IN THE UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

LAWRENCE E. JAFFE PENSION PLAN, ON BEHALF OF ITSELF AND ALL OTHERS SIMILARLY SITUATED,	Lead Case No. 02-C-5893 (Consolidated)
Plaintiff,	
- against -	Judge Ronald A. Guzman Magistrate Judge Nan R. Nolan
HOUSEHOLD INTERNATIONAL, INC., ET AL.,	
Defendants.	

APPENDIX OF UNREPORTED CASES

APPENDIX OF UNREPORTED AUTHORITIES

1. *Feldman v. Motorola,* No. 90 C 5887, 1993 WL 497228 (N.D. Ill. Oct. 14, 1993), adopted by, 1994 WL 160117 (N.D. Ill. Jan 31, 1994)

2. *In re Comidisco Sec. Litig.*, No. 01 C 2110, 2003 U.S. Dist. LEXIS 5047 (N.D. Ill. Apr. 1, 2003)

3. *In re Crossroads Systems, Inc. Sec. Litig.*, No. A-00-CA-457 JN, 2002 U.S. Dist. LEXIS 26716 (W.D. Tex. Nov. 22, 2002), vacated in part on other grounds sub nom. *Greenberg* v. *Crossroads Systems, Inc.*, 364 F.3d 657 (5th Cir. 2004)

4. *D.E. & J Limited Partnership* v. *Conaway*, No. 03-2334, 03-2417, 2005 WL 1386448 (6th Cir. June 10, 2005)

5. *Donnelli* v. *Peters Securities Co.*, No. 02 C 0691, 2002 WL 2003217 (N.D. Ill. Aug. 29, 2002)

6. *Hoopla Sports and Entertainment, Inc.* v. *Nike, Inc.*, No. 96 C 1642, 1998 WL 60776 (N.D. Ill. Feb. 5, 1998), *aff'd*, 175 F. 3d 1020, 1999 WL 130685 (7th Cir. Mar. 3, 1999) (unpublished opinion)

7. *In re Initial Public Offering Securities Litigation*, 2005 WL 1162445, No. MDL 1554 (SAS), 21 MC 92, 04 Civ. 3757 (S.D.N.Y. May 6, 2005)

8. *Jaffe* v. *Household*, No. 02 C 5893 (N.D. Ill. Mar. 19, 2004)

9. *Miller* v. *Apropos Tech., Inc.*, No. 01 C 8406, 2003 U.S. Dist. LEXIS 5074 (N.D. Ill. Mar. 31, 2003)

10. *Muhammad* v. *Village of Bolingbrook*, No. 02 C 3770, 2004 WL 1557958 (N.D. Ill. July 8, 2004)

11. *In re Salomon Analyst Litig.*, No. 02 Civ. 6801 (GEL), 02 Civ. 6919 (GEL), 02 Civ. 8114 (GEL), 02 Civ. 8156 (GEL), 2005 WL 550847 (S.D.N.Y. Mar. 8, 2005)

12. *Tatz* v. *Nanophase Tech. Corp.*, No. 01 C 8440, 2003 U.S. Dist. LEXIS 9982 (N.D. Ill. June 13, 2003)

13. *In re Westell Tech., Inc., Sec. Litig.*, No. 00 C 6735, 2001 U.S. Dist. LEXIS 17867 (N.D. Ill. Oct. 30, 2001)

TAB 1

United States District Court, N.D. Illinois.
FELDMAN, et al.
v.
Motorola, Inc., et al.
Civ. A. No. 90 C 5887.

Oct. 14, 1993.

To The Honorable Charles R. Norgle, Sr., one of the Judges of the United States District Court for the Northern District of Illinois.

GOTTSCHALL, United States Magistrate Judge.

REPORT AND RECOMMENDATION

*1 Two matters are presently pending in the referral of this case to this court. This report addresses each motion in turn.

MOTION FOR CLASS CERTIFICATION

Plaintiffs move under Fed.R.Civ.P. ("Rule") 23(b)(3) for certification of the two claims of securities fraud asserted in their second consolidated amended complaint ("complaint").

In Count I, plaintiffs bring claims under Section 10(b) of the Securities Exchange Act ("the Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5. The class is defined as including all persons who purchased the common stock of Motorola, Inc. ("Motorola" or "the Company") during the period extending from May 4, 1990 through January 16, 1991 ("the Class Period"). [FN1]

To prove liability for securities fraud, plaintiffs rely on the fraud on the market theory articulated in *Basic, Inc. v. Levinson,* 485 U.S. 224 (1988), pursuant to which theory the market price of a security is determined by publicly available information concerning the company and its business. *See, e.g., Roots Partnership v. Lands' End, Inc.,* 965 F.2d 1411, 1416 n. 4 (7th Cir.1992) (quoting *Basic,* 485 U.S. at 241-242). Because most publicly available information is reflected in market price, an investor is presumed to have relied on material misrepresentations concerning the Company and its financial status. *In re Bally Mfg. Corp. Sec. Litig.,* 141 F.R.D. 262, 269 (N.D.Ill.1992). The liability of the individual defendants under Count I is premised on their status as "controlling persons" of Motorola under Act § 20, 15 U.S.C. § 78t(a). Alternatively, plaintiffs contend that the individual defendants directly participated in or aided and abetted Motorola's acts of securities fraud.

In Count II, a subclass of plaintiffs asserts claims of insider trading under 15 U.S.C. § 78t-1(a) against individual defendants Robert W. Galvin, John F. Mitchell, and Morton L. Topfer (collectively "the insider-trading defendants"). The subclass is defined as including all persons who purchased Motorola common stock contemporaneously with sales of Motorola common stock by the insider-trading defendants during the period July 24, 1990 to August 16, 1990. With the exception of the issue of standing, the parties have not separately addressed the requirements of Rule 23 as applied to this insider trading claim. Since the challenge to standing overlaps with defendants' arguments that most of the insider trading claims should be dismissed, this report will return to the question of certification of Count II after it addresses the motion to dismiss.

In determining whether to certify a class under Rule 23(b)(3), a two-step procedure must be followed. First, plaintiffs must establish that the following four requirements of Rule 23(a) are met: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the class representatives are typical of the claims or defenses of the other class members; and (4) the class representatives are able to protect the interests of the class fairly and adequately. *Harriston v. Chicago Tribune Co.,* 992 F.2d 697, 703 (7th Cir.1993); *Spencer v. Central States, Southeast and Southwest Areas Pension Fund,* 778 F.Supp. 985, 989 (N.D.Ill.1991). Besides satisfying all the requirements of Rule 23(a), a plaintiff must establish one of the requirements of Rule 23(b). *Rosario v. Livaditis,* 963 F.2d 1013, 1017 (7th Cir.1992), *cert. denied,* 113 S.Ct. 972 (1993). As part of the analysis on class certification, the court makes no determination as to the merits of the case. *Eisen v. Carlisle and Jacquelin,* 417 U.S. 156, 178 (1979). Plaintiffs bear the burden of proving that each of the requirements for class certification has been met. *General Telephone Co. of Southwest v. Falcon,* 457 U.S. 147, 162 (1982); *Trotter v. Klincar,* 748 F.2d 1177, 1183 (7th Cir.1984). In ruling on the motion, the court accepts as true the allegations made in support of certification. Bally Mfg. Corp. Sec. Litig., 141 F.R.D. 262, 267 (N.D.Ill.1992).

***2** Several elements of the test for class certification are not challenged here, and this court agrees that they are met. First, under Rule 23(a)(1), the court must determine that the plaintiff class is so numerous that joinder is impracticable. This finding may be supported by common sense assumptions. *In re* VMS Sec. Litig., 136 F.R.D. 466, 473 (N.D.Ill.1991). Since more than 44 million shares of Motorola stock were traded on major stock exchanges during the Class Period, and hundreds of thousands of shares were traded during the periods when the insider-trading defendants sold large blocks of their stock, the class and subclass are so numerous that joinder would be impracticable.

The inquiry into adequacy of representation is two-pronged. *Fry v. UAL Corp.*, 136 F.R.D. 626, 634 (N.D.Ill.1991); *Riordan v. Smith Barney*, 113 F.R.D. 60, 64 (N.D.Ill.1986). "First, the named representatives must have a sufficient interest in the outcome to insure vigorous advocacy while having no interest antagonistic to the interest of the class." *Id.* Second, "counsel for plaintiffs must be competent, experienced, and capable of conducting the class action." *Harris v. General Dev. Corp.*, 127 F.R.D. 655, 662 (N.D.Ill.1989). This court readily concludes that the named plaintiffs' claims are coincidental with those of other potential class members, and that they have a sufficient interest in the outcome of this suit. Also, counsel is experienced, competent and capable of representing the class.

Certification under Rule 23(b)(3) entails two sets of findings: (1) that the questions of law or fact common to class members predominate over any question affecting only individual members, and (2) that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. *Riordan*, 113 F.R.D. at 65. Looking to the second requirement under that subsection, this court agrees with those decisions concluding that the class action device is a superior means of litigating claims like those that are raised in this lawsuit. *See, e.g.*, Bally Mfg. Corp. Sec. Litig., 141 F.R.D. 262, 267 (N.D.Ill.1992). Thus, only the requirement of predominance of common issues is potentially problematical. Defendants' challenge to predominance, as well as to commonality and typicality under Rules 23(a)(3) and (a)(4), interrelates with their argument that the Class Period should be limited to the time period between July 25, 1990 and October 9, 1990. Accordingly, these three elements will be discussed after defendants' arguments concerning the class period.

Question of the Appropriate Class Period

The named plaintiffs in this case purchased their stock in Motorola on or after July 26, 1990. However, they seek to represent a class of investors that purchased stock as early as May 4, 1990 and as late as January 16, 1991. The latter date is approximately three months after plaintiffs sued Motorola for securities fraud. Thus, some potential class members would have purchased their shares of Motorola stock after this lawsuit had already commenced.

***3** The Class Period corresponds to the period over which defendants allegedly made a series of misleading statements in order to artificially inflate the price of Motorola common stock. The statements in question all related to Motorola's 1990 earnings and were allegedly made without a reasonable basis for defendants' representations that its earnings would increase over 1989 levels. A number of the public pronouncements also are alleged to have had an immediate impact on the market price of Motorola stock.

First, on July 25, 1990, defendants' statements in a meeting with securities analysts allegedly assured the public that market concerns with lagging profits were unwarranted. Cmplt., ¶ ¶ 43-44. The representations impacted favorably on analysts' views of the Company, and the price of Motorola stock increased $3 1/8 per share the day after the meeting. Cmplt. ¶ ¶ 45-47. All along, though, defendants allegedly knew that increased research and development expenditures would result in declining profit margins. Cmplt., ¶ ¶ 48-49.

The market allegedly first came to suspect that earnings predictions were inflated on September 5, 1990, after Motorola informed analysts of reductions in certain growth estimates and profit predictions. At that point, the market price of Motorola common stock fell sharply. Cmplt. ¶ 51. A month later, on October 9, 1990, "without warning and to the shock of the marketplace," Motorola announced a decline in third quarter earnings. Cmplt., ¶ 54. The announcement of third quarter earnings caused the market price of the Company's stock to decline nearly 12 percent, down $7.00 per share from the closing price on the previous day. Cmplt. ¶ 57. Finally, "Motorola shocked investors once again" when it announced poor fourth quarter 1990 results on

January 16, 1991. Cmplt., ¶ 62. This announcement caused the market price of Motorola stock to decline from a closing price of $49.625 on January 16, 1991 to a closing price of $45.875 on January 17, 1991. Cmplt., ¶ 65. Throughout this period between the announcement of third and fourth quarter results, defendants are alleged to have assured the public that profits would improve. For instance, it is alleged that contemporaneously with the Company's announcement of third quarter earnings, management emphatically predicted a sharp snap back due to reduced research and development spending. Cmplt., ¶ 57.

Initially, this action was brought on behalf of persons purchasing Motorola stock between July 23, 1990 [FN2] and October 8, 1990. Consolidated Amended Complaint, ¶ 16. As defendants see it, a class period commencing July 25, 1990 is a more appropriate one, since it was then that Company officials met with analysts to address their concerns. As already noted, the price of Motorola stock rose after that meeting. Defendants further contend that the announcement of third quarter results, rather than fourth quarter results, should mark the end of the class period, since it is then that the market learned the truth about Motorola's predictions. Indeed, plaintiffs were apparently disabused of any misconception concerning the stock's value at the time of the third quarter announcement, since they sold their shares and sued for fraud.

*4 A number of cases provide some support for defendants' argument that the Class Period should be limited to the time period between Motorola's two announcements. First, numerous decisions have found that a class period ends when curative facts are publicly announced or otherwise effectively disseminated. *See, e.g., Farber v. Public Serv. Co. of New Mexico,* [1990-1991 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,663 at 98,112 (D.N.M.1990); McFarland v. Memorex Corp., 96 F.R.D. 357, 364 (N.D.Cal.1982); Cohen v. Uniroyal, Inc., 77 F.R.D. 685, 688 (E.D.Pa.1977). *See also* Piel v. Nat'l Semiconductor Corp., 86 F.R.D. 357, 369 (E.D.Pa.1980). One of this court's own opinions acknowledges that principle. In a case when a named plaintiff purchased shares of stock *after* a critical announcement of reverses in the business of a corporate issuer, this court commented that the plaintiff was arguably an inappropriate representative of parties who purchased stock before the adverse reports. *Blumenthal v. Pomerantz,* No. 90 C 4080, 1992 U.S.Dist. LEXIS 8461 at *26 (N.D.Ill. June 16, 1992).

In making that comment, this court relied on a decision in which the Seventh Circuit held that loss causation was not established if a plaintiff purchased corporate shares after the company's announcement of actual operating results dispelled any misconceptions created in the minds of investors by its previous predictions of earnings. Roots Partnership v. Lands' End, Inc., 965 F.2d 1411, 1419 (7th Cir.1992). *Roots Partnership* further found the plaintiff had no claim based on post-purchase statements of the issuer because later statements could not have affected the price at which stock was purchased. *Id.* at 1420. although *Roots Partnership* dismissed the case before the plaintiff moved for class certification, the Seventh Circuit commented that the plaintiff would not be a proper representative of persons buying stock in reliance on later statements of the issuer. *See id.* at 1420 n. 6. This court having made note of the Seventh Circuit's comment in *Blumenthal,* 1992 U.S.Dist. LEXIS 8461 at *27, defendants ask it to find that plaintiffs here cannot represent purchasers buying Motorola stock after they sold theirs on or shortly after October 9, 1990.

For a number of reasons, this court would not limit the Class Period as defendants ask. First, *Roots Partnership* did not address the question of class certification. The essence of the holding there was that the plaintiff lacked standing to assert a claim based on any of the corporate issuer's statements. Having no claim whatsoever, the plaintiff could not represent a class that relied on those statements. Second, while the decision concerning the named plaintiff in *Blumenthal* impacted on class certification, the circumstances of that case were unique and no decision was made on class certification. More importantly, both the *Roots Partnership* and *Blumenthal* decisions effectively decided the merits of the claims of named plaintiffs before class certification.

*5 Persuasive authority holds that this kind of preliminary assessment of the merits should be deferred until after the class has been certified. *See, e.g.,* Bally Mfg. Corp. Sec. Litig., 141 F.R.D. 262, 270 (N.D.Ill.1992) [FN3] (citing In re IGI Sec. Litig., 122 F.R.D. 451, 462 (D.N.J.1988)); *Shields v. Smith,* [1992 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,001 at 94,377 (N.D.Cal.1992), Margolis v. Caterpillar, 815 F.Supp. 1150, 1153-1154 (C.D.Ill.1990); In re Lilco Sec. Litig., 111 F.R.D. 663, 668 (E.D.N.Y.1986); In re LTV Sec. Litig., 88 F.R.D. 134, 147 (N.D.Tex.1980). When there are questions of fact as to whether a particular release cured prior misrepresentations, a broader time period may be certified. In re Kirschner Medical Corp. Sec. Litig., 139 F.R.D. 74, 82 (D.Md.1991); Sherin v. Gould, 115 F.R.D. 171, 174-175 (E.D.Pa.1987). *See also Nicholas v. Poughkeepsie Sav. Bank/FSB,* [1990-1991 Transfer Binder] Fed.Sec.L.Rep. (CCH), ¶ 95,736 at 98,495 (S.D.N.Y.1990).

Here it is alleged that defendants' comments of July 25, 1990 served to confirm assurances of improving profits made in earlier statements to the public. Thus, the announcement continued a course of conduct already begun. While the October 9, 1990 announcement caused a severe decline in stock prices, defendants allegedly continued to reassure investors that there would be a turnaround. The alleged scheme, then, continued. Overall, this court concludes that there are fact questions as to the appropriate limits of the class period, and it would therefore not limit the period as defendants propose. Having reached this conclusion, the inquiry returns to the requirements of Rule 23. As discussed below, concerns relating to changes in the mix of information during the Class Period permeate defendants' challenges to plaintiffs' ability to meet the requirements of Rules 23(a)(2) and (a)(3), as well as the predominance requirement under Rule 23(b)(3).

Typicality

The analysis of typicality under Rule 23(a)(3) focuses on whether there is a similarity of legal theory between the claims of the named plaintiffs and those of other class members. A plaintiff's claim is typical if it arises from the same event, practice, or course of conduct that gives rise to the claims of other class members and the claims are based on the same legal theory. *Rosario v. Livaditis,* 963 F.2d 1013, 1018 (7th Cir.1992), *cert. denied,* 113 S.Ct. 972 (1993) (quoting *De La Fuente v. Stokley-Van Camp, Inc.,* 713 F.2d 225, 232 (7th Cir.1983)). Rule 23(a)(3) does not require that all class members suffer the same injury as the named class representative. *Rosario, id.* Rather, the court looks to the defendant's conduct and the plaintiff's legal theory to satisfy the rule. *Id.*

On the other hand, the presence of even an arguable defense peculiar to a named plaintiff or a small subset of a plaintiff class may destroy typicality and bring into question the adequacy of a named plaintiff's representation. *J.H. Cohn and Co. Self-Employment Retirement Trust v. American Appraisal Assoc., Inc.,* 628 F.2d 994, 999 (7th Cir.1980). "The fear is that the named plaintiff will become distracted by the presence of a possible defense applicable only to him so that the representation of the rest of the class will suffer." *Id.* A frequently recurring defense is not "unique," however. *See Goldwater v. Alston and Bird,* 116 F.R.D. 342, 352-353 (S.D.Ill.1987).

*6 Defendants' challenge to typicality is two-pronged. First, they argue that plaintiffs' claims are not typical of those buying Motorola stock beyond the period of their purchases because the mix of information relied on will differ. This argument has been repeatedly rejected in fraud-on-the-market cases since the decision in *Basic.* *See, e.g., Scholes v. Stone, McGuire and Benjamin,* 143 F.R.D. 181, 185 (N.D.Ill.1982); *In re Scott Paper Co. Sec. Litig.,* 142 F.R.D. 611, 615 (E.D.Pa.1992); *Alfus v. Pyramid Technology Corp.,* 764 F.Supp. 598, 606 (N.D.Ill.1991); *see also Walsh v. Chittenden Corp.,* 798 F.Supp. 1043, 1055 (D.Vt.1992). As one decision has commented, were the rule otherwise, there could never be a class action in securities fraud cases because a representative plaintiff would potentially be needed for each day of the class period, since on each day the mix of information available to the public would vary. *Farber v. Public Serv. Co. of New Mexico,* [1990-1991 Transfer Binder] Fed.Sec.L.Rep. (CCH), § 95,663 at 98,112 (D.N.M.1990).

Defendants also argue that plaintiff Saul Pearl ("Pearl") is subject to a unique defense in that he did not rely on the market in deciding to purchase shares of Motorola common stock after October 9, 1990. (This purchase is not alleged in the complaint. *See* Cmplt., ¶ 5(c).) Pearl has testified at deposition that he bought shares after the October 9, 1990 announcement because he felt Motorola stock was undervalued. His strategy was to "average down" his purchases, and he even made a slight profit when he later sold the shares in question.

The fact that a named plaintiff has made a profit on a sale of securities does not preclude his or her participation in a class action for securities fraud. *In re VMS Sec. Litig.,* 136 F.R.D. 466, 481-482 (N.D.Ill.1991). Nor are class representatives required to rely exclusively on the integrity of the market. *In re Bally Mfg. Corp. Sec. Litg.,* 141 F.R.D. 262, 269 (N.D.Ill.1992). *Bally* further opines that to delve into a named plaintiff's investment strategy at this point in a lawsuit would entail an impermissible consideration of the merits. *Id.* Also, different traders may use market information differently, all the while relying on it. *See Moskowitz v. Lopp,* 128 F.R.D. 624, 631 (E.D.Pa.1989). The fact that investors have divergent motivations in purchasing securities should not defeat the fraud-on-the market presumption absent convincing proof that price played *no* part whatsoever in their decisionmaking. *Id. See also Nicholas v. Poughkeepsie Sav. Bank/FSB,* [1990-1991 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,736 at 98,493-98,494 (S.D.N.Y.1990). Because the evidence of record does not establish that Pearl or any other of the named plaintiffs here employed a strategy that did not take into account market factors, none are subject to the kind of unique defense that would preclude a finding of typicality. This court finds that the typicality requirement is satisfied.

Commonality and Predominance of Common Issues Over Individual Questions

***7** Under Rule 23(a)(2), a class may not be certified unless "there are questions of law or fact common to the class." A common nucleus of operative fact is normally sufficient to satisfy this requirement, despite some factual variation among class grievances. *Rosario v. Livaditis,* 963 F.2d 1013, 1017-1018 (7th Cir.1992), *cert. denied,* 113 S.Ct. 972 (1993). In the context of a fraud-on-the-market action, commonality is met when defendants allegedly engaged in a common cause of conduct by making substantially similar misrepresentations and omissions concerning a security. *See VMS,* 136 F.R.D. at 474.

The questions of commonality under Rule 23(a)(2) and predominance of common issues under Rule 23(b)(3) are closely related. *Heastie v. Community Bank of Greater Peoria,* 125 F.R.D. 669, 674 (N.D.Ill.1989); *United Energy Corp. Solar Power Modules Tax Shelter Invest. Sec. Litig.,* 122 F.R.D. 251, 254 (C.D.Cal.1988) (finding of predominance implies that common questions exist). In determining whether common issues predominate over questions affecting only individual members, the court ascertains "the existence of a group which is more bound together by a mutual interest in the settlement of common questions than it is divided by the individual members' interest in matters peculiar to them. *Spicer v. Chicago Bd. Options Exchange,* [1989-1990 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 94,943 at 95,254 (N.D.Ill.1990). The court is not required to mechanically sum up the common and individual issues and predict which will consume more time, a result that would unduly block class actions because only the most complex of common questions would require more litigation time than a series of mini-trials. *Simer v. Rios,* 661 F.2d 655, 672 (7th Cir.1981), *cert. denied,* 456 U.S. 917 (1982). Instead, resolution of the predominance question tends to focus on the form trial would take, with consideration of whether the action would be manageable. *See id.* at 672- 673.

In actions involving a widely held security, the court is not unaware that a potentially very large class size could make the litigation unmanageable. *See Bally,* 141 F.R.D. at 268. However, that risk is better addressed down the road, if necessary, by altering or amending the class. *Id.* To prohibit certification on the basis of such speculation would undermine the utility of the class action device and the policy that Rule 23 is intended to promote. *Trief v. Dun & Bradstreet Corp.,* 144 F.R.D. 193, [1992 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,023 at 94,506 (S.D.N.Y.1992).

Defendants' arguments concerning commonality and predominance tend to reiterate their concern that not all class members were influenced by the same factors in their decisions to purchase stock. Besides noting that changes would have occurred within the Company during the Class Period, defendants argue that significant changes in the American economy during the summer of 1990 would have impacted on investment decisions. Overall, they suggest that the trial would be an amalgam of mini-trials on the essential elements of liability, as people purchasing at different times would have wholly different sets of proof. As plaintiffs correctly note, however, defendants make no allegations of misrepresentations directed at any individual plaintiff. As has been the case throughout this litigation, the only statements on which liability would be premised were directed at the public generally.

***8** This court agrees with the many decisions cited in this opinion which conclude that both the commonality and predominance requirements are met in an action such as this one. It further considers it rather unlikely that this case will degenerate into an uncontrollable series of mini-trials, as this action is based on a rather limited group of statements made by defendants. On the present record, those statements are alleged to have been substantially similar, and made as part of a single scheme. While not unmindful that differences in investment strategy or other defenses might ultimately necessitate subclassing or changes in the class definition, the court believes that a class action will be manageable. Accordingly, it concludes that the elements under Rule 23(a)(2) and (b)(3) have been met. Having found that plaintiffs have satisfied all the requirements for certification under Rule 23(b)(3), the court recommends that their motion for class certification be granted.

MOTION TO DISMISS IN PART THE SECOND CONSOLIDATED AMENDED COMPLAINT

In this motion, defendants seek to eliminate a number of issues from this litigation. Two of the three arguments made on the motion relate to allegations in Count I. If successful, defendants' third argument would result in the dismissal of a number of the insider trading claims in Count II. Since the court considers these arguments on a motion to dismiss, it accepts as true all well-pleaded factual allegations, and construes those allegations in plaintiffs' favor. Roots Partnership v. Lands' End, Inc., 965 F.2d 1411, 1416 (7th Cir.1992). Dismissal of the complaint is proper only if it appears beyond doubt that plaintiffs can prove no set of facts in support of their claim that would entitle them to relief. *Id.* For instance, a claim may be dismissed if the complaint fails to allege an essential element of that claim. *Id.*

Regulation S-K

Plaintiffs allege that Motorola's second quarter reports to the SEC on Form 10-Q failed to disclose that Motorola expected that its expenses would increase more than its revenues, and that certain research and development ("R & D") expenditures would rise dramatically, causing the Company's profit margins and income to decline materially. According to plaintiffs, the failure to disclose these facts "violated Item 303(b) of SEC Regulation S-K, 17 C.F.R. § 229.303(b), which requires, *inter alia,* that a company disclose anticipated changes 'in the relationship between costs and revenues.' " Cmplt. ¶ 42. Similarly, they allege that Motorola's third quarter 1990 Form 10-Q failed to disclose that R & D spending was continuing to increase sharply, with material increases in R & D spending budgeted for the fourth quarter. Again, the Form 10-Q allegedly failed to disclose that profit margins were declining. Plaintiffs allege that the third quarter Form 10-Q "violated Item 303(b) of SEC Regulation S-K by failing to disclose the foregoing trends and changes in the relationship between the Company's costs and revenues." Cmplt. ¶ 60.

*9 Defendants take issue with plaintiffs' characterization of the Company's obligation to make disclosure of forward-looking information in Form 10-Q, and they argue that under existing law the Company had no obligation to disclose internal projections. Plaintiffs for their part counter that the omitted information was the kind of forward-looking information required to be disclosed under SEC rules. Much of the argument concerns whether the information concerned an "existing trend" or an internal prediction of the future.

Although plaintiffs have not sought to imply a cause of action under SEC regulations, defendants ask for a declaration that Motorola had no duty under Regulation S-X to disclose internal projections or budgets. Two of defendants' cases in fact state that there is no duty to disclose internal projections, but they made that finding under the securities statutes and cases interpreting them. *In re Lyondell Petrochemical Sec. Litig.,* 984 F.2d 1050, [1992-1993 Transfer Binder] FED.SEC.L.REP. (CCH) ¶ 97,335 at 95,704 (9th Cir.1993); *In re Verifone Sec. Litig.,* 784 F.Supp. 1471, [1992-1993 Transfer Binder] FED.SEC.L.REP. (CCH) ¶ 97,368 at 95,933 (N.D.Cal.1992). Both decisions consider in passing the question of whether Item 303 of Regulation S-K creates an alternative source of a duty to disclose, but their conclusions are not, in this court's view, particularly helpful to defendants' argument here. *Lyondell* states that SEC regulations do not require disclosure of internal projections, while acknowledging that "known trends of uncertainties" must be disclosed. *Lyondell, supra,* ¶ 97,335 at 95,704-95,705. For its part, *Verifone* states that Regulation S-K "governs the disclosure of known historic trends, but does not provide a basis of liability when a corporation fails to 'disclose' the future." *Verifone, supra,* ¶ 97,368 at 95,933. Given their dispute over the characterization of the information omitted from Motorola's Form 10-Q, each of the parties could argue that *Lyondell* and *Verifone* support its theory of the case. Since this court has not seen the omitted information, it cannot say which side's characterization is the better one.

It has been held that demonstration of a violation of the disclosure requirements of Item 303 does not inevitably lead to the conclusion that such disclosure would be required under Rule 10b-5. *Alfus v. Pyramid Technology Corp.,* 764 F.Supp. 598, 608 (N.D.Cal.1991). Because plaintiffs have only asserted a claim under § 10(b) and Rule 10(b)(5) in this lawsuit, it is unnecessary on this motion to dismiss to determine whether Motorola violated the requirements of Item 303. While failure to comply with disclosure requirements under Regulation S-K may be probative of the presence or absence of intent to defraud in making a public pronouncement, on the present record the court is unable to determine compliance with obligations under SEC regulations. Accordingly, it is recommended that this portion of the motion to dismiss be denied.

Theories of Secondary Liability

***10** All of the individual defendants in this case are officers or directors of Motorola. Among those defendants, George M.C. Fisher is alleged to have made a number of misleading statements concerning the Company's business. In addition, defendants Gary L. Tooker, Donald R. Jones, and Morgan L. Topfer allegedly made misleading statements on that topic at Motorola's July 25, 1990 meeting with securities analysts. Cmplt., ¶ 43. Only Robert W. Galvin and John F. Mitchell, two of the three insider trading defendants, are not alleged to have made statements to the public concerning Motorola. Galvin is a former Chairman of Motorola's Board of Directors, who assumed the position of Chairman of the Board's Executive Committee in January 1990. Cmplt., ¶ 10. Mitchell is Vice-President of the Board of Directors. Cmplt., ¶ 11. Plaintiffs allege that all the individual defendants are "control persons" of the Company. Cmplt., ¶ 13. They further contend "each of the control person defendants is liable as a direct participant in and/or as an aider and abettor of the wrongs complained of herein." Cmplt., ¶ 14.

Defendants move to dismiss all Count I claims against all individual defendants except Fisher. In addition, they argue that the claims of secondary liability against Fisher should be dismissed. Since defendants have not addressed the question of primary liability in their briefs, this court addresses only the questions of secondary liability. Also, because all defendants except Galvin and Mitchell allegedly made statements to analysts at the July 25 meeting, it will be assumed that plaintiffs have sufficiently alleged that Fisher, Tooker, Jones, and Topfer were participants in an act of securities fraud. Having made that threshold determination, the court turns to the questions of secondary liability presented.

Control person liability

To establish control person liability under § 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), the Seventh Circuit requires that a plaintiff "show that the defendant has 'the practical ability to direct the actions of the people who issue or sell the securities.' " *Donohoe v. Consolidated Operating and Production Corp.*, 982 F.2d 1130, 1138 (7th Cir.1992) (quoting *Barker v. Henderson, Franklin, Starnes and Holt*, 797 F.2d 490, 494 (7th Cir.1986)). The ability to control depends not on the qualifications of the control people, but on their authority. *Id.* Control person liability will attach if a control person possessed the power or ability to control the specific transaction or activity on which the primary violation was based, even if that power was not exercised. *Id.* This circuit has explicitly rejected a requirement that the control person actually participate in the transaction. *Donohoe, id.*, at 1138-1139 n. 7 (citing *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 880-881 (7th Cir.1992) *cert. denied*, 113 S.Ct. 2994 (1993).

Plaintiffs' allegations of control person liability are found at ¶ ¶ 14-15 of their complaint. There they allege that the individual defendants, by reason of their positions of control and authority as principal executive officers, controlled the dissemination of information to securities analysts and the investing public. Other than to make these sweeping conclusions, however, plaintiffs allege no facts detailing the individual defendants' place in the flow of corporate information. Without these details, control person liability is premised solely on status within the Company. Although the Seventh Circuit has not enunciated a requirement that facts underlying control person liability be alleged with particularity, district courts employing the since-rejected "culpable participation" test have in the past dismissed claims where allegations of control person status did not explain a control person's role in the alleged fraud. *Koplin v. Labe Federal Sav. and Loan Ass'n.*, 748 F.Supp. 1336, 1341-1342 (N.D.Ill.1990); *Brickman v. Tyco Toys, Inc.*, 731 F.Supp. 101, 106 (S.D.N.Y.1990); *Beck v. Cantor, Fitzgerald and Co., Inc.*, 621 F.Supp. 1547, 1564 (N.D.Ill.1985). Plaintiffs would not have the court require that level of detail here. Instead, they advance conclusory allegations of ability to control disclosures to analysts and the public.

***11** In the case of the four individual defendants alleged to have made statements to analysts, this court concludes that plaintiffs' allegations of control person liability are sufficient. These defendants not only possessed the power or authority to control the dissemination of news to the public--they themselves made statements. However, as to Galvin and Mitchell, there are not allegations, other than their job titles, to support an inference of control over Motorola's statements to the public. Bearing in mind that fraud must be pleaded with particularity and that the liability to be imposed here is vicarious, this court would recommend that the allegations that Galvin and Mitchell were control persons be stricken.

Aiding and abetting liability

Decisions addressing the standard for aiding and abetting liability have most frequently considered claims against third parties, such as a corporation's attorneys and accountants. Aider and abettor liability requires, at a minimum, (1) that the defendants commit a manipulative or deceptive act within the meaning of § 10(b) and Rule 10b-5, and (2) that the act be committed with the same degree of scienter that primary liability requires. *E.g., Robin v. Arthur Young and Co.,* 915 F.2d 1120, 1123 (7th Cir.1990), *cert. denied,* 111 S.Ct. 1317 (1991); *Renovitch v. Kaufman,* 905 F.2d 1040, 1045 (7th Cir.1990). Where the wrong complained of is a failure to disclose the truth, there is an additional requirement. The test in these instances is three-pronged, comprising the following elements: (1) someone committed a primary violation; (2) positive law obliges the abettor to disclose the truth; and (3) the abettor fails to do this, with the same degree of scienter necessary for the primary violation. *E.g., DiLeo v. Ernst and Young,* 901 F.2d 624, 628 (7th Cir.) *cert. denied,* 498 U.S. 941 (1990). The difference, then, is a legal duty to speak. *Robin,* 915 F.2d at 1125. Such a duty does not find its source in securities law, but comes from a fiduciary relation outside securities law. *Id.*

As already noted, defendants Galvin and Mitchell are not alleged to have made any statements to analysts or to the public concerning Motorola. As a consequence, the wrong complained of is a "duty to blow the whistle." Plaintiffs contend that this duty had its source in the individual defendants' status as officers and directors with access to internal financial information, but they have provided no authority establishing that corporate officers have such a duty to speak. Plaintiffs having failed to establish this essential element of their aiding and abetting claim against Galvin and Mitchell, this court would strike these claims. There being no allegations of direct participation in a violation of the securities law, and because the court has already recommended dismissal of the control person claims against these two individuals, it would recommend that the claims against them in Count I of the complaint be dismissed.

***12** Looking to the remaining individual defendants, plaintiffs' claims of aiding and abetting liability would similarly have to be dismissed if the offense is construed as a failure to disclose. Nonetheless, albeit somewhat redundantly, one can infer that they aided one another in the affirmative action of making statements to analysts and the public. Assuming, then, that the problem of duty is overcome, there remains the question of scienter. Scienter must be pleaded with particularity, although it can be inferred when the fraud or cover-up was in the interest of the defendants. *Robin,* 915 F.2d at 1127-1128. For instance, scienter can be inferred from the selling of large quantities of stock during a class period. *In re Abbott Lab. Sec. Litig.,* 813 F.Supp. 1315, 1320 (N.D.Ill.1992).

In their allegations concerning Motorola's disclosures, plaintiffs consistently allege that statements were made without a reasonable basis or in reckless disregard for the truth. Plaintiffs also allege that individual defendants received large sums of money as compensation from the Company and that they traded in Motorola stock at a profit. Overall, this court considers scienter to have been sufficiently alleged. While the claims of aiding and abetting are arguably redundant of plaintiffs' claims of primary liability, this court would not dismiss the aiding and abetting claims against Fisher, Tooker, Jones and Topfer.

Insider Trading

Count II is brought under § 20A of the Securities Exchange Act, 15 U.S.C. § 78t-1, which contains the following provision for a right of action based on contemporaneous trading:

> Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information shall be liable in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

15 U.S.C. ¶ 78t-1(a). The total amount of liability for any such violation "shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation." 15 U.S.C. ¶ 78t-1(b).

The duty imposed on a person possessing material nonpublic information is to either disclose the information or abstain from trading in the securities concerned while the inside information remains undisclosed. *Wilson v. Comtech Telecommunications Corp.,* 648 F.2d 88, 94 (2d Cir.1981). The duty is owed only to those trading contemporaneously with the insider, however. *Id.* Non-contemporaneous traders do not require the protection of the "disclose or abstain" rule, since they do not suffer disadvantage of trading with someone who has superior access to information. *Id.* at 94-95. Contemporaneous trading is a required element of an insider trading claim in order to substitute for the privity requirement of common law. Since there is no practical method of matching purchases and sales in the open market, to require privity in the common law sense as an element of the cause of action would create an insurmountable obstacle to a plaintiff. *Fridrich v. Bradford,* 542 F.2d 307, 325 (6th Cir.1976) (Celebrezze, J., concurring), *cert. denied,* 429 U.S. 1053 (1977).

***13** Decisions on the question of contemporaneity recognize that liability does not extend beyond the period of contemporaneous trading; otherwise, it could go on indefinitely if the material nonpublic information was never disclosed. *See* Wilson, 648 F.2d at 94. The duration of the "contemporaneous trading" period is not fixed under the case law, although it is not met if a plaintiff's trading occurred *before* the wrongful insider transaction. *See Alfus v. Pyramid Technology Corp.,* 745 F.Supp. 1511, 1522 (N.D.Cal.1990); *Backman v. Polaroid Corp.,* 540 F.Supp. 667, 670 (D.Mass.1982). Generally, the contemporaneity requirement is not met if a plaintiff's trades occurred more than a few days apart from a defendant's transactions. *Alfus, id.* In the context of stock heavily traded on a daily basis, it has been held that trades are not contemporaneous unless they take place on the same day. *Aldus Sec. Litig.,* [1992-1993 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,376 at 95,987 (W.D.Wash.1993). The question of whether a plaintiff has traded contemporaneously with insiders is a significant one in a lawsuit like this, as a plaintiff not meeting the requirement lacks standing to represent putative class members that did trade contemporaneously with insiders. *In re Verifone Sec. Litig.,* 784 F.Supp. 1471, [1992-1993 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,368 at 95,938-95,939 (N.D.Cal.1992); *Aldus, supra,* ¶ 97,376 at 95,987; *Alfus,* 745 F.Supp. at 1523.

The insider trading defendants are Robert Galvin, John F. Mitchell, and Morton L. Topfer. Galvin sold Motorola stock on August 7, 1990, Cmplt., ¶ 10; Mitchell sold stock on August 3, 1990, Cmplt. ¶ 11, and Topfer sold stock on the following days in 1990: July 24, July 26, July 27, July 31, August 1, August 3, August 7, and August 16, Cmplt., ¶ 12. Significantly, only plaintiff Harold Sucher traded on one of these days, July 26, 1990. Cmplt., ¶ 5(a). Plaintiffs Saul Pearl and Meyer Feldman traded on days before and after insider trades, having respectively purchased stock on August 2 and August 6, 1990. Cmplt., ¶ 5(c)-(d). However, plaintiff Albert Feldman purchased shares in Motorola over a month after the last insider trade alleged, having bought his shares on September 24, 1990. Cmplt., ¶ 5(f).

Under the above authorities, defendants ask that all the insider trading claims except Sucher's claim against Topfer be dismissed. As support for the use of a same-day contemporaneous trading limitation, they cite authority that trades on the New York Stock Exchange are consummated within a single trading day. Facts concerning the operation of the stock exchange are not alleged in the complaint, however, and plaintiffs have not included in their complaint any allegations concerning volume of trading on the days of the insider trades here. On this motion to dismiss, the court may not consider facts outside the complaint and the exhibits thereto.

***14** Several cases have declined to determine the parameters of a contemporaneous trading period on motions for class certification, concluding that such question is better decided on a more developed record. *In re Genentech Sec. Litig.,* [1990 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,347 at 96,682 (N.D.Cal.1990); *In re Worlds of Wonder Sec. Litig.,* [1989-1990 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 95,004 at 95,631 (N.D.Cal.1990). While this court is not so certain that to do so is inappropriate on a motion for class certification, this question has been raised on a motion to dismiss. Given the lapse of over a month between the last of the insider defendants' trades and September 24, 1990, this court concludes that Albert Feldman cannot establish an insider trading claim. However, this court would not dismiss the claims of Sucher, Pearl, and Meyer Feldman, as all purchased stock in Motorola within one day of an insider trade. Rather, this court would defer any such determination, allowing plaintiffs to present proof of trading volume and market conditions in connection with the certification of Count II.

Certification of Insider Trading Claims

It has been held that a common course of conduct in selling stock at inflated prices based on inside information creates the common question required for certification of an insider trading claim. *Genetech, supra,* ¶ 95,347 at 96,680. Also, common questions of duty to disclose or abstain from trading predominate over individual issues of contemporaneity and damages. *Worlds of Wonder, supra.* ¶ 95,004 at 95,631. While these facts militate in favor of certification, this court cannot at the present make the requisite finding as to numerosity, since relevant information concerning trading on the days at issue has not been presented. *See Genetech, supra,* ¶ 95,347 at 96,680. For that reason, at this point in time, this court recommends only the certification of Count I.

CONCLUSION

For the reasons set forth above, this court recommends that plaintiffs' motion for class certification be granted as to Count I, and that decision be deferred as to Count II. The court further recommends that defendants' motion to dismiss be granted in part and denied in part. The court would grant the motion to dismiss with respect to the claims against Galvin and Mitchell in Count I, and it would dismiss Albert Feldman as a plaintiff in Count II.

Counsel are given ten days from the date hereof to file objections to this Report and Recommendation with the Honorable Charles R. Norgle, Sr. Failure to object waives the right to appeal.

FN1. Defendants and certain others are excluded from both the class bringing Count I, and the subclass bringing Count II. Second Consolidated Amended Complaint ("Cmplt."), ¶ 16.

FN2. July 23, 1990 is the date Motorola filed its second quarter Form 10-Q with the Securities and Exchange Commission ("SEC"). That statement is alleged to have violated Item 303(b) of SEC Regulation S-K, 17 C.F.R. § 229.303(b), in that it did not disclose anticipated changes in the relationship between costs and revenues. Cmplt. ¶ 42.

FN3. The plaintiffs in *Bally* moved unsuccessfully for reconsideration of a different aspect of Judge Aspen's decision. 144 F.R.D. 78 (N.D.Ill.1992). Although that decision was recently upheld on appeal, *see Arazie v. Mullane,* No. 92-3667 (7th Cir. Aug. 17, 1993), the question of an appropriate class period was not addressed on the appeal. Consequently, an opportunity for clarification of the Seventh Circuit's dicta in *Roots Partnership* did not present itself.

1993 WL 497228 (N.D.Ill.), Fed. Sec. L. Rep. P 97,806

END OF DOCUMENT

TAB 2

LEXSEE 2003 U.S. DIST. LEXIS 5047

In re COMDISCO SECURITIES LITIGATION

No. 01 C 2110

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

2003 U.S. Dist. LEXIS 5047

March 31, 2003, Decided
April 1, 2003, Docketed

SUBSEQUENT HISTORY: Later proceeding at In re Comdisco Secs. Litig., 2004 U.S. Dist. LEXIS 7230 (N.D. Ill., Apr. 26, 2004)

PRIOR HISTORY: In re Comdisco Secs. Litig., 166 F. Supp. 2d 1260, 2001 U.S. Dist. LEXIS 15824 (N.D. Ill., 2001)

DISPOSITION: [*1] Defendants Pontikes and Vosicky's motion to dismiss denied.

LexisNexis(R) Headnotes

COUNSEL: For MICHAEL BLITZER, plaintiff: Daniel W Krasner, Wolf, Haldenstein, etal, New York, NY.

For MICHAEL BLITZER, plaintiff: Adam J. Levitt, Wolf, Haldenstein, Adler, Freeman & Herz LLC, Chicago, IL.

For COMDISCO, INC., NICHOLAS K PONTICKES, JOHN J VOSICKY, defendants: Alan Norris Salpeter, Javier H. Rubinstein, Michele Odorizzi, Mayer, Brown, Rowe & Maw, Chicago, IL.

JUDGES: Milton I. Shadur, Senior United States District Judge.

OPINIONBY: Milton I. Shadur

OPINION:

MEMORANDUM OPINION AND ORDER

With Comdisco, Inc. ("Comdisco") having vanished as a potential defendant in consequence of its bankruptcy, n1 counsel for the proposed plaintiff class have tendered an Amended Class Action Complaint for Violations of the Federal Securities Laws ("Complaint") against individual defendants Nicholas Pontikes ("Pontikes") and John Vosicky ("Vosicky"). Pontikes and Vosicky have in turn moved to dismiss the Complaint, and the parties have submitted bulky memoranda (and, on the part of Pontikes and Vosicky, far bulkier exhibits) to address the issues.

> n1 This Court has heretofore sought to be circumspect in not responding (in kind or otherwise) to the ill-considered (and unfortunately ill-mannered) handling by the former Bankruptcy Judge of the sensible and non-intrusive partial modification of the bankruptcy stay that had been sought to permit a test of the potential facial viability of a like complaint against Comdisco (which could of course have been pursued only upon its emergence from bankruptcy) as well as against Pontikes and Vosicky. Despite the regrettable and extensive delay that was caused by the needless rejection of that effort, nothing other than this footnote will be said on the subject.

[*2]

But the answer to the question of the Complaint's legal sustainability in Fed.R.Civ.P. ("Rule") 12(b)(6) terms can be stated far more simply than the volume of the litigants' input would suggest. As briefly summarized in the Introduction to their Reply and Memorandum ("R. Mem."), Pontikes and Vosicky assert (emphasis in original):

> In this case, when the Court looks at everything Comdisco said about Prism n2 during the purported class period, it becomes clear that investors would not have been misled about what Prism had already achieved or what it hoped to achieve in the future.

That contention does not adequately credit, as this Court must for Rule 12(b)(6) purposes, the well-pleaded allegations of the Complaint. n3 Those allegations plainly entitle the class to stay in court as having advanced a viable complaint against Pontikes and Vosicky for violation of the securities laws.

n2 [Footnote by this Court] Prism was the ultimately ill-fated venture whose collapse was a major (but by no means the only) factor in Comdisco's ultimately being brought to its knees.

n3 In lieu of providing its own summary of those allegations, this opinion simply attaches class counsel's accurate summary, as set forth at their Mem. 4-7 directed to the current motion. Because class counsel's Preliminary Statement at their Mem. 1-3 also provides an accurate analysis of the legal effect of those allegations in the current Rule 12(b)(6) context, that Preliminary Statement is attached as well.

[*3]

Indeed, it is worth adding a point that is not sufficiently remarked in the case law in situations where the effect of the material misrepresentations or material omissions, which form the gravamen of the securities law claims, itself provides further confirmation of the sustainability of such claims. In that respect counsel for Pontikes and Vosicky have essentially urged the "total mix" approach first articulated in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449, 48 L. Ed. 2d 757, 96 S. Ct. 2126 (1976) — as R.Mem. 3-4 (emphasis in original) puts it:

> The fraud-on-the-market doctrine assumes that the market will absorb all publicly-available information about the price of a widely-traded stock.

But if that is really so — if the market here (that is, the universe of investors and perspective investors) really processed all of the information about Prism that Comdisco was putting out, both good and bad, in pegging the price of Comdisco stock at all times — it is difficult to understand why the revelation of the news about Comdisco's giving up on the Prism venture should have caused such a major and precipitate drop in the stock price if, as Pontikes [*4] and Vosicky would have it, their earlier and assertedly accurate statements should have prepared the investing public for the reality that "something is rotten in the state of Prism." n4 In an important sense, the Pontikes-Vosicky arguments about the omniscience of the market and market forces really undercut what they now attempt to urge on this Court.

n4 Cf. William Shakespeare, Hamlet act I, sc.4, line 90.

This is not a matter of arguing from results — of post hoc ergo propter hoc. It is rather that the contentions put forth by Pontikes and Vosicky — that Comdisco's representations about Prism, about how well it was doing and would do in the future, were no more than mere puffery readily recognizable as such by the market, and that the purported "safe harbor" hedges operated to prevent investor deception in that respect — really do not withstand analysis.

This Court has examined the parties' arguments with care. Class counsel have provided a powerful memorandum that delivers an effective point-by-point [*5] response to the Pontikes-Vosicky attack. It graphically demonstrates that the Complaint more than suffices to state a claim with the level of particularity required by the securities law.

There is consequently no need to reinvent the wheel here. Simply put, the motion to dismiss is denied, and Pontikes and Vosicky are ordered to file an answer to the Complaint in this Court's chambers (with a copy of course to be delivered to class counsel) on or before April 17, 2003. This action is set for a status hearing at 8:45 a.m. April 21, 2003 to discuss the establishment of a plan to move the case forward to as expeditious a trial as possible.

Milton I. Shadur

Senior United States District Judge

Date: March 31, 2003

PLAINTIFFS' MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS THE AMENDED CLASS ACTION COMPLAINT

[EDITOR'S NOTE: TEXT WITHIN THESE SYMBOLS [O> <O] IS OVERSTRUCK IN THE SOURCE.]

[O>Plaintiffs respectfully submit this memorandum of law in opposition to defendants Nicholas K. Pontikes' and John J. Vosieky's motion to dismiss the Amended Class Action Complaint for Violation of the Federal Securities Laws (the "Complaint"). n1 <O]

n1 Citations to the Complaint are referenced as "P ."

[*6]

I. PRELIMINARY STATEMENT n2

n2 As an initial matter, defendants' assertion that "plaintiffs could have proceeded without delay against the two individual defendants, [but] chose not to do so," *Defendants' Memorandum in Support of Their Motion to Dismiss the Amended Class Action Complaint ("Defs. Mem.")* at 2, is a gross distortion of the record. At the July 17, 2001 status hearing, plaintiffs, in light of Comdisco, Inc.'s ("Comdisco" or the "Company") pending Chapter 11 bankruptcy reorganization proceedings, sought leave to file their Amended Complaint solely against individual defendants Pontikes and Vosicky. This Court denied plaintiffs' request and instructed plaintiffs' counsel to move the bankruptcy court overseeing Comdisco's Chapter 11 bankruptcy reorganization proceedings for a partial modification of the automatic stay, pursuant to 11 U.S.C. § 362, to enable this Court to adjudicate a single set of challenges to the sufficiency of any amended complaint plaintiffs would file against all defendants. Subsequent motion practice in the bankruptcy court with respect to the stay modification issue (which motion was ultimately denied), and arising out of plaintiffs' opposition to Comdisco's bankruptcy counsel's efforts to release plaintiffs' securities fraud claims against defendants Pontikes and Vosicky (which resulted in an agreement that such claims would not be released) ended in mid-2002. Plaintiffs moved this Court for leave to file their Complaint soon thereafter.

[*7]

This case involves a fraud implemented by defendants to deceive purchasers of Comdisco n3 (the "Company") common stock. As set forth in the Complaint, between November 3, 1999 and October 3, 2000, defendants — individually and as controlling persons of Comdisco, n4 as well as other Comdisco officers and directors, repeatedly misrepresented Comdisco's financial condition, business activities, and prospects, particularly with respect to its wholly-owned subsidiary Prism Communications Services ("Prism"). Defendants, individually and as controlling persons of Comdisco, made a series of materially false and misleading statements and omissions about Comdisco's business dealings, intentions, and prospects with respect to Prism, the center of Comdisco's purported recasting of itself as a cutting edge Internet company and a major player in the Internet "revolution." P 2.

n3 By virtue of its bankruptcy filing and by agreement (see footnote 2, above), Comdisco is not named as a defendant in this case and plaintiffs are pursuing their claims only against defendants Pontikes and Vosicky. P 1.

n4 For the reasons set forth below, Comdisco's complete ownership and utter domination and control of Prism during the time period relevant to this litigation render defendants liable for Prism's false and misleading statements and omissions during this time period as well. *See, e.g.*, PP 36, 37, 42-44.

[*8]

Throughout the Class Period, defendants falsely and repeatedly highlighted Prism's purported position as, *inter alia*, a "market leader," P 56, and a "leading integrated communications provider," P 57, and further promoted Comdisco's purported ability to cross-sell Prism's services to its existing customers. Defendants did so with full knowledge that Prism had virtually no market share, was losing the few customers it did have, and that Comdisco's existing customers had no desire to acquire DSL lines from Prism or to subscribe to any of Prism's services and that Comdisco, in fact, was losing existing customers as a result of its efforts to saddle them with unwanted Prism services. PP 3, 48-49, 54, 57-58.

Defendants were highly motivated to overstate Prism's value and operations and to conceal the complete failure of the acquisition. Defendants repeatedly hyped their purported plans to spin Prism off in an initial public offering ("IPO"), despite their awareness throughout the Class Period that Prism was not viable, in an effort to shed Prism before the investing public learned of its shortcomings. PP 3, 4, 55. When they finally announced the inevitable cancellation of the Prism [*9] IPO plans, defendants continued to misrepresent the facts and withheld their plan to shut down Prism until Comdisco was able to close its then-pending offering of $500 million of its notes (the "Note Offering"). PP 4-5, 74-81. On October 3, 2000, having closed the Note Offering and thus having milked the last possible benefits from the Prism hype, defendants revealed Comdisco's plans to shut Prism down, causing an immediate downgrade of Comdisco's bond rating and causing its stock price to slide more than 24% on that day — and more than 77% from its Class Period high. PP 5-6, 85-88.

The Complaint properly pleads, with great detail, that during the Class Period, the defendants knowingly issued materially false and misleading statements and made material omissions as part of a fraudulent scheme to artificially inflate the price of Comdisco's common stock. Notably, in their motion papers, defendants do not deny that any of the alleged misstatements were made nor that they are specifically alleged to be false. Rather, defendants devote the vast majority of their brief attempting to explain the purported true context of each of their misstatements, or asserting that those statements [*10] were immaterial, misconstrued, or mere puffery. Not only do defendants' efforts, at best, raise questions of fact that cannot presently be resolved, but their inability to disclaim any of the alleged misrepresentations speaks volumes. Indeed, defendants' premature factual contentions and unavailing arguments that the Complaint does not sufficiently connect them to the false and misleading statements alleged, cannot sustain their heavy burden on a motion to dismiss, and thus, their motion should be denied.

II. SUMMARY OF THE FACTUAL ALLEGATIONS OF THE COMPLAINT

Comdisco was a leader in the business of leasing computer systems and mainframes. P 27. In January 1999, Comdisco announced that it was moving away from these traditional core businesses to focus on "next-generation technologies," such as the provision of broadband services and equipment. PP 32-33. This repositioning of the company away from the business segments that had brought it success since its inception in 1969 was driven by defendant Nicholas Pontikes, the son of Ken Pontikes, Comdisco's founder. P 31. Nicholas Pontikes, Ken's designated heir, had little exposure to the basic business of the Company. PP 28, 29. [*11] His background was in investment banking and junk bond trading. P 29. As one financial expert put it, he was primarily oriented toward "packaging his company to fit the buzz." P 30 (quoting Professor James Schrager of the Chicago School of Business).

The acquisition of Prism was a key element of Comdisco's transition to a "new age company" P 33. This acquisition cost Comdisco more than $125 million (and, ultimately, more than $478 million, P 86), for which it received nothing more than a start-up telecommunications company with little infrastructure, almost no customers, and virtually no management. P 38. Despite these facts, Comdisco represented Prism as one of its core business divisions, P 32, and set about to convince the investing public that it represented Comdisco's future.

At all times relevant to this action, Comdisco completely controlled Prism. According to a former Prism Director of Operations and Director of Information Technologies, "Comdisco took [Prism] over and ran it the way they wanted." P 44. Indeed, following its acquisition, Prism's operations were overseen by Comdisco employees and did not have independent leadership, including a CEO. P43, 44.

Through [*12] Comdisco's acquisition of this barely established company, defendants sought to hype Comdisco stock, convincing the market that Comdisco was a powerful figure in the new "Internet Age." P39. While praising Prism as offering "a unique opportunity to offer customers the best technology infrastructure solutions," and proclaiming the symbiotic connection between Comdisco's existing customers and the new Prism endeavors, defendants concealed the fact that Comdisco's existing customers were uniformly rejecting Prism's services. PP 40-42, 49. Comdisco made a series of announcements concerning the "expansion" of Prism services into new markets, announcing administrative approvals in various states and cities for the roll-out of its "RED DSL service." PP 50, 55, 63, 64, 71. Defendants, however, failed to disclose that Prism was unable to provide service in these new markets, was not signing up substantial numbers of new customers in its already existing market areas, and could not provide the promised services to the few customers that it did have. P 50. For example, Comdisco publicly represented that, in the New York market, there was overwhelming interest and support for RED," despite the [*13] fact that at the time, Prism had less than 2,000 customers in all of its markets combined. P 54 (quoting February 17, 2000 statement of Dennis Kruse, Prism's chief marketing officer).

Defendants' plan to salvage Comdisco's investment in Prism was, from at least as early as November 1999, the beginning of the Class Period, to spin Prism off, in an IPO. PP 4, 43, 44, 47, 55, 57, 60, 64, 68, 72, 93. In connection with this plan, Comdisco sought to generate public "buzz" about Prism's prospects, benefiting Comdisco in the process, while allowing Comdisco to rid itself of Prism before its non-viability and true outlook became publicly known. *Id.* As is apparent from the behavior alleged in the Complaint, defendants were willing to tell the market whatever it needed to hear to prepare it for such an IPO.

Defendants repeatedly issued press releases and other public statements describing Prism as a "leading telecommunications provider" and "on the forefront" of companies in its field. P 62-63. One press release went so far as to state that Prism "dramatically reduces provisioning time to 5 to 7 days" (despite the fact that their provisioning actually took between 3 and 6 months for each [*14] new account, a reality which cost Prism a significant number of customers, according to a former Prism Senior Field Operations Manager). P 68-69. As a result of this increased promotion Comdisco's stock price continued to rise on a wave of artificial inflation, reaching an all time high, on March 10, 2000, of $57.25 (up from $36.25, where it had closed on February 7, 2000, the day that Comdisco announced its retention of Saatchi & Saatchi, the global advertising firm, to promote Prism). P 61-64. Throughout this period, Comdisco insiders sold substantial portions of their personal Comdisco holdings., *See, e.g.*, PP 61, 66-67, 96. For example, between March 6, 2000 and March 10, 2000, defendant Vosicky alone sold 123,157 shares of his stock, worth more than $5,862,000. P 96.

When they were forced to reveal that their CPO plan could not be realized, defendants still withheld the truth of Prism's condition from the market, instead announcing, on July 26, 2000, that they were determined to look for other "strategic alternatives" for Prism. P 74. Even in disclosing that Comdisco had discarded its plans for a Prism IPO, defendants continued to hide the true condition of Prism's dysfunctional [*15] operations and nearly non-existent customer base from the public, P 76; instead Comdisco claimed to be looking for new strategic alternatives even though defendants knew that Comdisco's only alternative would be to terminate Prism's operations entirely, because Prism had no value as a continuing business entity. P 76.

Defendants' motivation for withholding the truth about Prism was to ensure the continued artificial inflation of Comdisco's stock price, as well as permit Comdisco to complete the Note Offering. P 79. The fraud was necessary to the completion of this offering because, pursuant to the terms of the S-3 Registration Statement upon which the note offering was based, "any material adverse change in, or any material development known to management which is likely to result in a material adverse change in the condition, financial or otherwise, of the Company and its subsidiaries, would prevent the offering from being consummated." P 80. The Note Offering was successfully completed on August 8, 2000. Less than eight weeks later, on October 3, 2000, Comdisco finally revealed the true status of Prism, issuing a press release that it would cease funding of Prism and sell off its [*16] assets, charging them against the Company's fourth quarter financial results. P 85.

Immediately after defendants made this belated disclosure, the three top credit rating agencies lowered Comdisco's debt rating. Also in the immediate aftermath, Comdisco's stock price experienced a one day drop in share price of 24% from $17.5625 per share to $13.375 per share. P 88. This lawsuit followed. Within a few months of Comdisco's disclosure concerning Prism, defendant Pontikes resigned as President and CEO of Comdisco stating that "Comdisco needed a more experienced leader." P 89. On July 16, 2001, Comdisco filed for protection under Chapter 11 of the United States Bankruptcy Code. P 89. Its stock is presently without value, down from a high at the apex of Comdisco's fraudulent hype of $57.25 per share. P 88-89.

[EDITOR'S NOTE: TEXT WITHIN THESE SYMBOLS [O> <O] IS OVERSTRUCK IN THE SOURCE.]

[O>**III. ARGUMENT**<O]

[O>A. THE STANDARDS ON A MOTION TO DISMISS<O]

[O>In Considering a motion to dismiss, the court must "take all facts alleged in the complaint, and any inferences that might be reasonably drawn from those factual allegations, in the light most favorable [*17] to the plaintiff[s]." *Szumny v. American Gen. Fin., Inc.*, 246 F.3d 1065, 1067 (7th Cir. 2001)(citing *Autry v. Northwest Premium Servs.*, 144 F.3d 1037, 1039 (7th Cir. 1998)). The claims averred in the complaint may be dismissed under Rule 12(b)(6) "only if it appears '***beyond doubt*** that the plaintiff can prove ***no set of facts*** in support of his [or her] claim which would entitle him [or her] to relief."' *Lindelow v. Hill*, No. 00 C 3727, 2001 U.S. Dist. LEXIS 10301, at *8 (N.D. Ill. July 20, 2001) (J. Holderman) (quoting *Conley v. Gibson*, 355 U.S. 41, 2 L. Ed. 2d 80, 78 S. Ct. 99.<O]

TAB 3

LEXSEE 2002 U.S. DIST. LEXIS 26716

In re CROSSROADS SYSTEMS, INC. SECURITIES LITIGATION; This Document Relates To: ALL ACTIONS

MASTER FILE NO. A-00-CA-457 JN

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TEXAS, AUSTIN DIVISION

2002 U.S. Dist. LEXIS 26716; Fed. Sec. L. Rep. (CCH) P92,272

November 22, 2002, Decided
November 22, 2002, Filed

SUBSEQUENT HISTORY: Affirmed in part and vacated in part by, Remanded by, Sub nomine at Greenberg v. Crossroads Sys., 364 F.3d 657, 2004 U.S. App. LEXIS 7189 (5th Cir. Tex., 2004)

PRIOR HISTORY: [*1] In re Crossroads Sys., Inc., 2001 U.S. Dist. LEXIS 14780 (W.D. Tex., Aug. 15, 2001)

DISPOSITION: Defendants' Motion for Partial Summary Judgment granted. All other pending motions denied as moot..

LexisNexis(R) Headnotes

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For ERIC SCHUESSLER, on behalf of himself and all others similarly situated, consolidated plaintiff: William S. Lerach, James R. Hail, Milberg Weis Bershad Hynes & Lerach LLP, San Diego, CA.

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For REAGAN Y. SAKAI, consolidated defendant: [*8] Howard M. Privette, II, Los Angeles, CA.

JUDGES: JAMES R. NOWLIN, CHIEF UNITED STATES DISTRICT JUDGE.

OPINIONBY: JAMES R. NOWLIN

OPINION:

ORDER

Before the Court are Defendants' Motion for Partial Summary Judgment (Clerk's Doc. No. 84), Plaintiffs' Opposition to Defendants' Motion for Partial Summary Judgment (Clerk's Doc. No. 89), Defendants' Reply Brief in Support of Their Motion for Partial Summary Judgment (Clerk's Doc. No. 90), Plaintiffs' Sur-Reply in Opposition to Defendants' Motion for Partial Summary Judgment (Clerk's Doc. No. 91), and Defendants' Additional Briefing on the Motions for Partial Summary Judgment and Class Certification (Clerk's Doc. No. 96). Upon review of these documents, the entire case file, and the applicable legal authorities, the Court enters the following Order.

According to Defendants' Additional Briefing on the Motions for Partial Summary Judgment and Class Certification, "the sole issue presented in Defendants' Motion for Partial Summary Judgment is whether defendants' alleged misstatements affected the market price of Crossroads stock under the test established by the Fifth Circuit in *Nathenson v. Zonagen*, 267 F.3d 400, 418-19 (5th Cir. 2001) [*9] ." While the *Nathenson* case does not seem to establish a new test, it does clarify some of the issues surrounding the fraud-on-the-market cases from the Basic Inc. v. Levinson, 485 U.S. 224, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988)) and the Fifth Circuit Court of Appeals (*Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988)). The fraud-on-the-market presumption deals with the reliance requirement of actions brought pursuant to § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities Exchange Commission. "Recovery of damages for false or misleading statements under section 10(b) and Rule 10(b)(5) requires, among other things, that the statements have been material and that the plaintiffs have relied on them and as a proximate result suffered damage." *Nathenson*, 267 F.3d at 413. However, reliance can be "rebuttably presumed with respect to publicly disseminated materially misleading statements concerning companies whose shares are traded on a well-developed, efficient market." *Id.* This fraud-on-the-market presumption assumes that "the market price of shares traded on [*10] well-developed markets reflects all publicly available information." *Id.* A natural consequence of this assumption is that the presumption of reliance may be rebutted by "any showing that severs the link between the alleged misrepresentation and . . . the price received or paid by the plaintiff." *Id.* at 414. The showing that Defendants are attempting to make is crystallized by the following edict from *Nathenson*: "It is clear that a fraud-on-the-market theory may not be the basis for recovery in respect to an alleged misrepresentation which does *not* affect the market price of the security in question." *Id.*

Based on the foregoing and absent any "special circumstances," n1 the Court will disallow recovery for alleged misrepresentations that did not affect market price in the way that one would expect in an efficient market. In order to make this determination, the Court must decide how long it takes an efficient market to digest unexpected new information in the form of a new market price. According to Plaintiffs' Consolidated Amended Complaint, "as would be expected where a stock is traded in an efficient market, material information concerning Crossroads' [*11] business and prospects had an immediate effect on the market price of Crossroads stock . . ." Consequently, the Court will employ a two-day window in analyzing the relevant historical closing prices. n2 In using this criteria to examine the historical closing prices n3 of Crossroads stock (incorporated in this Order as Exhibit A), the Court finds that alleged positive misrepresentations made on the following dates cannot serve as the basis of recovery under a fraud-on-the-market theory: 23 February 2000, 27 March 2000, 19 April 2000, 23 May 2000, 24 May 2000, 12 June 2000, 14 June 2000, 27 June 2000, and 13 July 2000. n4 Moreover, the Court finds that the following dates also cannot serve as the basis of recovery under a fraud-on-the-market theory as the gains in the stock price after the alleged misrepresentations on these dates, *if any*, are statistically insignificant: 25 January 2000, 22 February 2000, 6 June 2000, 20 June 2000, and 5 July 2000. n5

n1 *Nathenson* recognized "that in certain special circumstances public statements falsely stating information which is important to the value of a company's stock traded on an efficient market may affect the price of the stock even though the stock's market price does not soon thereafter change." *Nathenson*, 267 F.3d at 419. The *Nathenson* court gives the example of a company making a false statement that the market already expects not affecting the stock price at the time even though the statement is false. *See id.* The Fifth Circuit also makes it clear that these special circumstances must be alleged or at least hinted at. *See id.*

[*12]

n2 This two-day window is consistent with prior deposition testimony of Plaintiffs' expert, Dr. Hakala, and case law from a sister court. First, Dr. Hakala testified in the Northern District of California case of *Howard v. Hui* that "most of the movement in stock price that ultimately occurs as a result of [an] announcement occurs with in the first 5 to 15 minutes in the market and sometimes faster . . . However, [this] does not negate the fact that the market may take up to a day or two days to digest the information . . ." Second, the court in *Krogman v. Sterritt*, 202 F.R.D. 467, 477 n. 14 (N.D. Tex. 2001), explicitly rejects a one-week to ten-day window as being "inconsistent with the concept of market efficiency" and appears to accept a two-day window.

n3 The Court takes judicial notice of the historical closing prices in Exhibit A pursuant to Federal Rule of Evidence 201.

n4 For example, the Consolidated Amended Complaint alleges that the positive representations in S.G. Cowen's 19 April 2000 report on Crossroads "were materially false and misleading." The closing stock price on 18 April 2000, the day before the report was issued, was $71. On the day the report was issued the stock price fell to $68.50. On the second day after the report was issued, 20 April 2000, the share price fell further to $67.31. The same trend of consistent, daily decline can be seen for the other dates listed. And there is no hint or allegation that the share price fell because report from S.G. Cowen was less positive than was expected by the market and therefore already incorporated in the share price in order to come within *Nathenson's* "special circumstances." *See Nathenson*, 267 F.3d at 419.

[*13]

n5 The historical closing data from these dates is presented and analyzed in the Court's Exhibit B which is incorporated into this Order. Exhibit B shows that only one of these dates, 20 June 2000, had a positive two-day change and that positive change was an increase of 1%. The two-day change for the other dates was either negative or unchanged. The Court also examined the change in the share price for different time intervals. This additional analysis did not yield results that point to any of the dates producing statistically significant positive changes in the share price that would correspond to the alleged misrepresentations made on those dates. The numbers in Exhibit B become even more statistically insignificant when one considers the overall volatility of Crossroads's stock price during the class period.

That leaves just one date, 7 February 2000, from Plaintiffs' Consolidated Amended Complaint that shows a statistically significant increase for the two-day window. n6 However, the Consolidated Amended Complaint does not allege that any *new* false and misleading misrepresentations [*14] were made on that day. The Complaint contends that the statements made on 7 February 2000 were false and misleading for the reasons set out in the Complaint at P38. n7 Paragraph 38 in the Complaint sets out the reasons that Plaintiffs feel that the 25 January 2000 announcement of Crossroads's third-generation storage router family was false and misleading. Accordingly, any false and misleading information released on 7 February 2000 was already reflected in the share price following the 25 January 2000 announcement assuming that Crossroads's stock traded in an efficient market as alleged in the Complaint. Therefore, the alleged misrepresentations made on 7 February 2000 cannot be the basis for recovery under a fraud-on-the-market theory.

n6 On 4 February 2000 Crossroads's stock price was $90.25, on 7 February 2000 it was $109.75, and on 8 February 2000 it was $133.75 for a total increase of 48%.

n7 The two events mentioned in the Complaint as occurring on 7 February 2000 are the worldwide reseller agreement with Hitachi Data Systems and an interview with Defendant Smith published in *The Wall Street Transcript*.

[*15]

Finally, the Complaint alleges that the truth about the problems with Crossroads's products came to light beginning with a 27 July 2000 press release and continued with the 24 August 2000 release of Crossroads's third-quarter results. However, the declines following these two disclosures do not establish the requisite link between the earlier misrepresentations and Crossroads's stock price as these declines were also statistically insignificant in light of the decline in the stock prior to 27 July 2000. The two-day decline following the 27 July 2000 release was $8.44 and for the 24 August 2000 release was $3.43. By comparison, the stock price fell $67.31 between the first day of the class period, 25 January 2000, and the day before the 27 July 2000 release. If the decline in the stock price is measured from the historical high during the class period, the decline comes in at $165.37. Compared to either pre-disclosure decline measure, the post-disclosure declines simply are not statistically significant enough to save Plaintiffs' fraud-on-the-market presumption. n8 Moreover, the decline drops to $1.56 per share when viewed from 26 July 2000 to 30 August 2000. A decline of this [*16] nature after the supposedly horrible news about Crossroads had come to light and after the preceding free-fall in the share price is insufficient to show that the alleged misrepresentations affected the share price.

n8 The Third Circuit came to similar conclusion when comparing a 3 1/6-point drop in share price suffered by the plaintiff to the 10-point drop that occurred prior to the plaintiff purchasing the stock. *See Ieradi v. Mylan Laboratories, Inc.*, 230 F.3d 594, 600 (3rd Cir. 2000) (noting that the 10-point drop was in excess of 300% of the 3 1/6-point drop). When viewed in this light, the $67.31 drop is 798% greater than the $8.44 drop and is 1962% greater than the $3.43 drop. If measured against the drop from the historical high, the numbers change to 1959% and 4821%, respectively. And while it is of little practical significance for this case, it should be noted that the Third Circuit and the Fifth Circuit agree that in cases pleading the fraud-on-the-market theory that the misrepresentation must have affected the stock price; the only difference is that the Fifth Circuit relates this requirement to reliance while the Third Circuit relates it to materiality. *See Nathenson*, 267 F.3d at 415.

[*17]

IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED that Defendants' Motion for Partial Summary Judgment is hereby GRANTED.

IT IS FURTHER ORDERED that Plaintiffs are not entitled to the fraud-on-the-market presumption of reliance.

IT IS FURTHER ORDERED that all other pending Motions are hereby DENIED AS MOOT.

SIGNED AND ENTERED this 22ND day of November, 2002.

JAMES R. NOWLIN

CHIEF UNITED STATES DISTRICT JUDGE

Exhibit A — In re CROSSROADS SYSTEMS, INC. SECURITIES LITIGATION — MASTER FILE NO. A-00-CA-457 JN

Historical Closing Prices for Crossroads Stock

Date	Close	Date	Close	Date	Close
3-Jan-00	79.62	24-Mar-00	123.38	14-Jun-00	43.50
4-Jan-00	69.00	27-Mar-00	123.25	15-Jun-00	40.19
5-Jan-00	68.75	28-Mar-00	120.50	16-Jun-00	38.75
7-Jan-00	68.12	29-Mar-00	114.75	19-Jun-00	26.25
10-Jan-00	69.00	30-Mar-00	105.00	20-Jun-00	23.12

Historical Closing Prices for Crossroads Stock

Date	Close	Date	Close	Date	Close
11-Jan-00	69.62	31-Mar-00	103.25	21-Jun-00	26.50
12-Jan-00	75.00	3-Apr-00	92.88	22-Jun-00	29.94
13-Jan-00	72.50	4-Apr-00	88.00	23-Jun-00	27.94
14-Jan-00	74.12	5-Apr-00	88.75	26-Jun-00	28.25
18-Jan-00	77.25	6-Apr-00	90.75	27-Jun-00	26.19
19-Jan-00	76.00	7-Apr-00	93.62	28-Jun-00	25.38
20-Jan-00	75.25	10-Apr-00	94.50	29-Jun-00	24.38
21-Jan-00	79.00	11-Apr-00	92.12	30-Jun-00	25.25
24-Jan-00	79.00	12-Apr-00	81.50	3-Jul-00	24.50
25-Jan-00	80.75	13-Apr-00	78.75	5-Jul-00	23.00
26-Jan-00	79.00	14-Apr-00	52.00	6-Jul-00	23.12
27-Jan-00	81.44	17-Apr-00	53.88	7-Jul-00	22.81
28-Jan-00	80.12	18-Apr-00	71.00	10-Jul-00	22.50
31-Jan-00	72.75	19-Apr-00	68.50	11-Jul-00	21.69
1-Feb-00	76.12	20-Apr-00	67.31	12-Jul-00	19.44
2-Feb-00	79.25	24-Apr-00	65.19	13-Jul-00	17.50
3-Feb-00	88.88	25-Apr-00	67.75	14-Jul-00	17.25
4-Feb-00	90.25	26-Apr-00	85.00	17-Jul-00	18.75
7-Feb-00	109.75	27-Apr-00	67.00	18-Jul-00	18.19
8-Feb-00	133.76	28-Apr-00	70.62	19-Jul-00	16.88
9-Feb-00	163.25	1-May-00	71.75	20-Jul-00	17.12
10-Feb-00	163.00	2-May-00	66.00	21-Jul-00	16.25
11-Feb-00	175.25	3-May-00	68.81	24-Jul-00	15.00
14-Feb-00	155.12	4-May-00	68.00	25-Jul-00	14.75
15-Feb-00	154.00	5-May-00	72.50	26-Jul-00	13.44
16-Feb-00	156.00	8-May-00	68.25	27-Jul-00	6.38
17-Feb-00	163.50	9-May-00	63.00	28-Jul-00	5.00
18-Feb-00	178.38	10-May-00	64.12	31-Jul-00	4.56
22-Feb-00	178.81	11-May-00	65.38	1-Aug-00	6.69
23-Feb-00	184.50	12-May-00	64.38	2-Aug-00	5.75
24-Feb-00	153.50	15-May-00	60.88	3-Aug-00	6.38
25-Feb-00	137.00	16-May-00	67.00	4-Aug-00	8.25
28-Feb-00	141.00	17-May-00	66.00	7-Aug-00	10.88
29-Feb-00	142.75	18-May-00	60.50	8-Aug-00	8.62
1-Mar-00	155.00	19-May-00	62.12	9-Aug-00	8.50
2-Mar-00	151.50	22-May-00	59.88	10-Aug-00	7.50
3-Mar-00	154.50	23-May-00	50.88	11-Aug-00	8.31
6-Mar-00	154.75	24-May-00	43.00	14-Aug-00	7.81
7-Mar-00	149.00	25-May-00	42.00	15-Aug-00	7.38
8-Mar-00	150.12	26-May-00	34.12	16-Aug-00	7.91
9-Mar-00	149.00	30-May-00	37.25	17-Aug-00	8.00
10-Mar-00	148.12	31-May-00	39.88	18-Aug-00	7.59
13-Mar-00	136.25	1-Jun-00	38.44	21-Aug-00	7.44
14-Mar-00	135.50	2-Jun-00	47.75	22-Aug-00	10.50
15-Mar-00	118.00	5-Jun-00	56.56	23-Aug-00	12.62
16-Mar-00	117.00	6-Jun-00	50.50	24-Aug-00	10.94
17-Mar-00	122.38	7-Jun-00	51.12	25-Aug-00	9.19
20-Mar-00	117.00	8-Jun-00	52.50	28-Aug-00	9.00
21-Mar-00	108.38	9-Jun-00	52.25	29-Aug-00	11.88
22-Mar-00	120.50	12-Jun-00	50.00	30-Aug-00	11.88

Historical Closing Prices for Crossroads Stock

Date	Close	Date	Close	Date	Close
23-Mar-00	123.00	13-Jun-00	46.50		

[*18]

Exhibit B — In re CROSSROADS SYSTEMS, INC. SECURITIES LITIGATION — MASTER FILE NO. A-00-CA-457 JN

Date	Prior Day's Close	Day Of Close	Day After's Close	Two-Day Change	% of Prior Day's Close
25-Jan-00	$ 79.00	$ 80.75	$ 79.00	$ -	0%
22-Feb-00	$ 178.38	$ 178.81	$ 164.50	$ (13.88)	-8%
6-Jun-00	$ 56.56	$ 50.50	$ 51.12	$ (5.44)	-10%
20-Jun-00	$ 26.25	$ 23.12	$ 26.50	$ 0.25	1%
5-Jul-00	$ 24.50	$ 23.00	$ 23.12	$ (1.38)	-6%

Date	Day-Of Change	% of Prior Day's Close	Day-After Change	% of Day Of's Close
25-Jan-00	$ 1.75	2%	$ (1.75)	-2%
22-Feb-00	$ 0.43	0%	$ (14.31)	-8%
6-Jan-00	$ (6.06)	-11%	$ 0.62	1%
20-Jun-00	$ (3.13)	-12%	$ 3.38	15%
5-Jul-00	$ (1.50)	-6%	$ 0.12	1%

TAB 4

H

Only the Westlaw citation is currently available.

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

NOT RECOMMENDED FOR FULL--TEXT PUBLICATION

Sixth Circuit Rule 28(g) limits citation to specific situations. Please see Rule 28(g) before citing in a proceeding in a court in the Sixth Circuit. If cited, a copy must be served on other parties and the Court.

Please use FIND to look at the applicable circuit court rule before citing this opinion. Sixth Circuit Rule 28(g). (FIND CTA6 Rule 28.)

United States Court of Appeals, Sixth Circuit.
D.E. & J. LIMITED PARTNERSHIP, Individually, and on behalf of All Others Similarly Situated, Plaintiffs-Appellants,
v.
Charles CONAWAY, Jeffrey Boyer, Mark S. Schwartz, Matthew F. Hilzinger, Martin E. Welch and PricewaterhouseCoopers LLP, Defendants-Appellees.
Nos. 03-2334, 03-2417.

June 10, 2005.

On Appeal from the United States District Court for the Eastern District of Michigan.

Sanford P. Dumain, Milberg Weiss Bershad & Schulman LLP, New York, NY, for Plaintiff-Appellee.

Marc L. Newman, Miller Shea, Rochester, MI, Scott R. Lassar, Hille R. Sheppard, Erin E. Kelly, Walter C. Carlson, Sidley, Austin, Brown & Wood, David H. Kistenbroker, Pamela G. Smith, Carl E. Volz, Katten, Muchin & Zavis, Emily Nicklin, John F. Hartmann, James J. Boland, Paul J. Ferak, Kirkland & Ellis, Chicago, IL, Martin L. Perschetz, Matthew L. Craner, Schulte Roth & Zabel, Brian Rosner, Tiffany E. Cale, Natalie A. Napierala, Heather J. Haase, Rosner Moscow & Napierala, New York, NY, Jonathan T. Walton, Jr., Walton & Donnelly, Dennis J. Levasseur, Bodman, Longley & Dahling, Detroit, MI, Thomas J. Tallerico, Bodman, Longley & Dahling, Troy, MI, for Defendants-Appellees.

Before KENNEDY, DAUGHTREY, and SUTTON , Circuit Judges.

SUTTON, Circuit Judge.

***1** On January 22, 2002, Kmart Corporation, one of the most familiar brands in discount retailing and one of the largest--operating through approximately 1,900 stores with approximately 234,000 employees--filed for bankruptcy. Kmart's bankruptcy announcement was followed by a predictable drop in its stock price, by the restatement of some of its interim financial reports and by this securities fraud lawsuit.

On February 21, 2002, D.E. & J. Limited Partnership filed this lawsuit on behalf of a class of Kmart stockholders who purchased their stock from March 13, 2001, to May 15, 2002, against several of Kmart's senior executives and its auditor, PricewaterhouseCoopers (PwC). The district court dismissed D.E. & J.'s complaint with prejudice for failing to meet the pleading standards of the Private Securities Litigation Reform Act (PSLRA). As the plaintiffs have failed adequately to plead "loss causation" under 15 U.S.C. § 78u-4(b)(4) and *Dura Pharmaceuticals, Inc. v. Broudo,* --- U.S. ----, 125 S.Ct. 1627, --- L.Ed.2d ---- (2005), we affirm.

I.

Kmart is a Delaware Corporation. Its principal place of business is Troy, Michigan, where it was first incorporated as the successor to the business developed by its founder, S.S. Kresge.

In May of 2000, Kmart hired Charles Conaway and gave him a mandate to revitalize the discount-retail chain. During his tenure as Kmart's Chairman and Chief Executive Officer from May 2000 until his resignation in March of 2002, Conaway replaced much of Kmart's existing management. Two of the individual defendants in this case were among the officers that Conaway hired or promoted during this period: Mark Schwartz, who was Kmart's President and Chief Operating Officer from March 14, 2001, until November 9, 2001; and Jeffrey Boyer, who was Kmart's Chief Financial Officer from May 4, 2001, until November 9, 2001. The other two named individual defendants were among those officers whom Conaway replaced at the very beginning of the class period: Matthew Hilzinger, who was Kmart's Vice President and Controller until July 2001; and Martin Welch, who was Kmart's Executive Vice President and Chief Financial Officer until May of 2001.

In order to compete more effectively with Kmart's two principal rivals, Wal-Mart Stores and Target Corporation, Conaway implemented several projects intended to strengthen Kmart's inventory controls, customer service and price competitiveness. These initiatives achieved initial success, with Kmart reporting improved sales and gross margins and an improving inventory situation. The price of Kmart stock, as a result, rose from $9.19 per share on March 13, 2001, to $13.16 per share on August 7, 2001, an increase of 43% at a time when the stock market was generally stagnant or declining.

Kmart's brief financial success during this period, D.E. & J. alleges, was the result of accounting fraud. According to D.E. & J., senior executives at Kmart represented that Kmart was experiencing a financial turnaround while concealing the extent of Kmart's financial difficulties in several ways. First, Kmart allegedly tried to mask losses by using interim financial statements that reported rebates that it hoped to earn from its vendors at the end of the year. By reporting vendor rebates as a reduction of expenses in interim statements and by basing its interim statements on aggressive forecasts, Kmart ran the risk that it would not ultimately obtain all of the rebates and that its interim statements would reflect unrealistically high projections of future sales. Second, Kmart's outdated internal control system failed to track and monitor inventory effectively, (1) reporting an item as "in-stock" even if the company had only one piece of inventory, (2) causing stores to accumulate obsolete merchandise and (3) ultimately misstating inventory ledgers. Third, Kmart's aggressive efforts to obtain discounts and other benefits from its vendors damaged the company's long-term relationships with its vendors. Fourth, Kmart's expansion of its "Bluelight Special" discount program to a "Bluelight Always" program failed, because the company's competitors responded by cutting their prices as well. JA 0140.

***2** By late 2001, whether as a result of fraud or not, it was clear that Conaway's initiatives were not succeeding. In October of 2001, the company disclosed that its sales had been flat during September, and in November and December the company disclosed a decline in sales.

On January 22, 2002, Kmart filed for bankruptcy. In a press release, the company attributed its bankruptcy filing to a "combination of factors, including a rapid decline in its liquidity resulting from Kmart's below-plan sales and earnings performance in the fourth quarter." JA 0155. The price of Kmart's stock subsequently dropped from $1.74 to $0.70 per share.

On January 25, 2002, Kmart disclosed that it had received an anonymous "whistleblower" letter expressing serious concerns about the Company's accounting methods and financial results. The anonymous author of the letter stated that he or she had "kept copies of transactions [he or she] consider[ed] to be inaccurate" and "recorded conversations during which distortions and misstatement[s] of records were discussed." JA 0128. The letter directly implicated Schwartz and PwC. *See* JA 0128 (reporting that Schwartz told a "superior to not be surprised if Kmart shares were trading at four or five dollars per share by the end of the year"); *id.* ("Resident auditors from PricewaterhouseCoopers are hesitant to pursue these issues or even question obvious changes in revenue and expense patterns."). Kmart announced that it would conduct an internal investigation to look into the allegations. Three similar letters followed.

On February 21, 2002, D.E. & J. brought this securities fraud lawsuit on behalf of purchasers of Kmart securities between May 17, 2001, and January 22, 2002. The lawsuit initially named only Conaway as a defendant.

On May 15, 2002, Kmart, in its Form 10-K disclosure for fiscal year 2001, reported a loss of $2.42 billion for the year. In addition to adjusting for a single vendor transaction in 2001 and moving a $167 million loss contingency from the fourth quarter to the third quarter (matters not at issue here), Kmart announced that, due to the bankruptcy and resulting inability to estimate vendor purchases and associated allowances, it had changed its policy of estimating and recording vendor allowances on an interim basis. It then restated its financial statements to lower its vendor rebates for the first three quarters of fiscal year 2001 (which until then had not been audited) by $311, $211 and $32 million respectively. In the disclosure, Kmart attributed its bankruptcy filing to a "rapid decline in our liquidity resulting from our below-plan sales and earnings performance in the fourth quarter, the evaporation of the surety bond market and erosion of supplier confidence," and stated that "[o]ther factors includ[ing] intense competition in the discount retailing industry, unsuccessful sales and marketing initiatives, the continuing recession, and recent capital market volatility" played a role as well. JA 0205. Following this announcement, Kmart's common stock dropped five cents, from $1.22 to $1.17 per share.

***3** On June 14, 2002, Kmart announced a $1.45 billion loss during the first fiscal quarter of 2002. The company recorded a charge of $758 million to "write-down inventory in 283 stores that were closed in May and June, and inventory transferred from the remaining stores to the closing stores." JA 0158.

On August 15, 2002, D.E. & J. filed an amended complaint naming Boyer, Schwartz, Hilzinger, Welch and PwC as defendants; attaching the whistleblower letters; and expanding the class period to March 13, 2001, through May 15, 2002, five months longer than the period in the original complaint. On November 1, 2002, D.E. & J. filed its "corrected consolidated amended complaint," declaring that its counsel had conducted interviews with "[f]ormer employees of Kmart, who worked at the Company during the relevant time" and "[f]ormer employees of certain vendors of Kmart," both of whom, the complaint claimed, were "knowledgeable with respect to the matters referred to herein." JA 0125-- 26. Any remaining information, the complaint continued, was "within the possession and control of defendants and other Kmart insiders, thus preventing plaintiffs from further detailing defendants' misconduct at this time." JA 0126. The complaint reiterated the expanded class period of March 13, 2001, to May 15, 2002.

On September 19, 2003, the district court dismissed all of the claims with prejudice. In doing so, it determined that D.E. & J. had failed to meet the PSLRA's pleading requirements for scienter and misrepresentation for all defendants except Conaway and Schwartz. The court dismissed the complaint in its entirety, however, because D.E. & J. had failed to plead the necessary element of "loss causation" for any of its allegations. Because D.E. & J. had failed to plead primary violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), by any of the defendants, the district court also found that it had failed to plead that they were "controlling persons" liable under § 20(a) of the Act, 15 U.S.C. § 78t(a). And the district court denied D.E. & J. leave to amend its complaint, first and foremost because, instead of filing a motion for leave to amend, it had merely requested in its brief that "if the Court concludes that any aspect of plaintiffs' claims are inadequately pled ... [the plaintiffs] be granted leave to replead and cure any deficiencies." D. Ct. Op. at 58.

II.

D.E. & J. appeals the dismissal of its § 10(b) claims against all parties save for Boyer, Hilzinger and Welch and appeals the dismissal of its § 20(a) claims against all parties. We review the district court's dismissal of the complaint de novo. *Helwig v. Vencor, Inc.,* 251 F.3d 540, 553 (6th Cir.2001).

A.

Section 10(b) of the Securities Exchange Act of 1934 forbids (1) the "use or employ[ment]" of any "deceptive device," (2) "in connection with the purchase or sale of any security," and (3) "in contravention of" Securities and Exchange Commission "rules and regulations." 15 U.S.C. § 78j(b). Promulgated under this statute by the Securities and Exchange Commission, Rule 10b-5 forbids the making of any "untrue statement of material fact" or the omission of any material fact "necessary in order to make the statements made ... not misleading." 17 C.F.R. § 240.10b-5(b).

***4** On the basis of this statute and this rule, individuals may bring a private damages action resembling the common-law tort actions for deceit and misrepresentation. *See, e.g., Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 730, 744, 95 S.Ct. 1917, 44 L.Ed.2d 539 (1975); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 196, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). With the passage of the PSLRA, however, Congress has imposed additional statutory requirements on this private action, including the heightened pleading requirements that a plaintiff (1) specify "each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading" and (2) allege "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).

Under § 78u-4(b)(4) of the PSLRA, private plaintiffs also must prove that a defendant's securities fraud caused their economic loss. In relevant part, the statute says the following:

Loss causation. In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

15 U.S.C. § 78u-4(b)(4).

Construing this causation provision, *Dura Pharmaceuticals v. Broudo* recently held that a plaintiff could not satisfy it merely by alleging (and later establishing) that the price of the security on the date of the purchase was inflated because of the misrepresentation. 125 S.Ct. at 1631. In *Dura,* the plaintiff represented a class of individuals who bought stock in Dura Pharmaceuticals on the public market between April 15, 1997, and February 24, 1998. *See id.* at 1629. During that period, the plaintiffs alleged, Dura (or its officials) made false statements concerning its profits and the prospects for future approval by the Food and Drug Administration (FDA) of its products. Upon disclosure of the news on February 24, 1998, that its earnings would be lower than previously expected (principally due to slow drug sales), Dura's shares lost almost half of their value, falling from $39 per share to about $21 per share. *See id.* at 1630. In November of 1998, Dura announced that the FDA would not approve its new product, prompting a further drop in its share price. *See id.* The plaintiffs argued that, "[i]n reliance on the integrity of the market, [they] ... paid artificially inflated prices for Dura securities and ... suffered damage[s] thereby." *Id.* (quotations and emphasis omitted).

This type of allegation, the Supreme Court concluded, did not adequately plead loss causation under the PSLRA. Because a purchaser may sell the "shares quickly before the relevant truth begins to leak out," *id.* at 1631, a seller's misrepresentation (and its associated inflated price) does not inevitably lead to a loss, but rather "*might* mean a later loss," *id.* at 1632. Even if the purchaser later resells those shares at a lower price, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." *Id.* "[A]t the moment the transaction takes place," therefore, "the plaintiff has suffered no loss," *id.* at 1631, and the most than can be said "is that the higher purchase price will *sometimes* play a role in bringing about a future loss," *id.* at 1632.

*5 Drawing on this insight and on the observation that securities-fraud actions resemble common-law fraud actions that have long required a showing that an individual suffered actual economic loss, the Court held that private securities-fraud plaintiffs may recover damages only when they "adequately allege and prove the traditional elements of causation and loss." *Id.* at 1633. And although the Federal Rules of Civil Procedure require only "a short and plain statement of the claim showing that the pleader is entitled to relief," *see* Fed.R.Civ.P. 8(a)(2), the mere allegation that the plaintiff class purchased their shares at an artificially inflated price did not serve to place the defendants on "fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Id.* at 1634 (quoting *Conley v. Gibson,* 355 U.S. 41, 47, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957)). The *Dura* complaint (1) failed "to claim that Dura's share price fell significantly after the truth became known," (2) failed to specify "the relevant economic loss," and (3) failed to describe "the causal connection ... between [the] loss and the misrepresentation." *Id.* Without the requirement that a plaintiff "provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind," the Court concluded, the securities laws would become nothing more than "a partial downside insurance policy." *Id.*

D.E. & J.'s complaint here does not differ in any material respect from Broudo's. Like Broudo, D.E. & J. did not plead that the alleged fraud became known to the market on any particular day, did not estimate the damages that the alleged fraud caused, and did not connect the alleged fraud with the ultimate disclosure and loss. Rather, the heart of D.E. & J.'s causation theory looks remarkably like Broudo's allegations in his complaint:

> Plaintiffs and the Class have suffered damages in that, in reliance on the integrity of the market, they *paid artificially inflated prices* for Kmart publicly traded securities. Plaintiffs and the Class would not have purchased Kmart publicly traded securities at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements.
>
> As a direct and proximate result of defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of Kmart publicly traded securities during the class period.

JA 0189--90 (emphasis added). The recitation of D.E. & J.'s belief that the "defendants' wrongful conduct" "direct[ly] and proximate[ly]" caused the plaintiffs' losses does not change matters. For if these allegations would suffice here, the mere inclusion of boilerplate language would suffice everywhere and would defeat the requirement that a plaintiff explain how the loss occurred.

In D.E. & J.'s view, two other facets of this case distinguish it from the pleading failings that doomed the complaint in *Dura.* First, D.E. & J. claims that the complaint's observation that the price of Kmart stock dropped from $1.74 per share to $0.70 per share on January 22, 2002, following the company's disclosure that it had filed for reorganization under Chapter 11, suffices to plead that Kmart caused the investors' losses. *See* JA 0155. And second, D.E. & J. asserts that its observation on appeal that "Kmart's stock did drop more than 4%" on the day that Kmart announced its restatements (May 15, 2002) suffices to meet the statutory requirement. *See* D.E. & J. Br. at 36--37; *id.* at 28 ("[T]he price of Kmart's stock *did decline* after the Company announced its massive restatement.").

***6** Neither of these observations (one in the complaint, the other on appeal) "provide[d] the defendants with notice of what the relevant economic loss might be or of what the causal connection might be between the loss and the misrepresentation." *Dura,* 125 S.Ct. at 1634. As to the bankruptcy filing, D.E. & J. never alleged that Kmart's bankruptcy announcement disclosed any prior misrepresentations to the market. *See* JA 0155 (observing only that "[a]ccording to [Kmart's] press release, the Company's decision to seek 'judicial reorganization' was based on a 'combination of factors, including a rapid decline in its liquidity resulting from Kmart's below-plan sales and earnings performance in the fourth quarter" ' and that "[f]ollowing this announcement, the price of Kmart common stock dropped"). And, of course, the filing of a bankruptcy petition by itself does not a security fraud allegation make. *Cf. Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 175 n. 4 (2d Cir.2005) (explaining that defendant Merrill Lynch's downgrades in its stock recommendations--from "accumulate" to "neutral" and from "buy" to "accumulate"--did "not amount to a corrective disclosure ... because they do not reveal to the market the falsity of the prior recommendations"). Here, D.E. & J. has done nothing more than note that a stock price dropped after a bankruptcy announcement, never alleging that the market's acknowledgment of prior misrepresentations caused that drop. But the observation that a stock price dropped on a particular day, whether as a result of a bankruptcy or not, is not the same as an allegation that a defendant's fraud caused the loss.

As to the stock price drop following Kmart's restatements, D.E. & J. never mentioned in its complaint the five cent drop in Kmart's stock prices on May 15, 2002, the day Kmart announced its restatements. By failing even to note that Kmart's stock dropped in price after the company restated its financial records and by failing to present this argument to the district court, D.E. & J. simply never pleaded that the defendants' alleged misrepresentations caused economic losses on May 15, 2002. Ultimately, as in *Dura,* D.E. & J. has said "the following (and nothing significantly more than the following) about economic losses attributable to the ... misstatement," 125 S.Ct. at 1630: "Plaintiffs and the Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for Kmart publicly traded securities." JA 0189. And ultimately, as in *Dura,* that pleading does not satisfy the PSLRA's loss causation requirement.

B.

D.E. & J. also seeks to hold each of the individual defendants liable as "controlling persons" of Kmart under § 20(a) of the Exchange Act. That provision extends liability to

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder ...

unless the controlling person acted in good faith and did not directly induce the act or acts constituting the violation or cause of action.

*7 15 U.S.C. § 78t(a); *see also* 17 C.F.R. § 240.12b-2 (defining "control" as "the power to direct or cause the direction of the management and policies of a [company], whether through the ownership of voting securities, by contract, or otherwise").

Because "controlling person" liability is derivative, however, a plaintiff may hold a defendant liable under this theory only if the defendant controlled an entity that violated the Securities Act. D.E. & J. has not charged Kmart with a violation of the Securities Act, and accordingly it may not bring a claim for recovery under this theory. *See PR Diamonds, Inc. v. Chandler,* 364 F.3d 671, 696--98 (6th Cir.2004); *In re Comshare Inc. Sec. Litig.,* 183 F.3d 542, 554 n. 11 (6th Cir.1999); *Moss v. Morgan Stanley, Inc.,* 719 F.2d 5, 17 (2d Cir.1983). The district court properly rejected this claim on the pleadings.

III.

Lastly, we do not believe that the district court abused its discretion in denying D.E. & J. an opportunity to file what would have amounted to a fourth complaint. *See Miller v. Champion Enters., Inc.,* 346 F.3d 660, 671 (6th Cir.2003); *Parry v. Mohawk Motors of Michigan, Inc.,* 236 F.3d 299, 306 (6th Cir.2000). D.E. & J. did not file a formal motion for leave to amend in this case and did not submit a proposed amended complaint to the district court, in contravention of local rules. *See* E.D. Mich. Local R. 15.1 ("A party who moves to amend a pleading shall attach the proposed amended pleading to the motion."). The sole way in which D.E. & J. indicated that it wished to amend its complaint was by "request[ing], almost as an aside in their brief opposing Defendants' motions to dismiss, that 'if the Court concludes that any aspect of the plaintiffs' claims are inadequately pled ... that they be granted leave to replead and cure any deficiencies identified by the Court." ' D. Ct. Op. at 58. *See* JA 0847 (requesting "an opportunity to amend" the complaint "if the Court deems the claims [ ] insufficiently pleaded"). The district court did not abuse its discretion in choosing not to credit this statement in a brief as a motion to amend where D.E. & J. previously had been given two opportunities to amend its complaint. *See PR Diamonds,* 364 F.3d at 698--700 (upholding the district court's denial of leave to amend where the plaintiffs made the following request in a brief opposing the defendants' motions to dismiss: "Alternatively, in the event the Court grants any part of the Defendants' motions to dismiss, plaintiffs respectfully request leave to amend their Complaint"); *Begala v. PNC Bank, Ohio, Nat'l Ass'n,* 214 F.3d 776, 784 (6th Cir.2000) (affirming denial of leave to amend because "[w]hat plaintiffs may have stated, almost as an aside, to the district court in a memorandum in opposition to the defendant's motion to dismiss is [ ] not a motion to amend"); *see also id.* (plaintiffs cannot expect "an advisory opinion from the Court informing them of the deficiencies of the complaint and then an opportunity to cure those deficiencies") (emphasis omitted); *Parry,* 236 F.3d at 306 ("[A] party requesting leave to amend must 'act with due diligence if it wants to take advantage of the Rule's liberality." ') (quotations and citation omitted).

IV.

***8** For these reasons, we affirm.

2005 WL 1386448 (6th Cir.(Mich.))

END OF DOCUMENT

TAB 5

Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
Robert DONNELLI, an individual, Plaintiff,
v.
PETERS SECURITIES CO., L.P., a limited partnership, Reuben Peters, Robert G. Peters, C. Timothy Vlahos, Steve Helms, Christopher Rosman, Chris Randle, Steve Stoycha and Jason Perhacs, Defendants.
No. 02 C 0691.

Aug. 29, 2002.

MEMORANDUM OPINION AND ORDER

GETTLEMAN, J.

***1** Plaintiff Robert Donnelli filed a five-count complaint against defendants Peters Securities Co., LP ("Peters Securities"), Reuben Peters, Robert G. Peters, C. Timothy Vlahos ("Vlahos"), Steve Helms ("Helms"), Christopher Rosman ("Rosman"), Chris Randle ("Randle"), Steve Stoycha ("Stoycha"), and Jason Perhacs ("Perhacs"), seeking payment allegedly due to him arising out of Donnelli's marketing efforts performed under an alleged oral agreement with Peters Securities. Donnelli asserts the following causes of action: breach of contract against Peters Securities, Reuben Peters, Robert G. Peters, Vlahos, Helms, Rosman, Randle, Stoycha and Perhacs (Count I); "quantum meruit for reasonable value of services" against Peters Securities, Reuben Peters, Robert G. Peters, Vlahos, Helms, Rosman, Randle, Stoycha and Perhacs (Count II); intentional interference with contract against Reuben Peters. Randle, Stoycha and Perhacs (Count III); intentional interference with prospective economic advantage against Reuben Peters, Randle, Stoycha and Perhacs (Count IV); and, an accounting against all defendants (Count V). Before the court is defendants' motion to dismiss all claims pursuant to Federal Rules of Civil Procedure 12(b)(6) for failure to state a claim upon which relief can be granted. Based on the following, the court grants in part and denies in part defendants' motion.

LEGAL STANDARD

In ruling on a motion to dismiss for failure to state a claim, the court considers "whether relief is possible under any set of facts that could be established consistent with the allegations." *Bartholet v. Reishauer A.G.,* 953 F.2d 1073, 1078 (7th Cir.1992). A plaintiff's complaint will generally not be dismissed unless it is beyond doubt that under no set of facts would plaintiff's allegations entitle him to relief. *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957). The purpose of a motion to dismiss is to test the sufficiency of the complaint, not to rule on its merits. *See Gibson v. City of Chicago,* 910 F.2d 1510, 520(7th Cir.1990).

BACKGROUND

When considering a motion to dismiss, the court accepts the allegations of the complaint as true as well as reasonable inferences therefrom, and views these both in the light most favorable to the plaintiff. *Travel All Over the World, Inc v. Kingdom of Saudi Arabia,* 73 F.3d 1423, 1428 (7th Cir.1996) . Donnelli's allegations are set forth below.

Prior to August 1996, Donnelli was a market maker on the floor of the Chicago Board of Options Exchange ("CBOE"). In August 1996, Donnelli entered into an agreement with John Najarian ("Najarian"), the owner of Mercury Trading and a partner with Shamrock Investment Bank. Najarian, among other businesses, operated as a Third Market Maker ("TMM") through Mercury/Shamrock. A TMM is a person or entity that purchases buy and sell orders from securities brokerage firms, and trades out of these newly purchased positions.

***2** Under the agreement between Donnelli and Najarian, Donnelli was to leave market making on the CBOE and become the marketing partner for Mercury/Shamrock. Donnelli agreed to attempt to develop order flow from large on-line brokerage firms such as E*Trade Securities, Inc. ("E*Trade") in return for a $5000 monthly consulting fee, all expenses, and 20% of the profit from the business generated from Donnelli's efforts. From September 1996 through January 1998, Donnelli continued to work for Najarian and worked on developing relationships with E*Trade and other firms.

In late 1997, as a result of Donnelli's efforts, E*

Trade committed to send trades to Mercury/ Shamrock and in January 1998 began sending orders. At about this time, Najarian lost interest in the TMM business and told E*Trade that he would no longer target them for clearing. Based on Najarian's statements, E*Trade stopped its order flow and, based on the substantial sum of time and money it spent establishing its operation for clearing securities trades for Najarian's TMM operation, E* Trade threatened to sue Najarian.

In an effort to continue business between Mercury/ Shamrock and E*Trade, Donnelli searched for a broker/dealer to replace Mercury/Shamrock, contacted defendant Peters Securities, and spoke with defendant Randle. [FN1] Donnelli presented the business concept and strategy to Peters Securities, including financial information and projections. The proposed sale price of the business to Peters Securities was $250,000 plus a percentage of the trading profits on the business, and Donnelli's compensation would be $50,000 and a division of the prospective trading profits. When Peter's Securities indicated an interest, Donnelli put Randle, Reuben Peters and Najarian in contact to work out the financial package.

FN1. With regard to the individual defendants, Donnelli alleges that Reuben Peters controls Peters Securities in Chicago, as the managing general partner. Robert Peters, Vlahos, Helms and Christopher Rosman are "general partners and/or employees or agents" of Peters Securities, and Randle, Stoycha and Perhacs are "employees and/or agents" of Peters Securities.

During these initial discussions, Peters Securities and Reuben Peters agreed that 20% of the trading profits would be split evenly between Donnelli, Stoycha and Perhacs, whom Peters Securities would employ as traders. It was also initially agreed that Donnelli would receive another 5% of the profits, 5% would be paid to Najarian, E*Trade would receive 20%, and the final 50% of profits would go to Peters Securities. After these initial discussions, Donnelli negotiated with E*Trade to stop its process of suing Najarian in return for which, among other things, E*Trade demanded that Najarian could not be involved with the new Mercury/Peters TMM. In response to E*Trade's demand regarding Najarian, Peters Securities and Reuben Peters agreed Najarian would not be involved and that the 30% trading profits remaining above the 20% to E*Trade and 50% to Peters Securities, would be equally split among Donnelli, Stoycha and Perhacs.

In February 1998, Peters Securities purchased Mercury/Shamrock's TMM business. For the next two years, between February 1998 and 2000, Donnelli worked to build Peters Securities' TMM business. Instead of paying Donnelli 10% of the trading profits, however, Peters Securities began paying Donnelli only 8 1/3% of the profits, splitting 25% between the three traders instead of 30%. Peters [FN2] promised Donnelli that when the firm met its projections, Donnelli's profit distribution would be raised to "the agreed upon amount (i.e ., a one-third split of 30%)" or higher, depending on the level of success. Donnelli acquiesced and accepted the 8 1/3% split in reliance on Peter's representations.

FN2. The complaint does not specify if it was Reuben or Robert Peters.

*3 In the ensuing two years, Mercury/Peters continued to experience numerous systems problems that caused E*Trade to stop sending Mercury/Peters its business on at least two occasions. Donnelli continued to work with E*Trade to motivate them to continue sending Mercury/Peters its business. Donnelli also performed various other services for Peters Securities, including bringing in business from other smaller brokerage firms.

During the entire two year period--February 1998 through February 2000--Peters Securities paid Donnelli 8 1/3% of the profits from Peters Securities' TMM trading business. In February 2000, Donnelli's relationship with Peters Securities was severed allegedly as a result of certain intentionally malicious acts of Reuben Peters, Randle, Stoycha and Perhacs.

DISCUSSION

Defendants have moved to dismiss all five counts of plaintiff's complaint for failure to state a claim. In response, in addition to arguments relating to the individual claims, plaintiff asserts that the court should deny defendant's entire motion as untimely pursuant to Fed.R.Civ.P. Rule 12(g).

FEDERAL RULES OF CIVIL PROCEDURE
RULE 12(g) [FN3]

FN3. Rule 12(g)-(h)(2) provides:

(g) Consolidation of Defenses in Motion. A party who makes a motion under this rule may join with it any other motions herein provided for and then available to the party. If a party makes a motion under this rule but omits therefrom any defense or objection then available to the party which this rule permits to be raised by motion, the party shall not thereafter make a motion based on the defense or objection so omitted, except a motion as provided in subdivision (h)(2) hereof on any of the grounds there stated.

(h) Waiver or Preservation of Certain Defenses.

(1) A defense of lack of jurisdiction over the person, improper venue, insufficiency of process, or insufficiency of service of process is waived (A) if omitted from a motion in the circumstances described in subdivision (g),

or (B) if it is neither made by motion under this rule nor included in a responsive pleading or an amendment thereof permitted by Rule 15(a) to be made as a matter of course.

(2) A defense of failure to state a claim upon which relief can be granted, a defense of failure to join a party indispensable under Rule 19, and an objection of failure to state a legal defense to a claim may be made in any pleading permitted or ordered under Rule 7(a), or by motion for judgment on the pleadings, or at the trial on the merits.

Plaintiff originally filed his action in an Arizona federal district court where defendants filed a motion to dismiss for lack of personal jurisdiction and improper venue pursuant to Rule 12(b)(2) and (3), and a motion to transfer pursuant to 28 U.S.C. § 1406(a). Defendants did not file a Rule 12(b)(6) motion to dismiss at that time. The Arizona court concluded that it had neither general nor specific personal jurisdiction over the defendants. Finding that personal jurisdiction existed over the defendants in the Northern District of Illinois, however, the court granted defendants' motion to transfer to this court.

Generally, courts have denied defendants' attempts to file multiple pre-answer motions to dismiss, finding such motions contravene the purpose of Rule 12(g): to prevent litigants from interposing defenses in a piecemeal fashion and eliminate unnecessary delay at the pleading stage. *See generally, Moore v. Ford Motor Co.,* 1994 WL 25822 at *2 (N.D.Ill. Jan. 26, 1994); *U.S. Fidelity & Guaranty Co. v. Jepsen,* 1991 WL 249706 at *2-3 (N.D.Ill. Nov. 14, 1991). Defendants respond that the current motion to dismiss was not intended for purposes of delay but to expedite resolution of the current matter, and that based on the merits of its jurisdictional and venue motions before the Arizona court, defendants felt that there was no reason to burden the Arizona court with the additional 12(b)(6) defenses.

In *Strandell v. Jackson County, Illinois,* 648 F.Supp. 126, 129 (S.D.Ill.1986), denying the plaintiff's request to deny the defendants Rule 12(b)(6) motion filed after a previously litigated Rule 12 motion, the court quoted from 2A Moore's Federal Practice ¶ 12.22 at 12-102:

Although the proper procedure for raising the [Rule 12(b)(6)] defenses now at issue is in a motion for judgment on the pleadings, 'since the objection [of failure to state a claim] is so basic and is not waived, the Court might properly entertain the second motion [to dismiss] if convinced that it is not interposed for delay and that the disposition of the case on the merits can be expedited by so doing.'

*4 *See also, Kincaid v. City of Anchorage,* 100 F.Supp. 325, 327 (D.Alaska 1951), in which the court addressed the merits of a Rule 12(b)(6) motion filed after a fully adjudicated Rule 12(b)(7) motion, recognizing that in doing so it was disregarding the literal language of Rule 12(g). The court reasoned that the 12(b)(6) motion was not interposed for delay, that the motion addressed each of the causes of action, and that if the supporting grounds for such motion were valid, adjudication of the motion would "clearly expedite the disposition of the case on the merits."

After considering the parties' briefs, the reasoning in *Strandall* and *Kincaid* appears particularly applicable to the instant case. The court finds defendants' motion was not filed for the purpose of delay and that adjudication of the instant motion will narrow the scope of this matter, greatly expediting resolution of the case. Accordingly, the court will now turn to the merits of defendants' motion to dismiss.

BREACH OF CONTRACT

Defendants move to dismiss Count I based on two arguments: 1) under Illinois law, no action for breach of contract can be brought for breach of an "at-will" employment contract with Peters Securities; and, 2) Donnelli does not allege that a valid contract existed between plaintiff and the individual defendants. Plaintiff in essence concedes the validity of defendants' second argument, asserting that a "clerical error" was made when the individual defendants were included in the "parenthetical characterization" of Count I as being filed against the individual defendants. Accordingly, the court grants defendants' motion to dismiss the individual defendants from the breach of contract claim alleged in Count I.

In response to Peters Securities' argument that no cause of action lies against it for breach of an "at-will" contract, Donnelli argues that the contract was not an "employment contract" and that Count I states all the essential elements of a breach of contract claim. Before discussing the applicable law, the court notes that as pled, there are two parts to Donnelli's breach of contract claim against Peters Securities: 1) breach of defendant's oral contract to pay Donnelli a certain percentage of trading profits during the period that plaintiff actually worked for Peters Securities, i.e., February 1998 to February 2000; and, 2) breach of the oral contract arising from the termination of the alleged oral contract with Donnelli and the resulting failure to pay Donnelli profits after the termination date.

Under Illinois law, [FN4] to state a claim for breach of contract Donnelli must allege: 1) the existence of a valid contract with Peters Securities; 2) Peters Securities' breach of that contract; 3) Donnelli's performance under the contract; and, 4) damages to Donnelli resulting from such breach. *See, Owen Wagener & Co. v.. U.S. Bank,* 697 N.E.2d 902, 906 (Ill.App.Ct.1998). It is also well-established Illinois law, however, that "[c]ontracts of indefinite duration are terminable at the will of either party." *Jespersen v. Minnesota Mining and Manufacturing Co.,* 700 N.E.2d 1014, 1016 (Ill.1998).

FN4. The parties have not raised a choice of law issue and, because both parties rely on Illinois law in their briefs, the court will apply Illinois law. *Wood v. Mid-Valley Inc.,* 942 F.2d 425, 426 (7th Cir.1991) ("The operative rule is that when neither party raises a conflict of law issue in a diversity case, the federal court simply applies the law of the state in which the federal court sits.").

***5** While the cases cited and discussed in defendants' brief all relate to employment contracts, the Illinois Supreme Court in *Jespersen* applied the rule that a breach of contract claim cannot arise from the termination of an at-will contract to a sales distribution agreement, noting that the rule that "contracts of indefinite duration are terminable at will" has long been followed in Illinois. *Id.* at 1017. The court further noted that Illinois courts have applied this rule to a variety of types of contracts including employment contracts, credit card agreements, money market fund accounts and sales contracts. *Id.*

Under this rule, either party to the contract can "terminate the agreement for any reason or no reason without committing a breach of contract." *Id.* (affirming judgment dismissing plaintiff's complaint alleging defendant breached sales distribution contract by terminating it, for failure to state a cause of action for breach of contract); *see also, O'Brien v. Omni Pro Electronics, Inc.,* 1996 WL 459853 at *4 (N.D.Ill. Aug. 13, 1996) (where contract did not specify duration, court dismissed plaintiff's claim that defendant breached the contract by failing to pay him the remainder of his annual salary and commissions after the defendant terminated the plaintiff's employment).

Donnelli's complaint does not allege that the oral contract between Peters Securities and him provided for a specific duration of the contract. The court finds that under Illinois law, Donnelli has failed to allege a breach of contract based on Peters Securities' termination of the contract and subsequent failure to pay Donnelli any profits after February 2000. Construing the allegations in Count I most favorably in Donnelli's favor, however, the court finds Count I arguably [FN5] states the elements of a breach of contract claim for failure to pay Donnelli the proper amount as agreed upon under the terms of the alleged oral contract for his services during the contract's duration.

FN5. It is unclear under the allegations in plaintiff's complaint whether Peters Securities affected a valid unilateral modification of the terminable at will contract with Donnelli with regard to his remuneration, and whether Donnelli in turn acquiesced in and ratified such modification by continuing to work under the contract under Peters Securities' modified terms. *See, Bass v. Prime Cable* *of Chicago, Inc.*, 674 N.E.2d 43, 50-51 (Ill.App.Ct.1996) (cable operator's discontinuance of formerly free television guide unless customer paid fee was valid permissible modification of terminable at-will contract which was supported by sufficient consideration through company's continued service to customer under new terms: "[a] contract without a specified duration is terminable at will by either party [and] ... may be unilaterally modified").

Accordingly, the court grants defendants' motion to dismiss Donnelli's breach of contract claim based on termination of the contract and his request for damages based on a failure to pay Donnelli profits beyond February 2000, but denies defendants' motion to dismiss Count I against Peters Securities for failure to pay Donnelli the profits allegedly due during the period Donnelli performed services for Peters Securities, February 1998 to February 2000.

QUANTUM MERIUT

Defendants move to dismiss Count II because, (a) Donnelli's *quantum meruit* claim alleges a valid contract between the parties, and (b) his allegation acknowledging receipt of some compensation from Peters Securities during the years he performed marketing services is fatal to asserting a *quantum meruit* claim. To state a claim for *quantum meruit,* Donnelli must allege: 1) he performed a service to benefit Peters Securities and the individual defendants; 2) he performed the service non-gratuitously; 3) defendants accepted this service; and, 4) "no contract existed to prescribe payment of this service." *Owen Wagener & Co. v. U.S. Bank,* 697 N.E.2d 902, 908 (Ill.App.Ct.1998); *Canel and Hale, Ltd. v. Tobin,* 710 N.E.2d 861, 868 (Ill.App.Ct.1999).

***6** In the general allegations of his complaint, Donnelli alleges that he entered into a contract with defendants and that there were specific payment terms within the contract. This contract is alleged not only in the preliminary paragraphs of his complaint, incorporated by reference in Count II, but is further alleged in ¶ 34 of Count II, which states: "[w]hile Robert Donnelli was performing these services, Robert Donnelli and these defendants expected that Robert Donnelli would be paid the agreed upon and reasonable value for those services." Accordingly, plaintiff has failed to state a claim for *quantum meruit* because he has pled the existence of a contract for the services for which he claims *quantum meruit* damages. The court therefore grants defendants' motion to dismiss Count II of the complaint.

The court notes that there is language in Illinois Supreme and Appellate court cases that support dismissal of Count II based Donnelli's allegation that he was paid some compensation for his services, i.e., Peters Securities' payment of 8 1/3% of the profits over the course of the period Donnelli performed services for Peters Securities. In *First National Bank of Springfield v. Malpractice Research, Inc.*, 688 N.E.2d 1179, 1185 (Ill.1997), while finding the plaintiff was not entitled to recovery under a *quantum meruit* claim because it failed to establish that its activities conferred any benefit on the defendants, the Illinois Supreme Court stated (*emphasis added*):

Quantum Meruit means, literally, "as much as he deserves." ... A party seeking recovery on a *quantum meruit* theory must demonstrate the performance of services by the party, the conferral of the benefit of those services on the party from whom recovery is sought, and the unjustness of the latter party's *retention of the benefit in the absence of any compensation.*

See also, Owen Wagener & Co., 697 N.E.2d at 1053 (*citations omitted*) (*emphasis added*)("The basis for *quantum meruit* recovery is equitable: '... receipt by a defendant from a plaintiff of a benefit which is unjust for him to *retain without paying for it*" ').

Donnelli alleges in his complaint that Peters Securities did in fact pay him for his services, just arguably not as much as Donnelli was entitled to under the alleged oral agreement between the two parties. The parties did not cite, nor did the court find, a single case directly on point addressing this issue or a case in which a party was paid some form of compensation and yet was entitled to further recovery under a *quantum meruit* claim. Based on the court's finding that Donnelli's reliance on the terms of his alleged oral contract bars his *quantum meruit* claim, and the lack of controlling precedent on this issue, the court declines to reach the issue of the effect of Donnelli's payment for his services in ruling on the motion to dismiss Count II.

TORTIOUS INTERFERENCE WITH CONTRACT

***7** Defendants move to dismiss Donnelli's claim for tortuous interference with contract, asserting that such a cause of action cannot be asserted based on a contract that is terminable at will. As set forth by defendants, "[u]nder Illinois law a plaintiff cannot bring an action for tortuous interference with contractual relations based on a contract that is terminable at will." *3Com Corp. v. Electronics Recovery Specialists, Inc.*, 104 F.Supp.2d 932, 937 (N.D.Ill.2000). The case defendants cite for this proposition, *Hoskins v. Droke,* 1995 WL 318817 (N.D.Ill. May 24, 1995), addresses an employee's claim based on alleged interference with his employment contract causing the plaintiff's termination. Plaintiff argues, without authority, that such law applies only to employment contracts and that his claim is not based on an employment agreement.

In *3Com Corp.*, 104 F.Supp.2d at 937, however, the court applied this rule of law to the plaintiff's claim alleging that the defendant tortiously interfered with the agreement between the plaintiff seller of scrap materials and the buyer of the scrap materials "by participating in the scheme of understating the scrap's weight and value." [FN6] The case cited and relied on by the *3Com Corp* court for this legal proposition, *Canel and Hale, Ltd. v. Tobin,* 710 N.E.2d 861, 871 (Ill.App.Ct.1999), concerned a plaintiff's claim arising from the termination of a contract. In *Canel,* the court held that an "action for tortuous interference with contractual relations is not the proper vehicle for a discharged attorney seeking to recover damages," but rather the court should re-classify such claim as one for intentional interference with prospective economic advantage. *Id.*

FN6. The court did not dismiss the plaintiff's claim entirely, but held such claim must be classified and considered under the standard applied to tortious interference with prospective economic advantage claims. *3Com Corp.*, 104 F.Supp.2d at 937.

Similarly, the *Hoskins* court, relied on the Illinois Supreme Court's decision in *Fellhauer v. City of Geneva,* 568 N.E.2d 870 (Ill.1991). In *Fellhauer,* 568 N.E.2d at 877, the plaintiff, a former director of the Geneva City electric department, brought an action against the city's mayor for various claims including intentional interference with contractual relations, alleging "that defendant Lewis embarked on a course of conduct intended to result in the termination of plaintiff's employment with the City of Geneva ." Addressing the viability of this claim, the court noted a split among the Illinois Appellate courts on whether a plaintiff can prevail on this type of claim under the theory of tortuous interference with contractual relations, and determined that:

> an at-will employee such as plaintiff has no enforceable contractual right to employment and therefore cannot prevail under the theory of tortuous interference with contractual relations. Reasoning that an at-will employee may have a legitimate expectation of continued employment, however, the appellate court found that count III of plaintiff's amended complaint sounds in the tort of intentional interference with a prospective economic advantage.

***8** *Fellhauer,* 568 N.E.2d at 877. Noting that the plaintiff did not challenge the appellate court's reclassification of his claim to one for tortious interference with a prospective economic advantage, the Illinois Supreme Court analyzed the court's ruling under that theory. *Id.*

In order to state a claim for tortious interference with contractual relations under Illinois law, a party must allege: 1) the existence of a valid and enforceable contract; 2) the defendants' knowledge of such contract; 3) the defendants' intentional and unjustified inducement of breach of the contract; 4) a subsequent breach by the other contracting party caused by defendant's wrongful conduct; and 5) damages resulting from such breach. *See, R.J.N. Corp. v. Connelly Food Products, Inc.*, 529 N.E.2d 1184, 1190 (Ill.App.Ct.1988).

The court finds that a reasonable interpretation of the holdings in *Canel, Hoskins* and *Felhauer* parallels the court's previous discussion separating Donnelli's ability to state a claim for breach of contract for Peters Securities' failure to pay the proper amount of profits due during the period in which Donnelli performed services for Peters Securities, from his inability to state a viable claim for breach of an at-will contract based on the termination of such contract. Applied in the context of stating a viable claim for tortious interference of contract under Illinois law, the court finds that if the allegations in Donnelli's complaint allege the elements set forth in *R.J.N. Corp,* Donnelli can state a viable claim for tortious interference only with Peters Securities' alleged breach of paying the proper amount due during the time Donnelli performed services under the alleged oral contract, between February 1998 and February 2000. Based on the precedent set forth above, however, any tortuous interference based on acts allegedly causing Peters Securities to sever or terminate the contract with Donnelli cannot state a claim for tortious interference with contract and are therefore dismissed from Count III.

In the complaint, Donnelli alleges he had a valid, enforceable oral contract with Peters Securities to provide marketing and other services, and defendants Reuben Peters', Randle's, Stoycha's and Perhacs' [FN7] knowledge of such contract. Donnelli further alleges that these defendants "intentionally and with malice, caused defendant Peters Securities to breach its contract with Robert Donnelli by ... causing Peters Securities to not pay Robert Donnelli the amounts due under that contract ... because these defendants wanted to eliminate Robert Donnelli's participation in the profits of Peters Securities TMM business and to increase their share of the monies received from that business."

FN7. Defendants Reuben Peters, Randle, Stoycha and Perhacs are the only defendants named in Counts III and IV.

While Donnelli does not allege specific actions performed by each defendant, the court finds that for purposes of a motion to dismiss, the allegations as set forth are sufficient to state a cause of action for tortious interference with contractual relations. Accordingly, based on the preceding analysis, the court grants in part defendants' motion to dismiss the allegations in Count III relating to claims arising from the severance of Donnelli's contract with Peters Securities and the resulting damages therefrom. The court denies, however, defendants' motion to dismiss Donnelli's claim for intentional interference with contractual relations arising from the alleged conduct of the individual defendants allegedly causing Peters Securities to pay Donnelli less than he was entitled to under the contract between February 1998 and February 2000.

TORTIOUS INTERFERENCE WITH PROSPECTIVE ECONOMIC ADVANTAGE

*9 Under Illinois law, in order to state a claim for tortuous interference with prospective economic advantage Donnelli must allege: "1) the existence of a valid business relationship or expectancy; 2) knowledge of the relationship or expectancy on the part of the interferer; 3) an intentional and malicious interference inducing or causing a breach of termination of the relationship or expectancy; [and] 4) resultant damage to the party whose relationship has been disrupted." *Small v. Sussman,* 713 N.E.2d 1216, 1223 (Ill.App.Ct.1999). Defendants argue that Donnelli fails to adequately allege the first and third elements.

Defendants argue that under Illinois law, because of the at-will status of his contract, Donnelli fails to allege a reasonable expectancy of continuation of his contract. The cases cited by defendants are factually distinguishable and thus inapplicable. [FN8] In cases where the parties have operated under an at-will contract for at least two years, courts have held such allegations are sufficient to meet the first element of a claim for tortuous interference with prospective economic advantage. *See, 3Com Corp. v. Electronic Recovery Specialists, Inc.,* 104 F.Supp.2d 932, 937-938 (N.D.Ill.2000) (holding complaint sufficiently pled a reasonable expectation of continued contractual relationship where plaintiff alleged the contractual arrangement had lasted for at least two years); *Speakers of Sport, Inc. v. ProServ, Inc.,* 1998 WL 473469 at *3-4 (N.D. Ill. Aug 07, 1998), *affirmed,* 178 F.3d 867 (7th Cir.1999) (denying summary judgment because genuine issue of fact remained regarding reasonable expectation based on two-and-a-half year business relationship: "Happy or not, it should be noted that Rodriguez had been with Speakers for the past two-and-ahalf years despite his fickle relationship with previous agents.").

FN8. In *Byker v. Sequent Computer Systems, Inc.,* 1997 WL 639045 at *12 (N.D.Ill. Oct. 1, 1997), addressing a motion for summary judgment, the court stated that an "at-will employee may possess a legitimate expectation of future economic advantage if he or she can establish there existed a presumption that his or her employment would continued indefinitely." The issue addressed in *Byker,* however, was plaintiff's failure to meet this element based on the fact that the plaintiff was demoted rather than terminated, and then voluntarily chose to resign following his demotion. In the other case cited by defendants, *Williams v. Weaver,* 495 N.E.2d 1147, 1152 (Ill.App.Ct.1986), the court held that the plaintiff could not meet the first element based on the fact that it was undisputed that there was a written employment contract between the parties under which the plaintiff's employment was for a fixed one-year academic term, and he therefore had no reasonable expectation of employment beyond the one-year term.

In *Fellhauer v. City of Geneva,* 568 N.E.2d 870, 878 (Ill.1991), the court similarly rejected the defendant's argument that the plaintiff, a city employee who was originally appointed to his position for a specific term and while not reappointed continued beyond such term as a "holdover appointee," failed to allege the element of reasonable expectation in continued relationship, reasoning:

This court ... has long recognized a legitimate expectancy in an employment relationship. "[W]here the contract is one of employment, it is immaterial whether it is for a fixed period or is one which is terminable by either party at will, both parties being willing and desiring to continue the employment under that contract for an indefinite period."

In the instant complaint, Donnelli alleges an ongoing contractual relationship with Peters Securities spanning two years, during which time the contracting parties continued regardless of the fact that the main customer Donnelli brought to Peters Securities, E*Trade, withdrew its business on multiple occasions. For purposes of a motion to dismiss, the court finds such allegations are sufficient to meet the first element of his claim for tortuous interference with prospective economic advantage.

***10** The court also rejects defendants' argument that plaintiff has failed to allege that the individual defendants, partners and employees of Peters Securities, acted for purely personal reasons unrelated to their employer's interest. The complaint alleges that Donnelli had developed substantial business for Peters Securities' TMM business and was in the process of bringing in more customers when his contract was severed based on the intentional and malicious acts of the individual defendants. This count also incorporates the previous allegations in the complaint, including that the individuals' acts in causing Peters Securities to breach its contract with Donnelli were done in furtherance of their own personal goal to eliminate Donnelli's participation in the profits of the TMM business "and to increase their share of the monies received from that business."

While Donnelli does not enumerate the acts taken by the individual defendants that caused the termination of his contract, for purposes of the instant motion to dismiss, the court finds Donnelli has sufficiently pled the elements of his claim for tortuous interference with prospective economic advantage. The court, therefore, denies defendants' motion to dismiss Count IV.

ACCOUNTING

"In order to state a claim for accounting under Illinois law, a plaintiff must allege that he has no adequate remedy at law and one or more of the following: 1) a breach of a fiduciary duty; 2) a need for discovery; 3) fraud; or 4) the existence of complex mutual accounts." *Firstar Bank, N.A. v. Faul,* 2001 WL 1636430 at *8 (N .D.Ill.Dec. 20, 2001); *3Com Corp. v. Electronic Recovery Specialists, Inc.,* 104 F.Supp.2d 932, 941 (N.D.Ill.2000). "Generally, the lack of an adequate legal remedy is the essential prerequisite to an accounting claim." *3Com Corp.,* 104 F.Supp.2d at 941. In the instant case, the complaint in general, and Count V in particular, fails to plead an inadequate remedy at law. In fact, Donnelli has pled a viable breach of contract claim as well as tort claims arising from the same set of operative facts on which he bases his accounting claim.

In his response brief, without reference to an allegation in his complaint or authority for such argument, Donnelli argues that defendants "owed Donnelli fiduciary duties once an agreement was reached whereby they would jointly develop and launch the Peters Securities' TMM operation." Donnelli's complaint is devoid of any such allegation and there is no support for such an argument in Illinois law. *See generally, 3Com Corp.,* 104 F.Supp.2d at 941 (buyer who relied on seller to accurately report amount and value of scrap it removed from buyer's facilities for resale did not have fiduciary relationship with seller for purposes of establishing claim for accounting under Illinois law: "This was a contractual relationship not a fiduciary relationship"). The court further notes that dismissal of Donnelli's accounting claim "is of little negative consequence to plaintiff ... as the information [he] seeks in the accounting claim will likely be revealed during the discovery phase of this case." *Id.* at 942; *Firstar Bank,* 2001 WL 1636430 at *8. Accordingly, the court grants defendants' motion to dismiss Count V of the complaint.

CONCLUSION

***11** For the reasons set forth above, the court: grants defendants' motion to dismiss Count I against the individual defendants and against Peters Securities as to any claim arising from the termination of the alleged oral contract and any claim for post-contract termination profits; denies the motion to dismiss Count I against Peters Securities as to any potential breach of the payment terms during the period between February 1998 and February 2000; grants defendants' motion to dismiss Count II against all defendants; grants in part and denies in part defendants' motion to dismiss Count III; consistent with its ruling on Count I, denies defendants' motion to dismiss Count IV; and grants defendants' motion to dismiss Count V in its entirety. To clarify, remaining before the court is plaintiff's breach of contract claim alleged in Count I against Peters Securities for failure to pay the agreed upon profits percentage between February 1998 and February 2000, plaintiff's tortuous interference with contract claim alleged in Count III arising from individual defendants' Reuben Peters, Randle, Stoycha and Perhacs alleged conduct causing Peters Securities to fail to pay the agreed upon profits percentage between February 1998 and February 2000, and Count IV against Reuben Peters, Randle, Stoycha and Perhacs for intentional interference with prospective economic advantage. All claims against Robert G. Peters, C. Timothy Vlahos, Steve Helms and Christopher Rosman are dismissed.

Plaintiff is directed to file an amended complaint conforming to the court's ruling herein on or before September 18, 2002. Defendants shall respond on or before October 9, 2002. The parties are directed to file a joint status report using the court's form on or before October 9, 2002. This matter is set for a status report on October 22, 2002, at 9:00 a.m., at which the court will set a definitive discovery schedule.

2002 WL 2003217 (N.D.Ill.)

Motions, Pleadings and Filings (Back to top)

. 2002 WL 32510774 (Trial Pleading) Defendants' Answer and Affirmative Defenses (Oct. 09, 2002)

. 2002 WL 32743750 (Trial Pleading) Defendants' Answer and Affirmative Defenses (Oct. 09, 2002)

. 2002 WL 32510769 (Trial Pleading) First Amended Complaint (Sep. 18, 2002)

. 2002 WL 32743745 (Trial Pleading) First Amended Complaint (Sep. 18, 2002)

. 2002 WL 32743735 (Trial Motion, Memorandum and Affidavit) Defendants' Reply Brief in Support of Motion to Dismiss (May. 21, 2002)

. 2002 WL 32743727 (Trial Motion, Memorandum and Affidavit) Plaintiff's Response to Defendants' Motion to Dismiss (May. 07, 2002)

. 2002 WL 32509771 (Trial Motion, Memorandum and Affidavit) Defendants' Motion to Dismiss (Apr. 02, 2002)

. 1:02CV00691 (Docket)
(Jan. 28, 2002)

END OF DOCUMENT

TAB 6

Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois.
HOOPLA SPORTS AND ENTERTAINMENT, INC., Plaintiff,
v.
NIKE, INC. and Columbia Broadcasting Systems, Defendants.
No. 96 C 1642.

Feb. 5, 1998.

MEMORANDUM OPINION AND ORDER

CASTILLO, District J.

***1** Plaintiff Hoopla Sports and Entertainment, Inc. sues defendants, Nike, Inc. and Columbia Broadcasting Systems ("CBS"), under § 43(a) of the Lanham Act. 15 U.S.C. § 1125. Hoopla alleges that Nike, Inc. and CBS violated § 43(a) of the Lanham Act when they appropriated plaintiff's idea for an international high-school-age all-star basketball game and presented the game to the public as defendants' own creation. In addition, Hoopla alleges that Nike and CBS unfairly capitalized on plaintiff's efforts in staging the Father Liberty Game ("FLG") by presenting their version of the high-school "U.S. against the World" basketball event known as the Hoop Summit.

In a prior opinion, this Court granted defendants' motion to dismiss all counts of plaintiff's complaint without prejudice. *See Hoopla Sports and Entertainment, Inc. v. Nike, Inc.,* 947 F.Supp. 347 (N.D.Ill.1996). We found that plaintiff failed to state causes of action for trademark infringement, copyright infringement, breach of contract, intentional interference with prospective advantage, fraud, and violation of the Illinois Deceptive Trade Practices Act. *Id.* Plaintiff subsequently filed an amended complaint and, upon its dismissal, a second amended complaint. Currently before the Court is the defendants' motion for summary judgment on all counts of the plaintiff's second amended complaint. Plaintiff concedes the merits of defendants' motion, acknowledging that it cannot, "in good faith, argue that there is convincing evidence that Defendants sought to, or did, confuse the public into believing that they were attending John Walsh's game when they attended the Hoop Summit or that they sought to draw luster from John Walsh's game and affix it to the Hoop Summit." Pl.'s Res. at 2-3. We agree and grant the defendants' motion for summary judgment.

This is not the end of our inquiry, however, as plaintiff seeks leave to replead its complaint to state a claim for common law misappropriation and/or unjust enrichment. For the reasons that follow, we deny plaintiff's request for leave to replead.

FACTUAL BACKGROUND [FN1]

FN1. The facts are derived from statements that the parties filed with this Court under Northern District of Illinois Local General Rule 12(M)-(N). Rule 12(M)(3) requires a party moving for summary judgment to file "a statement of material facts as to which the moving party contends that there is no genuine issue." The movant's statement must contain "specific references to affidavits, parts of the record, and other supporting material relied upon to support the facts set forth." Rule 12(M)(3). Defendant's statement is cited as "Defs. Facts ¶ ---." Similarly, Rule 12(N)(3)(a) requires the non-moving party to file a concise response to the movant's statement including, in the case of any disagreement, specific references to supporting materials. Additionally, Rule 12(N)(3)(b) authorizes the non-moving party to submit a statement of "additional facts that require the denial of summary judgment"; under Rule 12(M), the moving party may then submit a reply to the non-moving party's additional facts. All properly supported material facts set forth in either party's statements are deemed admitted unless properly uncontroverted. *See* Local Rule 12(M) and (N)(3)(b); *see also Flaherty v. Gas Research Institute,* 31 F.3d 451, 453 (7th Cir.1994). Moreover, the mere denial of a particular fact without specific references to the affidavits, parts of the record, and other supporting materials is insufficient, and, where a properly supported factual assertion is met with such a naked denial, the fact may be deemed admitted. *Flaherty,* 31 F.3d at 453.

John Walsh, president of Hoopla, conceived of the idea to stage the first-ever competition between a team of high-school aged basketball stars from the United States and similarly aged players from abroad. Defs. Facts ¶ 1. After clearing significant administrative and procedural hurdles, plaintiff staged the Father Liberty Game ("FLG"), in Chicago, Illinois on June 18, 1994. Defs. Facts ¶ 1.

In an effort to solicit sponsors and acquire clearance for the event, Walsh compiled an Event Profile, which generally described the FLG and noted that the game was being played to promote international peace and freedom. In addition, the Event Profile listed the tentative line-up for the U.S. team and the international team. On March 10, 1994, Walsh sent an Event Profile and a letter to Rich Sheubrooks, then Sports Marketing Director for Nike, soliciting Nike's sponsorship of the FLG. *See* 2d Am. Compl. Ex. 3. Walsh again mailed Sheubrooks the solicitation and a copy of the FLG Event Profile on May 29, 1994. *Id.* Ex. 5. In addition to the mailings, Walsh had a few conversations with Sheubrooks regarding Nike's sponsorship of the FLG. Defs. Facts ¶ 8. Nike ultimately agreed to sponsor the event, providing shoes and uniforms for both teams. However, Nike disputes that it agreed to sponsor the event annually.

*2 While Walsh envisioned the FLG as an annual event, he stopped promoting the game upon learning that Nike was planning to stage a similar event, the Nike Hall of Fame Hoop Summit ("Hoop Summit"). Plaintiff alleges that shortly after he staged the FLG, Nike and CBS planned a "virtually identical basketball game which not only adopted the format of Walsh's game but involved recruitment of some of the same players, and had some of the same sponsors that had been contacted by Walsh in connection with the Father Liberty Game." Pl.'s Resp. at 3. Additionally, plaintiff alleges that defendants have wrongfully taken advantage of plaintiff's efforts in staging the FLG, which includes: seeking U.S. and foreign high schools' authorization for players' participation; researching and ensuring compliance with the National Collegiate Athletic Association rules; obtaining sanction of U.S.A. Basketball; recruiting players; and arranging for sponsorship and television coverage. *Id.* at 2. Despite the plaintiff's protests, CBS broadcast the Hoop Summit from the Basketball Hall of Fame in Springfield, Massachusetts on May 13, 1995.

The pleadings demonstrate that Walsh had at least minimal contacts with Nike through Sheubrooks prior to the FLG. However, Sheubrooks left Nike's employ in August of 1994, almost a year before the Hoop Summit. Defs. Facts ¶ 8. There is no evidence that Sheubrooks later disclosed to Nike the nature of his conversations with Walsh, or was involved with the staging of the Hoop Summit. Defs. Facts ¶ 8.

Defendants allege that the inspiration for the Hoop Summit was distinct from any incidental contact with Walsh. Defendants assert that the concept of a Hoop Summit was originally promoted by Billy Packer, a member of the board of directors for the Basketball Hall of Fame and an on-air sports personality. Defs. Facts ¶ 2. Packer testified that the Hoop Summit was the product of a Hall of Fame board of directors' meeting, and that he had no knowledge of Walsh's efforts to stage the FLG. Defs. Facts ¶¶ 2, 5.

Packer presented the idea for the Hoop Summit to Douglas Stamm, the Assistant Director for Sports Marketing at Nike, and Nike agreed to sponsor the event. Defs. Facts ¶ 2. Stamm testified that he had no knowledge of Hoopla, Walsh, or the FLG. Defs. Facts ¶ 4. Further distancing defendants from plaintiff's allegations, the evidence demonstrates that Packer arranged for CBS's television coverage of the Hoop Summit. This appears to be the extent of CBS's involvement in the event. Defs. Facts ¶ 3.

After learning that Nike and CBS planned a second annual Hoop Summit for April of 1996, Walsh filed suit against these defendants on March 22, 1996. After the dismissal of its original and first amended complaints, plaintiff filed the instant action. At a hearing on May 2, 1997, plaintiff's counsel indicated his intention to amend the complaint yet again prior to the completion of discovery. The Court directed the plaintiff to file the appropriate motions. Despite the Court's order granting the plaintiff's motion to extend the discovery cut-off until July 31, 1997, the plaintiff failed to amend the complaint. Currently, plaintiff concedes the merit of the defendants' motion for summary judgment, but asks this Court for leave to replead its complaint to state a claim for common law misappropriation and/or unjust enrichment. Specifically, plaintiff's proposed amendment alleges that defendants wrongfully appropriated plaintiff's idea, the FLG, which plaintiff had developed after significant effort. For the reasons stated below, the plaintiff's request is denied.

ANALYSIS

*3 Under Federal Rule of Civil Procedure 15(a), leave to amend a complaint "shall be freely given when justice so requires." Fed.R.Civ.P. 15(a). In addition, the Supreme Court has instructed: "In the absence of any apparent or declared reason--such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to correct deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of the allowance of the amendment, etc.--the leave sought should, as the rules require, be 'freely given'." *Foman v. Davis,* 371 U.S. 178, 182, 83 S.Ct. 227, 9 L.Ed.2d 222 (1962). The decision to grant or to deny a motion to amend is within the sound discretion of the trial court. *Kleinhans v. Lisle Savings Profit Sharing Trust,* 810 F.2d 618, 625 (7th Cir.1987) (citing *Foman,* 371 U.S. at 181). We find that the circumstances of this case compel the denial of plaintiff's request for leave to replead.

Upon review of the procedural history, we find that plaintiff had ample opportunity to amend its complaint prior to defendants' filing of its motion for summary judgment. While this Court granted both of the defendants' motions to dismiss, we did so without prejudice, allowing plaintiff to replead its case on two separate occasions. At a hearing on May 2, 1997, plaintiff's counsel informed the Court that he was considering filing a motion for leave to file an amended complaint before discovery closed and before defendants filed this motion for summary judgment. [FN2] Despite this Court's invitation in open court to file the necessary motions, plaintiff failed to file a motion for leave to amend its complaint. Clearly, the deadline for filing amendments to the pleadings in this case has come and passed.

FN2. Any deficiencies in the second amended complaint should have been apparent to counsel at this time. Pursuant to this Court's standing order regarding pretrial procedures in civil cases, prior to filing a motion for summary judgment, the moving party must first serve the nonmoving party with a concise letter summarizing the legal and factual grounds for the motion, with references to supporting authorities, and make a sincere effort to resolve issues relating to the motion. Plaintiff has not asserted that defendants neglected this requirement.

Plaintiff seeks "to amend its complaint to allege misappropriation and/or unjust enrichment claims, on the same facts gathered during discovery of the trademark claims." Pl.'s Resp. at 4. In view of plaintiff's decision not to seek leave to amend prior to the filing of defendants' summary judgment motion, its request to raise yet a new theory of the case based upon the "same facts" is improper. *Murphy v. White Hen Pantry Co.,* 691 F.2d 350, 353 (7th Cir.1982) (finding no abuse of discretion in denying motion to amend complaint where motion was filed after discovery was completed and sought to inject a new theory of recovery into the litigation). Plaintiff's proposed amendment is not based on any newly discovered information and arrives nineteen months after the original complaint was filed and almost three months after the close of discovery. *Kleinhans v. Lisle Savings Profit Sharing Trust,* 810 F.2d 618, 625 (7th Cir.1987) (finding no abuse of discretion in denying motion to amend the complaint where amendment was not based on any newly discovered information and was filed eighteen months after the original complaint and six months after discovery had closed). Accordingly, the Court finds that plaintiff has unduly delayed in seeking to amend its complaint. *See Cleveland v. Porca,* 38 F.3d 289, 297 (7th Cir.1994) (finding no abuse of discretion in denying motion to amend complaint where motion was filed after discovery was completed, motions for summary judgment were fully briefed, and witness and exhibit lists were already submitted).

*4 Moreover, this Court finds that plaintiff's request for leave to replead should be denied because it is "an apparent attempt to avoid the effect of summary judgment." *Kleinhaus,* 810 F.2d at 625 (finding no abuse of discretion in denying motion to amend complaint where motion filed after discovery was complete and after defendant had moved for summary judgment without adequate explanation for the delay, in "an apparent attempt to avoid the effect of summary judgment."). In addition, the form of plaintiff's request for leave to replead is improper--it failed to file the required motion for leave to replead, raising the issue in its response brief instead. "A plaintiff may not amend his complaint through arguments in his brief in opposition to a motion for summary judgment." *Shanahan v. City of Chicago,* 82 F.3d 776, 781 (7th Cir.1996) (citing *Car Carriers, Inc. v. Ford Motor Co.,* 745 F.2d 1101, 1107 (7th Cir.1984) ("complaint may not be amended by brief in opposition to motion to dismiss.").

The Court also finds that permitting the plaintiff to assert a new theory of recovery would be prejudicial to defendants. If we allowed plaintiff to amend its complaint at this late hour, defendants would be forced to duplicate their previous discovery efforts. As we noted in *Fry v. UAL Corp.,* 895 F.Supp. 1018, 1052 n. 32 (N.D.Ill.1995), any assertion that defendants would not be prejudiced because extensive discovery has already been taken ignores the fact that "[a]ny experienced litigator is well aware that a deposition cannot be adequately conducted or defended without a solid understanding of the theory of the case."

Finally, even in the absence of delay and the plaintiff's procedural errors, we believe that plaintiff's efforts in amending the complaint would ultimately be futile because the facts do not support a claim of common law misappropriation and/or unjust enrichment. Citing a 1918 United States Supreme Court case (*International News Service v. Associated Press,* 248 U.S. 215, 39 S.Ct. 68, 63 L.Ed. 211 (1918)), and a 1970 Illinois Appellate Court case (*Capitol Records, Inc. v. Spies,* 130 Ill.App.2d 427 (1970)), the plaintiff argues that the "gravamen of such a claim is that Defendant has appropriated a valuable but unprotected 'idea' which Plaintiff develops after great effort...." Pl.'s Res. at 4. Without addressing the merit of the plaintiff's interpretation of such claims, we note that there is insufficient evidence to establish that defendants unfairly utilized Walsh's ideas in developing the Hoop Summit. The uncontested facts demonstrate that the idea for the Hoop Summit was conceived by an independent source, Parker, who never had any knowledge of or connection with the activities of Walsh, Hoopla, or the FLG. Consequently, plaintiff's request for leave to replead its complaint to state a claim for common law misappropriation and/or unjust enrichment is denied.

CONCLUSION

Having conceded the merit of defendants' motion for summary judgment, plaintiff attempts to avoid the effects of such a concession by requesting leave to replead in its response brief. We find that plaintiff's request is untimely, and that granting such a request would not further the interests of justice.

*5 Therefore, defendants' motion for summary judgment is granted, and plaintiff's request for leave to replead is denied.

1998 WL 60776 (N.D.Ill.)

Motions, Pleadings and Filings (Back to top)

. 1:96CV01642(Docket)
(Mar. 22, 1996)

END OF DOCUMENT

H

Briefs and Other Related Documents

NOTICE: THIS IS AN UNPUBLISHED OPINION.

(The Court's decision is referenced in a "Table of Decisions Without Reported Opinions" appearing in the Federal Reporter. Use FI CTA7 Rule 53 for rules regarding the citation of unpublished opinions.)

United States Court of Appeals, Seventh Circuit.
HOOPLA SPORTS AND ENTERTAINMENT, INC., Plaintiff-Appellant,
v.
NIKE, INC. and COLUMBIA BROADCASTING SYSTEMS, Defendants-Appellees.
No. 98-1567.

Argued Aug. 4, 1998.
Decided March 3, 1999.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division. No. 96 C 1642. Ruben Castillo, Judge.

Before Hon. RICHARD A. POSNER, Chief Judge, Hon. MICHAEL S. KANNE, Hon. DIANE P. WOOD, Circuit Judges.

ORDER

****1** Approximately five years ago, Hoopla Sports and Entertainment Inc. decided to sponsor a competition between a team of high school aged basketball stars from all over the United States and a similar team of players from other countries. Its efforts came to fruition with the Father Liberty Game, which took place in Chicago on June 18, 1994. One of the sponsors of that game was Nike, Inc. This case arose when Nike and the Columbia Broadcasting System (CBS) decided the next year to stage a similar event in Springfield, Massachusetts, which it called the Nike Hall of Fame Hoop Summit. Hoopla believed that Nike and CBS had violated its right to the concept, and it eventually sued them for trademark violations. The district court granted the defendants' motion for summary judgment, which Hoopla had opposed in part with a request to file an amended complaint. The district court refused, and Hoopla brought this appeal, in which the only issue it has presented is whether the refusal to allow the amendment amounted to reversible error.

Hoopla's President John Walsh believes that the Nike marketing representative who worked with Hoopla on the Father Liberty Game, one Rich Sheubrooks, essentially took his idea for the game and passed it along to Nike. Walsh sent an event profile about the Father Liberty Game to Sheubrooks as part of his effort to line up sponsors for the event. Nike ultimately was one of the sponsors, providing shoes and uniforms for both teams. Shortly after the game, according to Hoopla, Nike and CBS began planning a virtually identical game, using the format, many of the same players, and some of the same sponsors as Hoopla had used. Walsh (and thus Hoopla) believed, and charged in the complaint, that Sheubrooks passed on detailed business information about the contest to the responsible people at Nike.

Hoopla's first effort to present its claims in the district court resulted in a dismissal of the complaint without prejudice. See *Hoopla Sports and Entertainment, Inc. v. Nike, Inc.*, 947 F.Supp. 347 (N.D.Ill.1996). It then filed an amended complaint, and after that was also dismissed, a second amended complaint. Remarkably, in its opposition to the defendants' motion for summary judgment on the second amended complaint, Hoopla conceded that it could not, "in good faith, argue that there is convincing evidence that Defendants sought to, or did, confuse the public into believing that they were attending John Walsh's game when they attended the Hoop Summit or that they sought to draw luster from John Walsh's game and affix it to the Hoop Summit." The district court found that this was fatal to Hoopla's claims alleging trademark infringement, copyright infringement, breach of contract, intentional interference with prospective advantage, fraud, and a violation of the Illinois Deceptive Trade Practices Act. 815 ILCS § 510/1.

Hoopla pinned its principal hopes of avoiding summary judgment on the second amended complaint on a request that it included in its memorandum in opposition, asking that it be allowed to pursue a claim of common law misappropriation or unjust enrichment. It did not, however, ever file a motion for leave to amend the pleadings, nor did it submit a proposed third amended complaint. The district court decided that the request to replead in Hoopla's memorandum in opposition to summary judgment was not sufficient as a procedural matter, that it came too late in the day, and that in any event amendment would be futile in light of the undisputed facts relevant to the proposed new theories.

****2** This court reviews the district court's decision to deny a request to amend a complaint only for abuse of discretion. See *Diersen v. Chicago Car Exch.,* 110 F.3d 481, 488 (7th Cir.1997). There was no such abuse here. First, the district court was within its rights to insist that Hoopla should present its request to amend the complaint properly, so that it would be clear to all parties exactly how the proposed amended complaint would read and what effect it would have on the litigation. This is why we have held in the past that a complaint may not be amended by arguments made in a brief in opposition to a motion for summary judgment. See *Speer v. Rand McNally & Co.,* 123 F.3d 658, 665 (7th Cir.1997); *Shanahan v. City of Chicago,* 82 F.3d 776, 781 (7th Cir.1996).

Hoopla has now tried to excuse its failure to file a proper request for leave to amend by explaining that it was represented by new counsel after the dismissal of the first amended complaint. It argues that the schedule the district court had imposed was unreasonably onerous for the new lawyers. The facts do not bear this out, however; they merely show that the district court was keeping a firm hand on the progress of the litigation. The scheduling order in question was entered on April 14, 1997. New counsel appeared for the first time on May 2, 1997, and filed their formal appearance shortly thereafter. Discovery did not close until July 31, 1997, and on August 29, 1997, the defendants filed the motion for summary judgment that inspired the responsive effort to add the misappropriation and unjust enrichment claims. Nothing in the court's schedule prevented counsel from filing a proper amendment, and we therefore reject Hoopla's effort to show an abuse of discretion on this basis.

The district court also made it clear that it would have denied leave to amend even if Hoopla had filed a proposed third amendment complaint and a motion, as it should have done. First, it found that the request came too late in the day--19 months after the original complaint had been filed, and three months after discovery had closed. Second, it found that the proposed amendment was just a transparent effort to avoid the effects of the earlier summary judgment (unaccompanied by any sufficient reason for the court to revisit those rulings). Third, the court stated that the proposed amendment would force Nike and CBS to engage in additional discovery, which would have been prejudicial to them. Finally, it believed that any possible third amended complaint would have been futile, because the uncontested facts on the summary judgment record before it revealed that the idea for the Hoop Summit was conceived by an independent source, Billy Packer, who was a member of the board of directors for the Basketball Hall of Fame and an on-air sports personality. (Hoopla never filed a statement under Local Rule 12(N) contesting the facts on which Nike and CBS relied in their motion for summary judgment on the second amended complaint.)

****3** The first and third of these grounds indisputably support the district court's action. District courts have broad discretion to manage the cases before them, and the court's conclusions about undue delay and prejudice to the defendants are unassailable. As for the second point, it is probably true that most amended complaints are in part inspired by a desire to avoid a previous unfavorable ruling, such as a dismissal under Rule 12(b)(6) or Rule 56. Here, however, we understand the district court to be saying that Hoopla was simply churning the same facts around without any basis to show that it could recover under the new theories. As such, the court's second reason blends into the fourth. On the basis of those undisputed facts, no new theory was going to save Hoopla's case. There can be no question that Hoopla's failure to file a Rule 12(N) statement permitted the district court to accept the defendants' 12(M) version of the facts for purposes of the summary judgment motion directed against the second amended complaint. See, *e.g., Karazanos v. Madison Two Assoc.,* 147 F.3d 624, 626 (7th Cir.1998). Whether or not the record had to remain frozen in that status for purposes of assessing later amended complaints is a question we need not resolve here, although we note that if the proposed amended complaint had been presented properly and the district court had exercised its discretion to allow the amendment, the court may have required a new round of 12(M) and 12(N) statements to accompany any later motions for summary judgment. No matter: in this case, the court was well within its discretion to refuse the amendment both because it was not in the proper form and because it was unduly delayed and prejudicial to the defendants.

We therefore AFFIRM the judgment of the district court.

175 F.3d 1020 (Table), 1999 WL 130685 (7th Cir.(Ill.)) Unpublished Disposition

Briefs and Other Related Documents (Back to top)

. 1998 WL 34180025 (Appellate Brief) Brief of Defendants-Appellees Nike, Inc. and CBS Broadcasting Inc. (Jun. 01, 1998)Original Image of this Document (PDF)

. 1998 WL 34180024 (Appellate Brief) Brief of Appellant (May. 01, 1998)Original Image of this Document with Appendix (PDF)

. 98-1567 (Docket)
(Mar. 10, 1998)

END OF DOCUMENT

TAB 7

Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court,
S.D. New York.
In re: INITIAL PUBLIC OFFERING Securities Litigation
Amy LIU, Robert Tenney, Robert Tate, Mary Gorton, Carla Kelly, Henry Ciesielski, Ed Grier, Frank Turk, Jennie Papuzza, Stanley Warren, Ellen Dulberger, Craig Mason, and Sharon Brewer, Plaintiffs,
v.
CREDIT SUISSE FIRST BOSTON CORP., Credit Suisse First Boston (USA), Inc., Credit Suisse First Boston, Credit Suisse Group, Efficient Networks, Inc., eMachines, Inc., Lightspan Partnership, Inc., Tanning Technology Corp., and Tumbleweed Communications Corp., Defendants.
No. MDL 1554(SAS), 21 MC 92(SAS), 04 Civ. 3757(SAS).

May 6, 2005.

John G. Watts, Yearout & Traylor, P.C., Birmingham, AL, for Plaintiffs.

Kristin Linsey Myles, Robert L. Dell Angelo, Munger, Tolles & Olson LLP, San Francisco, CA, Michael L. Hirschfeld, John A. Boyle, Milbank, Tweed, Hadley & McCloy LLP, New York, NY, Randall J. Clement, Sheppard, Mullin, Richter & Hampton LLP, Costa Mesa, CA, Mitchell E. Herr, Holland & Knight LLP, Miami, FL, for Issuer Defendants.

Peter K. Vigeland, Robert W. Trenchard, Wilmer, Cutler & Pickering, New York, NY, for CSFB Defendants.

OPINION AND ORDER

SCHEINDLIN, J.

***1** This document relates to:

I. INTRODUCTION

In an Opinion and Order dated April 1, 2005, this Court dismissed plaintiffs' claims in this action, No. 04 Civ. 3757, in their entirety. [FN1] Plaintiffs now move for reconsideration. [FN2]

FN1. *See In re Initial Public Offering Sec. Litig. ("In re IPO"),* No. 21 MC 92, 2005 WL 743550 (S.D.N.Y. Apr. 1, 2005) *("Liu II").*

FN2. Plaintiffs have styled their motion as a "Rule 59(e) Motion to Alter, Amend, or Vacate the Order of April 1, 2005, Dismissing the Plaintiffs' Complaint." The motion seeks substantially the same relief as a motion for reconsideration under Local Rule 6.3. Indeed, because plaintiffs filed within the ten-day period prescribed by Rule 59(e), whether they styled their motion as one under Local Rule 6.3 or Rule 59(e) is immaterial. *See Lichtenberg v. Besicorp Group Inc.,* 204 F.3d 397, 401 (2d Cir.2000) ("A postjudgment motion requesting alteration or amendment of the judgment but denominated a motion under a rule other than Civil Rule 59(e) is generally treated as having been made under Rule 59(e), thereby extending the time to appeal, if the motion was filed within the 10-day period allowed for a Rule 59(e) motion."); *see also id.* at 404 (Winter, C.J., dissenting) ("Local Rule 6.3 simply adds flesh to the skeletal procedure set out in Civil Rule 59(e)").

II. LEGAL STANDARD

A motion for reconsideration is governed by Local Rule 6.3 and is appropriate where a court overlooks "controlling decisions or factual matters that were put before it on the underlying motion ... and which, had they been considered, might have reasonably altered the result before the court." [FN3] Alternatively, a motion for reconsideration may be granted to "correct a clear error or prevent manifest injustice." [FN4]

FN3. *Range Road Music, Inc. v. Music Sales Corp.,* 90 F.Supp.2d 390, 392 (S.D.N.Y.2000) (quotation marks and citation omitted). *See also Shrader v. CSX Transp., Inc.,* 70 F.3d 255, 257 (2d Cir.1995) ("The standard for granting ... a motion [for reconsideration] is strict, and reconsideration will generally be denied unless the moving party can point to controlling decisions or data that the court overlooked--matters, in other words, that might reasonably be expected to alter the conclusion reached by the court.").

FN4. *Doe v. New York City Dep't of Soc. Servs.,* 709 F.2d 782, 789 (2d Cir.1983).

Local Rule 6.3 should be "narrowly construed and strictly applied so as to avoid repetitive arguments on issues that have been considered fully by the Court." [FN5] A motion for reconsideration "is not a substitute for appeal." [FN6] Courts have repeatedly been forced to warn counsel that such motions should not be made reflexively, "to reargue those issues already considered when a party does not like the way the original motion was resolved." [FN7] The purpose of Local Rule 6.3 is to "ensure the finality of decisions and to prevent the practice of a losing party examining a decision and then plugging the gaps of a lost motion with additional matters." [FN8]

FN5. *Dellefave v. Access Temps., Inc.,* No. 99 Civ. 6098, 2001 WL 286771, at *1 (S.D.N.Y. Mar. 22, 2001).

FN6. *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.,* 207 F.Supp.2d 292, 296 (S.D.N.Y.2002) (quotation omitted).

FN7. *Houbigant, Inc. v. ACB Mercantile,* 914 F.Supp. 997, 1001 (S.D.N.Y.1996).

FN8. *Carolco Pictures, Inc. v. Sirota,* 700 F.Supp. 169, 170 (S.D.N.Y.1988).

III. DISCUSSION

A. Transaction Causation

Plaintiffs rest their motion for reconsideration primarily on a single premise: that the Court misinterpreted the true meaning of plaintiffs' allegations regarding price increases and artificial inflation. [FN9] Plaintiffs now maintain that all references to price increases contained in their Third Amended Complaint and motion papers [FN10] should have been construed as allegations of artificial inflation, not literal price increases. [FN11] Plaintiffs argue extensively that one particular allegation of actual price increases--which appeared in the section of the Third Amended Complaint summarizing plaintiffs' claims--was misconstrued by the Court.

FN9. In addition to their arguments regarding causation, plaintiffs also assert that the April 1 Opinion overlooked some misrepresentations made during the IPO process in dismissing the Third Amended Complaint. *See* Plaintiffs' Memorandum of Law in Support of the Rule 59(e) Motion to Alter, Amend, or Vacate ("Pl.59(e) Mem.") at 10-11. However, plaintiffs' case was dismissed for a failure to plead *causation* adequately; no matter how many misrepresentations are alleged or considered, a failure to plead that the scheme *caused* plaintiffs' losses mandates dismissal.

FN10. Plaintiffs allege that defendants worked together to create, publish and disseminate artificially depressed earnings estimates that, when beaten by actual results, created upward momentum in stock prices and conditioned the market to believe that estimates would always be beaten. *See, e.g.,* Plaintiffs' Response in Opposition to Defendants' Motions to Dismiss ("Pl.Opp.") at 36 ("Plaintiffs make [allegations regarding prospectus misstatements] to provide support for their claims that Defendants engaged in an ongoing, consistent scheme of depressing revenue projections to achieve quick and sustained *growth in share prices."*) (quoting *In re IPO,* 341 F.Supp.2d 328, 348 n. 185 (S.D.N.Y.2004) (*"Liu I"*) (emphasis added); *id.* at 59 ("Plaintiffs' complaint alleges that Defendants' manipulative scheme was successful in its intent to get each of the Issuer Defendant[s'] stock to 'Perform' to some degree above the IPO price ... [and] alleges that Defendants' manipulative scheme was successful in its intent to condition stock prices to rise in anticipation of forecasts being exceeded."); *id.* at 62 ("The intent was to prime the market to *expect* (anticipate) that the surprise would occur (and keep occurring indefinitely). As the TAC states: 'During the class period, stock prices of technology IPO Stocks rose *in anticipation* of forecasts being exceeded by actual results." ') (emphasis in Pl. Opp.) (quoting Third Amended Complaint ("TAC") ¶ 222); TAC ¶ 1 (scheme was intended "to create upward price momentum"); *id.* ¶ 90 ("scheme was to manufacture the perception among buyers that large economic returns accrued to holders of an Issuer's stock" after each IPO); *id.* ¶ 100 (defendants promised their customers that their "stocks continued to increase in price in the subsequent days and months beyond the first day's closing price"); *id.* ¶ 114 ("CSFB fraudulently understated revenue data in order for the Issuer's stock price to increase ...."); *id.* ¶ 212 (intended effect "was to directly affect the price of an Issuer's stock by falsely causing the stock price to jump substantially on the day of the IPO and then falsely causing it to continue to rise and/or to sustain growth in subsequent months"); id. ¶ 224 (CSFB repeatedly "revised its [earnings] forecasts to create a spike").

FN11. Plaintiffs thus focus on the causation section of the April 1 Opinion, in which this Court found that plaintiffs' allegations of continuing price increases in conjunction with the alleged misstatements and omissions were flatly contradicted by judicially noticeable trading data.

The disputed allegation reads:

The purposes and effect of said scheme was to create the illusion of ever rising stock prices so that Bank Defendants could profit from the sale of resulting over-priced securities owned by them, profit from increased underwriting and market making fees resulting from the price manipulation, and induce Plaintiffs and the members of the Class to purchase common stock at artificially inflated prices. [FN12]

FN12. TAC ¶ 256. *See also id.* ¶ 267 ("The purposes and effect of said scheme was to create the illusion of ever-rising stock prices so that Issuer Defendants could profit from the sale of resulting over-priced securities owned by them and induce Plaintiffs and the members of the Class to purchase common stock at artificially inflated prices.").

Plaintiffs assert that this grammatically incoherent sentence should be parsed to mean that defendants merely intended to create an illusion and to profit from it, and that the last "purpose"--and the only "effect"--"was to 'induce Plaintiffs ... to purchase common stock at artificially inflated prices." ' [FN13] Plaintiffs also offer a wealth of citations from their Third Amended Complaint using the terms "artificial inflation," "positive impact" or "positive effect" to establish that plaintiffs did not really mean that prices themselves went up during the class period, but rather that the alleged misrepresentations built some artificial premium into share prices that dissipated when a disclosing event occurred.

FN13. Pl. 59(e) Mem. at 4 (quoting TAC ¶ 256) (alteration in Pl. 59(e) Mem.).

***2** In my April 1, 2005, Opinion, I found that "plaintiffs' theory of causation depends not just on the *content* of individual misstatements creating misleading information about market value, but rather on beliefs caused by the *confluence* of depressed projections, conditioning statements, upside surprises and observed increases in stock prices." [FN14] Plaintiffs now argue that "[w]hether the Defendants were successful in their purpose of 'creating the illusion of ever rising stock prices' is [ ] irrelevant ." [FN15] Essentially, plaintiffs now contend that the alleged scheme caused price *inflation--i.e.,* caused stocks to trade at a higher price than they would have absent the scheme--rather than actual *increases* in price. Under this theory, actual stock price declines would not necessarily contradict a theory of artificial inflation. As Judge Gerard Lynch of this Court has noted, "[t]he fact of gradual price decline is not inconsistent with the theory that the price was artificially inflated, since the misrepresentations may well have buoyed a price that would otherwise have sunk much faster, thus raising the price at which plaintiffs purchased the stock." [FN16]

FN14. *Liu II,* 2005 WL 743550, at *11.

FN15. Pl. 59(e) Mem. at 4.

FN16. *Demarco v. Robertson Stephens, Inc.,* 318 F.Supp.2d 110, 124 (S.D.N.Y.2004).

Consequently, if plaintiffs' latest attempts to recast their allegations are credited, trading data that fails to show any relationship between upside surprises and rising stock prices does not by itself destroy plaintiffs' allegations of artificial inflation. In light of plaintiffs' new interpretation, plaintiffs' allegations that defendants intended to create "upward price momentum" [FN17] and "the illusion of ever rising stock prices" [FN18] must be understood to allege that defendants tried--but often failed--to create actual price increases. Indeed, it is not surprising that earnings reports that exceeded estimates failed to create much market excitement, because the so-called "conditioning statements" allegedly made by defendants cautioned investors that the estimates were likely to be beaten. It is thus difficult to discern how such a scheme--

characterized by issuing depressed earnings estimates, cautioning consumers that the estimates were likely to be too low, and then beating the estimates without any reliable quickening of actual share prices--could have artificially inflated the prices of the securities at issue. However, regardless of how difficult it may be for plaintiffs to *prove* that the alleged scheme caused their losses, their latest revisions at least *allege* that the scheme caused some artificial inflation.

FN17. TAC ¶ 1 (summarizing the central elements of the alleged scheme).

FN18. *Id.* ¶¶ 256, 267 (setting forth the basis for plaintiffs' claims against the CSFB defendants and Issuer defendants respectively).

B. Loss Causation

It is now clear, however, that plaintiffs cannot satisfactorily allege loss causation simply by alleging that they purchased securities at artificially inflated prices. [FN19] On April 19, 2005, in *Dura Pharmaceuticals, Inc. v. Broudo,* [FN20] the Supreme Court rejected the Ninth Circuit's permissive pleading standard for loss causation, which required only that a plaintiff allege that she had bought a security at an artificially inflated price. [FN21] The Court noted that "it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind. At the same time, allowing a plaintiff to forgo giving any indication of the economic loss and proximate cause that the plaintiff has in mind would bring about harm of the very sort the statutes seek to avoid." [FN22]

FN19. In my April 1 Opinion, I noted that the Supreme Court had not yet ruled on the appropriate standard for pleading loss causation in the securities fraud context. *See Liu II,* 2005 WL 743550, at *6.

FN20. 125 S.Ct. 1627, 1630 (2005).

FN21. *See Broudo v. Dura Pharms., Inc.,* 339 F.3d 933, 938 (9th Cir.2003).

FN22. *Dura,* 125 S.Ct. at 1634.

***3** In the Second Circuit, "a plaintiff must allege something more than merely artificial inflation [to plead loss causation adequately]." [FN23] However, "a plaintiff need not allege a totally independent basis for her loss *in addition to* artificial inflation; if that were the case, then allegations of artificial inflation would be superfluous." [FN24] Nonetheless, "in material misstatement and omission cases, a court cannot presume dissipation of the inflationary effect; a plaintiff must explicitly allege a disclosure or some other corrective event." [FN25] Moreover, "to establish loss causation, 'a plaintiff must allege ... that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered,' *i.e.,* that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." [FN26]

FN23. *Fogarazzo v. Lehman Bros.,* 341 F.Supp.2d 274, 287 (S.D.N . Y.2004) (footnote omitted). *See also Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp.,* 343 F.3d 189, 198 (2d Cir.2003) (holding "that a purchase-time loss allegation *alone* could [not] satisfy the loss causation pleading requirement") (emphasis in original); *cited with approval by Dura,* 125 S.Ct. at 1630. *Dura* itself does not define a pleading standard for loss causation; rather, it simply rejects the Ninth Circuit's standard as overly permissive. Accordingly, the Second Circuit's standard--which certainly requires "a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind," *id.* at 1634--is undisturbed by *Dura.*

FN24. *Fogarazzo,* 341 F.Supp.2d at 287 (emphasis in original).

FN25. *In re IPO,* 297 F.Supp.2d 668, 673 (S.D.N.Y.2003) (footnote omitted).

FN26. *Lentell v. Merrill Lynch & Co., Inc.,* 396 F.3d 161, 173 (2d Cir.2005) (citation omitted) (emphasis in original) (quoting *Suez Equity Investors, L.P. v. Toronto-Dominion Bank,* 250 F.3d 87, 95 (2d Cir.2001)). *See also Fogarazzo,* 341 F.Supp.2d at 289 (noting that courts have found plaintiffs sufficiently pleaded loss causation where "defendants ['] misrepresentations [ ] went to the value of the security" and "the ultimate decline in the companies' stock price was attributable to the very thing that the defendants allegedly lied about").

It is vital to understand the scheme that plaintiffs allege was concealed from the market. Plaintiffs allege that the defendants intentionally discounted earnings estimates and issued cautionary statements to excite the market and inflate prices when those estimates were beaten. To allege loss causation, plaintiffs must allege that, at some point, the concealed scheme was disclosed to the market.

Plaintiffs allege that "when each Issuer failed to continue the trend which had been established since the IPO of consecutively and sequentially posting actual revenue results that exceeded those which had been forecasted, the fraud effectively ended and purchasers of the inflated stocks were damaged." [FN27] Plaintiffs point to three types of "Disclosing Events" that purportedly disclosed the fact of the alleged fraud: (1) reports of quarterly revenues that failed to exceed forecasts; (2) announcements prior to quarterly reports that the Issuer would fail to meet forecasts; and (3) downward revisions of the analysts' own published estimates. [FN28] Plaintiffs assert that, whenever a Disclosing Event occurred, "the fraudulently induced expectation of continuing upside surprises ended." [FN29]

FN27. TAC ¶ 225.

FN28. *Id.* ¶¶ 225, 227.

FN29. *Id.* ¶ 225.

That *expectation,* though, is not the scheme plaintiffs allege. It is merely an expression of the market's belief that the securities were valuable. The fact that an event--in this case, a failure to meet earnings forecasts or a statement foreshadowing such a failure--disabused the market of that belief does not mean that the event disclosed the alleged scheme to the market. In other words, a failure to meet earnings forecasts has a *negative* effect on stock prices, but not a *corrective* effect. [FN30] Such a failure does not imply that defendants concealed a scheme to depress earnings estimates and drive up prices. It does not disclose the scheme; therefore, it cannot correct the artificial inflation caused by the scheme. [FN31]

FN30. In my first opinion in this case I noted that each Disclosing Event was the unfortunate but commonplace event of a publicly traded company failing to meet its revenue forecast, coupled with a concomitant and predictable immediate drop in share prices. Such an event could not alone have led a reasonable investor to believe that the market for her stock had been artificially buoyed through a well-coordinated scheme of discounting revenue forecasts.

Liu I, 341 F.Supp.2d at 350.

FN31. *See Lentell,* 396 F.3d at 173.

Because plaintiffs do not allege that the scheme was ever disclosed, they fail to allege loss causation. Although plaintiffs' latest reinterpretation of their Third Amended Complaint alleges that defendants' omissions and misrepresentations artificially inflated share prices, it does not allege any disclosure that would correct those omissions or misrepresentations. If downturns in stock prices based on such mundane events as failures to meet forecasts and downward revisions of forecasts were legally sufficient to constitute disclosures of securities fraud, then any investor who loses money in the stock market could sue to recover for those losses without alleging that a fraudulent scheme was ever disclosed and that the disclosure caused their losses. That would effectively convert the securities laws into an insurance policy for investors. "But the statutes make [private securities fraud actions] available, not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause."

***4** It is illustrative to consider what kind of event could have disclosed the actual fraud alleged, thereby permitting a determination of whether the alleged fraud actually caused any losses. In the context of plaintiffs' earlier motion for leave to amend, in which defendants asserted that press accounts of IPO underpricing placed plaintiffs on inquiry notice of the alleged scheme, defendants uncovered a single article that referred to the type of discounting alleged by plaintiffs. At that time, I noted:

In the April 23, 2000 Sunday Times of London, the following language appeared:

"Chuck Hill, research director at First Call, a firm that collates analysts' estimates, condemns another increasingly common and deceptive practice of deliberately understating a company's expected

earnings.
"He says: 'Nowadays it is imperative not to miss your estimates (because the market will punish the stock). More and more firms are giving (confidential) low-ball guidance figures to analysts, knowing they can beat them. It is naive and it is going to end badly." ' [FN32]

FN32. *Liu I,* 341 F.Supp.2d at 349 (footnotes omitted).

Although that single article, standing alone, was not specific enough to constitute actual disclosure of the alleged fraud with respect to any of the Issuers, [FN33] a similar release stating that one of the Issuers had engaged in such behavior could have constituted a disclosing event. Plaintiffs allege no such disclosures. The lack of such disclosures--and, accordingly, any sufficient allegations of loss causation--dooms plaintiffs' Third Amended Complaint.

FN33. *See id.* ("However, although the article does specifically refer to high-technology 'bubble' stocks, it makes no mention of any of the Issuers by name, and does not suggest that CSFBC or any of the other Defendants were engaging in the practice of deliberately underestimating a company's expected earnings. Moreover, the article does not claim that the low-ball figures were disseminated to the public.").

IV. CONCLUSION

For the foregoing reasons, plaintiffs' motion to reconsider is granted in part. The discussion contained in this Opinion supplements the April 1, 2005 Opinion with respect to its discussion of transaction causation and loss causation. For the reasons stated in this Opinion and my April 1 Opinion, plaintiffs' Third Amended Complaint is dismissed. Defendants may submit letters in support of their contention that sanctions should be granted, not to exceed a total of ten pages for all defendants, by May 27, 2005. Plaintiffs' response, if any, is due June 6, 2005.
SO ORDERED.

2005 WL 1162445 (S.D.N.Y.)

Motions, Pleadings and Filings (Back to top)

. 2004 WL 2245646 (Trial Motion, Memorandum and Affidavit) Issuer Defendants' Reply Memorandum of Law in Further Support of Plaintiffs' Motion for Preliminary Approval of the Partial Settlement with Issuer Defendants (Aug. 04, 2004)

. 2004 WL 2245647 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Reply Memorandum of Law in Further Support of Motion for Preliminary Approval of Proposed Settlement with Issuer Defendants (Aug. 04, 2004)

. 2004 WL 2270817 (Trial Motion, Memorandum and Affidavit) Underwriter Defendants' Memorandum in Opposition to Plaintiffs' Motion for Preliminary Approval of Settlement with Defendant Issuers and Individuals (Aug. 04, 2004)

. 1:04CV03757(Docket)
(May. 18, 2004)

. 2002 WL 32495945 (Trial Motion, Memorandum and Affidavit) Plaintiff Mdcm Holdings, Inc.'s Memorandum of Law in Opposition to Defendant Credit Suisse First Boston Corporation's Motion for an Order Limiting the Scope of Discovery (Feb. 06, 2002)

. 2002 WL 32595836 (Trial Motion, Memorandum and Affidavit) Plaintiff Mdcm Holdings, Inc.'s Memorandum of Law in Opposition to Defendant Credit Suisse First Boston Corporation's Motion for an Order Limiting the Scope of Discovery (Feb. 06, 2002)

. 2002 WL 32495877 (Trial Pleading) Amended Class Action Complaint (Feb. 04, 2002)

. 2002 WL 32595835 (Trial Pleading) Amended Class Action Complaint (Feb. 04, 2002)

. 1:21MC00092 (Docket)

TAB 8

Motions, Pleadings and Filings

United States District Court,
N.D. Illinois, Eastern Division.
LAWRENCE E. **JAFFE** PENSION PLAN, on Behalf of Itself and All Others Similarly Situated, Plaintiff,
v.
HOUSEHOLD INTERNATIONAL, INC., Merrill Lynch, Pierce, Fenner, & Smith, Inc., Goldman Sachs & Co., Inc., Arthur Andersen, L.L.P., William F. Aldinger, David A. Schoenholz, Gary Gilmer, J.A. Vozar, Robert J. Darnall, Gary G. Dillon, John A. Edwardson, Mary Johnston Evans, J. Dudley Fishburn, Cyrus F. Freidheim, Louis E. Levy, George A. Lorch, John D. Nichols, James B. Pitblado, S. Jay Stewart, and Louis W. Sullivan, Defendants.
No. 02 C 5893.

March 22, 2004.

Frederic S Fox, Kaplan, Kilsheimer & Fox LLP, New York, NY, Gary L. Specks, Kaplan, Fox & Kilsheimer LLP, Chicago, IL, for Plaintiff.

Warren Roger Stern, Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen & Katz, New York, NY, Nathan P. Eimer, Adam B. Deutsch, Eimer Stahl Klevorn & Solberg, LLP, Sheila Marie Finnegan, Lucia Nale, Stanley J. Parzen, Debra L Bogo-Ernst, Susan Charles, Mayer, Brown, Rowe & Maw LLP, Marshall J. Hartman, Eric S. Palles, Attorney, Gary Jay Ravitz, Ravitz & Palles, P.C., Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER

GUZMAN, J.

***1** Plaintiff Lawrence E. Jaffe Pension Plan, on behalf of itself and all others similarly situated, brought this suit alleging violations of 15 U.S.C. § 78(j)(b) (" § 10(b)" of the Exchange Act of 1934 ("1934 Act")) and 17 C.F.R. § 240.10b-5 ("Rule 10b-5") against Household, Household Officers, identified as Aldinger, Schoenholz, and Gilmer, and Arthur Andersen ("Andersen") in Count I; violation of 15 U.S.C. § 78(t)(a) (" § 20(a)" of the 1934 Act) by Household, and Household Officers in Count II; violations of 15 U.S.C. §§ 77k, 771(a)(2), and 77o (" §§ 11, 12(a)(2), and 15" of the Securities Act of 1933 ("1933 Act")) by Household, Household Officers, Household Directors, Andersen, Goldman Sachs & Co., Inc. ("Goldman Sachs"), and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") in Count III, and violations of 15 U.S.C. § § 77k, 77o (" §§ 11, 15" of the 1933 Act) by Household, Household Directors and Andersen in Count IV. Glickenhaus & Co. has been named lead plaintiff in this case, which is a consolidation of a number of cases.

Household, Officer Defendants, Individual Defendants and Andersen have moved to dismiss Counts I and II under Fed.R.Civ.P. ("Rule") 9(b) and 12(b)(6). Household Officers, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch have moved to dismiss Counts III and IV under Rule 12(b)(6). In addition, Andersen has moved to strike two paragraphs in the Amended Complaint pursuant to Rule 12(f). For the reasons set forth in this Memorandum Opinion and Order, the Court: (1) denies Household's, Household Officers' and Andersen's motion to dismiss Count I; (2) denies Household's, and Household Officers' motion to dismiss Count II; (3) grants Household's, Household Officers', Household Directors', Andersen's, Goldman Sachs', and Merrill Lynch's motions to dismiss Counts III; (4) denies in part and grants in part Household's, Household Directors' and Andersen's motions to dismiss Count IV; and (4) denies Andersen's motion to strike.

FACTS

The complaint at issue relates to violations of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Exchange Act of 1934 and 17 C.F.R. § 240.10b-5.

Lead plaintiff Glickenhaus & Company and the other proposed class members purchased shares of Household common stock, preferred stock, bonds, notes, InterNotes(SM) and Trust indentures between October 23, 1997 and October 11, 2002 ("Class Period"). Defendant Household International, Inc. is engaged primarily in consumer lending.

During the Class Period, Household reported continuous and dramatic growth in income and net earnings. On the basis of quarterly earning statements, meetings, conference calls with analysts and other publication of data, stock analysts from a variety of respected firms issued "buy" reports with respect to Household offerings. Also during this period, Household filed a number of required forms and statements with the Securities and Exchange Commission ("SEC") with the inclusion of reports from various named directors and officers as well as audit reports generated by Andersen and stock analysis reports by Goldman Sachs and Merrill Lynch. On the basis of these statements and assurances, plaintiff purchased Household securities.

***2** During the Class Period, allegations of predatory lending and improper "reaging" of loans began to surface from a variety of sources. These included allegations in Washington and California that ultimately resulted in the filing of lawsuits during the Class Period. During the Class Period Household entered into a settlement agreement regarding Household's lending practices with the Attorneys General of several states. Also during the Class Period, Washington published the Washington Department of Financial Institutions Expanded Report of Examination of Household Finance Corporation III (April 30, 2002) ("Washington Report"). All of these allegations arose from what plaintiff characterizes as Household's predatory lending practices as outlined in what Household had named the "EZ Pay Plan," wherein Household allegedly loaned money to high-risk consumers and home owners, employing a variety of tactics intended to boost the fees and costs associated with the loans. In order to assist in the overall management of Household, during this period Household perfected what it called the "Vision System" that the Officer Defendants publicly praised as making company-wide data available to them and allowing them to engage in proactive management of lending practices at all of the branch offices. In addition, plaintiff alleges Household engaged in "reaging" loans, whereby delinquent loans were reclassified as still current by the addition of the delinquent payments onto the end of the loan term, thereby lengthening the loan term and reducing the appearance of default loans on Household's books.

Although both Household and Andersen argue that Household's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP") and generally accepted accounting standards ("GAAS"), this was not true according to plaintiff. Under these principles, "reaging" of loans in the manner Household used is strongly recommended against because it fails to indicate whether the accounts may ultimately be collectable. This results in the diminution of the reliability of aging scales and, practically speaking, obscures the risk of delinquency associated with the outstanding loans.

Throughout most of the Class Period, Household securities generally increased in value, ultimately rising to over $63.25. This began to change, though. On August 14, 2002 Household announced that its new auditors KPMG had recommended a substantial restatement of earnings for a period including the Class Period. The ultimate result was a lowering of net income and equity by $386 million for the period from 1994 to the second quarter 2002. Additionally, with the circulation of rumors about a pending California class action legal settlement that would restrict Household's lending practices and result in a multi-million settlement, there was a dramatic fall in stock price to around $28 a share in less than three months.

Each of the proposed class members purchased Household securities during the Class Period at allegedly artificially inflated prices, relying on the integrity of the market price and market information. Each has been damaged as a result of defendants' misrepresentations.

***3** Officer Defendants participated directly in the day-to-day operations of Household and were instrumental in the development and execution of the practices and programs plaintiff alleges led to the instant complaint. Each had access to confidential information about the company's business and operations. Each directly and indirectly controlled the conduct of the company's business, the information contained in its filings with the SEC, and public statements about its business and financial results. Officer and Director Defendants were signatories on the Registration Statements that resulted in the issuance of further Household securities. Auditor defendant, Andersen, performed independent audits and provided accounting, management consulting, and tax services for Household during the Class Period. It reviewed financial data used in a variety of SEC filings, *e.g.*, debt registration statements and audit reports included as attachments to various SEC filings. Andersen was intimately involved in Household's confidential corporate financial and business operations. Household Director Defendants were all Household directors during the Class Period. Merrill Lynch and Goldman Sachs both provided stock analysis services in connection with the merger between Beneficial and Household.

DISCUSSION

Each defendant has moved to dismiss various counts of the Amended Complaint. Household, Officer Defendants, Individual Defendants and Arthur Andersen have moved to dismiss Counts I and II. Household, Officer Defendants, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch have moved to dismiss Counts III and IV. Additionally, Andersen has moved to strike paragraphs 180 and 181 of the Amended Complaint as prejudicial and irrelevant. The Court addresses each of these arguments in turn.

A Rule 12(b)(6) motion to dismiss does not test the merits of the case and merely attacks the sufficiency of the complaint. *Fishman v. Meinen,* No. 02 C 3433, 2003 WL 444223, at *4 (N.D.Ill. Feb.24, 2003). A court may only dismiss a complaint for failure to state a claim upon which relief may be granted if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding,* 467 U.S. 69, 73, 104 S.Ct. 2229, 81 L.Ed.2d 59 (1984); *see Ledford v. Sullivan,* 105 F.3d 354, 356 (7th Cir.1997). A court must accept all well pleaded allegations of the complaint as true, and must view those allegations in the light most favorable to plaintiff. *Fishman,* 2003 WL 444223, at *4. The Court need not accept as true legal conclusions alleged in the complaint, though a plaintiff may plead conclusions if they "provide the defendant with at least minimal notice of the claim." *Jackson v. Marion County,* 66 F.3d 151, 154 (7th Cir.1995).

I. Fraud Claims: Section 10(b) and Section 20(a) of the 1934 Act and Rule 10b-5

Plaintiff seeks relief against Household, Officer Defendants and Andersen for fraud under Section 10(b) of the 1934 Act and Rule 10b-5 in Count I and Section 20(a) in Count II. Defendants contend that plaintiff has insufficiently pleaded according to the standards for fraudulent averments under Rule 9(b), or according to the standards of the Private Securities Litigation Reform Act ("PSLRA"). 15 U.S.C. § 78u-4. (Household Mot. Dismiss at 22-24; Andersen Mot. Dismiss at 1-2.)

***4** It is well settled that "Rule 9(b) [of the Federal Rules of Civil Procedure] governs claims based on fraud and made pursuant to the federal securities laws." *Sears v. Likens,* 912 F.2d 889, 893 (7th Cir.1990) (alteration in original, quotations omitted). "Circumstances constituting fraud ... shall be stated with particularity," which has been interpreted as requiring inclusion of " 'the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff" ' in fraud allegations. Fed.R.Civ.P. 9(b); *Uni*Quality, Inc. v. Infotronx, Inc.,* 974 F.2d 918, 923 (7th Cir.1992) (quoting *Bankers Tr. Co. v. Old Republic Ins. Co.,* 959 F.2d 677, 683 (7th Cir.1992)). In essence, the complaint must specify the "who, what, when, where, and how" of the allegedly fraudulent acts. *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir.1990). The purpose of this "is to force the plaintiff to do more than the usual investigation before filing his complaint." *Ackerman v. Northwestern Mut. Life Ins. Co.,* 172 F.3d 467, 469 (7th Cir.1999). The rule serves to (1) protect defendants' reputations from harm, (2) minimize 'strike suits' and 'fishing expeditions', and (3) provide notice of claims to adverse parties. *Fishman,* 2003 WL 444223, at *5 (citing *Vicom, Inc. v. Harbridge Merch. Servs., Inc.,* 20 F.3d 771, 777 (7th Cir.1994)).

In addition, a complaint of securities fraud under the 1934 Act is subject to the PSLRA. 15 U.S.C. § 78u-4(a)(1). Under the PSLRA, a plaintiff must allege a defendant "made an untrue statement of a material fact" or "omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading." 15 U.S.C. § 78u-4(b)(1). In either case, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* Further, plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). If these requirements are not met, the Court shall dismiss the complaint. 15 U.S.C. § 78u-4(b)(3).

Together, the overlapping pleading requirements of Rule 9(b) and the PSLRA make it clear that a plaintiff must aver which defendants said what, to whom, and when. *Ackerman,* 172 F.3d at 471; *Fishman,* 2003 WL 444223, at *5; *see also Sears,* 912 F.2d at 893. "Where a plaintiff alleges that a group of individuals is part of a fraudulent scheme, he or she must put each defendant on notice of his or her alleged role." *Fishman,* 2003 WL 444223, at *5; *see Vicom,* 20 F.3d at 777-78. In addition, a plaintiff must show a "strong inference" of scienter, whether through a showing of "motive and opportunity to commit fraud" or through a showing of "conscious misbehavior or recklessness." *Johnson v. Tellabs, Inc.* ., No. 02 C 4356, 2004 WL 324752, at *18 (N.D.Ill. Feb.19, 2004).

A. § 10(b) and Rule 10b-5

***5** In pertinent part Section 10(b) and Rule 10b-5 provide that it is unlawful for any person in connection with a securities sale or purchase "[t]o 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 ... [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5(b), (c); *see* 15 U.S.C. § 78j(b).

To state a claim for a violation under Section 10(b) or Rule 10b-5, a plaintiff must allege that (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages. *Otto v. Variable Annuity Life Ins. Co.,* 134 F.3d 841, 851 (7th Cir.1998); *Caremark, Inc. v. Coram Healthcare Corp.,* 113 F.3d 645, 648 (7th Cir.1997). Plaintiff must establish that defendants had a duty to disclose the omitted information. *Basic Inc. v. Levinson,* 485 U.S. 224, 239, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988).

1. Alleged false and misleading statements

The first requirement of the PSLRA is to identify each statement alleged to be misleading. For the most part, plaintiff has done this, identifying who made particular statements, when, how they were misleading, and the results of the statements. They point to the following representations as false and misleading.

a. Household

Throughout the Class Period Household published quarterly financial data, usually accompanied by statements from one or more directors. (Am. Compl. at ¶¶ 192, 214, 218, 230, 233, 237, 243, 252, 258, 263, 272, 285, 289, 298, 311, 333.) These statements included net income and earnings per share information, giving both dollar amounts and various comparative statistics with respect to earlier quarters. In each case, the income and earnings per share information increased by double digit percentages over earlier quarters. Plaintiff contends these quarterly statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the inclusion in the statements of what it alleges were the knowingly inaccurate financial representations, as well as its assertion that Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at ¶¶ 126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) Plaintiff contends the result of these quarterly releases was the republication of the Household data in a variety of respected analyst reports accompanied by "buy" recommendations and immediately subsequent share price rises based on both Household's and the analysts' reports. (*Id.* at ¶¶ 193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

***6** Further, Household filed Form 10-K SEC filings signed by Aldinger, Schoenholz and Director Defendants that asserted Household was in compliance with SEC Regulations S-X and S-K. (*Id.* at ¶¶ 200, 225, 246-48, 277, 313.) This was supported by Andersen's audit opinion of the data incorporated by reference in the filing. (*Id.* at ¶¶ 202, 227, 249, 279, 316.) In the audit opinions Andersen asserted "that it had audited Household's financial statements and Schedule 14(d) for [the respective years] in accordance with GAAS and opined that it 'fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole." ' (*Id.*) The March 28, 2000 filing contained assertions related to how Household had increased in various indices of operating net income. (*Id.* at ¶ 246.) It also stated that risk-based pricing and effective collection efforts for its loans resulted in effective management of credit losses. (*Id.* at ¶ 247.) Household also stated that it had shifted its credit card receivables to its subsidiary HFC, according to plaintiff, for the purpose of avoiding newly enacted federal banking regulations that significantly altered reporting requirements. (*Id.* at ¶ 250.) The March 28, 2001 filing stated that Household "continue[s] using risk-based pricing and effective collection efforts for each loan. We have a process that gives us a reasonable basis for predicting the asset quality of new accounts." (*Id.* at ¶ 278.) The March 13, 2002 filing reiterated this language. (*Id.* at ¶ 315.) It additionally stated in the "Management Report" signed by Aldinger and Schoenholz that "the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards." (*Id.* at ¶ 314.) Plaintiff contends Household through the agency of its officers, directors and auditor based these filings on knowingly false and misleading financial data. (*Id.* at ¶¶ 126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) As a result of the successful filings, Household was able to maintain what plaintiff contends was its false financial position which misled analysts and investors. (*Id.* at ¶¶ 200, 225, 246-48, 277, 313.)

b. Aldinger

In addition to Aldinger's signatures on the above-mentioned SEC filings, plaintiff alleges Aldinger repeatedly made materially misleading statements during the Class Period. Many of these statements were included in Household's quarterly releases of its financial results. (*Id.* at ¶¶ 192, 197, 209, 214, 218, 229, 233.) Aldinger repeatedly made statements included in these releases concerning Household's financial status and the alleged means used to reach the published results. These statements included ones such as (1) "wider margins, higher average managed receivables, and a continued focus on efficiency [ ]more than offset the impact of higher credit losses"; (2) "[w]e grew revenues 18 percent and kept expenses essentially flat. We absorbed increased chargeoffs consistent with industry-wide trends and further strengthened our credit loss reserves. We also improved our return on managed assets. Our return on equity exceeded 18 percent, even though we significantly increased our capital levels"; (3) "[o]ur tight focus on our core markets, our conservative capital base and our disciplined approach to funding and liquidity management enabled Household to achieve record earnings for the quarter"; (4) "[t]he company's operating results were solid with 6 percent annualized receivable growth, margin expansion and improving efficiency .... reserve coverage remains conservative"; (5) reporting net income increases in excess of 70%, resulting in part from "higher yields on unsecured products and lower funding costs, partially offset by the effect of a shift in mix toward secured products"; and (6) "[s]trong loan growth in our consumer finance business, improved efficiency and higher income from our tax refund loan business" as the underlying causes for increases. (*Id.* at ¶¶ 192, 197, 214, 218, 229.)

*7 In response to analyst questions on February 7, 2002 concerning rumors that Household might change its accounting policies, thereby affecting stock value, Aldinger and Schoenholz made various statements indicating that Household would not change its accounting policies. (*Id.* at ¶ 320.) These included statements such as "Household has had no problems with its commercial paper funding and the costs of that funding has not increased," "Arthur Andersen has always been aggressive with HI. There are no accounting changes being discussed and there are to be no surprises in the 10K. HI's board of directors has had long conversations about Arthur Andersen and they plan to watch to see if a change has to be made but none is anticipated at this point." (*Id.*)

Plaintiff contends the statements made by Aldinger were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on what it asserts was Aldinger's knowledge of Household's improper business and accounting practices. The result of Aldinger's alleged concealment of Household's true financial state resulted in the re-publication of the Household data along with Aldinger's statements and paraphrases of Aldinger's statements in a variety of respected analyst reports, causing immediately subsequent share price rises and "buy" recommendations. (*Id.* at ¶¶ 193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

c. Schoenholz

In addition to Schoenholz's signatures on the above-mentioned SEC filings, plaintiff alleges Schoenholz authorized, signed and caused to be filed multiple SEC Form 10-Q's. Each filing stated it was prepared in accordance with GAAP procedures and that it included, "[i]n the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation." (*Id.* at ¶¶ 194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.) Plaintiff contends that both statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the inclusion in the 10-Qs of what it alleges were the knowingly inaccurate financial representations published in Household's quarterly corporate financial reports, as well as its assertion that Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at ¶¶ 126, 142-47, 194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.)

Schoenholz, in particular, is cited by plaintiff for having made misleading public statements about the restatement resulting from the KPMG audit. (*Id.* at ¶¶ 146-47.) Plaintiff contends that the financial reports included in the 10Qs materially misrepresented Household's true financial condition because they failed to disclose losses and the ephemeral nature of claimed assets. (*Id.* at ¶¶ 196, 217, 242, 271, 302, 308, 332, 342.)

d. Gilmer

***8** Plaintiff contends that Gilmer oversaw a sales training manual update project that featured the "EZ Pay Plan." (*Id.* at ¶ 96 .) The subsequent nationwide distribution of this manual to Household offices and its use as the basis of sales training programs resulted in the nationalization of practices previously confined to the Washington State area. (*Id.* at ¶¶ 94-96.) Plaintiff alleges the distribution and training authorized by Gilmer directly resulted in company-wide predatory lending practices and subsequent accounting irregularities, ultimately resulting in the misrepresentation of Household's financial status. (*Id.* at ¶¶ 26, 102.) Despite the allegedly unethical nature of the "EZ Pay Plan," the Origination News quoted Gilmer as stating that "[u]nethical lending practices of any type are abhorrent to our company, our employees and most importantly customers." (*Id.* at ¶ 280.) Thus, Gilmer reassured the market and contributed to analyst optimism, "buy" recommendations, and increasing share prices.

e. Andersen

In addition to the inclusion of Andersen's audit reports and opinions in the above-mentioned SEC filings, plaintiff alleges Andersen failed to conduct its audits of Household in compliance with GAAS and GAAP standards, or even to conduct proper audits at all, despite asserting the contrary. Specifically, Andersen stated in a report to Household's shareholders:

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

(*Id.* at ¶ 174.)

Plaintiff alleges this, and similar statements, are untrue and resulted in false and misleading audit reports of Household's financials. This further resulted in the allegedly false SEC filings noted above. (*Id.* at ¶ 176.) Additionally, plaintiff alleges that Andersen "knew its reports would be relied upon by potential investors in Household securities," whether they appeared in the SEC filings or the quarterly Household financial data releases. (*Id.* at ¶ 176.)

The Court concludes that each of these statements satisfies Rule 9(b) and the PSLRA's requirement for particularly pointing out misleading statements related to securities sales, indicating why it is material, and relating how the statements caused plaintiff's damages. Accordingly, the Court holds that plaintiff has articulated the who, what, when, where, and how of the fraud with sufficient particularity.

2. Scienter

***9** The only remaining question is whether plaintiff has pleaded sufficiently that defendants Household, Officer Defendants and Andersen acted with the requisite scienter to meet PSLRA standards. While the Seventh Circuit has yet to address precisely how rigorously the PSLRA's pleading standards must be applied to plead the "requisite state of mind," cases in the Northern District of Illinois have generally followed the Second Circuit's pleading standard. Thus, plaintiff must allege facts either (1) showing that the defendant had both motive and opportunity to commit fraud; or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. *See Suez Equity Investors, L.P. v. Toronto-Dominion Bank,* 250 F.3d 87, 100 (2d Cir.2001); *see, e.g ., In re Hartmarx Sec. Litig.,* No. 01 C 7832, 2002 WL 653892, at *2 (N.D.Ill. Apr.19, 2002) (collecting cases); *Beedie v. Battelle Mem'l Inst.,* No. 01 C 6740, 2002 WL 22012, at *2 (N.D.Ill. Jan.7, 2002) (collecting cases).

Officer Defendants Aldinger, Schoenholz and Gilmer contend they did not knowingly publish inaccurate or misleading statements on behalf of Household. They also contend that plaintiff has failed to "state with particularity facts giving rise to a strong inference" that defendants acted with the required state of mind, or knew of the predatory lending and "reaging" practices or knew that such practices were material. (Mem. Supp. Household's Mot. Dismiss at 18, 23-25.) Further, Officer Defendants argue that the tie between compensation and company performance is insufficient to establish scienter. (*Id.* at 20.)

Defendants are correct that the tie between compensation and company performance without more is not sufficient. *Tricontinental Indus. v. Anixter,* 215 F.Supp.2d 942, 950 (N.D.Ill.2002); *Chu v. Sabratek Corp.,* 100 F.Supp.2d 827, 837 (N.D.Ill.2000). However, "[i]t is well established in this Circuit that a party may be excused from Rule 9(b)'s requirement of pleading with particularity if the information that he is required to plead rests exclusively within the defendants' control or is otherwise unavailable to him." *In re NeoPharm, Inc. Sec. Litig.,* No. 02 C 2976, 2003 WL 262369, at * 11 (N.D.Ill. Feb.7, 2003) (citing *In re Newell Rubbermaid Sec. Litig.,* No. 99 C 6853, 2000 WL 1705279, at *14 (N.D.Ill. Nov.14, 2000)). As a result, it is necessary to consider if plaintiff has sufficiently pleaded facts indicating strong circumstantial evidence of defendants' awareness and direction of the allegedly predatory pricing and "reaging" programs.

Officer Defendants Aldinger, Schoenholz and Gilmer are characterized by plaintiff as "hands-on" managers of Household and its subsidiaries, with access to and control over the daily operations of Household, including the programs that resulted in predatory lending and in "reaging" of loans. (*Id.* at ¶ 165.) As such the Officer Defendants were in possession of non-public information "based on their review of Household's internal operating data, including information provided to them by Household's Vision system," directly contradicting their public statements on behalf of the company about Household's financial dealings. (*Id.* at ¶¶ 155-56, 196, 217, 242, 271, 302, 308, 332, 342.) As a result, plaintiff alleges Officer Defendants in their individual capacities and as representatives of Household either knew or were grossly reckless in not knowing that the public statements and omissions regarding Household's financial status, and business and accounting practices were false or misleading when made. (*Id.*)

***10** Plaintiff asserts the Officer Defendants Aldinger, Schoenholz and Gilmer had motive and opportunity to commit fraud, and further, acted with conscious recklessness. Household's "pay-for-performance" policy tied executive compensation to company performance, both economic and non-economic. (*Id.* at ¶¶ 157-64.) Targeted earnings per share, targeted return on equity, targeted operating efficiency ratios, targeted reserve to charge-off ratios and targeted equity to managed asset ratios all played a role in determining the officer defendants' compensation. (*Id.* at ¶¶ 160-62.) Thus, plaintiff assert that "without the boost provided by defendant's improper accounting, Household would likely not have had a single quarter of meeting or exceeding analysts' expectations," nor as a result would Officer Defendants have garnered the bonuses they did. (*Id.* at ¶ 163.)

With respect to Andersen, plaintiff asserts it had motive and opportunity to make misrepresentations as well. Plaintiff alleges Andersen partners "were under enormous pressure" to increase its Household billing. (*Id.* at ¶ 177.) In addition to its auditing fees, Andersen sought and gained further extensive, non-auditing consulting service work and fees from Household. (*Id.* at ¶ 178 .) By involving itself closely in Household's various business ventures, it abrogated its independent status as an auditor, thereby compromising its independence. (*Id.* at ¶ 179.) As a result, plaintiff alleges Andersen had a vested interest in going along with Household's allegedly improper accounting practices and supporting Household's misrepresentations and material misstatements. (*Id.* at ¶ 177.)

The Court concludes that plaintiff has sufficiently pleaded the requisite state of mind for each defendant from the information currently available to it. As a result, the heightened pleading requirements for § 10(b) and Rule 10b-5 have been met and the defendants' motions to dismiss Count I are denied.

B. § 20(a)

Section 20(a) of the 1934 Act imposes liability on anyone "who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder." 15 U.S.C. § 78t(a). It is a predicate offense, requiring a violation of some other section of the 1934 Act in order to be applicable. *Id.* That threshold requirement has been met via the § 10(a) and Rule 10b-5 allegations. Additionally, § 20(a) does not have a scienter requirement or a heightened pleading standard. Accordingly, liberal pleading requirements apply. *In re Anicom, Inc.,* No. 00 C 4391, 2001 WL 536066, at *6 (N.D.Ill. May 18, 2001); *Chu,* 100 F.Supp.2d at 843.

"To plead control person liability, the plaintiff[ ] must adequately allege that each 'control person' participated in or exercised control over the company in general and that he or she possessed the 'power or ability to control [the specific] transactions upon which the primary violation was predicated,' whether or not that power was exercised." *Nanophase Techs. Corp. Sec. Litig.,* Nos. 98 C 3450, 98 C 7447, 2000 WL 1154631, at *7 (N.D.Ill. Aug.14, 2000) (citing *Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 881 (7th Cir.1992)). Plaintiff alleges that the Officer Defendants, Aldinger, Schoenholz and Gilmer, exercised "hands on" management, involving themselves in all aspects of Household's activities. (Am. Compl. at ¶ 165.) Further, plaintiff alleges Officer Defendants had control over the content and issuance of public statements "issued by or on behalf of Household," *e.g.,* quarterly and annual reports, press releases and SEC filings. (*Id.* at ¶ 166.) Plaintiff alleges these defendants had the requisite knowledge, the opportunity, and the power to correct any misstatements prior to publication. (*Id.*) This is sufficient for the purposes of a § 20(a) claim. *Chu,* 100 F.Supp.2d at 843; *Nanophase,* 2000 WL 1154631, at *7. As a result, defendants' motions to dismiss Count II are denied.

II. Strict Liability under the 1933 Act

***11** Plaintiff also seeks relief against Household, Officer Defendants, Director Defendants, Andersen, Goldman Sachs and Merrill Lynch under §§ 11, 12(a)(2) and 15 of 1933 Act in Counts III, and against Household, Director Defendants and Andersen under §§ 11 and 15 of 1933 Act in Count IV. Defendants contend that plaintiff has failed to state a claim upon which relief can be granted on two grounds. They primarily contend that the statute of limitations has passed. Even if it has not, they contend the claims lack sufficient particularity, fail to give notice, or otherwise are improperly pleaded.

A. Statute of Limitations

In stating its claims, plaintiff has asserted that the Sarbanes-Oxley Act (2002) applies to §§ 11, 12(a)(2) and 15 of 1933 Act. Defendants contest this.

In 2002, prior to the original filing of this suit, Congress prospectively lengthened the statute of limitations in federal securities fraud suits from a one-year/three-year arrangement to a two-year/five-year arrangement. 28 U.S.C. § 1658(b). As amended in 2002, 28 U.S.C. § 1658 provides:
(b) Notwithstanding subsection (a), a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a

regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47), may be brought not later than the earlier of--
(1) 2 years after the discovery of the facts constituting the violation; or
(2) 5 years after such violation.
28 U.S.C. § 1658(b).

A statute of limitations begins to run on either actual or inquiry notice of facts constituting fraud. *See Tregenza v. Great Am. Communications Co.,* 12 F.3d 717, 722 (7th Cir.1993). The Seventh Circuit employs an objective inquiry notice test:

The one-year [now two-year] statute of limitations applicable to suits under Rule 10b-5 begins to run not when the fraud occurs, and not when the fraud is discovered, but when (often between the date of occurrence and the date of the discovery of the fraud) the plaintiff learns, or should have learned through the exercise of ordinary diligence in the protection of one's legal rights, enough facts to enable him by such further investigation as the facts would induce in a reasonable person to sue within a year [now two years].

Fujisawa Pharm. Co., Ltd. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir.1997); *see Law v. Medco Research, Inc.,* 113 F.3d 781, 786 (7th Cir.1997). The ease of access to evidence that would trigger an appropriate inquiry is an important factor in determining when the statute of limitations begins running. *Fujisawa,* 115 F.3d at 1334. Further, "[t]here must also be a suspicious circumstance to trigger a duty to exploit the access; an open door is not by itself a reason to enter the room.... *How* suspicious the circumstance need be to set the statute of limitations running ... will depend on how easy it is to obtain the necessary proof by a diligent investigation aimed at confirming or dispelling the suspicion." *Id.* at 1335 (emphasis in original).

***12** Defendants make two arguments. First, defendants argue that the lengthened statute of limitations period granted by Sarbanes-Oxley is not applicable, and rather a shorter one-year/three-year statute of limitation applies to §§ 11, 12(a) and 15 violations because they do not sound in fraud. Second, even if some other alleged wrongdoing occurred, plaintiff's Complaint is untimely as not having been filed the earlier of five years after the occurrence or two years after notice. The Seventh Circuit has stated that, if a "plaintiff pleads facts that show its suit [is] barred by a statute of limitations, it may plead itself out of court under a Rule 12(b)(6) analysis." *See Whirlpool Fin. Corp. v. GN Holdings, Inc.,* 67 F.3d 605, 608 (7th Cir.1995) (affirming district court's dismissal of federal securities fraud claim on inquiry notice issue). Each of these arguments will be addressed in turn.

1. Applicability of the Sarbanes-Oxley Act to the 1933 Act

Defendants have individually moved to dismiss all claims brought under the 1933 Act as time barred by the statue of limitations period contained in 15 U.S.C. § 77m (" § 13"). Section 13 requires a claim to be

brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.... In no event shall any such action be brought to enforce a liability ... more than three years after the security was bona fide offered to the public, or ... more than three years after the sale.
15 U.S.C. § 77m.

In response, plaintiff contends that Section 804 of the Sarbanes-Oxley Act governs and that it had until the earlier of five years from the event or two years from the date of notice to bring their action. 28 U.S.C. § 1658(b). This raises the question of whether Sarbanes-Oxley applies to Section 11, 12(a)(2) and 15 claims, which the plaintiff properly asserts require only strict liability or negligence. (Am.Compl.¶¶ 136, 147.)

"Interpretation of a statute must begin with the statute's language." *Mallard v. U.S. Dist. Court for So. Dist. of Iowa,* 490 U.S. 296, 300, 109 S.Ct. 1814, 104 L.Ed.2d 318 (1989). A court may look beyond "the express language of a statute only where that statutory language is ambiguous or a literal interpretation would lead to an absurd result or thwart the purpose of the overall statutory scheme." *Nauheim v. Interpublic Group of Cos. Inc.,* No. 02 C 9211, 2003 WL 1888843, at *3 (N.D.Ill. Apr.16, 2003). The language of the statute itself, both in terms of the words used themselves and within the context of the statute, determines whether the meaning is plain or ambiguous. *Robinson v. Shell Oil Co.,* 519 U.S. 337, 341, 117

S.Ct. 843, 136 L.Ed.2d 808 (1997). A court must endeavor to give effect to the plain language of the statute. *Mallard*, 490 U.S. at 300. Where there is no ambiguity in the statute, there is " 'no occasion to look to the legislative history." ' *T.D. v. LaGrange Sch. Dist. No. 102*, 349 F.3d 469, 482 (7th Cir.2003) (quoting *Neosho R-V Sch. Dist. v. Clark*, 315 F.3d 1022, 1032 (8th Cir.2003)).

***13** The Sarbanes-Oxley Act provides:
(b) Notwithstanding subsection (a), *a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance* in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. § 78c(a)(47)), may be brought not later than the earlier of--
(1) 2 years after the discovery of the facts constituting the violation; or
(2) 5 years after such violation.
28 U.S.C. § 1658(b) (emphasis added).

While 15 U.S.C. § 78c(a)(47) provides:
(47) The term "securities laws" means the Securities Act of 1933 (15 U.S.C. § 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. § 78a et seq.), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (15 U.S.C. § 79a et seq.), the Trust Indenture Act of 1939 (15 U.S.C. § 77aaa et seq.), the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. § 80b et seq.), and the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa et seq .).
15 U.S.C. § 78c(a)(47).

While it is true that sections of the Securities Act of 1933 fall under Sarbanes-Oxley, the plain language of the Sarbanes-Oxley Act only applies to claims including "fraud, deceit, manipulation, or contrivance." 28 U.S.C. § 1658(b). It does not apply to non-fraud based claims brought under the 1933 Act. While relatively few courts have had opportunity to consider this question, each court has come to the same conclusion. *See Friedman v. Rayovac Corp.*, 295 F.Supp.2d 957, 975 (W.D.Wis.2003); *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F.Supp.2d 243, 265 (S.D.N.Y.2003); *In re WorldCom, Inc. Sec. Litig.*, Nos. 02 Civ. 3288(DLC), 03 Civ. 6592, 2003 WL 22738546, at *9 (S.D.N.Y. Nov.21, 2003). Hence, plaintiff's strict liability claims brought under Sections 11, 12(a)(2) and 15 claims of the 1933 Act are not covered by the Sarbanes-Oxley Act. [FN1]

FN1. To state a claim for violation of §§ 11, 12(a)(2) and 15, plaintiff need only allege that "material facts have been omitted" from a registration statement or "presented in such a way as to obscure or distort their significance." *Meyer Pincus & Assocs., P .C. v. Oppenheimer & Co.*, 936 F.2d 759, 761 (2d Cir.1991) (quotation omitted). These minimal proof requirements create extensive liability for issuers and those involved in the preparation and dissemination of the registration statements filed in the context of a public offering. *WorldCom*, 2003 WL 22738546, at *7. Section 11, 12(a)(2) and 15 claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by Rule 9(b) and PSLRA. *See In re WorldCom, Inc. Sec. Litig.*, 294 F.Supp.2d 392, 423 (S.D.N.Y.2003). Plaintiff clearly understands this because it has disavowed that its §§ 11, 12(a)(2) and 15 claims are anything other than strict liability or negligence claims. (Am. Compl. at ¶ ¶ 354, 383.)

Plaintiff's alternate contentions supporting its position are, likewise, without merit. Plaintiff's contention that Sarbanes-Oxley pertains to all sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 because Congress failed to explicitly exclude any sections of either invites the Court to step into the role of legislator, which is inappropriate.

Plaintiff also contends that a more inclusive meaning must be given to the terms "manipulation" and "contrivance," such that they cover any "vehicle through which the fraud is achieved" whether falling under the definition of fraud or not. (Pl's Resp. Household's Mot. Dismiss at 48.) Plaintiff's reliance on case law and legislative history to support this position is also misplaced. In *Ernst & Ernst v. Hochfelder*, the Supreme Court distinguished between intentional and negligent behavior in the context of securities fraud. 425 U.S. 185, 199, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). In particular, the Court held that the "[u]se of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* Intent to deceive is a necessary element of "manipulation" or "contrivance," making these terms ones of scienter, not negligence or strict liability. BLACK'S LAW DICTIONARY 741, 846, 1081 (7th ed.2000).

***14** Plaintiff's attempt to bolster this position through reference to the legislative history of the Sarbanes-Oxley Act is not well founded. The argument presented is nearly identical to the one presented, and rejected, in *WorldCom. WorldCom,* 2003 WL 22738546, at *9. In *WorldCom* the court stated that the legislative record shows that while the senators involved were greatly concerned with contemporaneous business frauds, they had no intention of conflating fraud with strict liability or negligence. *WorldCom,* 2003 WL 22738546, at *8-9.

The Court holds that the language of 28 U.S.C. § 1658(b) is unambiguous and does not apply to strict liability or negligence claims. As a result, the one-year/three-year statute of limitations in Section 13 of the 1933 Act applies to §§ 11, 12(a)(2) and 15. 15 U.S.C. § 77m.

2. Timing of the Claims

Because the Amended Complaint arose from the consolidation of multiple suits, it is necessary to determine the date of the earliest original pleading. Rule 15 of the Federal Rules of Civil Procedure provides that an amended pleading relates back to the date of the original timely pleading when "the claim or defense asserted in the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading." Fed.R.Civ.P. 15(c)(2). The earliest of the consolidated suits was filed August 19, 2002, hence that is the correct date for calculating notice.

Plaintiff bases its Section 11, 12(a)(2) and 15 claims on various SEC filings and associated statements and publications. Count III is based on a June 1, 1998 Form S-4 Registration and Joint Proxy Statement-Prospectus. (Am. Compl. at ¶ 357.) Applying the one year/three year statute of limitations, there is some question as to when plaintiff should first have been on inquiry notice. Plaintiff cites both the letter to Aldinger and the publication of the Washington Report as key indications that something was possibly not right with Household's financials, providing the "suspicious circumstance." *Fujisawa,* 115 F.3d at 1335. But the ability to pursue a diligent inquiry also plays a role in determining when inquiry notice should have begun. *Id.* Plaintiff would like to argue that inquiry notice should not have begun until the release of the Restatement by Household on August 14, 2002 made the recalculations of profits and losses accessible to the public, all other meaningful data having been sealed by settlement agreements. However, to assume that would mean that inquiry notice would have arisen more than three years after the complained of violation, the filing of the S-4 Registration. Because Section 13 requires claims to be filed the earlier of three years after the occurrence or one year after plaintiff is on actual or constructive notice, three years after the alleged violation, June 30, 2001, is the earliest date in this case. 15 U.S.C. § 77m. As a result, the claims in Count III filed on August 19, 2002 against Household, Officer Defendants, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch are untimely.

***15** Count IV is based on a series of Form S-3 debt registration statements. The dates of these SEC filings were on or about June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am.Compl.¶ 384.) The same circumstances for inquiry notice apply for Count IV claims as the Count III claims. If the one year inquiry notice period could not have begun until the publication of the Restatement on August 14, 2002, the earliest Section 13 dates for the June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000 filings are three years after each filing, respectively June 30, 2001, February 16, 2002, July 1, 2002, March 24, 2003. The earliest Section 13 dates for the remainder of the filings, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002, is one year after inquiry notice should have begun, August 14, 2003, which plaintiff's August 19, 2002 filing satisfies. As a result, only the allegations arising out of the March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002 Debt Registration Statements against Household, Officer Defendants, Individual Defendants and Andersen are timely. [FN2]

FN2. Neither equitable tolling nor estoppel are appropriate in securities cases. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 501 U.S. 350, 363, 111 S.Ct. 2773, 115 L.Ed.2d 321 (1991); *Short v. Belleville Shoe Mfg. Co.,* 908 F.2d 1385, 1391 (7th Cir.1990). The holdings in both cases have subsequently been modified with respect to retroactivity, but the tolling and estoppel holdings have been upheld. *Klehr v. A.O. Smith Corp.,* 521 U.S. 179, 200-01, 117 S.Ct. 1984, 138 L.Ed.2d 373 (1997); *Plaut v. Spendthrift Farm,* 514 U.S. 211, 217, 115 S.Ct. 1447, 131 L.Ed.2d 328 (1995); *Lewis v. Long Grove Trading Co.,* 13 F.3d 1028, 1029 (7th Cir.1994); *Cortes v. Gratkowski,* 795 F.Supp. 248, 249 (N.D.Ill.1992); *Cont'l Assurance Co. v. Geothermal Res. Int'l, Inc.,* No. 89 C 8858, 1991 WL 202378, at *2 (N.D.Ill. Sept.30, 1991); *see also* ABA COMMITTEE ON FEDERAL REGULATION OF SECURITIES, REPORT OF THE TASK FORCE ON STATUTE OF LIMITATIONS FOR IMPLIED ACTIONS 645, 655 (1986) (advancing "the inescapable conclusion that Congress did not intend equitable tolling to apply in actions under the securities laws").

B. Sufficiency of the Pleadings

1. §§ 11, 12(a) & 15

To establish a violation of § 11, plaintiff must prove that a defendant's registration statement "contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). The statute sets forth five groups of people who may be liable for the misrepresentation: (1) anyone who signed the registration statement; (2) anyone who was a director or partner in the issuer at the time of the filing; (3) anyone who is named in the registration statement as being a director or partner; (4) anyone who has certified any part of the registration statement; and (5) any underwriter of the security. *Id.*

To establish a violation of § 12(a)(2), plaintiff must show that defendants offered or sold a security to the plaintiff by means of a prospectus or oral communication that was false or misleading with respect to material facts. 15 U.S.C. § 77l. Defendants may avoid liability by proving that plaintiff knew the statement was false when made. Additionally, under § 12(a)(2), a defendant is not liable if he or she can prove that he did not know and could not have reasonably discovered that the statement was false. *Friedman,* 295 F.Supp.2d, 979.

Section 15 imposes liability on those who "control" persons liable under other provisions of the 1933 Act.

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

***16** 15 U.S.C. § 77.

2. Standard of Pleading

Section 11, 12(a)(2) and 15 claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by Rule 9(b) and PSLRA. *See In re WorldCom, Inc. Sec. Litig.,* 294 F.Supp.2d at 423; *Friedman,* 295 F.Supp.2d at 977. Plaintiff's allegations only need satisfy the liberal notice pleading requirements of Fed.R.Civ.P. 8. *Hoskins v. Poelstra,* 320 F.3d 761, 764 (7th Cir.2003). The complaint need not contain "all of the facts that will be necessary to prevail." *Id.* So long as the complaint gives defendant sufficient notice of the claim to file an answer, it "cannot be dismissed on the ground that it is conclusory or fails to allege facts." *Higgs v. Carver,* 286 F.3d 437, 439 (7th Cir.2002).

3. Materiality and Sufficiency

Defendants contend that plaintiff has insufficiently pleaded §§ 11 and 12(a)(2) claims by failing to establish that any of the SEC statements contained misstatements and by failing to show a traceable loss to plaintiff arising from any of the alleged misstatements.

A misstatement or omission is material if there is a substantial likelihood that the disclosure of the misstatement or omitted fact "would have been viewed by the reasonable investor as having significantly altered the total mix of information." *Friedman,* 295 F.Supp.2d at 981 (citing *Basic, Inc.,* 485 U.S. at 231).

Defendants assert plaintiff failed to plead contemporary facts, relying instead on hindsight, something that is disallowed under PSLRA. (Household Mot. Dismiss at 39; Andersen Mot. Dismiss at 1.) As a result, defendants urge that no material misstatement or omission was made because plaintiff could not have construed any of the debt registrations statements as containing misstatements or omissions until later events transpired. (Household Mot. Dismiss at 39; Memo Supp. Andersen Mot. Dismiss at 11.)

However, plaintiff has pleaded sufficient facts to make a colorable inference that defendants did know, and failed to disclose, or misrepresented material information at the time the debt registration statements were filed with the SEC. Plaintiff alleges defendants made materially and deliberately false statements in SEC filing on September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am. Compl. at ¶ 384.) Plaintiff alleges essentially the same grounds in each case, that the ratio of earnings to fixed charges was deliberately falsified. (*Id.* at ¶¶ 390-91.) Earnings were over reported and losses were not reported. The basis for plaintiff's statements about defendant Household's earnings are related primarily to Household's allegedly engaging in a variety of predatory lending schemes in order to conceal the true value of the loans held. (*Id.* at ¶¶ 51- 54.) Plaintiff primarily cites details of lending settlements Household reached with a variety of State Attorneys General and bank regulators, exposure of Household's "Vision" system and practice of "reaging" loans by a Washington state investigation, and the publication of the Washington Report as foundation. (*Id.* at ¶¶ 51-99, 110-24.) Plaintiff claims Household's 2002 $600 million restatement of earnings was the direct result of these activities. (*Id.* at ¶ 135.) Andersen's role in assisting Household with its regular accounting and management and, most importantly, its consent to the inclusion of its own statements about Household's financial status in the SEC statements at issue establish its culpability, according to plaintiff. (*Id.* at ¶¶ 171-79, 185-91, 388.)

***17** Plaintiff's allegations are detailed and voluminous, more than sufficient to put defendants on notice. Accordingly, plaintiff's claims under the 1933 Act cannot be dismissed for failing to allege sufficient facts.

Defendants further allege that members of the class did not have losses as the result of the activities plaintiff complains of, hence plaintiff has no grounds for complaint. (Household Mot. Dismiss at 43.) Defendants argue that if disclosure of negative information does not "move the market" (that is, if the price of shares does not go down), the omission is immaterial as a matter of law. However, there may be reasons unrelated to the restatement that initially insulated the stock price from adverse effects. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.,* 320 F.3d 920, 935 (9th Cir.), *cert. denied,* 540 U.S. 966, 124 S.Ct. 433, 157 L.Ed.2d 311 (2003) (concluding that information was material even though disclosure had no immediate effect on market price); *see also Folger Adam Co. v. PMI Indus., Inc.,* 938 F.2d 1529, 1533 (2d Cir.1991) ("[I]t is well-established that a material fact need not be outcome-determinative.").

This Court cannot conclude as a matter of law that defendants' alleged omissions and misstatements were immaterial. Assuming the truth of plaintiff's allegations as the Court must, there is a colorable argument that a reasonable investor would view the defendants' actions as material, which is all that is required. Therefore, plaintiff has sufficiently pleaded Section 11 and 12(a)(2) claims to raise questions of fact and to place defendants on notice. As a result, these claims cannot be dismissed.

4. Predicate Claims

Defendants also urge that no § 15 violation can be alleged without first establishing a predicate violation. (Household Mot. Dismiss at 44.) And, that even if such is found, the group pleading doctrine is no longer good law, thereby limiting the individuals who can be considered "control" personnel. (*Id.* at 45.) The purpose of a complaint is to plead allegations, not to prove them. Plaintiff has sufficiently pleaded Section 11 and 12(a)(2) allegations. As a result, there is no bar to plaintiff likewise pleading a Section 15 allegation.

As for the group pleading doctrine, "[t]he Seventh Circuit has not ruled on the applicability of the group pleading doctrine following the enactment of the PSLRA." *Tricontinental,* 215 F.Supp.2d at 947. This Court, as well as others in the district, continue to recognize it. *Fishman,* 2003 WL 444223, at *6; *Friedman,* 295 F.Supp.2d at 991-93. As a result, plaintiff's Section 15 claims cannot be dismissed.

C. Conclusion

As a result of the foregoing, Count III is dismissed for untimeliness. The motions to dismiss Count IV is granted with regard to the June 30, 2001, February 2002, July 2002 SEC Debt Registration Statements, but denied with regard to the March 2000, September 2000, February 2001, May 2001, November 2001, December 2001 and April 2002 SEC Debt Registration Statements.

III. Andersen's Motion to Strike

***18** Defendant Andersen has moved to strike paragraphs 180 and 181 of the Amended Complaint as prejudicial and irrelevant. (Andersen Mot. to Strike at 1.) Andersen brings this motion pursuant to Rule 12(f). Rule 12(f) provides that "upon motion made by a party within 20 days after the service of the pleading upon the party or upon the court's own initiative at any time, the court may order stricken from any pleading any insufficient defense or any redundant, immaterial, impertinent, or scandalous matter." Fed.R.Civ.P. 12(f). Motions to strike are disfavored and usually denied. *Spearman Indus., Inc. v. St. Paul Fire & Marine Ins. Co.,* 109 F.Supp.2d 905, 907 (N.D.Ill.2000). Courts will strike portions of a complaint if the challenged allegations are so unrelated to the present claims as to be void of merit and unworthy of consideration and if the allegations are unduly prejudicial. *Kies v. City of Aurora,* 149 F.Supp.2d 421, 427 (N.D.Ill.2001); *Robinson v. City of Harvey,* No. 99 C 3696, 1999 WL 617655, at *1-2 (N.D.Ill. Aug.11, 1999). "Prejudice results when the challenged allegation has the effect of confusing the issues or is so lengthy and complex that it places an undue burden on the responding party." *Cumis Ins. Soc'y Inc. v. Peters,* 983 F.Supp. 787, 798 (N.D.Ill.1997).

Andersen questions whether material from other litigation and accounting scandals cited by plaintiff is discoverable for the purposes of this litigation. It also asserts that material contained in paragraphs 180 and 181 is misleading, inflammatory, inaccurate, prejudicial and irrelevant. Andersen does little to convince this court to strike these paragraphs. Whether any particular allegation is admissible will be dealt with more appropriately at a later time. The motion to strike is denied.

CONCLUSION

For the reasons set forth above, the Court denies Household, Household Officers, and Andersen's motion to dismiss Count I [88-1, 94-1, 97-1]; denies Household and Household Officers' motion to dismiss Count II [88-1]; grants Household, Household Officers, Household Directors, Andersen, Goldman Sachs, and Merrill Lynch's motions to dismiss Count III [88-1, 94-1, 95-1, 97-1]; grants in part and denies in part Household, Household Directors, and Andersen's motions to dismiss Count IV [88-1, 94-1, 97-1] and denies Andersen's motion to strike [93-1]. Goldman Sachs and Merrill Lynch are hereby terminated as parties.

SO ORDERED

Motions, Pleadings and Filings (Back to top)

. 2004 WL 2256723 (Trial Motion, Memorandum and Affidavit) Defendants' Reply in Further Support of Motion to Compel Lead Plaintiffs to Comply with Their Obligations Under Fed. R. Civ. P. 26(a)(1) (Aug. 20, 2004)

. 2004 WL 2256721 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Memorandum of Law in Support of Motion for Class Certification (Jul. 06, 2004)

. 2004 WL 2256714 (Trial Pleading) Answer and Affirmative Defenses of Defendant Arthur Andersen LLP to Plaintiffs' %ADCorrected%BD Amended Consolidated Class Action Complaint (Jul. 02, 2004)

. 2004 WL 2256718 (Trial Pleading) Answer of Household International, Inc., Household Finance Corporation, William F. Aldinger, David A. Schoenholz, Gary Gilmer, and J.A. Vozar to %ADCorrected%BD Amended Consolidated Class Action Complaint (Jul. 02, 2004)

. 2004 WL 1243919 (Trial Filing) Notice of Filing (May. 20, 2004)

. 2003 WL 23817841 (Trial Motion, Memorandum and Affidavit) Defendant Arthur Andersen LLP's Reply Memorandum in Support of Its Motion to Dismiss Counts I, III and IV of Plaintiffs' %ADCorrected%BD Amended Consolidated Complaint (Aug. 01, 2003)

. 2003 WL 23817836 (Trial Motion, Memorandum and Affidavit) Defendants Goldman Sachs and Merrill Lynch's Reply Memorandum of Law in Support of Their Motion to Dismiss the Corrected Amended Consolidated Class Action Complaint (Jul. 21, 2003)

. 2003 WL 23817839 (Trial Motion, Memorandum and Affidavit) Reply Memorandum of Law in Support of Household Defendants' Motion to Dismiss the Corrected Amended Consolidated Class Action Complaint (Jul. 21, 2003)

. 2003 WL 23817827 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Response to Arthur Andersen LLP's Motion to Dismiss Counts I, III and IV of Plaintiffs' %ADCorrected%BD Amended Consolidated Complaint (Jun. 19, 2003)

. 2003 WL 23817830 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Response to the Motion to Dismiss the %ADCorrected%BD Amended Consolidated Class Action Complaint by Defendants Goldman Sachs & Co. and Merrill Lynch, Pierce, Fenner & Smith, Inc. (Jun. 19, 2003)

. 2003 WL 23817833 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Response to Household Defendants' Motion to Dismiss %ADCorrected%BD Amended Consolidated Class Action Complaint (Jun. 19, 2003)

. 2003 WL 23817820 (Trial Motion, Memorandum and Affidavit) Houseold Defendants' Motion to Dismiss the Corrected Amended Consolidated Class Action Complaint (May. 13, 2003)

. 2003 WL 23817822 (Trial Motion, Memorandum and Affidavit) Defendant Arthur Andersen LLP's Motion to Dismiss Counts I, III and IV of Plaintiffs' %ADCorrected%BD Amended Consolidated Complaint (May. 13, 2003)

. 2003 WL 23817824 (Trial Motion, Memorandum and Affidavit) Motion to Dismiss the Corrected Amended Consolidated Class Action Complaint by Defendants Goldman Sachs and Merrill Lynch (May. 13, 2003)

. 2003 WL 23817818 (Trial Pleading) Amended Consolidated Class Action Complaint for Violation of the Federal Securities Laws (Mar. 07, 2003)

. 2003 WL 23817814 (Trial Motion, Memorandum and Affidavit) Plaintiff Williamson's Reply to Plaintiff Jaffe's Motion for a Finding of Relatedness and Arthur Andersen, Llp's Opposition (Feb. 28, 2003)

. 2003 WL 23817816 (Trial Motion, Memorandum and Affidavit) Plaintiffs' Reply to Arthur Andersen LLP's Opposition to Plaintiffs' Motion for a Finding of Relatedness (Feb. 28, 2003)

. 2002 WL 32676426 (Trial Motion, Memorandum and Affidavit) The Glickenhaus Institutional Group's Memorandum of Points and Authorities in Opposition to Natcan Investment Management, Inc.'s Motion for Appointment As Lead Plaintiff (Dec. 06, 2002)

. 2002 WL 32676417 (Trial Motion, Memorandum and Affidavit) Memorandum of Law in Support of Motion of Natcan Investment Management, Inc. to Consolidate Actions, to Be Appointed Lead Plaintiff, and for Approval of Lead Plaintiff's Selection of Lead Counsel and Liaison Counsel (Oct. 18, 2002)

. 2002 WL 32676420 (Trial Motion, Memorandum and Affidavit) Memorandum of Law in Support of the Glickenhaus Institutional Group's Motion to Consolidate Related Actions for Violations of the Securities Exchange Act of 1934 and to Preserve Documents (Oct. 18, 2002)

. 2002 WL 32676425 (Trial Motion, Memorandum and Affidavit) Motion of the Glickenhaus Institutional Group for Appointment As Lead Plaintiff and for Approval of Lead Plaintiff's Choice of Lead Counsel (Oct. 18, 2002)

. 2002 WL 32676415 (Trial Pleading) Class Action Complaint for Violations of the Federal Securities Law (Aug. 19, 2002)

. 1:02CV05893(Docket)
(Aug. 19, 2002)

END OF DOCUMENT

TAB 9

LEXSEE 2003 U.S. DIST. LEXIS 5074

CLIVE T. MILLER, on behalf of himself and all others similarly situated, Lead Plaintiff, v. APROPOS TECHNOLOGY, INC., et al., Defendants.

No. 01 C 8406

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

2003 U.S. Dist. LEXIS 5074

March 31, 2003, Decided
March 31, 2003, Docketed

SUBSEQUENT HISTORY: Settled by, Dismissed by Miller v. Apropos Tech., Inc., 2004 U.S. Dist. LEXIS 17345 (N.D. Ill., Aug. 25, 2004)

DISPOSITION: [*1] Defendants Apropos, Profita and Underwriter's' motions to dismiss granted in part and denied in part.

LexisNexis(R) Headnotes

COUNSEL: For MARTIN MAYO, plaintiff: Jules Brody, Edwin J Mills, Aaron L Brody, Stull, Stull & Brody, New York, NY.

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For MARTIN MAYO, plaintiff: Robert D. Allison, Robert D. Allison & Associates, Chicago, IL.

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For MARTIN MAYO, plaintiff: Charles J Piven, Law Offices of Charles J. Piven, P.A., Baltimore, MD.

For MARTIN MAYO, plaintiff: Joseph H. Weiss, Weiss & Yourman, New York, NY.

For MARTIN MAYO, plaintiff: Patrick Vincent Dahlstrom, Pomerantz Haudek Block Grossman & Gross LLP, Chicago, IL.

For APROPOS TECHNOLOGY, INC., KEVIN G KERNS, PATRICK K BRADY, CATHERINE R BRADY, KEITH L CRANDELL, IAN LARKIN, MAURICE A COX, JR, GEORGE B KOCH, JODY P WACKER, WILLIAM W BACH, defendants: Theodore Thomas Poulos, Terence H. Campbell, Cotsirilos, Stephenson, Tighe & Streicker, Chicago, IL.

For [*2] APROPOS TECHNOLOGY, INC., KEVIN G KERNS, PATRICK K BRADY, CATHERINE R BRADY, KEITH L CRANDELL, IAN LARKIN, MAURICE A COX, JR, GEORGE B KOCH, JODY P WACKER, WILLIAM W BACH, defendants: Brian E. Pastuszenski, Testa, Hurwitz & Thibeault, Boston, MA.

For APROPOS TECHNOLOGY, INC., KEVIN G KERNS, PATRICK K BRADY, CATHERINE R BRADY, KEITH L CRANDELL, IAN LARKIN, MAURICE A COX, JR, GEORGE B KOCH, JODY P WACKER, WILLIAM W BACH, defendants: John J Falvey, Jr, Testa, Hurwitz & Thibeault, LLP, Boston, MA.

For MICHAEL J PROFITA, defendant: David H. Kistenbroker, Pamela Gregory Smith, Katten Muchin Zavis Rosenman, Chicago, Il.

For HAMBRECHT & QUIST INCORPORATED, SG COWEN SECURITIES CORPORATION, defendants: Terry M. Grimm, Timothy John Rooney, Peggy M. Kane, Winston & Strawn, Chicago, IL.

JUDGES: David H. Coar, United States District Judge.

OPINIONBY: David H. Coar

OPINION:

MEMORANDUM OPINION AND ORDER

This is a lawsuit arising under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Plaintiff Clive T. Miller represents a putative class of plaintiffs who purchased common stock in Defendant Apropos Technology on the open market during the period from February 17, 2000 through [*3] April 10, 2001 ("the class period"). The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933 , 15 U.S.C. §§ 77k, 77o, and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78t(a). Plaintiffs named as Defendants Apropos Technology, several of Apropos' corporate officers, and several corporations who served as underwriters for the initial public offering of stock. Currently pending and fully briefed are three Motions to Dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6); one each from Defendant Michael J. Profita, the Apropos Technology Defendants, and the underwriter Defendants.

Factual and Procedural Background

Defendant Apropos Technology, Inc. ("Apropos") is a corporation that develops, markets, and supports technology driven customer interaction management solutions for multimedia contact centers. n1 (Pl. Comp., P 3) Translated roughly into plain English, Apropos builds software systems for companies that handle a high volume of customer inquiries. Apropos' software is adaptable to specific business needs, and it can accommodate the transfer and routing [*4] of customer inquiries that arrive via telephone, email, and/or the internet. Apropos began developing this product in January 1989 and the first product was shipped in March 1995. (Apropos Defs.' Mem. Supp. Mot. Dismiss, Ex. A ("Prospectus"), at 4.)

> n1 This recitation of facts comes primarily from Plaintiff's Complaint. The Court assumes that all of the well-pleaded allegations of the Complaint are true for the purposes of a Motion to Dismiss under Rule 12(b)(6).

In 1999, Plaintiffs allege that there was a power struggle taking place between Apropos' CEO Kevin G. Kerns, and two other corporate officers: Chief Technology Officer Patrick K. Brady, and Vice-President for Technology William M. Bach. (Pl. Comp., P 5.) Brady was a co-founder of the corporation; he and Bach were the Company's "most senior technology officers." (Pl. Comp., P 4; Pl. Comp., P 56-57.) At the Apropos Board meeting preceding the initial public offering, in July 1999, this struggle came to a head. Kerns emerged with the support of the majority [*5] of the Board.

After the Board Meeting, Brady left Apropos and did not return. (Pl. Comp., P 58.) On September 21, 1999, Kerns sent an e-mail to others at Apropos explaining that Brady was on sabbatical for the next six months. (Pl. Comp., Ex. A.) Bach, meanwhile, was assigned to a more limited role with the corporation, a move which Plaintiffs believe was calculated to force his resignation. (Pl. Comp., P59.) In short, when Brady and Bach lost the power struggle, they were de facto ousted from the corporation. (Pl. Comp., PP 5-6.)

Meanwhile, Apropos Technologies was preparing for its initial public offering of stock. Apropos prepared a registration statement to authorize the sale of stock pursuant to 15 U.S.C. § 77f. Federal law regulates the contents of registration statements for the sale of Securities. See 15 U.S.C. §§ 77g, 77aa. Apropos also prepared a prospectus offering the securities for sale. This, too, would have to conform to the requirements of federal law. See 15 U.S.C. § 77j. In advance of the initial public offering (IPO), Apropos contracted with several financial organizations to serve as underwriters [*6] of the IPO.

On February 17, 2000, Apropos held an initial public offering of shares of common stock, trading on the NASDAQ under symbol APRS. From the perspective of Apropos, the IPO was a success. The corporation sold almost 4 million shares of common stock, which generated 79.3 million dollars of net proceeds. (Pl. Comp., P 3.) The price of the stock rose quickly from the initial offering at twenty-two dollars to a high of seventy dollars per share. (Pl. Comp. P 76.)

From the perspective of Plaintiffs, however, the IPO was a failure. After its initial price increase, the stock flopped. By the end of the class period, the stock was trading at $2.98 per share. (Pl. Comp. P 76.) Faced with devastating losses, Plaintiffs believe they were hoodwinked into buying the stock by certain material misrepresentations in the prospectus. Putative class representative Clive T. Miller filed the consolidated amended class action complaint on April 17, 2002. The complaint alleges that the registration statement and prospectus contained material misrepresentations and omissions. Specifically, Plaintiff alleges that the registration statement omitted material information relating to Brady's and Bach's [*7] diminished roles within the company. (Pl. Comp. PP 57, 62-68.) Plaintiff also claims that the registration statement contained false or misleading statements regarding the intended use of the proceeds from the initial public offering. (Pl. Comp., PP 69-75.) Defendants' motions to dismiss followed.

DISCUSSION

Plaintiff's complaint contains four counts. Count I alleges that all the Defendants (Apropos Technologies, Apropos' officers, and the underwriters of the IPO) n2 violated Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, through material misrepresentations about three things: (1) the changed role of William Bach; (2) the changed role of Patrick Brady; and (3) the intended use of proceeds from the IPO. Count II alleges that Defendant Kerns, as a control person at Apropos, is jointly and severally liable for any violations of Section 11 of the Securities Act of 1933 by persons under his control pursuant to Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o. Count III alleges that Defendants Brady and Kerns violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), [*8] through their knowing misrepresentation in the registration statement about Brady's and Bach's roles in the corporation. Count IV alleges that Defendant Kerns, as a control person at Apropos, is jointly and severally liable for any violations of Section 10(b) of the 1934 Act by persons under his control pursuant to Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a).

n2 Named as Defendants are: the corporation, seven individuals who signed the registration statement, and nineteen underwriters of the initial public offering. For a list of all the Defendants and their roles, see Pl. Comp. at PP 17-47.

The Apropos Defendants, which include the corporation and six the seven individuals who signed the registration statement, moved to dismiss all four counts of the complaint. Defendant Michael J. Profita, the seventh individual who signed the registration statement, joined in the arguments pertinent to Count I of the Apropos Defendants' Motion to Dismiss and also separately [*9] moved to dismiss Count I of the complaint. The Underwriter Defendants also joined in the Apropos Defendants' Motion to Dismiss to the extent it was pertinent to Count I, and filed their own Motion to Dismiss.

The Court will analyze the Motions to Dismiss the Complaint count by count.

Legal Standard

The purpose of a motion to dismiss is to test the sufficiency of the complaint, not to decide the merits of the case. In evaluating the motion, the Court accepts as true all facts and allegations in the complaint and makes all reasonable inferences in the plaintiff's favor. See Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1330 (7th Cir. 1995). Complaints should only be dismissed if it is clear that no set of facts in support of the claim would entitle the plaintiff to relief. See Ledford v. Sullivan, 105 F.3d 354, 356 (7th Cir. 1997) (quoting Hishon v. King & Spalding, 467 U.S. 69, 73, 81 L. Ed. 2d 59, 104 S. Ct. 2229 (1984)).

Ordinarily, the only document the Court relies upon in deciding a motion to dimiss is the Plaintiff's Complaint. Where the complaint alleges violations of federal securities laws, however, several [*10] circuits have held that the district court may also consider documents that are integral to Plaintiff's claims, such as the Registration Statement and Prospectus. See San Leandro Emergency Medical Group Profit Sharing Plan v. Phillip Morris Cos., 75 F.3d 801, 809 (2d Cir. 1996); Lovelace v. Software Spectrum, Inc., 78 F.3d 1015, 1018 (5th Cir. 1996); Bovee v. Coopers & Lybrand, CPA, 272 F.3d 356, 360-61 (6th Cir. 2001); Ehlert v. Singer, 245 F.3d 1313, 1317 n.4 (11th Cir. 2001). n3 Although the Seventh Circuit has not spoken to this issue in the context of securities litigation, it has held that on a motion to dismiss the district court may rely upon documents outside of the complaint provided that those documents are integral to the complaint. See Wright v. Associated Ins. Co., 29 F.3d 1244, 1248 (7th Cir. 1994); Venture Associates Corp. v. Zenith Data Systems, Inc., 987 F.2d 429, 431 (7th Cir. 1993). "Documents that a defendant attaches to a motion to dismiss are considered part of the pleadings if they are referred to in the plaintiff's complaint and are central to [the] claim. [*11] " Venture Associates Corp., 987 F.2d at 431 (citing cases). In this case, although it was the Defendant that submitted the Prospectus, this Court finds it is central to Plaintiff's complaint and therefore can be considered on a Motion to Dismiss.

n3 Although they all reach the same conclusion, the circuits have taken two approaches to the use of documents integral to a securities complaint on a motion to dismiss. The majority approach, exemplified by the Second Circuit (where most securities litigation occurs), holds that district courts can consider SEC filings because securities complaints incorporate those filings by reference. See San Leandro, 75 F.3d at 808-09; Goldman v. Belden, 754 F.2d 1059, 1065-66 (2d Cir. 1985); see also Credit Suisse First Boston Corp. v. Arm Financial Group, Inc., 2001 U.S. Dist. LEXIS 3332, No. 99 CIV 12046 WHP, 2001 WL 300733, at *3 (S.D.N.Y. March 28, 2001). The minority approach, only employed in the Fifth Circuit, allows the district court to take judicial notice of statements required to be filed and actually filed with the Securities and Exchange Commission (SEC) on a motion to dismiss a securities fraud complaint. See Lovelace, 78 F.3d at 1018; see also In re Azurix Corp. Securities

Litigation, 198 F. Supp. 2d 862, 877 (S.D. Tex. 2002).

[*12]

Count III of Plaintiff's Complaint asserts a violation of Section, 10(b) of the Securities Exchange Act. This portion of the Complaint implicates the heightened pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure. Rule 9(b) requires that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Fed. R. Civ. Pro. 9(b). When the Court addresses that count below, it will address the heightened pleading requirements of Rule 9(b).

COUNT I: Violation of Section 11 of the Securities Act of 1933

In Count I, Plaintiffs allege that Apropos made false statements or material misrepresentations in its Securities Registration Statement. Liability for making false statements or material misrepresentations in a Securities registration statement extends quite broadly. The statute reads, in pertinent part:

> In case any part of the registration statement . . . 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 who acquires such security . . . may . . . sue (1) [*13] every person who signed the registration statement; (2) every person who was a director of . . . the issuer at the time of the filing . . . of the registration statement; . . . (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a). Count I of Plaintiff's Complaint is pleaded against seven people who signed the registration statement, six of whom were directors of Apropos at the time, and nineteen corporate underwriters of the initial public offering.

To state a claim under section 11 of the Securities Act, plaintiffs must allege that defendants made untrue statements of material fact or omitted material facts in a registration statement or prospectus. See, e.g., Parnes v. Gateway 2000, Inc., 122 F.3d 539, 546 (8th Cir. 1997). A material omission from the registration statement or prospectus is actionable if the omitted facts were necessary to make the disclosures therein not misleading. See In re N2K Securities Litigation, 82 F. Supp. 2d 204, 207 (S.D.N.Y. 2000), aff'd 202 F.3d 81 (2d Cir. 2000) (per curiam).

The Section 11 claim in this case has three components: (1) the changed role [*14] of William Bach; (2) the changed role of Patrick Brady; and (3) the intended use of the proceeds from the IPO. The Court addresses each separately below.

1. Changed Role of William Bach

Plaintiffs allege that Bach's position within the corporation changed substantially prior to the IPO. According to the Complaint, Bach's role as Vice President for Technology had been substantially reconfigured to diminish his impact on the corporation and inspire him to resign. Plaintiffs' contention that the omission of this information about Bach was a material misrepresentation is readily dismissed. The Apropos Defendants rightly point out that the "diminished" duties Plaintiff's Complaint ascribes to Bach are entirely consistent with the description of his duties as Vice President for Technology. n4 If the Court were to accept Plaintiff's position as regards Bach, corporations would either be paralyzed from making internal changes to the duties of their corporate officers or required to disclose any and all internal changes of executive duties. Neither result is desirable or required under federal securities laws and regulations.

> n4 Defendants assert that Bach continues to be an employee of Apropos, and that he experienced a promotion to Senior Vice President for Technology in 2000. (Apropos Def. Mem. L. Supp. Mot. Dismiss, at 19 n.5). Although the Court makes no findings of fact on a motion to dismiss, if true, this further undermines the Complaint's untenable position regarding Mr. Bach.

[*15]

Corporations are given a relatively free hand to determine their organizational structure and the allocation of duties within that structure. A disclosure requirement for changes like those Plaintiff alleges Bach experienced at Apropos would accomplish little besides making it more difficult to determine which, if any, disclosures in securities filings are material. Accepting the allegations in Plaintiff's Complaint regarding Bach as true, the Court finds that the Prospectus did not contain a material misrepresentation about the role of William Bach in the corporation at the time of the IPO.

2. Changed Role of Patrick Brady

The allegations regarding Patrick K. Brady, however, require closer scrutiny. Both parties agree that at the time of the IPO, Patrick K. Brady, the Chief Technology Officer and co-founder of Apropos, was on a leave of absence from the corporation. Plaintiffs assert that at least Kevin Kerns, the CEO of Apropos, and Patrick Brady both knew that Brady would not be coming back to the corporation. n5 The Prospectus makes no mention of any dispute between Brady and Kerns, nor does it discuss that Brady may not return to the corporation.

n5 Their knowledge supports Counts III and IV of the Complaint, and will be discussed along with those Counts, infra.

[*16]

The central thrust of the Apropos' Defendants reply is that "when the Prospectus is read as a whole, no reasonable person could have attached any importance to the possible future role of . . . Brady at Apropos." (Apropos Def. Rep. Mem. L. Supp. Mot. Dismiss, at 6.) The prospectus as a whole certainly permits an inference that the key personnel in general and Brady in particular had a future role at Apropos. For example, it reads: "We depend on the continued services of our executive officers and other key personnel. The loss of services of any of our executive officers or key personnel could have a material adverse effect on our business, financial condition and results of operations." (Prospectus at 8.) Elsewhere, the Prospectus reads: "Our future performance depends in significant part upon the continued service of our key technical, sales and marketing, and senior management personnel. **The loss of the services of one or more of our key employees would harm our business.**" (Prospectus at 37.) (emphasis added) Apropos highlights this language as warning investors that "retention of personnel was a risk factor." (Apropos Def. Mem. L. Supp. Mot. Dismiss, at 12.) Again, Plaintiff's [*17] position is that Apropos was aware that the risk regarding Brady had already been realized at the time of the IPO.

As regards Brady particularly, there can be no doubt that he was both an executive officer and one of the key employees at Apropos. The Prospectus indicates that he was one of four members of Apropos' Executive Committee, which "has the authority of the Board of Directors to manage our business...." (Prospectus at 42.) The Prospectus contains conflicting statements about Brady's term as a Director of Apropos. At one point, it indicates that Brady's term as a Director was due to end in 2002, two years after the IPO. (Prospectus at 41) Elsewhere, it indicates that Brady "is entitled to be one of our directors until the expiration of his employment agreement [on March 19, 2000]." Whether his term as Director expired in 2000 or 2002, the Prospectus definitely establishes Brady as one of the four most central figures in the corporation. Plaintiff's Complaint alleges that the Prospectus failed to mention that Brady was already effectively out of the company at the time of the IPO.

Apropos' strongest argument in support of the failure to disclose Brady's pending departure [*18] from the corporation is that the Prospectus indicates that Brady's employment contract was due to expire on March 19, 2000. (Prospectus at 44.) From that, Apropos argues that no investor could reasonably expect Brady to remain with the corporation after the expiration of his employment agreement. Here, Apropos seeks to defend itself from the charge that its Prospectus was misleading with an assertion that it was factually accurate. Even if the Prospectus is factually accurate, that does not mean that it cannot be materially misleading as a matter of law. Disclosure of the expiration date of an employment agreement is not equivalent to disclosure that an executive officer and co-founder of the corporation is going to leave the corporation when the contract expires. If proven, the failure to disclose this information in the Prospectus would render it materially misleading. The factual truth of the information regarding Brady does not alter its misleading nature.

The presence of cautionary language about retention of key personnel similarly does not render the omission of information about Brady acceptable under Section 11. A statement that "we can give no assurance that we can retain [*19] or attract key personnel in the future" (Prospectus at 37) does not justify the omission of information regarding Brady's departure from the Prospectus. As regards Patrick Brady, Count I of Plaintiff's Complaint states a claim under Section 11 of the Securities Act of 1933.

3. Intended Use of Proceeds

Plaintiffs assert that the Prospectus contained material misrepresentations regarding the intended use of proceeds from the IPO. The Prospectus indicated that it anticipated net proceeds of either $74.2 million or $79.9 million, with the latter figure depending on whether the underwriters "exercised their overallotment option in full." (Prospectus at 14.) Of those proceeds, the Prospectus indicated that "$ 8.0 million of the net proceeds will be used to repay debt," with the debt repayment plan described in some detail. Beyond the $8 million dedicated to debt repayment, the Prospectus contains some estimates regarding the use of the net proceeds from the IPO. Plaintiffs allege that Apropos did not adhere to the estimates given in the Prospectus regarding the Use of Proceeds.

Securities law requires that statements in Prospectus to be true and not misleading at the time they [*20] are made. 15 U.S.C. § 77k; see also Glassman v. Computervision Corp., 90 F.3d 617, 627 (1st Cir. 1996) ("Statements in the Prospectus . . . are required by law to be true *as of the effective date of the offering*."). Plaintiff's Complaint alleges that a little over one year after the effective date of the IPO "the Company still had unspent proceeds of the Offering invested in cash and short term investments totaling over $60 million, rather than in pursuit of the Company's strategic goals". (Comp. P 75.)

Defendant correctly responds that the Prospectus did not contain a timetable for spending the proceeds from the IPO. Furthermore, the Prospectus indicates, "Pending any use, the net proceeds of this offering will be invested in short-term, interest bearing investment grade securities." (Prospectus at 14.). This is exactly how Plaintiff's Complaint alleges the proceeds were being used. Plaintiff's complaint regarding the use of proceeds is dismissed. Even accepting the allegations in the Complaint, Apropos is using the proceeds in keeping with the intended use described in the Prospectus.

Furthermore, the statements in the Prospectus about [*21] the intended use of proceeds are immediately proceeded by cautionary language about "forward-looking statements" and immediately followed by cautionary language about potential changes in the use of proceeds. (Prospectus at 13-14.) The "bespeaks caution" doctrine provides that forward-looking statements may not be misleading where they are accompanied by meaningful warnings and cautionary statements. See Harden v. Raffensperger, Hughes & Co., 65 F.3d 1392, 1404 (7th Cir. 1995) (quoting 3B Harold S. Bloomenthal, Securities and Federal Corporate Law § 8.26 [1] at 8-110 (1995)). Even if Apropos were not using the proceeds in accord with the estimates in the Prospectus, the estimates are sandwiched between such meaningful cautionary language that they can not be misleading as a matter of law.

COUNT II: DEFENDANT KERNS' LIABILITY AS A CONTROL PERSON UNDER SECTION 15 OF THE SECURITIES ACT OF 1933

Section 15 of the Securities Act of 1933 makes "every person who . . . controls any person liable under section 77k [, that is, Section 11 of the Securities Act of 1933] . . . jointly and severally [liable] with and to the same extent as such controlled person [*22] . . . unless the controlling person had no knowledge of or reasonable ground to believe" that the facts supporting liability under Section 11 exist. 15 U.S.C. § 77o. In this case, Plaintiff's Complaint states a claim for a violation of Section 15 against Defendant Kerns. The requirements for claims under Section 15 are largely co-extensive with the requirements for Section 11 claims. The only additional element that Section 15 would require is that the Defendant was in a position of control over the alleged violators of Section 11. Here, the allegation that Defendant Kerns was CEO of Apropos at the time of the IPO is sufficient to make out the additional element.

As described above, Plaintiff's Complaint states a claim under Section 11 of the Securities Act of 1933 only for the failure to disclose information relating to Patrick Brady's departure from the corporation. The allegations relating to William Bach and to the use of proceeds do not support a finding that the Prospectus was materially misleading in violation of Section 11. As such, Kerns could be jointly and severally liable under Section 15 only to the extent that the Count I Defendants are liable [*23] for the Section 11 violation.

COUNT III: DEFENDANTS KERNS AND BRADY'S VIOLATIONS OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

Section 10(b) of the Securities Exchange Act of 1934 imposes private civil liability on those who commit a manipulative or deceptive act in connection with the purchase or sale of a security. See 15 U.S.C. § 78j(b); Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 166, 128 L. Ed. 2d 119, 114 S. Ct. 1439 (1994). As mentioned earlier, violations of Section 10(b) of the Securities Exchange Act implicate the heightened pleading requirements of Rule 9. "With respect to securities fraud cases, Rule 9(b) requires that . . . 'the complaint ... must afford a basis for believing that plaintiffs could prove scienter.' DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir.1990)." In re HealthCare Compare Corp. Securities Litigation, 75 F.3d 276, 281 (7th Cir. 1996).

Plaintiffs' allegations in Count III are only stated against Defendants Kerns and Brady. Plaintiffs' complaint alleges with particularity the elements of this violation of Section [*24] 10(b). Plaintiffs' position is that Kerns "effectively pushed Brady out of the company" (Comp. P 5.) and that Kerns and Brady conspired to keep his ouster secret until after the IPO. In support of their position, they attached to the complaint an email from Kerns to the company regarding Brady's leave of absence dated September 21, 1999. (Pl. Comp. Ex. A) This email indicated that Brady would be taking a six-month leave of absence from the corporation. Since his employment agreement terminated on March 19, 2000, this leave of absence would cover his absence for the final six months of his contract.

Defendants assert that this e-mail reflects Brady's "continued technical leadership of the company." (Apropos Def. Mem. L. Supp. Mot. Dismiss, at 14.) While Defendants are certainly free to pursue this imminently plausible theory as this litigation proceeds, the e-mail could just as readily be interpreted as evidence of Kerns' and Brady's efforts to prevent his departure from Apropos from becoming public prior to the IPO. On a Motion to Dismiss, where the Court makes reasonable inferences in the Plaintiff's favor, the latter interpretation must be attributed to the e-mail. The Complaint [*25] provides sufficient allegations to support Plaintiff's allegations of scienter as against Brady and Kerns.

As with Count I, Count III of the Complaint also attempts to state a claim regarding William Bach. The analysis relating to Bach's role under Count I pertains equally well to Count III. Even if Plaintiff's allegations regarding Bach are true, his alleged changed role with the Defendant is not sufficiently material to sustain liability under Section 10(b).

Defendants rely to various degrees on the absence of loss causation in support of their motions to dismiss. All parties properly agree that "[section] 11. . . does not require a plaintiff to plead loss causation in the complaint." Apropos Def. Mot. Dismiss at 6; accord Profita Mot. Dismiss at 3 ("loss causation is not an element of a § 11 claim"). See 15 U.S.C. § 77k(e). Counts I and II, therefore, will not be dismissed for failure to allege loss causation. n6

> n6 Defendants request the Court to dismiss the Complaint on loss causation grounds because the absence of loss causation is apparent from the face of Plaintiff's Complaint. While affirmative defenses such as the absence of loss causation can be grounds for dismissal under Rule 12(b)(6), see Pani v. Empire Blue Cross Blue Shield, 152 F.3d 67, 74 (2d Cir. 1998)§, the Court does not find that the affirmative defense is sufficiently proved from the face of Plaintiff's Complaint to merit dismissal.

[*26]

Loss causation is a required element of Section 10(b) claims, though. The Apropos Defendants contend that the Seventh Circuit decision in Bastian v. Petren Res. Corp., 892 F.2d 680 (7th Cir. 1990), provides controlling precedent that requires their Motion to Dismiss to be granted. This suggestion is unavailing. In Bastian, the Seventh Circuit affirmed dismissal of an SEC Rule 10(b)(5) violation because the Plaintiffs failed to allege "the cause of the transaction's turning out to be a losing one." Id., 892 F.2d at 684. In this case, Plaintiffs do make allegations that support the element of loss causation. Plaintiffs allege that the failure to disclose the alleged truth about Brady's pending absence from the company "caused the offering price of Apropos common stock on the [date of the] Offering to be higher than the offering price would have been had the true facts regarding the status and role[] of Defendant Brady . . . been disclosed to the investing public." (Comp. P 117). While this does not explain precisely why the stock eventually fell in value, it does support the charge that the Defendants' fraud caused damages to Plaintiffs who [*27] purchased common stock in the IPO at the inflated price.

Defendants point to the general decline in value of stocks, particularly internet stocks, since the IPO in February 2000 in support of their position that Plaintiffs cannot prove loss causation. While it is clear that the stock market has declined over the past few years, on a motion to dismiss, this Court is not prepared to hold as a matter of law that the Plaintiffs could not prove causation of damages. Plaintiffs may have a difficult road ahead in proving loss causation, but they allege the element in their Complaint, which is all they must do at this stage.

COUNT IV: DEFENDANT KERNS' LIABILITY AS A CONTROL PERSON UNDER SECTION 20(a) OF THE SECURITIES EXCHANGE ACT

As with Section 15 of the Securities Act of 1933, Section 20(a) of the Securities Exchange Act creates joint and several liability in a control person for violations of Section 10(b) of the Exchange Act by persons within the control person's control. See 15 U.S.C. § 78t(a). The only additional element of a Section 20(a) violation is that the Defendant be in control of the alleged violators of Section 10(b). Defendant Kerns, [*28] as CEO of Apropos, would be a control person vis-a-vis Defendant Brady at the time of the IPO. Consequently, the Complaint states a claim against Defendant kerns for a violation of Section 20(a) of the Securities Exchange Act of 1934.

CONCLUSION

Counts I and II of Plaintiff's Complaint state claims for violations of Sections 11 and 15 of the Securities Act of 1933 for the failure to disclose that Patrick K. Brady was leaving Apropos in the prospectus and registration statement. Counts III and IV of Plaintiff's Complaint state claims for violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of

1934. Consequently, the Motions to Dismiss Count I (Defendant Michael J. Profita's Motion, the Underwriter Defendants' Motion, and Apropos Defendants' Motion) are granted as they relate to the role of William Bach and the intended use of proceeds, and denied as they relate to the role of Patrick Brady. The Apropos Defendants Motion to Dismiss Counts II, III, and IV is granted as they relate to the role of William Bach and (as to Count II) the intended use of proceeds, and denied as they relate to the changed role of Patrick Brady.

Enter:

David H. Coar [*29]

United States District Judge

Dated: March 31, 2003

TAB 10

Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois, Eastern Division.
Maria A. MUHAMMAD, Plaintiff,
v.
VILLAGE OF BOLINGBROOK, Bolingbrook Police Department, Chief Kenneth Each, Commander Keith George, Sergeant Michael Johnstone, Defendants
No. 02 C 3770.

July 8, 2004.

ORDER AND MEMORANDUM OPINION

GOTTSCHALL, J.

***1** Maria A. Muhammad ("Muhammad"), a police officer with the Bolingbrook Police Department ("Bolingbrook PD"), has sued Bolingbrook PD, the Village of Bolingbrook (the "Village"), and several of her superior officers alleging that she was discriminated against on the basis of age, race, national origin, religion and gender in violation of Title VII of the Civil Rights Act of 1964 ("Title VII"), 42 U.S.C. § 2000e, *et seq.*, the Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. § 621, and 42 U.S.C. § 1983. On November 4, 2002, defendants moved to dismiss some of Muhammad's claims. This court granted defendants' motion in part and denied it in part, dismissing (a) Muhammad's Title VII claim against Bolingbrook PD because Bolingbrook PD is not an "employer" within the meaning of that act, (b) her Section 1983 claim against Bolingbrook PD because the department has no legal existence separate from the Village and, therefore, is not a "person" against whom a suit can be brought under that section, and (c) her Title VII and ADEA claims against her superior officers because there is no individual liability under those statutes.

In their initial motion, defendants did not move to dismiss Muhammad's ADEA claim against Bolingbrook PD or her Section 1983 claim against her superior officers. In the "renewed motion" before the court, defendants now seek dismissal of those claims pursuant to Federal Rule of Civil Procedure 12(b)(6). For the reasons stated below, defendants' renewed motion to dismiss is granted in part and denied in part. Muhammad's ADEA claim against defendant Bolingbrook PD is dismissed. Defendants' motion to dismiss Muhammad's Section 1983 claim against her superior officers is denied.

ANALYSIS

When ruling on a motion to dismiss pursuant to Fed.R.Civ.P. 12(b)(6), the court accepts the factual allegations made in the plaintiff's complaint as true. *Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit,* 507 U.S. 163, 164 (1993). The court will then consider whether any set of facts, consistent with the allegations could support plaintiff's claim for relief. *Bartholet v. Reishauer A.G.,* 953 F.2d 1073, 1078 (7th Cir.1992). A complaint need only contain enough facts to put the defendant on notice of the claim so that an answer can be filed. *Flannery v. Recording Indus. Assoc. of America,* 354 F.3d 632, 639 (7th Cir.2004). Dismissal should be granted only if it is "beyond doubt" that the plaintiff cannot prove any facts to support a claim entitling plaintiff to relief. *Haines v. Kerner,* 404 U.S. 519, 520- 521 (1972). In that inquiry, complaints prepared *pro se,* such as Muhammad's, are given greater latitude. *Id.*

Ordinarily, defendants' renewed motion to dismiss would be barred by Fed.R.Civ.P. 12(g), which provides that any issues or objections that the defendant fails to raise in the initial motion to dismiss are waived. Fed.R.Civ.P. 12(b)(6). The purpose of Rule 12(g) is to prevent litigants from unnecessarily delaying proceedings at the pleading stage by interposing their defenses piecemeal. *Donnelli v. Peters Sec. Co.,* No. 02-C-0691, 2002 WL 2003217, *3 (N.D.Ill. Aug. 29, 2002). However, "a court might properly entertain [a] second motion to dismiss if convinced that it is not interposed for delay and that the disposition of the case on the merits can be expedited by doing so." *Id.* The court finds that defendants' renewed motion meets that standard: the motion does not appear to have been filed to delay proceedings and adjudication of this motion will narrow the issues before the court, allowing it to resolve this matter more quickly. Failure to rule would result only in unnecessary delay, expense and inconvenience for all parties. Therefore, the court will address the merits of defendants' motion.

I. Muhammad's ADEA Claim Against Bolingbrook PD

***2** Bolingbrook PD argues that Muhammad's ADEA claim must be dismissed because it is not a proper defendant for such a claim. Although caselaw on ADEA claims against law enforcement agencies is sparse, defendants analogize to Title VII, pointing out that, under that statute, police departments are neither an employer, nor a proper defendant. *E.g., McCraven v. City of Chicago,* 18 F.Supp.2d 877, 881 (N.D.Ill.1998). This is so because, as this court held in dismissing Muhammad's Section 1983 and Title VII claims against Bolingbrook PD, municipal police departments have no legal existence independent from the municipality that they serve. *See Chan v. City of Chicago,* 777 F.Supp. 1437, 1442 (N.D.Ill.1991); *Collins v. Village of Woodridge,* 1995 WL 632260, *1 (N.D.Ill.1995). Rather, the municipality is responsible for the unlawful acts of its police department and, therefore, is the proper defendant to a Title VII claim alleging discrimination by that department. *McCraven* 18 F.Supp.2d at 881. The court finds that the same logic applies to Muhammad's ADEA claim. *See, e.g., EEOC v. AIC Sec. Investigations, Ltd.,* 55 F.3d 1276, 1280 (7th Cir.1995) (noting that courts often apply arguments of liability to Title VII and the ADEA interchangeably). The court concludes that the Village of Bolingbrook, which is already a party to this action, is the proper defendant for Muhammad's ADEA claim and that naming Bolingbrook PD as a defendant in that claim adds nothing to Muhammad's complaint. The court, therefore, dismisses Muhammad's ADEA claim as to Bolingbrook PD.

II. Muhammad's Section 1983 Claims Against Her Supervisors

Defendants also argue that Muhammad's complaint as to the individual officers should be dismissed because it "does not contain allegations against [them] in their individual capacity." However, that is not the case. Although Muhammad has not made specific factual allegations against each defendant by name, the gravamen of her complaint is clear. She claims that defendants denied her several promotions due to her age and gender despite her "excellent qualifications." [FN1] She describes her claim in great detail, identifying each of the promotions she was denied, naming the officers who received the promotion and describing the age and education of the promoted officers. While she has not specified each individual officer's role in the promotions process, she has provided enough information to place her superior officers on notice of the claims against them. The court finds that Muhammad's Section 1983 claim meets the liberal notice pleading standard of Fed.R.Civ.P. 8 and, therefore, defendants' motion to dismiss that claim is denied.

FN1. Muhammad's Title VII claims that she was discriminated against on the basis of religion, color, national origin and race have been dismissed because those claims were not raised in her complaint before the Equal Employment Opportunity Commission.

CONCLUSION

For the reasons stated above, defendants' motion to dismiss is granted in part and denied in part. Plaintiff's ADEA claim against defendant Bolingbrook Police Department is dismissed. Defendants' motion to dismiss Muhammad's Section 1983 claim against her superior officers is denied.

2004 WL 1557958 (N.D.Ill.)

Motions, Pleadings and Filings (Back to top)

. 2004 WL 1685807 (Trial Motion, Memorandum and Affidavit) Reply in Support of Renewed Motion of Defendants to Strike and Dismiss Allegations Against Police Department and Individual Defendants (Mar. 15, 2004)

. 2004 WL 1685806 (Trial Motion, Memorandum and Affidavit) Plaintiff's Response to Defendants' Motion to Strike and Dismiss Allegations Against Police Department and Individual Defendants (Mar. 01, 2004)

. 2003 WL 23683767 (Trial Pleading) Answer to Amended Complaint (Dec. 22, 2003)

. 2002 WL 32602111 (Trial Pleading) Complaint Amended Complaint of Employment Discrimination (Oct. 15, 2002)

. 2002 WL 32602103 (Trial Pleading) Complaint of Employment Discrimination (May. 28, 2002)

. 1:02CV03770(Docket)
(May. 28, 2002)

END OF DOCUMENT

TAB 11

Motions, Pleadings and Filings

Only the Westlaw citation is currently available.

United States District Court,
S.D. New York.
In re SALOMON ANALYST Litigation
No. 02 Civ. 6801(GEL), 02 Civ. 6919(GEL), 02 Civ. 8114(GEL), 02 Civ. 8156(GEL).

March 8, 2005.

OPINION AND ORDER

LYNCH, J.

*1 This Order Relates to All Actions in: In re Salomon Analyst AT & T Litigation In re Salomon Analyst Level 3 Litigation In re Salomon Analyst XO Litigation In re Salomon Analyst Williams Litigation

On December 2, 2004, this Court denied in part defendants' motions to dismiss the complaints in these securities fraud actions, rejecting *inter alia* arguments that plaintiffs had failed adequately to plead loss causation. *In re Salomon Analyst AT & T Litig.,* 350 F.Supp.2d 455, 471 (S.D.N.Y.2004); *In re Salomon Analyst Level 3 Litig.,* 350 F.Supp.2d 477, 495 (S.D.N.Y.2004). Shortly thereafter, the Second Circuit decided *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161 (2d Cir.2005), which elaborated and clarified the Circuit's case law with respect to loss causation. Defendants promptly filed renewed motions to dismiss, arguing that *Lentell* undermined this Court's reasoning. Defendants now seek a ruling that the Private Securities Litigation Reform Act's ("PSLRA") automatic stay of discovery and other proceedings "during the pendency of any motion to dismiss," 15 U.S.C. § 78u-4(b)(3)(B), has been reimposed by the mere filing of their renewed motions. Although defendants' reasoning is not fully persuasive, a stay will be granted.

Defendants argue that the statutory language applies to *any* motion to dismiss, and contend that the discovery stay provision should not "apply differently simply because the pending motion to dismiss is the second such motion." (Letter from Richard A. Rosen to the Court of February 4, 2005 ("Rosen Letter"), at 2.) Defendants emphatically argue that the stay applies *automatically* and not as a matter of judicial discretion. They do not ask the Court to consider the likelihood that their motion will succeed on the merits; to the contrary, they vigorously object to plaintiffs' effort to argue its likely failure, contending that the Court should not attempt to "predict" the ultimate merits of the motion. (Letter from Richard A. Rosen to the Court of February 7, 2005, at 1.) Rather, defendants insist that the mere filing of *any* motion to dismiss, "successive or otherwise" (Rosen Letter at 2), automatically renews the statutory stay.

This argument has troubling implications. The purpose of the statutory stay is to prevent abusive, expensive discovery in frivolous lawsuits by postponing discovery until "after the Court has sustained the legal sufficiency of the complaint." S.Rep. No. 104-98 at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 693. In a case where the court already *has* sustained the legal sufficiency of the complaint, this purpose has been served. To permit defendants indefinitely to renew the stay simply by filing successive motions to dismiss would be to invite abuse. Some judicial discretion to evaluate the desirability of a renewed stay appears to be necessary.

Moreover, defendants' assertion that "the law is well established that successive motions ... *do* stay discovery under the PSLRA" (Rosen Letter at 2) (emphasis in original) is, to say the least, overstated. Defendants cite three district court opinions in support of this claim. All are distinguishable, or are flatly misstated by defendants. In *Faulkner v. Verizon Communications, Inc.,* 156 F.Supp.2d 384 (S.D.N.Y.2001), the court granted defendant's motion to dismiss, but allowed plaintiffs to replead. Defendants then sought leave to move to dismiss the amended complaint. The court granted this request, along with a stay pending determination of that motion, but gave no indication that it believed the stay was an automatic consequence of the filed motion to dismiss. *Id.* at 406. In any event, the case is completely different from this one, as the court there had never "sustained the legal sufficiency of the complaint," but conversely had dismissed it. In the case *In re Tyco Int'l Ltd. Sec. Litig,* No. 00MD1335, 2000 WL 33654141 (D.N.H. July 27, 2000), the court found that the PSLRA stay applied even though a motion was not yet pending. Defendants' argument here that the motion that was expected to be filed in *Tyco* was a "successive motion[ ]" (Rosen Letter at 2) appears to turn on the fact that motions to dismiss addressed to certain individual actions had been filed prior to consolidation, and a schedule for filing an amended consolidated complaint and motions to dismiss that complaint had just been established. *Id.* at *1 n. 1. Nothing in the opinion suggests that any prior motion had been decided, let alone that the contemplated motions were "successive" in the sense that the court had already upheld the merits of the complaint. Rather, it seems that the anticipated motion would have been the first to test the sufficiency of the operative complaint in the consolidated case.

***2** The only case cited by defendants that appears at all comparable to the present matter is *In re Southern Pacific Funding Corp. Sec. Litig.,* 83 F.Supp.2d 1172 (D.Or.1999). There, as here, a motion to dismiss the complaint was denied "in large measure." *Id.* at 1174-75. However, intervening appellate decisions "affect[ed]" the court's prior holdings, and induced plaintiffs to seek leave to amend their complaint and defendants to move to dismiss. *Id.* at 1174. Under these circumstances, the court noted that "[w]ith the pendency of these new dismissal motions, discovery has been stayed again." *Id.* at 1175 n. 1. The court simply observed that discovery had been stayed, without further explanation of why or how, or any indication that the stay had been contested or any legal issue decided by the court. The court's passing remark hardly qualifies even as dictum. [FN1]

FN1. Somewhat more helpful to defendants is a case they cite only in a footnote. (*See* Rosen Letter at 2 n.l.) In *Powers v. Eichen,* 961 F.Supp. 233 (S.D.Cal.1997), a Magistrate Judge held that a PSLRA stay applied pending resolution of a motion for reconsideration of the District Court's earlier denial of a motion to dismiss. This Court is not persuaded, however, by the *Powers* court's argument that if the PSLRA were "read more narrowly, defendants would be afforded very little of the protection that Congress intended." *Id.* At 236.

Thus, none of the cases cited by defendants come close to addressing their claim that the PSLRA stay automatically applies to a successive motion to dismiss filed after a court has already sustained the validity of all or part of a complaint. Nevertheless, this Court need not accept defendants' argument in order to grant a stay. Without in any way prejudging the merits of their motion to dismiss, the successive motion here, as in *Southern Pacific,* is neither frivolous nor advanced solely to delay the proceedings, but was occasioned by an intervening appellate decision. The Second Circuit has decided a case, binding precedent for this Court, that advances new reasoning addressing a significant issue in the case and warrants revisiting the Court's analysis of the issue of loss causation.

Nor is this simply a case in which defendants merely cite new authority for an old argument. It is indisputable that the Second Circuit's case law on loss causation was in some disarray, and that *Lentell* represents a major effort to clarify the doctrine, in a context relevant to this case. The Court expresses no view whatsoever on whether *Lentell* is inconsistent with its earlier opinions. However, it is reasonable to afford the parties an opportunity to brief the implications of that decision, so that the Court can decide whether *Lentell* affects the viability of plaintiffs' complaints. In view of the policy of the PSLRA to deny discovery until a complaint has been authoritatively sustained by the court, it is appropriate to extend the stay under the present circumstances. Since that result is appropriate as an exercise of the Court's discretion, there is no need to decide whether the filing of a successive motion, or even of any non-frivolous motion, after a court has already denied on the merits an earlier motion to dismiss would trigger an automatic stay under the PSLRA.

The Court recognizes that these cases have been pending for a long time, and that discovery could be further delayed by this motion. The parties' agreement to a speedy briefing schedule does not obviate the problem of delay. The Court's docket is crowded with trials and other motions, and it is impossible to predict that the Court's resolution of the issue will be as quick as the parties' briefing. Under the circumstances, however, it is appropriate to stay discovery until defendants' arguments are heard.

***3** Accordingly, all proceedings in these cases are stayed pending resolution of defendants' renewed motions to dismiss.

SO ORDERED.

2005 WL 550847 (S.D.N.Y.)

Motions, Pleadings and Filings (Back to top)

. 1:02CV08114(Docket)
(Oct. 11, 2002)

. 1:02CV06919(Docket)
(Aug. 30, 2002)

. 1:02CV06801(Docket)
(Aug. 26, 2002)

END OF DOCUMENT

TAB 12

LEXSEE 2003 U.S. DIST. LEXIS 9982

GEORGE TATZ, individually and on behalf of all others similarly situated, Plaintiff, v. NANOPHASE TECHNOLOGIES CORPORATION, JOSEPH CROSS JESS JANKOWSKI, DANIEL S. BILICKI, and GINA KRITCHEVSKY, Defendants.

No. 01 C 8440

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

2003 U.S. Dist. LEXIS 9982

June 12, 2003, Decided
June 13, 2003, Docketed

PRIOR HISTORY: Tatz v. Nanophase Techs. Corp., 2002 U.S. Dist. LEXIS 19467 (N.D. Ill., Oct. 9, 2002)

DISPOSITION: [*1] Plaintiff's motion for class certification pursuant to Federal Rule of Civil Procedure 23(b)(3) granted.

LexisNexis(R) Headnotes

COUNSEL: For GEORGE TATZ, plaintiff: Lionel Z Glancy, Richard Rothenberg, Glancy & Binkow, LLP, Los Angeles, CA.

For GEORGE TATZ, plaintiff: Patrick Vincent Dahlstrom, Pomerantz Haudek Block Grossman & Gross LLP, Chicago, IL.

For GEORGE TATZ, plaintiff: Michael Goldberg, Law Offices of Lionel Z. Glancy, Los Angeles, CA.

For NANOPHASE TECHNOLOGIES CORPORATION, JOSEPH CROSS, defendants: Michael R. Dockterman, David L. Weinstein, Wildman, Harrold, Allen & Dixon, Chicago, IL.

For NANOPHASE TECHNOLOGIES CORPORATION, JOSEPH CROSS, defendants: Samuel Seth Cohen, Duane Morris LLC, Chicago, IL.

JUDGES: Wayne R. Andersen, United States District Judge.

OPINIONBY: Wayne R. Andersen

OPINION:

MEMORANDUM OPINION AND ORDER

Plaintiff, George Tatz, brings this putative class action on behalf of himself and those similarly situated against Defendants Nanophase Technologies Corp., Joseph Cross, Jess Jankowski, Daniel Bilicki, and Gina Kritchevsky. Plaintiff now moves for class certification pursuant to Federal Rule of Civil Procedure 23(b)(3). For the following reasons, Tatz's motion for [*2] class certification is granted.

BACKGROUND

The following factual history is taken from our prior opinion in this case denying the defendants' motion to dismiss pursuant to Federal Rules of Civil Procedure 9(b) and 12(b)(6) and the Private Securities Litigation Reform Act of 1995. *See Tatz v. Nanophase Technologies Corp.*, 2002 U.S. Dist. LEXIS 19467, 2002 WL 31269485, at *1-3 (N.D. Ill. Oct. 9, 2002).

Defendant Nanophase Technologies Corporation (hereinafter "Nanophase") is a Delaware Corporation, with headquarters in Romeoville, Illinois, that develops, manufacturers, and sells nanocrystalline materials for commercial use. Nanophase uses its extensive proprietary technology to engineer and produce nanocrystalline materials for specific applications, including environmental catalysts. Defendant Joseph Cross was at all relevant times the Chief Executive Officer, president, and a director of Nanophase. The other individual defendants were, at all relevant times, senior executive officers of Nanophase.

On January 21, 2001, Cross told the *Wall Street Journal* that Nanophase had met each of the goals for the year 2000 and announced that the company's 2001 targets included "tripling revenues [*3] again." He stressed that Nanophase needed to "increase the revenue stream as quickly as possible," not only to become profitable but also to show that customers perceive that the company's technology has value. Shortly thereafter, Nanophase was notified by BASF, its largest customer, of an "unexpected delivery rescheduling for sunscreen materials." Under the new schedule, the company would ship product to BASF primarily in the third and fourth quarters, reducing shipments by 50% in the first quarter and 30% in the second quarter. According to the complaint, because Nanophase had already reduced its 2001 revenue forecast in February 2001, the defendants needed to find some way to replace the deferred BASF revenues.

Just before the close of the first quarter, on March 28, 2001, Nanophase issued a press release stating that Nanophase "received an order for approximately $400,000 for a new environmental catalyst application to be filled in the first quarter of 2001." While the company anticipated "significant" revenue in 2001 from this customer, quantities and timing would not be known for a few months. Also, for "competitive reasons," the customer was not named. As a result of this [*4] deal, Nanophase's release of first quarter results was positive. On April 5, 2001, Nanophase reported a 73% rise in revenues from the prior year and "robust" business development, "as evidenced by our recent announcement of a new customer for environmental catalyst."

Apparently as a result of shareholder confusion concerning the recording of the revenue from the new environmental catalyst sale, defendant Jankowski, the company's acting Chief Financial Officer, explained at the beginning of the April 26, 2001 conference call how the company was able to record the revenue in the first quarter. He stated:

> ". . . $400,000 of first quarter 2001 product revenue related to the catalyst order that we discussed in our March 28 press release. We had positive negotiations with that customer for some time prior to finalizing arrangements and were ready to fill the order immediately upon coming to terms. The timing of this revenue seems to have been a point of confusion to some of our shareholders."

Aside from accruing the revenue in the first quarter, which could only occur, according to the company's stated policy, if shipment had made been made, other defendants also suggested [*5] that the product had already been shipped. Specifically, Dan Bilicki, Vice President of Sales and Marketing, stated: "The nanocrystalline material provided will be used for large-scale tests." Similarly, Cross added, "For the catalyst order . . ., we also have deliveries scheduled for the second quarter."

Based in large part on these announcements, Nanophase's stock price rose from $6.44 to $11.81 on May 18, 2001. That day, and again on May 22 and May 24, when the closing price ranged from $10.60 to $11.81, defendants Bilicki, Jankowski, and Gina Kritchevsky, Vice President of Technology and Engineering, sold 53,228 shares of stock, 33.3% of all shares traded on those days.

One week later, Nanophase terminated its exclusive relationship with the unnamed customer of the environmental catalyst, based upon "concerns that the customer is not currently adequately capitalized to fulfill its remaining obligations." The company lowered expected second quarter revenues by $500,000 and 2001 projections by $2-2.5 million. However, the company never disclosed that it had not been paid for the first quarter sale. Nevertheless, this partial disclosure caused the stock price to drop [*6] $2.06, or 17.44%, on the next trading day (June 4, 2001), on the third highest trading day volume in the purported class period.

According to the amended complaint, shareholders' suspicions were again aroused by this announcement, especially as it came just days after three executives sold 53,000 shares of stock. During a July 26, 2001 conference call, defendants again explained their actions. Cross stated during the conference call that:

> "As many of you are aware, three Officers and one Director sold some stock this past quarter . . . Stock options are a form of compensation in this company. In each case, the Officers involved had personal reasons for their decisions, as is their right to manage their own compensation. While the timing turned out to be awkward, related to our decision to exit the relationship with the European customer, all the factors that led to that decision were not known until literally hours before the press release."

Regarding the termination of the agreement, Cross said that, although a memorandum of understanding had been executed setting forth quantities and delivery dates, the customer did not sign a "legal agreement" because it was "undercapitalized. [*7] " Again, four months after the first quarter order had been filled, defendants still had not disclosed that the customer had not yet paid Nanophase. This partial disclosure still caused a price drop of 15%, from $7.74 on July 25 to $6.60 on July 26.

On October 25, 2001, Nanophase reversed the first quarter sale, reducing third quarter revenues from $1.1 million to $700,000. Revealing the customer's identity, Nanophase explained that not only had Celox failed to pay for the order, but Celox never gave shipping instructions to Nanophase, although it had been required to do so by July. Thus, even though Nanophase had "exited the relationship" with an "undercapitalized" Celox on June 1, 2001 and had never sent Celox any product, defendants claimed that only on October 16, 2001 was "significant uncertainty" first raised as to whether Celox would "ever pay for the product it bought," and for which revenue was accrued seven months earlier. Consequently, the stock's price fell 13.5% the next day, from $6.20 to $5.36.

On March 8, 2002, the plaintiff filed an amended two count complaint against the defendants alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act [*8] of 1934 and Rule 10b-5 of the Code of Federal Regulations. By order dated January 29, 2002, Tatz was appointed Lead Plaintiff and his counsel, Glancy & Binkow LLP, was appointed Lead Counsel for the class. In the instant motion, the plaintiff requests that we certify a class defined as follows:

> All persons or entities who purchased or acquired Nanophase Technologies Corporation ("Nanophase" or "Corporation") common stock during the period from April 5, 2001, through and including October 24, 2001 (the "Class Period"), and were damaged thereby. Excluded from the class are the defendants, their affiliates and any officers or directors of Nanophase or its affiliates, and any members of immediate families and their heirs, successors and assigns (the "Class").

DISCUSSION

I. Class Certification is Particularly Appropriate in Securities Cases

The Seventh Circuit Court of Appeals has liberally construed Rule 23 in shareholder suits. *See King v. Kansas City Southern Industries, Inc.*, 519 F.2d 20, 25-26 (7th Cir. 1975). Courts in this district recognize that:

> securities fraud cases are uniquely situated to class action treatment since the [*9] claims of individual investors are often too small to merit separate lawsuits. The class action is thus a useful device in which to litigate similar claims as well as an efficient deterrent against corporate wrongdoing.

Gilbert v. First Alert, Inc., 904 F. Supp. 714, 719 (N.D. Ill. 1995) (quoting *Ridings v. Canadian Imperial Bank of Commerce Trust Co. (Bahamas), Ltd.*, 94 F.R.D. 147, 150 (N.D. Ill. 1982)), *opinion amended on other grounds*, 165 F.R.D. 81 (1996). A class action is often the most fair and practicable means to address claims in securities cases. *Brosious v. Children Place Retail Stores*, 189 F.R.D. 138, 147 (D.N.J. 1999) ("class actions are often the most fair and practical vehicle for plaintiffs' claims in securities suits because 'those who have been injured are in a poor position to seek legal redress' . . . because individual claims might be small in monetary value, they might not be prosecuted on an individual basis due to the costs of litigation") (quoting *Zinberg v. Washington Bancorp. Inc.*, 138 F.R.D. 397, 410 (D.N.J. 1990)). *See also Endo v. Albertine*, 147 F.R.D. 164 (N.D. Ill. 1993) [*10] (certifying plaintiff class under § 11 of the 1933 Act).

II. The Requirements of Rule 23(a)

A party seeking to represent a class of similarly situated individuals has the burden of establishing that class certification is proper under Federal Rule of Civil Procedure 23. *Retired Chicago Police Assoc. v. City of Chicago*, 7 F.3d 584, 596 (7th Cir. 1993). The Court must determine the propriety of class certification with reference to the requirements of Rule 23 and not to whether the plaintiff will ultimately prevail on the merits of his claim. "Nothing in either the language or history of Rule 23 . . . gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177, 94 S. Ct. 2140, 40 L. Ed. 2d 732 (1974). However, the Court may look beyond the pleadings to determine whether the requirements of Rule 23 have been met. *Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672, 677 (7th Cir. 2001). The Court must "understand the claims, defenses, relevant facts and applicable substantive law in [*11] order to make a meaningful determination of certification issues." *Dhamer v. Bristol-Myers Squibb Co.*, 183 F.R.D. 520, 530 (N.D. Ill. 1998).

In determining whether class certification is proper under Rule 23, the Court must undertake a two-step analysis. The Court must first determine whether the initial requisites for class certification delineated in Rule 23(a) are satisfied: (1) that the class is so numerous that joinder of all members is impracticable (numerosity); (2) that there are questions of law or fact common to the class (commonality); (3) that the claims or defenses of the representative parties are typical of the claims or defenses of the class (typicality); and (4) that the representative parties will fairly and adequately protect the interests of the class (adequacy of representation). Second, the Court must determine whether the proposed class satisfies one of the sub-parts of Rule 23(b). In this case, Tatz seeks certification under Rule 23(b)(3), which requires that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods [*12] for the fair and efficient adjudication of the controversy," Fed.R.Civ.P. 23(b)(3). With these principles in mind, we turn to whether Tatz has satisfied the requirements under Rule 23 for class certification.

A. The Effect of Defendants' Offer of Judgment

In its opposition to the motion for class certification, the defendants argue that the motion should be denied because Tatz's claims are moot because of an offer of judgment. The substance of this argument is that since the defendants offered, in a Rule 68 offer of judgment, the full amount of damages Tatz could recover if he prevails on the merits, all of Tatz's claims as a putative class representative are moot. Thus, according to the defendants, the class certification motion should be denied. We disagree.

The relevant portions of Rule 68 provide that "an offer not accepted shall be deemed withdrawn and evidence thereof is not admissible except in a proceeding to determine costs." Fed.R.Civ.P. 68. It is clear from the text of this rule that its terms are not self-executing. It is within the discretion of the party to whom the offer of judgment is made to accept the offer or not within 10 days. The record in this case is [*13] clear that Tatz did not respond to the offer of judgment within the requisite time period. Thus, Tatz's claims technically are not moot because no offer has been accepted and recorded with the Clerk of this Court.

Further, the Seventh Circuit has addressed the impact of an offer of judgment on class certification in cases such as this. In *Greisz v. Household Bank (Illinois), N.A.*, 176 F.3d 1012, 1015 (7th Cir. 1999), the court found that an offer of judgment made before a class is certified is not sufficient to moot the class representative's claim because "an offer to one is not an offer of the *entire* relief sought by the suit . . . ." (Emphasis in original) (citing *Deposit Guaranty National Bank v. Roper*, 445 U.S. 326, 341, 100 S. Ct. 1166, 63 L. Ed. 2d 427 (1980); *Alpern v. Utilicorp United, Inc.*, 84 F.3d 1525, 1539 (8th Cir. 1996)). The court also noted that an offer of judgment may moot a plaintiff's claim if it was made prior to a motion for class certification and "before the existence of other potential plaintiffs has been announced." *Id.* (citing *Holstein v. City of Chicago*, 29 F.3d 1145, 1147 (7th Cir. 1994)). [*14] While it is true that the defendants made the offer of judgment to Tatz two months before the instant motion for class certification was filed, it cannot be denied that "the existence of other potential plaintiffs" had been announced. *Id.* Plaintiff's counsel performed this function by not only filing a class action complaint which specifically contemplated the existence of hundreds of plaintiffs but also by persuading this Court to enter an order appointing Tatz as lead class plaintiff - a clear message to those interested in such things that a class certification motion would be filed forthwith. Thus, we find that the offer of judgment has not mooted Tatz's claims.

B. Numerosity

Rule 23(a)(1) requires that the class be "so numerous that joinder of all class members is impracticable." Fed.R.Civ.P. 23(a)(1). Because there is no mystical number at which the numerosity requirement is established, courts have found this element satisfied when the putative class consists of as few as 10 to 40 members. *See Markham v. White*, 171 F.R.D. 217, 221 (N.D. Ill. 1997) (35-40 class members); *Hendricks-Robinson v. Excel Corp.*, 164 F.R.D. 667, 671 (C.D. Ill. 1996) [*15] (38 class members); *Riordan v. Smith Barney*, 113 F.R.D. 60, 62 (N.D. Ill. 1983) (29 class members). Although the plaintiff need not allege the exact number or identity of the class members, the plaintiff ordinarily "must show some evidence or reasonable estimate of the number of class members." *Long v. Thornton Township High Sch. Dist.*, 82 F.R.D. 186, 189 (N.D. Ill. 1979). The Court is permitted to "make common sense assumptions in order to find support for numerosity." *Cannon v. Nationwide Acceptance Corp.*, 1997 U.S. Dist. LEXIS 3517, 1997 WL 139472, at *2 (N.D. Ill. March 25, 1997) (quoting *Evans v. United States Pipe & Foundry*, 696 F.2d 925, 930 (11th Cir. 1983)).

Here, the putative class contains hundreds of potential persons or entities. Some 13,000,000 shares of Nanophase's common stock were publicly traded on the NASDAQ National Market during the Class Period. It is reasonable to conclude, and no one seriously contends otherwise, that these 13,000,000 shares were likely owned by hundreds of persons or entities throughout the United States. Thus, the numerosity requirement is satisfied.

In addition, Rule 23(a)(1) provides that a class [*16] action may be maintained only if "joinder of all members is impracticable." To demonstrate that joinder is impracticable, the class representatives "only need to show that it is extremely difficult or inconvenient to join all members of the class." C.A. Wright, A. Miller & N. Kane, FEDERAL PRACTICE AND PROCEDURE, § 1762 at

159 (2d ed. 1986). In this case, it would be extremely difficult to join the hundreds of members of the class.

C. Commonality

Rule 23(a)(2) requires that there be a common question of law or fact among class members. This Court has characterized the commonality requirement as a "low hurdle, easily surmounted." *Scholes v. Stone, McGuire & Benjamin*, 143 F.R.D. 181, 185 (N.D. Ill. 1992)(citing *Wesley v. General Motors Acceptance Corp.*, 1992 U.S. Dist. LEXIS 3594, 1992 WL 57948, at *3 (N.D. Ill. 1992)). Common questions exist when, despite the existence of individual issues among class members, there is a common nucleus of operative facts. *Rosario v. Livaditis*, 963 F.2d 1013, 1017-18 (7th Cir. 1992); *Beale v. Edgemark Financial Corp.*, 164 F.R.D. 649, 654 (N.D. Ill. 1995). This element is satisfied when each class member's [*17] claim hinges on the same conduct by the defendants. *Beale*, 164 F.R.D. at 658.

The present case involves several common questions that relate to the defendants' conduct including, but not limited to: 1) whether the federal securities law were violated by the defendants' acts and omissions; 2) whether the defendants participated in and pursued the common course of conduct; 3) whether financial statements, audit reports, press releases, and other statements disseminated to the investing public and Nanophase's shareholders omitted to state and/or misrepresented material facts about the business, products, financial condition, and business prospects of Nanophase; 4) whether the defendants acted willfully, knowingly, or recklessly; and 5) whether the market price of Nanophase's common stock was artificially inflated due to the alleged conduct by the defendants. Therefore, the commonality requirement of Rule 23(a)(2) is satisfied.

D. Typicality

The typicality requirement of Rule 23(a)(3) requires the Court to determine whether the representative plaintiff's claims have the same essential characteristics as the claims of the class at large. *De la Fuente v. Stokely-Van Camp, Inc.*, 713 F.2d 225, 232 (7th Cir. 1983). [*18] *See also Beale*, 164 F.R.D. at 654. A finding that commonality exists generally results in a finding that typicality also exists. *Arenson* v. *Whitehall Convalescent and Nursing Home, Inc.*, 164 F.R.D. 659, 664 (N.D. Ill. 1996). The Rule does not require that each member of a class suffer exactly the same injury as the named class representative. *Tidwell v. Schweiker*, 677 F.2d 560, 566 (7th Cir. 1982). Even when factual differences exist, similarity of legal theory satisfies the requirement. *See De la Fuente*, 713 F.2d at 232-33.

In their opposition to the class certification motion, the defendants have argued that this Rule 23(a) requirement has not been met because Tatz is subject to unique defenses which make him serving as class representative inappropriate. Specifically, the defendants contend that Tatz cannot prove that he individually relied on the allegedly fraudulent misrepresentations of the defendants. Obviously, Tatz disagrees with this argument and he contends that he need not prove individual reliance in this case because he is entitled to the "fraud on the market" presumption.

To state a claim under [*19] Section 10(b) or Rule 10b-5, a plaintiff must ordinarily show that he relied on a material misstatement or omission in purchasing a security. *See In re HealthCare Compare Corp. Sec. Lit.*, 75 F.3d 276, 280 (7th Cir. 1996). However, the "fraud on the market" theory of reliance permits a plaintiff to pursue a Section 10(b)/Rule 10b-5 claim without showing direct reliance on the misstatement or omission; indirect reliance may be presumed. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 243, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988). The theory holds that efficient trading markets automatically establish a causal link between material misstatements or omissions and a stock purchaser's injury, and manifest that link in the stock's price. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1129 (7th Cir. 1993).

The defendants argue that the "fraud on the market" presumption should not apply because shares of Nanophase were not sold in an open, developed, and efficient securities market. While the Seventh Circuit has not formally done so, numerous courts have adopted the following five factors (the so-called *Cammer* factors) to aid in the determination [*20] of market efficiency: 1) whether the stock trades at a high weekly volume; 2) whether securities analysts follow and report on the stock; 3) whether the stock has market makers and arbitrageurs; 4) whether the company is eligible to file SEC registration form S-3, as opposed to form S-1 or S-2; and 5) whether there are empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price. *See, e.g., Binder v. Gillespie*, 184 F.3d 1059, 1065 (9th Cir. 1999); *Hayes v. Gross*, 982 F.2d 104, 107 (3d Cir. 1992); *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989).

In this case, the plaintiff has submitted a declaration as part of his class certification motion which, in our estimation, establishes that the market for Nanophase's share was open and efficient. Specifically, the declaration states that: 1) during the Class Period, Nanophase stock had a trading volume of nearly nine million share with a total dollar trading volume of $72.08 million;

2) Nanophase stock was addressed in written reports by securities analyst Robinson Humphrey and conference [*21] calls during the Class Period were monitored by sell-side analysts from, at least, Robinson Humphrey, Merrill Lynch, Morgan Stanley, Tucker Anthony and CIBC World Markets, and by buy-side analysts from, at least, Target Capital Management and NWQ Investment Management; 3) 11% to 13% of the total outstanding common stock of Nanophase was held by numerous large institutional investors during the Class Period, including mutual funds, insurance companies, pension plans, banks, and other professional investors who manage equity portfolios in excess of $100 million; 4) Nanophase was eligible to file a Form S-3 during the Class Period and did later file a Form S-3 on June 12, 2002, and an amended Form S-3/a on September 6, 2002; and 5) the market did react to unexpected news released during the course of and just after the Class Period (i.e. statistically significant price changes to Nanophase's stock price on at least April 5, 2001, June 4, 2001, June 25, 2001, July 26, 2001, October 3, 2001, and October 25, 2001). (Declaration of Michael Marek, at PP 24-26, 30-31, 33, 41, 46-57.) Based on this declaration, we conclude that the market for Nanophase stock was open and efficient. Accordingly, [*22] we find that the "fraud on the market" presumption is appropriate in this case.

In addition to their market efficiency argument, the defendants also attack the typicality requirement by suggesting that Tatz's securities trading practices have left him open to unique reliance defenses. We disagree. As a general matter, we must remind the defendants that a plaintiff's claim is typical under Rule 23(a)(3) "if it arises from the same event or practice or course of conduct that gives rise to the claims of other class members and his or her claims are based on the same legal theory." *Rosario*, 963 F.2d at 1018; *De la Fuente*, 713 F.3d at 232. Tatz's Section 10(b) claims are typical of those of the class because he has alleged that he, like the class he purports to represent, relied to his detriment on the defendants' misrepresentations concerning Nanophase's business relationship with Celox. The fact that Tatz "may have used somewhat distinctive buying strategies does not render him atypical with respect to this claim of overarching fraud." *Danis v. USN Communications, Inc.*, 189 F.R.D. 391, 397 (N.D. Ill. 1999); *see also Gilbert*, 904 F. Supp. at 720; [*23] *Ridings*, 94 F.R.D. at 152. Therefore, we find that Rule 23(a)(3) has been satisfied.

E. Adequacy of the Representation

To satisfy the adequacy of representation requirement, a plaintiff must show that: 1) the proposed representative does not have "antagonistic or conflicting claims with other members of the class;" 2) the proposed representative has "sufficient interest in the outcome of the case to ensure vigorous advocacy;" and 3) its counsel is "competent, qualified, experienced and able to vigorously conduct the litigation." *Sebo v. Rubenstein*, 188 F.R.D. 310, 316 (N.D. Ill. 1999) (citation omitted). "Basic consideration[s] of fairness require that a court undertake a stringent and continuing examination of the adequacy of representation by the named class representative at all stages of the litigation where absent members will be bound by the court's judgment." *Susman v. Lincoln Am. Corp.*, 561 F.2d 86, 89-90 (7th Cir. 1977). "[A] court must in the broadest sense be satisfied that the fiduciary duties and responsibilities of the class representative and class counsel will be conscientiously, fairly, and justly discharged [*24] in order to protect the interests of the class." *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 479 (W.D. Mich. 1994).

In their opposition to the motion for class certification, the defendants have primarily argued that the adequacy of representation requirement has not been satisfied through a variety of *ad hominem* attacks on Tatz. Specifically, the defendants contend that Tatz is not an adequate class representative because he supposedly lacks even basic knowledge and understanding of the case, he is only a sop for his class action attorneys, and he lacks the personal credibility necessary to properly represent the class. We disagree with the defendants' characterization of Tatz's potential representation of this putative class.

It is clear from the transcript of Tatz's deposition that he is fully aware and in control of this litigation. He indicated that he understood that he was bringing the suit on behalf of individuals like himself who allegedly were harmed when they relied on the purported misstatements and omissions of the defendants regarding the financial condition of Nanophase. He also established during his deposition that he was the individual who was primarily [*25] responsible for overseeing not only the progress of the lawsuit but also the actions of class counsel. Based on what we have seen in the pleadings, we are confident that Tatz has no interests with respect to this litigation that conflict with, or are antagonistic to, the interests of absent class members and that he will vigorously prosecute this action on behalf of the class. With respect to the defendants' somewhat spurious argument that Tatz lacks the necessary credibility to represent the class, we trust that the plaintiff is an upstanding individual who will do his best to make sure the best interests of the class are properly represented and protected.

III. The Requirements of Rule 23(b)(3)

The proposed class also satisfies the requirements of

Rule 23(b)(3) which provides:

> that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

Each of these requirements is met in this case.

A. Common Questions Predominate

While common questions of law or fact [*26] must predominate, they need not be exclusive. *Scholes v. Moore*, 150 F.R.D. 133, 138 (N.D. Ill. 1993). To determine whether common questions predominate, courts look to whether there is a "common nucleus of operative facts." *Ziemack v. Centel Corp.*, 163 F.R.D. 530, 535 (N.D. Ill. 1995) (citing *Rosario*, 963 F.2d at 1018). A court should direct its inquiry primarily toward the issue of liability, rather than damages, in determining whether common questions predominate. *See Beale*, 164 F.R.D. at 658.

The defendants' alleged misstatements and omissions of material fact to members of the class are at the core of the complaint. The issues of law and fact that flow from the defendants' alleged misstatements and omissions predominate over any individual issue. Because the many common issues will unquestionably dominate this Court's attention, common questions of law and fact predominate. *Id. See also Rosario*, 963 F.2d at 1018 ("[a] common nucleus of operative fact is usually enough to satisfy the commonality requirement") (citing *Franklin v. City of Chicago*, 102 F.R.D. 944, 949-50 (N.D. Ill. 1984)); [*27] *Scholes*, 150 F.R.D. at 138 (finding predominance of common issues notwithstanding variance in material information)

B. A Class Action is Superior

A class action in this case is superior to other means of adjudication for several reasons. First, there is a common core of law and fact pertaining to the defendants' alleged misstatements and omissions in connection with its allegedly improper accounting of the Celox sale. Accordingly, class treatment is a more efficient means of adjudicating this matter than the myriad individual suits that potentially could be filed in the absence of class certification. *See Basile v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 105 F.R.D. 506, 508 (S.D. Ohio 1985). *See also Research Corp. v. Pfister Associated Growers, Inc.*, 301 F. Supp. 497, 503 (N.D. Ill. 1969). Indeed, any alternative to this class action could create duplication of actions, the very "evil that Rule 23 was designed to prevent." *Califano v. Yamasaki*, 442 U.S. 682, 690, 99 S. Ct. 2545, 61 L. Ed. 2d 176 (1979). Such "separate actions by each of the class members would be repetitive, wasteful and an extraordinary [*28] burden on the courts." *Kennedy v. Tallant*, 710 F.2d 711, 718 (11th Cir. 1983).

Second, class members will benefit from class treatment because litigation costs are high and it is, therefore, unlikely shareholders will prosecute individual claims. *See Haynes v. Logan Furniture Mart, Inc.*, 503 F.2d 1161, 1164-65 (7th Cir. 1974). A class action is a superior means to adjudicate claims of class members who would be overwhelmed by the defendants' resources if they attempted to prosecute their individual claims. *See Chandler v. Southwest Jeep-Eagle, Inc.*, 162 F.R.D. 302, 310 (N.D. Ill. 1995); *Alexander v. Centrafarm Group, N.V.*, 124 F.R.D. 178, 185 (N.D. Ill. 1988).

Third, principles of judicial economy and efficiency favor trying this case in one action rather than forcing class members to litigate identical claims individually. *See Scholes*, 143 F.R.D. at 189 ("judicial economy and efficiency, as well as consistent judgments, are achieved by certifying the class"). Under these circumstances, class certification is the best way to manage this situation which could otherwise disintegrate into piecemeal [*29] adjudication of many individual actions involving essentially identical questions of law and fact.

Finally, this matter does not present significant management problems. Rule 23 was designed for this exact type of case. In this case, there is no realistic alternative to class action treatment.

CONCLUSION

For the foregoing reasons, the plaintiff's motion for class certification pursuant to Federal Rule of Civil Procedure 23(b)(3) is granted. Mr. George Tatz is hereby appointed as class representative. The following class is certified:

> All persons or entities who purchased or acquired Nanophase Technologies Corporation ("Nanophase" or "Corporation") common stock during the period from April 5, 2001, through and including October 24, 2001 (the "Class Period"), and were damaged thereby. Excluded from the class are the defendants, their affiliates and any officers or directors of Nanophase or its affiliates, and any members of immediate families and their heirs, successors and assigns (the "Class).

It is so ordered.

Wayne R. Andersen

United States District Judge

Dated: June 12, 2003

TAB 13

LEXSEE 2001 U.S. DIST. LEXIS 17867

IN RE WESTELL TECHNOLOGIES, INC., SECURITIES LITIGATION

00 C 6735

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

2001 U.S. Dist. LEXIS 17867; Fed. Sec. L. Rep. (CCH) P91,628

October 26, 2001, Decided
October 30, 2001, Docketed

DISPOSITION: [*1] Motion to dismiss was granted in part.

LexisNexis(R) Headnotes

COUNSEL: For ERIC BERGH, plaintiff: Michael Jerry Freed, Carol V Gilden, Michael E. Moskovitz, Much, Shelist, Freed, Denenberg, Ament & Rubenstein, P.C., Chicago, IL.

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For WESTELL TECHNOLOGIES, INC., MARC ZIONTS, WILLIAM J NELSON, BRUCE ALBELDA, HOWARD L KIRBY, JR, THOMAS A REYNOLDS, JR, defendants: Steven Samuel Scholes, Christopher Mac Neil Murphy, Jeffrey J. Bushofsky, Robert S. O'Meara, Anthony F. Fata, McDermott, Will & Emery, Chicago, IL.

For WESTELL TECHNOLOGIES, INC., MARC ZIONTS, WILLIAM J NELSON, BRUCE ALBELDA, HOWARD L KIRBY, JR, THOMAS A REYNOLDS, JR, defendants: Joseph G. Fisher, Eimer Stahl Klevorn & Solberg, Chicago, IL.

JUDGES: JOAN HUMPHREY LEFKOW, United States District Judge.

OPINIONBY: JOAN HUMPHREY LEFKOW

OPINION:

MEMORANDUM OPINION AND ORDER

Lead plaintiff, Fuller & Thaler Asset Management, Inc., has sued individually and on behalf of a class of purchasers of common stock of defendant Westell Technologies, Inc. ("Westell") between the dates of June 27, 2000 and October 18, 2000, alleging [*2] that Westell and a number of its directors and officers n1 violated §§ 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78t(a), and Rule 10b-5 promulgated under § 78j(b), 17 C.F.R. § 240.10b-5, by knowingly and/or recklessly making false and misleading statements to plaintiff through press releases and conversations with analysts. Plaintiff n2 further alleges that defendants Marc Zionts ("Zionts"), William Nelson ("Nelson"), Howard Kirby, Jr. ("Kirby"), Nicholas Hindman ("Hindman"), and Thomas Reynolds ("Reynolds") profited from these misrepresentations, in that they sold off their personal holdings to plaintiff after they artificially inflated the price of Westell stock. Defendant Bruce Albelda ("Albelda"), Westell's head of Investment Relations Department, although not alleged to have personally profited, is sued for making false and misleading statements. All defendants have moved to dismiss the complaint under Federal Rules of Civil Procedure 12(b)(6) for failure to state a claim upon which relief may be granted and 9(b) for failure to plead fraud with particularity. For the reasons articulated below, [*3] the court grants the motion in part and denies it in part.

n1 At all pertinent times, the directors and officer defendants held the following positions at Westell: Marc Zionts ("Zionts") was Chief Executive Officer ("CEO") and a director; William Nelson ("Nelson") was President, Chief Operating Officer ("COO"), and a director; Nicholas Hindman ("Hindman") was Vice President, Chief Financial Officer ("CFO") and Secretary-Treasurer; Bruce Albelda ("Albelda") was head of the Investment Relations Department and spokesperson to shareholders and analysts; Howard Kirby, Jr. ("Kirby") was a director; and Thomas Reynolds ("Reynolds") was a director.

n2 The word "plaintiff" refers to the lead plaintiff and the putative class.

MOTION TO DISMISS STANDARDS

A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) challenges the sufficiency of the complaint for failure to state a claim upon which relief may be granted. *Gen. Elec. Capital Corp.* v. *Lease Resolution Corp.*, 128 F.3d 1074, 1080 (7th Cir. 1997). [*4] Dismissal is appropriate only if it appears beyond a doubt that the plaintiff can prove no set of facts in support of its claim that would entitle it to relief. *Conley* v. *Gibson*, 355 U.S. 41, 45-46, 2 L. Ed. 2d 80, 78 S. Ct. 99 (1957); *Kennedy* v. *Nat'l Juvenile Det. Ass'n*, 187 F.3d 690, 695 (7th Cir. 1999). In ruling on the motion, the court accepts as true all well pleaded facts alleged in the complaint, and it draws all reasonable inferences from those facts in favor of the plaintiff. *Jackson* v. *E.J. Brach Corp.*, 176 F.3d 971, 977 (7th Cir. 1999); *Zemke* v. *City of Chicago*, 100 F.3d 511, 513 (7th Cir. 1996).

In addition to the mandates of Rule 12(b)(6), Federal Rule of Civil Procedure 9(b) requires "all averments of fraud" to be "stated with particularity," although "malice, intent, knowledge, and other condition of mind of a person may be averred generally." "The rule requires the plaintiff to state 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 Merch. Servs., Inc.*, 20 F.3d 771, 777 (7th Cir. 1994); [*5] *see also DiLeo* v. *Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) ("Although states of mind may be pleaded generally [under Rule 9(b)], the 'circumstances' must be pleaded in detail. This means the who, what, when, where, and how: the first paragraph of any newspaper story."). "'Because only a fraction of financial deteriorations reflects fraud,' . . . plaintiffs in securities cases must provide enough information about the underlying facts to distinguish their claims from those of disgruntled investors." *Arazie* v. *Mullane*, 2 F.3d 1456, 1458 (7th Cir. 1993) (quoting in part *DiLeo*, 901 F.2d at 628).

Further, in addition to Rule 9(b), the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b), imposes "heightened pleading requirements" to discourage claims of "so-called 'fraud by hindsight.'" *Sakhrani v. Brightpoint, Inc.*, 2001 U.S. Dist. LEXIS 5023, No. IP99-0870-C-H/G, 2001 WL 395752, at *3 (S.D. Ind. Mar. 29, 2001). Section 78u-4(b) "requires a court to dismiss a complaint that fails to (1) identify each of the allegedly material, misleading statements, (2) state facts that [*6] provide a basis for allegations made on information and belief, or (3) state with particularity 'facts giving rise to a strong inference that the defendant acted with the required state of mind.'" 2001 U.S. Dist. LEXIS 5023, *Id.* at *4.

FACTS

Plaintiff's consolidated class action complaint alleges the following facts, which are taken as true for purposes of this motion: Defendant Westell, a Delaware corporation headquartered in Aurora, Illinois, provides digital and analog products to telephone companies primarily for use in the delivery of high speed data to users over existing telephone wires. Westell provides three business products: (1) Customer Premises Equipment ("CPE") products, (2) Transport Systems, and (3) Telco Access Products. The key component of Westell's success is its CPE unit, which develops and manufactures Digital Subscriber Line ("DSL") modems to provide high-speed internet access to residential and small business users. The majority of Westell's CPE sales stems from the sale of DSL modems to SBC Communications Inc. ("SBC"), Verizon Communications, and British Telecommunications, three large telecommunications companies.

On June 27, 2000, when Westell stock was trading at about [*7] $14 or $15 per share, Westell issued a press release stating that it was expanding its line of modem products. On June 28, 2000, Westell issued another press release touting expanding demand for its DSL products and announcing that it was adding a manufacturing partner and that its Aurora plant was running at full capacity. On June 29, 2000, Barry Sine ("Sine") and Clifton Gray ("Gray"), stock analysts from Kaufman Bros. who covered Westell, issued a report after speaking with Westell, that based on "massive demand for DSL services by Westell's customers," they were raising revenue estimates for the first and second quarters and issued a "strong buy" recommendation. Westell stock reacted by gaining 12% to end the day trading at $15 per share. On July 7, another analyst, Joseph Bellace ("Bellace") of Jefferies & Co., issued a "buy" rating with a 12-month target share price of $50, and, after consulting with "Westell management," increased his revenue estimates for fiscal year 2001 from $400 million to $425 million, the highest estimate in the investment community. Westell stock gained 23% to close at $19 per share on that day.

On July 17, Gray appeared on a "Radio Wall Street" [*8] investor broadcast and stated that after conversations with "the Company's management," he had learned that Westell had entered into an unannounced new supply order with SBC, its largest customer, and based on this business would meet its sales forecasts of $65-$ 70 million in CPE sales for the second quarter (end-ing September 30). Westell then issued a press release on July 18 stating that SBC had again chosen Westell as a provider of DSL modems. On July 19, Westell issued another press release stating that the first quarter revenue for fiscal 2001 had been $107 million, $61.9 million coming from CPE sales. "Hindman stated that the Company was 'delighted with our record quarter,' and that Westell had 'demonstrated significant top-line growth in our equipment business and DSL revenues climbed to 63% of revenues from 46% in the prior quarter." (Compl. P 39.) n3 Based on these statements, Gray and Sine reiterated their "strong buy" recommendation on July 20, forecasted a 12-month share price target of $65, and increased their CPE revenue projection for the second quarter of 2001 from $45 million to $80 million. Another analyst, Reggie King ("King") of Chase, Hambrect & Quist Inc. [*9] , issued a "buy" report on July 21 with a forecasted 12-month share price target of $70. Westell stock was trading at about $28 per share on July 21, but climbed to $30.1875 per share on July 25.

n3 Although not specifically stated in the complaint, the court will infer that Hindman's statement was made in the July 19 press release.

The June 28, July 18 and July 19 Westell press releases, and the June 29, July 7, and July 17 analyst statements, were allegedly all false and misleading because defendants knew "as early as June 2000" that SBC was experiencing difficulties in the installation of DSL lines due to new regulatory guidelines, which had caused SBC's DSL installation rate to drop from 8,000 to 9,000 lines per day to about 1,000 lines per day. This slower pace meant that SBC would not be selling as many modems and, therefore, would not be purchasing as many from Westell during the second fiscal quarter of 2001. Additionally, "by mid-summer 2000" this problem had created a massive inventory buildup of [*10] over 200,000 Westell modems in SBC's warehouse. "This information was reported to defendants by Brian Powers, the head of sales at Westell, and by Ray Sims, Westell's head of customer service, both of whom reported directly to Nelson, the Company's President." (Compl. P 47.)

Between the dates of July 21 and August 1, 2000, at unusual times in relation to their prior trading history, defendants Zionts, Kirby, Reynolds, and Hindman sold "highly unusual quantities" of their personal holdings of Westell common stock for prices ranging between $22.79 and $30 per share: Zionts, 172,500 shares (50% of his holdings, realizing over $5.5 million), Kirby 80,000 shares (19% of his holdings, realizing over $2.0 million), Reynolds 27,200 shares (30% of his holdings, realizing $0.77 million), and Hindman 4,000 shares (realizing $41,220). Defendant Nelson, without reference to his prior trading history, is alleged to have sold 100,000 shares (28% of his holdings, realizing over $2.7 million). Defendant Albelda did not sell any stock during this time.

On August 2, 2000, analyst Bellace reported that, beginning in June 2000, SBC had changed its installation procedures to comply with new regulations, [*11] that this change had slowed the pace of installations, that SBC was not selling as many Westell modems as it previously had, and that SBC's inventory of Westell modems had been building substantially in June and July, 2000. (Compl. P 46. n4) As a result of this information, Westell stock declined 14% from $18-7/16 to $15-7/8 per share on August 3.

n4 The court reads P 46 to mean that Bellace reported all of the information contained in the paragraph, not merely the change in SBC's procedures.

Defendants downplayed the effect that these problems would have on Westell's revenue and falsely assured investors that it would reach predicted levels. Specifically, Zionts stated on August 3 during an interview on CBS Market Watch that while he had concerns about SBC's ability to keep up with installation demand, he thought this would not adversely affect Westell's September quarter and that Westell had no concerns about keeping up with demand for its modems. Zionts also stated, "Within the DSL modem business, I actually [*12] feel good about most of our big customers. . . . We did a tremendous amount of business with SBC last quarter. They could have installed more lines than they did, but operational issues prevented them from installing more than they did." (Compl. P 49.) Westell stock reacted by gaining 7% to close at $17.056 per share on August 4.

On August 4, Albelda and/or Zionts spoke with Syed Haider ("Haider"), an analyst at Frost Securities, and told him that Westell's expected second quarter earnings were still in line with forecasts and that they would warn investors before September 20 if they learned that earnings would fall short of the forecasts. Haider then issued a "buy" report forecasting a 12-month share price target of $80. On August 7, Sine and Gray reported that after discussions with "Westell's management," they learned that July results were in line with expectations, reiterated their "strong buy" ratings, and kept their second quarter revenue projections for Westell's CPE unit at $80 million. On the same day, "defendants" assured Charles

Pluckhahn, an analyst from Stephens Inc., that Westell would meet his projections of $70 million in CPE revenues for the second quarter and [*13] Pluckhahn issued a "buy" report forecasting a 12-month share price target of $40. Westell was trading at about $17 per share on August 7.

Also "in early August 2000," Westell participated in a road show with Kaufman Bros. analysts where they "informed investors that although SBC was experiencing a slowdown in DSL line installations, SBC would not cause Westell to have a shortfall in its CPE sales for the second quarter." (Compl. P 50.) Around this same time, SBC informed Westell that it would place fewer orders with Westell and, instead, purchase more modems from Westell's main competitor because it was angry that Westell was publicly discussing its installation difficulties. Albelda's and Zionts's August statements, along with statements made at the early August road show and to or by analysts in August were allegedly all materially false and misleading for the same reasons rendering previous statements false and misleading and, additionally, because SBC had informed Westell that it would be purchasing modems from Westell's main competitors.

On August 14, the following exchange occurred on public television's Nightly Business Report:

> **Diane Eastabrook, Nightly Business [*14] Report Correspondent [("Eastabrook")]:** Since last fall, employees of Westell Technologies have been working around the clock assembling modems and networking equipment for digital subscriber lines. Westell has been flooded with orders from telecom companies that are trying to meet the crushing demand for broadband service.
>
> **Marc Zionts, ["Chief Executive Officer"] CEO, Westell Technologies [("Zionts")]:** Our belief is that broadband is a service that ultimately will be like television.
>
> **Eastabrook:** In the company's first quarter, which ended June 30th, sales of Westell's DSL hardware soared to nearly $68 million from a paltry $3.5 million during the same period last year. Westell says it has the production capability of producing about seven times more DSL equipment this year than it did last year so it can go a long way in meeting the growing demand by consumers for digital subscriber lines. But some of Westell's largest customers, like the newly created Verizon Communications and SBC Communications are having a tough time keeping up with the avalanche of broadband orders. Analysts say some investors fear inventories of DSL hardware could be building [*15] up at the phone companies and that is why Westell's stock has been so volatile over the past couple of months. But Zionts is confident the telecom companies will eventually be able to work through their backlog of orders.
>
> **Zionts:** I think that they'll have, that they'll run into bumps on the road and that it takes them a little time to solve them and they keep going. And if you smooth out the trend, it's going to be this, you know, linear or logarithmic growth will continue.

(Compl. P 56.) Analyst Anton Wahlman of UBS Warburg was also interviewed for this Nightly Business Report and "stated that Westell would benefit from the booming broadband industry and predicted 'strong revenue growth again this quarter.'" (Compl. P 57.)

On or about August 21, Haider issued a report stating that Westell's CPE unit likely would fall short of its sales projections due to inactivity by a major customer. In response, Zionts and/or Albelda reassured the analyst that the SBC issues had been resolved, that DSL installation rates were back to normal levels, that they expected the order activity from SBC to increase, and that second quarter numbers were still in line with forecasts. They [*16] again stated that they would disclose prior to September 20 if they anticipated any problems in meeting the forecasts. Haider then issued a "strong buy" forecasting a 12-month target price of $80. Westell stock was trading at about $16 per share on August 21. Zionts's and/or Albelda's statements to Haider, along with Zionts' statements on the August 14 Nightly Business Report, were allegedly false and misleading because these defendants knew that SBC had decreased its orders and this slowdown would negatively affect Westell's CPE revenues for the second fiscal quarter of 2001.

On September 7, Westell issued a press release stating that its CPE unit is now the world-wide leader in desktop modem sales, and that during the second quarter, Westell had jumped from fifth to second place in overall DSL modem shipments. Westell issued another release on September 12 announcing a new product, and Westell stock reacted by gaining 15% to close at $16 per share. Also on September 12, Zionts and Albelda participated in a road show with Kaufman Bros. analysts and met with Kaufman Bros. institutional clients in New York City. "At the road show, Zionts and Albelda stated that they were 'comfortable' [*17] with their guidance for the current quarter which included CPE revenues of $65-$ 75 million," and that the SBC slowdown would have a limited effect on modem sales in the second quarter because other business could make up for the lost revenue. Based on these statements, Kaufman Bros. analyst Gray published a report with a "strong buy" recommendation for Westell stock and projecting a 12-month target price of $65 per share. The report also stated that Westell had reiterated its guidance for the current quarter and acknowledged that the SBC slowdown would have a limited effect on revenue. Westell common stock traded at $16 per share on September 12.

At a DSL industry conference hosted by Kaufman Bros. on September 18, Hindman stated that Westell was on track and felt comfortable with its predictions of $65-$ 75 million in CPE revenues for the second quarter. The statements made by Westell in the two September press releases, by Zionts and Albelda at the September 12 road show, and by Hindman during the September 18 DSL industry conference were materially false and misleading for the same reasons that prior statements were false and misleading; namely, that SBC was having installation [*18] difficulties, possessed a massive inventory buildup of modems, and would place more future modem orders from Westell's competitor.

On October 18, 2000, Westell issued a press release stating that its CPE revenues for the second quarter were only $49.5 million. As a result of the news, Westell stock decreased 34% from $9 per share at the close of trading on October 18 to $5.94 per share at the close of trading on October 19.

ANALYSIS

Section 10(b) of the Securities Exchange Act of 1934 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 . . . to 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 [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

To establish liability under section 10(b) and Rule 10b-5, plaintiff must prove that "(1) the defendant made a false statement or omission [*19] (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages." *Caremark, Inc.* v. *Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir. 1997). The Private Securities Litigations Reform Act of 1995 ("PSLRA") also requires that a complaint "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading," 15 U.S.C. § 78u-4(b)(1), and "state with particularity facts giving rise to a strong inference that the defendants acted with the requisite state of mind," 15 U.S.C. § 78u-4(b)(2). Defendants contend that plaintiff has failed to properly plead all elements but the fourth under the applicable pleading standards.

1. *False Statements or Omissions of Material Fact*

A material misrepresentation is found where a defendant "either made a false statement of material fact or failed to make a statement of material fact thereby rendering the statements which were in fact made misleading." *Searls* v. *Glass*, 64 F.3d 1061, 1065 (7th Cir. 1995). [*20] A statement is material if it would be viewed by "a reasonable investor as significantly altering the total mix of available information." *In re Newell Rubbermaid Inc. Sec. Litig.*, No. 99 C 6853, 2000 WL 1705279, at *14 (N.D. Ill. Nov. 14, 2000) (citing *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231-32, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988) and *Parnes* v. *Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir. 1997)).

Plaintiff's complaint contains two distinct categories of alleged misrepresentations: statements made prior to August 2, alleged to have been misleading because they omitted the fact that SBC was having problems and would be ordering fewer modems from Westell; and statements and predictions made after the August 2 news that SBC was experiencing installation problems, alleged to have been misleading because the defendants downplayed without reasonable basis the effect that SBC's difficulties would certainly have on Westell. As to both categories, defendants contend that each alleged misrepresentation and omission cited by the plaintiff is insufficiently pled under Rule 9(b) and the PSLRA, all hinging on a factually unsupported [*21] assertion that unspecified "defendants" knew of an imminent slowdown at SBC as early as June, 2000. The court will discuss the two groups of statements separately. n5

n5 Although not recited in the facts section above, each of the press releases contained a "'Safe Harbor' statement under the [PSLRA]," which warned that certain statements contained in the release involve risks and uncertainties, followed by a recitation of risks. Defendants contend that all the press releases were forward looking statements accompanied by meaningful cautionary statements identifying important facts that could cause actual results to differ; thus, invoking the "safe harbor" of 15 U.S.C. § 78u-5(c)(1)(A)(i). Plaintiff does not respond to this argument other than to say the "forward-looking statements to analysts are actionable. . . ." The court takes plaintiff's response as a concession that any forward looking statements contained in the press releases are within the safe harbor.

A. *Pre-August 2 Statements* [*22]

Prior to August 2, plaintiff attributes six separate statements to one or more defendants:

1. On June 28, press release announces Westell had added a new manufacturing partner and Aurora plant was running at full capacity (not forward looking);

2. On June 29, analyst raises revenue estimate after conversations with "the Company";

3. On July 7, analysts report via Westell that there was "massive demand" from Westell's customers and that SBC was its "largest account" and that Westell was raising revenue estimates";

4. On July 17, based on conversation with "management," analyst announces Westell's new supply order with SBC, indicating Westell would meet second quarter revenue projection;

5. On July 18, press release announces Westell "had been selected by SBC as one of its providers for DSL modems," describing SBC as the leading supplier of DSL service and otherwise praising both its own product (not forward looking) and SBC's deployment plans (forward looking); and

6. On July 19, press release quotes Hindman as touting its record first quarter earnings (not forward looking), causing analysts to increase revenue and price projections.

Defendants argue that plaintiff has not adequately [*23] pled why each of the statements is false, as they must under the PSLRA, 15 U.S.C. § 78u-4(b)(1). They contend that all that is alleged concerning the pre-August 2 statements is that at some unknown point, as early as June, Westell somehow knew that something was happening at SBC. Further, they point out that none of the press releases projected SBC sales or addressed Westell's CPE revenues. Plaintiff responds that defendants' sin was their omission, in that they painted a falsely positive picture of Westell's prospects when they knew, by early June 2000, that due to SBC's slowdown, SBC would be decreasing its orders from Westell. Consequently, defendants knew but omitted to disclose that Westell would not meet the guidance defendants had provided to analysts for sales in its CPE unit of $65-$ 70 million in the second quarter. Plaintiff contends that defendants had a duty to make this disclosure.

"The disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers." *Lindelow* v. *Hill*, 2001 U.S. Dist. LEXIS 10301, No. 00 C 3727, 2001 WL 830956 (N.D. Ill. July 20, 2001). [*24] Defendants cannot be liable unless they had a duty to disclose. "A duty to disclose non-public material information arises when (a) disclosure is needed to make a prior statement not misleading; (b) defendant engages in insider trading; or (c) defendant causes rumors linked to unusual market activity." *Holstein* v. *Armstrong*, 751 F. Supp. 746, 748 (N.D. Ill. 1990). A misleading statement is material if there is "'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.'" *Sakhrani v. Brightpoint, Inc.*, 2001 U.S. Dist. LEXIS 5023, 2001 WL 395752 (quoting *Basic Inc.*, 485 U.S. at 231-32). The cited cases from this district in which motions to dismiss have been denied entailed overstating income by mischaracterizing research and development expenditures as "intangible assets," coupled with unusual insider trading, *Chu* v. *Sabratek*, 100 F. Supp. 2d 827 (N.D. Ill. 2000); overstating revenues in violation of generally accepted accounting principles, while ignoring several "red flags" indicating the fact [*25] and risk of inflated revenue recognition, *Retsky Family Ltd. P'ship* v. *Price Waterhouse LLP*, 1998 U.S. Dist. LEXIS 17459, No. 97 C 7694, 1998 WL 774678 (N.D. Ill. Oct. 21, 1998); knowingly or recklessly announcing grandiose goals without having taken material steps to accomplish them, *Lindelow*; release of positive news while omitting information that half of the contracts on which profitable projections had been made were in jeopardy, coupled with unusual insider trading, *In re Spyglass, Inc. Sec. Litig.*, 1999 U.S. Dist. LEXIS 11382, No. 99 C 512, 1999 WL 543197 (N.D. Ill. July 21, 1999); knowingly or recklessly failing to reveal in Securities and Exchange Commission ("SEC") filings and press releases that, for nine quarters, defendant artificially inflated reported earnings and profits, *In re Anicom Inc. Sec. Litig.*, 2001 U.S. Dist. LEXIS 6607, No. 00 C 4391, 2001 WL 536066 (N.D. Ill. May 18, 2001); and conscious or reckless misrepresentation of known net income and credit losses in SEC filings while making repeated public statements assuring investors of the reliability of its financial reports, *Rehm* v. *Eagle Finance Corp.*, 954 F. Supp. 1246 (N.D. Ill. 1997).

Unlike most of the cited [*26] cases above, this case is not about objectively ascertainable misinformation. Rather, it can best be compared with *Lindelow* and *In re Spyglass, Inc. Sec. Litig.*, where defendants were accused of creating unjustifiable excitement about the company's prospects. Disregarding scienter for the moment, if SBC was the centerpiece of Westell's prosperity and Westell's top managers knew that sales to SBC would certainly drop precipitously, then the court finds it reasonable to infer that the optimism defendants focused on SBC before August 2 was misleading. That several defendants engaged in insider trading shortly before the information became public reinforces this conclusion.

B. *Post-August 2 Statements*

The statements made after August 2 present a somewhat different picture. On August 3, Zionts acknowledged concerns about SBC but insisted it would not cause a shortfall in Westell's sales for the second quarter. On August 14, Zionts again acknowledged problems associated with installation services but assured listeners that it would eventually smooth out; on August 21, after an announcement that sales had faltered, Zionts and/or Albelda stated the SBC issues had been resolved, [*27] that installation rates were back to normal levels, that they expected order activity from SBC to increase, and that second quarter revenues were still in line with projections. In September, they assured analysts that other business could make up for the lost revenue from SBC and Westell was still on track. There was no announcement, as promised, by September 20, that a shortfall was anticipated, but on October 18, Westell announced that rather than the $65-$ 75 million projected, revenues for the second quarter were only $49.5 million. Plaintiff contends that these statements were all misleading because defendants lacked any countervailing factual basis to assure the investment community that Westell would meet its earnings expectations for the second quarter of 2001.

These releases, along with statements made to or by analysts and by Zionts and/or Albelda, were issued after an analyst had publicly disclosed SBC's problems and after the drop in purchases from Westell. "A plaintiff cannot credibly claim to be misled by a company's attempt to hide negative information when that same information is publicly available via alternate channels." *Chu*, 100 F. Supp. 2d at 834 [*28] (citing *Eckstein* v. *Balcor Film Investors*, 58 F.3d 1162, 1169 (7th Cir. 1995)); see also *Clark v. TRO Learning, Inc.*, 1998 U.S. Dist. LEXIS 7989, No. 97 C 8683, 1998 WL 292382, at *6 (N.D. Ill. May 20, 1998). Plaintiff contends, however, that statements made after August 2 are not actionable because they failed to disclose the SBC slowdown, "but rather, the statements omitted to disclose that due to the slowdown, Westell would not meet its sales forecasts for its CPE unit." (Resp. at 8 (emphasis in the original).) This distinction, however, lacks persuasive force as plaintiff's argument inherently relies on SBC's slowdown as the reason the post-August 2 statements were misleading. At any point after Bellace's August 2 statement, SBC's problems were public knowledge and, therefore, part of the total mix of information available to the investor who wished to assess the effect on Westell. A reasonable investor who relied before August 2 on defendants' touting the centrality of SBC would certainly have understood that the disclosure was ominous news. *See Zoghlin* v. *Renaissance Worldwide, Inc.*, 1999 U.S. Dist. LEXIS 20815, No. 99 C 1965, 1999 WL 1004624, at *8 (N.D. Ill. Nov. 4, 1999) [*29] ("Sophisticated investors, such as [plaintiff], are expected to 'understand the limits of a projection.' In short, '*caveat emptor*' applies equally, if not more, in the securities market." (citation omitted.)). In addition, plaintiff alleges not only that Bellace, and others in August, disclosed SBC's problems and its likely effect on Westell, but also that Westell stock declined 14% immediately after this information was disclosed, which suggests that the disclosure did affect investors. Comfort statements made in reaction to acknowledged problems are cold comfort which a reasonable investor would assess skeptically. For this and the other reasons set out above, the court will dismiss the complaint insofar as it attempts to state a claim for statements made after the August 2 disclosures.

2. *Pleading Culpability of Each Defendant*

Defendants object to the failure of plaintiff to specify who made the allegedly false statements to the analysts or who in the corporation put his imprimatur on the specific projection reported, citing *In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 934 (9th Cir. 1996) ("In order to be liable for unreasonably disclosed third-party [*30] forecasts, defendants must have put their imprimatur, express or implied, on the projections. The complaint must state particular facts as required by Rule 9(b)" (citations and quotations omitted.)), n6 and *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 265 (2d Cir. 1993) (Rule 9(b) requires, at a minimum, that the plaintiff identify the speaker of the allegedly fraudulent statements. Completely unattributed statements, even made on information and belief, are insufficient. (citations and quotations omitted.)). Further, defendants argue that defendants Nelson, Kirby and Reynolds are not alleged to have made any statements, so they should certainly be dismissed from the complaint.

n6 The court also cited *In re Caere Corporate Sec. Litig.*, 837 F. Supp. 1054, 1059 (N.D. Cal.1993), for the proposition that "adoption occurs when a defendant 'sufficiently entangled himself with the analysts' forecasts'; '[there are] sound reasons to construe the entanglement requirement strictly'." *Id.*

[*31]

Plaintiff responds that he has identified the individuals involved in the alleged misrepresentations, as narrowly as is practicable without discovery, as Zionts, Albelda, or Hindman and/or "Westell management," which encompasses the individual defendants. Plaintiff relies on a number of cases from this district which, in general, stand for the proposition that fair notice of the claims is all that is required, see, e.g., *Market St. Sec. v. Racing Champions Corp.*, 2000 U.S. Dist. LEXIS 19103, No. 00 C 3267, 2000 WL 1727788 (N.D. Ill. Nov. 20, 2000), and that plaintiff cannot be required to plead facts exclusively within the defendants' control or otherwise unavailable to it, *see In re Newell Rubbermaid Inc. Sec. Litig.*, 2000 WL 1705279, at *14. In addition, because the conversations between a person at Westell and a journalist are confidential, plaintiff believes it is not required to name the precise source of the journalist's information within the company. *See id.*

"A complaint that attributes misrepresentations to all defendants, lumped together for pleading purposes, generally is insufficient." *Sears v. Likens*, 912 F.2d 889, 892 (7th Cir. 1990) (citations [*32] omitted.). Nevertheless, where press releases are concerned, a reasonable inference can be drawn that Westell's spokesperson made the statement as authorized by one or more members of top management, an inference not inconsistent with *In re Syntex Corp. Sec. Litig* or *In re Time Warner Inc. Sec. Litig.* on which defendants rely. Similarly, the court agrees with plaintiff that an analyst's source is not someone that a plaintiff could typically identify with particularity. As Judge Kennelly stated in a similar context in *In re Newell Rubbermaid Inc. Sec. Litig.*, "it is well established in this Circuit that a party may be excused from Rule 9(b)'s requirement of pleading with particularity if the information that he is required to plead rests exclusively within the defendants' control or is otherwise unavailable to him." 2000 WL 1705279, at *14. Where, as here, the plaintiff has narrowed the possible sources of information to Westell's CEO, Chief Financial Officer ("CFO"), and the head of Investment Relations, the court finds that plaintiff has sufficiently pled who made the alleged misrepresentations. n7 Although the complaint does not specifically plead lack of [*33] access to information, it is plain enough here that the statements to analysts that were not publicly attributed are not likely to be available to plaintiff without discovery. *See id.* at *14 ("We can see no good reason why a defrauded person's right to maintain an action ought to turn on whether an analyst is willing to volunteer the source of his information to a plaintiff's attorney planning litigation. And there is nothing in the Federal Rules of Civil Procedure or the PSLRA which requires a securities fraud plaintiff to be a mind-reader or have a 'mole' feeding him inside information."). Nothing in the complaint, however, points to Nelson as a declarant of any of the statements at issue. Further, there is no basis to infer from the allegations that members of the board of directors, Kirby and Reynolds, were involved in making any statement. Thus, these three individual defendants will be dismissed from the complaint.

n7 The court acknowledges plaintiff's assertion (in a footnote) that the complaint is sufficient under what some courts have termed the "group pleading" doctrine, which allows plaintiff "to rely on the presumption that certain statements of a company, such as financial reports, prospectuses, registration statements, and press releases, are the collective work of those high-level individuals with direct involvement in the everyday business of the company." *Sutton* v. *Bernard*, 2001 U.S. Dist. LEXIS 11610, No. 00 C 6676, 2001 WL 897593, at *5 n.5 (N.D. Ill. Aug. 6, 2001). The viability of this doctrine after the PSLRA's enactment has been debated by courts within this district, and the Seventh Circuit has yet to rule. See Lindelow v. Hill, 2001 U.S. Dist. LEXIS 10301, No. 00 C 3727, 2001 WL 830956, at *7 (N.D. Ill. July 20, 2001) ("Judges of this District have . . . been unable to agree as to what is required to attribute fraudulent statements to corporate directors.") (citing *Dardick* v. *Zimmerman*, 149 F. Supp. 2d 986, 987 (N.D. Ill. 2001)); *In re Anicom Inc. Sec. Litig.*, 2001 U.S. Dist. LEXIS 6607, No. 00 C 4391, 2001 WL 536066, at *6 (N.D. Ill. May 18, 2001) ("The Seventh Circuit has not ruled on the applicability of 'group pleading' following the more stringent pleading requirements of the PSLRA. The courts are split on whether it still exists."). The court prefers the approach of Judge Shadur in *Dardick*, in which the Judge states the "proper course" is to examine each individual's liability based on "defendant's own conduct (or, where applicable, on respondeat superior principles)."

[*34]

3. *Scienter with respect to pre-August 2 Statements*

Scienter "may be established 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." *Rehm,* 954 F. Supp. at 1253 (citing *Shields* v. *Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994)); *see, e.g., Sutton* v. *Bernard,* 2001 U.S. Dist. LEXIS 11610, No. 00 C 6676, 2001 WL 897593, at *6 (N.D. Ill. Aug. 9, 2001); *Lindelow,* 2001 U.S. Dist. LEXIS 10301, 2001 WL 830956, at *6. "Reckless conduct is, at the least, 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,* 954 F. Supp. at 1255 (citing *Rolf* v. *Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978)).

Allegations that a corporate insider delayed disclosing materially adverse information in order to sell personally-held stock at a huge profit can supply the [*35] requisite motive for a scienter allegation. 954 F. Supp. at 1254. Some courts have stated that plaintiff must also show that a defendant engaged in unusual trading activity, meaning the defendant traded "in amounts dramatically out of line with prior trading practices, at times calculated to maximize personal benefit from undisclosed inside information." *Id.* (quoting *Marksman Partners, L.P.* v. *Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1312 (C.D. Cal. 1996)); *see In re System Software Associates, Inc.*, 2000 U.S. Dist. LEXIS 3071, No. 97 C 00177, 2000 WL 283099, at *13 (N.D. Ill. Mar. 8, 2000). The precise form of insider trading is not statutorily defined, nor has the Seventh Circuit ruled on the issue. As Judge Hamilton pointed out in *Sakhrani v. Brightpoint, Inc.*, a "strong inference of scienter may arise where the complaint sufficiently alleges that the defendants benefitted in a concrete and personal way from the purported fraud, . . . knew facts or had access to information suggesting that their public statements were not accurate, or failed to check information they had a duty to monitor." 2001 U.S. Dist. LEXIS 5023, 2001 WL 395752, at *13 (citing *Novak* v. *Kasaks,* 216 F.3d 300, 311(2d Cir. 2000)). [*36] Plaintiff alleges that Zionts sold half of his Westell holdings, reaping proceeds of $5.5 million, or ten multiples of his salary. If plaintiff establishes that the information attributable to Zionts was material and misleading, then a fact finder could infer that he acted with scienter by "unloading a massive 50% of his Westell holdings." (Compl. P 71.) Although Nelson is alleged to have sold 28% of his holdings, there is no allegation that this trading was unusual. n8 But the fact that he sold a large amount, on the same day as co-defendants Zionts, Reynolds and Kirby, coupled with his knowledge about SBC, suggests both a motive and an opportunity to maximize personal gain before the news about SBC became public, from which a strong inference could be drawn that the information known by insiders was used to benefit insiders before that information became public. n9

n8 Plaintiff alleges that Zionts, Reynolds, and Kirby had not sold any shares during the preceding year-and-a-half. What Nelson's prior activity had been is not alleged.

n9 Nelson, as the COO, is alleged to have been told in early June about the downturn at SBC. By virtue of his position, it is fair to infer that this information was shared with others at the helm of Westell. Although as indicated above, Nelson has not been adequately identified as a speaker of the misleading statements, his knowledge and insider trading permits a strong inference of scienter as to Zionts and Westell.

[*37]

On the other hand, Hindman, who can be directly linked to the press releases, sold only 4,000 shares. More significantly, plaintiff does not allege, as he does with Zionts, Nelson, Reynolds, and Kirby, that Hindman unloaded huge amounts of his personal holdings of Westell common stock. (Compl. P 71.) Thus, although he may have had motive and opportunity, the sale of 4,000 shares without more does not permit an inference of scienter based on insider trading. Albelda, the defendant arguably most connected with alleged misrepresentations made to analysts, sold no stock, so no inference of scienter can be based on insider trading as to Albelda.

Hindman and Albelda, then, must be subjected to the "strong circumstantial evidence" test. *Rehm,* 954 F. Supp. at 1255. Hindman, as the CFO, was in a position to know that sales to SBC, its primary customer, were falling, yet on July 19 he expressed delight with Westell's record first quarter and noted the increase in DSL revenues, leading analysts to increase revenue projections. Under the circumstances, this conduct permits a strong inference that the danger of misleading the public was either known to Hindman or so obvious that [*38] he must have been aware of it. With respect to Albelda, as indicated above, he was not an officer of the corporation and not among those alleged to have control of the content of public statements issued by Westell. Thus, the facts alleged do not constitute strong circumstantial evidence that Albelda acted with scienter, and Albelda will be dismissed from the complaint.

4. *Reliance and Causation*

Defendants argue that plaintiff has not adequately pled reliance because defendants never represented the amount of anticipated SBC or second quarter revenue before August 2 and they have not adequately pled causation of any losses. Plaintiff responds that this pleading requirement is not a difficult one and "ought not place unrealistic burdens on the plaintiff at the initial pleadings stage." *Danis* v. *USN Communications, Inc.*, 73 F. Supp. 2d 923, 943 (N.D. Ill. 1999) (quoting *Caremark*, 113 F.3d at 649). The complaint alleges a "fraud on the market" theory of reliance, such that plaintiff's losses resulted from paying an artificially inflated price for Westell stock due to the misrepresentations and omissions made by defendants through the class [*39] period. Specifically, that Westell common stock was traded on an active and efficient market and that plaintiff, relying on the defendants' materially false and misleading statements, and relying on the integrity of the market, purchased shares of Westell common stock at prices artificially inflated by defendants' misrepresentations. As such, had plaintiff known the truth, it would not have purchased the shares or would not have purchased them at the inflated prices. (Compl. PP 84-85.) With respect to the omissions of material fact prior to August 2, discussed above, plaintiff's allegations support the inference that they bought stock as a result of defendants' inflated public statements and not knowing the truth about SBC. These allegations adequately set out reliance and causation. *See Retsky*, 1998 U.S. Dist. LEXIS 17459, 1998 WL 774678, at *12 (stating the allegations must support a fair inference that the defendant's actions caused the alleged loss and citing *Bastian* v. *Petren Resources Corp*, 892 F.2d 680, 684-85 (7th Cir. 1989)).

5. *Liability Under § 20(a)*

Defendants move to dismiss Count II on the basis that it fails to state a claim upon which relief can [*40] be granted. Plaintiff does not respond to this argument; therefore, unless the court discerns that defendants' argument is obviously unfounded, it will not endeavor to make plaintiff's argument for it. Section 20(a) of the Securities Exchange Act of 1934 n10 is remedial, to be construed liberally, and requires only some indirect means of discipline or influence short of actual direction to hold a control person liable. *Harrison* v. *Dean Witter Reynolds, Inc.*, 974 F.2d 873, 880 (7th Cir. 1992). To state a claim, a plaintiff must allege (a) a primary violation; (2) that the defendant exercised control over the operations of the primary violator; and (3) that the defendant possessed the power, whether or not exercised, to control the fraudulent activity. *See Lambert* v. *Calprotrack, Inc.*, 1996 U.S. Dist. LEXIS 5795, No. 95 C 4076, 1996 WL 224515, at *1 (N.D. Ill. May 1, 1996). It appears that defendant Albelda, who is merely an employee of Westell, could not be liable under this section. Neither does the complaint make any allegations about Kirby and Reynolds, who are represented to be outside directors, that would permit an inference that they exercised control or had the [*41] power to control the actions of the top managers. Whether defendants Nelson, Zionts or Hindman can be considered control persons (with respect to Albelda or one another) has not been demonstrated either in the complaint or by response to this motion. For these reasons, the court will dismiss Count II.

n10 Section 20(a) provides,

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 USCA s 78t.

ORDER

For the reasons stated above, the motion to dismiss is denied with respect to Count I insofar as it alleges securities fraud regarding misrepresentations made before August 2, 2000 against [*42] Westell, Zionts and Hindman. The motion is granted in all respects in favor Nelson, Albelda, Kirby and Reynolds and granted as to Westell, Zionts and Hindman as to statements made after August 2, 2000. The motion is also granted with respect to Count II of the complaint.

Date: October 26, 2001

Enter: United States District Judge

JOAN HUMPHREY LEFKOW