Cases
Federal securities fraud does not include unsound or oppressive corporate reorganizations. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

**[4] Securities Regulation 349B 60.48(3)**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

349Bk60.48(3) k. Fraud on the Market. Most Cited Cases
If a fraud affects the price of a publicly traded security, investors will be affected even if they trade without knowledge of the misrepresentations that influenced the price at which they traded; they are "relying," albeit indirectly, on the misrepresentations. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

**[5] Securities Regulation 349B 60.48(1)**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(1) k. In General. Most Cited Cases
Under federal securities law, reliance does not refer to the investor's state of mind but to the effect produced by a material misstatement or omission; reliance is the confluence of materiality and causation. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

**[6] Securities Regulation 349B 25.25**

349B Securities Regulation
349BI Federal Regulation
349BI(B) Registration and Distribution
349BI(B)4 Registration Statements
349Bk25.25 k. Pleading. Most Cited Cases
Sophisticated hedge fund investors had to allege that they sold their shares at loss, among other elements, in order to state claim that registration statement was false. Securities Act of 1933, §§ 11(a, e), 15 U.S.C.A. §§ 77k(a, e).

**[7] Securities Regulation 349B 25.21(3)**

349B Securities Regulation
349BI Federal Regulation
349BI(B) Registration and Distribution
349BI(B)4 Registration Statements
349Bk25.17 False Statements or Omissions; Accuracy
349Bk25.21 Grounds of and Defenses to Liability
349Bk25.21(3) k. Materiality; Reliance. Most Cited Cases
A claim that a registration statement was false does not require proof of reliance. Securities Act of 1933, § 11(a), 15 U.S.C.A. § 77k(a).

**[8] Federal Civil Procedure 170A 1772**

170A Federal Civil Procedure
170AXI Dismissal
170AXI(B) Involuntary Dismissal
170AXI(B)3 Pleading, Defects In, in General
170Ak1772 k. Insufficiency in General. Most Cited Cases
A complaint in a complex case must, to avert dismissal for failure to state a claim upon which relief can be granted, include sufficient allegations to enable a judgment that the claim has enough possible merit to warrant the protracted litigation likely to ensue from denying a motion to dismiss. Fed.Rules Civ.Proc.Rule 12(b)(6), 28 U.S.C.A.

Christopher J. Barber (argued), Peter J. Meyer, Chicago, IL, for Plaintiffs-Appellants.
Gregory A. Markel (argued), Cadwalader, Wickersham & Taft, Joseph S. Allerhand (argued), Weil, Gotshal & Manges, New York, NY, Christopher J. Barber, Chicago, IL, William J. Mulligan, Davis & Kuelthau, Milwaukee, WI, for Defendants-Appellees.

Before POSNER, KANNE, and TINDER, Circuit Judges.

POSNER, Circuit Judge.
***1** The plaintiffs have appealed from the dismissal, for failure to state a claim, of their securities fraud suit. The suit is based primarily on the Securities and Exchange Commission's Rule 10b-5. The claims they make under other provisions of federal securities law-all but section 11 of the Securities Exchange Act, 15 U.S.C. § 77k, which we discuss at the end of this opinion-fall with the 10b-5 claim.

The parties have spent too much time in this court, as they did in the district court, arguing over whether the typically Brobdingnagian complaint (289 paragraphs sprawling over 85 pages) adequately alleges scienter, as required by 15 U.S.C. § 78u-4(b)(2). (The

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

suit is more than three years old, yet it has not progressed beyond the motion to dismiss stage.) A claim of fraud fails if there is no proof that the plaintiff relied to his detriment on the's misrepresentations or misleading omissions. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164, 180, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994); *Isquith v. Caremark Int'l, Inc.,* 136 F.3d 531, 534, 536 (7th Cir.1998).“[W]ithout reliance, fraud is harmless.” *Dexter Corp. v. Whittaker Corp.,* 926 F.2d 617, 619 (7th Cir.1991). So implausible is an inference of reliance from the complaint in this case when read in conjunction with documents of which the court can take judicial notice, *Deicher v. City of Evansville,* 545 F.3d 537, 541-42 (7th Cir.2008); *Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1278 (11th Cir.1999), that the dismissal of the 10b-5 claim must be affirmed without regard to scienter or the other issues that the parties have spent years jousting over.

The complaint tells the following story. Brascan Asset Management, Inc. (now called Brascan Corporation) owned 41 percent of the common stock of Noranda, Inc., which in turn owned 59 percent of Falconbridge, Inc., both being large Canadian mining companies. Brascan wanted to get out of Noranda. It was able to cause Noranda to offer Noranda's common stockholders, who of course included Brascan, preferred stock in exchange for their common stock. (That is called an issuer bid.) Noranda agreed to redeem the preferred stock for cash, at a price of $25 a share, which exceeded the current market value of the common stock. By redeeming, Brascan would be able to exchange its shares for cash and thus achieve its objective of getting out of Noranda. Why it didn't cause Noranda simply to offer $25 per share to all the common stockholders, thus cutting out the intermediate swap of common for preferred, is not explained, but probably was connected with the next and critical transaction, for which Noranda needed a lot of its common stock.

For on the same day that it announced the issuer bid (March 9, 2005), Noranda also announced that it would offer every minority shareholder in Falconbridge 1.77 shares of Noranda common stock for each share of Falconbridge common stock that the shareholder tendered. The offer was conditioned on being accepted by more than half the minority shareholders (the half being weighted of course by number of shares).

***2** The offer succeeded, and the two hedge funds that are the plaintiffs in this case were among the minority shareholders who tendered their stock by the expiration date, May 5. Three months later, Noranda and Falconbridge merged. The resulting firm was named Falconbridge Limited, and was eventually acquired by a Swiss mining company named Xstrata. But in October 2005, before that acquisition, another mining company, Inco, offered to buy Falconbridge Limited at a price substantially above the tender-offer price (1.77 shares of Noranda common stock for every share of Falconbridge common stock) that the plaintiffs had received for their Falconbridge stock.

The plaintiffs had begun buying that stock on March 17; they do not say when they stopped, except that it had to be before the May 5 deadline for tendering. They had bought into Falconbridge because they thought the company was worth more than its current capitalization by the stock market. At the same time that they had bought Falconbridge shares they had sold some Noranda stock short, apparently as a hedge. According to the complaint, Falconbridge was Noranda's major asset (how major, no one has bothered to tell us), so if its shares fell in value or even just failed to rise Noranda's share price would probably fall and the plaintiffs would obtain some profits from their short sales to offset the lack of profit from being long in Falconbridge. By the same token, if Falconbridge's stock rose in price Noranda's stock price probably would rise too and if it did the plaintiffs would lose money from their short sale. But they thought Falconbridge stock more likely to rise, and so invested much less in selling stock in Noranda short than in buying stock in Falconbridge.

Brascan states in its brief that the plaintiffs hoped to make money both from Falconbridge's stock price rising and Noranda's falling. That's a misunderstanding of hedging. The prices of the two companies were going to move in the same direction, but by going long in one and short in the other the plaintiffs were reducing the variance in the expected return on their investments. That is what hedging means. But this is an aside.

In a typical Rule 10b-5 case, the plaintiff buys stock at a price that he claims was inflated by misrepresen-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

tations by the corporation's management and sells his stock at a loss when the truth comes out and the price plummets. Our plaintiffs believed they were buying an undervalued stock, and events after their purchase, culminating in Xstrata's purchase of Falconbridge Limited (Falconbridge's successor) at a high price, proved them correct. They do argue that the issuer bid (the offer to swap preferred stock in Noranda for common stock) inflated the apparent value of Noranda stock, and therefore made the offer of Noranda stock for Falconbridge stock look generous. But they were not fooled. They knew that the tender offer undervalued Falconbridge-that Noranda was trying to buy out the minority shareholders (thus including the plaintiffs) cheap.

***3** They admit that before the period for tendering their Falconbridge shares to Noranda expired, they "became aware of some of the inaccuracies in the offering documents"-and that is an understatement. On April 29, a week before the deadline in the tender offer, they wrote a letter to the Ontario Securities Commission that alleges, and in considerable detail (the letter, including enclosures, runs to 21 pages, much of it in fine print), most of the facts that their complaint charges as fraud, such as: (1) concealing a conflict of interest of the investment bank that had provided a valuation of Falconbridge for the tender offer, and of the special committee of Falconbridge that had advised Falconbridge's minority shareholders to accept the offer on the basis of the investment bank's valuation, and (2) overstating Noranda's value, thus enabling Noranda to pay for Falconbridge in a thoroughly debased currency (Noranda's overvalued stock), which further reduced the real price at which Noranda was able to buy out Falconbridge's minority shareholders.

The plaintiffs must have been gratified to learn, from their perceiving the "inaccuracies" in the tender-offer registration statement, that they had been right that Falconbridge was undervalued; their letter to the securities commission was calculated to force Noranda to sweeten its offer (though that never happened). But they say in paragraph 205 of the complaint, which is the heart of their case, that they were afraid that the tender offer would succeed and that unless they tendered their shares they would be squeezed out and Canadian law, which governs the squeezing out of minority shareholders in a Canadian corporation, would not protect them, as U.S. law does, from a predatory majority shareholder.

The mystery deepens. Since the tender offer would have failed by its own terms had not a majority of the minority shareholders tendered, why didn't the plaintiffs try to dissuade the other minority shareholders from tendering? Why didn't they mail them copies of the letter to the securities commission or publicize the letter in the financial press? The minority shareholders owned in the aggregate some 78 million shares, 5.5 million of which were owned by the plaintiffs. Noranda needed to obtain at least 39 million shares for the tender offer to succeed. If the plaintiffs refused to tender, Noranda would have to obtain 54 percent of the shares held by the remaining minority shareholders, and it might fail to do so in the face of a vigorous campaign of public opposition to the offer, mounted by the plaintiffs.

[1][2][3] Whatever the plaintiffs were thinking-the complaint says virtually nothing about their strategy-we cannot find any basis for inferring that they relied on the defendants' bad mouthing of Falconbridge. They knew better. They knew Falconbridge was worth a lot-that's why they invested. They thought the tender offer price was too low and that Noranda had resorted to fraud to make it succeed. They had known they were buying into a company that had a majority shareholder, that it was a Canadian company, and therefore that a minority shareholder would not have the same legal protections (such as appraisal rights) that minority shareholders in U.S. corporations have. They also had to know that since they thought Falconbridge undervalued, so would Noranda, which would therefore try to buy out the minority shareholders before the market revalued Falconbridge upward. That would not be a nice way to treat minority shareholders but "securities fraud does not include the oppression of minority shareholders.... No more does securities fraud include unsound or oppressive corporate reorganizations." *Isquith v. Caremark Int'l, Inc., supra,* 136 F.3d at 535; see *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 473-77, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). And a week before the deadline for tendering their shares, the plaintiffs revealed in their letter to the securities commission the evidence that Brascan and Noranda were trying to pull a fast one on the minority shareholders.

***4** But though the plaintiffs didn't rely on Noranda's undervaluation of Falconbridge, maybe other minor-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

ity shareholders did and foolishly tendered, as a result of which the tender offer succeeded and the plaintiffs were left in the vulnerable position of minority shareholders (where of course they had been from the start). But believing that Falconbridge was undervalued and that the value estimates publicly disseminated by Noranda were inaccurate, why, to repeat, didn't the plaintiffs communicate their belief directly or indirectly to the Wall Street analysts? Such information spreads fast and would have given the other minority shareholders pause.

This assumes that the plaintiffs knew something about the tender offer that other investors did not know. That is unlikely, since the plaintiffs were not insiders. Almost certainly there was no deception but just a difference of opinion in the investor community about the significance of the widely known circumstances of the tender offer. And if there *was* deception and the other minority shareholders were too dumb to perceive it even after being warned, why didn't the plaintiffs sue to enjoin the tender offer?

[4][5] If contrary to the common sense of the situation other minority shareholders were fooled even though the plaintiffs were not, this might seem to allow the plaintiffs recourse to the doctrine of fraud on the market. *Basic Inc. v. Levinson,* 485 U.S. 224, 243-47, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). If a fraud affects the price of a publicly traded security, investors will be affected even if they trade without knowledge of the misrepresentations that influenced the price at which they traded. They are "relying," albeit indirectly, on the misrepresentations. " '[R]eliance' is a synthetic term. It refers not to the investor's state of mind but to the effect produced by a material misstatement or omission. Reliance is the confluence of materiality and causation. The fraud on the market doctrine is the best example; a material misstatement affects the security's price, which injures investors who did not know of the misstatement." *Eckstein v. Balcor Film Investors,* 58 F.3d 1162, 1170 (7th Cir.1995); see *Isquith v. Caremark Int'l, Inc., supra,* 136 F.3d at 536; cf. *Plaine v. McCabe,* 797 F.2d 713, 717 (9th Cir.1986).

So suppose some of the minority shareholders were induced by Noranda's misrepresentations to tender their shares, and others, though unaware of any representations, tendered their shares as well. They too would be victims of deception, because had the market known the truth the tender offer would have failed. Cf. *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970). But no one who saw through the fraud would be able to sue for fraud, for he could not have relied directly or indirectly. And that was the plaintiffs' position. Sophisticated investors, they must have considered the combination of the tender-offer price and a later suit (this suit) against the defendants a better deal than holding on to their shares and by doing so, and disseminating their doubts, trying to defeat the tender offer. That is not a strategy that the courts should reward in the name of rectifying securities fraud.

***5** So even if the other minority shareholders were blind sheep and the law impotent to prevent a dishonest tender offer, the plaintiffs would not have a claim under Rule 10b-5, or any other securities law requiring proof of reliance, because they were never deceived. At worst they were minority shareholders victimized by a heartless majority shareholder (remember that Noranda owned 59 percent of the common stock of Falconbridge), and as we noted earlier the federal law of securities fraud does not provide a remedy for oppression of minority shareholders. The lack of merit of the 10b-5 claim would be obvious had the plaintiffs refused the tender offer and later been squeezed out, as in the *Santa Fe Industries* case; but there is no pertinent difference between the two types of case.

[6][7] This leaves for consideration the plaintiffs' claim under section 11 of the Securities Exchange Act, which does not require proof of reliance. Section 11 provides that "in case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person [with an immaterial exception] acquiring such security" may sue. 15 U.S.C. § 77k(a). But the plaintiff in such a suit may recover (so far as pertains to this case) only "such damages as shall represent the difference between the amount paid for the security ... 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."§ 77k(e).

The plaintiffs gave up each of their Falconbridge shares for 1.77 Noranda shares. On May 5, 2005, the

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

date the tender offer expired, Falconbridge stock was trading at $39.59 (Canadian), so that was the price that the plaintiffs paid for the Noranda shares that they received in exchange. On November 7, 2005, the date on which they filed their lawsuit, a share in Falconbridge Limited (the new Falconbridge, after its merger with Noranda) was trading at C $34.43, so that the 1.77 Noranda shares that the plaintiffs had received in exchange for each share of Falconbridge were now worth C$60.94, which exceeded by C$21.35 what they had paid for the shares when they accepted the tender offer. The plaintiffs coyly suggest that maybe they sold their shares, or some of them, before they sued, and sustained a loss. But this is nowhere suggested in the complaint, or in the brief that the plaintiffs filed in the district court after the defendants pointed out that the plaintiffs had failed to allege that they had sold any of their shares at a loss. It would not make sense for them to have sold their shares at a loss, since they were convinced that Falconbridge was undervalued.

[8] The complaint's silence is deafening. Even notice pleading requires pleading the elements of a tort, and one element of the section 11 tort is sale at a loss. Moreover, the complaint in a complex case must, to avert dismissal for failure to state a claim, include sufficient allegations to enable a judgment that the claim has enough possible merit to warrant the protracted litigation likely to ensue from denying a motion to dismiss. *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007); *Limestone Development Corp. v. Village of Lemont,* 520 F.3d 797, 802-03 (7th Cir.2008). This suit was dismissed by the district court in January 2008, more than two years after it had been filed. Just imagine how long it would have taken to dispose of the case by summary judgment after the usual pretrial discovery in a big commercial case. Defendants are not to be subjected to the costs of pretrial discovery in a case in which those costs, and the costs of the other pretrial maneuvering common in a big case, are likely to be great, unless the complaint makes some sense. If after 85 pages of huffing and puffing in the complaint, and another 83 pages of appellate briefs, sophisticated investors cannot make their case seem plausible, the litigation must end then and there.

***6** AFFIRMED.

C.A.7 (Wis.),2009.

Stark Trading v. Falconbridge Ltd.
--- F.3d ----, 2009 WL 18140 (C.A.7 (Wis.)), Fed. Sec. L. Rep. P 95,028

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

# TAB B-15

Westlaw.

United States District Court, N.D. Illinois, Eastern Division.
In **re**: **SYSTEM SOFTWARE** ASSOCIATES, INC. Securities Litigation This Document Relates to All Actions.
**No. 97 C 177.**

March 8, 2000.

MEMORANDUM OPINION AND ORDER

PALLMEYER, District J.

***1** Plaintiffs bring this action against Defendants System Software Associates, Inc. ("SSA") and certain of its officers, Roger E. Covey ("Covey"), Terence H. Osborne ("Osborne"), Terry E. Notari ("Notari"), Joseph Skadra ("Skadra"), and Larry J. Ford ("Ford") for alleged violations of Sections 10(b) and 20(a) of the Securities Exchange Act, 15 U.S.C. § 78j(b), 78t. Plaintiffs seek to represent a class of purchasers of SSA common stock from August 22, 1994 through and including January 7, 1997 (the "Class Period"). Defendants now move to dismiss on grounds that an earlier state court class action settlement precludes Plaintiffs' cause of action. In the alternative, Defendants argue that the complaint fails to meet the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b)(1), (2). For the reasons set forth below, Defendant's motion to dismiss is denied in part and granted in part, and the parties are directed to brief the class certification issues.

FACTUAL BACKGROUND

A. The Allegations

In their Second Consolidated Amended Class Action Complaint (hereinafter "Complaint"), Plaintiffs make the following factual assertions. Defendant SSA markets and develops business application software. (Compl.¶ 18.) As class representatives, the named Plaintiffs each individually purchased SSA common stock between April 19, 1995 and January 7, 1997.[FN1] (*Id.* ¶¶ 7-17.)They allege that SSA's stock price was artificially inflated during the Class Period because Defendants improperly recognized revenue from at least three contracts: (1) a 1994 contract to provide software to Owens-Illinois, Inc. (hereinafter "O-I"); (2) a 1995 contract to provide software to Hewlett-Packard; and (3) a 1995 contract to provide software to Glaxo-Wellcome. (*Id.* ¶ 2.) Defendants do not dispute that they recognized almost the entire price of these contracts, representing millions of dollars, in SSA's balance sheets despite the fact that the contracts provided for payment in installments and included contingencies based on SSA's ability to develop compatible software. (Def. Mot., at 11.) Defendants do, however, vigorously dispute the significance of these contingencies and the relationship between SSA's reported revenue and its stock price. The price of SSA stock rose steadily from late 1994, after the O-I contract was signed, to early 1996. (Compl.¶ 3.) The stock price declined gradually in late 1996 and eventually crashed on January 7, 1997 when Defendants announced that SSA would restate its financial results for the 1994 and 1995 fiscal years to eliminate $30 million of previously reported revenue.(*Id.* ¶¶ 2-3.)SSA also announced that the restatement was the result of a change in its accounting procedures. (*Id.* ¶ 2.) SSA stock had traded as high as $30.52 per share during the Class Period, and closed at $11-3/8 after the restatement announcement. (*Id.* ¶ 3 .)

FN1. Plaintiffs bring this class action on behalf of persons or entities who purchased SSA common stock during the time period from August 22, 1994, through and including January 7, 1997. (Compl.¶ 1.) None of the named Plaintiffs actually purchased

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

SSA stock prior to April 19, 1995.(*Id.* ¶¶ 7-17.)The court notes that the adequacy of the named Plaintiffs as representatives of the class is an issue for a motion for class certification, and is not properly resolvable on a motion to dismiss for failure to state a claim.

***2** Plaintiffs allege SSA officers and senior managers FN2 knew the revenue recognition procedures were improper even before SSA entered the three contracts. (*Id.* ¶¶ 25, 44.)In support of this assertion, Plaintiffs point to a report made by SSA's outside auditor, Price Waterhouse, L.L.P. (hereinafter the "Auditor"), in June of 1994. In this report, the Auditor warned SSA that its practice of premature revenue recognition "was a matter of particular concern" and is inconsistent with Generally Accepted Accounting Procedures (hereinafter "GAAP").(*Id.* ¶¶ 107-108.)Further, when the Auditor reviewed the O-I contract as part of SSA's fiscal year 1994 audit,FN3 it reported that contingencies in the contract rendered revenue recognition based on this contract improper and suggested that SSA's disclosures in its 1994 10-K, filed with the SEC and signed by individual Defendants Skadra, Ford, and Covey, did not meet the "spirit" of full and adequate disclosure. (*Id.* ¶¶ 19, 20, 22, 109, 112.)In its report, the Auditor also referred to "an increasing number of software contracts that involve future obligations on the part of [SSA.]" Consequently, the Auditor entered extensive discussions with Skadra about inserting explanatory language into the 10-K, but Defendants declined to resubmit the form to the SEC.FN4(*Id.* ¶ 112.)The following year, the Auditor expressed the same concerns about SSA's revenue recognition practices, this time referring to the 1995 Hewlett-Packard and Glaxo-Wellcome contracts. (*Id.* ¶ 122-127.)Plaintiffs allege that at this time, SSA agreed that its revenue recognition practice was improper but again chose not to heed the Auditor's suggestion that the revenue be restated.(*Id.* ¶ 128.)

FN2. The individual officers and senior managers named in the Complaint are as follows: Covey, Chairman of the Board of Directors and CEO since October 31, 1994, (Compl.¶ 19); Skadra, Vice President and CFO (*Id.* ¶ 20); Osborne, President and COO (*Id* . ¶ 21); Notari, Vice President of the North American division (*Id.* ¶ 22); and Ford, Chairman of the Board of Directors and CEO until October 31, 1994 and Director until mid-1995. (*Id.* ¶ 23.)

FN3. Neither party has provided the court with the date of SSA's fiscal year 1994 audit.

FN4. Although not named in this suit, the Auditor is defendant to another federal lawsuit based on these facts, *Retsky v. Price Waterhouse, L.L.P.,* 97 C 7694.

In 1995, the relationship between O-I and SSA began to deteriorate after O-I expressed dissatisfaction with SSA's performance and the work yet to be done under the contract. (*Id.* ¶¶ 113-116.)Plaintiffs allege that as early as August 2, 1994, Bill King, SSA's project manager for the O-I Contract, communicated to SSA senior managers his doubts that SSA would be able to develop software for O-I in a timely manner. (*Id.* ¶ 103.)On September 6, 1994, King told Covey and other unidentified senior managers that he had "no confidence" that SSA could produce O-I's software by the contract date. (*Id.* ¶ 104.)On September 29, 1994, in a written memorandum to senior management, King stated that the O-I contract was "in serious trouble," and expressed his fear that SSA would be sued. (*Id.* ¶ 105.)The Complaint does not allege which of the Defendants, other than Covey, actually received these written memos from King. When SSA failed to deliver under the terms of the O-I agreement, O-I brought suit against SSA in November 1995, alleging, *inter alia,* breach of the 1995 contract. (*Id.* ¶ 117.)SSA settled the case on April 18, 1996 for an undisclosed amount. (*Id.*)

***3** Near the same time of the filing of the O-I ac-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

tion, in October of 1995, the SEC initiated an investigation into SSA's revenue recognition practices for the years 1994 and 1995.FN5 (*Id.* ¶¶ 136-137.)On August 1-2, 1996, the SEC deposed James Eidam, the Auditor's engagement partner, regarding the revenue recognition of the O-I, Glaxo-Wellcome and Hewlett-Packard contracts. After his deposition was taken, Eidam allegedly told SSA FN6 that the Auditor would not consent to the use of its report in the 1996 SEC filings unless the revenue reporting issues were resolved. (*Id.* ¶¶ 112, 139.)Obviously unwilling to heed the Auditor's advice, on or about November 4, 1996, SSA severed its relationship with the Auditor. (*Id.* ¶ 79.)Also on November 4, 1996, SSA announced Osborne's retirement. (*Id.* ¶ 80.)SSA retained a new outside auditor who presumably also came to the conclusion that fiscal year 1994 and 1995 revenue should be restated: on January 7, 1997, Defendants announced the restatement. (*Id.* ¶ 84.)The Complaint does not allege who at SSA made the decision to terminate the relationship with the Auditor, or the decision to retain a new auditor.

FN5. The record does not reflect the conclusion, if any, of that investigation.

FN6. The Complaint does not allege which individual Defendants were so told.

B. The State Court Settlement

The present case represents the consolidation of seven cases filed in federal court within days of Defendants' restatement announcement in 1997. One day before Plaintiffs filed this complaint, however, another set of lawyers filed a securities fraud class action against the same Defendants, excluding Ford, in the Circuit Court of Cook County, *Steinberg v. System Software Assoc., Inc.,* No. 97 CH 00287. (Def.Mot., Ex. 3.) Following extensive discovery, the parties to the state court action agreed to mediate their dispute. (Def. Mot., Ex. 7, Aff. of Gary S. Caplan.FN7) On June 27, 1997, after several mediation sessions, Steinberg, the named plaintiff, agreed to settle for an amount of cash and stock totaling approximately $3 million. (Def. Mot., Ex. 8, Settlement Agreement.) The next day, an Illinois court entered an order simultaneously granting preliminary approval of the settlement and certifying a nationwide class of

FN7. Gary Caplan, a partner at Sachnoff & Weaver, is legal counsel to SSA. (Caplan Aff. ¶ 1.)

[a]ll purchasers of Systems [sic] Software Associates, Inc. ("SSA") stock during the period between November 21, 1994 and January 7, 1997, inclusive, and who may have been damaged thereby. Excluded from the Class are defendant System Software, its officers, directors, subsidiaries or affiliates and defendants Roger E. Covey, Terence H. Osborne, Terry E. Notari and Joseph Skadra.

(Pl.'s Opp., Ex. 3, Order Preliminarily Approving Settlement and Providing for Notice ¶ 1.)

A formal settlement notice, including the aforementioned language, was mailed to prospective class members on July 18, 1997. (Def. Mot., Ex. 9 (hereinafter "Notice").) The Notice states that for purposes of damage calculation, any shares purchased within the class period and sold during the class period would be excluded from the computation of recognized losses. Specifically, the Notice states:

***4** For purposes of determining the number of shares purchased and held by an Eligible Class Member at the end of the Class Period, .. there shall be excluded from the computation of Recognized Loss any shares purchased within the Class Period and sold during the Class Period.

(*Id.,* at 2.) The Notice also provided prospective class members with the opportunity to appear at the settlement hearing and the opportunity to opt out of the class. (*Id.,* at 3-4.)Finally, the Notice provided that class members who did not opt out would be bound by the settlement, and therefore be precluded

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

from any potential recovery from this federal lawsuit.[FN8] (*Id.,* at 2-3.)

FN8. This court entered the order consolidating the present action on March 12, 1997, prior to the settlement of the state class.

Before the state court entered a final order approving the settlement, on August 22, 1997, Plaintiffs to this suit filed a petition to intervene in the state court settlement proceedings, challenging the adequacy of the state court plaintiff as class representative and the reasonableness of the settlement. *See Steinberg v. System Software Assocs., Inc., et al.,* 306 Ill.App.3d 157, 163, 713 N.E.2d 709, 712-13 (1st Dist.1999). A settlement hearing was held on September 30, 1997, during which the state court expressed particular concern about the interplay between the state court settlement and the federal cause of action. (Def. Reply, at 2-3.) When questioned at the hearing, Defendant's attorney[FN9] gave the following explanation:

FN9. The firm of Sachnoff & Weaver represented the Defendants both in the state action and in the present action.

And if this case is settled, this case is going to be approved and under the Supreme Court holding, in that it would be preclusive of the Federal case.

Except-and this is the last point, they have a case. They have a three month class. We're not selling, they have a defendant Larry Ford. We're not dealing.

They have people that trade in and out, we're not settling. They're welcome to this case, Judge. They're welcome to that case. I would continuing (sic) and win that case in like a zillion dollars. More power to them.

(Pl.s' Opp., Ex. 1, September 30, 1997 Transcript of Settlement Hearing.) On that same day, the court entered an order of final judgment and dismissal and subsequently denied the petition to intervene filed by Plaintiffs in this case. *See Steinberg v. System Software Assocs., Inc., et al.,* 306 Ill.App.3d 157, 160, 713 N.E.2d 709, 711 (1st Dist.1999).

Plaintiffs filed an unsuccessful appeal from the denial of their petition to intervene. (*Id.*) In the course of the appeal, Steinberg's attorney attempted to correct the ambiguity in the Notice by stating that the Notice should be read as including: " ... all purchasers of [stock] during the period between November 21, 1994 and January 7, 1997, inclusive, *who still held that stock on January 7, 1997.*" (emphasis added) (Pl.s' Opp., Ex. 5, Brief of Appellee Steinberg, at 6.) In his brief in opposition to Plaintiffs' appeal, Steinberg further argued that the persons who bought *and sold* the SSA stock between November 21, 1994 and January 7, 1997 were "unaffected" by the settlement and therefore had no standing to object. (*Id.*) The Illinois Appellate Court rejected Plaintiffs' appeal, finding the settlement class adequately represented. In its decision, the court declined to address the issue of the allegedly defective Notice, concluding that this issue was "more properly the subject of the federal case that remains after the state settlement."*See Steinberg v. System Software Assocs., Inc., et al.,* 306 Ill.App.3d 157, 169, 713 N.E.2d 709, 716-17 (1st Dist.1999).

C. The Motion to Dismiss

***5** Relying on the same "fraud on the market" theory alleged by the state court plaintiff, Plaintiffs here allege that Defendants knowingly and recklessly perpetrated a fraud on the market because each knew that SSA's accounting procedures were materially misleading yet nevertheless represented to the investing public that the financial reports accurately stated the company's revenue. (Compl.¶¶ 26-76.) Plaintiffs also bring claims against individual officers of SSA as "controlling persons" under Section 20(a) of the Exchange Act for failing to exercise reasonable and prudent supervision over SSA's management, policies and financial controls.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

(*Id.* ¶ 28.)Each named officer allegedly participated in the drafting, preparation and/or approval of SSA's shareholder reports, quarterly and annual financial reports, press releases and SEC filings despite having the ability and opportunity to prevent the issuance of such documents or to correct them. (*Id.* ¶ 32-34.)Plaintiffs maintain that Class Members purchased shares of stock during the Class Period in reasonable reliance on Defendants' material omissions and on the integrity of the market price for SSA stock. (*Id.* ¶ 147.)Defendants now argue that this case should be dismissed because the previous state court class action settlement bars Plaintiffs' claims and, in the alternative, that Plaintiffs fail to adequately allege fraud under the heightened pleading standards of the PSLRA.

DISCUSSION

A. Standard of Review

Defendants move to dismiss Plaintiffs' complaint on two grounds: (1) that this court is barred from hearing the case by the doctrine of *res judicata;* and (2) that Plaintiffs' complaint fails to meet the heightened pleading standards of the PSLRA. Pursuant to Federal Rule of Civil Procedure 8(c), *res judicata* is an affirmative defense. *See*FED. R. CIV. P. 8(c). The Seventh Circuit has held that the proper posture for dismissing a complaint based on an affirmative defense is a motion for summary judgment rather than a motion brought pursuant to Federal Rule of Civil Procedure 12(b).*See Anderson v. State of Illinois,* 70 F.3d 1275 (7th Cir.1995). Accordingly, as both sides have submitted evidentiary material, the court construes Defendants' motion to dismiss on *res judicata* grounds as a motion for summary judgment, to be granted only if "there is no genuine issue as to any material fact and ... the moving party is entitled to judgment as a matter of law."FED. R. CIV. P. 56(c); *see also Flores v. Preferred Tech. Group,* 182 F.3d 512, 514 (7th Cir.1999). When determining whether this standard is met, the court views all the evidence in the light most favorable to the nonmoving party, and draws all inferences in the nonmovant's favor. *See Dixon v. Godinez,* 114 F.3d 640, 642-43 (7th Cir.1997).

Defendants' motion to dismiss a securities fraud complaint implicates Federal Rules of Civil Procedure 12(b)(6) and 9(b) as well as the PSLRA. A motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6) does not test whether Plaintiffs will prevail on the merits but instead assesses whether Plaintiffs have properly stated a claim. *See Scheuer v. Rhodes,* 416 U.S. 232, 236 (1974). A court may dismiss a complaint for failure to state a claim only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."*See Maple Lanes, Inc. v. Messer,* 186 F.3d 823, 824-25 (7th Cir.1999) (quoting *Conley v. Gibson,* 355 U.S. 41, 45-6 (1957)). On a motion to dismiss, the court draws all inferences and resolves all ambiguities in favor of the plaintiff, and assumes that all well-pleaded facts are true. *See Long v. Shorebank Dev. Corp.,* 182 F.3d 548, 554 (7th Cir.1999) (citation omitted)."Rule 9(b) requires that 'the circumstances constituting fraud ... be stated with particularity." ' *See In re Healthcare Compare Corp. Sec. Litig.,* 75 F.3d 276, 281 (7th Cir.1996). The PSLRA amendments to the Securities Exchange Act of 1934 raised the pleading standards in securities fraud cases, requiring the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." See 15 U.S.C. § 78u-4(b)(2). SSA moves to dismiss Plaintiffs' complaint on *res judicata* grounds and for failure to state a claim under the heightened pleading standards of the PSLRA.

B. *Res Judicata*

***6** Under the Full Faith and Credit Act, 28 U.S.C. § 1738, the settlement of a state securities action may preclude similar pending federal securities class action suits arising out of the same facts. *See Matsushita Elec. Indus. Co. v. Epstein,* 516 U.S. 367, 387 (1996). According to *Matsushita,* in the ab-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

sence of a contrary federal law, state law determines whether a state court settlement precludes related federal proceedings. *See id.* at 375 (citing *Marrese v. American Acad. of Orthopaedic Surg.,* 470 U.S. 373, 381-2 (1985)). If a state court would be precluded from hearing the case under state law, the federal court is similarly barred, unless exceptional circumstances justify a refusal to give preclusive effect to the state court's judgment.*Id.* A failure of the state court to satisfy constitutional due process requirements would constitute an exceptional circumstance allowing the federal court to hear the claims. *Id.* at 884-5 (Ginsburg, J., Stevens, J. and Souter, J., concurring) (citations omitted).

Under Illinois law of *res judicata,* courts are precluded from hearing claims where: (1) there has been a final judgment on the merits rendered by a court of competent jurisdiction; (2) the parties involved are the same or in privity; and (3) the causes of action are the same. *See River Park, Inc. v. City of Highland Park,* 184 Ill.2d 290, 302, 703 N.E.2d 883, 889 (1998); *Schnitzer v. O'Connor,* 274 Ill.App.3d 314, 324, 653 N.E.2d 825, 832 (1st Dist.1995). Neither party disputes that a court of competent jurisdiction authorized the settlement in the state court case, nor that Plaintiffs' cause of action arises out of the same facts. Rather, the parties disagree as to whether the class proposed in this case is the same or in privity with the class in the state court proceedings. Noting the addition of three months to the state court class period and the inclusion of purchasers who sold SSA stock during the class period, Plaintiffs argue that their proposed class is not in privity with the state court class. Even if the class here is in privity with the class in the state court, Plaintiffs contend that judgment ought not bar this action because defects in the state court proceedings violated due process and support a collateral attack on the judgment.

In addressing these arguments, the court notes that Plaintiffs' proposed class may fairly be divided into three distinct subclasses: (1) a subclass consisting of purchasers of SSA stock between November 21, 1994 and January 7, 1997 who still held that stock on January 7, 1997 (hereinafter the "Purchasers and Holders"); (2) a second subclass consisting of purchasers of SSA stock between November 21, 1994 and January 7, 1997 who sold their stock prior to January 7, 1997 (hereinafter the "In and Out Purchasers"); and (3) a third subclass consisting of purchasers of SSA stock from August 22, 1994 to November 20, 1994, inclusive, regardless of whether they still held that stock on January 7, 1997 (hereinafter the "Early Class").

1. The In and Out Purchasers

***7** The court first considers whether the In and Out Purchasers are bound by the final state court judgment. Contrary to Defendants' assertion in their brief before this court (Def.'s Memo. in Support of Mot. to Dismiss, at 6-7), the record suggests that the plaintiffs to the state court settlement did not seek to represent the In and Out Purchasers in the negotiations. Specifically, Steinberg's attorney told the Illinois Appellate Court that the settlement notice sought to exclude persons who sold SSA stock within the critical time period, and in arguing that Plaintiffs should not be permitted to intervene in the state court action, he further explained that the In and Out Purchasers "are excluded from the Class ... [and are therefore] unaffected by this settlement."(Pl.s' Opp., Ex. 5, Brief of Appellee Steinberg, at 6.) The representations of Defendants' lawyer to the Illinois Appellate Court are less clear but generally support the idea that the In and Out Purchasers and the Early Class were not part of the settlement.[FN10] That the In and Out Purchasers were excluded from the settlement is the only conclusion consistent with the Illinois courts' decisions regarding the adequacy of the state court representative and the only one consistent with the parties' representations before that tribunal. Defendants make no arguments that under Illinois law a party excluded from a settlement class is nevertheless in privity with the settlement class. The court concludes that the In and Out Purchasers' claims are not barred by *res judicata,* and therefore it need not address

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

whether the In and Out Purchasers were afforded due process in the state court proceedings.

FN10. Defendants argue that their representations to the Illinois Appellate Court that some federal claims *may* continue after the settlement does not mean that Defendants intended to allow these purchasers to pursue their claims in this court. (Def. Mot., at 8 n. 4.) While there is nothing inherently wrong with the logic of this argument, Defendants in the same breath represent that the Illinois courts were extremely sensitive to the contours of the settlement in relation to the claims of the federal Plaintiffs. (*Id.*) Together with the arguments it now makes before this court, Defendants' line of reasoning comes very close to suggesting that in explaining the relationship between the state court action and the present action, Defendants purposely misled the Illinois Appellate Court, or at least failed to correct the Steinberg's assertion that the In and Out Purchasers were excluded from the class, by suggesting that the In and Out Purchasers may still have a claim in federal court. (Pl.s' Opp., Ex. 1, Sept. 30, 1997 Transcript of Settlement Hearing.) While this court chooses to give the Defendants the benefit of the doubt, it reminds them that this court does have the power to estop a party from acting inconsistently with its conduct in prior cases. *See Feldman v. American Memorial Life Ins. Co.,* 196 F.3d 783, 789 (7th Cir.1999) (doctrine of judicial estoppel prevents a party from adopting a position in a legal proceeding contrary to a position successfully argued in an earlier legal proceeding).

2. The Early Class

Defendants do not dispute that purchasers in the Early Class were never considered part of the state court settlement or that they did not receive the Notice. Rather, relying exclusively on *Torcasso v. Standard Outdoor Sales, Inc.,* 157 Ill.2d 484, 490, 626 N.E.2d 225, 228 (1993), Defendants argue that the interests between the Early Class and the state court settlement class are identical for *res judicata* purposes because their respective causes of action are identical. Defendants correctly note that under Illinois law, *res judicata* extends not only to every matter that was actually determined in the prior suit but also to every other matter that might have been raised and determined in it.[FN11] *See Torcasso,* 626 N.E.2d at 228, 157 Ill.2d at 490. *Torcasso,* however, was not a class action suit and Defendants do not elaborate as to how its holding should be applied to suits of a class nature. Instead, Defendants rely primarily on a theory of virtual representation developed in federal courts for Rule 23 cases. Defendants offer no arguments that the Illinois courts also recognize the notion of virtual representation, a doctrine recently acknowledged as “amorphous” by the Seventh Circuit in *Tice v. American Airlines, Inc.,* 162 F.3d 966 (7th Cir.1998), *cert. denied,* 119 S.Ct. 2396 (1999).

FN11. In a footnote to its brief, Defendant suggests that the inclusion of the Early Class is simply a tactical move by Plaintiffs to prevent preclusion. (Def. Mot., at 6 n. 3.) While there are cases in which the naming of additional plaintiffs have been found veiled attempts to avoid preclusion, this case is not one of them. *See e.g., In re Chicago Police Officer Promotions,* Nos. 91 C 668, 90 C 950, 90 C 1923, 89 C 6247, 90 C 4984, 90 C 5456 89 C 7262, 1991 WL 134218, at *5 (N.D.Ill. July 16, 1991). Plaintiffs filed this Complaint just one day after the state court cause of action began and six months before the state court certified the settlement class.

***8** Even assuming Illinois recognizes the theory of virtual representation, the theory clearly has no application here. The state court settlement provided benefits to members of a defined class, and barred

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

further claims brought by members of that class, but not claims of persons not included in the class. Defendants' arguments to the contrary are almost identical to those rejected in *Chancellor v. Nationwide Credit, Inc.,* No. 98 C 4431, 1999 WL 259951, at *1 (N.D. Ill. April 6, 1999). The defendant in *Chancellor* had settled Fair Debt Collection Practices Act claims with a class of plaintiffs which did not include plaintiff Chancellor. When Chancellor subsequently sued the defendant for the same violations as alleged by the prior settlement class, the defendant sought to preclude the action on the basis of *res judicata,* arguing that the Chancellor class was virtually represented by the settlement class. The *Chancellor* court held that privity could not exist between individuals representing a class and individuals not part of that class. *See id.* at *3-4.Like the plaintiff in *Chancellor,* members of the Early Class did not participate in settlement negotiations, were not notified of the state court settlement, and are not entitled to receive any benefits from it.

Defendants attempt to distinguish *Chancellor* on grounds that members of the Early Class had a full and fair opportunity to participate in the state court settlement but chose not to participate or opt out. The effort is unconvincing. Defendants do not explain how the Early Class could have had the opportunity to participate in the state settlement negotiations when they received no Notice and when the state court plaintiff did not seek to represent their interests. Nothing in the state court settlement therefore precludes the Early Class from making its claim before this court.

The court pauses here to note that the addition of individual Defendant Ford to the federal cause of action neither adds to nor detracts from the *res judicata* argument. Defendants argue that Plaintiffs added Ford to the complaint as a strategic maneuver to get around the "identity of parties" element of *res judicata.*The court rejects this argument, however, because there is no identity of parties with respect to the Early Class and the In and Out Purchasers and the state court class members anyway. Further, while the record does not offer explicit reasons for Ford's exclusion from the state court cause of action, this court notes that he acted as CEO only until October 1994, before the beginning of the critical time period defined in the state court action. It therefore does not appear that he could have been joined as a Defendant in a state court proceeding that did not include purchasers before this date.

3. The Purchasers and Holders

Next, this court turns to the claims of the Purchasers and Holders. As a subclass, this group is identical to the one represented in the state court settlement. Notably, it does not appear that the individuals seeking redress here opted out of the settlement and its preclusive effects. The parties do not dispute that under Illinois law, this subclass is bound to that settlement by the doctrine of *res judicata.*Rather, they dispute whether the failure to make any findings of fact regarding the adequacy of the state plaintiff as representative and whether the Notice violated due process requirements and prejudiced these purchasers.

***9** Plaintiffs are correct in asserting that a court judgment cannot bind absent class members unless that forum has provided minimal procedural due process protections to the absent members. *See Phillips Petroleum Co. v. Shutts,* 472 U.S. 797, 811-12 (1985). At a minimum, in a class action settlement, due process requires that (1) an absent plaintiff be provided with notice and an opportunity to be heard and participate in the litigation; and (2) the named plaintiff at all times adequately represents the interests of the absent class members. *See id.* at 812;*see also Richard's Lumber & Supply Co. v. U.S. Gypsum Co.,* 545 F.2d 18, 21 (7th Cir.1976). Plaintiffs urge this court to deny the preclusive effects of the state court settlement on the Purchasers and Holders class, alleging that defects in the state court procedures violated due process.

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

First, Plaintiffs argue that the state court erred by not making specific findings of fact as to the adequacy of the state court plaintiff representative. Indeed, Plaintiffs are correct in their assertion that under Illinois law, a court must find that the prerequisites of class representation are present before it certifies a class action suit. *See Wheatley v. Board of Educ. of Township High School Dist. 205,* 99 Ill.2d 481, 486, 459 N.E.2d 1364, 1367 (1984). Plaintiffs cite no Illinois cases suggesting that a court's action in certifying a class without making specific findings on each of the certification requirements constitutes reversible error. Instead, Plaintiffs rely exclusively on a Sixth Circuit Court of Appeals holding that a court's failure to make an explicit finding as to the adequacy of the class representative violates the requirements of Rule 23. *See In re American Med. Sys., Inc.,* 75 F.3d 1069 (6th Cir.1996). Under *Matsushita,* however, for purposes of determining the *res judicata* effect of a state court judgment, the inquiry is whether the original suit met the *state* law procedural requirements. In this case, the Illinois Appellate Court was unmoved by Plaintiffs' argument that putative class members were prejudiced because the trial court made no specific findings on the adequacy of the class representative. The Illinois Appellate Court rejected that argument and found both that the class was represented by able counsel with extensive experience in class action litigation and that the lower court did not abuse its discretion when it certified the settlement class. *See Steinberg v. System Software Assocs., Inc., et al.,* 306 Ill.App.3d 157, 169, 713 N.E.2d 709, 716 (1st Dist.1999). Further, Plaintiffs point to nothing in the record suggesting that the interests of the named plaintiff were not common and typical of the class, that prosecution or discovery was inadequate, or that the settlement agreement was not a product of arms-length negotiations; to the contrary, the negotiations were mediated by an objective outsider, former Illinois Appellate Court Justice Anthony Scariano. The state court's decision on this issue is entitled to full faith and credit here because Plaintiffs suffered no prejudice from the fact that the state court judge failed to make specific findings as to the representative's adequacy when he certified the state court class.

***10** Next, Plaintiffs argue that Purchasers and Holders absent from the state court proceedings were prejudiced by the dissemination of a defective Notice, and therefore suffered due process violations. In a class action settlement, due process requires that absent plaintiffs receive notice as well as an opportunity to be heard. *See Phillips Petroleum Co. v. Shutts,* 472 U.S. 797, 812 (1985).“The notice must be the best practicable, ‘reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.” ' *See id.*(quoting *Mullane v. Central Hanover Bank & Trust Co.,* 339 U.S. 306, 314-15 (1950)). Further, due process requires that an absent plaintiff be provided with the opportunity to opt out of the proposed class.*Id.*

Plaintiffs argue that even though the Purchasers and Holders received the Notice, they could not have understood that persons who sold their SSA stock before the end of the critical period were not included. Plaintiffs present the court with the hypothetical situation of a Purchaser and Holder who may have ultimately decided to opt out of the class after concluding he or she could recover more on his or her own rather than having to share the recovery with the In and Out Purchasers. The court is unconvinced by this hypothesis and concludes that the Notice was not defective. Although the definition of the settlement class in the Notice did not explicitly exclude those purchasers who may have sold their SSA stock during the critical period, the Notice did state that SSA stock sold within the period would be excluded from the computation of damages.[FN12] The Notice also provided putative class members with the opportunity to appear at a hearing on the settlement. The Notice conveyed the information sufficient to apprise interested parties of the pendency of the action, and provided an opportunity to appear and be heard, therefore satisfying the demands of due process. *See Air Lines*

*Stewards & Stewardesses Ass'n. v. American Airlines, Inc.,* 455 F.2d 101, 108 (7th Cir.1972).

FN12. Such language is arguably more accurate because there may be persons who sold a portion of their SSA stock during the critical period but retained another portion.

For the reasons set forth above, the court concludes that only a portion of Plaintiffs' proposed class is subject to preclusion by the state court settlement. The court therefore denies Defendants' motion to dismiss on *res judicata* grounds with respect to the Early Class and the In and Out Purchasers, but grants the motion with respect to the Purchasers and Holders. The court's determination that the claims of the In and Out Purchasers and the Early Class are not barred by the state court settlement is not a reflection of the court's view of the relative merits of their claims, which will no doubt be the subject of further argument. For now, however, the court rejects arguments that neither subclass can prove damages. Defendants correctly note that under the PSLRA, damages are limited to the difference between an investor's purchase price and the ninety-day average trading price of the stock following any curative disclosure. *See*15 U.S.C. § 78u-4(e). As discussed in more detail below, Defendants would count the relevant ninety days against the supposed curative disclosure in either of two newspaper articles published in the fall of 1995. As explained below, this court does not find either of those articles curative within the meaning of the PSLRA. If, after certification, Defendants still believe that Plaintiffs' damages are too minimal to maintain the cause of action, an early offer of judgment pursuant to Federal Rule of Civil Procedure 68 may satisfy Defendants' concerns.

C. Pleading Requirements

***11** Defendants also make a number of arguments in an attempt to establish that Plaintiffs fail to meet the heightened pleading standards of the PSLRA. The Seventh Circuit has explained that in order to state a claim under Rule 10b-5 of the Securities Exchange Act, a plaintiff must allege “that the defendant (1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which plaintiff has relied and (6) that reliance proximately caused plaintiff's injuries.”*See In Re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 280 (7th Cir.1996). A misstatement or omission is material if there was a “substantial likelihood that disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the ‘total mix’ of information available.”*See TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976). Because a 10b-5 claim alleges fraud, it must also meet the standards of FED. R. CIV. P.9(b) which requires that facts supporting an inference of fraud be pleaded with specificity. *See HealthCare Compare,* 75 F.3d at 280-81. Defendants argue that Plaintiffs' claims are barred by the statute of limitations, that Plaintiffs have failed to plead detrimental reliance, that Plaintiffs have failed to properly plead scienter, that Plaintiffs have failed to allege each individual Defendant's participation in the fraud, and that Plaintiffs have not adequately alleged control person liability. The court addresses each argument in turn.

1. Statute of Limitations

Defendants argue, first, that Plaintiffs' allegations are barred by the statute of limitations. Under the PSLRA, an individual may bring suit only within one year from the time the individual knew or should have known that a claim was available. *See Whirlpool Fin. Corp. v. GN Holdings, Inc.,* 67 F.3d 605, 609-10 (7th Cir.1995). An individual should know of a claim when a common sense inquiry into “suspicious circumstances” would have easily revealed the fraud. *See Law v. Medco Research, Inc.,* 113 F.3d 781, 786 (7th Cir.1997). Defendants argue that Plaintiffs should have known about the alleged fraud as early as October 5, 1995 when the *Wall Street Journal Europe* published an article suggest-

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

ing that SSA may have been overly aggressive in recording sales for which it had not yet been paid and for which payment might yet be withdrawn. (Def.Mot., Ex. 21.) Defendants also point to a *Bloomberg Business News* dated November 22, 1995, which mentioned O-I's lawsuit against SSA. (Def.Mot., Ex. 20.) Defendants argue that this information was widely published, easily discoverable by Plaintiffs fourteen months prior to SSA's restatement announcement, and should have triggered further investigation by Plaintiffs.

Defendants fail to acknowledge, however, their own emphatic denials of any improprieties published in these very same articles. In the *Wall Street Journal Europe* article, Defendants represented that their accounting procedures were "fair and reasonable" and suggested that SSA's deal with O-I would not adversely affect their profit-and-loss statement because it had "lots and lots of reserves." In the *Bloomberg News* article, SSA claimed that the O-I lawsuit "would [not] affect its financial condition."Defendants also fail to acknowledge the existence of other articles and press releases published about the same time which did not question the accuracy of SSA recorded revenue, but rather suggested that the company was reporting record earnings and revenue. (Compl.¶¶ 54-83.) Indeed, on the same day as the *Bloomberg News* article, a securities analyst from Alex. Brown & Sons recommended SSA stock as a "strong buy" and reported that SSA management had indicated that the company had full reserves for any losses from the O-I contract. (Compl.¶ 67.) One month later, an analyst at the META Group reported that the market expected SSA to continue its sales growth. (Compl.¶ 68.) On November 16, 1996, Standard & Poor's gave SSA stock its highest rating. (Compl.¶ 83.)

***12** More importantly, only the one *Wall Street Journal* article even addressed SSA's revenue accounting methods. The other article relied on by Defendants suggests that the market's only really concern about SSA's revenue was the outcome of the O-I contract dispute, rather than the method used by SSA to record revenue. Specifically, the *Bloomberg News* article mentioned that O-I had paid half the contract price but said nothing about the fact that Defendants had nevertheless reported more than two-thirds of the contract price as 1994 revenue. Defendants do not explain how Plaintiffs would be led to investigate SSA's practices based on one published article nor how such an investigation would have led them to the conclusion that SSA's accounting procedures were indeed improper.

2. Reliance

Defendants' second challenge to the adequacy of Plaintiffs' allegations focuses on the issue of reliance. Again noting the October 1995 *Wall Street Journal Europe* article, Defendants argue that Plaintiffs cannot prevail on their fraud on the market theory because the market was aware of SSA's revenue recognition practices and the stock price during this period therefore reflected the true value of the company. Under the fraud on the market theory, Plaintiffs need not allege facts showing individual reliance. They may, instead, raise a rebuttable presumption of reliance by alleging that (1) Defendants made public misrepresentations; (2) the misrepresentations were material and would induce a reasonable investor to misjudge the value of the shares; (3) the shares were traded on an open and efficient market; and (4) that Plaintiffs traded shares between the time the misrepresentations were made and the truth revealed. *See* *Basic Inc. v. Levinson,* 485 U.S. 224, 248 n. 27 (1988).

The fraud on the market theory presumes that because the market is interposed between sellers and buyers of stock, misleading statements reflected in the market defraud individual purchasers even if those purchasers do not directly rely on those misstatements. *See* *id.* at 241-42.Defendants may rebut the presumption of reliance by establishing that any alleged misstatement did not lead to a distortion in price or that an individual plaintiff would have purchased stock even if the misstatement were known

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

to be false. *Id.* at 248.Apart from one analyst in an October 1995 article, Defendants have offered no support for the contention that the market suspected any misstatement or ever suspected that the O-I dispute would lead SSA to lose money already recognized. Construing all facts in favor of Plaintiffs, this single article is insufficient to defeat this presumption. Any disparity between a Plaintiff's assumption that stock was traded on an informed market, and the notion that the market could remain misinformed despite some evidence to the contrary is a matter for trial. *Id.* at 249 n. 29.

3. Scienter

Defendants' third argument is that the Early Class members cannot establish scienter. Scienter, as applied to a securities fraud claim, refers to a mental state embracing the intent to deceive, manipulate or defraud. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976). Only intentional misstatements violate Section 10(b) and Rule 10B-5. *Id.* at 214.The PSLRA requires that the scienter allegation be supported with particular facts which give rise to a strong inference that defendants acted with fraudulent intent. *See*15 U.S.C. § 78-4(b)(2). One court in this district has characterized the PSLRA as effectively codifying the standard employed by Second Circuit, which requires a plaintiff "to plead the factual basis which gives rise to a 'strong inference' of fraudulent intent."*See Danis v. USN Communications, Inc.,* 73 F .Supp.2d 923, 936-37 (N.D.Ill.1999) (quoting *O'Brien Nat'l Property Analysts Partners,* 936 F.2d 674, 676 (2nd Cir.1991)); *see also In re Advanta Corp Sec. Litig.,* 180 F.3d 525, 533 (3rd Cir.1999) (PSLRA "establishes a pleading standard approximately equal in stringency to that of the Second Circuit"); *but see Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1282 (11th Cir.1999) (PSLRA does not codify the "motive and opportunity" test formulated by the Second Circuit for pleading scienter).

***13** The Seventh Circuit has not yet addressed the PSLRA pleading standard, but this court presumes the Court of Appeals will continue to require securities fraud complaints to recite facts and circumstances constituting the alleged fraudulent conduct. *DiLeo v.. Ernst & Young,* 901 F.2d 624, 628 (7th Cir.1990). This standard requires plaintiffs to plead "the who, what, when, where and how: the first paragraph of any newspaper story."*Id.*

A plaintiff may allege scienter by either (1) showing that defendants had both the motive and opportunity to commit fraud or (2) establishing strong circumstantial evidence of conscious behavior or recklessness. *See Rehm v. Eagle Fin. Corp.,* 954 F.Supp 1246, 1253 (N.D.Ill.1997)(quoting *Shields v. Citytrust Bancorp, Inc.,* 25 F.3d 1124, 1128 (2nd Cir.1994)); *Press v. Chemical Inv. Servs. Corp.,* 166 F.3d 529, 538 (2nd Cir.1999). Unlike the factual circumstances constituting the fraud, motive and intent may be averred generally, FED. R. CIV. P. 9(b); *In Re Discovery Zone Sec. Litig.,* 943 F.Supp. 924, 937 (N.D.Ill.1996), so long as facts that support an inference of circumstantial evidence of scienter are specific. *See Rehm,* 954 F.Supp. at 1255. The mere fact that a company restates its revenue does not establish scienter. *See Goldberg v. Household Bank, F.S.B.,* 890 F.2d 965, 979 (7th Cir.1989) ("Restatements of earnings are common... only intentional misstatements violate Section 10(b) and Rule 10b-5.").

Plaintiffs attempt to establish both that Defendants had motive and opportunity and that factual circumstances constituting the fraud establish scienter. In this case, Plaintiffs allege, for example, that scienter can be inferred from an examination of individual Defendants' respective sales of stock during the class period. Motive and opportunity may be inferred from the allegation that Defendants sold or intended to sell stock from their personal reserves during the class period. *See Discovery Zone,* 943 F. Supp at 937 (citing *Marksman Partners, L.P. v. Chantal Pharm. Corp .,* 927 F.Supp. 1297, 1312 (C.D.Cal.1996)). It is not enough, however, that defendants merely sold personal stock during the class period. Rather, a plaintiff must show that the sale

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

was drastically out of line with prior trading practices and that the sale was timed to maximize personal benefit from undisclosed inside information. *See Freeman v. Decio,* 584 F.2d 186, 197 n. 44 (7th Cir.1978); *Rehm,* 954 F.Supp. at 1254. Regardless of the significance of any individual defendant's trading patterns, the inference is obviously strongest when examined collectively-e.g. where the individual defendants bought or sold shares in a common pattern. *See Acito v. IMCERA Group, Inc.,* 47 F.3d 47, 54 (2nd Cir.1995).

Notably, Plaintiffs in this case merely catalogue the sales each individual Defendant made during the Class Period, without referring to sales made prior to this period. (Compl.¶ 102.) The Complaint fails to plead that these stock sales were out of line with Defendants' previous sales of stock. Collectively, there is no discernable pattern to the stock sales of the type that would lead someone to suspect that stock sales were coordinated in any way. In short, the Complaint fails to establish scienter based on motive and opportunity.

***14** Plaintiffs' failure to present allegations concerning stock sales that reflect motive and opportunity does not conclude the issue of scienter. Plaintiffs may also establish scienter by alleging that Defendants acted with reckless indifference to warnings about SSA's revenue practices. *See Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1282 (11th Cir.1999) (recklessness is sufficient to allege scienter under PSLRA); *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 534 (3rd Cir.1999) (same). Reckless conduct is conduct that deviates from the standard of ordinary care, to the extent that an alleged error was either known to the defendant or so obvious that the defendant must have known about it. *See Rehm,* 954 F. Supp at 1255; *Discovery Zone,* 943 F. Supp at 937. "The more serious the error, the less believable are defendants' protests that they were completely unaware of [the company's] true financial status and the stronger is the inference that defendants must have known about the discrepancy." *Rehm,* 954 F.Supp. at 1256. In *Rehm,* the court noted that a refusal to see the obvious or investigate the doubtful may in some cases give rise to an inference of recklessness. 954 F.Supp. at 1255. Nevertheless, the allegations that Defendants seriously departed from the GAAP does not alone establish scienter. *Id.* at 1246; *In re Comshare, Inc. Sec. Litig.,* 183 F.3d 542, 552 (6th Cir.1999). A complaint must also show facts supporting an inference that defendants recklessly disregarded the deviance or acted with gross indifference to the misrepresentations in its financial statements. *See Rehm,* 954 F.Supp. at 1246.

*Rehm* involved a class action suit brought by persons who purchased or acquired stock of the defendant corporation and alleged that the defendant and its executive officers materially misrepresented the corporation's known credit losses and net income in violation of the Securities Exchange Act of 1934. In *Rehm,* the court found that a significant GAAP violation, combined with statements mitigating the seriousness of a credit loss problem, raised a strong inference that the defendants there acted with knowledge of their public misstatements or with willful blindness to the truth. *Id.* The allegations made in Plaintiffs' Complaint are almost identical to those made in *Rehm,* with the exception that unlike the defendants there, Defendants here were clearly on notice of the alleged GAAP deviation. The Complaint alleges specific facts to show that despite the warnings and recommendations of the Auditor and despite the lost revenue from the O-I contract, Defendants nevertheless refused to acknowledge that SSA's revenue had been misstated and made numerous public statements that expressed confidence in the company's balance sheets.

Defendants vigorously maintain that a "best efforts" clause in the O-I contract precludes their conduct from meeting the reckless standard. Under this disingenuous reasoning, Defendants argue that it was proper for the company to report the revenue from the O-I Contract, or at least proper for Defendants to believe the revenue was appropriately reported, because SSA was under no obligation to

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

actually create all the software requested by O-I. Setting aside the issue of whether Defendants would have this court believe that O-I would enter a $12 million contract in which SSA could collect the entire contract price even if it were unable to produce the requested software, the court finds the Complaint adequate. Plaintiffs have alleged that even before the O-I contract was signed, the Auditor had warned Defendants about improper revenue recognition practices, that Defendants failed to restate the 1994 revenue immediately after the O-I settlement, and that these revenue recognition practices were not limited to the O-I Contract but included at least two other contracts. The Complaint establishes more than enough circumstantial evidence to support an inference that Defendants acted with gross indifference to the misrepresentations in SSA's financial statements.

4. Individual Defendants

***15** Defendants next turn to individual defendants Ford, Notari, and Osborne, making various arguments as to why the Early Class fails to establish facts specific to them. While Ford signed the 1994 10Q form, Defendants argue that because he was CEO only until October 1994, Early Class claims are based solely on the improper recognition of the O-I Contract and that Plaintiffs fail to allege any specific facts regarding Ford's knowledge that O-I revenue should not have been immediately recognized. Defendants note, further, that while all individual defendants signed at least one of System Software's 10Q and 10K forms for 1994 and 1995, only Covey, Skadra, and Ford made any public statements during the class period. Defendants maintain that therefore the claims against Notari and Osborne must be dismissed. As described above, under the PSLRA, Plaintiffs need only raise the inference that Defendants acted with reckless indifference to the original error-here the misstatement of the revenue.

The Seventh Circuit has held that a plaintiff pleading fraud under the Rule 9(b) standard must "reasonably notify the defendants of their purported role in the scheme."*See Vicom, Inc. v. Harbridge Merchant Servs., Inc.,* 20 F.3d 771, 776-7 (7th Cir.1994) (quoting *Midwest Grinding Co. v. Spitz,* 976 F.2d 1016, 1020 (7th Cir.1992)). Plaintiffs allege that the Auditor questioned SSA's revenue recognition procedures in the spring of 1994, *before* the O-I Contract was signed. Plaintiffs also allege that Ford was a corporate insider, identifying his position as CEO in 1994 and Director of SSA in 1995. Plaintiffs further allege that Notari, the Vice President of the North American Division and Osborne, President and COO of SSA, were corporate insiders. Plaintiffs make particular allegations as to how SSA, including Ford, Notari, and Osborne, perpetrated a fraud on the market by improperly recognizing revenue. Plaintiffs do not plead, because they do not and cannot at this point know, whether Ford, Notari, and Osborne actually read the Auditors' reports. Nevertheless, the facts are sufficient to establish that Ford, Notari, and Osborne, as senior management at SSA, knew or should have known about SSA's revenue practices and support an inference that they should have known about the terms of the $12 million contract with O-I.

Because this court finds that Plaintiffs have adequately pleaded facts indicating how the individual Defendants knew of the misstatements, it is unnecessary to address Defendants' somewhat undeveloped attack on Plaintiffs' mention of the group publication doctrine as a premise for liability against Notari and Osborne. Because the issue is a serious one, however, this court must at least recognize the argument. In the group publication doctrine, individual liability can be inferred from the collective actions of corporate officers, such as the publication of an annual report. Defendants argue that the PSLRA's heightened pleading standards have abolished the group publication doctrine because at least one court has held that the doctrine is now "suspect." *Allison v. Booktree Corp.,* 999 F. Supp 1342, 1350 (S.D.Cal.1998). It appears, however, that some circuits have explicitly held that the group publication doctrine survives the

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

amended PSLRA. *See, e.g, Schwartz v. Celestial Seasonings, Inc.,* 124 F.3d 1246, 1254 (10th Cir.1997); *In Re GlenFed, Inc. Sec. Litig.,* 60 F.3d 591, 593 (9th Cir.1995); *Powers v. Eichen,* 977 F.Supp. 1031, 1040 (S.D.Cal.1997). While the Seventh Circuit has not yet explicitly addressed the issue, there are at least two recent cases in which the courts of the Northern District of Illinois used the doctrine and apparently none in which the doctrine was rejected. *See Discovery Zone,* 943 F. Supp at 937-8; *Koehler v. Nationsbank Corp.,* No. 96-C-2050, 1997 WL 80928, *1 (N.D.Ill. Feb. 20, 1997). This court cannot address the issue today because Defendants do not make a single argument as to why the PSLRA may call the group publication doctrine into question except to note the dicta from one court, not in this district. Without deciding the issue, this court adopts the group publication theory-to the extent that any inferences mentioned above may seem to rely on that theory-for purposes of this opinion only.

5. Control Persons

***16** Finally, Defendants assert that the Early Class fails to establish that either Notari or Osborne are individually liable as control persons under Section 20(a) of the Exchange Act. To plead control person liability, Plaintiffs must adequately allege that each "control person" participated in or exercised control over SSA in general and that he possessed the "power or ability to control [the specific] transactions upon which the primary violation was predicated," whether or not that power was exercised. *See Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 881 (7th Cir.1992). That a person acted in good faith and did not directly or indirectly induce the act or acts constituting the alleged violation is an affirmative defense to control person liability. *Id.* Failure to supervise or exercise due diligence precludes a good faith defense. *Id.*

In support of their argument that Plaintiffs fail to establish Notari and Osborne as control person, Defendants cite language from a Ninth Circuit opinion (misidentified as a Seventh Circuit opinion) that "a director, officer, or even the president of a corporation often has superior knowledge and information, but neither the knowledge nor the information invariably attaches to these positions ."*See Rosenbloom v. Adams, Scott & Conway, Inc.,* 552 F.2d 1336, 1339 (9th Cir.1977). While this statement is true, Defendants failed to note that *Rosenbloom* dealt with whether the plaintiff, a board member of the defendant company, was a corporate insider precluded from making a 10(b) claim against the corporation. The plaintiff board member submitted an affidavit to the effect that as a board member he was merely a figurehead in the company. *Id.* In the affidavit, he declared that he exercised no control over the operation of company's business practices, and that the company's board of directors, of which he was a member, had not met for several years.*Id.* Rather than making a conclusive determination on the adequacy of the pleadings alleging control person liability, the Ninth Circuit merely held that given the affidavit, there was a genuine issue of fact concerning the plaintiff's access to information. The court further noted that plaintiff bore a formidable burden of proving that, in spite of his status as a corporate insider, he nevertheless had no access to the information in dispute. *Id.*

Plaintiffs allege that at all relevant times Osborne was the President and COO of SSA, and that Notari became Vice President of the SSA's North American Division in October 1994. (Compl.¶¶ 21, 22.) Unlike the other individual Defendants, neither Osborne nor Notari signed or filed any of the relevant forms with the SEC nor made any public statements regarding SSA's financial status. The allegation that Osborne was President and COO of the company nevertheless suggests that he had some power to control SSA's revenue recognition procedures and its press statements or annual reports. The Complaint need not establish whether he exercised that power. Whether Notari's role as Vice President of SSA North America supports the same conclusion is less certain. The role of a Vice President, as compared to a President or COO, varies widely among

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.

companies. Some companies, for example, have only one Vice President while others confer numerous individuals with the rank, a rank that may not carry substantial control or responsibility. Defendants offer no assistance in delineating either Osborne or Notari's duties at SSA. Therefore, construing all facts in favor of the Plaintiff, the court concludes that the allegation naming Notari as Vice President sufficiently alleges that he was a controlling person at SSA. This conclusion is buttressed by the fact that at least the O-I Contract was presumably a North American venture.

***17** Finally, the court notes that a motion for summary judgment on the fraud allegations may yield a conclusion different from that reached here today. Although the parties failed to cite the case, the court acknowledges that the court in *Advanta* affirmed the dismissal of the complaint in that case on the grounds that "allegations that a securities-fraud defendant, because of his position within the company, 'must have known' a statement was false or misleading" are inadequate under the heightened pleading standards adopted by PSLRA. *See In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 539 (3rd 1999).*Advanta* is distinguishable on the facts; here Plaintiffs *do* allege that at least some managers at SSA received notice from the Auditor about the adverse affects of the company's revenue reporting methods. On a motion for summary judgment, however, discovery should indicate which of the individual SSA officers and managers, if any, had actual knowledge of the problems with reporting revenue. The court invites the parties to pursue such a motion.

## CONCLUSION

For the reasons stated above, Defendants' motion for summary judgment on *res judicata* grounds is denied in part and granted in part, and Defendants' motion to dismiss (Doc. No. 96-1) for failure to state a claim is denied (Doc. No. 96-1). The court expects Plaintiffs to move promptly for class certification.

N.D.Ill.,2000.
In re System Software Associates, Inc.
Not Reported in F.Supp.2d, 2000 WL 283099 (N.D.Ill.), Fed. Sec. L. Rep. P 90,910

END OF DOCUMENT

© 2009 Thomson Reuters/West. No Claim to Orig. US Gov. Works.