UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

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

APPENDIX OF UNREPORTED AUTHORITIES SUBMITTED IN SUPPORT OF DEFENDANTS' TRIAL BRIEF

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

EIMER STAHL KLEVORN & SOLBERG LLP
224 South Michigan Avenue
Chicago, Illinois 60604
(312) 660-7600

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

TABLE OF CASES

Cases **Tab**

In re Allied Products Corp., Inc. Securities Litigation, No. 99 C 3597, 2000 WL 1721042 (N.D. Ill. Nov. 15, 2000)........ 1

In re Allscripts, Inc. Securities Litigation, No. 00 C6 796, 2001 WL 743411 (N.D. Ill. June 29, 2001) 2

In re Bally Total Fitness Securities Litigation, No. 04 C 3530, 2006 WL 3714708 (N.D. Ill. July 12, 2006) 3

Fishman v. *Meinen*, No. 02 C 3433, 2003 U.S. Dist. LEXIS 2527 (N.D. Ill. Feb. 21, 2003)........ 4

In re Glaxo Smithkline PLC Securities Litigation, No. 05 Civ. 3571, 2006 WL 2871968 (S.D.N.Y. Oct. 6, 2006) 5

Goldberg v. *Freedom Federal Savings Bank*, No. 88C 4787, 1989 WL 8503 (N.D. Ill. Jan. 31, 1989) 6

Iles v. *Swank*, No. 04 C 3757, 2006 U.S. Dist. LEXIS 45862 (N.D. Ill. June 28, 2006) 7

Kemper/Prime Industrial Partners v. *Montgomery Watson Americas, Inc.*, No. 97 C 4278, 2004 WL 725223 (N.D. Ill. March 31, 2004)........ 8

Lawrence E. Jaffe Pension Plan v. *Household Int'l, Inc.*, 2004 U.S. Dist. LEXIS 4659 (N.D. Ill. Mar. 22, 2004)........ 9

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

In re 2007 Novastar Financial, Inc. Securities Litigation, No. 07-0139-CV, 2008 WL 2354367 (W.D. Mo. June 4, 2008) 11

Ong v. *Sears, Roebuck & Co.*, No. 03 C 4142, 2005 WL 2284285 (N.D. Ill. Sept. 14, 2005) 12

Premier Capital Management, LLC v. *Cohen*, No. 02-C-5638, 2008 WL 4378300 (N.D. Ill. Mar. 28, 2008) 13

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

Stavroff v. *Meyo*, No. 95-4118, 1997 WL 720475 (6th Cir. Nov. 12, 1997)........... 15

Waldock v. *M.J. Select Global*, No. 30 C 5293, 2005 U.S. Dist. LEXIS 38001 (N.D. Ill. Dec. 27, 2005).......... 16

TAB 1

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
In re ALLIED PRODUCTS CORP., INC. SECURITIES LITIGATION
No. 99 C 3597.

Nov. 15, 2000.

MEMORANDUM OPINION AND ORDER

LEINENWEBER, J.

***1** This is a securities fraud action brought by a group of investors against Allied Products, Corp. ("Allied") and various of its officers and directors. Defendants seek dismissal pursuant to FED. R. CIV. P. 12(b)(6).

BACKGROUND

This is plaintiffs' Second Amended Class Action Complaint ("Complaint"). As before, for purposes of this motion, the Court accepts all well-plead factual allegations of the Complaint as true. *Travel All Over the World v. Kingdom of Saudi Arabia,* 73 F.3d 1423, 1429 (7th Cir.1996).

Plaintiffs are individuals who purchased common shares of Allied stock during the period between February 6, 1997 and March 11, 1999. Defendant Allied is a Delaware corporation in the business of manufacturing agricultural and industrial machinery. Beginning in 1996, Verson, the industrial machinery division of Allied, embarked on a plan to enter the market for the production of customized mechanical and hydraulic transfer presses ("A Presses"). The A Press business had been previously occupied almost exclusively by foreign companies. The major customers for the A Presses are the U.S. automakers who use the presses to fabricate machinery for the manufacture of their own products.

The A Presses, however, are very difficult to produce. In 1996, Verson accepted its first orders for A Presses from the Ford Motor Company. But when Verson began actual production on the Ford orders in 1997, it ran into immediate problems. Verson's facility was too small, its machinery was antiquated, and its engineering skills were deficient. This led to increasing costs and delays. Despite the problems, Verson accepted additional orders for customized presses from General Motors and Chrysler Motors in 1997 and 1998. At the same time, Verson continued to accept orders for its standard products. Unfortunately, the combined effect of attempting to meet all the new and old business was disastrous. Verson suffered from serious capacity limitations, bottlenecking, malfunctions, and delays on the contracts despite expensive attempts to expand facilities and to outsource their work.

The plaintiffs claim that the individual defendants were aware at all times of the magnitude of the problems at Verson. However, the individual defendants disseminated false and misleading public statements in order to perpetuate the fiction that Verson was making successful inroads against competitors in the A Press market. This fraudulent scheme was furthered through accounting manipulations and omissions of material information.

Specifically, the plaintiffs allege that Allied fraudulently overstated its earnings figures for all of 1996, 1997 and portions of 1998 by failing to recognize certain compensation expenses. Allied also accounted for the customized press contracts by means of the "percentage-of-completion" method, which allows a firm to recognize sales, costs, and profits over the lifetime of a contract. According to generally accepted accounting principles ("GAAP"), the percentage-of-completion method is only appropriate on substantial projects lasting longer than a year where reasonably dependable estimates of progress toward completion, revenues, and costs can be made. However, the plaintiffs allege that the defendants knew or recklessly failed to know that they could not make reasonably dependable estimates of costs for the customized press contracts. In fact, the plaintiffs claim that the percentage-of-completion method was utilized precisely so that the defendants, through another disapproved accounting method called the "reallocation method," could defer reporting escalating cost figures to subsequent reporting periods rather than recognizing those costs immediately.

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

***2** In addition to the percentage-of-completion method and the reallocation method, Allied also began in 1997 to measure progress on the customized press contracts by means of the "contract milestones" method as opposed to the usual "labor hours" method that Allied relied upon in previous years. The plaintiffs allege that this change in accounting method was not timely disclosed to the public in accordance with APB Opinions and SEC reporting rules. Again, the plaintiffs' theory is that the "contract milestone method" was hidden from the public because the method worked in conjunction with the other accounting methods to accelerate revenue and defer known cost overruns to later periods.

The full truth was not revealed until March 11, 1999 when Allied announced that the company would restate its net income for the years 1996, 1997 and a portion of 1998, and delay the filing of its 1998 Annual Report. As admitted later in Allied's Amended 1998 Annual Report, restatements were necessary to the 1997 and 1998 earnings figures because cost revisions that should have been recognized in the fourth quarter of 1997 were, instead, recognized in 1998 by means of the "reallocation" method. Furthermore, Allied disclosed that in attempting to fulfill both the A Presses orders and standard orders, Verson's production capacity was severely strained, that expansion efforts undertaken in 1997 and 1998 were not completed soon enough, and that Verson was unable to estimate costs accurately. Allied also stated that restatements for previously reported earnings were necessary to take into account certain omitted employee compensation expenses. The omitted compensation expenses for 1996, 1997 and 1998 amounted to $2.9 million, $900,000, and $700,000 respectively. When the news of the restatements initially broke on March 11, 1999, the stock dropped 17% to around $3 per share.

DISCUSSION

Standard of Review

As this motion is one for dismissal pursuant to FED. R. CIV. P. 12(b)(6), the Court will dismiss only if it appears beyond doubt that plaintiffs can prove no set of facts which would entitle them to relief. *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957). However, the Court is not required under this standard to ignore any of plaintiffs' own allegations that actually demonstrate that they are not entitled to judgment. *Early v. Bankers Life and Casualty Co.,* 959 F.2d 75, 79 (7th Cir.1992). It is possible for plaintiffs to plead themselves out of court. *Id.*

As with the plaintiffs' earlier complaint, the Second Amended Class Action Complaint asserts two counts: Count I alleges securities fraud against all defendants pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5; Count II alleges a claim against the individual defendants as "control persons" pursuant to Section 20(a) of the Act, 15 U.S.C. § 78t(a). To state a § 10(b) and Rule 10b-5 claim, a plaintiff must allege that the defendant (1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff relied, and (6) that reliance proximately caused plaintiff's injuries. *In re Healthcare Compare Corp. Sec. Litig.,* 75 F.3d 276, 280 (7th Cir.1996). Since a § 20(a) claim is merely a derivative claim, cognizable against a defendant only where an underlying violation is alleged, the survival of Count II depends upon whether plaintiffs sufficiently allege a violation of § 10(b) and Rule 10b-5. 15 U.S.C. § 78t(a).

***3** In evaluating the sufficiency of a claim for securities fraud, the Court must dispense with general notice pleading requirements and apply a heightened pleading standard. The Private Securities Litigation Reform Act of 1995 ("PSLRA") requires plaintiffs to "specify each statement alleged to have been misleading" and "with respect to each [fraudulent] act ..., 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)(1), (2). The requisite state of mind for securities fraud is an intent to deceive, manipulate, or defraud. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n. 12 (1976). This includes reckless disregard for the truth, where recklessness is understood as conduct that is so unreasonable it represents an extreme departure from the standards of ordinary care. *Chu v. Sabretek Corp.,* 100 F.Supp.2d 815, 822-23 (N.D.Ill.2000) (*"Chu I"*); *Danis v. USN Communications, Inc.,* 73 F.Supp.2d 923, 937-38 (N.D.Ill.1999); *Rehm v. Eagle Finance Corp.,* 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

While the PSLRA does not change substantively the scienter requirement, it does raise the bar in terms of

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

pleading the element. *Chu I,* 822-23. But contrary to some litigants' understandings, the PSLRA does not mandate that any particular set of facts be alleged to meet it. No matter what types of facts are offered, all that the plain language of the act requires is that they raise a “strong inference” of conscious misconduct with respect to each alleged fraudulent act. *In re Allied Products Corp., Inc. Sec. Litig.,* No. 99 C 3597, slip op. at 7 (N.D.Ill. March 13, 2000); *see also, Chu I,* 100 F.Supp.2d at 833.

In this case, the alleged misstatements and omissions fall into two distinct categories: (1) the failure to properly account for certain compensation expenses; and (2) the deferred reporting of cost escalations at the Verson division and defendants' failure to disclose the true state of affairs with respect to it's a Press business. Defendants submit that the entirety of the complaint should be dismissed for failure to adhere to the PSLRA. The Court finds that the defendants are only partially correct.

Compensation Expenses

As with its earlier complaint, the plaintiffs fail to raise a strong inference of conscious misconduct with respect to defendants' omission of compensation expenses in its 1996, 1997 and 1998 financial statements. Bare allegations of GAAP violations generally do not raise a strong inference of scienter. *See Chu v. Sabretek Corp.,* 100 F.Supp.2d 827, 838 (N.D.Ill.2000) (*“Chu II”*). For improper accounting to amount to securities fraud, plaintiffs must also show that the defendants recklessly disregarded or acted with gross indifference to any misrepresentations caused by the violation. *Id.; Rehm v. Eagle Finance Corp.,* 954 F.Supp. 1246, 1254 (N.D.Ill.1997).

Plaintiffs assert that given the size of the compensation expenses and the positions of responsibility held by the defendants, the omission of such expenses was too obvious to have been the result of honest mistake.“[M]agnitude of reporting errors may lend weight to allegations of recklessness where defendants were in a position to detect the errors.” *Rehm,* 954 F.Supp. at 1256. According to the Complaint, Allied omitted about $2.9 million in compensation expenses in 1996, $900,000 in 1997, and $700,000 in 1998. (Cplt.¶ 95(a)). The largest omission, in 1996, overstated net income by 18%, from $16 million to about $19 million. (*Id.* at ¶ 96).

***4** While the omissions are not minuscule, they do not approach the kind of restatements found by other courts to indicate actionable recklessness. *See, e.g., Chu II* at 839-40 (defendants improperly accounted for certain expenditures as “intangible assets” despite the fact that as a result of the accounting, intangible assets comprised 21% of the defendant company's total assets whereas previously, intangible assets comprised for only 1% of its total assets; the accounting irregularity resulted in overstatement of earnings by $39 million); *Rehm,* 954 F.Supp. at 1256 (the restatement slashed yearly earnings from $3.5 million to $325,000); *Rothman v. Gregor,* 220 F.3d 81, 88, 92 (2d Cir.2000) (the restatement announced an additional $73.8 million in expenses for one quarter, resulting in an operational loss of $25 million for the year). Nor do the plaintiffs suggest that the omissions involved such a central part of the defendants' business that any significant accounting discrepancy should have been detected immediately. *See Rehm,* 954 F.Supp. at 1256 (the accounting discrepancy involved a “defining characteristic” of the defendant's business).

Plaintiffs also suggest that the omissions were critical to the success of defendants' overall fraudulent scheme in that the resulting overstatements in income permitted Allied to meet certain debt covenants and, in turn, obtain credit to expand into the A Press market. (Pltf. Reps. at 15-16). However, the desire to maintain credit is a goal held generally by other corporate executives and, as such, is insufficient to raise an inference of fraud. *See, e.g., Chu II,* 100 F.Supp.2d at 841. Absent indication that Allied had particular problems with its creditors in obtaining cash or renegotiating credit agreements, such allegations do not carry much weight. *Cf., Rehm,* 954 F.Supp. at 1253 (general averments of a desire by defendant to maintain reputation in the capital markets without weight where plaintiffs did not allege a single instance of the defendant actually seeking to acquire capital); *see also Novak v. Kaskas,* 216 F.3d 300, 307-08 (2d Cir.2000) (plaintiffs must allege that defendants “benefitted in some concrete and personal way from the purported fraud”). In fact, in the third quarter of 1998-prior to the end of the class period-when defendants did report large losses at Verson, Allied obtained waivers on the debt covenants and was able to renegotiate their terms. (Cplt. at ¶¶ 204, 246).

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

Finally, any suggestion that Allied and the defendants admitted in an April 1999 press release that they knew about the omissions prior to the end of the class period is misplaced. (Pltf. Reps. at 18). A plain reading of the press release clearly refutes plaintiffs' interpretation of defendants' statements, (Cplt.¶ 93), especially in light of fact that in March of 1999, Allied explicitly stated to the public that it was informed of the compensation expense omissions "[s]ubsequent to the end of 1998."(*Id.* at ¶ 208). As such, plaintiffs fail to raise a strong inference of fraud with respect to the omission of compensation expenses. Furthermore, having granted ample opportunity for the plaintiffs to plead this claim, the Court concludes that another attempt at pleading would be futile. Therefore, dismissal of this aspect of the plaintiffs' case is with prejudice.

Deferred Costs and Masked Production Problems.

***5** On the other hand, the Court is not prepared to wholly dismiss plaintiffs' allegations that the Allied defendants fraudulently deferred the recognition of rising costs at its Verson division and masked known production problems with it's a Presses. Critical to raising a strong inference of conscious misconduct in this case is defendants' admitted improper use of the reallocation method in early 1998. According to Allied's Amended 1998 Annual Report, Verson raised cost estimates on the A Presses in February of 1998 by $5.3 million. (Cplt.¶ 47). The cost revisions took place after the public release of Allied's 1997 earnings figures but before the filing of its 1997 Annual Report. (*Id.*) However, instead of disclosing the revised cost estimates in the 1997 Annual Report, the defendants chose to reallocate those revisions to the remaining periods of production in 1998. (*Id.*). According to the plaintiffs, the reallocation method has been expressly prohibited in the general professional accounting literature since 1981. (*Id.* at ¶ 48). Furthermore, the reallocation was not even registered until the third quarter of 1998. (1998 Amended Annual Report, Pltf.App., Ex. A at 11). When a restatement was finally announced, the revised cost estimates reduced the 1997 reported income by 26%. (Cplt.¶ 96).

While a company's overstatement of earnings, revenues, or assets in violation of GAAP does not itself establish scienter, if combined with other circumstances suggesting fraudulent intent, such allegations may support a strong inference of scienter. *Chu I,* 100 F.Supp.2d at 824. The alleged circumstances surrounding the reallocation raise enough flags for this Court so as to withstand a motion to dismiss. The amount reallocated was relatively large, the actual reallocation was deferred as late as possible, and the accounting violation was, according to the plaintiffs, obvious. Furthermore, the plaintiffs insist that the A Presses constitute a critical part of Allied's business and defendants were daily and monthly appraised of problems with production and cost accounting. Thus, the allegations raise a "strong inference" that the defendants knew or recklessly disregarded, during the class period, that Verson was having difficulty estimating costs with respect to it's a Presses and that costs were dangerously escalating. Despite that knowledge, the defendants chose not to reform Verson's cost accounting procedures or to timely and accurately disclose escalating costs to the detriment of shareholders. The Court now must await the presentation of evidence to determine whether the inference is or is not warranted.

CONCLUSION

For the reasons stated above, defendants' motion to dismiss is granted in part and denied in part. Only plaintiffs' claim with respect to the omission of compensation expenses is dismissed with prejudice.

IT IS SO ORDERED.

N.D.Ill.,2000.
In re Allied Products Corp., Inc. Securities Litigation
Not Reported in F.Supp.2d, 2000 WL 1721042 (N.D.Ill.)

END OF DOCUMENT

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

TAB 2

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

June 29, 2001.

MEMORANDUM OPINION

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

BACKGROUND

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

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

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

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

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

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

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

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

Our business model depends on our ability to sell our TouchScript system to physicians and other healthcare providers and to generate usage by a large number of physicians. We have not achieved this goal with previously or currently available versions of our software.
(Allscripts Form 10-K, 3/30/00, at 23.) The Company also warned potential investors about the potential obstacle of convincing doctors to abandon traditional methods of writing prescriptions in favor of new technological opportunities:

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

(*Id.*) In addition, the 10-K Form warned of the risk of errors or defects in the technology:
[E]arly releases of software often contain errors or defects. We cannot assure you that, despite our extensive testing, errors will not be found in our new product releases and services before or after commercial release, which would result in product redevelopment costs and loss of, or delay in, market acceptance.

(*Id.* at 24.)Furthermore, the 10-K Form contained a frank conclusion about the risk of failure:
If we fail to achieve broad acceptance of our products and services by physicians and other healthcare participants or to position our services as a preferred method for pharmaceutical healthcare delivery, our prospects for growth will be diminished.

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

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

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

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

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

pany needed to offset public shareholder concerns about dilution.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

STANDARD OF REVIEW

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

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

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

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

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

Reflecting the heightened pleading requirements of Rule 9(b), the PSLRA requires complaints to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."15 U.S.C. § 78u-4(b)(1). Furthermore, with respect to scienter, complaints must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."15 U.S.C. § 78u-4(b)(2). The Seventh Circuit has not yet addressed the question whether the PSLRA standard displaces past case law regarding pleading standards in private securities litigation. Until the Seventh Circuit does so, we shall concur with other courts in this District who have adopted the Second Circuit's pleading standard but declined to bind courts to the Second Circuit's interpretation of that standard. *See Retsky Family Ltd. P'ship v. Price Waterhouse,* No. 97 C 7694, 1998 WL 774678 at *1 (N.D.Ill. Oct. 21, 1998); *Rehm,* 954 F.Supp. at 1252; *Fugman v. Aprogenex, Inc.,* 961 F.Supp. 1190, 1195 (N.D.Ill.1997). That standard requires plaintiffs to "allege facts that give rise to a strong inference of fraudulent intent." *Retsky,* 1998 WL 774678 at *1.

DISCUSSION

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

I. Count One: Securities Fraud

A. Alleged Omissions and False Representations

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

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

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

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

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

1. Statements Regarding TouchScript and Its Customers

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

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

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

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

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

Nor do we accept Plaintiffs' assertion that Allscripts failed to disclose that TouchScript was not credentialed with many insurance companies. As an initial matter, Plaintiffs have failed to plead this allegation with the requisite particularity. Under the PSLRA, complaints must "specify the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."15 U.S.C. § 78u-4(b)(1). At the pleading stage, a plaintiff may satisfy this requirement by referring to internal memoranda or other documents, press releases, news articles and government-mandated filings. *See In re Theragenics Corp. Sec. Litig.,* 137 F.Supp.2d 1339, 1345 (N.D.Ga.2001) (relying on *Novak v. Kasaks,* 216 F.3d 300 (2d Cir.2000)). Because the instant allegation identifies no source for the information, it cannot meet this threshold requirement.

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

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

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

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

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

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

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

2. Statements Regarding Recognition of $500,000

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

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

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

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

B. Scienter

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

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

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

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

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

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

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

II. Count Two: Control Group Liability

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

CONCLUSION

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

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

END OF DOCUMENT

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

TAB 3

Only the Westlaw citation is currently available.

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

In re BALLY TOTAL FITNESS SECURITIES LITIGATION.

Nos. 04 C 3530, 04 C 3634, 04 C 3713, 04 C 3783, 04 C 3844, 06 C 3936, 04 C 4697, 04 C 1437.

July 12, 2006.

MEMORANDUM OPINION

JOHN F. GRADY, United States District Judge.

***1** Before the court are defendants' motions to dismiss the consolidated class action complaint. For the reasons explained below, the motions are granted.

BACKGROUND

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

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

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

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

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

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

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

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

• improperly recognizing membership revenue

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

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

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

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

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

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

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

• improperly capitalizing costs incurred to develop internal-use software

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

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

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

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

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

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

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

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

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

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

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

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

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

(CCAC ¶¶ 121-174.)

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

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

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

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

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

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

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

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

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

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

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

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

DISCUSSION

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

FN4. Rule 10b-5 provides:

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

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

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

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

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

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

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

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

A. *Scienter*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. ***Loss Causation***

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

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

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

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

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

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

CONCLUSION

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

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

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

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

END OF DOCUMENT

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

TAB 4

LEXSEE 2003 U.S. DIST. LEXIS 2527

NORMAN W. FISHMAN, individually and as Trustee for ARI FISHMAN, UGMA, Plaintiff, v. WILBUR G. MEINEN, JR.; NORMAN D. RICH; AVROM H. GOLDFEDER; GLEN WHERFEL; SHERWIN KOOPMANS; JOSEPH A. CARI, JR.; GEORGE OHLHAUSEN; KURT C. FELDE; WACHOVIA SECURITIES, INC. f/k/a First Union Securities Inc., Defendants.

02 C 3433

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

2003 U.S. Dist. LEXIS 2527

February 21, 2003, Decided
February 24, 2003, Docketed

DISPOSITION: [*1] Individual defendants' motion to dismiss granted without prejudice. FUSI's motion to stay case and compel arbitration granted, motion to dismiss denied as moot.

COUNSEL: For NORMAN W FISHMAN, plaintiff: Robert H. Rosenfeld, Gold & Rosenfeld, Chicago, IL.

For NORMAN W FISHMAN, plaintiff: Janet Lynn Reed, Robert E. Williams, Terrence Buehler, Buehler Reed & Williams, Chicago, IL.

For WILBUR G MEINEN, JR, NORMAN D RICH, AVROM H GOLDFEDER, GLEN WHERFEL, SHERWIN KOOPMANS, JOSEPH A CARI, JR, GEORGE OHLHAUSEN, KURT C FELDE, defendants: Ray G. Rezner, Mark Scott Bernstein, Brock F. Renner, Barack, Ferrazzano, Kirschbaum, Perlman & Nagelberg, Chicago, IL.

For WACHOVIA SECURITIES, INC., defendant: John Hester Ward, Edward David Shapiro, Much, Shelist, Freed, Denenberg, Ament & Rubenstein, P.C., Chicago, IL.

JUDGES: HON. RONALD A. GUZMAN, United States Judge.

OPINION BY: RONALD A. GUZMAN

OPINION

MEMORANDUM OPINION AND ORDER

Norman Fishman sued defendants for violations of Section 10(b) of the Securities Exchange Act of 1934, *15 U.S.C. § 78j(b)*, and *Rule 10b-5*, *17 C.F.R. § 240.10b-5* [*2] . Before the Court is defendants Wilbur Meinen, Jr., Norman Rich, Avrom Goldfeder, Glen Wherfel, Sherwin Koopmans, Joseph Cari, Jr., [1] George Ohlhausen, and Kurt Felde's (collectively the "individual defendants") motion to dismiss the complaint pursuant to *Federal Rules of Civil Procedure ("Rule") 9(b)* and *12(b)(6)*. Also before the Court is Wachovia Securities; Inc., f/k/a First Union Securities, Inc.'s ("FUSI") motion to dismiss Fishman's complaint, or, in the alternative, to compel arbitration. For the following reasons, the Court grants the individual defendants' motion to dismiss without prejudice and grants FUSI's motion to compel arbitration.

1 By agreement of the parties, Joseph Cari, Jr. has been dismissed as a defendant.

FACTS

Fishman was a shareholder of Success Bancshares, Inc. ("SBI") in his own name and as a trustee for his son, Ari Fishman. (Compl. P 2.) Fishman was also a member of the Board of Directors of Success National Bank (the "Bank"), which was operated by SBI, from 1982 until [*3] December 31, 1999. (*Id.*) The Bank is a community bank, founded in 1973, which has its headquarters in Lincolnshire, Illinois. (*Id.* P 4.) SBI was created in 1984 as a Delaware corporation and bank holding company. It acquired the Bank and operated it through seven branch offices throughout the Chicago metropolitan area until 2001. (*Id.* PP 4-5.) In 1997, SBI went public and its stock traded thereafter on NASDAQ under the symbol SXNB. (*Id.*) On May 21, 2001, SBI was sold to BankFinancial, a wholly owned subsidiary of Financial Federal MHC, Inc., a federally chartered holding company. (*Id.*)

Wilbur Meinen, Jr. is the former President and CEO of SBI and the Bank, and in early 1999 became the Chairman of the SBI Board of Directors. (*Id.* P 3.) Norman Rich was a direct or SBI and the Bank since 1991. (*Id.*) Avrom H. Goldfeder was a director of SBI since 1997. (*Id.*) Glen Wherfel was a director of SBI since 1998 and a director of the Bank since 1992. (*Id.*) Sherwin Koopmans was a director of SBI since 1997, and served as the chairman of the Executive Committees of SBI's and the Bank's Board of Directors from August 1998 to December 1998. (*Id.*) Joseph Cari, [*4] Jr. was appointed as director of SBI in January 2000. (*Id.* P 4.) George Ohlhausen was a director of SBI from at least as early as 1982 through May 24, 2000. (*Id.*) Kurt Felde was Executive Vice President and Chief Financial Officer for SBI and the Bank from June 1, 1998 until its sale. FUSI is a North Carolina corporation and an investment banker which oversaw the sale of SBI's stock. (*Id.*)

SBI and the Bank had separate boards of directors. (*Id.* P 5.) When Saul Binder, the president of the Bank since 1982, died in July of 1998, the two boards convened to discuss the future of the Bank. (*Id.*) FUSI, acting as investment banker and a market maker in SBI stock, informed the Board that if it elected to sell SBI, its stock could be sold for $ 24 to $ 25 per share, which was double the stock price at that time (approximately $ 12.50). (*Id.*) The plaintiff was the only director of the Bank or SBI in favor of selling the Bank, and the rest of both boards' members agreed not to sell the Bank. (*Id.*) After this meeting, the two boards had no further interaction regarding the future of SBI. (*Id.*)

In September and October of 1998, the SBI board met with the investment [*5] banking firm of Keefe, Bruyette & Woods, Inc. ("KBW") to create a long-term strategic plan for SBI, and it formally retained KBW as its planning consultant in February of 1999. (*Id.* PP 5-6.) On January 11, 2000, defendant Meinen, the President and CEO of SBI as of December 1998, terminated Fishman as a member of the Bank's board of directors through a written letter. (*Id.*) Fishman claims that this was due to the fact that he had challenged an existing loan to an SBI shareholder, the large legal bills submitted by SBI's outside counsel, and the board's alleged refusal to investigate a possible sale or merger of the Bank. (*Id.*)

In early 1999, the SBI board commenced a stock repurchase program through a series of private transactions. (*Id.* P 6.) The board formally authorized this program in January 12, 2000 and allocated $ 2 million for the repurchasing of its stock. (*Id.* P 7.) The plan was formally ratified by the SBI Board at its annual meeting on May 24, 2000. (*Id.* P 9.) The repurchasing efforts were intensified during the first two quarters of 2000. (*Id.*) FUSI privately solicited purchases from Fishman and other large SBI shareholders. (*Id.*) By November [*6] 2000, SBI had repurchased approximately 660,000 shares at an average price of $ 10.4042 per share. (*Id.*) By the end of the second quarter of 2000, SBI had repurchased over 400,000 shares at $ 10 per share through private transactions. (*Id.* P 8.)

On May 18, 2000, Robert Krebs, and employee of FUSI, called Fishman and informed him about the repurchase plan. (*Id.*) Krebs allegedly told Fishman that there was no market for his shares, and advised Fishman to sell his shares for approximately $ 10 per share while the repurchase plan was still in effect. (*Id.*) As a result of this conversation, Fishman sold all but 300 of his own shares and all of the shares he was holding as trustee for his son during the week of May 18 through May 23, 2000.

Fishman contends that as early as January 11, 2000, Morgan Gasior, the CEO of BankFinancial, approached the management of SBI about a possible merger between the two companies, at share prices in the $ 16-$ 18 range. (*Id.* P 7.) On March 8, 2000, Fishman wrote a letter to SBI's corporate secretary, Marlene Sachs, requesting that a resolution seeking to solicit offers to purchase SBI be brought before the shareholders at the 2000 Annual [*7] Meeting scheduled for May 24, 2000. (*Id.* P 8.) On May

17, 2000, Lauri Breitenstein, General Counsel of SBI, rejected this request through a letter, stating that the resolution was inappropriate. (*Id.*) On April 25, 2000, SBI issued a press release reporting its first quarter earnings, in which it described a plan to expand the branches of the Bank. (*Id.*) Fishman again submitted a resolution to sell the Bank to the SBI Board for consideration at its annual meeting on May 24, 2000, which the Board refused to consider. (*Id.* P 9.)

Between June and August 2000, several engagement letters were transmitted between BankFinancial, SBI, and KBW relating to a potential merger of SBI with BankFinancial. (*Id.* P 9.) On May 26, 2000, Patricia McJoynt and Doug Reidel of KBW issued a report describing the potential effects of the proposed merger between SBI and BankFinancial. (*Id.* PP 9-10.) On June 1, 2000, SBI issued a public notice announcing that it was repurchasing stock. (*Id.* P 10.) On June 28, 2000, SBI entered into a contract with KBW for KBW to advise SBI regarding the proposed BankFinancial merger. (*Id.*) On that same day, Steven P. Kent of KBW issued a report [*8] for SBI entitled "Success Bancshares, Inc. Strategic Alternatives Presentation Concept of Conversion Strategic Merger with BankFinancial" updating past data relating to the proposed merger. (*Id.*) On July 26, 2000, SBI entered into Stock Option Agreements with defendants, which gave each defendant the option to purchase 3,000 shares at $ 11 per share on or before July 26, 2010. (*Id.*) Also, through a modified employment agreement, Meinen was issued 8,000 shares and granted options to purchase an additional 33,000 SBI shares. (*Id.*)

On September 8, 2000, BankFinancial made an offer to KBW to acquire SBI in a merger transaction at $ 18 to $ 20 per share, depending on the results of BankFinancial's due diligence. (*Id.* P 11.) KBW made a presentation to the SBI Board on September 27, 2000 regarding responses to questions raised by institutions relating to the proposed merger. (*Id.*) On May 21, 2001, SBI was sold to BankFinancial, and SBI shareholders received $ 19 per share. (*Id.*)

Following the sale, Fishman requested from SBI the corporate minutes or other documents that referred or related to the sale of SBI and to the SBl/BankFinancial merger. (*Id.*) When SBI [*9] refused this request, Fishman filed a lawsuit in the Circuit Court of Cook County seeking a court order for the production of the documents (*Fishman v. Success Bancshares. Inc.*, 01 CH 18583). (*Id.*) On January 4, 2002, SBI produced the requested document to Fishman. (*Id.*) Fishman filed the instant claim on May 13, 2002, on his own behalf and on behalf of his son, Ari Fishman, acting as his son's trustee, contending that the defendants violated the federal securities laws by making false representations and by failing to disclose that SBI was being sold and that his stock would be worth almost double the amount SBI offered him during its repurchase program. (*Id.* P 2.)

DISCUSSION

A motion to dismiss does not test the merits of the case, but rather attacks the sufficiency of the complaint. *Gibson v. Chicago, 910 F.2d 1510, 1520 (7th Cir. 1990)*. The court may only dismiss a complaint for failure to state a claim upon which relief may be granted only if it appears beyond doubt that the plaintiffs can prove no set of facts in support of his claims entitling them to relief. *Hishon v. King & Spalding, 467 U.S. 69, 73, 81 L. Ed. 2d 59, 104 S. Ct. 2229 (1984)*; [*10] *Ledford v. Sullivan, 105 F.3d 354, 356 (7th Cir. 1997)*. The court must accept all pleaded allegations of the complaint as true and must view those allegations in the light most favorable to the plaintiffs. *Cornfield v. Consol. High Sch. Dist. No. 230, 991 F.2d 1316, 1324 (7th Cir. 1993)*; *Gomez v. Ill. State Bd. of Educ., 811 F.2d 1030, 1039 (7th Cir. 1987)*. However, the Court need not accept as true the legal conclusions alleged in the complaint. *Vaden v. Vill. of Maywood, 809 F.2d 361, 363 (7th Cir. 1987)*. A plaintiff may plead conclusions, but those conclusions "must provide the defendant with at least minimal notice of the claim." *Jackson v. Marion County, 66 F.3d 151, 154 (7th Cir. 1995)*.

Fishman first seeks relief against both the individual defendants and against FUSI under Section 10(b) of the Securities Exchange Act of 1934 and *Rule 10b-5* of the Securities and Exchange Commission. The Act makes it unlawful for any person, in connection with the sale or purchase of a security, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the [*11] statements made, in light or the circumstances under which they were made, not misleading." *17 C.F.R. § 240.10b-5 (1979)*. To state such a claim, one must allege that the defendant: (1) made a misstatement or omission, (2) of material fact, (3) with scienter, (4) in connection with the purchase and sale of securities, (5) upon which the plaintiff relied, and (6) that reliance proximately caused the plaintiffs injuries.

Stransky v. Cummins Engine Co., 51 F.3d 1329, 1331 (7th Cir. 1995); *In re Allied Prods. Corp., Inc. Sec. Litig., 2000 U.S. Dist. LEXIS 16781, 2000 WL 1721042*, at *2 (N.D. Ill. Nov. 15, 2000). Further, the plaintiff must establish that the defendants had a duty to disclose the omitted information. *Basic Inc. v. Levinson, 485 U.S. 224, 239, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988)*.

I. Claims Against Individual Defendants

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)* (quotations omitted). Under *Rule 9(b)*, "circumstances [*12] constituting fraud . . . shall be stated with particularity." *FED. R. CIV. P. 9(b)*. In the Seventh Circuit, this rule has been interpreted as requiring the complaint alleging fraud to state "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." *Uni* Quality, Inc. v. Infotronx, Inc., 974 F.2d 918, 923 (7th Cir. 1992)*. Put more simply, 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 the heightened pleading requirement in fraud cases 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 three main purposes: "(1) protecting a defendant's reputation from harm; (2) minimizing 'strike suits' and 'fishing expeditions'; and (3) providing notice of the claim to the adverse party." *Vicom, Inc. v. Harbridge Merch. Servs., Inc., 20 F.3d 771, 777 (7th Cir. 1994)*. [*13]

In addition to the general fraud pleading requirements, when pleading securities fraud, under the PSLRA, the pleading with particularity requirements of 9(b) are "stiffened." *Law v. Medco Research, Inc., 113 F.3d 781, 785 (7th. Cir. 1997)*. The PSLRA requires plaintiffs to "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) (West 2000)*. It further requires a plaintiff to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." *15 U.S.C. § 78u-4(b)(1)*. If these requirements are not met, the Court shall dismiss the complaint. *15 U.S.C. § 78u-4(b)(3)*.

While the Seventh Circuit has yet to address specifically just how rigorous the PSLRA's pleading standard is for the "requisite state of mind" requirement, cases in the Northern District of Illinois generally have followed the Second Circuit's pleading standard, which requires plaintiffs to allege facts either (1) showing that the defendant had both motive and opportunity to commit fraud; or [*14] (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., 2002 U.S. Dist. LEXIS 6983, 2002 WL 653892*, at *2 (N.D. Ill. Apr. 19, 2002) (collecting cases); *Beedie v. Battelle Mem'l Inst., 2002 U.S. Dist. LEXIS 171, 2002 WL 22012*, at *2 (N.D. Ill. Jan. 7, 2002) (collecting cases).

Taken together, the 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*; *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. *See Vicom, 20 F.3d at 777-78*.

The plaintiff's complaint against the individual defendants falls short in that it fails to specify the "who, what, where, when and how" of the alleged misrepresentations or omissions on the part of each individual defendant regarding the prospects of the sale of SBI. Courts, [*15] both in this circuit and others, have held that a plaintiff may not vaguely attribute a fraudulent statement to a group of defendants. *Sears, 912 F.2d at 893*; *Mills v. Polar Molecular Corp., 12 F.3d 1170, 1175 (2d Cir. 1993)* ("*Rule 9(b)* is not satisfied where the complaint vaguely attributes the alleged fraudulent statements to 'defendants.'"). Further, as a general rule, a complaint that "lumps all the defendants together and does not specify who was involved in what activity" is generally insufficient to satisfy *Rule 9(b)*. *Sears, 912 F.2d at 893*.

While the plaintiff is correct that a minor exception to the group pleading rule exists where the information necessary is uniquely within the defendants' knowledge, *Midwest Grinding Co., Inc. v. Spitz, 976 F.2d 1016, 1020 (7th Cir. 1992)*; *Banowitz v. State Exch. Bank, 600 F.*

Supp. 1466, 1469 (N.D. Ill. 1985), such is not the case here. First, Fishman alleges that misrepresentations were specifically made to him by the individual defendants. Second, unlike plaintiffs in many securities cases, Fishman held a position which would allow him to be privy to [*16] the plans and operations of SBI. He was Chairman of the Bank and a member of its board from 1982 until late 1999. Last, Fishman has already had the opportunity of discovery of the most relevant SBI documents to the proposed sale. He obtained a court order for the production of all of the documents that referred to or related to the sale of SBI and to the SBI/BankFinancial merger, and SBI produced all of the documents requested by Fishman to him on January 4, 2002. (Compl. P 44.)

The plaintiff cites this Court's decision in *Talton v. Unisource Network Servs., Inc., 2001 U.S. Dist. LEXIS 14049, 2001 WL 1035732* (N.D. Ill. Sept. 10, 2001), in support of his group pleading argument. However, the *Talton* case is unsupportive of his argument. In *Talton*, the plaintiff was alleging that the defendants made misleading statements directly to her. *2001 U.S. Dist. LEXIS 14049*, *Id.* at *6. Thus, this Court held that the policy underlying group pleading would not be served because the information to be pleaded was not in the exclusive control of the defendants. *Id.*

As in *Talton*, Fishman alleges that fraudulent misrepresentations were made to him by the defendants. Further, Fishman possesses a certain degree [*17] of knowledge of the alleged fraud in this case. Unlike most shareholders who bring securities fraud cases, Fishman, like Ms. Talton, held a position that would allow him to be privy to information regarding defendant's business. Ms. Talton was the President and CEO of the defendant Unisource for almost fourteen years, and Mr. Fishman was chairman of the Bank, which was wholly run by SBI, and a member of the Bank's board of directors for almost twenty years. Through his position at the Bank, he personally knew and interacted with the individual SBI defendants. Further, in this case, Fishman is uniquely aware of the contents of documents relating to the merger of SBI and BankFinancial.

Because (1) Fishman has failed to specify the "who, what, where, when and how" of the alleged misrepresentations and (2) the group pleading exception is inapplicable in this case because the information necessary was not within the exclusive control of defendants, the Court grants the individual defendants' motion to dismiss.

The only alleged misrepresentation about which Fishman is more specific is one involving a statement during a phone conversation with a FUSI representative regarding his SBI stock. [*18] In order for the individual defendants to be held liable for the alleged misrepresentations made by the FUSI representative, however, there must be an agency relationship between FUSI and the individual defendants. According to the Seventh Circuit, "when the plaintiff relies upon the same circumstances to establish both the alleged fraud and the agency relationship of a defendant, the reasons for more particularized pleading that animate *Rule 9(b)* apply with equal force to the issue of agency and to the underlying fraud claim." *Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777, 783 (7th Cir. 1999)*; *see also MorEquity, Inc. v. Naeem, 118 F. Supp. 2d 885, 895 (N.D. Ill. 2000)*.

Fishman does not specify with particularity in his complaint the circumstances giving rise to any agency relationship between the FUSI representative and the individual defendants. While the plaintiff contends that the alleged agency relationship in this case, which the plaintiff contends is prescribed by law, does not need to be pleaded with particularity because such a pleading would serve "no purpose," the Seventh Circuit has not yet acknowledged such an exception to its [*19] holding in *Lachmund*. (Pl's Resp. at P 9.) Further, Fishman had set up a brokerage account with FUSI, and his 66,000 shares of SBI stock were held in a FUSI account. Thus, the FUSI representative could have potentially been acting solely as Fishman's broker during this call, independent FUSI's separate relationship with SBI. A particularized pleading as to agency would serve the purpose of clarifying this issue. The plaintiff further contends *Lachmund* does not apply because he does not rely upon the same circumstances to establish the fraud and the agency in this case. Because the Court finds that, in this case, the alleged agency relationship and the fraud claims are dependent on one another, the *Lachmund* standard is applicable. Accordingly, Fishman must plead the agency relationship between each individual SBI defendant and the FUSI representative according to the heightened particularity requirement of *Rule 9(b)*. Fishman has failed to fulfill this requirement.

For all of these reasons, the Court grants defendants' motion to dismiss. The complaint against the individual

defendants is dismissed without prejudice. [2]

2 Defendants argue, among other things, that Fishman failed to plead adequately the duty to disclose. However, because this Court has held that the plaintiff did not fulfill the pleading requirements of *Rule 9(b)* and the PSLRA and because a duty to disclose, as well as the other issues raised, are necessarily dependent on the nature and specifics of the particular misstatement(s) made, it need not reach the other issues raised by defendants.

[*20] **II. Claims Against FUSI**

Defendant FUSI has moved to compel arbitration and to stay the claims against it pending arbitration. The Federal Arbitration Act ("FAA") "provides that written agreements to arbitrate controversies arising out of an existing contract 'shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.'" *Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 218, 84 L. Ed. 2d 158, 105 S. Ct. 1238 (1985)* (quoting *9 U.S.C. § 2*). The FAA requires courts to interpret arbitration agreements according to their terms, just like any other private agreements. *Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 62, 131 L. Ed. 2d 76, 115 S. Ct. 1212 (1995)*. Thus, to determine whether the parties intended to submit an issue to arbitration, courts review the contract at issue through standard methods. *AT&T Techs., Inc. v. Communications Workers of Am., 475 U.S. 643, 648, 89 L. Ed. 2d 648, 106 S. Ct. 1415 (1986)*; *see also Mastrobuono, 514 U.S. at 54*. In making this review, courts must bear in mind that "questions [*21] of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration . . . [and] any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25, 74 L. Ed. 2d 765, 103 S. Ct. 927 (1983)*; *see also Nielsen v. Piper, Jaffray & Hopwood, Inc., 66 F.3d 145, 148 (7th Cir. 1995)*. Where the parties have a contract that calls for arbitration of the dispute, the court must enter an order compelling arbitration. *See 9 U.S.C. §§ 3, 4*; *Dean Witter, 470 U.S. at 218*.

Under the arbitration agreement entered into by Fishman and FUSI, Fishman consented to arbitration of "any" and

> "all claims or controversies, whether such arose prior to, on or subsequent to [March 6, 2000], between me and FUSI and/or any of its present or former officers, directors or employees concerning or arising from (i) any account maintained by me with FUSI individually or jointly with others in any capacity; (ii) any transaction involving FUSI or any predecessor firms by merger, acquisition or other business [*22] combination and me, whether or not such transaction occurred in such account or accounts; or (iii) the construction, performance or breach of this or any other agreement between us or any duty arising from the business of FUSI or otherwise, shall be submitted to arbitration . . . ."

(FUSI's Mot. Dismiss, Attach. A, at 2.) While the plaintiff is correct that the arbitration agreement was entered into as a part of his Client Agreement regarding his brokerage account with FUSI, the plain terms of this arbitration clause are broad, and include claims based upon transactions occurring both within and outside of his brokerage account. Further, the arbitration agreement covers "any duty arising from the business of FUSI." (*Id.*)

The Seventh Circuit recently characterized an arbitration clause recommended by the American Arbitration Association, which requires that "all controversies and claims" either "arising out of" or "relating to" the contract be settled by arbitration, as "very broad." *Welborn Clinic v. MedQuist, Inc., 301 F.3d 634, 639 (7th Cir. 2002)*. Further, the Court held that is has "naturally been willing" to read these "admittedly expansive clauses [*23] quite broadly to include all manner of claims tangentially related to the agreement, including claims of fraud, misrepresentation, and other torts." *Welborn, 301 F.3d at 639*.

The arbitration clause between Fishman and FUSI is even broader than the one described by the Seventh Circuit in *Welborn*. The Fishman/FUSI clause covers "any and all claims or controversies" "arising from" not only the specific contract in which it exists, but also "any other agreement" between the two parties and "any duty arising from the business of FUSI or otherwise." Thus, this clause falls squarely within the Seventh Circuit's definition of a "very broad" arbitration clause. Therefore,

Fishman's fraud claims, which are at least tangentially related to his agreement with FUSI, must be decided by arbitration.

Because this claim must be submitted to arbitration, all other issues raised by Fishman and FUSI must be arbitrated. Thus, this Court need not and more importantly, must not, address those issues.

CONCLUSION

For the foregoing reasons, the individual defendants' motion to dismiss [doc. no. 8-1] is granted without prejudice and FUSI's motion to stay the case and compel [*24] arbitration [doc. nos. 14-1, 14-3] is granted. FUSI's motion to dismiss [doc. no. 14-2] is denied as moot. The plaintiff is given ten days to cure any and all deficiencies of the complaint. If no amended complaint is filed on or before ten days after the date of this Memorandum Opinion and Order, the dismissal as to the individual defendants shall thereafter be with prejudice. The Court stays the case with regard to FUSI and hereby compels arbitration between Fishman and FUSI.

SO ORDERED.

ENTER: 2/21/03

HON. RONALD A. GUZMAN

United States Judge

TAB 5

United States District Court, S.D. New York.
In re GLAXO SMITHKLINE PLC Securities Litigation.
No. 05 Civ. 3751(LAP).

Oct. 6, 2006.

C. Mark Whitehead, Jules Brody, Aaron Lee Brody, Stull, Stull & Brody, New York, NY, Timothy Joseph Burke, Stull, Stull, & Brody, Los Angeles, CA, Samuel Howard Rudman, Lerach, Coughlin, Stoia, Geller, Rudman & Robbins, LLP, Melville, NY, for Plaintiffs.
Andrew J. Levander, Neil A. Steiner, Dechert LLP, New York, NY, for Defendant.

OPINION

LORETTA A. PRESKA, United States District Judge.
***1** Lead Plaintiff Joseph J. Masters ("Plaintiff" or "Masters") brings this putative class action alleging that GlaxoSmithkline ("GSK") and GSK CEO and Chairman Jean-Pierre Garnier ("Garnier") (collectively "Defendants") violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1994), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001), by making various false and misleading statements resulting in damages to GSK investors during the class period. Defendants move to dismiss pursuant to Rule 12(b)(6) for failure to state a claim on which relief may be granted on grounds, *inter alia,* that certain claims are time-barred, and that Plaintiff has failed to plead fraud with particularity, failed to allege scienter, and failed to allege loss causation. For the reasons set forth below, Defendants' motion (dkt. no. 13) is granted, and the Consolidated Second Amended Complaint ("SAC") is dismissed with prejudice.

I. *Background*

This is a putative class action filed on behalf of individuals who acquired GSK common stock or American Depositary Receipts ("ADRs") during the period from December 27, 2000 to August 5, 2004 (the "Class Period"). (SAC ¶ 9). Plaintiff alleges that he acquired GSK securities during the Class Period and suffered damages as a result. (SAC ¶ 2). More specifically, according to his class representative certifications, Masters purchased 1,400 shares of GSK on September 28, 2001 at a share price of $56.28 and sold the same number of shares on June 13, 2002 at a price of $39.43. Plaintiff purchased an additional 350 shares of GSK on February 17, 2004 at a share price of $42.96 and had not sold those shares as of May 10, 2005.

GSK is a public company whose securities trade on the New York and London Stock Exchanges. (SAC ¶ 3). Garnier was CEO and Chairman of GSK throughout the Class Period. (SAC ¶ 4). The SAC alleges that on February 19, 2004, Garnier sold 142,250 shares of GSK stock for $6,143,293 based on material non-public information. (SAC ¶ 279).[FN1]

FN1. The SAC also alleges that on December 14, 2004, Garnier sold 79,054 shares for $3,774,037, but this transaction occurred after the Class Period end date of August 4, 2004.

A. *Procedural History*

The initial complaint in this action was filed on April 12, 2005. Two additional actions, No. 05-cv-3885 and No. 05-cv-4723, were brought in this district on April 18, 2005 and May 16, 2005, respectively. A fourth related action, No. 05-cv-6231, was transferred here from the Eastern District of Pennsylvania.

By order dated July 25, 2005, this Court consolidated all four actions and granted Masters' unopposed motion for appointment as lead plaintiff. This Court also set up a procedure whereby Plaintiff was directed to serve a consolidated amended complaint, Defendants were to advise Plaintiff of perceived deficiencies, *i.e.,* grounds for a motion to dismiss, and Plaintiff was given the opportunity to file a second amended complaint with the understanding that no further amendments would be permitted. The parties availed themselves of this procedure, and the SAC was docketed on April 6, 2006.

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

B. *The Second Amended Complaint*

***2** The SAC alleges violations of the Exchange Act in two counts. The first count alleges that Defendants violated section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by, *inter alia,* making untrue statements of material fact that resulted in damages to Plaintiff and the class. (SAC ¶¶ 282-286). The second count alleges control person liability under section 20(a) of the Exchange Act as to Defendant Garnier. (SAC ¶¶ 287-291).

Broadly speaking, the SAC alleges that GSK violated the Exchange Act in four ways: 1) by misrepresenting the safety and efficacy of the use of its drug Paxil in children (the "Paxil Pediatric Allegations"); 2) by making false statements and omissions regarding the viability of GSK's patents for Paxil and Augmentin and engaging in a course of frivolous litigation with respect to those patents (the "Patent Allegations"); 3) by suppressing information about Paxil's addictiveness and withdrawal effects (the "Paxil Withdrawal Allegations"); and 4) by violating the Federal False Claims Act by overcharging Medicare and Medicaid for GSK's pharmaceutical products, resulting in multiple lawsuits against GSK (the "False Claims Act Allegations"). The SAC also alleges that Garnier sold GSK stock based on material, non-public information (the "Insider Trading Allegations"). (SAC ¶ 279).

1. *The Paxil Pediatric Allegations*

GSK manufactured and sold paroxetine under the name Paxil in the United States and Seroxat in Great Britain (hereinafter "Paxil") throughout the Class period. (SAC ¶ 18).Paxil is a selective serotonin reuptake inhibitor ("SSRI") that is approved by the FDA for treatment of depression, anxiety and other conditions in adults. (*Id.*).Paxil has not been approved by the FDA for treatment of any conditions in children or adolescents. (*Id.*). Physicians, however, are permitted to prescribe FDA-approved drugs for non-FDA-approved uses where, through the exercise of independent judgment, they determine that the prescription is appropriate.(*Id* .). This practice is referred to as an "off-label" use. (*Id.*). GSK reported Paxil sales of £1.55 billion for the year 2000. (SAC ¶ 31). In 2002, Paxil prescriptions to treat children and adolescents totaled $55 million in the United States and "much more" worldwide. (SAC ¶ 19).

The SAC alleges that GSK misrepresented the safety and efficacy of Paxil in treating Major Depressive Disorder ("MDD") in children by allowing positive information about Paxil to be disclosed publicly but withholding or concealing negative information. (SAC ¶ 20). More specifically, the SAC alleges that on various occasions prior to and during the Class Period, research scientists sponsored by or known to GSK published articles and presented posters at research conferences reporting on the safety and efficacy of Paxil for treatment of children and adolescents. (SAC ¶¶ 22-29, 32-47).

The SAC also alleges that GSK made misrepresentations about Paxil by allowing dissemination of a study that showed mixed results about the safety and efficacy of Paxil but withholding the results of studies that had negative results. (SAC ¶¶ 58-80). Two out of three placebo-controlled studies conducted by GSK, studies 377 and 701, showed no statistically significant difference between the effectiveness of Paxil and the effectiveness of the placebo. (SAC ¶ 67). A third study, study 329, presented a mixed picture, with Paxil failing to outperform the placebo on two primary measures of efficacy but outperforming the placebo on three out of five secondary measures of efficacy. (SAC ¶ 68). In all three studies, suicidal thoughts and acts, as well as mood swings and crying (behavior coded as "emotional lability") were significantly higher in the Paxil group compared to the placebo group. (SAC ¶ 70). Specifically, study 329 showed emotional lability in 6.5% of the Paxil group compared with 1.1% of the control group. (*Id.*); study 377 showed emotional lability in 4.4.% of the Paxil group compared with 3.2% of the control group; and study 701 showed emotional lability in 3.6% of the Paxil group compared with 1.4% of the control group. (*Id.*)

***3** The SAC alleges that GSK disseminated the results of study 329, concealing or downplaying its negative aspects, but suppressed dissemination of the other studies. (SAC ¶¶ 58-62, 73-80). After GSK submitted studies 329, 377 and 701 to the FDA in connection with an application for approval of Paxil to treat Obsessive Compulsive Disorder ("OCD") in children and adolescents, various regulatory agencies in the United States and abroad issued warnings against the use of Paxil in children and adolescents. (SAC ¶¶ 81-90).

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

With regard to loss causation, the SAC specifies two price drops of GSK securities following the release of information to the public about Paxil's adverse effects on children. On June 2, 2004, the New York State Attorney General announced a lawsuit against GSK based on suppression of the adverse pediatric studies, resulting in a price drop from $42.77 to $41.39, or $1.38 per share, on that date. (SAC ¶ 48). On December 9, 2004, the ABC News program Primetime Live aired a story about the adverse effects of Paxil on children, resulting in a stock price drop from $45.08 to $44.82, or 23 cents per share, the following day. (SAC ¶ 51).

2. *The Paxil Withdrawal Allegations*

The SAC alleges that GSK engaged in a “disinformation campaign” designed to suppress information about the withdrawal effects of Paxil. (SAC ¶ 238). The SAC alleges that GSK knew from pre-marketing studies that Paxil had higher addictive potential than other SSRIs. (SAC ¶¶ 240-242). Despite this alleged awareness, GSK included in its promotional literature the following statement: “Paxil belongs to a class of medications called SSRIs, which have not been shown to be associated with addiction.”(SAC ¶ 243). The SAC catalogues 18 scientific studies or reports between 1993 and 2000 documenting withdrawal symptoms as a result of Paxil discontinuation, none of which was acted upon. (SAC ¶¶ 246-263).

In August 2001, a class action was filed in California on behalf of consumers addicted to Paxil. (SAC ¶ 238). The SAC alleges that on September 6, 2001, GSK's share price fell from $45.14 to $44 .10, or $1.04 per share, on news of the class action suit alleging that Paxil caused withdrawal symptoms. (SAC ¶ 264). In December 2001, the FDA ordered GSK to begin warning patients about Paxil's withdrawal symptoms, and the company rewrote Paxil's warning label to include “discontinuation effects.” (SAC ¶ 265).

3. *The Patent Allegations*

Broadly speaking, the Patent Allegations allege that GSK misled investors by issuing statements misrepresenting the validity and duration of GSK's patents for Paxil and Augmentin. The Patent Allegations allege that GSK engaged in a course of baseless patent filings and frivolous patent litigation.

With regard to Augmentin, the SAC alleges that in a July 26, 2000 *Financial Times* article, Garnier stated that a newly granted patent on Augmentin would extend patent protection to 2013. (SAC ¶ 132). After a federal court ruled on February 2, 2002 that GSK lost certain patent protections for Augmentin, Garnier appeared for a CNBC interview and said, “We are very confident we can defend our patents.”(SAC ¶ 134). Garnier also stated, “The PTO confirmed that those patent[s] were genuine, they were rock solid. And we feel that the courts eventually will recognize the letter of the law and give us the added protection for Augmentin.”(*Id.*). On February 25, 2002, a federal district court ruled that GSK's '380 patent for Augmentin was invalid. (SAC ¶ 137). On November 23, 2003, the Federal Circuit upheld the district court's ruling that GSK did not have patent protection for Augmentin. (SAC ¶ 141).

***4** Regarding loss causation, the SAC alleges that after a March 13, 2002 announcement that GSK had lost part of its court battle over Augmentin, GSK's share price fell from $48.81 on March 13, 2002 to $48.27 on March 14, 2002, and to $47.62 on March 15, 2002, a total of $1.19 per share in two days. (SAC ¶ 138). When GSK announced on May 23, 2003 that it lost patent protection for Augmentin completely, GSK's share price fell from $41.47 to $38.03, or $3.44 per share. (SAC ¶¶ 139-140, 174-175).

The SAC alleges that GSK represented in its Form 20-F for the years 1999 through 2001 that its patent protection for Paxil expired in 2006. (SAC ¶¶ 99, 103). The SAC alleges that this representation was false because the patent protection was based upon “evergreening,” *i.e.,* obtaining frivolous patents in order to extend patent life. (SAC ¶ 111). More specifically, the SAC alleges that GSK attempted to protect Paxil from generic competition by filing additional patents “concerning chemical properties of the molecule that have nothing to do with its effectiveness.”(*Id.*).

The SAC alleges that GSK filed numerous baseless patent infringement lawsuits against competitors who sought to market generic forms of Paxil. (SAC ¶¶ 104-108, 158-161, 202-227). With regard to loss causation, the SAC describes six stock price drops following negative news about Paxil's patent protection.

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

After the *Financial Times* reported on Saturday July 13, 2002 that the German company BASF prevailed in court and won the right to produce generic versions of Paxil, GSK shares fell from $38.15 to $36.65 on Monday July 15, 2002. (SAC ¶ 165). When GSK announced on July 23, 2002 that it lost a Paxil patent case in the United States, GSK's stock fell from $34.02 to $32.86, or $1.16 per share. (SAC ¶ 166). On October 24, 2002, GSK's share price dropped from $41.34 to $39.27, or $2.07 per share, on news that GSK had reserved £145 million for legal costs. (SAC ¶ 169). Following a court ruling on March 4, 2003 that competitor Apotex did not infringe GSK's patent on Paxil, GSK's stock price fell from $35.27 to $34.15, or $1.12 per share. (SAC ¶ 173). When Apotex received FDA approval on July 31, 2003 to market a generic version of Paxil, GSK's stock price fell from $39.22 to $37.40, or $1.82 per share. Finally, when GSK announced on February 12, 2004 that Paxil sales were down by 40% because of generic competition, GSK's share price fell from $45.15 to $42.52, or $2.63 per share. (SAC ¶ 179).

4. *The False Claims Act Allegations*

The SAC's False Claims Act Allegations are brief, comprising only three paragraphs, and are focused on lawsuits against GSK for False Claims Act violations. The SAC alleges that GSK was sued for False Claims Act violations several times, starting with an action brought on November 16, 2001, when GSK was trading at $53.96 per share. (SAC ¶ 276). After news of the suit was reported in the *National Law Journal* on December 10, 2001, GSK's share price is alleged to have fallen to $49.40 on December 11, 2001, but the complaint is silent about what the share price was on December 10, 2001. *(Id.)* The SAC states that the lawsuits claimed that GSK was charging the government *(i.e.,* Medicare and Medicaid) higher prices for drugs than it charged private entities. (SAC ¶¶ 276-277). GSK announced settlement of its False Claims Act liabilities for $87,600,922 on April 16, 2003, resulting in a stock price drop from $39.10 on April 14, 2003 to $37.60 on April 16, 2003, or $1.50 per share.

5. *The Insider Trading Allegations*

***5** With respect to all of the above claims, the SAC alleges that Garnier took advantage of material adverse information not known to the public while issuing materially false and misleading statements. (SAC ¶ 279). The SAC alleges that the extent and timing of Garnier's trades establish that he possessed materially adverse information that he failed to disclose. (*Id.*). The only Garnier stock transaction during the Class Period alleged in the SAC is a sale of 142,250 shares of GSK on February 19, 2004, yielding proceeds of $6,143,293.

II. *Applicable Law*

A. *Standard of Review*

On these motions to dismiss the complaint, the Court accepts the factual allegations in the complaint and draws all inferences in favor of Plaintiff. *Karedes v. Ackerly Group,* 423 F.3d 107, 113 (2d Cir.2005). It is well-settled that a case may not be dismissed "unless the court is satisfied that the complaint cannot state any set of facts that would entitle the plaintiff to relief." *Miller v. Wolpoff & Abramson,* 321 F.3d 292, 300 (2d Cir.2002)(citing *Patel v. Contemporary Classics of Beverly Hills,* 259 F.3d 123, 126 (2d Cir.2001)). The Court, however, need not give "credence to plaintiff's conclusory allegations" or legal conclusions offered as pleadings. *Cantor Fitzgerald v. Lutnik,* 313 F.3d 704, 709 (2d Cir.2002) (citing *Dawes v. Walker,* 239 F.3d 489, 491 (2d Cir.2001)); *Van Carpals v. S.S. American Harvester,* 297 F.2d 9, 11 n. 1 (1961) (Friendly, J.) ("[I]n federal pleading there is no need to plead legal conclusions; these are for the court to apply."). On a motion to dismiss pursuant to Fed.R.Civ.P. 12(b)(6), the Court may consider materials of which the plaintiff had notice and relied upon in framing his complaint, as well as materials of which judicial notice may be taken. *See Kavowras v. New York Times,* 328 F.3d 50, 57 (2nd Cir.2003); *Cortec Indus. v. Sum Holding,* 949 F.2d 42, 48 (2d Cir.1991).

B. *Section 10(b) Elements and Pleading Requirements*

Section 10(b) of the Exchange Act makes it unlawful to "use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance" in violation of Securities and Exchange Commission ("SEC") rules and regulations. 15 U.S.C. § 78j(b). The SEC implementing rule, Rule 10b-5, 17 C.F.R. § 240.10b-5 (2004), pro-

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

hibits the making of untrue material statements of fact or the misleading omission of material facts in connection with the purchase or sale of securities. Courts have implied a private right of action from section 10(b) and Rule 10b-5, with the following basic elements: 1) a material misrepresentation or omission; 2) scienter or "wrongful state of mind;" 3) a connection with the purchase or sale of a security; 4) reliance; 5) economic loss; and 6) loss causation. *See* *Dura Pharmaceuticals v. Broudo,* 544 U.S. 336, 341-42 (2005). In other words, to state a claim for securities fraud, "a plaintiff must plead that 'in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material misrepresentation or omitted to disclose material information and that plaintiff's reliance on defendant's action caused [plaintiff's] injury.' " *In Re Time Warner Inc. Securities Litigation,* 9 F.3d 259, 264 (2d Cir.1993) (quoting *Bloor v. Carro, Spanbock, Londin, Rodman & Fass,* 754 F.2d 57, 61 (2d Cir.1985).

***6** "A complaint asserting securities fraud must also satisfy the heightened pleading requirement of Federal Rule of Civil Procedure 9(b), which requires fraud to be alleged with particularity." *Kalnit v. Eichler,* 264 F.3d 131, 138 (2d Cir.2001) (citing *Ganino v. Citizens Utilities Co.,* 228 F.3d 154, 168 (2d Cir.2000). The Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub.L. No. 104-67, 109 Stat. 737, heightened the requirements for pleading securities fraud. *Id.* It also protected forward-looking statements in a company's SEC filings and press releases from giving rise to a securities fraud claim as long as the statements are identified as forward-looking and are accompanied by sufficient cautionary language. *See*15 U.S.C. § 78u-5(c)(1)(A)(i). Similarly, under the "bespeaks caution" doctrine, "[c]ertain alleged misrepresentations ... are immaterial as a matter of law because it cannot be said that any reasonable investor could consider them important in light of adequate cautionary language." *In re Bausch & Lomb, Inc. Sec. Litig.,* No. 01-CV-6190-CJS, 2003 WL 23101782, at *2 (W.D.N.Y. Mar. 28, 2003) (quoting *Halperin,* 295 F.3d at 357);*see also* *Mercury Air Group, Inc. v. Jet USA Airlines, Inc.,* No. 97 Civ. 3473, 1998 WL 542291, at *4-*5 (S.D.N.Y. Aug. 26, 1998), *aff' d,* 189 F.3d 461 (2d Cir.1999).

The PSLRA also specifies the standard for pleading scienter:

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

15 U.S.C. § 78u-4(b)(2); *Kalnit,* 264 F.3d at 138. To meet the PSLRA requirement for alleging scienter, a securities fraud complaint must set forth allegations "giv[ing] rise to a strong inference of fraudulent intent."*Id.* (quoting *Novak v. Kasaks,* 216 F.3d 300, 307 (2d Cir.2000))."A plaintiff can establish this intent either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." *Id.* at 138-39 (citations and internal quotation marks omitted).

Where a plaintiff alleges securities fraud against a public company and its officers and directors, it is motive rather than opportunity that is at issue. *See, e.g.,* *Kalnit,* 264 F.3d at 139; *In Re Time Warner,* 9 F.3d at 269.*Kalnit* explained that in order to allege motive to commit fraud, a section 10(b) complaint must set forth something more than a generalized "assertion that the officers were motivated to inflate the value of stock to increase their executive compensation." *Kalnit,* 264 F .3d at 139. In other words, a plaintiff who alleges that directors or officers misled the public in order to profit from an inflated stock price must point to a "specific benefit that would inure to the defendants that would not be either generalized to all corporate directors or beneficial to all shareholders[.]" *Id.* at 142.Concrete, personal benefits giving rise to a strong inference of fraudulent intent must be alleged. *Id.* at 139.Allegations of stock sales by insiders are insufficient to establish scienter in the absence of factual allegations demonstrating that such sales were unusual in timing or amount. *See, e.g.,* *Rothman v. Gregor,* 220 F.3d 81, 94-95 (2d Cir.2000); *In re Glenayre Techs., Inc. Sec. Litig.,* No. 96 Civ. 8252, 1998 WL 915907, at *4 (S.D.N.Y. Dec. 30, 1998) ("Insider stock sales are [only] unusual where the 'trading was in amounts dramatically out of line with prior trading practices [and] at times

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

calculated to maximize personal benefit from undisclosed inside information.'") (citation omitted), *aff'd sub nom.* *Kwalbrun v. Glanayre Techs., Inc.,* 201 F.3d 431 (2d Cir.1999); *In re Health Mgmt. Sys. Inc. Sec. Litig.,* No. 97 Civ. 1865, 1998 WL 283286, at *6 n. 3 (S.D.N.Y. June 1, 1998); see also *Ressler v. Liz Claiborne, Inc.,* 75 F.Supp.2d 43, 60 (E.D.N.Y.1999).

***7** " 'Where motive is not apparent, it is still possible to plead scienter by identifying circumstances indicating conscious behavior by the defendant, though the strength of the circumstantial allegations must be correspondingly greater.' " *Id.* at 142 (quoting *Beck v. Mfrs. Hanover Trust* Co., 820 F.2d 46, 50 (2d Cir.1987). A plaintiff who pleads conscious misbehavior or recklessness must allege that defendant engaged in " 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care[.]' " *Id.*(quoting *Honeyman v. Hoyt (In Re Carter Wallace, Inc., Secs. Litig.),* 220 F.3d 36, 39 (2d Cir.2000).

In *Dura, supra,* the Supreme Court clarified the requirements for pleading economic loss and loss causation under the Exchange Act. Noting that the implied cause of action available under section 10(b) resembles a common law tort cause of action for deceit *(i.e.,* fraudulent misrepresentation), *Dura,* 544 U.S. at 343-344, the Court held that a plaintiff who brings an action under section 10(b) must "allege and prove the traditional elements of causation and loss," *id.* at 346.Put simply, a plaintiff must allege that he suffered a loss, *id.* at 344, and that "the defendant's misrepresentation proximately caused the plaintiff's economic loss," *id.* at 346.

In *Dura,* the complaint lacked this element because it alleged merely that the defendant had made misrepresentations and that the plaintiff had purchased stock at an artificially high price. *See id.* at 339-40."The complaint [ ] fail[ed] to claim that Dura's share price fell significantly after the truth became known[.]"*Id.* at 347.The loss causation inquiry, therefore, must focus on a link between dissemination of information about the alleged misrepresentations and significant drops in share price. Needless to say, the inquiry must also include whether the complaint alleges that Plaintiff suffered a loss.

C. *Statute of Limitations*

Section 804(1) of the Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley"), codified in part at 28 U.S.C. § 1658(b), extended the statute of limitations period applicable to section 10(b) and Rule 10b-5 to the earlier of "(1) two years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."The two-year limitations period, or the "inquiry notice" period, applies when " 'circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded[.]' " *LC Capital Partners v. Frontier Ins. Group,* 318 F.3d 148, 154 (2d Cir.2003) (quoting *Dodds v. Cigna Securities, Inc.,* 12 F.3d 346, 350 (2d Cir.1993).

The circumstances giving rise to inquiry notice in the securities litigation context are frequently compared to "storm warnings." *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 168 (2d Cir.2005)."Where ... the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of a fraud can be gleaned from the complaint ..., resolution of the issue on a motion to dismiss is appropriate." *LC Capital,* 318 F.3d at 156.

III. *Discussion*

A. *Statute of Limitations*

***8** The parties agree that, under Sarbanes-Oxley, the statute of limitations for an Exchange Act claim is the shorter of five years from the occurrence or two years from the time plaintiff had actual or inquiry notice of the claim. *See*28 U.S.C. § 1658(b). They also agree that the two-year period begins to run as soon as " 'circumstances would suggest to an investor of ordinary intelligence the probability that she had been defrauded.' " *LC Capital,* 335 F.3d at 193 (quoting *Dodds,* 12 F.3d at 350).

The first action in this litigation was filed on April 12, 2005. Assuming for these purposes that the Paxil Discontinuation Allegations, the Patent Allegations, and the False Claims Act Allegations state a claim under section 10(b), plaintiff was on notice of the facts underlying those claims more than two years earlier, thus any claim arising from those allegations is barred by the statute of limitations.

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

The Paxil Discontinuation Allegations assert that, from the early 1990s until August 2001, GSK withheld from physicians and the market information about alleged difficulties experienced by patients taking Paxil who attempted to discontinue use of the drug. (SAC ¶¶ 238, 264). The SAC further alleges that in December 2001, GSK, in consultation with the FDA, changed the labeling of Paxil to include a warning about such effects and the FDA approved the new label. (SAC ¶ 265). Moreover, the SAC alleges that disclosure of the discontinuation effects caused the price of GSK ADRs to drop by $1.04 on September 6, 2001, following the news of the consumer class action lawsuits. (SAC ¶ 264). Thus, even according to the SAC, plaintiff was on notice of any claim based on the Paxil Discontinuation Allegations well more than two years before this lawsuit was commenced. To the extent that plaintiff argues that the consumer actions did not constitute storm warnings because they were not brought by shareholders, (Pl. Mem. at 23), it is a distinction without a difference. The alleged fraudulent conduct-failing to disclose the withdrawal effects of Paxil-is the same.

The allegations of the SAC also show that any claim based on the Patent Allegations is time-barred. The Patent Allegations allege that GSK brought patent litigations seeking to prevent generic drug manufacturers from manufacturing and selling generic versions of Paxil and Augmentin beginning in 1998. (SAC ¶¶ 104, 161). The SAC alleges that in February 2002, at least one court had invalidated certain of GSK's patents covering Augmentin and that information was publicly disclosed no later than March 13, 2002. (SAC ¶¶ 133-134, 137-138). Similarly, on July 23, 2002, GSK announced that it had lost one patent case involving Paxil and on December 30, 2002, GSK publicly disclosed that a different court granted summary judgment in favor of GSK on one patent claim, granted summary judgment against GSK on a different patent, and declined to grant summary judgment to either party on two additional patents. (SAC ¶¶ 110, 166). All of those developments were disclosed, at the latest, in GSK's Form 20-F for the year ending December 31, 2002, which was filed with the SEC on March 28, 2003. (2002 Form 20-F at 103-107).

***9** In July 2002, the FTC issued a report critical of GSK's conduct in pursuing patent listings. (SAC ¶ 231). The SAC also alleges that GSK was sued in private antitrust actions arising out of its patent enforcement activities-litigations that were disclosed, at the latest, in GSK's Form 20-F for the year ending December 31, 2002. (SAC ¶ 99; 2002 Form 20-F at 106). The SAC alleges that GSK stock price dropped on at least five different occasions between April 1, 2002 and March 4, 2003 in response to developments in the patent litigation. Indeed, the SAC quotes a March 5, 2003 article published in *The Times (London)* that “the bad news [concerning the loss of patent protection for Paxil] is fully in the price.”Here again, there can be no dispute that plaintiff was on notice of any claim arising from the Patent Allegations more than two years before this action was filed. *See, e.g., Menowitz v. Brown,* 991 F.2d 36, 42 (2d Cir.1993). In any event, because, as noted below, the underlying facts about the patent litigations were all publicly available, there is no doubt that plaintiff was on inquiry notice long before April of 2003, and inquiry would have disclosed all of the facts he relies on now.

To the extent that plaintiff argues, based on *LC Capital,* that Garnier's “reassuring words” that GSK would prevail on its patent litigation somehow toll the statute of limitations, that case is of no assistance. There, the corporate officer announced that the recurring problem of under-reserving “is now behind us” and that the company had “paid the bill” on those items. *LC Capital,* 318 F.3d at 155. The court noted that the problem of under-reserving was a serious one for the company, an insurance company, and that it had recurred. But, because the “ ‘reassuring’ statements by management were mere expressions of hope, devoid of any specific steps taken to avoid under-reserving in the future,” the court found that “the claimed reassurances are unavailing.” *Id.* at 156.

The logic of *LC Capital* applies with even greater force here. Garnier's statements (“We are very confident we can defend our patents[,]” and “The PTO confirmed that those patent[s] were genuine, they were rock solid. And we feel that the courts eventually will recognize the letter of the law and give us the added protection for Augmentin.”(SAC ¶ 134)), can be viewed by a reasonable investor only as mere expressions of hope. The company had no ability to assure the result of the patent litigations, whereas at least in *LC Capital* the company had some ability to avoid under-reserving. Also the words used, “we are

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

very confident" and "we feel," can only be understood as aspirational, and thus no reasonable investor would understand them to be factual guarantees of patent protection. Accordingly, these supposed "reassuring" words are insufficient to toll the statute of limitations.

Finally, the SAC alleges that GSK "has also violated the Federal False Claims Act numerous times," that it was sued as a result of those violations on November 16, 2001, and that public disclosure of a False Claims Act lawsuit caused a drop in share price on December 11, 2001. (SAC ¶ 276). Because plaintiff had notice of GSK's alleged violations of the False Claims Act more than two years before bringing this action, any claim arising from those allegations is time-barred.[FN2] Accordingly, based on the allegations of the SAC and publicly-filed documents, claims based on the Paxil Discontinuance Allegations, the Patent Allegations and the False Claims Act Allegations are time-barred.

> FN2. The SAC also alleges that GSK agreed to pay $150 million to settle False Claims Act claims involving two additional drugs on September 20, 2005. That allegation cannot give rise to a claim because it occurred more than a year *after* the end of the alleged Class Period.

B. *Material Misrepresentation or Omission*

***10** The crux of the Paxil Pediatric Allegations is that GSK, through employees and sponsored researchers, disseminated information to the medical community about the most promising of its studies on Paxil's effects on children, while suppressing information about several negative studies. Assuming without deciding that 1) Plaintiff's allegations that GSK "sponsored" the doctors' research, (see SAC ¶¶ 34, 47), are sufficient to attribute the doctors' statements to GSK, *see, e.g., Wright v. Ernst & Young LLP,* 152 F.3d 169, 174-75 (2d Cir.1998); *SEC v. Pimco Advisors Fund Mgmt. LLC,* 341 F.Supp.2d 454, 466 (S.D.N.Y.2004) ("[A] defendant must actually make a false or misleading statement in order to be held liable under Sections 10(b).") (quoting *Wright,* 152 F.3d at 175), and 2) articles in medical journals and presentations at medical conferences are statements made in connection with the purchase or sale of securities, *see In re Carter Wallace, Inc. Sec. Litig.,* 150 F.3d 153, 156 (2d Cir.1998) (holding that allegedly misleading advertisements in medical journals could satisfy the "in connection with" requirement where plaintiffs alleged those advertisements were intended to impact stock price, but affirming dismissal of securities fraud claim because alleged misrepresentations were not material), the Paxil Allegations still fail because they are not material.

In order to be material, a pharmaceutical company's failure to disclose information about a drug must be of sufficient magnitude that the commercial viability of the drug would be called into question if the truth were disclosed. *In Re Carter Wallace,* 150 F.3d at 158. The SAC concedes that Paxil was a drug approved for adults, that prescriptions for children were an "off-label" use representing a small fraction of total sales, and that generic competitors were fighting to get a piece of Paxil's market share even after news about Paxil's effects on children came to light. The potential loss of a nominal amount of off-label sales certainly did not threaten the commercial viability of the drug, and thus the failure to disclose that potential loss cannot be said to be material. Because on the face of the SAC the alleged misrepresentations and omissions regarding Paxil's use in children are not material, the Paxil Pediatric Allegations fail to state a claim.

The Paxil Withdrawal Allegations similarly fail to allege a material misrepresentation or omission. The only decline in share price alleged to flow from revelations about Paxil withdrawal symptoms was a drop from $45.14 to $44.10 on September 6, 2001 following the announcement of a class action lawsuit. As with the Paxil Pediatric Allegations, the SAC fails to allege that withdrawal symptoms threatened the commercial viability of Paxil, and therefore the alleged misrepresentations and omissions cannot be found to be material. Thus, the Paxil Withdrawal Allegations fail to state a claim.

Although the loss of patent protection would appear to meet the materiality element, the Patent Allegations fail to allege a misrepresentation or omission. As noted above, the Patent Allegations concern statements made by GSK about the legal positions the company was taking with respect to patent protection for Paxil and Augmentin and Garnier's "confiden[ce]" in the outcome. As to the former, there is simply nothing in the SAC that alleges that GSK mis-

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

represented the legal positions it was taking or that GSK misrepresented developments in its patent cases as they occurred. To hold that a legal position taken by a publicly traded company, or an expression of confidence in a legal position, may be converted by hindsight into an actionable misrepresentation if the company later loses the lawsuit would have a chilling effect on publicly traded companies seeking to defend their interests in litigation. In any event, Garnier's and GSK's optimism that GSK would prevail in the litigation is a classic example of a forward-looking statement and is clearly protected as such. *See* *In re Bausch & Lomb, Inc. Sec. Litig.,* No. 01-CV-6190-CJS, 2003 WL 23101782, at *2 (W.D.N.Y. Mar. 28, 2003) (quoting *Halperin v. eBanker USA.com, Inc.,* 295 F.3d 352, 357 (2d Cir.2002)); *see also* *Mercury Air Group, Inc. v. Jet USA Airlines, Inc.,* No. 97 Civ. 3473, 1998 WL 542291, at *4-*5 (S.D.N.Y. Aug. 26, 1998), *aff'd,* 189 F.3d 461 (2d Cir.1999)).

***11** In any event, GSK's regulatory filings fully disclosed to investors like plaintiff all of the Company's material information about the patent litigations. For example, GSK's Form 20-F for the year ended December 31, 2002 fully disclosed, among other litigation, the patent litigation involving Paxil and Augmentin. For example, the "Joint Statement by the Chairman and Chief Executive Officer" of GSK at the very beginning of the Form 20-F explained that:

> In July [2002], in the USA, the first generic version of *Augmentin* was launched. This followed a ruling by a federal judge that our *Augmentin* patents were invalid. We are appealing against the decision, in the firm belief that our patents are valid.
>
> ...
>
> *Seroxat*/*Paxil* continues to be subject to threat of generic competition, particularly in the USA.
>
> A federal judge in Chicago recently ruled that GlaxosmithKline's patent in the USA covering the hemihydrate form of *Paxil* was valid but not infringed by generics company Apotex's product. We believe our patent to be infringed by Apotex's product and will appeal against the ruling. Also, we will continue to pursue litigation for infringement of other patents relating to *Paxil* against Apotex and other generics companies in the USA.
>
> As a result of these pending matters, the possible timing of generic competition to *Paxil* in the USA is unclear.

(2002 Form 20-F at 4). The "Legal Proceedings" section of the Form 20-F provided additional details of the patent litigations:

> In the USA a number of distributors of generic drugs have filed applications with the FDA to market generic versions of *Paxil*/*Seroxat* (paroxetine hydrochloride) prior to the expiration in 2006 of the Group's patent on paroxetine hydrochloride hemihydrate. The distributors are looking to bring to market anhydrate or other versions of paroxetine hydrochloride and in one case paroxetine mesylate. The cases are complex but the Group believes that the generic anhydrate and other versions infringe because they contain and/or convert to the hemihydrate form and/or infringe other Group patents. In response the Group has filed actions against all those distributors for infringement of various of the Group's patents.

(2002 Form 20-F at 103). The Form 20-F continued by identifying each of those patent litigations and describing the significant developments in each case-including that GSK had lost one case after trial because the judge had concluded that the generic company's product did not infringe the GSK patent, and that GSK was appealing that ruling. (2002 Form 20-F at 103). In the face of these disclosures in GSK's SEC filings, no reasonable investor can claim to have been deceived into believing that Paxil and Augmentin would remain free of generic competition until 2006 or beyond. *See* *In re Bausch & Lomb,* 2003 WL 23101782, at *2; *Halperin,* 295 F.3d at 357.

The False Claims Act Allegations fail to state a claim upon which relief may be granted because the SAC fails to allege a misrepresentation made by Defendants. The SAC alleges that GSK overcharged Medicare and Medicaid for certain drugs, resulting in lawsuits against GSK under the False Claims Act. (SAC ¶¶ 276-278).

***12** The only alleged misleading statement cited is GSK's April 16, 2003 announcement that it had settled its False Claims Act liabilities by paying $87,600,922 for overcharges on Paxil and Flonase. Plaintiff alleges that this statement was misleading

because the settlement did not represent *all* of GSK's liabilities under the False Claims Act, referring to a September 20, 2005 report that GSK would pay $150 million to settle False Claims Act liabilities for overcharging the Government for two other drugs, Zofran and Kytril. The SAC, however, alleges no connection between these two settlements, two and a half years apart, involving different drugs. In any event, in light of GSK's annual revenue of £1.55 billion in 2000 on Paxil sales alone, (SAC ¶ 31), these settlement amounts are unlikely to be material.

C. *Scienter*

The SAC fails to plead scienter with the requisite particularity prescribed by the PSLRA. The SAC recites dozens of statements, identifies the speakers and states the approximate dates and locations where those statements were made but fails to explain why the alleged misstatements were fraudulent, how any of the statements affected the price of GSK stock or how any plaintiff was damaged by any statement.

With respect to the Paxil Pediatric Allegations, for example, the SAC lists numerous presentations made at medical conferences by independent doctors and researchers over an approximately five-year period concerning the doctors' views as to the potential benefits of using Paxil to treat children and adolescents and alleges that GSK "sponsored" or "knew of" those presentations. Critically, however, the SAC does not allege that the doctors presented information knowing it was false, that the doctors did not in fact believe in the benefits of Paxil or how any of the doctors would have the motive to misrepresent the benefits of Paxil to the medical community. Accordingly, the Paxil Pediatric Allegations are insufficient.

The same result obtains as to the claim based on Garnier's trading. Although Garnier, like all CEOs, had the opportunity to commit fraud, the SAC fails to allege motive adequately. Plaintiff relies on the allegation that Garnier took advantage of information withheld from the public in order to sell shares of GSK at an artificially high price. As noted above, however, allegations of stock sales by insiders are insufficient absent allegations demonstrating that such sales were unusual in timing or amount. *See, e.g., Rothman,* 220 F.3d at 94-95.

During the Class Period, Garnier is alleged to a have executed a single sale of 142,250 shares on February 19, 2004. Of the thirteen share price declines alleged in the SAC, eleven occurred between September 6, 2001 and February 13, 2004, *i.e.,* prior to the February 19, 2004 stock sale. *(See* SAC ¶¶ 138-140, 165-166, 169, 173, 177, 179, 264, 276-277). Two drops in share price are alleged to have occurred after February 19, 2004, on June 2, 2004 and December 10, 2004, respectively, *(see* SAC ¶¶ 48, 51), but the net effect of these two alleged declines in share price turns out, upon closer examination, to be an increase in share price. According to the SAC, as negative news hit the market about the Paxil's effects on children, GSK stock fell from $42.77 to $41.39 on June 2, 2004, then again from $45.08 to $44.82 on December 10, 2004. If anything is to be drawn from the facts alleged in the SAC, it is that Garnier held GSK stock through eleven price declines that resulted from negative news reaching the market, then sold a large number of GSK shares prior to a period of time in which the stock rose from $42.77 to $44.82 in the face of some additional negative information. Under these circumstances, the SAC fails to allege motive.

***13** In any event, the public record discloses that Garnier's February 2004 sale was in connection with his exercise of stock options granted in 1994 that would expire unless exercised by November 22, 2004. Garnier sold only the number of ADRs necessary to pay the option price and applicable taxes and retained the remaining ADRs. Consequently, Garnier's net holdings of GSK *increased* by 88,802 ADRs as a result of the transaction, he continued to own 204,430 ADRs (worth in excess of $8 million) as of December 31, 2004 and had options to purchase an additional 3.8 million ADRs. *See* Form 6-K dated February 20, 2004; Form 20-F for the year ended December 31, 2004 at 53-54. In these circumstances, Garnier's stock sale cannot be said to have been unusual or suspicious.

In order to allege scienter under the alternative theory of conscious misbehavior or recklessness, the complaint must present strong circumstantial evidence. *Kalnit,* 264 F.3d at 142. " 'Where motive is not apparent, ... the strength of the circumstantial allegations [of conscious misbehavior or recklessness] must be correspondingly greater.' " *Id.* (quoting *Beck v. Mfrs. Hanover Trust Co.,* 820 F.2d 46, 50 (2d Cir.1987). As noted above, *see supra* Part IV.A, Plaintiff has failed even to allege a material misrepre-

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

sentation with respect to any of his allegations. Plaintiff falls far short of alleging " 'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care[.]" *Id.*(quoting *Honeyman v. Hoyt (In Re Carter Wallace, Inc. Sec. Litig.),* 220 F .3d 36, 39 (2d Cir.2000).

In sum, all of Plaintiff's claims fail to allege the scienter element of securities fraud because Plaintiff has not alleged facts that satisfy either the motive or conscious misbehavior/recklessness prong of scienter.

D. *Economic Loss and Loss Causation*

Even accepting plaintiff's factual allegations as true and drawing all reasonable inferences in favor of Plaintiff, *Karedes,* 423 F.3d at 113, Plaintiff has not alleged loss causation with respect to the Paxil Pediatric Allegations, the Paxil Withdrawal Allegations, or the False Claims Act Allegations. One of Plaintiff's class representative certifications, executed under penalty of perjury, states that Plaintiff acquired 1400 GSK shares on September 28, 2001 for $56.28 per share and sold the same number of shares on June 13, 2002 for $39.43 per share. Although Plaintiff suffered an overall loss on the sale of these shares, the SAC fails to allege that a misrepresentation by Defendants, when revealed to the public, was the proximate cause of any loss suffered by Plaintiff. *Dura Pharmaceuticals,* 544 U.S. at 346-347. A second certification states that Plaintiff purchased 350 shares of GSK on February 17, 2004 at $42.96 and still held those shares as of the date of the certification, May 10, 2005. With respect to these shares, too, Plaintiff fails to allege any particular loss after February 17, 2004 proximately caused by public revelation of Defendants' alleged misrepresentations.

***14** The SAC alleges two GSK share price declines in connection with the Paxil Pediatric Allegations. The first occurred on June 2, 2004, when the New York State Attorney General announced a lawsuit concerning suppression of the Paxil pediatric studies. On that date, GSK shares fell from $42.77 to $41.39. The only other alleged decline occurred on December 9, 2004, when GSK stock price dropped from $45.08 to $44.82 in reaction to a news program highlighting Paxil's effects on children. Plaintiff's certifications show that he held the stock at the time of both alleged price declines, but the SAC fails to allege that Plaintiff suffered a loss. The share price prior to the initial negative market reaction was $42.77, and the share price after the second negative market reaction was $44.82, or $2.05 higher. The SAC, therefore, fails to allege that Plaintiff suffered a loss proximately caused by the truth about Paxil's effects on children reaching the public. In fact, the Paxil Pediatric Allegations fail to allege a loss at all, given that Plaintiff purchased his shares for $42.96 on February 17, 2004 and still held those shares at $44.82, or $1.86 higher, on the date of the second alleged price decline.

The only alleged price decline linked to the Paxil Withdrawal Allegations occurred on September 6, 2001, when news of a class action lawsuit caused GSK shares to fall from $45.14 to $44.10. Here, too, Plaintiff has failed to allege a loss for the simple reason that he did not own GSK stock at the time of the only alleged price drop. Plaintiff made his initial purchase of GSK stock on September 28, 2001, three weeks *after* the alleged fall in share price. Accepting as true the facts put forward by Plaintiff, the only reasonable inference is that Plaintiff, if anything, benefited from a drop in share price due to disclosures made prior to his purchase of stock, not that he suffered a loss as a result of misrepresentations that came to light.

Plaintiff has also failed to plead loss causation with respect to the False Claims Act allegations. Here, news of a class action lawsuit is alleged to have caused a decline in stock price from $53.96 to $49.40 between November 16, 2001 and December 11, 2001. This decline could not possibly have been caused by the only alleged misleading statement made by GSK with respect to the False Claims Act litigation. The alleged misleading statement regarding settlement of GSK's False Claims Act liabilities was made on April 16, 2003, a full 16 months *after* the alleged stock price decline. Plaintiff did not own GSK stock in April 2003 and cannot allege a loss based on a share price decline in that month.

For all of the above reasons, GSK has failed to allege loss causation with respect to the Paxil Pediatric, Paxil Withdrawal, and False Claims Act Allegations.

IV. *Control Person Liability*

Plaintiff has failed to state a primary violation of the securities laws under section 10(b). Without a primary violation, there can be no secondary, or deriva-

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

tive, violation under Section 20(a).*See* *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1132 (2d Cir.1994); *Brown v. Hutton Group*, 795 F.Supp. 1317, 1324 (S.D.N.Y.1992). Accordingly, Plaintiff's Section 20(a) claim is also dismissed.

V. *Dismissal with Prejudice*

***15** Prior to the filing of the motion to dismiss, Plaintiff was given the opportunity to correct deficiencies pointed out by Defendants, with the understanding that no further amendments would be permitted. Plaintiff availed himself of this opportunity prior to serving the Consolidated Second Amended Complaint. In addition, the grounds for dismissal set forth above demonstrate that further amendment would be futile. Accordingly, the dismissal is with prejudice.

Conclusion

For the reasons stated herein, Defendants motion to dismiss the complaint (dkt. no. 13) is granted, and the Consolidated Second Amended Complaint is dismissed with prejudice.

The Clerk of the Court is directed to mark this action closed and all pending motions denied as moot.

SO ORDERED.

S.D.N.Y.,2006.
In re GlaxoSmithkline PLC
Not Reported in F.Supp.2d, 2006 WL 2871968 (S.D.N.Y.), Fed. Sec. L. Rep. P 94,104

END OF DOCUMENT

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

TAB 6

Only the Westlaw citation is currently available.

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

Marc S. GOLDBERG, Plaintiff,
v.
FREEDOM FEDERAL SAVINGS BANK and Eugene J. Culbertson, Defendants.

No. 88 C 4787.

Jan. 31, 1989.

MEMORANDUM OPINION AND ORDER

CONLON, District Judge.

***1** Plaintiff Marc S. Goldberg ("Goldberg") commenced this action against defendants Eugene J. Culbertson and Freedom Federal Savings Bank ("Freedom Federal") alleging federal securities law violations, common law fraud and negligent misrepresentation. Jurisdiction is based on Section 27 of the Securities and Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78aa, and on principles of pendent jurisdiction. Goldberg moves to certify a class of purchasers of Freedom Federal common stock under Fed.R.Civ.P. 23(b)(3). Freedom Federal moves to strike the class allegations in the complaint, and for summary judgment under Fed.R.Civ.P. 56.

FACTS

Goldberg is the owner of 200 shares of Freedom Federal common stock. He purchased these shares on August 10, 1987 at $25.50 per share. Complaint ¶ 5; Freedom Federal Statement of Facts ¶ 6. When Goldberg purchased these shares, Freedom Federal's stock was rising amidst rumors that the company might be acquired in a takeover.[FN1] Freedom Federal Statement of Facts ¶ 6. The stock continued to rise after Goldberg's purchase. Goldberg Statement of Facts ¶ 7. This prompted Goldberg to place an order with his broker to sell his 200 shares in the event Freedom Federal's stock reached $30.00 per share. Goldberg Dep. 90-91, 107-09.

Although Freedom Federal's stock traded at $30.00 per share or higher between September 17 and September 21, 1987, Goldberg's broker neglected to execute Goldberg's sell order. *Id.* at 108-09; Freedom Federal Statement of Facts ¶ 8. On September 22, 1987, Freedom Federal announced that a routine audit had uncovered miscalculations in the yields on Freedom Federal's loan portfolio. Complaint ¶ 22. The audit disclosed that net income for the first half of 1987 was overstated by $490,000 or 29 cents per share. *Id.* at ¶ 23. This necessitated a restatement of Freedom Federal's quarterly financial data, previously released to the public on May 13, 1987 and August 12, 1987.

The announcement that Freedom Federal had disseminated false information in its financial statements caused the price of its stock to drop from $29.25 on September 22 to $25.50 on September 23. *Id.* ¶ 24. The stock price remained at $25.50 on September 24 and 25. Freedom Federal Statement of Facts ¶ 11. However, on Monday, September 28, the price rose to $26.50. *Id.* The stock traded at or above the $26.00 level through October 12. *Id.* By October 15, however, the stock price had receded to $25.75. On October 20, widespread selling in the nation's securities markets created a market-wide panic, causing Freedom Federal's stock price to fall to $20.00 per share. *Id.*

Goldberg seeks to recover losses in the value of his stock allegedly caused by the misrepresentations in Freedom Federal's financial statements. Count I alleges violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78(b) ("Section 10(b)") and S.E.C. Rule 10b-5, 17 C.F.R. § 240.10b-5 ("Rule 10b-5"). Count II alleges fraud and deceit, and Count III alleges negligent misrepresentation. This court dismissed Count III in an order entered on December 20, 1988. Accordingly, this court will address only the remaining allegations in Counts I and II of the complaint.

DISCUSSION

A. Freedom Federal's Motion for Summary Judgment

***2** Under Fed.R.Civ.P. 56, a motion for summary judgment will be granted only if there are no material facts in dispute and the movant is entitled to judg-

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

ment as a matter of law. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 247 (1985); *Silverman v. Ballantine,* 694 F.2d 1091, 1093 (7th Cir.1982). A party responding to a motion for summary judgment must set forth specific facts supporting the existence of a genuine issue for trial. *Powers v. Dole,* 782 F.2d 689, 694 (7th Cir.1986); *Posey v. Skyline Corp.,* 702 F.2d 102, 105 (7th Cir.1983). All reasonable factual inferences must be viewed in favor of the non-movant. *Hermes v. Hein,* 742 F.2d 350, 353 (7th Cir.1984); *Korf v. Ball State Univ.,* 726 F.2d 1222, 1226 (7th Cir.1984). However, a bare contention that an issue of fact exists is insufficient to raise a factual issue. *Posey,* 702 F.2d at 105. Although summary judgment is usually not appropriate where questions of motive and intent are in issue, summary judgment is proper where the plaintiff presents no evidence of motive or intent to support his claim. *Munson v. Friske,* 754 F.2d 683, 690 (7th Cir.1985).

Count I of the complaint seeks recovery under Section 10(b) and Rule 10b-5. This means that Goldberg must allege that Freedom Federal (1) made a material misrepresentation or omission; (2) with the intent to deceive; and (3) proximately caused Goldberg's injury. *Rowe v. Maremont Corp.,* 850 F.2d 1226, 1232-39 (7th Cir.1988); *Rankow v. First Chicago Corp.,* 678 F.Supp. 202, 206 (N.D.Ill.1988). Because violations of Section 10(b) and Rule 10b-5 are predicated on fraud, the allegations in the complaint must be pleaded with sufficient particularity to satisfy the requirements of Fed.R.Civ.P. 9(b).[FN2] *Decker v. Massey-Ferguson, Ltd.,* 681 F.2d 111, 114 (2d Cir.1982); *Tomera v. Galt,* 511 F.2d 504, 508 (7th Cir.1975); *McKee v. Pope Ballard Shepard & Fowle, Ltd.,* 604 F.Supp. 927, 930 (N.D.Ill.1985).

The complaint alleges that Freedom Federal made several material misstatements as part of a scheme to manipulate and artificially inflate the price of Freedom Federal's common stock. Complaint ¶ 34. Goldberg claims that the first misrepresentations occurred in March 1987 when Freedom Federal released its 1986 annual report. *Id.* at ¶ 14. This report claimed that favorable yields on investments in the consumer lending division would contribute substantially to the company's future earnings. *Id.* at ¶ 15. Goldberg claims that Freedom Federal also made misrepresentations when it released quarterly reports for the first half of 1987 that contained erroneous earnings statements. *Id.* ¶ 22.

Freedom Federal does not deny that the forecasts made in its 1986 annual report, and its earnings statements for the first half of 1987, were misrepresentations. Because a substantial likelihood exists that these misrepresentations affected the market in Freedom Federal's stock, they are unequivocally “material misrepresentations.” *Rowe,* 850 F.2d at 1233; *Flamm v. Eberstadt,* 814 F.2d 1169, 1179-80 (7th Cir.1987).

***3** Less certain is whether Freedom Federal made these misrepresentations with the intent to defraud. The requisite intent may be established either by evidence of actual intent to deceive, manipulate or defraud, or by conduct amounting to reckless disregard for the truth of the representation. *Rowe,* 850 F.2d at 1238; *Rankow,* 678 F.Supp. at 206. Recklessness occurs when the defendant actually knows or is aware of the danger that the plaintiff will be misled. *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977). This is a difficult burden to meet; this circuit and others have emphasized that recklessness is equivalent to willful or intentional fraud. *Sundstrand,* 553 F.2d at 1045; *Securities and Exchange Comm'n v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 868 (2d Cir.1968).

The record in this case demonstrates that Goldberg has not alleged facts from which an inference of the requisite intent may be drawn. As a matter of law, projections of future success that prove to be ill-founded are not, without more, actionable under Rule 10b-5. *Decker,* 681 F.2d at 117. Goldberg has failed to provide a scintilla of evidence suggesting that the projections in Freedom Federal's 1986 annual report were made with the intent to deceive. Similarly, the record is barren of any facts suggesting that Freedom Federal intended to overstate its earnings in the first two quarters of 1987. This finding is reinforced by Goldberg himself who admits that he knows of no evidence that the earnings overstatements were intentional. Goldberg Dep. 145, 156-68.

Goldberg argues that without further discovery, he cannot be expected to allege facts sufficient to establish intent. This argument is without merit. Goldberg cannot resort to discovery to remedy the defects in his pleadings. *McKee,* 604 F.Supp. at 931-32.

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

In the alternative, Goldberg claims that Freedom Federal's misrepresentations were the result of recklessness. Goldberg claims that Freedom Federal's management failed to establish an adequate system of internal controls, to review and verify financial reports and to retain competent employees. Complaint ¶¶ 29-30. No concrete evidence is offered to substantiate these claims. Stripped to its essentials, Goldberg's claim amounts to an attack on management practices. However, Goldberg ignores the fact that Freedom Federal's routine audit procedures discovered the errors in the yield calculations. *Id.* ¶ 22. Freedom Federal immediately disclosed the information to the public. Significantly, this caused a potential suitor to withdraw its original offer. Under these circumstances, management candor vitiates any inference of willful intent. At most, Golderg alleges negligence. In this circuit, this is an insufficient basis from which to draw an inference of fraudulent intent or scienter. *Sanders v. John Nuveen & Co., Inc.,* 554 F.2d 790, 793 (7th Cir.1977), *cert. denied,* 450 U.S. 1005 (1981).

***4** Finally, Goldberg fails to allege any facts suggesting that Freedom Federal's misrepresentations caused his losses. In an action under Section 10(b) and Rule 10b-5, the plaintiff must plead "loss causation." *Kademian v. Ladish Co.,* 792 F.2d 614, 628 n. 11 (7th Cir.1986); *Rankow,* 678 F.Supp. at 207. This means that the complaint must allege facts suggesting that the misrepresentation was a reason for the investment's decline in value. *Rankow,* 678 F.Supp. at 207.

When Freedom Federal announced that its previous earnings statements were erroneous, the price of its stock fell from $29.25 on September 22, to $25.50 on September 23. Complaint ¶ 24. The stock remained at $25.50 for at least two days before it began to rise again. *Id.* Clearly, Goldberg suffered no immediate loss as a result of Freedom Federal's announcement. Freedom Federal's stock price did not decline below Goldberg's purchase price until mid-October when most stocks declined as a result of widespread selling in the nation's securities markets. This suggests that fluctuations in the market, rather than fraud, caused Goldberg's losses.[FN3] Under these circumstances, Goldberg has failed to allege facts suggestive of "loss causation." *Rankow,* 678 F.Supp. at 207.

Because the record is barren of any facts that Freedom Federal intended to defraud the market, or proximately caused Goldberg's losses, Freedom Federal is entitled to judgment on Count I as a matter of law. Accordingly, Goldberg's motion for class certification is denied for lack of standing. *Mintz v. Mathers Fund, Inc.,* 463 F.2d 495 (7th Cir.1972); *Katz v. Comdisco, Inc.,* 117 F.R.D. 403, 407 (N.D.Ill.1987). This court declines to exercise its jurisdiction over Goldberg's pendent state claims in Count II. *United Mine Workers v. Gibbs,* 383 U.S. 715, 726 (1966).

CONCLUSION

Freedom Federal's motion for summary judgment on Count I of the complaint is granted. Goldberg's motion for class certification is denied, thereby rendering Freedom Federal's motion to strike the class allegations moot. Count II is dismissed without prejudice.

FN1. On May 4, 1987, Freedom Federal's board of directors announced that they had retained Salomon Brothers, Inc. to advise them on a possible merger or sale of the company. Complaint ¶ 16. On June 17, 1987, the board announced that Salomon had been authorized to solicit offers to buy Freedom Federal. *Id.* at ¶ 19. By August 1987, a subsidiary of Household International, Inc. indicated that it was willing to acquire Freedom Federal for $60.00 per share. *Id.* at ¶ 21.

FN2. Rule 9(b) requires that the complaint specify the time, place and contents of the alleged fraud and, in the case of fraudulent misrepresentation, how the misrepresentation was communicated to the plaintiff. *McKee,* 604 F.Supp. at 930. Rule 9(b) is designed to be applied in conjunction with Fed.R.Civ.P. 8. *Id.* Rule 8 requires that the complaint provide the defendant with notice of the plaintiff's claims through short and concise statements. *Id.*

FN3. Freedom Federal argues that an additional intervening cause of Goldberg's losses was the failure of Goldberg's broker to sell Goldberg's shares once Freedom Federal's stock price reached $30.00. The record suggests that Goldberg's broker was under a

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

continuing order to sell the stock if it reached that level. Goldberg Dep. 107-09. Under these circumstances, the losses at issue could have been prevented had the broker followed Goldberg's orders. However, because the court finds that Goldberg's losses were caused by fluctuations in the market, the question of whether the broker's negligence amounted to an intervening cause need not be addressed.

N.D.Ill.,1989.
Goldberg v. Freedom Federal Sav. Bank
Not Reported in F.Supp., 1989 WL 8503 (N.D.Ill.)

END OF DOCUMENT

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

TAB 7

LEXSEE 2006 US DIST LEXIS 45862

ROGER E. ILES, Plaintiff, v. RALPH SWANK, JR., MICHAEL C., DEININGER, and ROGER J. SWARAT, Defendants.

Case No. 04 C 3757

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

2006 U.S. Dist. LEXIS 45862*; *Fed. Sec. L. Rep. (CCH) P93,906

June 28, 2006, Decided
June 28, 2006, Filed

PRIOR HISTORY: *Iles v. Swank, 2005 U.S. Dist. LEXIS 10709 (N.D. Ill., Mar. 18, 2005)*

COUNSEL: [*1] For Roger E Iles, Plaintiff: James Raymond Pranger, Jeralyn Hartwick Baran, Chuhak & Tecson, Chicago, IL.

For Ralph Swank, Jr, Defendant: Joseph E. Tighe, Douglas Ethan Kimbrel, Joseph E. Tighe, P.C., Chicago, IL.

For Stuart O Swank, Defendant: Richard Michael Kates, Law Office of Richard M. Kates, Chicago, IL.

For Mitchell C Deininger, Defendant: Joseph E. Tighe, Douglas Ethan Kimbrel, Joseph E. Tighe, P.C., Chicago, IL.

For Roger J Swarat, Defendant: Keith L. Young, Chicago, IL.

For Darryl Swank, Defendant: Richard Michael Kates, Law Office of Richard M. Kates, Chicago, IL.

JUDGES: Virginia M. Kendall, United States District Judge.

OPINION BY: Virginia M. Kendall

OPINION

MEMORANDUM OPINION AND ORDER

Judge Virginia M. Kendall

Plaintiff Roger lies ("Plaintiff") brings this action against Ralph Swank, Jr., Michael C. Deininger and Roger J. Swarat (collectively "Defendants") for alleged violations of *section 10(b)* of the Securities Exchange Act of 1934, *15 U.S.C. § 78j(b)*; the Securities and Exchange Commissioner's *Rule 10b-5*, *17 C.F.R. § 240.10b-5*; and section 12(2) of the Securities Act of 1933, *15 U.S.C. § 77l(a)(2)* [*2] ; as well as state common law and statutory claims. On March 18, 2005, this Court issued a Memorandum Opinion and Order dismissing, without prejudice, certain counts of Plaintiff's First Amended Complaint pursuant to *Federal Rule of Civil Procedure 9(b)* for failure to plead the alleged fraud with particularity. Plaintiff's state law negligent misrepresentation count was dismissed with prejudice for failure to state a claim under *Rule 12(b)(6)*. Based on the applicable statute of limitations period, the Court also limited any allegations in a re-filed complaint to claims related to Plaintiff's renewed investments of $ 50,000 on December 1, 2000 and $ 100,000 on June 1, 2001. Plaintiff filed a Second Amended Complaint and Defendants again have moved to dismiss for failure to plead with the particularity required by *Rule 9(b)* and for failure to state a claim under *Rule 12(b)(6)*.

Taking as true all facts alleged in the complaint, and construing all reasonable inferences in favor of Plaintiff, it is not beyond doubt that Plaintiff can prove a set of facts which would entitle him to relief from Ralph Swank, Jr. Plaintiff has pleaded with particularity [*3] the circumstances of the fraud and facts giving rise to a strong inference that Defendant Swank acted with the required state of mind. Plaintiff's allegations also support

a reasonable inference that Defendant Swank's representations and omissions were material and that the representations were not made in good faith or with a reasonable basis. As to Defendants Deininger and Swarat though, Plaintiff has not alleged that they made any misrepresentations nor alleged any facts from which it reasonably can be inferred that they had a duty to disclose the material facts allegedly omitted from Defendant Swank's statements. Accordingly, Defendant Swank's Motion to Dismiss is denied and Defendants Deininger's and Swarat's Motions to Dismiss are granted.

Plaintiff's Allegations

Plaintiff resides in Waukegan, Illinois, where he is president of Carriage Auto Body, a business specializing in automobile collision repair. Defendants were officers of Statewide Holding Company ("Statewide Holding") located in Waukegan. Defendants were also officers and employees of Statewide Insurance Company, an asset of Statewide Holding. Plaintiff developed a relationship with Statewide Insurance through [*4] his course of business, as he often performed estimates and repair work for car owners insured by the company. Statewide Insurance also insured Plaintiff.

In Spring 1991, Defendants marketed subordinate debentures [1] in Statewide Holding to Plaintiff. Plaintiff invested $ 100,000 and was issued Debenture No. 101 in May 23, 1991. In April 1992, Statewide informed Plaintiff that it intended to redeem its debenture, but told him he could reinvest in a new subordinated debenture at a lower rate of return. Plaintiff renewed his $ 100,000 investment. Defendants urged Plaintiff to purchase more subordinated debentures in the fall of 1995, which he did on December 1, 1995. Plaintiff invested $ 50,000 more and was issued five debentures for $ 10,000 each. Plaintiff renewed his $ 100,000 investment two more times on June 1, 1998 and June 1, 2001. He renewed his $ 50,000 investment on December 1, 2000.

1 A debenture is a debt secured only by a debtor's earning power, not by a lien on any specific asset. BLACK'S LAW DICTIONARY 430 (8th ed. 2004). A subordinate debenture is a debenture that is subject to the prior payment of ordinary debentures and other indebtedness. *Id.*

[*5] On June 9, 1992, Ralph Swank, Sr., father of Defendant Swank, sent Plaintiff a letter with a brochure and combined financial statement for Statewide Holding. At the time, as in 1991 when the debentures first were sold to Plaintiff, Statewide Holding's assets consisted of: Statewide Insurance Company, Swank Insurance Company, Statewide Financial Company, Statewide Risk Management & Adjustment Corporation and Swank Excess Brokers, Inc. At no time did Defendants advise Plaintiff that Statewide Holding had lost some of its assets or that businesses that comprised the holding company were defunct and no longer in business.

In or around November or December 2000, Plaintiff and Defendant Swank met several times at a local Waukegan restaurant and discussed Plaintiff's renewal of his investment. During these conversations, Defendant Swank did not provide Plaintiff with any current financial or other information regarding Statewide Holding or its assets. Defendant Swank, however, reassured Plaintiff that all was fine with Statewide Holding and that Statewide Holding was intending "to go public." Defendant Swank represented to Plaintiff during these conversations that Statewide Holding "remained [*6] profitable, was a safe investment, and emphasized the profitability of Statewide Insurance Company." In spring of 2001, before Plaintiffs June 1st renewal, Defendant Swank telephoned Plaintiff and again told him that "the company was doing great and assured him his investment was safe."

Plaintiff first learned of Statewide Holding's financial difficulties in December 2003, when he did not receive his biannual dividends for the debentures. By that point, Statewide Holding's principal asset, Statewide Insurance Co., had been in serious financial trouble for many years and subsequently became insolvent. The other businesses comprising Statewide Holding's portfolio of assets already had ceased business operations. Statewide Holding itself had sought bankruptcy protection.

DISCUSSION

When considering a motion under *Rule 12(b)(6)*, a court must take as true all facts alleged in the complaint, and construe all reasonable inferences in plaintiff's favor. *See Murphy v. Walker, 51 F.3d 714, 717 (7th Cir. 1995)*. A *Rule 12(b)(6)* motion will not be granted "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claims which would entitle [*7] him to relief." *Conley v. Gibson, 355 U.S. 41, 45-46, 78 S. Ct. 99, 2 L. Ed. 2d 80 (1957)*. Rather than requiring particular facts to be pleaded, *Rule 12(b)(6)* requires only that a complaint must "provide the defendant with at least minimal notice of the claim." *Kyle v. Morton High School, 144 F.3d 448, 454-55 (7th Cir. 1998)*; *Sanjuan v. American Bd. of Psychiatry and Neurology, Inc., 40 F.3d 247, 251 (7th Cir. 1994)* (stating that "[o]ne pleads a 'claim for relief by briefly describing the events . . . [m]atching facts against legal elements comes later").

Rule 9(b), however, sets a heightened pleading standard for most civil cases involving allegations of fraud. [2] *See Ackerman v. Northwestern Mutual Life Insur. Co., 172 F.3d 467, 470 (7th Cir. 1991)* ("*Rule 9(b)* requires

heightened pleading of fraud claims in all civil cases brought in federal courts, whether or not the applicable state or federal law requires a higher standard of proving fraud, which sometimes it does and sometimes it does not"). But in securities fraud cases, the Private Securities Litigation Reform Act ("PSLRA") requires pleading that "exceeds even the particularity requirement [*8] of *Federal Rule of Civil Procedure 9(b)*." *Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 594 (7th Cir. 2006)*. The PSLRA requires a securities fraud complaint to: (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4(b)(1), (2)*.

> 2 *Rule 9(b)* states that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." *Fed. R. Civ. P. 9(b)*. "Circumstances" include "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." *Bankers Trust Co. v. Old World Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992)*; *DiLeo v. Ernest & Young, 901 F.2d 624, 627 (7th Cir. 1990)* (*Rule 9(b)* requires the "who, what, when, where and how: the first paragraph of any newspaper story"). If a plaintiff pleads the circumstances with particularity, *Rule 9(b)* provides that a defendant's state of mind "may be averred generally." *See In re HealthCare Compare Corp. Securities Litigation, 75 F.3d 276, 281 (7th Cir. 1996)* (a plaintiff is required to plead facts that "afford a basis for believing that plaintiffs could prove scienter").

[*9] **I. Defendant Ralph Swank, Jr.**

To establish liability on his § 10(b) and Rule 10b-5 securities fraud claims, Plaintiff must prove that "the 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." [3] *Searls v. Glasser, 64 F.3d 1061, 1065 (7th Cir. 1995)*; *see 17 C.F.R. § 240.10b-5* (forbidding the making of "any untrue statement of a material fact or [omitting] 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"). A statement is material if a reasonable investor would view the misrepresented or omitted fact as "having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson, 485 U.S. 224, 232, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988)*, quoting *TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976)*. Plaintiff alleges that Defendant Swank both made false statements of material fact and omitted material facts that rendered his statements misleading.

> 3 Defendants do not challenge directly Plaintiff's state law claims. Instead, they argue that if the federal claims are dismissed, the Court should decline to exercise supplemental jurisdiction over the remaining state law claims.

[*10] **A. Misrepresentations**

Plaintiff alleges that Defendant Swank represented to him during in-person and telephone conversations in November or December 2000 and in the Spring of 2001 that Statewide Holding was "going public," "the company was doing great," "his investment was safe," and "Statewide remained profitable." Plaintiff alleges that in light of the fact that Statewide Holding's principal asset, Statewide Insurance Co., was nearly insolvent, the other businesses comprising Statewide Holding's portfolio of assets already had ceased business operations and Statewide Holding itself had sought bankruptcy protection, these statements were untrue. Having identified each statement alleged to have been misleading, who made the statement, when the statement was made and the reason or reasons why the statement was misleading, the complaint sufficiently pleads the alleged fraud. *See Makor, 437 F.3d at 594*.

Defendant Swank argues that, even accepting that he made the statements alleged, his statements are not actionable as a matter of law. Defendant Swank characterizes his statements as predictions or forecasts which are not subject to objective verification, [*11] and vague or non-specific rhetoric which merely promote the company. While some circuits assume that no reasonable investor would rely on such statements, the Seventh Circuit rejected a per se rule. *See Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1333 (7th Cir. 1995)*. The Seventh Circuit held that indefinite or forward-looking statements include implicit representations that the statements were made in good faith and with a reasonable basis. *Id.* Six months later, the Seventh Circuit made clear though that even statements made in bad faith or without a reasonable basis are not actionable unless they are material. *See Searls v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995)*. Putting the holdings of *Searls* and *Stransky* into a logical sequence, a court first must determine whether a statement is material. If the statement

is material, a court then must determine whether the statement was made in good faith and with a reasonable basis.

The determination of whether a statement is material "is highly fact-dependent analysis." *Searls, 64 F.3d at 1066*; *see Gilford Partners, L.P. v. Sensormatic Electronics Corp., 1997 U.S. Dist. LEXIS 19032, 1997 WL 757495,* [*12] **14 (N.D. Ill. 1997)* ("The materiality of indefinite forecasts and predictions should be determined on a case by case basis"). In *Stransky*, the court reversed the grant of a motion to dismiss and permitted the plaintiff to pursue claims based on the statements: "profit margins on these engines should improve" and "the costs of the engines should decline from current level." *Stransky, 51 F.3d at 1335*. Later, in *Searls*, the court affirmed a grant of summary judgment because statements that a company was "recession-resistant" and that it would maintain a "high level of disposition gains" were too vague to constitute material statements of fact. *See Searls, 64 F.3d at 1066* (holding that each statement's "lack of specificity precludes it from being deemed material; it contains no useful information upon which a reasonable investor would base a decision to invest"). Applying the materiality standard outlined in *Stransky* and *Searls*, courts in this district have addressed whether various indefinite and forward-looking statements were potentially material to a reasonable investor or were immaterial as a matter of law. In these cases, courts [*13] found statements similar to Defendant Swank's representations that the company was "going public" and "remained profitable" immaterial as a matter of law at the motion to dismiss stage. [4] *See Sequel Capital, LLC v. Rothman, 2003 U.S. Dist. LEXIS 20967, 2003 WL 22757758, *12 (N.D. Ill. 2003)* (finding statements "unparalleled management team," "highly profitable company," and this is an "opportunity [Plaintiff] cannot pass up" immaterial but statement that "[Kenny] has very successfully integrated the acquisitions" potentially material); *Fewell v. Kozak, 1999 U.S. Dist. LEXIS 16532, 1999 WL 966449, *5 (N.D. Ill. 1999)* (finding statement "growing and prosperous company soon to be listed on NASDAQ" immaterial). But based on the allegations here, this Court cannot say beyond doubt that there is no set of facts under which a reasonable investor would not have found the statements to significantly alter the total mix of information. [5] And thus it would be inconsistent with the fact specific nature of the materiality inquiry to dismiss Plaintiff's claims at this stage. *See Stransky, 51 F.3d at 1333* ("A blanket rule that forward-looking statements are not material does not allow for the contextual, [*14] fact-specific nature of the inquiry and would potentially allow companies to engage in conjecture with impunity").

4 *See also Davis v. SPSS, Inc., 385 F. Supp. 2d 697, 711 (N.D. Ill. 2005)* (finding understatement of the cost of agreement with AOL by $ 2.179 million potentially material but that AOL agreement provided SPSS "[a]n even more dominant position as the analytical solutions provider to the market research industry" immaterial); *Tricontinental Indus. Ltd. v. Anixter, 215 F. Supp. 2d 942, 948 (N.D. Ill. 2002)* (finding statements that the company's "current financial strength will allow us to continue growing aggressively," the company would "continue to maximize operating leverage from our acquisitions," and the company "had a great future and that the upward earnings trend reflected in Anicom's reporting earnings would continue" immaterial); *Sutton v. Bernard, 2001 U.S. Dist. LEXIS 11610, 2001 WL 897593, *3 (N.D. Ill. 2001)* (finding statements that the company's internal information systems were "currently operating without any significant interruptions" and that "integration moved ahead of schedule in the second quarter" potentially material but statement made about a merger that "Marchfirst has expertise in all of these areas, allowing us to immediately and profoundly impact our clients' performance . . . The combination of our two dynamic cultures and their extraordinary success stories givesus amazing competitive strengths" immaterial); *Gilford Partners, L.P. v. Sensormatic Electronics Corp., 1997 U.S. Dist. LEXIS 19032, 1997 WL 757495, *14 (N.D. Ill. 1997)* (finding statements that included projections of annual increases in revenues, quantified predictions of overall revenue increases, and specific projections for increases in earnings per share potentially material); *Ziemack v. Centel Corp., 1996 U.S. Dist. LEXIS 11254, 1996 WL 374120, *5-6 (N.D. Ill. 1996)* (finding statements that the bidding process is proceeding "smoothly" and that expressions of interest are "sufficient" and "widespread" material but statements "we would rather manage the process than be managed by it," we do not "pay a lot of attention" to "public statements at this stage of the (auction) process" immaterial). Of these cases, only *Ziemack* involved a motion for summary judgment, the remaining claims were dismissed under *Rule 12(b)(6)*.

[*15]

5 Although not considered by the Court on a motion to dismiss, this "total mix of information" also would include information known to Plaintiff or that Plaintiff could have discovered through a reasonable inquiry.

In addition to sufficiently pleading the fraud, the PSLRA requires that a plaintiff "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)*. Scienter for securities fraud claim requires proof that a defendant intended "to deceive, manipulate, or defraud." *Makor, 437 F.3d at 594*, quoting *Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194, 96 S. Ct. 1375, 47 L. Ed. 2d 668 & n.12 (1976)*. Additionally, in a case involving an indefinite or forward-looking statement, Plaintiff must plead facts that afford a basis for believing that a defendant made the indefinite or forward-looking statement in bad faith or without a reasonable basis. *See Stransky, 51 F.3d at 1333*. Plaintiff alleges that Defendant Swank made certain positive statements regarding the financial [*16] position of Statewide Holding. Plaintiff also alleges that Defendant Swank made the statements: (i) knowing that Statewide Holding actually was experiencing significant financial problems, (ii) knowing Plaintiff would rely on the statements and (iii) intending to induce Plaintiff into investing in the debentures. The dichotomy between the positive statements allegedly made by Defendant Swank and the alleged financial difficulties facing Statewide Holding raises a strong inference that his statements were made with the intent to deceive, manipulate or defraud. Similarly, the facts alleged indicate that the statements were not made in good faith or with a reasonable basis. Accordingly, Plaintiffs Complaint meets the pleading requirements of the PSLRA.

B. Omissions

Plaintiff alleges that Defendant Swank failed to disclose each of the following facts: (1) the debentures were securities that were unregistered with the Securities and Exchange Commission; (2) the changed and adverse financial condition of Statewide Holding; (3) Statewide Holding's only asset was Statewide Insurance Company because the other businesses that had been held by Statewide Holding, including Waukegan [*17] Insurance Agency and Statewide Finance Co., had ceased business operations; and (4) other material financial information about Statewide Holding or Statewide Insurance Company or the other businesses held as assets of Statewide. At this point, Defendant Swank does not contest that these facts are material. Defendant Swank instead challenges his duty to disclose the facts to Plaintiff. *See Stransky, 51 F.3d at 1331* ("Mere silence about even material information is not fraudulent absent a duty to speak"). A duty to speak can arise in several instances, two of which Plaintiff argues here. First, when omission of the material facts renders an existing statement misleading and, second, when a relationship of trust and confidence exists between the parties. *See 17 C.F.R. § 240.10b-5* (making it unlawful" 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"); *Chiarella v. United States, 445 U.S. 222, 228, 100 S. Ct. 1108, 63 L. Ed. 2d 348 (1980)* (finding a duty to disclose arising from a relationship of trust and confidence between parties to a transaction).

A duty to disclose known [*18] material facts arises when their omission makes some existing statement misleading. *See 17 C.F.R. § 240.10b-5*; *Selbst v. McDonald's Corp., 432 F. Supp. 2d 777, 2006 U.S. Dist. LEXIS 33623, 11, 2006 WL 1371475, *4 (N.D. Ill. 2006)* ("[A] speaker is liable if the statement contains an omission of a known material fact which makes the affirmative statement misleading or false); *Stransky, 51 F.3d 1329* ("If one speaks, he must speak the whole truth"). Judge Moran explained well exactly when this duty of disclosure arises:

> Whether a fact is material and whether a statement omitting it is misleading are closely intertwined. The more important a fact would be to investors, the more likely its omission will mislead them. Consequently, materiality is more like a continuum than a simple yes or no, material or immaterial. On one extreme, some facts are so important they independently demand disclosure. Silence on the issue is itself misleading. On the other extreme are direct misstatements. Because investors rely on them, inaccurately reporting even the most marginally material facts will likely mislead. This case, alleging that existing statements triggered the duty to disclose [*19] additional information, rests between these poles. Discussing an issue, while withholding specific facts, can mislead. Merely mentioning a topic, however, does not require the company to disclose every tangentially related fact that might interest investors, only those that are sufficiently important. If omitting the fact would make the statement so incomplete as to be misleading, the company must disclose it. But omitting smaller details, even if investors might care about them, is not necessarily misleading.

Anderson v. Abbott Laboratories, 140 F. Supp. 2d 894, 903 (N.D. Ill. 2001). Given the apparent significance of the facts allegedly omitted, Defendant Swank's omissions regarding the financial condition of Statewide Holding may have rendered his statements regarding the company

misleading. Plaintiff also has pleaded that a relationship of trust and confidence existed between himself and Defendant Swank based on their business relationship and their conversations regarding the debenture sales. *See Dirks v. SEC, 463 U.S. 646, 653-54, 103 S. Ct. 3255, 77 L. Ed. 2d 911 (1983)* (stating that a duty to disclose may arise from prior dealings or circumstances that lead one party [*20] to place trust and confidence in the other). Because Plaintiff has pleaded a duty for Defendant Swank to disclose the omitted facts, Plaintiff's fraudulent omission claims against him survive the motion to dismiss.

C. Duty to Update / Duty to Correct

Plaintiff constantly alleges that Defendant Swank was required to correct his inaccurate statements and supplement the information regarding Statewide Holding given to Plaintiff. A duty to correct "applies when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not." *Stransky, 51 F.3d at 1331*. Plaintiff has not alleged that the company made any historical statements that the company believed to be true, but were later revealed to be untrue. A duty to update "arises when a company makes a forward-looking statement -- a projection -- that because of subsequent events becomes untrue." *Id. at 1332*. The Seventh Circuit refused to impose a duty to update on companies. *Id. at 1333*. Instead, liability exists only where the statements were not made in good faith and with [*21] a reasonable basis. *See Grassi v. Information Resources, Inc., 63 F.3d 596, 599 (7th Cir. 1995)*. Accordingly, Plaintiff may pursue his claims that Defendant Swank made misrepresentations or omissions of material fact not in good faith or without a reasonable basis, but no liability arises specifically from a failure to correct or update financial information provided to Plaintiff.

II. Defendants Michael C. Deininger and Roger J. Swarat

Defendants Michael C. Deininger and Roger J. Swarat are both alleged to have been officers of Statewide Holding and Statewide Insurance during the relevant time period. Unlike Defendant Swank, Plaintiff does not allege that either Defendant Deininger or Defendant Swarat made any misrepresentations to Plaintiff. Instead, Plaintiff argues that because they knew that Defendant Swank had made certain misrepresentations to Plaintiff, they had a duty to correct his misrepresentations or disclose the omitted material information regarding the company's finances. Plaintiff additionally argues that a duty of disclosure arose from the relationship of trust and confidence between them and Plaintiff.

Despite a specific request from [*22] this Court, Plaintiff provided no law or persuasive argument that Defendants Deininger and Swarat had a duty to disclose any information regarding Statewide Holding to Plaintiff. Plaintiff cites cases that impute the knowledge of the company's failing finances to Defendants Deininger and Swarat, but in each of these cases the knowledge was relevant only in determining whether defendants actually knew that the statements they made were misleading. *See Davis, 385 F. Supp. 2d at 713*; *Asher v. Baxter International, Inc., 2005 U.S. Dist. LEXIS 2131, 2005 WL 331572, *1-2 (N.D. Ill. 2005)*; *Danis v. USN Communications, 73 F. Supp. 2d 923, 938-39 (N.D. Ill. 1989)*. Defendants Deininger and Swarat are not alleged to have made any statements to Plaintiff.

Beyond the cases cited by Plaintiff, it is true that "even absent any misleading statements, an independent duty to disclose material facts may be triggered by a fiduciary-type relationship." *Schlifke, 866 F.2d 935, 944*. Such a fiduciary duty does not arise, however, solely from Defendants Deininger's and Swarat's role in controlling the operations of the company. Generally speaking, "a corporation and its [*23] shareholders do not have the kind of fiduciary relationship which requires total disclosure,"*Blanchard v. Edgemark Financial Corporation, 2001 U.S. Dist. LEXIS 3090, 2001 WL 587861, *4 (N.D. Ill. 2001)*, and "parties to an impersonal market transaction owe no duty of disclosure absent a fiduciary or agency relationship, prior dealings or circumstances such that one party has placed trust and confidence in the other." *Schlifke, 866 F.2d at 945*. Aside from Plaintiff's bare legal conclusion that he trusted Defendants generally, Plaintiff has not pleaded any facts supporting a reasonable inference that a relationship of trust and confidence existed between himself and Defendants Deininger and Swarat. The only detail that Plaintiff provides regarding his relationship with Defendants Deininger and Swarat is that Defendant Swarat signed the debentures and caused them to be issued to Plaintiff. But Defendant Swarat's act of signing and issuing the debentures is not enough to invoke a duty of disclosure. *See Schlifke at 946* (rejecting fiduciary duty where Bank had no direct dealings with investors but merely drafted loan documents). Having not pleaded any facts that would support a [*24] duty of disclosure from either Defendant Deininger or Defendant Swarat, Plaintiff's claims against them fail to state a claim.

Conclusion and Order

Plaintiff has pleaded facts identifying the misleading statements and giving rise to a strong inference that Defendant Swank acted with the required state of mind. Based on the same facts, it cannot be said that there is no set of facts under which Plaintiff would be entitled to

relief against Defendant Swank. Plaintiff, however, has not pleaded facts showing that either Defendant Deininger or Defendant Swarat owed him a duty to disclose the allegedly omitted material facts. Wherefore, Defendant Swank's Motion to Dismiss is denied and Defendants Deininger's and Swarat's Motions to Dismiss are granted. Defendant Swank is ordered to answer the Complaint within 14 days.

So ordered.

Virginia M. Kendall, United States District Judge

Northern District of Illinois

Date: June 28, 2006

TAB 8

Only the Westlaw citation is currently available.

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

KEMPER/PRIME INDUSTRIAL PARTNERS, Plaintiff,
v.
MONTGOMERY WATSON AMERICAS, INC., Defendant.

No. 97 C 4278.

March 31, 2004.

Michael Nicholas Ripani, Julie Ann Doyle, Chuhak & Tecson, Daniel J. Biederman, Grotefeld & Denenberg, L.L.C., Chicago, IL, for plaintiff.
Daniel Charles Murray, Frederick S. Mueller, Johnson & Bell, Ltd., Chicago, IL, for defendant.

MEMORANDUM OPINION AND ORDER

GUZMAN, J.

***1** In its September 23, 2003 Memorandum Opinion and Order denying Defendant Montgomery Watson Americas, Inc.'s First and Second Motions in Limine, this Court expressed serious doubts about the ability of Plaintiff Kemper/Prime Industrial Partners to provide evidence of damages, without which the Court would not submit the issue to the trier of fact. In response, Plaintiff filed a Memorandum Of Evidence On Damages That It Will Present At Trial ("Pl.'s Mem."), and Defendant filed a responsive brief. For the reasons that follow, the Court finds that Plaintiff cannot offer proof of all necessary parameters of the damages calculation, and Plaintiff is barred from presenting evidence of damages at trial. The case is therefore dismissed with prejudice.

BACKGROUND

The Court presumes familiarity with the underlying facts and lengthy procedural history of this case. In brief, at Plaintiff's request, Defendant's predecessor performed a series of investigations and issued several preliminary and final reports (collectively the "1990 Report") about the nature and extent of the environmental contamination of a piece of industrial property (the "Property") that Plaintiff sought to purchase. After the 1990 Report was issued, Plaintiff did purchase the Property and now sues Defendant for negligent misrepresentation due to its alleged failure to report the entire cost of remediating the contamination.

On September 23, 2003, this Court entered a Memorandum Opinion and Order ("9/23/03 Order") in which it denied Defendant's First Motion in Limine to bar all evidence of Plaintiff's cost of remediation and Defendant's Second Motion in Limine seeking to bar the testimony of Plaintiff's damages expert. Defendant's First Motion in Limine essentially argued that the proper measure of damages in this case is the diminution in value of the land and that Plaintiff had no damages under this formulation. In the 9/23/03 Order, the Court agreed with Plaintiff that the proper measure of damages in this case was instead based on Section 552B of the *Restatement of Torts (2d),* which describes "Damages for Negligent Misrepresentation."

The Court concluded that under the *Restatement* formulation, "plaintiff is entitled to recover only the extra cost of remediation incurred as a result of cleaning up that pollution which the defendant negligently failed to include in its report to the plaintiff."[FN1](9/23/03 Order at 3.) Thus, to calculate its damages, Plaintiff must offer evidence of (1) the cost of remediating the contamination listed in the 1990 Report, and (2) the total cost of remediating the contamination that existed on the Property at the time of the 1990 Report. If Defendant were liable for negligent misrepresentation, the second figure should be greater than the first, and the difference would represent Plaintiff's damages.

FN1. The Court held that Plaintiff would also be entitled to the difference in the value of the land received and the purchase price paid for it. (9/23/03 Order at 3.) However, Plaintiff apparently does not claim these damages, nor has it attempted to calculate them if they exist.

While the Court agreed with Plaintiff's assertion of the appropriate measure of damages, it did not agree that the proper measure of damages was the full cost

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

of remediating the property to a Tier One level, which was estimated by Plaintiff's expert Laszewski to be between $24 million and $31 million, less a remediation estimate given by Defendant of $300,000. Based on its knowledge of Plaintiff's evidence at the time of the 9/23/03 Order, the Court expressed its concern that Plaintiff did not have sufficient evidence of both parameters of damages that would allow Plaintiff's actual damages to be calculated to any reasonable degree of certainty. (9/23/03 Order at 4-5, 10.) Specifically, the Court questioned whether Plaintiff could present evidence of the cost of remediating the contamination disclosed in the 1990 Report. (*Id.* at 5.) The Court noted that Plaintiff had offered no expert opinion as to this calculation, "and it is clearly too late to do so now."(*Id.*) The Court strongly emphasized that without such evidence, the issue of damages could not be presented to a jury. (*Id.* at 5, 10.)The Court then allowed Plaintiff to submit a memorandum describing the specific evidence on damages it intended to present at trial in order to address the issues raised in the 9/23/03 Order, and Defendant filed a response to Plaintiff's memorandum.

***2** After reviewing the parties' submissions, the Court concludes that its previous concerns have not been adequately addressed by Plaintiff, which offers no evidence by which a factfinder could reasonably calculate damages to any degree of certainty, or indeed that Plaintiff suffered damages at all.

DISCUSSION

Plaintiff "has the burden of proving damages to a reasonable degree of certainty." Telemark Dev't Group, Inc. v. Mengelt, 313 F.3d 972, 983 (7th Cir.2002); *see also* Schiller & Schmidt, Inc. v. Nordisco Corp., 969 F.2d 410, 415 (7th Cir.1992) ("For years we have been saying, without much visible effect, that people who want damages have to prove them...."). An award of damages cannot be based on conjecture or speculation. Telemark, 313 F.3d at 983.

1. *Remediation Costs in 1990 Report*

One necessary parameter of Plaintiff's damages is the cost of remediating the contamination that was described in the 1990 Report. That figure must be deducted from the actual cost of remediating the Property as it existed in 1990 in order to calculate Plaintiff's damages. "Clearly, some remediation would have been necessary even if the pollution were no more than what was described in defendant's allegedly negligent 1990 report. Only the difference between that cost and the full remediation cost plaintiff now claims is properly recoverable."(9/23/03 Order at 4.)

Plaintiff argues that the only remediation cost reflected in the 1990 Report is a remediation estimate of approximately $300,000 that Defendant gave Plaintiff in May 1990. (Pl.'s Mem. at 5.) Plaintiff refers to a three-page letter from Defendant dated May 31, 1990 summarizing a meeting between the parties in which they discussed "[a]reas of concern and additional investigation techniques."(Pl.'s Ex. J, at M62.) The letter estimates $300,000 to remediate a zone within the Property that was identified as "[t]he major area of concern."(Pl.'s Ex. J, at M64.) Plaintiff identifies no remediation cost estimates in either of Defendant's comprehensive reports issued in June 1990, the Environmental Assessment Report (Pl .'s Ex. M) and the Subsurface Investigation Report (Pl.'s Ex. N), and Plaintiff in fact avers that "none of Defendant's reports quantified the potential liabilities or remediation costs for the Property."(Pl.'s Mem. at 5.)

Plaintiff argues that "Defendant failed to quantify the contamination for locations where it found contamination as well as, obviously, for locations where it completely missed contamination."(*Id.* at 6.) Therefore, according to Plaintiff, the only remediation cost included in the 1990 Report was the $300,000 estimate listed in the May 31, 1990 letter. Plaintiff states that Jim Martell, The Prime Group, Inc.'s Senior Vice President and the person who retained Defendant's services, "reasonably believed that there were no remediation costs associated with the contamination on the Property other than the [$300,000] estimate...."(*Id.* at 8 .) On its face, however, the estimate relates to only a certain portion of the identified contamination.[FN2]A jury could reasonably find that Defendant's June 1990 reports, which comprise over fifty pages, not including attachments, and describe numerous areas of contamination in addition to the "major area of concern" discussed in the May 31, 1990 letter, sufficiently disclosed the need for remediation costs above and beyond the $300,000 figure, even if those costs were not expressly quantified. But a jury that did so find would be wholly unable to de-

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

termine the value of those additional reported remediation costs given the evidence Plaintiff will present at trial.

> FN2. Notably, Gary Vajda, Plaintiff's liability expert, also states that the $300,000 cost estimate addressed "only" certain areas of concern. (Pl.'s Ex. AA at 18.)

***3** Although Plaintiff does not waver from its contention that this parameter is capped at $300,000, Plaintiff also submits the report of its liability expert, Gary Vajda, who opined that the maximum potential liability that Defendant should have reported to Plaintiff, based on Defendant's work product, was $6,600,000. (Pl.'s Ex. AA at 19.) Arguably, this figure could be used to represent the cost of remediating all the contamination disclosed in the 1990 Report. Defendant responds first that under this district's Local Rules, only one expert may testify on each subject unless there is good cause shown, and Plaintiff already has a damages expert. The Court need not reach the issue of whether Vajda's testimony would be allowed under the Local Rules, however, because the Court agrees with Defendant's second argument, that Vajda's opinion on the maximum potential liability was purely speculative. Vajda testified that the liability values were a "guesstimate" (Def.'s Ex. 13, Vajda Dep. at 455:14, 456:12, 456:16), that he did not know what cleanup standard was used in calculating the values (*id.* at 453:8-10, 476:7-8), and that "it's not meant to be to that degree of accuracy"(*id.* at 453:9-10). Vajda's calculation is admittedly based on conjecture and speculation and cannot form the basis of a damage award. *See* Telemark, 313 F.3d at 983; SK Hand Tool Corp. v. Dresser Indus., Inc., 284 Ill.App.3d 417, 219 Ill.Dec. 833, 672 N.E.2d 341, 348 (Ill.App.Ct.1996). Plaintiff therefore has not offered any evidence from which a trier of fact could determine the first parameter of the damages calculation to any reasonable degree of certainty.

2. *Full Cost of Remediation in 1990*

To prove the second parameter of the damages calculation, the actual cost of remediating the Property as it stood in 1990, Plaintiff offers the testimony of its expert, Steve Laszewski, who would testify to the following:

Laszewski calculated the cost to remediate the Property to a Tier One standard. He will testify about his background and experience to perform such a calculation, the information upon which he relied to calculate that cost, the methodology employed to calculate that cost and that the cost to remeidate [sic] the contamination on the Property is $24-31 million.

(Pl.'s Mem. at 11.)

Plaintiff's evidence of the total cost of remediation in 1990 is fatally flawed for a number of reasons. First, it is not disputed that a certain amount of contamination to the Property, which is zoned for industrial use, occurred after Defendant's 1990 Report, and in fact Plaintiff has sued a tenant for lead contamination that allegedly occurred after 1990. Clearly Defendant would not be liable for failing to report contamination that did not exist in 1990. However, Plaintiff's damages expert makes no attempt to quantify or distinguish the contamination that existed in 1990 from subsequent contamination. Therefore, a jury could not possibly determine from Plaintiff's evidence the cost of remediating the property as it existed in 1990. Plaintiff's failure to offer any evidence in discovery of the measure of later contamination is particularly troubling given that a certain amount of that contamination is the subject of pending litigation, and Plaintiff should have ready access to the value of at least that contamination.

***4** Second, Plaintiff's expert offers only an estimate of remediating the Property to a Tier One level, a high degree of remediation. A jury, however, could find that damages for Tier One remediation may not be appropriate for the Property, which has been put to industrial use for over a hundred years and will continue that use for the foreseeable future. Plaintiff's proffered evidence, however, gives no guidance whatsoever for calculating the cost of a lesser standard of remediation. For reasons known only to Plaintiff, it asked Laszewski to prepare a report based only on a Tier One calculation, not Tier Two or Tier Three. (Def.'s Ex. 12 at 51-52.)

Morever, even if this Court were to assume that Tier One is the proper standard of remediation, Plaintiff's evidence would still not be sufficient to prove its damages. The Tier One remediation figure would only be useful if the other relevant calculations were expressed in Tier One terms as well. The cost of remediating the contamination listed in the 1990 Re-

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

port and the post-1990 contamination would have to be calculated to a Tier One level so that accurate deductions could be made. But Plaintiff has presented no evidence that would allow a trier of fact to make a Tier One to Tier One comparison.

Finally, Plaintiff goes to great lengths to explain that it may be liable for clean-up costs associated with portions of the Property now owned by subsequent purchasers, whose claims the Court previously dismissed with prejudice because Defendant owed them no duty. Plaintiff has offered no case law that would allow it to recover damages for mere potential liability to third parties. And not surprisingly, Plaintiff's expert did not allocate the costs of remediation between the parcels of the Property owned by Plaintiff and those sold to subsequent owners. Therefore, if a factfinder were to disagree with Plaintiff's theory, it could not determine the proper measure of damages for Plaintiff's share of the Property alone. In any event, the Court need not reach the issue of whether Plaintiff actually is liable to pay for remediation of parcels sold to others because Plaintiff has not offered evidence of damages under its own theory that it is liable for the cost of remediating the whole Property.

3. *Discovery Sanctions*

Federal Rule of Civil Procedure ("Rule") 26(a)(1)C) requires the disclosure, without awaiting a discovery request, of "a computation of any category of damages claimed by the disclosing party, making available for inspection and copying ... the documents or other evidentiary material ... on which such computation is based, including materials bearing on the nature and extent of injuries suffered."

Rule 37(c) provides that "[a] party that without substantial justification fails to disclose information required by Rule 26(a) ... is not, unless such failure is harmless, permitted to use as evidence at a trial, at a hearing, or on a motion any witness or information not so disclosed. In addition to or in lieu of this sanction, the court, on motion and after affording an opportunity to be heard, may impose other appropriate sanctions."Other appropriate sanctions include those authorized by Rule 37(b)(2)(B), which provides that a court may "refus[e] to allow the disobedient party to support or oppose designated claims or defenses, or prohibit[ ] that party from introducing designated matters in evidence," and Rule 37(b)(2)(C), which authorizes a court to dismiss the action.

***5** As discussed above, the Court finds that Plaintiff has failed to produce any evidence in discovery that would allow a trier of fact to determine the existence or extent of its damages. Plaintiff is therefore barred from presenting evidence of its damages at trial pursuant to Rule 37(b)(2)(B).*See* *G.D. Searle & Co. v. Philips-Miller & Assocs., Inc.,* No. 92 C 3377, 1994 WL 274943, at *2 (N.D.Ill. June 16, 1994). The Court has considered at length whether a lesser penalty would suffice in this case. However, it is clear that no other sanction would avoid the clear prejudice to Defendant caused by Plaintiff's utter failure of proof.[FN3]

> FN3. The Court also notes that Plaintiff's evidence of damages likely would not be admissible at trial because the probative value of that evidence is unquestionably "outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury...."Fed.R.Evid. 403.

Obviously, Plaintiff was interested in presenting the best possible damages claim, and to that end, it produced only evidence that maximized the parameter of total remediation costs and minimized the parameter of remediation costs disclosed in the 1990 Report. The problem with Plaintiff's strategy is that the proffered evidence would not allow a trier of fact to determine the issue of damages even if Plaintiff were successful in proving every other element of its claim. Plaintiff could not have been surprised by the standard of damages in this case, given that the Court agreed with Plaintiff that the *Restatement* applies, but it did not present evidence relevant to that standard. Plaintiff knew that subsequent contamination occurred on the Property, and indeed is probably aware of the value of at least a portion of that contamination, yet it failed to offer evidence in discovery of that value. Plaintiff could have asked its expert to calculate cost of remediation to a standard other than Tier One, or to assess the other damages parameters in Tier One terms, or to determine the total cost of remediating all of the contamination disclosed in the 1990 Reports, but it strategically chose not to do so.

Plaintiff has the burden to prove damages, a necessary element of its claim of negligent misrepresenta-

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

tion. *See* *Bd. of Educ. of City of Chicago v. A, C & S, Inc.,* 131 Ill.2d 428, 137 Ill.Dec. 635, 546 N.E.2d 580, 591 (Ill.1989). Because Plaintiff cannot offer any evidence of damages at trial, its claim must be dismissed with prejudice. *See* *G.D. Searle,* 1994 WL 274943, at *2; *Kapco Mfg. Co. v. C & O Enters., Inc.,* No. 84 C 10129, 1986 WL 13753, at *19 (N.D.Ill.Dec.1, 1986).

CONCLUSION

For the foregoing reasons, Plaintiff is barred from presenting evidence on the issue of damages, and this case is dismissed with prejudice. All other pending motions are dismissed as moot. This is a final and appealable order.

SO ORDERED.

N.D.Ill.,2004.
Kemper/Prime Indus. Partners v. Montgomery Watson Americas, Inc.
Not Reported in F.Supp.2d, 2004 WL 725223 (N.D.Ill.)

END OF DOCUMENT

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

TAB 9

LEXSEE 2004 U.S. DIST. LEXIS 4659

LAWRENCE E. JAFFE PENSION PLAN, on Behalf of Itself and All Others Similarly Situated, Plaintiff, v. HOUSEHOLD INTERNATIONAL, INC., MERRILL LYNCH, PIERCE, FENNER, & SMITH, INC., GOLDMAN SACHS & CO., INC., ARTHUR ANDERSEN, L.L.P., WILLIAM F. ALDINGER, DAVID A. SCHOENHOLZ, GARY GILMER, J.A. VOZAR, ROBERT J. DARNALL, GARY G. DILLON, JOHN A. EDWARDSON, MARY JOHNSTON EVANS, J. DUDLEY FISHBURN, CYRUS F. FREIDHEIM, LOUIS E. LEVY, GEORGE A. LORCH, JOHN D. NICHOLS, JAMES B. PITBLADO, S. JAY STEWART, and LOUIS W. SULLIVAN, Defendants.

02 C 5893 (Consolidated)

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

2004 U.S. Dist. LEXIS 4659*; *Fed. Sec. L. Rep. (CCH) P92,713

March 19, 2004, Decided
March 22, 2004, Docketed

SUBSEQUENT HISTORY: Motion granted by, in part, Motion denied by, in part *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 2004 U.S. Dist. LEXIS 18993 (N.D. Ill., Sept. 20, 2004)*

PRIOR HISTORY: *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc., 2003 U.S. Dist. LEXIS 7466 (N.D. Ill., May 2, 2003)*

DISPOSITION: [*1] Defendants' motions to dismiss ruled upon. Defendant Andersen's motion to strike denied.

COUNSEL: For THE GLICKENHAUS GROUP, LAWRENCE E JAFFE, Pension Plan, on behalf of itself and all others similary situated, plaintiff: Patrick J. Coughlin, Esq., Azra Z. Mehdi, Esq., Luke O. Brooks, Esq., Milberg Weiss Bershad Hynes & Lerach, LLP, San Francisco, CA. Marvin Miller, Esq., Miller Faucher and Cafferty, LLP, Chicago, IL. Frederic S Fox, Kaplan, Kilsheimer & Fox LLP, New York, NY. Gary L. Specks, Kaplan, Fox & Kilsheimer LLP, Chicago, IL.

For HOUSEHOLD INTERNATIONAL INC., W F ALDINGER, defendants: Warren Roger Stern, Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen & Katz, New York, HY. Nathan P. Eimer, Adam B. Deutsch, Eimer Stahl Klevorn & Solberg, LLP, Chicago, IL.

For ARTHUR ANDERSEN, L.L.P., defendant: Sheila Marie Finnegan, Lucia Nale, Stanley J. Parzen, Debra L Bogo-Ernst, Susan Charles, Mayer, Brown, Rowe & Maw LLP, Chicago, IL. Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen [*2] & Katz, New York, HY. Marshall J. Hartman, Illinois Capital Resource, Chicago, IL. Eric S. Palles, Attorney, Chicago, IL. Gary Jay Ravitz, Ravitz & Palles, P.C., Chicago, IL.

For D A SCHOENHOLD, defendant: Paul Vizcarrondo, Jr, Wachtell, Lipton, Rosen & Katz, New York, HY. Nathan P. Eimer, Adam B. Deutsch, Eimer Stahl Klevorn & Solberg, LLP, Chicago, IL.

JUDGES: HON. RONALD A. GUZMAN, United States Judge.

OPINION BY: RONALD A. GUZMAN

OPINION

MEMORANDUM OPINION AND ORDER

Plaintiff Lawrence E. Jaffe Pension Plan, on behalf of itself and all others similarly situated, brought this suit alleging violations of *15 U.S.C. § 78(j)(b)* ("*§ 10(b)*" of the *Exchange Act of 1934* ("1934 Act")) and *17 C.F.R. § 240.10b-5* ("*Rule 10b-5*") against Household, Household Officers, identified as Aldinger, Schoenholz, and Gilmer, and Arthur Andersen ("Andersen") in Count I; violation of *15 U.S.C. § 78(t)(a)* ("*§ 20(a)*" of the 1934 Act) by Household, and Household Officers in Count II; violations of *15 U.S.C. §§ 77k*,*77l(a)(2)*, and*77o* ("*§§ 11, 12(a)(2), and 15*" of the Securities Act of 1933 ("1933 Act")) by Household, [*3] Household Officers, Household Directors, Andersen, Goldman Sachs & Co., Inc. ("Goldman Sachs"), and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") in Count III, and violations of *15 U.S.C. §§ 77k*,*77o* ("*§§ 11, 15*" of the 1933 Act) by Household, Household Directors and Andersen in Count IV. Glickenhaus & Co. has been named lead plaintiff in this case, which is a consolidation of a number of cases.

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

FACTS

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

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

During the Class Period, Household reported continuous and dramatic growth in income and net earnings. On the basis of quarterly earning statements, meetings, conference calls with analysts and other publication of data, stock analysts from a variety of respected firms issued "buy" reports with respect to Household offerings. Also during this period, Household filed a [*5] number of required forms and statements with the Securities and Exchange Commission ("SEC") with the inclusion of reports from various named directors and officers as well as audit reports generated by Andersen and stock analysis reports by Goldman Sachs and Merrill Lynch. On the basis of these statements and assurances, plaintiff purchased Household securities.

During the Class Period, allegations of predatory lending and improper "reaging" of loans began to surface from a variety of sources. These included allegations in Washington and California that ultimately resulted in the filing of lawsuits during the Class Period. During the Class Period Household entered into a settlement agreement regarding Household's lending practices with the Attorneys General of several states. Also during the Class Period, Washington published the Washington Department of Financial Institutions Expanded Report of Examination of Household Finance Corporation III (April 30, 2002) ("Washington Report"). All of these allegations arose from what plaintiff characterizes as Household's predatory lending practices as outlined in what Household had named the "EZ Pay Plan," wherein Household allegedly loaned [*6] money to high-risk consumers and home owners, employing a variety of tactics intended to boost the fees and costs associated with the loans. In order to assist in the overall management of Household, during this period Household perfected what it called the "Vision System" that the Officer Defendants publicly praised as making company-wide data available to them and allowing them to engage in proactive management of lending practices at all of the branch offices. In addition, plaintiff alleges

Household engaged in "reaging" loans, whereby delinquent loans were reclassified as still current by the addition of the delinquent payments onto the end of the loan term, thereby lengthening the loan term and reducing the appearance of default loans on Household's books.

Although both Household and Andersen argue that Household's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP") and generally accepted accounting standards ("GAAS"), this was not true according to plaintiff. Under these principles, "reaging" of loans in the manner Household used is strongly recommended against because it fails to indicate whether the accounts may ultimately [*7] be collectable. This results in the diminution of the reliability of aging scales and, practically speaking, obscures the risk of delinquency associated with the outstanding loans.

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

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

Officer Defendants [*8] participated directly in the day-to-day operations of Household and were instrumental in the development and execution of the practices and programs plaintiff alleges led to the instant complaint. Each had access to confidential information about the company's business and operations. Each directly and indirectly controlled the conduct of the company's business, the information contained in its filings with the SEC, and public statements about its business and financial results. Officer and Director Defendants were signatories on the Registration Statements that resulted in the issuance of further Household securities. Auditor defendant, Andersen, performed independent audits and provided accounting, management consulting, and tax services for Household during the Class Period. It reviewed financial data used in a variety of SEC filings, *e.g.,* debt registration statements and audit reports included as attachments to various SEC filings. Andersen was intimately involved in Household's confidential corporate financial and business operations. Household Director Defendants were all Household directors during the Class Period. Merrill Lynch and Goldman Sachs both provided stock analysis [*9] services in connection with the merger between Beneficial and Household.

DISCUSSION

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

A *Rule 12(b)(6)* motion to dismiss does not test the merits of the case and merely attacks the sufficiency of the complaint. *Fishman v. Meinen, 2003 U.S. Dist. LEXIS 2527, No. 02 C 3433, 2003 WL 444223, at *4 (N.D. Ill. Feb. 24, 2003)*. A court may only dismiss a complaint for failure to state a claim upon which relief may be granted if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." *Hishon v. King & Spalding, 467 U.S. 69, 73, 81 L. Ed. 2d 59, 104 S. Ct. 2229 (1984)*; *see Ledford v. Sullivan, 105 F.3d 354, 356 (7th Cir. 1997).* [*10] A court must accept all well pleaded allegations of the complaint as true, and must view those allegations in the light most favorable to plaintiff. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *4*. The Court need not accept as true legal conclusions alleged in the complaint, though a plaintiff may plead conclusions if they "provide the defendant with at least minimal notice of the claim." *Jackson v. Marion County, 66 F.3d 151, 154 (7th Cir. 1995)*.

I. Fraud Claims: *Section 10(b)* and *Section 20(a)*

of the 1934 Act and *Rule 10b-5*

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

It is well settled that "*Rule 9(b) [of the Federal Rules of Civil Procedure*] governs claims [*11] based on fraud and made pursuant to the federal securities laws." *Sears v. Likens, 912 F.2d 889, 893 (7th Cir. 1990)* (alteration in original, quotations omitted). "Circumstances constituting fraud ... shall be stated with particularity," which has been interpreted as requiring inclusion of "'the identity of the person making the misrepresentation, the time, place, and content of the misrepresentation, and the method by which the misrepresentation was communicated to the plaintiff'" in fraud allegations. *Fed. R. Civ. P. 9(b)*; *Uni*Quality, Inc. v. Infotronx, Inc., 974 F.2d 918, 923 (7th Cir. 1992)* (quoting *Bankers Tr. Co. v. Old Republic Ins. Co., 959 F.2d 677, 683 (7th Cir. 1992))*. In essence, the complaint must specify the "who, what, when, where, and how" of the allegedly fraudulent acts. *DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990)*. The purpose of this "is to force the plaintiff to do more than the usual investigation before filing his complaint." *Ackerman v. Northwestern Mut. Life Ins. Co., 172 F.3d 467, 469 (7th Cir. 1999)*. The rule serves to [*12] (1) protect defendants' reputations from harm, (2) minimize 'strike suits' and 'fishing expeditions', and (3) provide notice of claims to adverse parties. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *5* (citing *Vicom, Inc. v. Harbridge Merch. Servs., Inc., 20 F.3d 771, 777 (7th Cir. 1994))*.

In addition, a complaint of securities fraud under the 1934 Act is subject to the PSLRA. *15 U.S.C. § 78u-4(a)(1)*. Under the PSLRA, a plaintiff must allege a defendant "made an untrue statement of a material fact" or "omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading." *15 U.S.C. § 78u-4(b)(1)*. In either case, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* Further, plaintiff must "state with particularity facts giving rise to a strong inference that the defendant [*13] acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2)*. If these requirements are not met, the Court shall dismiss the complaint. *15 U.S.C. § 78u-4(b)(3)*.

Together, the overlapping pleading requirements of *Rule 9(b)* and the PSLRA make it clear that a plaintiff must aver which defendants said what, to whom, and when. *Ackerman, 172 F.3d at 471*; *Fishman, 2003 U.S. Dist. LEXIS2527, 2003 WL 444223, at *5*; *see also Sears, 912 F.2d at 893*. "Where a plaintiff alleges that a group of individuals is part of a fraudulent scheme, he or she must put each defendant on notice of his or her alleged role." *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *5*; *see Vicom, 20 F.3d at 777-78*. In addition, a plaintiff must show a "strong inference" of scienter, whether through a showing of "motive and opportunity to commit fraud" or through a showing of "conscious misbehavior or recklessness." *Johnson v. Tellabs, Inc., 303 F. Supp. 2d 941, 2004 U.S. Dist. LEXIS 2617, No. 02 C 4356, 2004 WL 324752, at *18 (N.D. Ill. Feb. 19, 2004)*.

A. *§ 10(b)* and *Rule 10b-5*

In pertinent part *Section 10(b)* and *Rule 10b-5* provide that it is unlawful [*14] for any person in connection with a securities sale or purchase "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." *17 C.F.R. § 240.10b-5(b), (c)*; *see 15 U.S.C. § 78j(b)*.

To state a claim for a violation under *Section 10(b)* or *Rule 10b-5*, a plaintiff must allege that (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages. *Otto v. Variable Annuity Life Ins. Co., 134 F.3d 841, 851 (7th Cir. 1998)*; *Caremark, Inc. v. Coram Healthcare Corp.,*

113 F.3d 645, 648 (7th Cir. 1997). Plaintiff must establish that defendants had a duty to disclose [*15] the omitted information. *Basic Inc. v. Levinson, 485 U.S. 224, 239, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988)*.

1. Alleged false and misleading statements

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

a. Household

Throughout the Class Period Household published quarterly financial data, usually accompanied by statements from one or more directors. (Am. Compl. at PP192, 214, 218, 230, 233, 237, 243, 252, 258, 263, 272, 285, 289, 298, 311, 333.) These statements included net income and earnings per share information, giving both dollar amounts and various comparative statistics with respect to earlier quarters. In each case, the income and earnings per share information increased by double digit percentages over earlier quarters. Plaintiff contends these quarterly statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the [*16] inclusion in the statements of what it alleges were the knowingly inaccurate financial representations, as well as its assertion that Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at PP126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) Plaintiff contends the result of these quarterly releases was the republication of the Household data in a variety of respected analyst reports accompanied by "buy" recommendations and immediately subsequent share price rises based on both Household's and the analysts' reports. (*Id.* at PP193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

Further, Household filed Form 10-K SEC filings signed by Aldinger, Schoenholz and Director Defendants that asserted Household was in compliance with SEC Regulations S-X and S-K. (*Id.* at PP200, 225, 246-48, 277, 313.) This was supported by Andersen's audit opinion of the data incorporated by reference in the filing. (*Id.* at PP202, 227, 249, 279, 316.) In the audit opinions Andersen asserted "that it had audited Household's financial statements and Schedule [*17] 14(d) for [the respective years] in accordance with GAAS and opined that it 'fairly states in all material respects the financial data required to be set forth therein in relation to the basic financial statements taken as a whole.'" (*Id.*) The March 28, 2000 filing contained assertions related to how Household had increased in various indices of operating net income. (*Id.* at P246.) It also stated that risk-based pricing and effective collection efforts for its loans resulted in effective management of credit losses. (*Id.* at P247.) Household also stated that it had shifted its credit card receivables to its subsidiary HFC, according to plaintiff, for the purpose of avoiding newly enacted federal banking regulations that significantly altered reporting requirements. (*Id.* at P250.) The March 28, 2001 filing stated that Household "continue[s] using risk-based pricing and effective collection efforts for each loan. We have a process that gives us a reasonable basis for predicting the asset quality of new accounts." (*Id.* at P278.) The March 13, 2002 filing reiterated this language. (*Id.* at P315.) It additionally stated in the "Management Report" signed by Aldinger [*18] and Schoenholz that "the company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards." (*Id.* at P314.) Plaintiff contends Household through the agency of its officers, directors and auditor based these filings on knowingly false and misleading financial data. (*Id.* at PP126, 142, 196, 217, 242, 271, 302, 308, 332, 342.) As a result of the successful filings, Household was able to maintain what plaintiff contends was its false financial position which misled analysts and investors. (*Id.* at PP200, 225, 246-48, 277, 313.)

b. Aldinger

In addition to Aldinger's signatures on the above-mentioned SEC filings, plaintiff alleges Aldinger repeatedly made materially misleading statements during the Class Period. Many of these statements were included in Household's quarterly releases of its financial results. (*Id.* at PP192, 197, 209, 214, 218, 229, 233.) Aldinger repeatedly made statements included in these releases concerning Household's financial status and the alleged means used to reach the published results. These statements included ones such as (1) "wider margins, higher average [*19] managed receivables, and a continued focus on efficiency []more than offset the impact of higher credit losses"; (2) "we grew revenues 18

percent and kept expenses essentially flat. We absorbed increased chargeoffs consistent with industry-wide trends and further strengthened our credit loss reserves. We also improved our return on managed assets. Our return on equity exceeded 18 percent, even though we significantly increased our capital levels"; (3) "our tight focus on our core markets, our conservative capital base and our disciplined approach to funding and liquidity management enabled Household to achieve record earnings for the quarter"; (4) "the company's operating results were solid with 6 percent annualized receivable growth, margin expansion and improving efficiency . . . . reserve coverage remains conservative"; (5) reporting net income increases in excess of 70%, resulting in part from "higher yields on unsecured products and lower funding costs, partially offset by the effect of a shift in mix toward secured products"; and (6) "strong loan growth in our consumer finance business, improved efficiency and higher income from our tax refund loan business" as the underlying [*20] causes for increases. (*Id.* at PP192, 197, 214, 218, 229.)

In response to analyst questions on February 7, 2002 concerning rumors that Household might change its accounting policies, thereby affecting stock value, Aldinger and Schoenholz made various statements indicating that Household would not change its accounting policies. (*Id.* at P320.) These included statements such as "Household has had no problems with its commercial paper funding and the costs of that funding has not increased," "Arthur Andersen has always been aggressive with HI. There are no accounting changes being discussed and there are to be no surprises in the 10K. HI's board of directors has had long conversations about Arthur Andersen and they plan to watch to see if a change has to be made but none is anticipated at this point." (*Id.*)

Plaintiff contends the statements made by Aldinger were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on what it asserts was Aldinger's knowledge of Household's improper business and accounting practices. The result of Aldinger's alleged concealment of Household's true financial state resulted in the re-publication [*21] of the Household data along with Aldinger's statements and paraphrases of Aldinger's statements in a variety of respected analyst reports, causing immediately subsequent share price rises and "buy" recommendations. (*Id.* at PP193, 198, 205, 210, 222, 224, 230, 234, 238, 240, 244, 253, 259, 265, 273, 274, 287, 290, 291, 326, 335.)

c. Schoenholz

In addition to Schoenholz's signatures on the above-mentioned SEC filings, plaintiff alleges Schoenholz authorized, signed and caused to be filed multiple SEC Form 10-Q's. Each filing stated it was prepared in accordance with GAAP procedures and that it included, "in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation." (*Id.* at PP194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.) Plaintiff contends that both statements were untrue and materially misleading statements of Household's financial condition. Plaintiff bases these allegations on the inclusion in the 10-Qs of what it alleges were the knowingly inaccurate financial representations published in Household's quarterly corporate financial reports, as well as its assertion that [*22] Household admitted to violating GAAP through its correction of its financial statements, resulting in part from its "reaging" practices. (*Id.* at PP126, 142-47, 194, 206, 212, 215, 231, 235, 239, 254, 260, 269, 288, 292, 299, 328.)

Schoenholz, in particular, is cited by plaintiff for having made misleading public statements about the restatement resulting from the KPMG audit. (*Id.* at PP146-47.) Plaintiff contends that the financial reports included in the 10Qs materially misrepresented Household's true financial condition because they failed to disclose losses and the ephemeral nature of claimed assets. (*Id.* at PP196, 217, 242, 271, 302, 308, 332, 342.)

d. Gilmer

Plaintiff contends that Gilmer oversaw a sales training manual update project that featured the "EZ Pay Plan." (*Id.* at P96.) The subsequent nationwide distribution of this manual to Household offices and its use as the basis of sales training programs resulted in the nationalization of practices previously confined to the Washington State area. (*Id.* at PP94-96.) Plaintiff alleges the distribution and training authorized by Gilmer directly resulted in company-wide predatory lending practices [*23] and subsequent accounting irregularities, ultimately resulting in the misrepresentation of Household's financial status. (*Id.* at PP26, 102.) Despite the allegedly unethical nature of the "EZ Pay Plan," the Origination News quoted Gilmer as stating that

"unethical lending practices of any type are abhorrent to our company, our employees and most importantly customers." (*Id.* at P280.) Thus, Gilmer reassured the market and contributed to analyst optimism, "buy" recommendations, and increasing share prices.

e. Andersen

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

> We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, [*24] on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

(*Id.* at P174.)

Plaintiff alleges this, and similar statements, are untrue and resulted in false and misleading audit reports of Household's financials. This further resulted in the allegedly false SEC filings noted above. (*Id.* at P176.) Additionally, plaintiff alleges that Andersen "knew its reports would be relied upon by potential investors in Household securities," whether they appeared in the SEC filings or the quarterly Household financial data releases. (*Id.* at P176.)

The Court concludes that each of these statements satisfies *Rule 9(b)* and the PSLRA's requirement for particularly pointing out misleading statements related to securities sales, indicating why it is material, and relating how the statements caused plaintiff's damages. Accordingly, the Court holds that plaintiff has articulated the who, what, when, where, [*25] and how of the fraud with sufficient particularity.

2. Scienter

The only remaining question is whether plaintiff has pleaded sufficiently that defendants Household, Officer Defendants and Andersen acted with the requisite scienter to meet PSLRA standards. While the Seventh Circuit has yet to address precisely how rigorously the PSLRA's pleading standards must be applied to plead the "requisite state of mind," cases in the Northern District of Illinois have generally followed the Second Circuit's pleading standard. Thus, plaintiff must allege facts either (1) showing that the defendant had both motive and opportunity to commit fraud; or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness. *See Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 100 (2d Cir. 2001)*; *see, e.g., In re Hartmarx Secs. Litig., 2002 U.S. Dist. LEXIS 6983, No. 01 C 7832, 2002 WL 653892, at *2 (N.D. Ill. Apr. 19, 2002)* (collecting cases); *Beedie v. Battelle Mem'l Inst., 2002 U.S. Dist. LEXIS 171, No. 01 C 6740, 2002 WL 22012, at *2 (N.D. Ill. Jan. 7, 2002)* (collecting cases).

Officer Defendants Aldinger, Schoenholz and Gilmer contend they did not knowingly [*26] publish inaccurate or misleading statements on behalf of Household. They also contend that plaintiff has failed to "state with particularity facts giving rise to a strong inference" that defendants acted with the required state of mind, or knew of the predatory lending and "reaging" practices or knew that such practices were material. (Mem. Supp. Household's Mot. Dismiss at 18, 23-25.) Further, Officer Defendants argue that the tie between compensation and company performance is insufficient to establish scienter. (*Id.* at 20.)

Defendants are correct that the tie between compensation and company performance without more is not sufficient. *Tricontinental Indus. v. Anixter, 215 F. Supp. 2d 942, 950 (N.D. Ill. 2002)*; *Chu v. Sabratek Corp., 100 F. Supp. 2d 827, 837 (N.D. Ill. 2000)*. However, "it is well established in this Circuit that a party may be excused from *Rule 9(b)*'s requirement of pleading with particularity if the information that he is required to plead rests exclusively within the defendants' control or is otherwise unavailable to him." *In re NeoPharm, Inc. Sec. Litig., 2003 U.S. Dist. LEXIS 1862, No. 02 C 2976, 2003 WL 262369, at *11 (N.D. Ill. Feb. 7, 2003)* [*27] (citing

*In re Newell Rubbermaid Sec. Litig., 2000 U.S. Dist. LEXIS 15190, No. 99 C 6853, 2000 WL 1705279, at *14 (N.D. Ill. Nov. 14, 2000))*. As a result, it is necessary to consider if plaintiff has sufficiently pleaded facts indicating strong circumstantial evidence of defendants' awareness and direction of the allegedly predatory pricing and "reaging" programs.

Officer Defendants Aldinger, Schoenholz and Gilmer are characterized by plaintiff as "hands-on" managers of Household and its subsidiaries, with access to and control over the daily operations of Household, including the programs that resulted in predatory lending and in "reaging" of loans. (*Id.* at P165.) As such the Officer Defendants were in possession of non-public information "based on their review of Household's internal operating data, including information provided to them by Household's Vision system," directly contradicting their public statements on behalf of the company about Household's financial dealings. (*Id.* at PP155-56, 196, 217, 242, 271, 302, 308, 332, 342.) As a result, plaintiff alleges Officer Defendants in their individual capacities and as representatives of Household either knew or were grossly reckless [*28] in not knowing that the public statements and omissions regarding Household's financial status, and business and accounting practices were false or misleading when made. (*Id.*)

Plaintiff asserts the Officer Defendants Aldinger, Schoenholz and Gilmer had motive and opportunity to commit fraud, and further, acted with conscious recklessness. Household's "pay-for-performance" policy tied executive compensation to company performance, both economic and non-economic. (*Id.* at PP157-64.) Targeted earnings per share, targeted return on equity, targeted operating efficiency ratios, targeted reserve to charge-off ratios and targeted equity to managed asset ratios all played a role in determining the officer defendants' compensation. (*Id.* at PP160-62.) Thus, plaintiff assert that "without the boost provided by defendant's improper accounting, Household would likely not have had a single quarter of meeting or exceeding analysts' expectations," nor as a result would Officer Defendants have garnered the bonuses they did. (*Id.* at P163.)

With respect to Andersen, plaintiff asserts it had motive and opportunity to make misrepresentations as well. Plaintiff alleges Andersen partners [*29] "were under enormous pressure" to increase its Household billing. (*Id.* at P177.) In addition to its auditing fees, Andersen sought and gained further extensive, non-auditing consulting service work and fees from Household. (*Id.* at P178.) By involving itself closely in Household's various business ventures, it abrogated its independent status as an auditor, thereby compromising its independence. (*Id.* at P179.) As a result, plaintiff alleges Andersen had a vested interest in going along with Household's allegedly improper accounting practices and supporting Household's misrepresentations and material misstatements. (*Id.* at P177.)

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

B. *§ 20(a)*

Section 20(a) of the 1934 Act imposes liability on anyone "who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder." *15 U.S.C. § 78t(a)* [*30] . It is a predicate offense, requiring a violation of some other section of the 1934 Act in order to be applicable. *Id.* That threshold requirement has been met via the *§ 10(a)* and *Rule 10b-5* allegations. Additionally, *§ 20(a)* does not have a scienter requirement or a heightened pleading standard. Accordingly, liberal pleading requirements apply. *In re Anicom, Inc., 2001 U.S. Dist. LEXIS 6607, No. 00 C 4391, 2001 WL 536066, at *6 (N.D. Ill. May 18, 2001)*; *Chu, 100 F. Supp. 2d at 843*.

"To plead control person liability, the plaintiff[] must adequately allege that each 'control person' participated in or exercised control over the company in general and that he or she possessed the 'power or ability to control [the specific] transactions upon which the primary violation was predicated,' whether or not that power was exercised." *Nanophase Techs. Corp. Secs. Litig., 2000 U.S. Dist. LEXIS 11744, Nos. 98 C 3450, 98 C 7447, 2000 WL 1154631, at *7 (N.D. Ill. Aug. 14, 2000)* (citing *Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992))*. Plaintiff alleges that the Officer Defendants, Aldinger, Schoenholz and Gilmer, exercised "hands on" management, involving [*31] themselves in all aspects of Household's activities. (Am. Compl. at P165.) Further, plaintiff alleges Officer Defendants had

control over the content and issuance of public statements "issued by or on behalf of Household," *e.g.,* quarterly and annual reports, press releases and SEC filings. (*Id.* at P166.) Plaintiff alleges these defendants had the requisite knowledge, the opportunity, and the power to correct any misstatements prior to publication. (*Id.*) This is sufficient for the purposes of a *§ 20(a)* claim. *Chu, 100 F. Supp. 2d at 843*; *Nanophase, 2000 U.S. Dist. LEXIS 11744, 2000 WL 1154631, at *7*. As a result, defendants' motions to dismiss Count II are denied.

II. Strict Liability under the 1933 Act

Plaintiff also seeks relief against Household, Officer Defendants, Director Defendants, Andersen, Goldman Sachs and Merrill Lynch under *§§ 11, 12(a)(2)and 15* of 1933 Act in Counts III, and against Household, Director Defendants and Andersen under *§§ 11and 15* of 1933 Act in Count IV. Defendants contend that plaintiff has failed to state a claim upon which relief can be granted on two grounds. They primarily contend that the statute of limitations has passed. [*32] Even if it has not, they contend the claims lack sufficient particularity, fail to give notice, or otherwise are improperly pleaded.

A. Statute of Limitations

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

In 2002, prior to the original filing of this suit, Congress prospectively lengthened the statute of limitations in federal securities fraud suits from a one-year/three-year arrangement to a two-year/five-year arrangement. *28 U.S.C. § 1658(b)*. As amended in 2002, *28 U.S.C. § 1658* provides:

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

28 U.S.C. § 1658(b) [*33] .

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

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

Fujisawa Pharm. Co., Ltd. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997); *see Law v. Medco Research, Inc., 113 F.3d 781, 786 (7th Cir. 1997)*. The ease of access to evidence that would trigger an appropriate inquiry is an important factor in determining when the statute of limitations begins running. *Fujisawa, 115 F.3d at 1334*. Further, [*34] "there must also be a suspicious circumstance to trigger a duty to exploit the access; an open door is not by itself a reason to enter the room.... *How* suspicious the circumstance need be to set the statute of limitations running ... will depend on how easy it is to obtain the necessary proof by a diligent investigation aimed at confirming or dispelling the suspicion." *Id. at 1335* (emphasis in original).

Defendants make two arguments. First, defendants argue that the lengthened statute of limitations period granted by Sarbanes-Oxley is not applicable, and rather a shorter one-year/three-year statute of limitation applies to *§§ 11, 12(a)and 15* violations because they do not sound in fraud. Second, even if some other alleged wrongdoing occurred, plaintiff's Complaint is untimely as not having been filed the earlier of five years after the occurrence or two years after notice. The Seventh Circuit has stated that, if a "plaintiff pleads facts that show its suit [is]

barred by a statute of limitations, it may plead itself out of court under a *Rule 12(b)(6)* analysis." *See Whirlpool Fin. Corp. v. GN Holdings, Inc., 67 F.3d 605, 608 (7th Cir. 1995)* [*35] (affirming district court's dismissal of federal securities fraud claim on inquiry notice issue). Each of these arguments will be addressed in turn.

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

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

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

15 U.S.C. § 77m.

In response, plaintiff contends that Section 804 of the Sarbanes-Oxley Act governs and that it had until the earlier of five years from the event or two years from the date of notice to bring their action. *28 U.S.C. § 1658(b)*. This raises the question of whether Sarbanes-Oxley applies to *Section 11, 12(a)(2)* [*36] *and 15* claims, which the plaintiff properly asserts require only strict liability or negligence. (Am. Compl. PP136, 147.)

"Interpretation of a statute must begin with the statute's language." *Mallard v. U.S. Dist. Court for So. Dist. of Iowa, 490 U.S. 296, 300, 104 L. Ed. 2d 318, 109 S. Ct. 1814 (1989)*. A court may look beyond "the express language of a statute only where that statutory language is ambiguous or a literal interpretation would lead to an absurd result or thwart the purpose of the overall statutory scheme." *Nauheim v. Interpublic Group of Cos. Inc., 2003 U.S. Dist. LEXIS 6266, No. 02 C 9211, 2003 WL 1888843, at *3 (N.D. Ill. Apr. 16, 2003)*. The language of the statute itself, both in terms of the words used themselves and within the context of the statute, determines whether the meaning is plain or ambiguous. *Robinson v. Shell Oil Co., 519 U.S. 337, 341, 136 L. Ed. 2d 808, 117 S. Ct. 843 (1997)*. A court must endeavor to give effect to the plain language of the statute. *Mallard, 490 U.S. at 300*. Where there is no ambiguity in the statute, there is "'no occasion to look to the legislative history.'" *T.D. v. La Grange Sch. Dist. No. 102, 349 F.3d 469, 482 (7th Cir. 2003)* [*37] (quoting *Neosho R-V Sch. Dist. v. Clark, 315 F.3d 1022, 1032 (8th Cir. 2003))*.

The Sarbanes-Oxley Act provides:

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

28 U.S.C. § 1658(b) (emphasis added).

While *15 U.S.C. § 78c(a)(47)* provides:

> (47) The term "securities laws" means the Securities Act of 1933 (*15 U.S.C. § 77a et seq.*), the Securities Exchange Act of 1934 (*15 U.S.C. § 78a et seq.*), the Sarbanes-Oxley Act of 2002, the Public Utility Holding Company Act of 1935 (*15 U.S.C. § 79a et seq.*), the Trust Indenture Act of 1939 (*15 U.S.C. § 77aaa et seq.*), the Investment [*38] Company Act of 1940 (*15 U.S.C. § 80a-1 et seq.*), the Investment Advisers Act of 1940 (*15 U.S.C. § 80b-1 et seq.*), and the Securities Investor Protection Act of 1970 (*15 U.S.C. § 78aaa et seq.*).

15 U.S.C. § 78c(a)(47).

While it is true that sections of the Securities Act of 1933 fall under Sarbanes-Oxley, the plain language of the Sarbanes-Oxley Act only applies to claims including "fraud, deceit, manipulation, or contrivance." *28 U.S.C. § 1658(b)*. It does not apply to non-fraud based claims brought under the 1933 Act. While relatively few courts have had opportunity to consider this question, each court has come to the same conclusion. *See Friedman v. Rayovac Corp., 295 F. Supp. 2d 957, 975 (W.D. Wis. 2003)*; *In re Merrill Lynch & Co. Research Reports Sec. Litig., 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003)*; *In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 431, 2003 U.S. Dist. LEXIS 20955, Nos. 02 Civ. 3288 (DLC), 03 Civ. 6592, 2003 WL 22738546, at *9 (S.D.N.Y. Nov. 21, 2003)*. Hence, plaintiff's strict liability claims brought under *Sections 11, 12(a)(2)and* [*39] *15* claims of the 1933 Act are not covered by the Sarbanes-Oxley Act. [1]

1 To state a claim for violation of *§§ 11, 12(a)(2)and 15*, plaintiff need only allege that "material facts have been omitted" from a registration statement or "presented in such a way as to obscure or distort their significance." *I. Meyer Pincus & Assoc., P.C. v. Oppenheimer & Co., 936 F.2d 759, 761 (2d Cir. 1991)* (quotation omitted). These minimal proof requirements create extensive liability for issuers and those involved in the preparation and dissemination of the registration statements filed in the context of a public offering. *WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *7. Section 11, 12(a)(2)and 15* claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by *Rule 9(b)* and PSLRA. *See In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 423 (S.D.N.Y. 2003)*. Plaintiff clearly understands this because it has disavowed that its *§§ 11, 12(a)(2)and 15* claims are anything other than strict liability or negligence claims. (Am. Compl. at PP354, 383.)

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

Plaintiff also contends that a more inclusive meaning must be given to the terms "manipulation" and "contrivance," such that they cover any "vehicle through which the fraud is achieved" whether falling under the definition of fraud or not. (Pl's Resp. Household's Mot. Dismiss at 48.) Plaintiff's reliance on case law and legislative history to support this position is also misplaced. In *Ernst & Ernst v. Hochfelder,* the Supreme Court distinguished between intentional and negligent behavior in the context of securities fraud. *425 U.S. 185, 199, 47 L. Ed. 2d 668, 96 S. Ct. 1375 (1976)*. In particular, the Court held that the "use of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud [*41] investors by controlling or artificially affecting the price of securities." *Id.* Intent to deceive is a necessary element of "manipulation" or "contrivance," making these terms ones of scienter, not negligence or strict liability. BLACK'S LAW DICTIONARY 741, 846, 1081 (7th ed. 2000).

Plaintiff's attempt to bolster this position through reference to the legislative history of the Sarbanes-Oxley Act is not well founded. The argument presented is nearly identical to the one presented, and rejected, in *WorldCom. WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *9*. In *WorldCom* the court stated that the legislative record shows that while the senators involved were greatly concerned with contemporaneous business frauds, they had no intention of conflating fraud with strict liability or negligence. *WorldCom, 294 F. Supp. 2d 431, 2003 WL 22738546, at *8-9*.

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

2. Timing [*42] **of the Claims**

Because the Amended Complaint arose from the consolidation of multiple suits, it is necessary to determine the date of the earliest original pleading. *Rule 15 of the Federal Rules of Civil Procedure* provides that an amended pleading relates back to the date of the original timely pleading when "the claim or defense asserted in the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted

to be set forth in the original pleading." *Fed. R. Civ. P. 15(c)(2)*. The earliest of the consolidated suits was filed August 19, 2002, hence that is the correct date for calculating notice.

Plaintiff bases its *Section 11, 12(a)(2)and 15* claims on various SEC filings and associated statements and publications. Count III is based on a June 1, 1998 Form S-4 Registration and Joint Proxy Statement-Prospectus. (Am. Compl. at P357.) Applying the one year/three year statute of limitations, there is some question as to when plaintiff should first have been on inquiry notice. Plaintiff cites both the letter to Aldinger and the publication of the Washington Report as key indications [*43] that something was possibly not right with Household's financials, providing the "suspicious circumstance." *Fujisawa, 115 F.3d at 1335*. But the ability to pursue a diligent inquiry also plays a role in determining when inquiry notice should have begun. *Id.* Plaintiff would like to argue that inquiry notice should not have begun until the release of the Restatement by Household on August 14, 2002 made the recalculations of profits and losses accessible to the public, all other meaningful data having been sealed by settlement agreements. However, to assume that would mean that inquiry notice would have arisen more than three years after the complained of violation, the filing of the S-4 Registration. Because *Section 13* requires claims to be filed the earlier of three years after the occurrence or one year after plaintiff is on actual or constructive notice, three years after the alleged violation, June 30, 2001, is the earliest date in this case. *15 U.S.C. § 77m*. As a result, the claims in Count III filed on August 19, 2002 against Household, Officer Defendants, Individual Defendants, Andersen, Goldman Sachs and Merrill Lynch are untimely.

[*44] Count IV is based on a series of Form S-3 debt registration statements. The dates of these SEC filings were on or about June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am. Compl. P384.) The same circumstances for inquiry notice apply for Count IV claims as the Count III claims. If the one year inquiry notice period could not have begun until the publication of the Restatement on August 14, 2002, the earliest *Section 13* dates for the June 30, 1998, February 16, 1999, July 1, 1999, March 24, 2000 filings are three years after each filing, respectively June 30, 2001, February 16, 2002, July 1, 2002, March 24, 2003. The earliest *Section 13* dates for the remainder of the filings, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002, is one year after inquiry notice should have begun, August 14, 2003, which plaintiff's August 19, 2002 filing satisfies. As a result, only the allegations arising out of the March 24, 2000, September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and [*45] April 9, 2002 Debt Registration Statements against Household, Officer Defendants, Individual Defendants and Andersen are timely. [2]

2 Neither equitable tolling nor estoppel are appropriate in securities cases. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 363, 115 L. Ed. 2d 321, 111 S. Ct. 2773 (1991)*; *Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1391 (7th Cir. 1990)*. The holdings in both cases have subsequently been modified with respect to retroactivity, but the tolling and estoppel holdings have been upheld. *Klehr v. A.O. Smith Corp., 521 U.S. 179, 200-01, 138 L. Ed. 2d 373, 117 S. Ct. 1984 (1997)*; *Plaut v. Spendthrift Farm, 514 U.S. 211, 217, 131 L. Ed. 2d 328, 115 S. Ct. 1447 (1995)*; *Lewis v. Long Grove Trading Co., 13 F.3d 1028, 1029 (7th Cir. 1994)*; *Cortes v. Gratkowski, 795 F. Supp. 248, 249 (N.D. Ill. 1992)*; *Cont'l Assurance Co. v. Geothermal Res. Int'l, Inc., 1991 U.S. Dist. LEXIS 13925, No. 89 C 8858, 1991 WL 202378, at *2 (N.D. Ill. Sept. 30, 1991)*; *see also* ABA COMMITTEE ON FEDERAL REGULATION OF SECURITIES, REPORT OF THE TASK FORCE ON STATUTE OF LIMITATIONS FOR IMPLIED ACTIONS 645, 655 (1986) (advancing "the inescapable conclusion that Congress did not intend equitable tolling to apply in actions under the securities laws").

[*46] **B. Sufficiency of the Pleadings**

1. *§§ 11, 12(a) & 15*

To establish a violation of *§ 11*, plaintiff must prove that a defendant's registration statement "contained an untrue statement of material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." *15 U.S.C. § 77k(a)*. The statute sets forth five groups of people who may be liable for the misrepresentation: (1) anyone who signed the registration statement; (2) anyone who was a

director or partner in the issuer at the time of the filing; (3) anyone who is named in the registration statement as being a director or partner; (4) anyone who has certified any part of the registration statement; and (5) any underwriter of the security. *Id.*

To establish a violation of *§ 12(a)(2)*, plaintiff must show that defendants offered or sold a security to the plaintiff by means of a prospectus or oral communication that was false or misleading with respect to material facts. *15 U.S.C. § 77l*. Defendants may avoid liability by proving that plaintiff knew the statement was false when made. Additionally, under [*47] *§ 12(a)(2)*, a defendant is not liable if he or she can prove that he did not know and could not have reasonably discovered that the statement was false. *Friedman, 295 F. Supp. 2d 979*.

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

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

15 U.S.C. § 77.

2. Standard of Pleading

Section 11, 12(a)(2)and 15 claims, such as those alleged here, are not held to the heightened pleading standard required of fraud allegations by *Rule 9(b)* and [*48] PSLRA. *See In re WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d at 423*; *Friedman, 295 F. Supp. 2d at 977*. Plaintiff's allegations only need satisfy the liberal notice pleading requirements of *Fed. R. Civ. P. 8*. *Hoskins v. Poelstra, 320 F.3d 761, 764 (7th Cir. 2003)*. The complaint need not contain "all of the facts that will be necessary to prevail." *Id.* So long as the complaint gives defendant sufficient notice of the claim to file an answer, it "cannot be dismissed on the ground that it is conclusory or fails to allege facts." *Higgs v. Carver, 286 F.3d 437, 439 (7th Cir. 2002)*.

3. Materiality and Sufficiency

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

A misstatement or omission is material if there is a substantial likelihood that the disclosure of the misstatement or omitted fact "would have been viewed by the reasonable investor as having significantly [*49] altered the total mix of information." *Friedman, 295 F. Supp. 2d at 981* (citing *Basic, Inc., 485 U.S. at 231*).

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

However, plaintiff has pleaded sufficient facts to make a colorable inference that defendants did know, and failed to disclose, or misrepresented material information at the time the debt registration statements were filed with the SEC. Plaintiff alleges defendants made materially and deliberately false statements in SEC filing on September 13, 2000, February 23, 2001, May 3, 2001, November 20, 2001, December 18, 2001 and April 9, 2002. (Am. Compl. at P384.) Plaintiff alleges essentially the same grounds in each case, that the ratio of earnings [*50] to fixed charges was deliberately falsified. (*Id.* at PP390-91.) Earnings were over reported and losses were not reported. The basis for plaintiff's statements about defendant Household's earnings are related primarily to Household's allegedly engaging in a variety of predatory lending schemes in order to conceal the true value of the loans held. (*Id.* at PP51-54.) Plaintiff primarily cites details of lending settlements Household reached with a variety of State Attorneys General and bank regulators, exposure of Household's "Vision" system and practice of

"reaging" loans by a Washington state investigation, and the publication of the Washington Report as foundation. (*Id.* at PP51-99, 110-24.) Plaintiff claims Household's 2002 $ 600 million restatement of earnings was the direct result of these activities. (*Id.* at P135.) Andersen's role in assisting Household with its regular accounting and management and, most importantly, its consent to the inclusion of its own statements about Household's financial status in the SEC statements at issue establish its culpability, according to plaintiff. (*Id.* at PP171-79, 185-91, 388.)

Plaintiff's allegations are detailed and voluminous, [*51] more than sufficient to put defendants on notice. Accordingly, plaintiff's claims under the 1933 Act cannot be dismissed for failing to allege sufficient facts.

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

This Court cannot conclude as [*52] a matter of law that defendants' alleged omissions and misstatements were immaterial. Assuming the truth of plaintiff's allegations as the Court must, there is a colorable argument that a reasonable investor would view the defendants' actions as material, which is all that is required. Therefore, plaintiff has sufficiently pleaded *Section 11and 12(a)(2)* claims to raise questions of fact and to place defendants on notice. As a result, these claims cannot be dismissed.

4. Predicate Claims

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

As for the group pleading doctrine, "the Seventh Circuit has not ruled on the applicability of the group pleading doctrine following the enactment [*53] of the PSLRA." *Tricontinental, 215 F. Supp. 2d at 947*. This Court, as well as others in the district, continue to recognize it. *Fishman, 2003 U.S. Dist. LEXIS 2527, 2003 WL 444223, at *6*; *Friedman, 295 F. Supp. 2d at 991-93*. As a result, plaintiff's *Section 15* claims cannot be dismissed.

C. Conclusion

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

III. Andersen's Motion to Strike

Defendant Andersen has moved to strike paragraphs 180 and 181 of the Amended Complaint as prejudicial and irrelevant. (Andersen Mot. to Strike at 1.) Andersen brings this motion pursuant to *Rule 12(f)*. *Rule 12(f)* provides that "upon motion made by a party within 20 days after the service of the pleading upon the party or upon the court's own initiative at any time, the court may order stricken from any pleading any insufficient defense or any redundant, [*54] immaterial, impertinent, or scandalous matter." *Fed. R. Civ. P. 12(f)*. Motions to strike are disfavored and usually denied. *Spearman Indus., Inc. v. St. Paul Fire & Marine Ins. Co., 109 F. Supp. 2d 905, 907 (N.D. Ill. 2000)*. Courts will strike portions of a complaint if the challenged allegations are so unrelated to the present claims as to be void of merit and unworthy of consideration and if the allegations are unduly prejudicial. *Kies v. City of Aurora, 149 F. Supp. 2d 421, 427 (N.D. Ill. 2001)*; *Robinson v. City of Harvey, 1999 U.S. Dist. LEXIS 12478, No. 99 C 3696, 1999 WL 617655, at *1-2 (N.D. Ill. Aug. 11, 1999)*. "Prejudice

results when the challenged allegation has the effect of confusing the issues or is so lengthy and complex that it places an undue burden on the responding party." *Cumis Ins. Soc'y Inc. v. Peters, 983 F. Supp. 787, 798 (N.D. Ill. 1997)*.

Andersen questions whether material from other litigation and accounting scandals cited by plaintiff is discoverable for the purposes of this litigation. It also asserts that material contained in paragraphs 180 and 181 is misleading, inflammatory, [*55] inaccurate, prejudicial and irrelevant. Andersen does little to convince this court to strike these paragraphs. Whether any particular allegation is admissible will be dealt with more appropriately at a later time. The motion to strike is denied.

CONCLUSION

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

SO ORDERED

ENTERED: 3/19/04

HON. RONALD A. GUZMAN

United States Judge

TAB 10

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

June 8, 1994.

ORDER FOR SUMMARY JUDGMENT

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

I.

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

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

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

II.

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

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

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

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

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

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

III.

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

IV.

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

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

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

V.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

VI.

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

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

VII.

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

A.

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

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

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

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

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

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

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

B.

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

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

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

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

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

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

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

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

C.

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

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

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

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

VIII.

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

IT IS THEREFORE ORDERED that defendants'

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

motion for summary judgment is granted.

JUDGMENT

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

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

END OF DOCUMENT

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

TAB 11

Only the Westlaw citation is currently available.
United States District Court, W.D. Missouri, Western Division.
In re 2007 NOVASTAR FINANCIAL, INC., SECURITIES LITIGATION.
No. 07-0139-CV-W-ODS.

June 4, 2008.

Darren Robbins, Ramzi Abadou, Coughlin Stoia Geller Rudman & Robbins LLP, San Diego, CA, for Robert W. Boyd, III.
R. Frederick Walters, Walters Bender Strohbehn & Vaughn, PC, Kansas City, MO, for Robert W. Boyd, III, Bruce Gilmore, Steven J. Gedy, Norman Pelletier, James E. Murphy, Dr. Kevin Lester, Joshua Brown, Merri-Jo Hillaker, Charles McComb, Lois McComb, William Weakley, Alan James Bima, Gary M. Tanner, Michael Owens, Lee M. Eidson, Jack F. Dunbar, and Durston Winesburg.
Don R. Lolli, Dysart Taylor Lay Cotter & Mcmonigle, PC, Kansas City, MO, for Robert W. Boyd, III, Bruce Gilmore, Steven J. Gedy, Norman Pelletier, Gary M. Tanner, Michael Owens, and Lee M. Eidson.
Kenneth E. Nelson, Nelson Law Firm, PC, Kansas City, MO, for Bruce Gilmore, Steven J. Gedy, Gary M. Tanner, Jack F. Dunbar, and Durston Winesburg.
Alexandra S. Bernay, Coughlin Stoia Geller Rudman & Robbins, LLP, San Diego, CA, for Kevin Lester, Alan James Bima, Novastar Financial Inc., Scott F. Hartman, W. Lance Anderson, and Gregory S. Metz.
Thomas E. Egler, Coughlin Stoia Geller Rudman & Robbins, LLP, San Diego, CA, for Kevin Lester and Alan James Bima.
Jeffrey A. Klafter, Klafter & Olsen LLP, White Plains, NY, Kurt B. Olsen, Washington, DC, Lauren G. Kerkhoff, Coughlin Stoia Geller Rudman & Robbins, LLP, San Diego, CA, Paul Edwin Torlina, Arnold, Newbold, Winter, & Jackson, PC, Kansas City, MO, for Alan James Bima.
Lee A. Weiss, Dreier LLP, New York, NY, Susan F. Meagher, Nygaard Law Firm, PA, Leawood, KS, for Michael Owens.
Linda Catherine McFee, Thomas R. Buchanan, McDowell, Rice, Smith & Buchanan, P.C., Kansas City, MO, for Lee M. Eidson.
Brian D. Martin, Michael Thompson, Husch, Blackwell, Sanders, LLP, Kansas City, MO, for Novastar Financial Inc., Scott F. Hartman, W. Lance Anderson, and Gregory S. Metz.

ORDER AND OPINION (1) GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTION REQUESTING THE COURT TAKE JUDICIAL NOTICE AND (2) GRANTING DEFENDANTS' MOTION TO DISMISS

ORTRIE D. SMITH, District Judge.
***1** On October 19, 2007, Lead Plaintiff ("Plaintiff") filed a Consolidated Complaint ("the Complaint") asserting claims of securities fraud on behalf of a class of shareholders of Novastar Financial, Inc. ("Novastar" or "the Company"). The Defendants are Novastar, its Chief Operating Officer (W. Lance Anderson), its Chief Executive Officer (Scott F. Hartman), and its Chief Financial Officer (Gregory S. Metz). Defendants have filed a Motion to Dismiss and have asked the Court to take judicial notice of certain facts they deem supportive of the Motion to Dismiss. The motions to take judicial notice (Doc. # 72 and Doc. # 85) are granted in part and denied in part. The Motion to Dismiss (Doc. # 70) is granted.

I. REQUESTS FOR JUDICIAL NOTICE

Defendants ask the Court to take judicial notice of documents Novastar filed with the Securities and Exchange Commission ("SEC"), the history of the Company's stock price, and developments in the subprime mortgage industry. In large measure the request is unopposed: Plaintiff does not object to the Court's consideration of documents filed with the SEC so long as the Court does not accept them for the truth of the matters represented. *See* *Kushner v. Beverly Enter., Inc.,* 317 F.3d 820, 824 (8th Cir .2003). Plaintiff also does not object to consideration of the Company's stock price history. The motions are granted with respect to these topics. Plaintiff opposes the Court taking judicial notice of developments in the subprime mortgage history because these facts are not embraced by the Complaint. This is incorrect; in fact, Plaintiff alleges Defendants failed to properly anticipate and plan for the downturn. Complaint, ¶ 157(c).

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

Regardless, the Supreme Court has held that a Court may consider matters amenable to judicial notice when addressing a motion to dismiss. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* --- U.S. ----, ----, 127 S.Ct. 2499, 2509, 168 L.Ed.2d 179 (2007). The Court concludes the reversals in this industry are amenable to judicial notice. Fed.R.Evid. 201(b). However, just as the Court could take judicial notice of the fact that the country suffered from the Great Depression in the 1930s, the Court cannot use that fact to infer anything in particular about a business operating at the time. In short, while the Court can take judicial notice of the fact that the Company's industry suffered reversals, the Court cannot take judicial notice of the impact of those industry-wide reversals on the Company. As will be seen, this entire matter is of marginal importance in light of the issues currently before the Court.

II. MOTION TO DISMISS

Ordinarily, the liberal pleading standard created by the Federal Rules of Civil Procedure requires "a short and plain statement of the claim showing that the pleader is entitled to relief." *Erickson v. Pardus,* --- U.S. ----, ----, 127 S.Ct. 2197, 2200, 167 L.Ed.2d 1081 (2007) (per curiam) (quoting Fed.R.Civ.P. 8(a)(2))."Specific facts are not necessary; the statement need only 'give the defendant fair notice of what the ... claim is and the grounds upon which it rests.' " *Id.* (citing *Bell Atlantic Corp. v. Twombly,* ---U.S. ----, ----, 127 S.Ct. 1955, 1964, 167 L.Ed.2d 929 (2007)). However, with respect to securities fraud claims, the Private Securities Litigation Reform Act of 1995 ("PSLRA") "dictates a modified analysis due to its special heightened pleading rules." *Kushner,* 317 F.3d at 824. The heightened pleading standard is intended to eliminate abusive securities litigation and put an end to the practice of pleading "fraud by hindsight." *In re K-Tel Int'l, Inc. Sec. Litig.,* 300 F.3d 881, 889 (8th Cir.2002). The PSLRA requires plaintiffs "to specify each misleading statement or omission and specify why the statement or omission was misleading." *Kushner,* 317 F.3d at 826 (citing 15 U.S.C. § 78u-4(b)(1)). The complaint must also "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2); *see also Kushner,* 317 F.3d at 826 (citation omitted). In evaluating this information, the PSLRA requires the Court to consider plausible opposing inferences. *Tellabs,* 127 S.Ct. at 2509. Finally, the Court must "disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements." *Kushner,* 317 F.3d at 824 (quoting *Florida State Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 660 (8th Cir.2001)). After considering the Complaint's allegations in the light most favorable to Plaintiff, the Court concludes Plaintiff has not-and cannot-satisfy the PSLRA's pleading requirements.

A. Falsity

***2** One might be tempted to think that a complaint spanning more than 100 pages and consisting of more than 200 paragraphs could not fail to be specific. The temptation is dangerous and must be resisted. As stated above, the PSLRA requires a plaintiff to specifically identify the allegedly misleading statements. It then requires the plaintiff to "indicate why the alleged misstatements would have been false or misleading at the several points in time in which it is alleged they were made. In other words, the complaint's facts must necessarily show that the defendants' statements were misleading." *In re Cerner Corp. Sec. Litig.,* 425 F.3d 1079, 1083 (8th Cir.2005) (quotation omitted). For all of his protests to the contrary, Plaintiff has not specified the allegedly misleading statements, nor has he specified why the statements he has referred to are misleading. The Complaint presents a very broad picture, and Plaintiff discusses his claims in generalities-precisely what the PSLRA counsels against. This has allowed Plaintiff to pick isolated threads and snippets from the Complaint to create an illusion of detail and insinuate the existence of fraud, which in turn has made it exceedingly difficult for the Court to conduct the analysis required by law. The Court does not intend to parse out each and every sentence contained in the Complaint because doing so ignores the real problem: what the Complaint does not say is as critical as what it actually says.

Paragraphs 103 through 155 appear under the heading "Defendants' False and Misleading Statements Issued During the Class Period."These allegations occupy nearly thirty-five pages and consist largely of financial data (which is interesting, given the sparse allegations that financial data was incorrect). In his Suggestions in Opposition, Plaintiff merely refers to these paragraphs and characterizes them as sufficient for pleading purposes. Plaintiff's Suggestions in Op-

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

position at 11-14. This hardly qualifies as a specification of allegedly false statements.

To satisfy the falsity requirement's second component-detailing why the statements are false-Plaintiff has proffered five explanations which appear in paragraph 157. The Company's public statements allegedly concealed that it (1) lacked internal controls, which rendered its projections defective, (2) failed to properly account for its allowance for loan losses, (3) would need to tighten underwriting guidelines in light of the deterioration and volatility of the subprime mortgage market, (4) had no reasonable basis to predict its ability to maintain its status as a Real Estate Investment Trust ("REIT"), and (5) its deviation from underwriting standards created undue risk of default.

There is no obligation to divulge every "fact" known to everyone in a company, and the PSLRA's effort to combat claims of "fraud by hindsight" demonstrates a reluctance to countenance claims that attach heightened importance to facts only when looking back at the aftermath of misfortune. The Eighth Circuit addressed a similar situation in *Cerner Corp:*

> ***3** Crabtree's complaint alleges that Cerner's statements regarding future earnings were materially false and misleading because Cerner was losing deals due to increased competition, dissatisfied customers, a general economic downturn, an inexperienced sales force, and a neglect of smaller deals. The complaint is devoid, however, of any indication that this alleged loss of deals, even if "material," is necessarily inconsistent with Cerner's statements that its demand was "strong." A company could conceivably lose a material number of deals it had pursued, and yet continue to see a strong demand for its products and substantial future opportunities. Furthermore, there is no indication on the face of the complaint that even a material loss of deals necessarily rendered Cerner unable to achieve its projected earnings. Finally, and perhaps most importantly, the complaint does not identify a single specific deal that was lost due to alleged changes in Cerner's corporate structure and strategies.

425 F.3d at 1083-84. This analysis applies equally to the case at bar. For instance, the Company may have changed or even weakened its internal controls or underwriting standards, but this does not mean that those controls or standards were not "strong" or "effective" as described in the Company's public statements. Moreover, nothing in the Complaint demonstrates a connection between these changes and the Company's later misfortunes-particularly in light of the economic downturn described in paragraph 157. The Company may have incorrectly believed it had adequate reserves, but the mere fact that those reserves eventually proved to be inadequate does not mean a false statement was made. Plaintiff emphasizes the many confidential witnesses who report changes in various policies in procedures-changes the witnesses characterize as tending to increase risks faced by the Company. Setting aside the wisdom of relying upon confidential witnesses for such subjective matters, the Court merely observes that-despite the many pages of argument-Plaintiff has not explained how these reports demonstrate the falsity of any particular public statement.

The Complaint also alleges various violations of Generally Accepted Accounting Principles ("GAAP") by overstating gains, understating loan loss provisions and reserves, and failing "to properly disclose the effect of known trends and uncertainties in its financial statements."Complaint, ¶¶ 158-59. However, it is noteworthy that nobody-the SEC, Novastar's auditors, or anyone else-has suggested Novastar should or must restate its financial reports.[FN1] More importantly, although the allegations are couched in terms of GAAP principles, the allegations actually assert management's failure to plan sufficiently for future events. For instance, according to Plaintiff GAAP required Novastar to make adequate provisions for delinquent loans. Novastar made provisions, but those provisions turned out to be inadequate. This does not mean the initial provisions were "false;" it just means management did not do a good job. Ultimately, Plaintiff fails to identify a single false entry in the Company's financial statements, nor does he identify the "truth" that should have been disclosed. This is not a case in which the defendants falsified or "cooked" the books.

> FN1. Ordinarily, the Court would not be permitted to consider this when presented with a Rule 12(b)(6) motion. As stated earlier, the PSLRA-as interpreted by the Supreme Court in *Tellabs*-requires it in this case.

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

***4** Plaintiff's Complaint reads more like a cautionary tale from a treatise on business management than a charge of knowing misstatements and concealments. Plaintiff has not stated a claim because companies (and their management) are not expected to be clairvoyant, and bad decisions do not constitute securities fraud. *K-Tel Int'l,* 300 F.3d at 891;*see also* *Santa Fe Indus. v. Green,* 430 U.S. 462, 474-80, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). They may constitute negligence; they may constitute breach of fiduciary duty; they may constitute a claim for mismanagement-but they do not constitute fraud.

B. Scienter

"The PSLRA requires that the complaint state 'with particularity' facts giving rise to a 'strong inference' that the defendants acted with the scienter required for the cause of action." *In re Navarre Corp. Sec. Litig.,* 299 F.3d 735, 745 (8th Cir.2002) (quoting 15 U.S.C. § 78u-4(b)(2))."Scienter can be established in three ways: (1) from facts demonstrating a mental state embracing an intent to deceive, manipulate, or defraud; (2) from conduct which rises to the level of severe recklessness; or (3) from allegations of motive and opportunity." *Cornelia I. Crowell GST Trust v. Possis Medical, Inc.,* 519 F.3d 778, 782 (8th Cir.2008). Relying on the confidential informants, Plaintiff alleges Defendants "each knew about, or disregarded in a severely reckless manner, the disastrous problems arising from Novastar's bad and/or weakened underwriting practices during the Class Period through regularly scheduled meetings and reports."Suggestions in Opposition at 19. Plaintiff theorizes an intent to defraud can be inferred because Defendants regularly attended meetings during which the adverse effects of policy changes, adverse changes in the Company's financial position, and ways to improve the Company's operations were discussed. This conduct is normal and expected, and does not indicate fraudulent intent. Management is supposed to review results and search for ways to improve operations, and this customary endeavor does not indicate an intent to deceive when positive information is disseminated.

The Complaint's attempt to satisfy the scienter requirement suffers from the same flaws discussed earlier with respect to the falisty requirement. *See* pages 3-4, *infra.*Critically, Plaintiff does not compare (1) an allegedly false or misleading statement with (2) Defendants' prior receipt of information demonstrating that the statement would be false or misleading. Plaintiff's allegations are more consistent with a company and executives confronting a deterioration in the business and finding itself unable to prevent it than they are with a company and executives recklessly deceiving the investing community.

Finally, whatever minimal inference of fraudulent intent that can be gleaned from the Complaint is insufficient to allow the case to proceed. "Congress did not merely require plaintiffs to provide a factual basis for their scienter allegations, *i.e.,* to allege facts from which an inference of scienter rationally *could* be drawn. Instead, Congress required plaintiffs to plead with particularity facts that give rise to a strong-*i.e.,* a powerful or cogent-inference." *Tellabs,* 127 S.Ct. at 2510 (internal citations and quotations omitted). The Court must determine " 'whether all of the facts, taken collectively, give rise to" an inference of scienter that is " 'cogent and at least as compelling as any opposing inference one could draw from the facts alleged.' " In re *NVE Corp. Sec. Litig.,* No. 07-2931, slip op. at 3 (8th Cir. May 30, 2008) (quoting *Tellabs,* 127 S.Ct. at 2509-10). Plaintiff has not presented facts creating an inference of scienter that is at least as strong as an inference that Defendants lacked fraudulent intent, and this failing constitutes an independent reason to dismiss the case.

III. OPPORTUNITY TO AMEND

***5** Defendants contend Plaintiff should not be afforded an opportunity to amend, essentially because such an effort would be futile. Plaintiff has not addressed the issue, which means either (1) Plaintiff agrees he could not do a better job of framing the Complaint or (2) Plaintiff did not believe it possible the Court would find the Complaint to be inadequate. In any event, the Court agrees with Defendants that attempting to amend the Complaint would be futile. In all that has already been alleged, there is no suggestion that any material information was concealed or that any Defendant acted with fraudulent intent, and there is no reason to think further or different pleading will create the necessary inferences.

IT IS SO ORDERED.

W.D.Mo.,2008.
In re 2007 Novastar Financial, Inc., Securities Litiga-

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

tion
Not Reported in F.Supp.2d, 2008 WL 2354367 (W.D.Mo.), Fed. Sec. L. Rep. P 94,744

END OF DOCUMENT

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

TAB 12

United States District Court, N.D. Illinois, Eastern Division.
Thomas G. ONG for Thomas G. Ong Ira and Thomas G. Ong, individually and on behalf of all others similarly situated, Plaintiffs,
v.
SEARS, ROEBUCK & CO., Sears, Roebuck Acceptance Corp., Alan Lacy, Paul J. Liska, Glenn R. Richter, Kevin T. Keleghan, K.R. Vishwanath, Keith E. Trost, George F. Slook, Larry R. Raymond, Thomas E. Bergmann, Credit Suisse First Boston, Goldman, Sachs & Co., Morgan Stanley, Bear, Stearns & Co., Inc., Lehman Brothers and Merrill Lynch & Co., Inc., Defendants.
No. 03 C 4142.

Sept. 14, 2005.

Carol V. Gilden, Christopher James Stuart, Much, Shelist, Freed, Denenberg, Ament & Rubenstein, P.C., Chicago, IL, for Plaintiffs.
Jeffery S. Davis, John Claiborne Koski, Christopher Qualley King, Harold C. Hirshman, Sonnenschein, Nath & Rosenthal LLP, Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER

PALLMEYER, J.
***1** Plaintiffs Thomas G. Ong, Thomas G. Ong IRA, and State Universities Retirement System of Illinois ("State Universities") bring this federal securities class action lawsuit on behalf of (1) all those who purchased, pursuant to a prospectus, securities issued by defendant Sears, Roebuck Acceptance Corp. ("SRAC"). a wholly-owned subsidiary of Defendant Sears, Roebuck & Co. ("Sears"), between October 24, 2001 and October 17, 2002 (the "Class Period"), in any of three debt securities offerings dated March 18, May 21, and June 21, 2002, and (2) all those who, during the Class Period, purchased publicly traded securities issued by SRAC before the Class Period and actively traded them through the public markets and over national securities exchanges.

Sears is one of North America's largest general retailers. In addition to its retail division, Sears provides financing to its customers through private label credit cards and installment plans. SRAC's principal business is purchasing Sears' short-term notes and account receivable balances, which it finances through public sates of SRAC Notes. Defendants Alan Lacy, Glenn R. Richter, Paul J. Liska, Keith E. Trost, George F. Slook, Larry R. Raymond, Thomas E. Bergmann, Kevin T. Keleghan, and K.R. Vishwanath were all officers or directors of Sears, SRAC, or both. Defendants Credit Suisse First Boston Corporation ("CSFB"), Goldman, Sachs & Co. ("Goldman Sachs"), Morgan Stanley & Co., Inc. ("Morgan Stanley"), Bear, Stearns & Co., Inc. ("Bear Stearns"), Lehman Brothers Inc. ("Lehman Brothers"), and Merrill Lynch & Co., Inc. ("Merrill Lynch") were all underwriters of the three SRAC debt securities offerings at issue in this case.

Plaintiffs allege that Sears manipulated information regarding its credit card operations to make those operations appear "more stable and profitable than they actually were," which artificially inflated the market value of SRAC debt securities. Specifically, Sears misrepresented its reliance on subprime creditors; selectively reported delinquency and charge-off rates; and disguised portfolio losses in order to generate high levels of reported receivables that Sears knew would prove uncollectible. Plaintiffs claim that Defendants all made materially false and misleading statements or omissions in connection with Sears' credit card operations in violation of §§ 11. 12(a)(2), and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77l(a)(2), and 77o; and §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 ("SEA"), 15 U.S.C. § 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

On September 27, 2004, this court granted in part and denied in part Defendants' four separate motions to dismiss Plaintiffs' October 16, 2003 Amended Class Action Complaint. *Ong ex rel. Ong IRA,* 388 F.Supp.2d 871, 2004 WL 2534615 (N.D.Ill. Sept.27, 2004). In response. Plaintiffs filed a Second Amended Class Action Complaint ("SAC"), adding a variety of new allegations and a new plaintiff, State Universities. Defendants, with the exception of Merrill Lynch,[FN1] insist that the changes to the SAC are not sufficient to remedy the flaws identified by

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

the court, and seek dismissal of Counts Two, Four, Five, Seven, Eight, and Nine. For the reasons stated here, the motions are granted in part and denied in part.

FN1. Merrill Lynch filed its answer and affirmative defenses to the SAC on January 28, 2005.

BACKGROUND

***2** The extensive procedural and factual background of this case is set forth in this court's September 27, 2004 Memorandum Opinion and Order. *See* *Ong,* 2004 WL 2534615, at *2-15. The SAC largely repeats the allegations from the prior Complaint, as reflected below. This opinion assumes the reader's familiarity with the earlier decision and attempts to recite relevant facts only as necessary to resolve Defendants' current motions to dismiss.

Sears is one of the largest general retailers in North America. As part of its operations, Sears provides financing to customers through private label credit cards and installment plans. SRAC, Sears' wholly-owned subsidiary, is primarily in the business of purchasing short-term notes or receivable balances from Sears. SRAC funds these purchases by issuing debt securities such as commercial paper, medium term notes, and "other borrowings" (collectively, "SRAC Debt Securities") to the public. (SAC ¶¶ 12, 13, 46, 47.) FN2 Three SRAC Debt Securities offerings are at issue in this case: (1) $600 million of 6.70% notes due April 15, 2012, offered pursuant to an Indenture dated May 15, 1995 (the "Indenture"), a Registration Statement and accompanying Prospectus dated September 3, 1998 (the "Registration Statement"), and a Prospectus and Prospectus Supplement dated March 18, 2002 (the "3/18/02 Offering"); (2) $1 billion of 7.0% notes due June 1, 2032, offered pursuant to the Indenture, the Registration Statement, and a Prospectus and Prospectus Supplement dated May 21, 2002 (the "5/21/02 Offering"); and (3) $250 million of 7.0% notes due July 15, 2042, offered pursuant to the Indenture, the Registration Statement, and a Prospectus and Prospectus Supplement dated June 21, 2002 (the "6/21/02 Offering").(*Id.* ¶ 2.) Plaintiffs all allegedly purchased SRAC Debt Securities during the Class Period. (*Id.* ¶¶ 9-11.)

FN2. Plaintiffs' Second Amended Class Action Complaint for Violations of Federal Securities Laws is cited as "SAC ¶ __."

Mr. Lacy was Sears' Chief Executive Officer, President, and Chairman of the Board throughout the Class Period. Mr. Richter has been Sears' Chief Financial Officer since October 4, 2002 and also served as Sears' Senior Vice President, Finance prior to that date. Mr. Liska was Sears' Chief Financial Officer until Mr. Richter took over in October 2002. He also served as a director of SRAC. Mr. Trost was the President of SRAC as well as a director of the company. Mr. Slook, also a director of SRAC, was SRAC's Vice President of Finance. Mr. Raymond served as a director of SRAC, as did Mr. Bergmann, who was also Chief Accounting Officer and Controller of Sears. Mr. Keleghan was President of Sears' Credit and Financial Products segment and "an Executive Vice President from the start of the Class Period until October 4, 2002, when he was forced to resign ."Mr. Vishwanath was Sears' Vice President of Risk Management until the company terminated his employment on October 16, 2002. (*Id.* ¶¶ 14-22.)

CSFB, Goldman Sachs, Morgan Stanley, Bear Stearns, Lehman Brothers, and Merrill Lynch are all integrated financial services institutions that provide securities, investment management, and credit services to corporations, governments, financial institutions, and individuals. CSFB and Goldman Sachs were joint "book runners"-i.e., managing underwriters-for the 3/18/02 Offering of SRAC Debt Securities. Morgan Stanley, Bear Stearns, and Lehman Brothers were all joint lead managers for the 5/21/02 Offering. Morgan Stanley was also the book runner for that offering. Merrill Lynch was the book runner for the 6/21/02 Offering. (*Id.* ¶¶ 33-38.)

A. The Relationship Between Sears and SRAC

***3** SRAC's operating income is generated primarily from the earnings on its investments in Sears' short-term notes and account receivables. In addition, Sears determined the amount of SRAC's earnings by requiring SRAC to maintain a set ratio of earnings to fixed expenses. Plaintiffs allege that, "[a]s a result, the yield on SRAC's investment in Sears notes is directly related to SRAC's borrowing costs, i.e., the yield under which SRAC can issue and sell its Debt Securities."It is in Sears' financial interest to keep SRAC's borrowing costs as low as possible because the less

SRAC pays purchasers of its Debt Securities, the less Sears must pay to borrow from SRAC. (*Id.* ¶ 48.)

Given the inter-relationship between Sears and SRAC, "industry analysts and the rest of the market looked to the finances, financial condition and present and future operations of Sears when assessing the investment prospects for SRAC Debt Securities."(*Id* . ¶ 49.)When industry analysts viewed Sears favorably, SRAC was viewed favorably as well; when Sears experienced a downward change in its financial condition, SRAC's financial condition suffered as well. (*Id.* ¶¶ 49-54.)According to Plaintiffs, "the intertwining of the finances and operations of SRAC and Sears cause the SRAC Debt Securities to take on the status of a direct investment with Sears itself."(*Id.* ¶ 56.)

B. Sears' Credit Problems

For many years, Sears was one of the largest credit card issuers in the country. (*Id.* ¶ 62.)Prior to 1993, Sears stores accepted only Sears' own proprietary credit cards ("Sears Cards") and those cards could only be used to make purchases at Sears. (*Id* . ¶ 63.)When Sears began accepting general credit cards in 1993, the company saw a drastic decrease in the use of its Sears Cards; by mid-2000, 24 million of the 60 million Sears Cards were either inactive or carried a zero balance. (*Id.*) At the same time, Sears' retail sales were also in decline due to increased competition from discount retailers like Wal-Mart and Kohl's. (*Id.* ¶ 64.)

In late 2000, Sears began to issue a Sears MasterCard, a general purpose credit card that could be used wherever MasterCard was accepted. The cards carried higher lines of credit and generated fee income for Sears when used at non-Sears locations. Sears hoped that the Sears MasterCard would "stimulate sales and help regain income Sears had lost in recent years due to the decline of its proprietary cards."(*Id.* ¶ 66.)In November 2000, Mr. Lacy, who had been named President and CEO of Sears just a month earlier, identified the Sears MasterCard as a top area for growth within the company. (*Id.* ¶¶ 65, 67.)

By February 2001, the Sears MasterCard carried $1.4 billion in receivables and Sears, through its subsidiary Sears National Bank, had become one of the top 25 bank card issuers. A February 15, 2001 article in *American Banker* reported that Mr. Keleghan, President of Sears Credit, had described Sears MasterCard users as "a very pristine group, almost too pristine.... We don't expect significant delinquencies since we're starting out with a low-risk group."(*Id.* ¶ 69.)Sears' retail segment continued to decline over the next several months, but Mr. Lacy asserted at an April 19, 2001 analysts presentation that Sears' credit segment had "a strong portfolio quality overall" and was "a great business" and "strategically very important" to Sears. (*Id.* ¶¶ 70, 71.)

***4** Despite these representations, Sears credit operations actually suffered from several weaknesses and problems which were hidden from the market. Those weaknesses, described below, ultimately led to an announcement that Sears planned to sell the credit business. (*Id.* ¶ 73.)

1. Reliance on Subprime Creditors

During the Class Period, Sears aggressively marketed its credit cards, particularly the Sears MasterCard, to "create the appearance of a growing, profitable loan portfolio."(*Id.* ¶ 74.)To that end, Sears intentionally lowered its acceptable credit profile so that more consumers would qualify for credit cards, and adopted aggressive marketing strategies designed to appeal to low-income or unstable borrowers. Sears also offered multiple credit cards and increased credit limits to customers who did not qualify for such benefits.(*Id.*) At the beginning of the Class Period, approximately 54% of Sears' credit portfolio consisted of subprime borrowers, compared with a United States industry average of 36.6%. By the end of the Class Period, the portfolio was still nearly half subprime. (*Id.* ¶¶ 75, 76.)

2. Selective Reporting Techniques

In addition to targeting subprime creditors, Sears misleadingly reported the charge-off and delinquency rates [FN3] of its credit cards on a portfolio-wide basis rather than separating out the performances of the Sears Card and the Sears MasterCard. The Sears MasterCard had higher credit limits than those traditionally offered under the Sears Card, as well as lower delinquency and charge-off rates. According to the Plaintiffs, "[t]hese factors, when combined with the dramatic increases in MasterCard receivables, declining Sears proprietary card receivables, [and]

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

the fact that the Sears proprietary card portfolio was much larger than the new MasterCard portfolio, created an interesting phenomenon during the Class Period ."Specifically, though both portfolios were separately experiencing a "striking rise in delinquencies and charge-offs every quarter," the combined portfolios reflected delinquencies and charge-offs that were relatively stable "because the Sears Card receivables overweighted the average of the two groups."(*Id.* ¶¶ 78-80.)

> FN3. Charge-offs are write-offs taken on uncollectible credit card receivables. *See In re Sears, Roebuck and Co. Sec. Litig.,* 291 F.Supp.2d 722, 724 n. 2 (N.D.Ill.2003). Delinquency rates describe the number of credit card receivables that are past due relative to all outstanding loans.

3. Disguised Losses

Plaintiffs allege that Sears also engaged in practices designed to disguise losses to its credit portfolio. Sears National Bank, which Sears created in 1995, is not subject to the same rules and regulatory oversight as ordinary bank card issuers.[FN4]Thus, Sears was able to adopt more lenient credit policies than its competitors. (*Id.* ¶ 82.)For example, Sears charged-off delinquent credit card loans after 240 days compared with 180 days by competitors. (*Id.* ¶ 82(a).) Sears also deferred charge-offs by relying on generous "renewal" policies, such as offering to make a delinquent account "current" if a customer made a single, minimum payment, and then closing the account and implementing an installment plan to collect the balance due. In addition, Sears "cured" or "re-aged" delinquent accounts (i.e., converted them to current status) after receiving only two consecutive minimum payments; federal regulations require three consecutive minimum payments prior to re-aging. (*Id.* ¶ 82(b)-(c).)

> FN4. The Complaint does not explain why Sears National Bank is not subject to federal regulation and oversight. Nor does it describe the Bank's specific role with respect to Sears, though presumably it was the institution that issued the Sears credit cards.

***5** Sears also adopted promotional programs, such as zero percent financing, that allowed cardholders to minimize or avoid payments for periods of up to a year. This made it "difficult, or even impossible, for cardholders to fall behind in their payments and allowed Sears to delay reporting such accounts as delinquent."(*Id.* ¶ 82(d).) In addition, Sears repeatedly lowered the required minimum monthly payments, which allowed individuals with poor credit histories to purchase higher priced items on more extended payment schedules. This practice increased Sears' income from finance charges but also increased its exposure to bad debt. (*Id.* ¶ 82(e).) Finally, though it is industry practice to report delinquencies after 30 days, Sears did not report them until after 60 days. (*Id.* ¶ 82(f).) According to Plaintiffs, these policies misled investors as to the true quality of Sears' credit portfolio. (*Id.* ¶ 83.)

4. Fraudulent Billings

A final practice that served to weaken Sears' credit portfolio was fraudulent billings on customer accounts. Sears strongly encouraged its employees to induce customers to purchase additional services, including life insurance, credit protection, and extended warranties, whenever they bought a Sears product. "The incentives to make such sales were so strong that it became a regular practice for salespersons to put such items on customers' accounts without their knowledge or consent."(*Id.* ¶ 84.)This, in turn, "helped drive up the high levels of reported receivables that Sears knew to be uncollectible."(*Id.*)

C. False and Misleading Statements

Plaintiffs allege that Defendants issued numerous false and misleading statements to deceive the investing public into believing that Sears' credit operations were "far better, more successful and profitable, than was actually the case."(*Id.* ¶ 85.)*See Ong,* 2004 WL 2534615, at *5-12. For purposes of the pending motions to dismiss, there is no dispute that Plaintiffs have sufficiently alleged that the relevant Defendants made false and misleading statements and, thus, the court will not repeat them here.

The court notes generally, however, Plaintiffs' allegations that between the third quarter of 2001 and the second quarter of 2002, Defendants issued SEC Form 8-Ks and Form 10-Qs reflecting "strong" and "stable" credit portfolio quality. (*Id.* ¶¶ 72, 104.)In truth, the Sears Card and Sears MasterCard portfolios were

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

excessively weighted towards the subprime market and, when viewed separately, each reflected rising delinquency and charge-off rates.(*Id.* ¶¶ 77, 80, 104, 110, 145, 174-75.)Nevertheless, Defendants made statements at analysts meetings, in press releases, and during investor conference calls confirming the stable and pristine quality of the portfolios and projecting significant increases in earnings each year. Indeed, by July 18, 2002, a Sears press release quoted Mr. Lacy as saying that Sears expected a 22% increase in full year comparable earnings. (*See generally* *id.* ¶¶ 86-158); *Ong,* 2004 WL 2534615, at *5-12.

D. Sears Reveals Its Credit Problems

***6** Plaintiffs allege that the true state of Sears' credit portfolios finally began to emerge in October 2002. On October 4, 2002, Sears issued a press release abruptly announcing that Mr. Liska had replaced Mr. Keleghan as Sears' Executive Vice President and President of Credit and Financial Products. On October 7, 2002, Sears issued a press release reaffirming its July 18, 2002 projection of a 22% increase in comparable earnings per share, but stating that: “The company now expects comparable earnings increases ... in the mid-single digit percent range in its credit and financial products segment.”(*Id.* ¶¶ 159-62.)This represented a significant decrease from earlier projections; as of July 18, 2002, Sears had projected credit segment growth “in the low double digits.” Sears' stock started to trade down in response to the revised projections. (*Id.* ¶ 162.)

Later that day, Mr. Lacy spoke to investors during a conference call and “reaffirm[ed]” Sears' projection of a 22% increase in earnings per share. With respect to Mr. Keleghan, Mr. Lacy explained that “Kevin left the company at my request, because I lost confidence in his personal credibility.... His departure is not related to business performance and does not indicate a change in our credit strategy.”(*Id.* ¶¶ 163-65.)Financial services firm W.R. Hambrecht issued a report commenting on Mr. Keleghan's departure as follows: “[W]e got incrementally bad news.... CEO Lacy stated that he asked Keleghan to leave because he had lost confidence in Keleghan's personal credibility. We don't know what that means, exactly, but we believe it bodes poorly for Sears Credit operations which represent approximately 65% of operating profit and creates even greater uncertainty about the quality of earnings at the credit division.”(*Id.* ¶ 168.)By the close of business on October 7, 2002, the price of Sears stock had fallen from $37.64 to $32.25. (*Id.* ¶ 166.)The price of SRAC Debt Securities issued pursuant to the 6/21/02 Offering also fell from $24.81 per share on October 8, 2002 to $21.91 per share on October 10, 2002. (*Id.* ¶ 167.)

On October 17, 2002, Sears issued a press release announcing that it would be increasing its allowance for bad debt by $222 million. The charge against earnings required to cover this increase reduced Sears' earnings for the quarter by 26% as compared to the prior year. Despite having ten days earlier projected a 22% increase in earnings per share that year, Sears now estimated earnings per share would increase only 15%. (*Id.* ¶ 171.)In an analysts meeting conducted by conference call that day, Mr. Lacy attributed Sears' problems in its credit business to the duplicity of Mr. Keleghan and Mr. Vishwanath:

> [I]t became clear to me that Kevin [Keleghan] was not being forthcoming about these issues that this business was facing ... and had become a barrier to getting an objective situation assessment as to what was happening in our business and I terminated him for basically my personal loss of confidence in him relative to his personal credibility ... You should also know that during the course of our analysis we determined that the VP of Risk Management and Credit [Mr. Vishwanath] had also withheld information and had led us to terminate his employment effective yesterday.

***7** (*Id.* ¶ 172.)

When Mr. Liska took over the conference call, he admitted that “[o]ne of the disclosures that [we] make today centers around a portion of our portfolio that is Middle American. A large portion of the proprietary card, our proprietary card portfolio is Middle America.”(*Id.* ¶ 173.)In an analysts meeting a year earlier, Mr. Keleghan had explained, “we try to target the middle market,” distinguishing that group from the “subprime” market; in this October 2002 meeting, in contrast, Mr. Liska refers to “Middle America” as another way of saying “subprime”: “It is generally recognized that [M]iddle America accounts deteriorate more quickly in a tough economy than prime accounts do.”Though he suggested that the proportion of Sears borrowers that were subprime was declining, Mr. Liska acknowledged that Sears' credit

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

portfolio had been heavily subprime for years: "In 1998 Middle America balances represent[ed] 60% of our portfolio. They represent 48% today. Last year the segment represented 54% of our portfolio."(*Id.* ¶ 174)

In response to Sears' disclosures, W.R. Hambrecht reported that Sears' "shocking 26% decrease in earnings ... stunned the Street and all in attendance" at the analysts meeting. "Frankly, it was the realization of our worst-case scenario regarding the state of the company's credit operations, which represent more than 60% of Sears' operating profit."(*Id.* ¶ 176.)Indeed, the price of Sears stock fell $10.80 per share (approximately 32%) to close at $23.15 on October 17, 2002, and there was "extraordinary trading volume" that day of 36 million shares, 12 times greater than Sears' daily trading average of 2.9 million shares during the Class Period. SRAC Debt Securities also fell 8.6% from $24.05 per share on October 16, 2002 to $21.99 per share on October 17, 2002, "on trading of 153,600 Notes, six times the daily trading average of 25,000 shares."(*Id.* ¶¶ 177, 178.)Shortly before the end of the Class Period, SRAC had announced its intention to offer approximately $800 million of three-year SRAC Debt Securities at an interest rate of 13 to 14 basis points above the one-month London Interbank Offered Rate ("Libor").[FN5](*Id.* ¶¶ 53, 179.)After the October 2002 announcements, however, the debt securities were priced at 38 points above Libor. (*Id.* ¶ 180.)

FN5. Libor represents the rate banks charge each other for short-term Eurodollar loans. Libor is "frequently used as the base for resetting rates on floating-rate securities." http://www.pncadvisors.com/investments/view/1,1419,Glossary,00.html.

On November 12, 2002, Sears filed its Form 10-Q for the third quarter of 2002. In that report, Sears for the first time revealed to investors how the Sears MasterCard and Sears Card portfolios had both been deteriorating during the Class Period. Sears explained that "[b]ecause the MasterCard portfolio has a lower delinquency rate than the Sears Card, the growth in the MasterCard portfolio coupled with the decline in the Sears Card portfolio led to an improvement in the total portfolio delinquency rate as compared to the third quarter of 2001."Sears also stated that it "charges off accounts at 240 days where[as] most bankcard issuers charge off at 180 days. Therefore Sears' delinquency rate is not directly comparable to participants of the bankcard industry."(*Id.* ¶¶ 182, 183.)With respect to its re-aging policies, Sears disclosed that

> ***8** [t]he Company's current credit processing system charges off an account automatically when a customer's number of missed monthly payments reaches eight, except that accounts can be re-aged once per year when a customer makes two consecutive monthly payments. Also, accounts may be charged off sooner in the event of customer bankruptcy. Finance charge and credit card fee revenue is recorded until an account is charged off at which point the charged off balances are presented as a reduction of revenue.

(*Id.* ¶ 184.)

An article on *The Street.com* reported that this new data "shows deep deterioration in the MasterCard portfolio. A back-of-the-envelope calculation suggests that, if this rot continues, the company may have to make loan provisions in 2003 that could wipe out a large part of the earnings analysts currently forecast."(*Id.* ¶ 186.)On November 20, 2002, Bear Steams described Sears' "aggressive write-off policy" as a "key concern," and expressed "uneas [e]" as to whether Sears had "adequately accounted for the potential level of charge-offs."[FN6](*Id.* ¶ 187.)

FN6. The Complaint does not identify the format of this report.

On January 16, 2003, Sears issued a press release announcing that it was adding another $150 million to its reserves for uncollectible accounts, in part due to "increases in the net charge-off rate and delinquencies."(*Id.* ¶ 188.)On February 28, 2003, S & P downgraded its rating on Sears, no longer deeming the company to be A-list. On March 12, 2003, Sears filed its 2002 Form 10-K repeating the delinquency and charge-off information contained in the third quarter 2002 SEC filings. (*Id.* ¶¶ 189, 190.)For the first time in a Form 10-K, Sears acknowledged, as it had in the Form 10-Q for the third quarter of 2002, that "the Company contractually charges off accounts at 240 days, whereas most bank card issuers charge off at 180 days. As a result, Sears' delinquency rates

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

are not directly comparable to participants in the bank card industry."(*Id.* ¶ 191.)

At its height, Sears' credit represented almost 70% of Sears' earnings and by 2003, Sears had become the third largest issuer of MasterCard. On March 26, 2003, however, Sears announced that it would be selling all of its credit operations "in an attempt to create value for all investors and focus on its profitable core retail and related services business."(*Id.* ¶ 192.)A number of lawsuits followed. *See, e.g., In re Sears, Roebuck & Co. Sec. Litig.,* 291 F.Supp.2d 722 (N.D.Ill.2003) (securities action filed on behalf of all persons "who purchased securities of defendant Sears, Roebuck & Co. ('Sears') between October 24, 2001 and October 17, 2002 ('class period')."); *In re Sears, Roebuck & Co. ERISA Litig.,* No. 02 C 8324, 2004 WL 407007 (N.D.Ill. Mar.3, 2004) (ERISA action filed on behalf of participants in a Sears 401(k) Savings Plan).

E. This Lawsuit

On June 17, 2003, Plaintiffs Thomas G. Ong and Thomas G. Ong IRA filed suit against Sears, SRAC, Mr. Lacy, Mr. Liska, Mr. Richter, and Mr. Bergmann, alleging violations of federal securities laws in connection with the 6/21/02 Offering of SRAC's Debt Securities. Shortly thereafter on August 27, 2003, the court appointed Plaintiffs Lead Plaintiffs pursuant to the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78O-4, *et seq.* Plaintiffs amended the Complaint on October 16, 2003, adding Mr. Keleghan, Mr. Vishwanath, Mr. Trost, Mr. Slook, Mr. Raymond, and all the underwriter Defendants as Defendants.

1. The September 27, 2004 Opinion

***9** In January 2004, Defendants filed four separate motions to dismiss the amended Complaint, variously arguing that Plaintiffs lacked standing to pursue claims relating to the 3/18/02 and 5/21/02 Offerings; the Complaint failed to identify any false and misleading statements attributable to them; Plaintiffs failed to allege *scienter,* and there was no basis for control person liability under § 15 of the Securities Act or § 20(a) of the SEA.

The court first held that Plaintiffs did not have standing to pursue their §§ 11 and 12(a)(2) Securities Act claims against the underwriter Defendants involved in the 3/18/02 and 5/21/02 SRAC Debt Securities Offerings because Plaintiffs Ong and the Ong IRA purchased securities only in the 6/21/02 Offering. *Ong,* 2004 WL 2534615, at *18. The court declined, however, to dismiss Merrill Lynch, the sole underwriter Defendant involved in the 6/21/02 Offering, finding sufficient allegations that the company had made false and misleading statements in the Registration Statement and Prospectuses. *Id.* at *18-21.

The court next addressed Plaintiffs' claim that Sears, SRAC, and all of the individual Defendants had violated § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 by misrepresenting the financial performance of Sears' credit operations. With respect to the "Sears Defendants" (including Sears, SRAC, Mr. Lacy, Mr. Liska, Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergman), the court agreed that Plaintiffs did not have standing to redress allegedly misleading statements made after Plaintiffs purchased their securities on June 21, 2002. *Id.* at *22-23. Plaintiffs adequately alleged that the Sears Defendants made false and misleading statements prior to that date relating to loan loss reserves, subprime lending, underwriting standards, and delinquencies and charge-offs. *Id.* at "23-25. Plaintiffs did not, however, allege false statements based on comparisons to other subprime lenders, such as Capital One and Discover. *Id.* at *26-27.

Nor did Plaintiffs allege facts giving rise to a strong inference that all of the Sears Defendants acted with fraudulent intent. Defendants did not dispute that Mr. Lacy or Mr. Liska had knowledge of the false and misleading statements alleged in the Complaint, which was sufficient to uphold their § 20(a) control person liability claim. *Id.* at *29, 33 (citing *Johnson v. Tellabs, Inc.,* 303 F.Supp.2d 941, 969 (N.D.Ill.2004) (a § 20(a) claim requires, in part, a primary violation of § 10(b).) As for Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann, however, the court found "no allegations ... regarding any specific meetings that [they] attended, or the information they received at those meetings that would have put them on notice that Sears was making material misstatements."*Id.* at *29.The mere fact that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann were all corporate officers was insufficient to suggest that they were aware that Sears' SEC filings and other statements were false. *Id.* at

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

*30.In addition, Plaintiffs did not allege any facts indicating that the men acted to achieve some concrete personal gain. *Id.* at *31.

***10** The court found similar deficiencies in the § 10(b) allegations relating to Mr. Keleghan and Mr. Vishwanath. Plaintiffs sufficiently alleged false and misleading statements attributable to Mr. Keleghan, but they did not offer facts supporting a strong inference of *scienter.*Plaintiffs did not identify any document or record that was authored or reviewed by Mr. Keleghan and that showed Sears deliberately sought out subprime customers. *Id.* at *35. Mr. Keleghan allegedly "routinely reviewed financial data indicating that the Sears Card and Sears MasterCard portfolios were separately declining throughout the Class Period," but then on March 14, 2002 "brag[ged] that Sears' portfolio nearly equals the market leader MBNA in its charge-off rate."*Id.* In the court's view, this comment was not enough to raise a strong inference that Mr. Keleghan acted with fraudulent intent. "All of Mr. Keleghan's admissible statements regarding the quality of Sears' credit portfolio occurred on the first day of the Class Period [October 24, 2001]; the fact that the quality of the credit portfolio declined after that date does not demonstrate that Mr. Keleghan knew his statements on October 24, 2001 were false or misleading."*Id.*

Also unavailing was Plaintiffs' argument that Mr. Keleghan was "personally responsible for the implementation of Sears' risk management policies" and, thus, must have known "such rudimentary facts as the extent to which the Company's outstanding loan balances were actually owed by subprime borrowers."*Id.* at *36. The only evidence of such knowledge was a March 7, 2002 UBS Warburg report indicating that Sears' management *"seems* focused on employing a prudent and risk averse growth strategy."*Id.* (emphasis added). The court finally declined to find an inference of *scienter* based on the fact that Mr. Keleghan was fired shortly before Sears' credit problems became public. "Given Mr. Lacy's own equivocation as to the reason for Mr. Keleghan's departure, the court is unable to infer from his termination that Mr. Keleghan knowingly made fraudulent statements."*Id.* The court did preface the foregoing conclusions, however, by noting that Mr. Keleghan's was a "close case." *Id.* at *35.

Mr. Keleghan also sought dismissal of Plaintiffs' § 20(a) claim, insisting that as President of Sears Credit, he did not exercise any control over SRAC.*Id.* at *36. Plaintiffs failed to respond to this argument, but the court found it unpersuasive. There was no dispute that Mr. Keleghan could be a controlling person with respect to Sears, and Plaintiffs alleged that there was a significant interrelation between Sears and SRAC. In the court's view, "[d]etermination of whether an individual defendant is a 'controlling person' under § 20(a) is a question of fact that cannot be determined at the pleading stage."*Id.* at *37 (quoting *In re Sears, Roebuck & Co. Sec. Litig.,* 291 F.Supp.2d 722, 727 (N.D.Ill.2003).

***11** With respect to Mr. Vishwanath, the Complaint did not allege that he made any false or misleading statements during the Class Period. *Id.* Nor could Plaintiffs establish that Mr. Vishwanath acted with fraudulent intent solely based on his position as Vice President of Sears Credit, or by reliance on the group pleading doctrine. *Id.* (citing *Chu v. Sabratek Corp.,* 100 F.Supp.2d 815, 837 (N.D.Ill.2000) ("To the extent the plaintiff's plead *scienter* based exclusively on an individual defendant's position in Sabratek's hierarchy, their claims must be dismissed."); *Johnson v. Tellabs, Inc.,* 262 F.Supp.2d 937, 946 n. 7 (N.D.Ill.2003) ("It is entirely clear ... that the PSLRA abolishes the use of the group pleading doctrine to allege defendant's *scienter."*) As with the other Defendants, however, Plaintiffs' § 20(a) control liability claim against Mr. Vishwanath survived dismissal. *Id.*

2. The Current Motions to Dismiss

On November 15, 2004, Lead Plaintiffs filed a second Amended Complaint (the "SAC"), attempting to remedy these deficiencies by adding State Universities as a Plaintiff and by asserting several new allegations. As noted earlier, Plaintiffs here seek to represent (1) all those who purchased or acquired SRAC Debt Securities pursuant to a prospectus during the Class Period (the "Issuer Class") in the 3/18/02 Offering, the 5/21/02 Offering, and the 6/21/02 Offering; and (2) all those who purchased, during the Class Period, publicly traded SRAC Debt Securities that were issued by SRAC before the start of the Class Period and actively traded through the public markets and over national security exchanges (the "Trader Class").

In Counts One through Three, Plaintiffs allege that

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

the underwriter Defendants, as well as Mr. Trost, Mr. Slook, Mr. Liska, Mr. Raymond, Mr. Richter, and Mr. Bergman violated § 11 of the Securities Act by "failing to make a reasonable investigation or possess reasonable grounds for believing that the representations contained in the Registration Statement, including the documents incorporated therein, were true and without omissions of any material facts and were not misleading."(SAC ¶¶ 249, 253, 254, 266, 270, 292, 296, 297.) Counts Four through Six charge the underwriter Defendants with violating § 12(a)(2) of the Securities Act by making material misrepresentations in the three SRAC Debt Securities offerings "knowingly or recklessly and for the purpose and effect of concealing the truth with respect to the SRAC's and Sears' operations, business management, performance and prospects from the investing public and supporting the artificially inflated price of the SRAC Debt Securities."(*Id.* ¶¶ 319, 331, 343.)Count Seven alleges that Mr. Lacy, Mr. Liska, Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann violated § 15 of the Securities Act because they acted as controlling persons of SRAC and had the power to influence and control the decision-making of both Sears and SRAC, "including the content and dissemination of the various statements which Plaintiffs contend are false and misleading herein."(*Id.* ¶ 349.)

***12** In Count Eight, Plaintiffs claim that Sears, SRAC, and all of the Individual Defendants except Mr. Vishwanath violated § 10(b) of the SEA and Rule 10b-5 promulgated thereunder by engaging in a "plan, scheme and course of conduct" to deceive the investing public regarding Sears' high-risk credit practices and induce Plaintiffs to purchase SRAC Debt Securities at artificially inflated prices during the Class Period. (*Id.* ¶ 353.)Plaintiffs also charge in Count Nine that all of the Individual Defendants violated § 20(a) of the SEA because they acted as controlling persons of SRAC and had the power to influence and control the decisions of SRAC and/or Sears, "including the content and dissemination of the SEC filings and other statements that Lead Plaintiffs contend are false and misleading."(*Id.* ¶ 365.)

Defendants have filed three separate motions to dismiss the SAC for failure to comply with the pleading requirements of FED. R. CIV. P. 9(b) and the PSLRA, and for failure to state a claim. The underwriter Defendants involved in the 3/18/02 and 5/21/02 SRAC Debt Securities Offerings-CSFB, Goldman Sachs, Morgan Stanley, Bears Stearns, and Lehman Brothers (collectively, the "Underwriter Defendants")-insist that Plaintiffs still lack standing to sue under § 12(a)(2) for statements made with respect to the 3/18/02 Offering. The Underwriter Defendants further argue that Plaintiffs have not sufficiently alleged damages relating to the 5/21/02 Offering. The Sears and SRAC Defendants, Mr. Keleghan, and Mr. Vishwanath variously claim that the SAC fails to allege that they acted with the requisite *scienter* for purposes of § 10(b) and SEC Rule 10b-5, and that they cannot be liable as control persons under § 20(a) of the Securities Exchange Act or § 15 of the Securities Act. The court addresses each argument in turn.

DISCUSSION

The purpose of a motion to dismiss is to test the sufficiency of the plaintiffs' complaint, not to decide its merits. *Gibson v. City of Chicago,* 910 F.2d 1510, 1520 (7th Cir.1990). A motion to dismiss will be granted only "if it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which entitles him to relief." *Conley v. Gibson,* 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). Plaintiffs alleging fraud must do so "with particularity," FED. R. CIV. P. 9(b), meaning that they must identify "the who, what, when, where and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young,* 901 F.2d 624, 628 (7th Cir.1990). The particularity requirement ensures that plaintiffs "conduct a precomplaint investigation in sufficient depth to assure that the charge of fraud is responsible and supported, rather than defamatory and extortionate." *Ackerman v. Northwestern Mut. Life Ins. Co.,* 172 F.3d 467, 469 (7th Cir.1999).

In addition to complying with Rule 9(b), Plaintiffs must also follow the strict pleading requirements of the PSLRA, which was enacted to discourage claims of "so-called 'fraud by hindsight.' " *In re Midway Games, Inc. Sec. Litig.,* 332 F.Supp.2d 1152, 1155 (N.D.Ill.2004) (quoting *In re Brightpoint, Inc. Sec. Litig.,* No. IP99-0870-C-H/G, 2001 WL 395752, at *3 (S.D.Ind. Mar.29, 2001)). The PSLRA requires plaintiffs to "specify each statement alleged to have been misleading, [and] the reason why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). Plaintiffs must also "state with particularity facts giving rise to a strong inference that the defendant acted with the

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

required state of mind." 15 U.S.C. § 78u-4(b)(2).*See also* *Chu,* 100 F.Supp.2d at 823.

I. The Underwriter Defendants

***13** The Underwriter Defendants argue that the addition of State Universities as a Plaintiff in this case is not sufficient to allege a § 12(a)(2) claim with respect to the 3/18/02 Offering because State Universities was an after-market purchaser. (UD Mem., at 5.) [FN7] The Underwriter Defendants also claim that Plaintiffs have not sufficiently alleged damages to support their §§ 11 and 12(a)(2) claims relating to the 5/21/02 Offering. The Sears Defendants have joined in both arguments and the court considers each in turn.

> FN7. The Memorandum of Law in Support of Credit Suisse First Boston LLC, Goldman Sachs & Co., Inc., Morgan Stanley, Bear, Stearns & Co. Inc. and Lehman Brothers' Motion to Dismiss Counts II, IV and V of Plaintiffs' Second Amended Complaint is cited as "UD Mem., at __."

A. The 3/18/02 Offering

The Underwriter Defendants first seek dismissal of Count Four of the SAC, in which Plaintiffs allege a § 12(a)(2) claim against CSFB and Goldman Sachs relating to the 3/18/02 Offering, for lack of standing. Standing under § 12(a)(2) requires the purchase of securities offered in the prospectus. *See* *Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 644 F.2d 1194, 1196 (6th Cir.1981) (options trader was a seller, and not a purchaser of securities so he lacked standing to sue under § 12(a)(2)); *Cathedral Trading, LLC v. Chicago Bd. Options Exchange,* 199 F.Supp.2d 851, 858 (N.D.Ill.2002) (quoting *Akerman v. Oryx Communications, Inc.,* 810 F.2d 336, 344 (2d Cir.1987)) ("Section 12 imposes liability on persons who offer or sell securities and only grants standing to the person purchasing such security from them"). The purchase, moreover, must be from an initial public offering. *See* *Gustafson v. Alloyd Co.,* 513 U.S. 561, 580, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995) ("Congress contemplated that § 12(2) would apply only to public offerings by an issuer."); *Danis v. USN Communications, Inc.,* 73 F.Supp.2d 923, 932 (N.D.Ill.1999) ("the text of § 12 grants a cause of action only to those who purchase 'from' 'a seller of a security by prospectus'-in an initial public offering.")

State Universities is the only named Plaintiff to have purchased stock from the 3/18/02 Offering. The Underwriter Defendants argue that State Universities purchased the stock on the open market, and not from the initial public offering. As a result, the Underwriter Defendants insist, State Universities was an after-market purchaser and does not have standing to redress claims under § 12(a)(2). (UD Mem., at 4-5 (citing *In re Transkaryotic Therapies, Inc. Sec. Litig.,* 319 F.Supp.2d 152, 158 (D.Mass.2004) (dismissing § 12(a)(2) claim asserted by plaintiffs who admitted to purchasing their securities on the open market and not through an initial public offering); UD Reply, at 2.) [FN8]

> FN8. The Reply Memorandum of Law in Support of Credit Suisse First Boston LLC, Goldman Sachs & Co., Inc., Morgan Stanley, Bear, Stearns & Co. Inc. and Lehman Brothers' Motion to Dismiss Counts II, IV and V of Plaintiffs' Second Amended Complaint is cited as "UD Reply, at __."

Plaintiffs neither confirm nor deny that State Universities purchased stock on the open market, arguing instead that this presents a question of fact that cannot be resolved on a motion to dismiss. (Pl. UD Resp., at 3-4.) [FN9]In support of this assertion, Plaintiffs cite *Shapiro v. UJB Fin. Corp.,* 964 F.2d 272 (3d Cir.1992), in which the plaintiffs brought §§ 11 and 12 claims against UJB, a bank holding company, alleging that it issued a false and misleading prospectus and registration statement in connection with a dividend reinvestment and stock purchase plan ("DRISP"). *Id.* at 275, 285-86."Under the DRISP, shareholders reinvested their dividends by purchasing additional UJB Shares.... Some of these new shares were authorized but previously unissued treasury stock, but others were purchased by UJB in the secondary market." *Id.* at 285-86.Given that the after-market shares were purchased by the defendant, and not by the plaintiffs, the court determined that the plaintiffs needed discovery in order "to know whether their shares were newly issued or were purchased in the secondary market." *Id.* at 286.The court therefore assumed, for purposes of a motion to dismiss, that the "plaintiffs' shares did not come from the secondary market." *Id.* at 287 n. 16.

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

FN9. The Memorandum in Support of Plaintiffs' Opposition to Defendants Credit Suisse First Boston LLC, Goldman Sachs & Co., Inc., Morgan Stanley, Bears Stearns & Co. Inc., and Lehman Brothers Motion to Dismiss Counts II, IV and V of the Second Amended Complaint is cited as "Pl. UD Resp., at __."

***14** Unlike the plaintiffs in *Shapiro,* Plaintiff State Universities purchased the stock at issue in this case. Plaintiffs surely do not need discovery to determine whether that purchase was from an initial public offering or the secondary market. Indeed, the SAC confirms that State Universities purchased stock from the 3/18/02 Offering on September 17, 2002, some six months after the initial offering. (SAC Ex. D ¶ 5.) As noted, Plaintiffs nowhere deny that State Universities was an after-market purchaser and, thus, it is not a qualified purchaser for purposes of § 12(a)(2).

Plaintiffs attempt to avoid this result by citing to cases addressing the pleading and traceability requirements of § 11. *See, e.g., Harden v. Raffensperger, Hughes & Co.,* 65 F.3d 1392, 1399-1400 (7th Cir.1995) ("Section 11 of the Securities Act creates an express cause of action against a series of individuals for material misstatements in or omissions of material fact from a registration statement."); *In re Global Crossing, Ltd. Sec. Litig .,* 313 F.Supp.2d 189, 208 (S.D.N.Y.2003) (for purposes of § 11 claim, "[p]laintiffs have not been required to explain how their shares can be traced; general allegations that plaintiff purchased 'pursuant to' or traceable to false registration statement have been held sufficient to state a claim."); *In re Royal Ahold N.V. Sec. & ERISA Litig.,* 351 F.Supp.2d 334, 403 (D.Md.2004) ("Considering the issue of traceability, ... plaintiffs have not adequately stated a claim under § 11.") None of these cases, however, addresses § 12(a)(2)'s requirement that a plaintiff purchase stock pursuant to an initial public offering. Plaintiffs do not have standing to assert a § 12(a)(2) claim against CSFB and Goldman Sachs relating to the 3/18/02 Offering, and Count Four of the SAC is therefore dismissed.

B. The 5/21/02 Offering

The Underwriter Defendants also argue that Plaintiffs' §§ 11 and 12(a)(2) claims relating to the 5/21/02 Offering (Counts Two and Five, respectively) must be dismissed for failure to allege any cognizable damages. To recover under §§ 11 and 12(a)(2), a purchaser must have suffered damages. *See, e.g., In re Old Banc One Shareholders,* No. 00 C 2100, 2004 WL 1144043, at *5 (N.D.Ill. Apr.30, 2004) ("[T]here can be no recovery [under § 12] unless the purchaser has suffered a loss."); *In re Broderbund/Learning Co. Sec. Litig.,* 294 F.3d 1201, 1203 (9th Cir.2002) (dismissing §§ 11 and 12 claims where the plaintiff sold his shares at a profit). Section 11 provides that damages are capped at "the difference between the amount paid for the security ... and (1) the value thereof as of the time such suit was brought."15 U.S.C. § 77k(e). Under § 12(a)(2), a plaintiff still holding the challenged security at the time he files a lawsuit is entitled to rescission; i.e., "the consideration paid for such security with interest thereon...."15 U.S.C. § 77l(a).

The SAC alleges that State Universities made the following purchases from the 5/21/02 Offering: (1) 430,000 shares on May 21, 2002 at $97.101 per share; (2) 200,000 shares on May 29, 2002 at $97 .494 per share; and (3) 350,000 shares on June 18, 2002 at $97.478 per share. (SAC Ex. D ¶ 6.) The SAC also alleges generally that State Universities "purchased SRAC Debt Securities during the Class Period at artificially inflated prices and has been damaged thereby."(*Id.* ¶ 11.)The Underwriter Defendants insist that these allegations are inadequate because they nowhere suggest that State Universities sold its notes at a loss. (UD Mem., at 6-7 (citing *In re AOL Time Warner, Inc. Sec. and "ERISA" Litig.,* 381 F.Supp.2d 192, 2004 WL 992991, at "38-39 (S.D.N.Y. May 5, 2004) (dismissing claims against bond underwriters for lack of standing where the bonds purchased by the plaintiffs "actually increased in value" and were trading above their offering prices when the underwriter defendants were added to the lawsuit).)

***15** Plaintiffs concede that State Universities "continues to hold the May 2002 notes."(Pl. UD Resp., at 9.) The Underwriter Defendants argue that the value of these notes at the time of suit exceeded their value at the date of purchase, and that Plaintiffs therefore have no cognizable claim under § 11. (UD Mem., at 7.) Specifically, the Underwriter Defendants present securities prices for the 5/21/02 Offering notes [FN10] reflecting that at the time this lawsuit was filed on June 17, 2003, the notes were trading at $113.65 per

share. When Plaintiffs amended the complaint on October 16, 2003 to add the Underwriter Defendants, the notes were trading at $105.89. (*Id.* at 4-5, Ex. A.) Indeed, between October 16, 2003 and November 17, 2004, the notes traded below $100 per share only once-on May 13, 2004, when they traded at $99.84 (still higher than any price paid by State Universities).(*Id.* Ex. A.)

> FN10. On a motion to dismiss, the court may take judicial notice of published stock prices if they are in the record. *Grimes v. Navigant Consulting, Inc.,* 185 F.Supp.2d 906, 913 (N.D.Ill.2002) (internal citations omitted).

Plaintiffs respond that this lawsuit "effectively commenced" for purposes of calculating damages under § 11 on October 18, 2002, when they filed a different federal class action on behalf of "persons who purchased securities of defendant Sears, Roebuck & Co. ("Sears") between October 24, 2001 and October 17, 2002."*See* *In re Sears, Roebuck and Co. Sec. Litig.,* 291 F.Supp.2d 722, 724 (N.D.Ill.2003); (Pl. UD Resp., at 6.) At that time, the notes were trading at $81.25, "far lower than the approximately $97 [State Universities] originally paid."[FN11](*Id.* at 7.) Plaintiffs contend that under FED. R. CIV. P. 15(c)(2), the lawsuit pending before this court should "relate back" to the earlier October 18, 2002 lawsuit, which remains pending before Judge Bucklo. (*Id.*) Plaintiffs note that both cases allege "very similar, if not identical, violations of the federal securities laws relating to [Sears'] earnings guidance and credit portfolio." (*Id.* at 7-8 (citing *Bularz v. Prudential Ins. Co. of Am.,* 93 F.3d 372, 379 (7th Cir.1996) (new substantive claim that was otherwise time-barred related back to the date of the original pleading where the claim stemmed from the same " 'conduct, transaction or occurrence' as was alleged in the original complaint.").)

> FN11. The securities prices submitted by the Underwriter Defendants indicate that as of October 18, 2002, the notes were trading at $77.57. (UD Mem., Ex. A.)

Plaintiffs' argument misconstrues Rule 15(c)(2), which provides for relation back "where an amended complaint asserts a new claim on the basis of the same core of facts, but involving a different substantive legal theory than that advanced in the original pleading ." *Bularz,* 93 F.3d at 379. Nothing in Rule 15(c)(2) supports the theory that one lawsuit may relate back to an entirely separate lawsuit. The fact that both lawsuits allege similar conduct by Sears is not sufficient, particularly where, as here, the October 18, 2002 lawsuit seeks redress for those who purchased Sears stock, not the SRAC Debt Securities at issue in this case. *See, e.g., Merzin v. Provident Fin. Group, Inc.,* 311 F.Supp.2d 674, 686 (S.D.Ohio 2004) ("Silverback Plaintiffs" who did not file original complaint but who joined the lawsuit sometime thereafter could not price their securities as of the filing date of the original complaint; "[i]t would not comport with the interests of justice to allow the Silverback Plaintiffs to relate back to a Complaint which they did not file ...") Plaintiffs do not dispute that the 5/21/02 notes purchased by State Universities were worth more on June 17 and October 16, 2003 than State Universities paid for them. The State Universities suffered no damage and, thus, Count Two of the SAC will be dismissed.

***16** As for Plaintiffs' § 12(a)(2) claim, the Underwriter Defendants argue that State Universities' only potential remedy-rescission-is unavailable here because the notes are currently trading at a price that exceeds the purchase price. (UD Mem., at 7-8 (citing *Merzin,* 311 F.Supp.2d at 684 (dismissing § 12(a)(2) claim where rescission "would clearly result in a loss for Plaintiffs.") .) In *Merzin,* for example, the plaintiffs purchased securities for $25 per share. At the time they filed their lawsuit, the price per share had dipped below $25, but by the time of the court's ruling on the defendants' motion to dismiss, the stock was trading in excess of $30 per share. 311 F.Supp.2d at 684. The court dismissed the plaintiffs' § 12(a)(2) claim, noting that they would suffer a loss by tendering back their stock in exchange for the value of the consideration paid (*i.e.,* $25 per share) as opposed to selling the shares on the open market for in excess of $30 per share. *Id.*

Plaintiffs oppose such a "moving target approach," noting that "[i]nvestors in this scenario would be forced into a form of Russian roulette in trying to time the sale of their securities."(Pl. UD Resp., at 9-10.) In Plaintiffs' view, "the damages suffered by investors who purchase securities pursuant to false and misleading information [are] not abrogated simply because the price of those securities ultimately

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

(or temporarily) rises."(*Id.* at 10.)Plaintiffs do not cite any support for this argument, and courts have found that "[t]he proper time for the plaintiff to choose between damages and rescission 'is at the time the complaint is filed." ' *In re AOL Time Warner, Inc. Sec. and "ERISA" Litig.,* 2004 WL 992991, at *39 (quoting *Wigand v. Flo-Tek, Inc.,* 609 F.2d 1028, 1035 (2d Cir.1979)).*But see* *Merzin,* 311 F.Supp.2d at 684. In this court's view, the proper time for the damages/rescission choice in this case was November 15, 2004, the date State Universities was added as a Plaintiff. On that date, the SRAC notes were trading at $105.04 per share, well above the $97 per share purchase price. (UD Reply, Ex. A.)

Even using the dates of the previous complaints, moreover, State Universities would still suffer a loss by tendering back its SRAC notes in exchange for the purchase price. On June 17, 2003, the notes were trading at $113.65 per share, and on October 16, 2003, the notes were trading at $105.89 per share. (*Id.*) Plaintiffs have failed to state a claim for damages under § 12(a)(2) with respect to the 5/21/02 notes and Count Five of the SAC is therefore dismissed.

II. The Sears and SRAC Defendants

Plaintiffs allege that Sears, SRAC, and all of the individual Defendants except Mr. Vishwanath violated § 10(b) of the Securities Exchange Act and SEC Rule 10b-5 by misrepresenting the financial performance of Sears' credit operations, which caused Plaintiffs to purchase securities at artificially inflated prices. Plaintiffs also allege that all of the individual Defendants are responsible for the misrepresentations as controlling persons under § 20(a) of the SEA and under § 15 of the Securities Act. To state a claim under § 10(b) and Rule 10b-5, Plaintiffs must allege that each defendant "(1) made a misstatement or omission, (2) of material fact, (3) with *scienter,* (4) in connection with the purchase or sale of securities, (5) upon which the plaintiff[s] relied, and (6) that reliance proximately caused plaintiff[s'] injuries." *In re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 280 (7th Cir.1996).

***17** To state a claim under § 20(a) of the Act, Plaintiffs must allege "(1) a primary securities violation; (2) [that] each of the Individual Defendants exercised general control over the operations of [Sears and/or SRAC]; and (3) [that] each of the Individual Defendants 'possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Tellabs,* 303 F.Supp.2d at 969 (quoting *Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 881 (7th Cir.1992)). The requirements for claims under § 15 of the Securities Act "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." *Miller v. Apropos Technology, Inc.,* No. 01 C 8406, 2003 WL 1733558, at *7 (N.D.Ill. Mar.31, 2003).*See also*15 U.S.C. § 77o(a).

In addition to Count Two discussed above, the Sears Defendants have moved to dismiss Counts Seven, Eight, and Nine of the SAC. They insist that Plaintiffs have once again failed to allege that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, or Mr. Bergmann acted with fraudulent intent for purposes of a § 10(b) claim. The Sears Defendants also urge that the *scienter* allegations against Mr. Lacy and Mr. Liska are insufficient as a matter of law. As a result, the Sears Defendants argue, the § 10(b) claim against Sears and SRAC fails as well, requiring dismissal of Plaintiffs' §§ 10(b) and 20(a) claims (Counts Eight and Nine). Finally, the Sears Defendants seek dismissal of Count Seven on the ground that none of the Individual Sears Defendants was a controlling person of SRAC. Mr. Keleghan and Mr. Vishwanath have separately moved to dismiss Counts Eight and Nine on similar grounds. The court addresses each argument in turn.

A. *Scienter*

The Sears and SRAC Defendants argue that Plaintiffs have not alleged *scienter* with respect to any of the individual Defendants in this case, and that the § 10(b) claims against all Defendants should therefore be dismissed. To establish *scienter,* Plaintiffs must plead facts establishing that the Sears and SRAC Defendants acted with intent to deceive. *S.E.C. v. Jakubowski,* 150 F.3d 675, 681 (7th Cir.1998). The Seventh Circuit has not addressed the proper test for *scienter* in light of the PSLRA, and courts in this district are split. Most courts, however, have adopted the standard enunciated by the Second Circuit, requiring plaintiffs in a PSLRA action to allege (1) facts show-

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

ing that defendants had both motive and opportunity to commit fraud; or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Press v. Chemical Investment Servs. Corp.,* 166 F.3d 529, 538 (2d Cir.1999).*See In re Spiegel, Inc. Sec. Litig.,* 382 F.Supp.2d 989, 2004 WL 1535844, at *24 (N.D.Ill. July 8, 2004) (collecting cases).

***18** Plaintiffs claim that the Sears and SRAC Defendants knew that Sears' credit card accounts were riskier and more unstable than they led the public to believe, which demonstrates conscious misbehavior or recklessness. (Pl. Sears Resp., at 3.) [FN12] Recklessness requires "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care ... to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Finance Corp.,* 954 F.Supp. 1246, 1255 (N.D.Ill.1997)."[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements. Under such circumstances, defendants knew or, more importantly, should have known that they were misrepresenting material facts related to the corporation." *Novak v. Kasaks,* 216 F.3d 300, 308 (2d Cir.2000). One of the "classic fact patterns" that gives rise to a strong inference of *scienter* is where "defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate." *Florida State Bd. of Admin. v. Green Tree Fin. Corp.,* 270 F.3d 645, 665-66 (8th Cir.2001) (citing *City of Philadelphia v. Fleming Cos.,* 264 F.3d 1245, 1260-61 (10th Cir.2001)); *In re Scholastic Corp. Sec. Litig. .,* 252 F.3d 63, 76 (2d Cir.2001); *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1064 (9th Cir.2000); *Novak,* 216 F.3d at 311.

> FN12. Plaintiffs' Response to the Sears Defendants' Motion to Dismiss Claims Two, Seven, Eight and Nine of the Second Amended Class Action Complaint is cited as "Pl. Sears Resp., at ___."

1. The Deficiencies in the Amended Complaint

As noted, this court found the *scienter* allegations of the Amended Complaint lacking in several respects. First, the court found "no allegations ... regarding any specific meetings that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, or Mr. Bergmann attended, or the information they received at those meetings that would have put them on notice that Sears was making material misstatements." *Ong,* 2004 WL 2534615, at *29. The mere fact that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann were all corporate officers was insufficient to suggest that they were aware that Sears' SEC filings and other statements were false. *Id.* at *30. In addition, Plaintiffs did not allege any facts indicating that the men acted to achieve some concrete personal gain. *Id.* at *31.

The court also determined that "[a]ll of Mr. Keleghan's admissible statements regarding the quality of Sears' credit portfolio occurred on the first day of the Class Period [October 24, 2001]," and that the decline in the credit portfolio quality after that date "d[id] not demonstrate that Mr. Keleghan knew his statements on October 24, 2001 were false or misleading."*Id.* at *35.In that regard, the court noted that Plaintiffs did not identify any document or record that was authored or reviewed by Mr. Keleghan and that showed Sears deliberately sought out subprime customers. *Id.* at *35.Plaintiffs' assertion that Mr. Keleghan "routinely reviewed financial data indicating that the Sears Card and Sears MasterCard portfolios were separately declining throughout the Class Period" and was "personally responsible for the implementation of Sears' risk management policies," without more, was not sufficient to raise a strong inference that Mr. Keleghan acted with fraudulent intent. *Id.* at *35, 36.

***19** In addition, Mr. Keleghan's discharge shortly before Sears' credit problems became public did not support an inference of *scienter* given "Mr. Lacy's own equivocation as to the reason for Mr. Keleghan's departure."*Id.* at *36. The court allowed Plaintiffs' § 10(b) claims to proceed as against Sears, SRAC, Mr. Lacy, and Mr. Liska, however, finding no clear objection to the sufficiency of the *scienter* allegations with respect to the latter two individuals. The court nonetheless invited Mr. Lacy and Mr. Liska to challenge the *scienter* allegations in light of the findings regarding the other individual Defendants. *Id.* at *29 n .20.

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

2. The *Scienter* Allegations in the SAC

In the SAC, Plaintiffs allege that the Individual Defendants "were fully aware of the problems inherent in [Sears' credit] portfolio because of a detailed reporting system that enabled them to monitor the credit ratings of each consumer on a regular basis."(SAC ¶ 209.) Plaintiffs note that in Sears' 2001 Form 10-K, "[m]anagement represented ... that it [Sears] maintained a system of internal controls to ensure proper accounting and financial disclosures, and that it reviewed loan loss reserves to ensure that such reserves were adequate to account for likely losses inherent in the portfolio."(*Id.* ¶ 210.)The President of Sears National Bank in Arizona, which developed Sears' policies for granting credit, reported directly to Mr. Keleghan. So did both the Vice President of Asset Management and Risk Management and the Vice President of Account Services, who oversaw Sears' collections and accounts services provided by regional credit centers. (*Id.* ¶¶ 214, 215.)Each credit center had a collection division that handled matters relating to payment, and an account services division that handled initial grants of credit, alteration of credit limits, and general consumer inquiries.(*Id.* ¶ 215.)

According to the SAC, information "was gathered" every month from the regional centers and compiled into reports detailing delinquency and charge-off rates. In addition, the entire Sears portfolio "would be rescored for credit history" every quarter, and reports "were compiled" detailing the credit scores of Sears' cardholders. (*Id.* ¶ 216.)Plaintiffs do not indicate who did the gathering, compiling, or rescoring, but they do allege that the reports "were provided to" Mr. Keleghan, Mr. Vishwanath and Mr. Lacy. (*Id.*) Plaintiffs further allege that all senior executives and management, including the Individual Defendants, received a Monthly Operating Review ("MOR") from each of the collection and account services divisions. The MORs "were circulated in the second week of each month" and "compiled all pertinent financial information for each division," including "the amount of profits derived from late fees, up-to-date delinquency figures, and other important information" on charge-offs, customer composition, and loan loss reserves. (*Id.* ¶¶ 217, 218.)

***20** In addition to receiving the MORs, Mr. Keleghan purportedly attended monthly meetings at Sears headquarters to discuss problems in Sears' credit business. According to an unidentified former Sears employee who "served as an analyst in the credit finance division until November 2001," Mr. Keleghan also met "routinely" with Mr. Liska to discuss matters addressed in the division meetings, and he met with Mr. Lacy in that regard "on occasion." (*Id.* ¶¶ 217, 219, 220.)At Sears' quarterly meetings for all managers and directors responsible for collection, which were "usually" led by Mr. Keleghan and attended by Mr. Lacy, participants discussed promotional policies, delinquency statistics, credit scores, and the effectiveness of the collections operations. "Each meeting also included discussions of similar reports that were generated and available at headquarters, and in the field, detailing payment, delinquency, and charge-off data on a monthly basis."(*Id.* ¶ 221.)Plaintiffs claim that these meetings demonstrate that "organizational structures were in place which facilitated the flow of information, through meetings and reports, to senior management at Sears and SRAC," and that "Sears' top management (including the Sears Defendants) were made personally aware of the credit scores of the entire Sears credit portfolio."(*Id.* ¶¶ 220, 222.)

According to another unidentified former Sears employee described as "a twenty-year veteran of the Company who served as director of finance for Sears' retail division from 1993 through 2001," Mr. Lacy and Mr. Liska attended planning meetings where "each division presented key financial information, analyses of each division's performance, and comparative analyses with previous years' performance and projections."(*Id.* ¶ 223.)All of the Sears Defendants, moreover, "were kept apprised of" the credit card business by virtue of a DOS-based computer program known as Total System ("TSYS"). According to a third, unidentified former Sears national management employee who worked at the company from June 2002 until January 2003, "TSYS processed and tracked all credit card transactions, as well as delinquencies and charge-offs."Plaintiffs claim that TSYS "could be viewed at any point in time so that managers could be kept informed of current delinquency and charge-off data."(*Id.* ¶ 226.)In fact, TSYS integrated a computer program developed by Mr. Keleghan and Mr. Vishwanath and launched in 1999 "that conducted risk analyses for the credit card portfolio."(*Id.* ¶ 233.)

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

3. Analysis

Plaintiffs' new allegations essentially fall into three categories: (1) all senior executives and management received MORs containing profit and loss information, including up-to-date delinquency figures and information on charge-offs, customer composition, and loan loss reserves (*id.* ¶¶ 217, 218); (2) senior executives met regularly to discuss the performance of Sears' credit division (*id.* ¶¶ 218-220, 223); and (3) Sears management had access to the TSYS computer database, which integrated a risk analysis computer program developed by Mr. Keleghan and Mr. Vishwanath. (*Id.* ¶ 233.)The Sears and SRAC Defendants argue that these new allegations are insufficient to demonstrate that they knew or recklessly disregarded the truth about the quality of the Sears portfolio. For the reasons explained below, the court sustains Defendants' objections in part and overrules them in part.

a. The Individual Defendants

***21** The Individual Defendants begin by arguing that general allegations that a defendant received internal financial reports cannot support an inference of *scienter.*(Sears Mem., at 5 (citing *Johnson v. Tellabs, Inc.*); K/V Mem., at 10).) [FN13] In *Tellabs,* the plaintiffs alleged that the defendants knew or recklessly disregarded that their statements about Tellabs' financial condition were false because the defendants received regular reports about daily product bookings, revenues, and product development. 303 F.Supp.2d at 963. The court found these allegations insufficient, noting that the complaint omitted a variety of pertinent details about those reports:

> FN13. The Memorandum of Law in Support of Motion to Dismiss of Defendants Kevin Keleghan and K.R. Vishwanath is cited as "K/V Mem., at ___."

> Plaintiffs do not describe the contents of these reports or detail what such reports reflected. They do not allege who, other than the "finance department," prepared such reports. They do not allege any particularized facts showing how the information contained in the reports demonstrated the falsity of Tellabs' fourth quarter financial results or sufficient facts regarding how the information supports any inference of knowledge of falsity.

Id. Also insufficient were slightly more specific allegations that the reports showed "declining demand in the third and fourth quarters of 2000 for a variety of Tellabs' products, including the TITAN 5500."Specifically, the plaintiffs failed to allege "what reports showed a decline in the demand," "who received such reports," "what information was reflected in th[e] report[s], how significant the decline in demand was, or how much of the decline was attributed to the TITAN 5500 as opposed to other products."*Id.* In the court's view, "allowing a plaintiff to go forward with a case based on general allegations of 'negative internal reports' would expose all ... companies [with internal reporting systems] to securities litigation whenever their stock prices dropped."*Id.* at 963-64 (quoting *In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1087-88 (9th Cir.2002)).

The Individual Defendants also rely on *Tellabs* for the proposition that attendance at meetings is not alone sufficient to demonstrate fraudulent intent. (Sears Mem., at 7-8 (citing *Tellabs,* 303 F.Supp.2d at 966 (fact that Tellabs' officer made quarterly presentations with respect to Tellabs' financial position at "town hall" meetings did not create strong inference of *scienter* absent allegations that the officer knew of the alleged problems with the product at issue); K/V Mem., at 9-10.) As for access to the TSYS computer database, the Sears Defendants argue, Plaintiffs point to no specific information contained in that system that would have put the Individual Defendants on notice that Sears was making material misstatements. (*Id.* at 8; K/V Mem., at 9.) In addition, Plaintiffs do not allege that any individual Defendant actually received, reviewed, or recklessly ignored reports generated by TSYS. (*Id.* at 9.)

***22** Plaintiffs first object that the Individual Defendants have employed the wrong standard for pleading *scienter* because this court adopted the Second Circuit's test, which the *Tellabs* court rejected. (Pl. Sears Resp., at 4.) This argument is a non-starter. In a case where a plaintiff seeks to establish *scienter* based on conscious disregard or recklessness, the requirements set forth in *Tellabs* are the same as those adopted by this court: "Reckless conduct is, at 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

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

have been aware of it." *Tellabs,* 303 F.Supp.2d at 961 n. 15 (quoting *Rehm,* 954 F.Supp. at 1255); *Ong,* 2004 WL 2534615, at *27 (quoting *Rehm,* 954 F.Supp. at 1255). The *Tellabs* court held that plaintiffs "may use 'motive and opportunity' or 'circumstantial evidence' to establish *scienter* under the PSLRA, only if Plaintiffs' allegations support a strong inference that each Defendant acted recklessly or knowingly." 303 F.Supp.2d at 961. This court has already determined that Plaintiffs failed to plead *scienter* based on motive and opportunity even under a test arguably less stringent than the one imposed by *Tellabs,* and the SAC does not add any new allegations in that regard. *Ong,* 2004 WL 2534615, at *30-31.

Plaintiffs next insist that the SAC does provide allegations of "specific documents received by the Sears Defendants and specific meetings attended by them."(Pl. Sears Resp., at 9; Pl. K/V Resp., at 7-8.) [FN14]For example, all senior executives and management received MORs and had access to the TSYS computer program, which was integrated with a risk analysis program developed by Mr. Keleghan. (SAC ¶¶ 217, 218, 226, 233.) In addition, Mr. Lacy "w[as] provided [with]" reports detailing delinquency and charge-off rates and the credit scores of Sears' cardholders. (*Id.* ¶ 221.)Mr. Liska "routinely" met with Mr. Keleghan to discuss matters addressed at monthly meetings of executives within Mr. Keleghan's division, and Mr. Lacy and Mr. Liska both attended planning meetings two or three times per year at which each division presented certain "key financial information." (*Id.* ¶¶ 220, 223.)(*See also* Pl. Sears Resp., at 9-11.) In Plaintiffs' view, these allegations, "read in conjunction with the entire Complaint, show an organizational structure that gave each Sears Defendant access to the very credit information concealed from the investing public."(*Id.* at 11.)

> FN14. Plaintiffs' Memorandum of Law in Opposition to Motion of Defendants Kevin Keleghan and K.R. Vishwanath to Dismiss the Second Amended Class Action Complaint is cited as "Pl. K/V Resp., at ___."

In support of this argument, Plaintiffs cite *Sutton v. Bernard,* No. 00 C 6676, 2001 WL 897593 (N.D.Ill. Aug.9, 2001), where the plaintiffs alleged that the defendants were high-level executives who were involved in the day-to-day operations of the company and who closely monitored the company through internal reports. The court found those allegations sufficient to create a strong inference of *scienter. Id.* at *6. Notably, however, *Sutton* also embraced the "group pleading" doctrine, which "allows plaintiffs 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."*Id.* at *5 n. 5. In *Ong,* this court reaffirmed its conclusion that "group pleading may be appropriate in certain circumstances notwithstanding the PSLRA, [only] as long as the complaint sets forth facts demonstrating that each defendant may be responsible for the fraudulent statements." 2004 WL 2534615, at *30 (quoting *Spiegel,* 2004 WL 1535844, at *20-23). Under that standard, Plaintiffs' allegations are sufficient only with respect to some of the Individual Defendants.

i. Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann

***23** The SAC does not present any facts demonstrating that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, or Mr. Bergmann acted with fraudulent intent. Plaintiffs once again fail to identify a single meeting that these Defendants attended, much less the specific information they purportedly reviewed at those meetings. Indeed, the names of these five individuals do not appear anywhere in Plaintiffs' new *scienter* allegations. (SAC ¶¶ 209-34.) General allegations that these Defendants attended meetings where they discussed promotional policies, delinquency statistics, credit scores, and the effectiveness of the collections operation do not satisfy the PSLRA's requirement that Plaintiffs plead facts showing that each Defendant knew or recklessly disregarded that Sears was making material misstatements. (SAC ¶ 221.) Significantly, these are the same allegations this court found lacking to establish *scienter* on the part of Mr. Keleghan in the prior Complaint. *Ong,* 2004 WL 1534615, at *35.*See also*15 U.S.C. § 78u-4(b)(2) (plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."); *Chu,* 100 F.Supp.2d at 823.

With respect to the MORs and the monthly reports

from the regional centers, Plaintiffs identify neither who prepared the documents nor which ones Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond or Mr. Bergmann actually saw or reviewed. Plaintiffs also fail to cite any specific data within those reports that should have alerted these Defendants that Sears was making material misstatements. Plaintiffs' general assertions that the reports and MORs contained "pertinent financial information" regarding delinquency and charge-off rates is insufficient. *See, e.g., Arazie v. Mullane,* 2 F.3d 1456, 1466-67 (7th Cir.1993) (affirming dismissal where stockholders failed to refer to any document, meeting, or transaction that could or should have put the defendant on notice that the New Jersey Casino Control Commission objected to a $50 million loan from defendant's Atlantic City casino to service its own debt on casinos located in Nevada).

The fact that "TSYS could be viewed at any point in time" and was "made available to each Individual Defendant" similarly fails to establish that Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond or Mr. Bergmann knew their statements regarding Sears' credit portfolio were false. Plaintiffs do not allege that these Defendants ever accessed TSYS or received and reviewed specific TSYS reports that conflicted with Sears' public statements. *See In re Spiegel,* 2004 WL 1535844, at *35 (finding no inference of *scienter* where the plaintiffs did not allege that the company's CEO "actually received or reviewed" two documents prepared by an internal auditor regarding serious problems with the company's credit business).*Compare Asher v. Baxter Int'l, Inc.,* No. 02 C 5608, 2005 WL 331572, at *8 (N.D.Ill. Feb.3, 2005) (allegations that the individual defendants "routinely accessed ... Baxter's weekly (and even daily) revenue and financial reports via a computer system," combined with allegations that nine of eleven defendants financially benefitted from false information by selling their company stock, and that the company was able to acquire a competitor at a much lower cost, supported inference of *scienter*).

***24** Plaintiffs' additional arguments regarding Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann merit little discussion. The court has already rejected Plaintiffs' theory that *scienter* may be inferred because "organizational structures were in place which facilitated the flow of information, through meetings and reports, to senior management at Sears and SRAC."(SAC ¶ 223.) *Ong,* 2004 WL 2534615, at *35. In addition, a violation of Generally Accepted Accounting Principles ("GAAP"), standing alone, is insufficient to raise an inference of fraudulent intent. *Stavros v. Exelon Corp.,* 266 F.Supp.2d 833, 850 (N.D.Ill.2003).

ii. Mr. Lacy, Mr. Liska, and Mr. Keleghan

With respect to Mr. Lacy, Mr. Liska, and Mr. Keleghan, the court concludes that Plaintiffs have sufficiently alleged *scienter* for purposes of the PSLRA. Unlike the other Individual Defendants, Mr. Liska and Mr. Keleghan both attended management meetings to discuss Sears' financial status. For example, Plaintiffs allege that two or three times a year, Mr. Lacy's "staff-including CFO Paul Liska" attended senior management planning meetings at which "each [account services and collection] division presented key financial information, analyses of each division's performance, and comparative analyses with previous years' performance and projections."(SAC ¶ 223.) Plaintiffs also allege that Mr. Keleghan attended monthly meetings at which "all Sears credit delinquencies were tracked and discussed," and that he led quarterly meetings for all managers and directors responsible for collections around the country. (*Id.* ¶¶ 219, 221.)Mr. Keleghan also developed the credit portfolio risk analysis computer program that was integrated with the TSYS system. (*Id.* ¶ 233.)

Of primary significance, however, is the fact that the court may now consider statements that Mr. Lacy, Mr. Liska, and Mr. Keleghan made after June 21, 2002. The court previously determined that such statements were inadmissible because the only Plaintiffs named in the Amended Complaint, Thomas G. Ong and the Thomas G. Ong IRA, had purchased their debt securities on June 21, 2002. Thus, the court determined that the purchase price "could not have been affected by statements made after that date." *Ong,* 2004 WL 2534615, at *23. The Sears Defendants now concede that the addition of State Universities as a named Plaintiff "cures the Section 10(b) standing defect; according to its certification, [State Universities] bought SRAC notes as late as October 17, 2002."(Sears Mem., at 2 n. 3.)

Mr. Lacy, Mr. Liska, and Mr. Keleghan made several admissible statements within the Class Period sug-

gesting that they had knowledge regarding the performance of the separate Sears Card and Sears MasterCard portfolios. During an April 18, 2002 conference call with analysts, for example, Mr. Liska declined to provide information on the separate portfolios, stating:

> ***25** [W]e're approaching this on a portfolio basis, because as you probably know, we originally ... substituted people out of the Sears card into the Sears MasterCard that were of better credit quality or had stopped using their Sears card. So we look at it more as managing a portfolio and we're probably never going to be in that position that we're going to talk about them as discrete portfolios because we don't manage it like that. And it would probably be misleading if we did that. So, we're just going to comment on it on a total portfolio basis.

(*Id.* ¶ 121.)Sears' decision to move customers from one card to the other based on their credit quality suggests that Sears did have data regarding the separate portfolios. Indeed, during a July 18, 2002 conference call with analysts, Mr. Lacy stated, "what we've been about with our *MasterCard* product, is having a product that has a better rate structure and more convenience, that's more appealing to better credit quality customers."(*Id.* ¶ 139 (emphasis added).) Mr. Lacy further stated that "Sears['] billed *MasterCard* balances at the end of the quarter were $8.5 billion...." (*Id.* ¶ 141 (emphasis added).) Mr. Keleghan similarly appeared to have separate information regarding the Sears Card and Sears MasterCard portfolios when he stated in a July 25, 2002 interview with *Bloomberg News* that "[w]e don't do subprime lending at all *in the MasterCard portfolio.*All my growth is coming from prime and superprime."(*Id.* ¶ 149 (emphasis added).)

Approximately two months after Mr. Keleghan assured investors that the Sears portfolio consisted entirely of prime and superprime customers, he was abruptly discharged on October 4, 2002. (*Id.* ¶¶ 149, 160.)Three days later, Mr. Lacy spoke to investors during a conference call and explained that "Kevin [Keleghan] left the company at my request, because I lost confidence in his personal credibility.... His departure is not related to business performance and does not indicate a change in our credit strategy."(*Id.* ¶¶ 163, 165.)At an analysts meeting on October 17, 2002, however, Mr. Liska stated that "Kevin was not being forthcoming about these issues that this business was facing ... and had become a barrier to getting an objective situation assessment as to what was happening in our business and I terminated him for basically my personal loss of confidence in him relative to his personal credibility."(*Id.* ¶ 172.)

Also on October 17, 2002, Sears issued a press release announcing that it would be increasing its allowance for bad debt by $222 million. (*Id.* ¶ 171.)At that time, Mr. Liska acknowledged that Sears' credit portfolio actually had been heavily subprime for years: "In 1998 Middle America balances represent[ed] 60% of our portfolio. They represent 48% today. Last year the segment represented 54% of our portfolio."(*Id.* ¶¶ 171, 174.)Despite the magnitude of the increased allowance for bad debt, Mr. Lacy had assured investors just three months earlier on July 18, 2002 that "[t]he credit quality of our receivables portfolio has ... improved."Mr. Liska had similarly confirmed that Sears had invested significantly in risk management and "fe[lt] very good about the systems environment."(*Id.* ¶¶ 135, 142.)

***26** In light of these allegations, the court is satisfied that Plaintiffs have raised a strong inference that Mr. Lacy, Mr. Liska, and Mr. Keleghan either knew or were reckless in disregarding information that the separate Sears MasterCard and Sears Card portfolios were in decline.

b. Sears and SRAC

In light of the court's determination that Plaintiffs' § 10(b) claims against Mr. Lacy, Mr. Liska, and Mr. Keleghan survive this motion, Defendants' motion to dismiss the § 10(b) claims against Sears and SRAC is denied. *See Ong,* 2004 WL 2534615, at *28 n. 19 ("A corporation can only 'know' those things known by persons acting on its behalf. The court concludes that if Plaintiffs' allegations on this matter [*scienter*] are adequate with respect to the Individual Defendants, they are adequate with respect to Sears and SRAC, as well.")

B. Control Person Liability Under § 20(a)

To state a claim under § 20(a) of the Act, Plaintiffs must allege (1) a primary violation of § 10(b); (2) each defendant's control over the operations of Sears

and/or SRAC; and (3) each defendant's power or ability to control the specific transaction or activity forming the basis of the primary violation. *Tellabs,* 303 F.Supp.2d at 969; *Sears, Roebuck and Co.,* 291 F.Supp.2d at 727. Section 20(a) does not require *scienter* or heightened pleading. *Sears, Roebuck and Co.,* 291 F.Supp.2d at 727. The Sears and SRAC Defendants claim that Plaintiffs' § 20(a) claim must fail because they have not alleged a primary violation under § 10(b). (Sears Mem., at 11-12; K/M Mem., at 10.) Having rejected the latter argument, the court concludes that the former fails as well.

Mr. Vishwanath separately argues that the § 20(a) claim against him must be dismissed because there are no allegations indicating that he had the "power or ability to control the specific transaction or activity forming the basis of the primary violation."(K/M Mem., at 11.) The court has already considered and rejected this argument in addressing Mr. Vishwanath's previous motion to dismiss. *Ong,* 2004 WL 2534615, at *37 (recognizing that the position of Vice President varies widely in the amount of control and responsibility conferred but noting that whether a defendant is a "controlling person" is a question of fact).*See also* *In re System Software Assocs., Inc.,* No. 97 C 177, 2000 WL 283099, at *16 (N.D.Ill. Mar.8, 2000).

Mr. Vishwanath insists that Plaintiffs have improperly relied on the group pleading doctrine to establish his control over Sears. In fact, the SAC alleges that "all credit finance models within the Company were under Vishwanath's control," and that Mr. Vishwanath "directly supervised the consultants who build the credit models" and "controlled the data that was released and disseminated."(SAC ¶ 224.) In addition, Mr. Vishwanath received weekly reports from the regional credit centers detailing delinquency and charge-off rates, and he helped Mr. Keleghan develop the risk analysis computer program. (*Id.* ¶¶ 225, 233.)These allegations do not rely on Mr. Vishwanath's membership in a group and are sufficient to allege that he was a controlling person for purposes of § 20(a).

C. Control Person Liability Under § 15

***27** The Sears and SRAC Defendants finally argue that Count Seven should be dismissed because Plaintiffs have not named SRAC as a primary violator of the Securities Act. Controlling person liability under § 15 of the Securities Act requires a primary violation of § 11. *See* *Tabankin v. Kemper Short-Term Global Income Fund,* No. 93 C 5231, 1994 WL 30541, at *6 (N.D.Ill. Feb.1, 1994) ("Without primary liability, there is no secondary liability.") The SAC alleges that Mr. Lacy, Mr. Liska, Mr. Richter, Mr. Trost, Mr. Slook, Mr. Raymond, and Mr. Bergmann violated § 15 because they were "controlling persons of SRAC." (SAC ¶ 349.) SRAC, however, is not named as a defendant with respect to the § 11 claims.

Plaintiffs insist that the SAC, "when taken in its totality, clearly puts the defendants on notice that SRAC is [a] primary violator under the Securities Act for the issuance of false and misleading registration statements and prospectuses."(Pl. Sears Resp., at 14-15.) The court disagrees that such an inference suffices for purposes of imposing control liability under § 15. Neither party has addressed whether SRAC qualifies as a primary violator under § 11 and, thus, Plaintiffs will be granted leave to amend the SAC with respect to this issue. The court cautions, however, that any amendment should be consistent with applicable law and immune to further objection from Defendants.

CONCLUSION

For the reasons stated above, the Underwriter Defendants' Motion to Dismiss Counts Two, Four, and Five (Docket No. 56) is granted. The Motions to Dismiss filed by Mr. Lacy and Mr. Liska, by the Sears and SRAC Defendants, and by Mr. Keleghan and Mr. Vishwanath (Docket Nos. 51, 57, and 59) are granted in part and denied in part. Count Two is dismissed for the reasons stated in discussing the Underwriter Defendants' motion to dismiss. Count Eight is dismissed as against all Defendants except Sears, SRAC, Mr. Lacy, Mr. Liska, and Mr. Keleghan. Finally, the motion to dismiss Count Seven is granted with leave to amend as set forth in this opinion, but the motion to dismiss Count Nine is denied.

N.D.Ill.,2005.
Ong ex rel. Ong v. Sears, Roebuck & Co.
Not Reported in F.Supp.2d, 2005 WL 2284285 (N.D.Ill.), Fed. Sec. L. Rep. P 93,524

END OF DOCUMENT

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

TAB 13

Only the Westlaw citation is currently available.
United States District Court, N.D. Illinois, Eastern Division.
PREMIER CAPITAL MANAGEMENT, LLC, TMB, LLC, and Xen Investors, LLC, Plaintiffs,
v.
Larry COHEN, Brian Flanagan, Wan Hee Kim, Jung Koh, Michael Turcotte, Ron Falese, Blair Robinson, Northview Bank & Trust, and Xentex Technologies, Inc., [FN1] Defendants.

FN1. This is the caption of the original complaint. On March 26, 2003, after Xentex Technologies, Inc. had filed for Chapter 11 bankruptcy, the court granted Plaintiffs' motion to dismiss Xentex without prejudice. Plaintiffs dismissed defendant Ron Falese on October 28, 2004 with their third amended complaint. Defendant Jung Koh, named in Counts XVII-XVIII, has never appeared or been defaulted in the past six years of litigation and there is nothing in the docket to show that he has even been served. Two other parties joined the case during litigation: Mathieu Reyna ("Reyna"), counter-defendant, and Douglas Tucker ("Tucker"), third party defendant. The court denied a motion for summary judgment on the counterclaims, filed by Premier and Reyna, on September 13, 2007.

No. 02 C 5368.

March 24, 2008.

West KeySummary
Federal Civil Procedure 170A 2513

170A Federal Civil Procedure
170AXVII Judgment
170AXVII(C) Summary Judgment
170AXVII(C)2 Particular Cases
170Ak2513 k. Stock, Stockholders, and Corporations, Cases Involving. Most Cited Cases
Shareholders created a genuine issue of material fact as to whether a member of a corporation's board of directors had the ability to assert general and specific control over alleged misrepresentations related to a laptop computer developer's deteriorating financial condition, such that the member could be held liable in a securities fraud action. The board member attended two board meetings, owned just ten shares of stock in the corporation, and could not be removed from the board until a $500,000 loan he made to the corporation was paid off. These facts were sufficient to create a question as to whether he exercised general control over the operations of the company. In addition, the board member's role in the creation of documents that were presented to investors involved numerous factual disputes.

Howard Steven Suskin, Marc David Sokol, Jenner & Block LLP, Christopher J. Stasko, Richardson, Stasko, Boyd & Mack, LLC, Chicago, IL, for Plaintiffs.
Jeanne Marie Hoffmann, Raymond Marion Krauze, Jennifer B. Cromheecke, Brycedowney, LLC, Alan S. Rutkoff, Steven Henry Hoeft, Avid L. Hanselman, Jr., Michael D. Arnold McDermott, Will & Emery LLP, Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER

JOAN B. GOTTSCHALL, District Judge.
***1** Plaintiffs, Premier Capital Management, LLC ("Premier"), TMB, LLC ("TMB") and Xen Investors, LLC ("Xen") (collectively "Plaintiffs"), have filed a twenty-two count third amended complaint claiming violations of federal and state securities laws, as well as several state common laws. Plaintiffs allege, among other things, that the officers and directors of Xentex Technologies, Inc. ("Xentex") violated the various laws when they induced Plaintiffs to invest in Xentex. These officers and directors were Larry Cohen ("Cohen"), Wan Hee Kim ("Kim"), Michael Turcotte ("Turcotte"), and Brian Flanagan ("Flanagan"). Plaintiffs also allege that Northview Bank & Trust ("Northview"), Xentex's bank, and its president, Blair Robinson ("Robinson"), aided and abetted that inducement by providing an environment in which Jeffrey Batio ("Batio"), the founder and Chief Executive Officer ("CEO") of Xentex, could misappropriate corporate funds. The various defendants have filed motions for summary judgment.[FN2] Before the court are two motions: (1)

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

Flanagan's motion for summary judgment on Counts VII-XI; and (2) motion for summary judgment on Counts I-VI, XII-XVI, and XIX-XX filed by defendants Cohen, Kim, and Turcotte (collectively “the Cohen Defendants”). Because Plaintiffs' claims against the four defendants are almost identical, and because the defendants raise essentially the same legal arguments, the court is ruling on both motions together. For the reasons stated below, the court grants both parties' motions in part and denies them both in part.

> FN2. The court has granted defendants Blair Robinson and Northview Bank & Trust's motion for summary judgment on Counts XXI-XXII. Plaintiff is ordered to show cause why defendant Koh should not be dismissed.

I. BACKGROUND[FN3]

> FN3. Facts are taken from the parties' Rule 56.1 statements of material facts and are undisputed unless otherwise noted. Facts specific to a particular legal claim are addressed in the relevant section below.

A. The Parties And Relevant Persons

Xentex was a Delaware corporation that, around the year 2000, was developing and launching a laptop computer with a folding screen known as the Voyager. Premier is a registered investment advisor, registered as a Delaware limited liability company. Xen is a Virginia limited liability company formed for the purpose of making investments in Xentex. TMB is a Virginia limited liability company formed for the sole purpose of making an investment in Xentex.

Cohen was a member of the Board of Directors of Xentex (the “Board”). Kim was also a member of the Board, as well as Chairman of the Executive Committee of Xentex, and the primary liaison for product development and manufacturing efforts with Xentex's business partners, including Korean Data Systems, Ltd. (“KDS”). Turcotte was Vice President of Accounting and Control and Chief Financial Officer of Xentex. Flanagan's company, Mercury Partners 135 XT, Inc., made a $500,000 loan to Xentex, the terms of which allowed the company to designate a person to be elected to the Board. Flanagan was elected to the Board and attended his first meeting in October 2000. From March to October 2000 and then again from around March 2001, Batio served as CEO of Xentex. From October 2000 to around March 2001, Batio served as Chief Strategic Officer and Joe Negler (“Negler”) joined Xentex as CEO. Douglas Tucker (“Tucker”) is an attorney who was President of Xentex from March 2000 to October 2000, Executive Vice President of Xentex from October 2000 to January 2002, and a member of the Board during his entire tenure.

B. The Transactions At Issue

***2** Xentex, through Batio and Tucker, first presented Plaintiffs with an opportunity to invest at a meeting held in Virginia on November 1, 2000. During that meeting, Plaintiffs received an Information Statement dated November 1, 2000 (the “Information Statement”), which contained numerous representations relating to Xentex, the Voyager computer, Xentex's plans for launching the Voyager into the market, and the ability of Xentex's supplier, KDS, to finance, manufacture and service necessary hardware. Plaintiffs communicated-orally and in writing-with various representatives of Xentex after this date, including at a multi-day meeting at the Xentex facility in California. Xen made a series of stock purchases between November 2000 and February 2001, purchasing a total of 400,000 shares of common stock in Xentex for $1.2 million. Subsequently, on June 4, 2001, TMB loaned Xentex $650,000 in exchange for a promissory note that was repayable in stock.

Plaintiffs allege that the representations made in the Information Statement, the oral representations made at the November 1 st meeting, and various other representations made in connection with the stock purchases and execution of the promissory note were false. Plaintiffs claim that the defendants hid Xentex's deteriorating financial condition from Plaintiffs, thereby obscuring the true value of Plaintiffs' investment.

II. ANALYSIS

A. Summary Judgment Legal Standard

Summary judgment is appropriate when the record reveals that there is no genuine issue as to any material fact and the moving party is entitled to judgment

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

as a matter of law. Fed.R.Civ.P. 56(c). It is not appropriate if a reasonable jury could return a verdict for the nonmoving party. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

In seeking a grant of summary judgment the moving party must identify "those portions of 'the pleadings, depositions, answers to the interrogatories, and admissions on file, together with the affidavits, if any,' which it believes demonstrate the absence of a genuine issue of material fact." *Celotex Corp. v. Catrett,* 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986) (quoting Fed.R.Civ.P. 56(c)). This initial burden may be satisfied by presenting specific evidence on a particular issue or by pointing out "an absence of evidence to support the non-moving party's case." *Id.* at 325.

In response, the non-moving party cannot rest on the pleadings, but must designate specific material facts showing that there is a genuine issue for trial.[FN4] Fed.R.Civ.P. 56(e); *Celotex Corp. .,* 477 U.S. at 324."The applicable substantive law will dictate which facts are material. Only disputes that could affect the outcome of the suit under governing law will properly preclude the entry of summary judgment." *McGinn v. Burlington N.R.R. Co.,* 102 F.3d 295, 298 (7th Cir.1996) (internal citation omitted). The non-moving party must make a "sufficient showing of evidence for each essential element of its case on which it bears the burden at trial." *Salas v. Wis. Dep't of Corrs.,* 493 F.3d 913, 921 (7th Cir.2007) (citing *Celotex,* 477 U.S. at 322-23). The court must view the record and any inferences to be drawn from it in the light most favorable to the opposing party. *Grifin v. Thomas,* 929 F.2d 1210, 1212 (7th Cir.1991).

FN4. Flanagan and the Cohen Defendants have moved to strike parts of Plaintiffs' Statement of Facts for noncompliance with Local Rule 56.1 (docket no. 429). Local Rule 56.1 states that the party opposing summary judgment shall file "a statement, consisting of short numbered paragraphs, of any additional facts that require the denial of summary judgment .... " Local R. 56. 1(b)(3)(C). Defendants assert that Plaintiffs' statement contains paragraphs with sub-parts and dozens of sentences in violation of the rule. In addition to the Local Rule 56. 1, the court has issued a very specific standing order regarding summary judgment. The standing order prohibits argument and inference in 56.1 statements of fact and requires a simple denial and cite to the record for disputed facts. *See* Standing Order, *available at* http://www.ilnd.uscourts.gov. As Plaintiffs point out in their response to the motion to strike, both parties are guilty of violations. The various rules exist to maximize judicial efficiency and promote the smooth flow of litigation. The court simply does not possess the resources to comb through the parties' statements of fact in an attempt to sift out usable fact from impermissible argument or inference or to refer to original contracts and deposition transcripts to see if a party has accurately parsed its contents. Furthermore, there is no reason why it should have to do so. *See United States v. Dunkel,* 927 F.2d 955, 956 (7th Cir.1991) ("Judges are not like pigs, hunting for truffles buried in briefs."). In making its ruling, the court has considered all paragraphs-in the briefs of both sides-that comport with Federal Rule of Civil Procedure 56, Local Rule 56. 1, and the court's standing order. For those that do not, mindful of the age of this case, the court has exercised its discretion to consider those parts that help decide the motion before it (namely material facts) and has ignored statements that contain clearly inadmissible evidence, impermissible argument, or immaterial facts. Thus, defendants' motion to strike is denied in part and granted in part.

B. Claims Under The Securities Act of 1933

***3** The Securities Act of 1933 (the "1933 Act") requires that investors receive certain information on securities being offered for public sale and prohibits misrepresentations in the sale of securities. Section 12(a)(2) of the 1933 Act imposes liability on those who offer or sell a security by means of a sales prospectus that "includes an untrue statement of material fact or omits to state a material fact ...." *See*15 U.S.C. § 77l(a)(2). Under § 15 of the 1933 Act, liability flows to anyone who "controls any person liable under section[ ] ... 12," unless that control per-

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

son can establish an absence of negligence. *See id* . § 77o.

Plaintiffs assert claims under § 15 of the 1933 Act, seeking to hold liable Xentex's control persons for Xentex's alleged violation of § 77l by use of a prospectus and other communications containing false statements and misleading omissions. Specifically, Plaintiffs allege that Xentex provided misleading financial disclosures, misrepresented the involvement and commitment of KDS, failed to disclose known misappropriations of funds, and provided inaccurate information regarding the launch date of the product. They argue that certain defendants are control persons within the meaning of § 77o and are therefore derivatively liable for Xentex's misrepresentations and omissions.

In Count VII, Plaintiffs allege that Flanagan, as a director of Xentex, violated § 77o. Flanagan argues that: (1) he is not a control person; (2) if he is a control person, he has the defense of good faith; and (3) even if he does not have a defense, Xentex did not commit a primary violation of the 1933 Act for which Flanagan can be derivatively liable. Flanagan therefore asserts that he is "entitled to judgment as a matter of law on [Xen's] federal ... securities law claims."Mem. in Supp. of Flanagan's Mot. for Summ. J. at 5.

In Count I, Plaintiffs allege that Turcotte, as Chief Financial Officer and Vice President of Accounting and Control of Xentex, violated § 77o. In Count XII, they allege that Kim, as a director and officer of Xentex, violated § 77o. (Plaintiffs do not allege that Cohen violated the 1933 Act.) The Cohen Defendants argue (1) Kim and Turcotte are not control persons; (2) even if they are, they have the defense of good faith; (3) even if they do not have a defense, Plaintiffs cannot maintain a cause of action because the sale of Xentex stock to Xen was not a public offering; (4) Xentex did not commit a primary violation of the 1933 Act so there can be no derivative liability; and (5) Xen has no losses for which Kim and Turcotte can be liable.

Before it considers the evidence presented on the § 77o claims, the court will address the more expansive arguments that: (1) the sales of stock to Plaintiffs were not covered by the 1933 Act; and (2) Plaintiffs' claims are barred by a one-year statute of limitations.

1. *Whether The Transactions Are Covered By The 1933 Act*

a. *Whether The Stock Sales Were Made Pursuant To Regulation D*

***4** Under the 1933 Act, any offer or sale of securities must be either registered with the U.S. Securities and Exchange Commission ("SEC") or quality for an exemption. Registration of securities ensures that companies file essential facts with the SEC, which then makes these facts public. However, the SEC exempts small offerings from the registration process "to foster capital formation by lowering the cost of offering securities to the public."*See* SEC, The Laws That Govern the Securities Industry (2007), http://www . sec.gov/about/laws.shtml.

Flanagan and the Cohen Defendants argue that the Xen transaction was exempt from registration as a private placement made pursuant to Regulation D, a "safe harbor" regulatory provision under the 1933 Act. *See*15 U.S.C. § 77d(2) (exempting from registration "transactions by an issuer not involving any public offering"); 17 C.F.R. § 230.506 (providing specific rules under which an issuer can ensure a transaction is not a public offering). Therefore, they argue, the transaction is exempt from the requirements of § 12(a) (2) of the 1933 Act, upon which Plaintiffs claims rest, because that section requires that the false statements or omissions to have been made in connection with a "prospectus." And, as this court explained in a previous order, only documents related to public offerings involve a "prospectus," which means that "causes of action brought under [the 1933 Act], where the transaction at issue was a private placement rather than a public offering, are subject to dismissal."*See Premier Capital Mgmt., LLC v. Cohen,* 02 C 5368, 2005 WL 21960357, *10 (N.D.Ill. Aug. 15, 2005) (citing *Gustafson v. Alloyd Co.,* 513 U.S. 561, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995)). Flanagan explicitly invokes Regulation D, whereas the Cohen Defendants frame their arguments in a more general "public offering" context, which includes a Regulation D component. The court will address Flanagan's specific argument first.

The burden of proof for establishing that Regulation D applies rests with the defendants. *See SEC v. Ralston-Purina Co.,* 346 U.S. 119, 126, 73 S.Ct. 981, 97

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

L.Ed. 1494 (1953) (finding the "imposition of the burden of proof on an issuer who would plead the [private placement] exemption" to be "fair and reasonable" given the "broadly remedial purposes of federal securities regulation"); *SEC v. Van Horn,* 371 F.2d 181, 187 (7th Cir.1966) (same).

The specific section of Regulation D upon which Flanagan relies is Rule 506. Rule 506 provides, in relevant part, that "[o]ffers and sales of securities by an issuer that satisfy [the general and specific conditions listed in paragraph (b) of this rule] shall be deemed to be transactions not involving any public offering ...." *See*17 C.F.R. § 230.506(a). The "general conditions" are those conditions contained in Rule 501, which provides definitions of terms used in Regulation D, and in Rule 502. *Id.* § 230.506(b). In turn, Rule 502 provides, in part, that:

> ***5** All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D ....

Id. § 230.502(a) (commonly known as the "incorporation doctrine). Rule 502 also requires certain information to be disclosed to non-accredited investors, limits the manner of offering, and limits the resaleability of securities sold. *Id.* § 230.502(b)-(d). The "specific conditions" to which Rule 506 refers limit the number of purchasers to "no more than 35" and require that all non-accredited investors [FN5] have "knowledge and experience in financial and business matters [so] that he is capable of evaluating the merits and risks of the prospective investment."*Id.* §§ 230.506(b)(2)(i)-(ii). Robinson has the burden of proving that the offering meets these requirements.

> FN5. An "accredited investor" includes any person "whose individual net worth ... at the time of his purchase exceeds $1,000,000" and "who had an individual income in excess of $200,000 in each of the two most recent years."17 C.F.R. §§ 501(a)(5)-(6). An accredited investor is excluded from the maximum number of purchasers under § 506(b).*Id.*§ 501(e)(1)(iv).

Flanagan (who incorporates the reply arguments of the Cohen Defendants) argues that the only issue is whether Plaintiffs purchased stock pursuant to a private placement and that other investors' purchases and other sales by Xentex are irrelevant to this analysis. However, the very purpose of the incorporation doctrine is to require a broad analysis of the company's stock transactions to ensure that, cumulatively, they do not violate Rule 506. Additionally, Flanagan argues that Plaintiffs do not raise "even a scintilla of evidence raising a genuine issue for trial regarding the fact that its own purchase of Xentex stock was pursuant to a private placement, not a public offering."Cohen Defs. Reply at 4. However, the burden of proof that a Regulation D exemption applies lies with Flanagan and, until he establishes an exemption applies, Plaintiffs have no need to rebut. Thus, Flanagan's evidence is the first order of concern.

Flanagan relies exclusively on the evidence provided by Tucker, who was President or Executive Vice President of Xentex around the time of the sales to Xen and who was present during the meeting in November 2000. However, Tucker's evidence is insufficient to establish a *prima facie* exemption under Regulation D because he does not address actual sales of stock. For example, in support of his argument that "there were no other offers ... that could be integrated with the offering to Xen Investors," Flanagan cites to Tucker's deposition. Mem. of Law in Supp. of Flanagan Mot. for Summ. J. at 14 (citing to Flanagan Statement of Facts ¶ 93). However, Tucker says nothing specific in regard to other stock sales in the cited portions. Rather, he states, in conclusory terms, that the stock sale to Xen Investors "was not an offering" and that "[Xentex] never-never before that date nor subsequent to that date-*discussed"* with any other party the terms offered to Plaintiffs. *See* Flanagan Statement of Facts, Tab 14, Dep. of Tucker at 322:22-325:9 (emphasis added). Other evidence offered from Tucker is similarly inadequate to establish an exemption applies. For example, Tucker states that the terms were different from those in *"previous* private placement memoranda," without addressing subsequent memoranda, and that "Xentex *did not solicit* other investors to purchase stock on the same terms offered to Xen In-

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

vestors," without addressing actual sales. *Id.,* Tab 2, Tucker Aff. ¶ 10 (emphasis added). The most favorable inference from these statements may be that if Xentex did not discuss such sales it did not make them; however, the court is obligated to draw reasonable inferences in favor of the *non-moving* party, and in so doing, it finds that Flanagan has not provided sufficient information on actual sales of stock sufficient to meet his burden.

***6** Rule 502 requires there to be no "offers *or* sales of securities" (emphasis added) within the relevant six-month time frame. To conflate the two terms would be to render one of them surplusage, which this court will not do. *See* *TRW, Inc. v. Andrews,* 534 U.S. 19, 31, 122 S.Ct. 441, 151 L.Ed.2d 339 (2001) ("It is a cardinal principle of statutory construction that a statute ought, on the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant."(internal citation and quotation marks omitted)); *see also* *Nat'l Ass'n of Home Builders v. Defenders of Wildlife,* --- U.S. ----, ----, 127 S.Ct. 2518, 2535, 168 L.Ed.2d 467 (2007) (refusing to interpret an agency regulation in a way that would render part of the text surplusage). In addition, other court's holdings support such an interpretation of the regulation. *See, e .g.,* *Wright v. Nat'l Warranty Co.,* 953 F.2d 256, 260 (6th Cir.1992) (finding an exemption under Regulation D where defendants' lawyer's affidavit "stated that the technical requirements found in 230.501 [through] 503 were satisfied [and] states that Form D [FN6] was duly filed with the SEC ...."); *Fay L. Roth Revocable Trust v. UBS Painewebber, Inc.,* 323 F.Supp.2d 1279, 1283 (S.D.Fla.2004) (finding no material dispute that the offering complied with Regulation D where the defendants' statement of facts stated that "the offering and issuance of interests in the Fund was made pursuant to Rule 506 of Regulation D"). The burden is on Flanagan-as the movant and proponent of the exemption-to prove Regulation D applies and he fails to address a key element.[FN7] Therefore, Flanagan has failed to prove that the exemption applies and summary judgment on this ground is denied. The Cohen Defendants argue that the Information Statement contained explicit language stating that the stock was being sold pursuant to Regulation D, but they-like Flanagan-fail to provide evidence sufficient to sustain a Regulation D affirmative defense.

FN6. Rule 500 requires that "a notice on [Form D] shall be filed with the [Securities and Exchange] Commission no later than 15 days after the first sale of securities in an offering under Regulation D (§ 230.501- § 230.508 of this chapter) ...." 17 C.F.R. § 239.500(a). Although the filing of Form D is not a condition to a Rule 506 exemption, failure to file may result in disqualification from future use of exemptions or felony charges, if the failure was wilful. *Hamby v. Clearwater Consulting Concepts, LLP,* 428 F.Supp.2d 915, 920 (E.D.Ark.2006).

FN7. The court reviewed all the evidence cited by Flanagan in support of his Regulation D argument, not just that offered for Rule 502, and found not a single reference to the existence or absence of actual sales to persons other than Plaintiffs. *See, e.g.,* Flanagan Statement of Facts, Tab 2, Tucker Aff. at ¶ 8 (discussing offerings); *id.,* Tab 19 at PCM019526 ("Information Statement" discussing the offering); *id.,* Tab 21 at PCM029236 (discussing the agreement between Plaintiffs and Xentex); *id.,* Tab 20 at PCM020795 (subscription agreement between Plaintiffs and Xentex).

The court now turns to the flip-side of the Regulation D argument, namely the Cohen Defendants' contention that Plaintiffs cannot prove the "public offering" element of their *prima facie* case. As the court observed in a previous order, the case law supports the Cohen Defendants' argument that Plaintiffs would lack standing to assert a § 77l(a)(2) claim if Xen did not purchase stock in a public offering. *See Premier Capital Mgmt., LLC,* 2005 WL 21960357 at *10 (citing to *Gustafson*);*see also* *Yung v. Lee,* 432 F.3d 142, 149 (2d Cir.2005) (*"Gustafson'* s definition of a prospectus as 'a document that describes a public offering of securities' compels the conclusion that a Section 12(a) (2) action cannot be maintained by a plaintiff who acquires securities through a private transaction, whether primary or secondary."(citing to *Gustafson,* 513 U.S. at 584)).

The Cohen Defendants argue that the evidence shows that Xentex "took no money from anyone who was not an accredited investor,""never permitted anyone who did not qualify for an exemption to purchase stock," and closed the last of its four "financing

rounds" more than a year before Xen purchased stock. Cohen Defs.' Mem. in Supp. of Mot. for Summ. J. at 9-10. In response, Plaintiffs have presented undisputed evidence that Xentex sold to non-accredited investors, several of whom purchased stock around the same time as Xen, although the parties dispute whether these sales fall within the scope of the incorporation doctrine. *See* Pls.' Statement of Facts (Cohen Defs.) ¶ 42 (listing eight people who bought Xentex stock). In addition, close inspection of the record shows that the deposition testimony relied on by the Cohen Defendants is much more tentative about whether the sales were part of a public offering than their brief suggests. *See, e.g.,* Cohen Defs.' Statement of Facts ¶¶ 58-59 (deposition of Tucker where he says he *"probably* talked about [whether or not Xentex's stock sales were public offerings or private placements] with [Xentex's counsel] and other people at Xentex" and agrees that he and Xentex's counsel *"took efforts to ensure* that there were no public offerings" (emphasis added)). A reasonable jury, considering the tentative statements and Plaintiffs' evidence of other sales, could reject the Cohen Defendants' conclusory argument that Xen's purchase was a private placement and find that it was part of a public offering. Thus, Plaintiffs survive summary judgement on this issue.

2. *Statute of Limitations Bar*[FN8]

> FN8. Flanagan originally raised the statute of limitations bar as an affirmative defense in his answer to the third amended complaint. The Cohen Defendants also raised the defense in their answers, but inappropriately raised it on summary judgment for the first time in their reply (incorporating Flanagan's arguments), thus denying Plaintiffs the opportunity to respond.

***7** Flanagan argues that Plaintiffs' claims are barred by the statute of limitations because, under the 1933 Act, no § 77l(a)(2) claim may be maintained "unless 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 ...."15 U.S.C. § 77m. He argues that Plaintiffs knew or could have found out about the alleged fraudulent statements and omissions more than a year before they filed suit (on March 20, 2002), namely when: (1) Xentex delivered documents to Plaintiffs' attorney around November 2000; (2) Xentex failed to produce computers according to schedule in early 2001; (3) Xentex, at the beginning of 2001, sent a letter to Plaintiffs telling them of delays and design revisions; and/or (4) Plaintiffs, around March 15, 2001, received a memorandum that conflicted with representations made by Batio and Tucker.

Plaintiffs have raised a triable issue of material fact as to whether the claims are barred. Specifically, they dispute that the documents were actually sent to their attorney and that they were put on notice of fraudulent statements by events and documents relating to manufacturing delays, and allege that they were reassured that everything was alright by Xentex. *See, e.g.,* Pls .' Statement of Facts (Flanagan) ¶ 27 (citing deposition testimony from Plaintiffs' lawyer stating he did not recall seeing the documents and from the person who allegedly sent the documents saying she did not recall sending them); *id.* ¶ 44 (citing deposition testimony where Plaintiffs' representative states the January 2001 letter did not contradict earlier statements). Therefore, summary judgment on this ground is denied.

3. *Plaintiffs' Control Person Liability Claims*

Plaintiffs allege that Flanagan, Kim, and Turcotte are liable as control persons for Xentex's misstatements and omissions in its prospectus pursuant to § 77o of the 1933 Act, which states:

> 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 controlled person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o. Flanagan and the Cohen Defendants argue that they do not meet the control person test and so cannot be held liable. The Seventh Circuit has established a two-prong test to determine control

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

person liability: FN9 "First, the 'control person' needs to have actually exercised general control over the operations of the wrongdoer, and second, the control person must have had the power or ability-even if not exercised-to control the specific transaction or activity that is alleged to give rise to liability." *Donohoe v. Consol. Operating & Prod. Corp.,* 30 F.3d 907, 911-12 (7th Cir.1994) (citing *Harrison v. Dean Witter Reynolds, Inc.,* 974 F.2d 873, 880-81 (7th Cir.1992)); *Premier Capital Mgmt.,* 2005 WL 21960357 at *11 (internal citations omitted).

> FN9. The cited case deals with § 78(t)(a), which establishes control person liability under the Securities Exchange Act of 1934 (the "1934 Act"), not with § 77o under the 1933 Act. However, "[t]hough the two sections are not identical, the analysis applied to them is the same." *Cent. Laborers' Pension Fund v. SIR VA, Inc.,* 04 C 7644, 2006 WL 2787520, *24 (N.D.Ill. Sept.22, 2006) (citing *Dohohoe,* 30 F.3d at 911-13 and *Barker v. Henderson, Franklin, Starnes & Holt,* 797 F.2d 490, 494 (7th Cir.1986)).

a. *Control Person Status: Flanagan, Kim, and Turcotte*

i. Flanagan's Status

***8** In its order denying Flanagan's motion to dismiss this count, the court noted that "[s]imply relying on Flanagan's status as a member of the Board of Directors is insufficient ...." *Premier Capital Mgmt., LLC,* 2005 WL 21960357 at *11 (observing that Plaintiffs did "a bit more" by alleging active participation in and control of decisions of the Board, helping and/or reviewing the Information Statement, and holding a security interest in Xentex's assets). The issue before the court now, however, is whether Plaintiffs have raised sufficient questions of disputed fact to survive for summary judgment on their claims under § 77o.

(a) General Control

First, Plaintiffs must prove that Flanagan exercised general control over the operations of Xentex. The parties do not dispute that: (1) Flanagan owned just ten shares of Xentex stock; (2) he attended only two Board meetings, one in October 2000 and one (by telephone) in May 2001; (3) the majority shareholder had authority to remove any or all Directors, except that Flanagan could not be removed until his $500,000 loan was paid off; (4) the JB Family Trust FN10 was the majority shareholder; (5) Xentex formed an Executive Committee (consisting of Batio, Tucker and Kim) in May 2000 to make decisions for the Board; (6) Flanagan was never a member of the Executive Committee; (7) the Executive Committee had the same authority as the Board to remove officers, fill office vacancies, and control the CEO, President, and Executive Vice President. Despite these undisputed facts, which certainly seem to suggest that Flanagan's role in Xentex was not a major one, Plaintiffs posit five reasons why Flanagan did, in fact, exercise general control: (1) he was a director; (2) he was not a passive director, rather he was active and spoke out and voted for and against resolutions; (3) he exercised control over some board decisions, including the rejection of the original loan terms proposed by TMB; (4) he played an instrumental role in replacing Batio as the CEO of Xentex; (5) he made a $500,000 loan to Xentex. Flanagan does not dispute this, but rather argues that, even cumulatively, these actions are insufficient to show control person status.

> FN10. Plaintiffs, and a Xentex document (Pls.' Statement of Facts (Flanagan), Tab 44), say the majority shareholder is "JB Family Trust," Flanagan says the majority shareholder is "Jeff Batio's family trust," and Tucker writes in a document proffered by Plaintiffs (*id.*Tab 82) that "Jeff" is the "majority stockholder."

The dispute essentially comes down to whether Flanagan had more influence than it would appear he should have had as a minority shareholder and non-member of the Executive Board. Flanagan is correct that neither his status as director nor his status as creditor is alone sufficient to establish he was a control person. *See Schlifke v. Seafirst Corp.,* 866 F.2d 935, 949 (7th Cir.1989) (concluding that a bank that lent money to a corporation did not have control over the corporation's activities); *Premier Capital Mgmt., LLC,* 2005 WL 21960357 at *11.However, the *intersection* of his status as a creditor *and* a board member allows an inference that he could have exerted an influence over Xentex that was greater than a person who occupied just one of those statuses. *See, e.g., Harrison,* 79 F.3d at 614 ("We have long recognized that some indirect means of discipline or influence,

although short of actual direction, is sufficient to hold a 'control person' liable."). Additionally, by virtue of his $500,000 loan to Xentex, Flanagan was the only member of the Board who could not be dismissed at the whim of the majority stockholder. His "tenured" status could have provided him with more influence over both the majority shareholder and other Board members. Thus, viewing the facts in the light most favorable to Plaintiffs, the court concludes that a genuine factual dispute exists as to the weight of Flanagan's influence on day-to-day decisions and the general control of Xentex.

(b) Specific Control

***9** Plaintiffs also need to show that Flanagan had the "power or ability ... to control the specific transaction or activity that is alleged to give rise to liability," namely the misrepresentations and omissions. *See* *Donohoe,* 30 F.3d at 912. Flanagan argues that he was simply a member of the Board of Directors who had no role in creating the Information Statement and was not present when any fraudulent statements were made to Plaintiffs. Plaintiffs argue that, even if this is true (which they dispute), Flanagan had the ability to review the documents and control the transactions, which makes him liable.[FN11] The parties do not dispute that Flanagan did not personally attend the November 2000 meeting and did not personally present Plaintiffs with an offer to invest. Pls.' Resp. to Flanagan Statement of Facts ¶ 65.

> FN11. Plaintiffs rely, in part, on an expert opinion by Matthew Clary ("Clary"). The Cohen Defendants have filed a motion in limine to bar Clary's testimony at trial (docket no. 344); Flanagan has joined that motion. As an initial matter, the court finds unpersuasive the argument that Clary, a lawyer with twenty years of practice experience in corporate law who serves as Chairman of the Securities Law Committee of the Business Law Section of the Virginia Bar Association, is unqualified to offer opinions in this case. The defendants also argue that Clary's opinions are no more than legal conclusions and are therefore inadmissible. To the extent that the motion goes to Plaintiffs' reliance on Clary's opinions in their response to summary judgment, the court has treated it as a motion to strike. However, Clary's opinions played no part in the court's finding of disputed issues of fact for any defendant; therefore, the motion is moot. To the extent that the motion goes to Clary's testimony at trial, the motion is premature and is denied without prejudice.

However, Flanagan's role in the creation of the Information Statement is disputed as is his ability to correct or supplement information previously given to Plaintiffs. Specifically, there are factual disputes about whether Flanagan was involved as part of "management" in crafting the content of the Information Statement, whether he was on notice of a potential disclosure problem given that he knew before November 1, 2000 that Xentex was meeting with potential investors, and whether he had an obligation in January 2001 to be more actively involved in the solicitation statements given what he was told about production delays, the lack of "Plan B" financing options, and Executive Committee approval of funding deals up to $7 million. Flanagan Am. Resp. to Pls.' Statement of Facts ¶¶ 15, 17, 19. When viewed in the light most favorable to them, Plaintiffs raise an issue of disputed fact as to whether Flanagan had the ability to control the misrepresentations sufficient to survive summary judgment.

ii. Kim's Status

(a) General Control

The Plaintiffs argue that Kim exercised general control over Xentex because: (1) he was a director; (2) he was not a passive director; (3) he was Chairman of the Xentex Executive Committee; (4) he was an officer (Vice-Chairman), who was paid $200,000 per year and maintained physical office space at the Xentex offices; (5) he controlled Xentex's relationships with its suppliers, including KDS. The Cohen Defendants answer that Kim was simply one member of a multi-member Board and that ascribing general control to him would eviscerate the general rule that a director is not automatically liable as a controlling person.

The Cohen Defendants are correct that Kim's status as a director is insufficient alone to render him a control person. *Premier Capital Mgmt., LLC,* 2005 WL 21960357 at *11.However, Kim was not a "typical" director as the Cohen Defendants assert; he was a

member of the Executive Committee. The parties do not dispute that Xentex's three-person Executive Committee was formed in May 2000, that Kim was its Chairman from the beginning, and that a resolution could be adopted by a majority of the Executive Committee (that is, by two of the three members). Pls.' Statement of Facts (Cohen Defs.) ¶¶ 25-26; *id.*Tab 46. Although the Executive Committee could only recommend action to the Board, the Board was made up of just eight people, including the three members of the Executive Committee. *Id.* ¶ 26,*id.*Tab 49. Thus, decision-making power was concentrated in the hands of very few people and Kim held a very powerful position within that group. Because this is sufficient evidence from which to infer Kim had general control over the operations of Xentex the court does not reach the other arguments advanced by Plaintiffs.

(b) Specific Control

***10** The Cohen Defendants argue that Kim "did not participate in any manner in the solicitation, negotiation or completion of Plaintiffs' investments in Xentex and had only one social meeting with any of the principals ...." Cohen Defs.' Mem. in Supp. of Mot. for Summ. J. at 5. Plaintiffs dispute this and assert that Kim oversaw the sale and issuance of stock as part of the Executive Committee and Board, was part of the management team that created and approved the Information Statement, and personally made false statements to Plaintiffs.

The following facts are undisputed. Kim was on the Board and Executive Committee and, as such, he was part of the group that oversaw stock sales. Defs.' Statement of Facts ¶ 37. Kim was aware (even if only "vaguely") that Xentex was raising funds from investors and he met with Plaintiffs in early November 2000 (even if only for lunch).*Id.* ¶¶ 40-41.The Information Statement identifies Kim as a member of Xentex management and includes language that it is written from management's perspective. Cohen Defs.' Resp. to Pls' Statement of Facts ¶ 12. Kim helped prepare summaries of the KDS agreements that were used in the Information Statement, although he may not have seen the final product. *Id.* ¶ 7. A reasonable inference from these facts is that Kim knew Xentex was selling stock, had input into the materials used to solicit investors, and had the ability, even if he did not use it, to control misrepresentations to investors by means of oversight or direct intervention as a member of the Executive Committee. As such, Plaintiffs have established a genuine issue of material fact regarding Kim's control person status and summary judgment on this basis is denied.

iii. Turcotte's Status

(a) General Control

The Plaintiffs argue that Turcotte exercised general control over Xentex because: (1) he was an employee and officer (Controller, then Executive Vice President of Accounting and Control, then Vice President of Finance and Chief Financial Officer); and (2) he exercised control over Xentex's money, including the ability to stem the misappropriation of funds by Batio. The Cohen Defendants contend that Turcotte was simply the in-house accountant who prepared unaudited financial statements for internal use only.

The job titles and compensation details relating to Turcotte's employment with Xentex are undisputed. Plaintiffs' attempt to ascribe general control to Turcotte by emphasizing, for example, the facts that he "controlled" Xentex's money and drafted a policy for reimbursement of travel expenses. These tasks are unremarkable given the fact he was hired to take care of Xentex's finances. *Id* . ¶ 20.Plaintiffs' argument that Turcotte "influenced the direction of Xentex" by allowing Batio to misappropriate funds, *id.* ¶ 4, stretches the concept of general control too far and is nothing more than an attempt to insert a claim for aiding and abetting a breach of fiduciary duty into a federal securities claim. Even construing the evidence in the light most favorable to Plaintiffs, the court fails to see how the facts show that Turcotte was anything more than a very well-compensated employee and officer who received significant annual raises and had considerable latitude in hiring his own assistants. *See* Pls. Statement of Facts (Cohen Defs.) ¶¶ 17-21. In short, Plaintiffs have proffered no triable issue of material fact regarding Turcotte's general control of Xentex. Therefore, the court does not need to reach the issue of specific control or Turcotte's "good faith." Summary judgment is granted.

b. *Affirmative Defenses: Flanagan and Kim*

***11** Both Flanagan and Kim argue that they are not liable as control persons because they acted in good

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

faith and their behavior was not reckless. Plaintiffs dispute that "reckless" is the appropriate state of mind under a § 77o claim and argue that Flanagan and Kim are liable if he acted negligently. Under either standard, Flanagan and Kim have the burden of proof of the affirmative defense. *See, e.g., Donohoe,* 30 F.3d at 912.

i. State Of Mind

Section 15 of the 1933 Act and § 20(a) of the 1934 Act provide for liability of controlling persons, 15 U.S.C. § 77o and § 78t respectively. It is well-established that the test for whether a person is a control person is the same under both sections. *See* § II(B)(3)(a) *supra.*However, it is less clear whether the scienter required for the affirmative defense is the same under each section as the majority of cases deal primarily with the 1934 Act or fail to make explicit the standard they are applying. The parties therefore dispute whether recklessness or negligence is the appropriate standard.[FN12]

> FN12. The court imputes the dispute over necessary scienter to the Cohen Defendants because, although they do not raise the issue explicitly, they employ "good faith" language throughout their argument. In fact, the Cohen Defendants mix up § 78t and § 77o in their memorandum of law, erroneously asserting that § 77o provides that there is no liability if the defendant acted in "good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."*See* Cohen Defs .' Mem. in Supp. of Mot. for Summ. J. at 5-6. The Plaintiffs explicitly called attention to the error in their response. Pls.' Resp. in Opp'n to Cohen Defs.' Mot. for Summ. J. at 12 n. 1. Nevertheless, the Cohen Defendants again used the same "good faith" quote in their reply brief. *See* Cohen Defs.' Reply at 4 n. 5.

Flanagan cites to *Donohoe* for the proposition that, to be liable, "[t]he controlling person must ... act recklessly." 30 F.3d at 912 (citing *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 209 n. 28, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); *Monieson v. Commodity Futures Trading Comm'n,* 996 F.2d 852, 860 (7th Cir.1993)). However, as Plaintiffs point out, although the *Donohoe* court cites to both § 78t and § 77o in its control person analysis, a claim under § 78t was the sole claim remaining at the point when the court was addressing the issue of a good faith defense to control person liability. *See Donohoe,* 982 F.2d at 1138 (noting that only § 20(a) of the 1934 Act was at issue because the court affirmed the dismissal of plaintiff's § 15 claim). Thus, it is unclear that the Seventh Circuit was deciding the scienter required for a defense under § 77o.

The starting point of the analysis is the statutory language itself. *Williams v. Taylor,* 529 U.S. 420, 431, 120 S.Ct. 1479, 146 L.Ed.2d 435 (2000).Section 78t, the affirmative defense for a control person under the 1934 Act, 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 U.S.C. § 78t (emphasis added). In contrast, § 77o of the 1933 Act, provides:

> 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.*

***12** *Id.*§ 77o (emphasis added). The plain language of the two statutory sections differs in regard to the circumstances that excuse a control person from liability. Under § 78t, acting in "good faith" suffices to absolve a control person of liability; however, under § 77o, a control person must prove an absence of knowledge and any "reasonable ground to believe" that there was any kind of misrepresentation. Section § 77o appears to place a higher burden on the control

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

person.

In *Ernst & Ernst,* the U.S. Supreme Court discusses the statutory structure of the 1933 and 1934 Acts and the state of mind required for liability under different sections. *See* 425 U.S. at 207-08. As part of its discussion, the Court notes that "the express civil remedies in the 1933 Act allow[ ] recovery for negligent conduct" and includes § 77o as an example of such a provision. *See* *id.* 208-09 ("We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12[a](2), 15, 15 U.S.C. §§ 77k, 77l(2), 77o, is subject to significant procedural restrictions not applicable under § 10(b).")). In an associated footnote, the Court discusses the relationship between § 12(a)(2) and § 77o in more depth. *See* *id.* at 209 n. 27.The Court contrasts the 1933 Act provisions with "provisions of the 1934 Act that expressly create civil liability [and] contains a state-of-mind condition requiring something more than negligence."*See* *id.* at 209 & n. 28.It specifically cites to § 78t. *See* *id.* at 209 n. 28 ([S]ection 20, which imposes liability upon 'controlling person[s]' for violations of the [1934] Act by those they control ...."). It is to footnote 28, referring to provisions of the 1934 Act, that the Seventh Circuit cites to support its conclusion that a recklessness standard applies to control person liability.

Therefore, the court concludes that, given the clear difference in the plain language of the two control person statutory provisions, the dicta of *Ernst & Ernst,* and the limited claims at issue in *Donohoe,* a recklessness standard applies only to § 78t, and a negligence standard applies to § 77o. *But see* *Carpenter v. Harris, Upham & Co., Inc.,* 594 F.2d 388, 394 (4th Cir.1979) ("The controlling persons provision [of both the 1933 and 1934 Acts] contain a state-ofmind condition that requires a showing of something more than negligence to establish liability."(citing *Ernst & Ernst,* 425 U.S. at 209 nn. 27-28)). Thus, to prevail in his affirmative defense, Flanagan must establish that he was not negligent in regard to Xentex's alleged use of a materially misleading prospectus or other communications in the offer or sale of its securities.

ii. Flanagan's Actions

Flanagan asserts that he did not have actual knowledge of the Information Statement or the November 2000 meeting and therefore could not have done anything to prevent the alleged misrepresentations. However, he frames the issue too narrowly. Section 77o also requires that Flanagan show that he had "no ... reasonable ground to believe" that Xentex was using materially misleading information to solicit sales.

***13** The parties agree that Flanagan was elected to the Board in May 2000, but dispute if he knew about the election before September 2000. In any event, Flanagan was a member of the Board when Xen purchased stock and TMB made its loan. Plaintiffs argue that a director is obligated to oversee stock sales and ensure that representations are accurate. Flanagan points out that the Board had delegated its authority in this regard to the Executive Committee (consisting of Tucker, Batio, and Kim). Although such a designation is generally appropriate in order to streamline decisionmaking in an organization, it raises a question of material fact about Flanagan's duty to investigate in this particular case. Xentex was a small company with a Board of only eight people. *See* Flanagan Statement of Facts, Tab 22 (minutes of October 18, 2000 Xentex Board of Directors meeting listing the Board as Batio, Kim, Flanagan, Cohen, Tucker, Michael Venditti, Jung Koh, and Victor DeDois). Despite its small size and concentrated stock ownership, the Board decided to pare down further the number of decision makers in May 2000. *See* Flanagan Statement of Facts ¶ 32. Such a concentration of power allows an inference that the Board eliminated its ability to oversee effectively important tasks relating to the authorization and offering of stock. *See, e.g.,* Pls.' Statement of Facts (Flanagan), Tab 38 at ¶ 3 (email from Flanagan stating that he asked Tucker about Board approval of the stock sales to "the east coast real estate family" and was told that "the Exec. committee was given board approval to authorize funding deals up to 7 million.").

Thus, there is a genuine issue of fact regarding whether it was reasonable for Flanagan to rely on the Executive Committee to ensure that the offerings complied with the law or whether, as a director on a small corporate board, he had an obligation to review personally documents and oversee communications. Flanagan has not met his burden to prove his affirmative defense, and his motion for summary judgment as to § 15 liability is denied.

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

iii. Kim's Actions

The Cohen Defendants argue that Kim: (1) had nothing to do with the Information Statement; (2) had no ability to police what Batio and Tucker told Plaintiffs; and (3) acted in "good faith" by reasonably relying on Tucker, a securities lawyer and co-member of the Executive Committee, to take care of everything to do with sales of stock. The first two arguments are identical in content to those raised by Flanagan and rejected by the court. In Kim's case, the oversight obligation is more explicit than it was for Flanagan because Kim was not only a member of the Board, but was also the Chairman of the three-member Executive Committee to which the Board had designated that very obligation. Turning to Kim's argument regarding reasonable delegation to Tucker, such delegation to a specialist is eminently reasonable in certain circumstances, such as when a large company employs an outside expert to ensure the company's actions comply with legal requirements. However, in Xentex's case, the specific facts regarding that delegation raise questions about abdication of duty. Here, an eight-person Board of a small corporation delegated responsibility for oversight to a three-person Executive Committee, which then allegedly further delegated to just one person whose own financial and professional future was enmeshed the financial success of Xentex. Under those circumstances, a reasonable jury could find that Kim was negligent in failing to review documents and oversee communications notwithstanding the fact that he relied on Tucker to ensure Xentex's actions complied with the law. Therefore, Kim has not met his burden to prove his affirmative defense, and his motion for summary judgment as to § 15 liability is denied.

c. *Whether There Was A Primary Violation of Securities Laws by Xentex*

***14** Flanagan and the Cohen Defendants argue that Plaintiffs cannot prove a primary violation of the 1933 Act because: (1) the Information Statement contained sufficient cautionary language to notify Plaintiffs of the high degree of risk involved in investing in Xentex; (2) the statements Plaintiffs identify do not constitute a material misrepresentation; (3) Plaintiffs suffered no economic loss; and (4) Plaintiffs cannot establish loss causation.

The court addressed legal arguments similar to the first two of these arguments when it ruled on a motion to dismiss in this case. At that time, it concluded that: (1) Plaintiffs' allegations that the Information Statement misstated assets, falsely indicated preparations for the launch of a product were complete, and falsely described the involvement of KDS were "not 'soft' predictions, but rather, alleged misstatements of then-existing fact"; and (2) "[t]he 'bespeaks caution' doctrine does not as a matter of law negate the materiality of those statements." *Premier Capital Mgmt., LLC v. Cohen,* 02 C 5368, 2004 WL 2203419, *4 (N.D.Ill. Sept.27, 2004) (citing *Harden v. Raffensperger, Hughes & Co., Inc.* ., 65 F.3d 1392, 1404, 1406 (7th Cir.1995)). The passage of time, in this case almost four years, has not changed the court's conclusion that the disclaimers in the Information Statement do not eradicate Plaintiffs' claims.

Thus, the only issue is whether Plaintiffs have established a question of material fact as to the alleged misrepresentations sufficient to survive summary judgment. The court has already concluded that there is disputed issue of material fact as to whether Plaintiffs received certain information about KDS prior to making their investments. *See* § II(B)(2) *supra; see also* Pls.' Statement of Facts (Flanagan) ¶ 27 (citing deposition testimony from Plaintiffs' lawyer stating he did not recall seeing the documents and from the person who allegedly sent the documents saying she did not recall sending them); Pls.' Statement of Facts (Cohen Defs.) ¶ 15 (same). Additionally, the accuracy of the financial information provided to Plaintiffs is a disputed material fact. *See, e.g.,* Pls.' Statement of Facts (Flanagan) ¶ 22 (deposition testimony of Turcotte regarding two spreadsheets with the same date that show tooling figures disparate by almost $3 million); Pls.' Statement of Facts (Cohen Defs.) ¶ 9 (contrasting a disclosure of $40 million in product financing in the Information Statement with Turcotte's admission that that it never received any such financing). A reasonable jury could conclude that this constituted a violation of the disclosure requirements of the 1933 Act justifying § 77o liability.

As to the issue of damages, Flanagan and the Cohen Defendants briefly argue that Plaintiffs have no right to damages (under a waiver or estoppel argument-it is unclear which) and, even if they do, they cannot prove loss causation. Waiver, estoppel, and the lack of loss causation are affirmative defenses for which the burden of proof rests with defendants. *See, e.g.,* 15

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

U.S.C. § 77l (*"[I]f the person who offered or sold such security proves* that any portion or all of the amount recovered under [§ 77l(a)(2)] represents other than the depreciation in value of the subject security ... then such portion or amount ... shall not be recoverable."(emphasis added)); *Meyers v. C & M Petroleum Producers, Inc.,* 476 F.2d 427, 429 (5th Cir.1973) (finding that under the 1933 Act, waiver was not a defense to the lawsuit even where the plaintiff had rejected a conditional offer of settlement after the defendant discovered it had violated the law). Thus, Plaintiffs need only rebut if the defendants make out a *prima facie* affirmative defense, not, as Flanagan and the Cohen Defendants assert, preemptively offer facts to overcome the defenses as part of their case in chief.

***15** At the heart of the waiver/estoppel argument of both Flanagan and the Cohen Defendants is the Virginia State Corporation Commission ("SCC") investigation of Premier. Plaintiffs do not dispute that the SCC investigation resulted in a settlement agreement whereby Premier offered to rescind certain contracts for Xentex stock sales. Flanagan and the Cohen Defendants assert that, because the Plaintiffs turned down the rescission offer from Premier, they cannot pursue Flanagan and the Cohen Defendants for damages that would have been recovered. In support, they cite to general cases on the issue of mitigation, the application of which may reduce damages to the point where liability is foreclosed. *See, e.g., Savino v. C.P. Hall Co.,* 199 F.3d 925, 934-35 (7th Cir.1999) (discussing the "avoidable consequences" doctrine). They do not cite to any case that holds that a rejected rescission offer made by a third-party (who itself is a plaintiff) bars claims. Nor do they provide sufficient facts to allow the court to determine whether the rescission offer would have made at least some of the Plaintiffs whole. To meet their burden of proof and prevail on an affirmative defense at summary judgment, Flanagan and the Cohen Defendants must do more than simply make a conclusory statement that Plaintiffs have no damages.

Flanagan and the Cohen Defendants also argue that Plaintiffs cannot establish loss causation because Xen's loss was caused by KDS going into bankruptcy and becoming unable to produce computers for Xentex. Plaintiffs do not dispute that KDS filed for bankruptcy, but counter that Xentex failed because of technical problems with the Voyager computer and the fact that Xentex could not afford to pay vendors to make the computers. The statements that the Cohen Defendants rely on to support their argument show nothing more than: (1) Xentex was having financial difficulties; (2) KDS went bankrupt. *See*Cohen Defs.' Statement of Facts ¶¶ 140, 142; *see also* Flanagan Statement of Facts ¶ 139 (discussing KDS receivership). The Cohen Defendants infer that the KDS bankruptcy was the cause of Xentex's ultimate demise. However, the court draws inferences in favor of the *non-movant* and neither the Cohen Defendants nor Flanagan produce sufficient facts to meet their burden of proof.

Summary judgment is denied as to both Flanagan and the Cohen Defendants for both affirmative defenses.

C. Claims Under The Virginia Securities Act, Va.Code Ann. § 13.1-522(C)

Flanagan and the Cohen Defendants merge their arguments on liability under the Virginia Securities Act, Va.Code Ann. § 13.1-501 *et seq.* (the "VSA") with those under the 1933 Act. However, because the court agrees with Plaintiffs that legal distinctions exist between the two statutes, it is treating them separately. Plaintiffs allege that Flanagan and the Cohen Defendants are liable under provisions of the VSA that parallel control person liability under the 1933 Act. In response, Flanagan argues (as he did for the 1933 Act claims) that: (1) he is not a control person; (2) even if he is, he acted in good faith; and (3) there was no primary violation of the security laws by Xentex. [FN13]

FN13. Flanagan offers the statute of limitations and public offering affirmative defenses only in regard to the 1933 Act.

1. *Control Person Status: Flanagan, Cohen, Kim, and Turcotte*

***16** The court concluded that a material question of fact existed as to Flanagan and Kim's control person statuses under the 1933 Act, but granted summary judgment as to Turcotte. No federal claim was brought against Cohen. Flanagan and the Cohen Defendants argue,[FN14] for the same reasons as they did under the 1933 Act, that they not control persons within the meaning of the VSA. Plaintiffs argue that an officer or director is *automatically* a control per-

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

son under the VSA. If Plaintiffs are correct, then certain defendants' control person status is undisputed for the purposes of trial.

> FN14. Flanagan makes additional arguments in regard to TMB's claims. *See* II(D), *infra.*The Cohen Defendants do not and, absent argument to the contrary, the court accepts Plaintiffs' contention that "[i]n short, [the Cohen Defendants] are liable to TMB for the same reasons they are liable to Xen ... because the same representations were made to both Plaintiffs."Pls.' Resp. in Opp'n to Cohen Defs.' Mot. for Summ. J. at 31.

The relevant sections of the VSA provide:

> Any person who: (i) sells a security [in violation of the VSA], or (ii) sells a security by means of an untrue statement of a material fact or any omission to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were [sic] made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him ....

> Every person who directly or indirectly controls [FN15] a person liable under [§ 13.1-522], *including every partner, officer, or director* of such a person, every person occupying a similar status or performing similar functions, every employee of such a person who materially aids in the conduct giving rise to the liability, and every broker-dealer, investment advisor, investment advisor representative or agent who materially aids in such conduct shall be liable jointly and severally with and to the same extent as such person, unless able to sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There shall be contribution as in cases of contract among the several persons so liable.

> FN15. The VSA defines "control" as "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."Va.Code Ann. § 13.1-501.

Va.Code Ann. § 13.1-522(A); *id.* § 522(C) (emphasis added). Flanagan argues that the phrase "including every partner, officer, or director" is simply meant to provide examples of persons who *may* qualify as controlling persons, but that there is no presumption of control person status for the enumerated persons. Flanagan Reply at 11. (The Cohen Defendants do not make such an explicit statutory interpretation argument, but they do argue that the test for a "control person" under the VSA is the same as that under the 1933 Act, thus implicitly agreeing with Flanagan's position. *See*Cohen Defs.' Reply at 10-11.)

Flanagan argues that Virginia courts agree with his interpretation of § 522(C) and points to *Atocha Ltd. P'ship v. Witness Tree, LLC,* 65 Va. Cir. 213 (Va.Cir.Ct.2004), as proof. *See* Flanagan Reply at 12. However, he seriously misreads this case. To begin with, he incorrectly states it is an appellate court case, whereas in fact it is a letter opinion from a trial court. He argues that it "specifically held that a 'director is not automatically liable as a controlling person' under the VSA."*Id* . However, the purported "holding" is merely dicta in a prefatory section of the court's analysis, a quote from a non-binding Ninth Circuit case that discussed control person liability under federal law. In fact, the *Atocha* court did not even discuss "directors" because the case involved an LLC's members, a category of persons *not* specifically enumerated in § 522(C), which is likely why the court performed a parallel analysis to that required under federal law; the court specifically noted the limited case law interpreting the VSA and the "informative" nature of federal cases to aid statutory construction. *Atocha Ltd. P'ship,* 65 Va. Cir. at 225. After completing the analysis, the court concluded that the members of the LLC who shared control of the company were controlling persons and observed that a contrary result "would not be in keeping with [§ 522(C)], which specifically names partners, officers, and directors as control persons, whether they are directly in control or not." *Id.* at 225-26,*id.* 226 n. 48.

***17** The plain language of § 522(C) and dicta in opinions of Virginia courts indicate that directors are *per se* liable as control persons under Virginia law.

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

See also Williams v. Chamer, 32 Va. Cir. 12, 21 (Va.Cir.Ct.1993) (noting that the liability of a defendant "arises, if at all, by virtue of his status as a director and therefore a controlling person ... pursuant to Section 13.1-522(C)"). There is no ambiguity here: a director is a control person under the VSA and Flanagan, Cohen, and Kim admit they were directors. *See*Cohen Defs.' Statement of Facts ¶ 29 (Cohen was a member of the Board); *id.* ¶ 37 (Kim was a member of the Board and Executive Committee); Flanagan Statement of Facts ¶ 40 (Flanagan elected to the Board).

The court now turns to Turcotte, for whom it granted summary judgment under the 1933 Act. Turcotte admits he was an "officer and employee," but fails to clarify when he became an officer. Pls.' Statement of Facts (Cohen Defs.) ¶ 54; *id.*Tab 102 (employment contract for "Controller" starting in April 1999); *id.*Tab 103 (contract for "Executive Vice President of Accounting and Control" starting in April 2000); *id.*Tab 104 (contract for "Vice President of Finance and Chief Financial Officer" starting in April 2001). Xentex's Bylaws enumerate officers as: "the Chief Strategic Officer, the Chief Executive Officer, the President, the Executive Vice President, the Secretary, and any other individual performing functions similar to those performed by the foregoing persons, including any Officer designated by the Board as performing such functions."Cohen Defs. Statement of Facts, Tab L at 9. None of Turcotte's job titles are specifically enumerated and his job description does not appear to have changed over the course of his tenure (other than his title and compensation package). Absent contradictory evidence from Turcotte, a reasonable inference is that Turcotte became an officer no later than April 2000, upon adoption of the "Executive Vice President" title. Thus, as an officer at the time the alleged misrepresentations occurred in November 2000, Turcotte is a "control person" under the VSA.

Summary judgment is denied and Flanagan, Cohen, Kim, and Turcotte's status as control persons is an undisputed fact for the purposes of trial.

2. *Affirmative Defenses*

Flanagan argues that he cannot be held liable as a control person because he did not know about the Information Statement or meetings and he acted in good faith. The Cohen Defendants argue that they reasonably relied on Tucker to oversee the sale of stock, they had no role in the creation of the Information Statement, and they could not control the oral representations made by Batio and Tucker.

The language of the VSA control person statute is very similar to that of the 1933 Act, both imposing a burden on the defendant to show an absence of actual knowledge and an absence of negligence in failing to gain such knowledge. *Compare*15 U.S.C. § 77o (imposing liability "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"), *with* § 522(C) (imposing liability "unless [the defendant is] able to sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist") *and Dellastatious v. Williams,* 242 F.3d 191, 195 (4th Cir.2001) (finding that the control persons had satisfied the "affirmative defense under both [15 U.S.C. § 78t] and Virginia's allegedly more-exacting standard"). Therefore, the court concludes that: (1) the burden is on the defendants to establish an affirmative defense; and (2) the applicable standard is negligence, not recklessness. For the reasons stated in its analysis of § 77o, *supra,* Flanagan and Kim have failed to meet their burden. Because the court did not address Turcotte or Cohen's arguments under the 1933 Act, a few additional words of analysis are needed.

***18** Like Flanagan, Cohen was a member of the Board who claims he had no control over the Information Statement or Batio and Tucker's actions. For the same reasons as for Flanagan, there is a triable issue of material fact regarding whether it was reasonable for Cohen to rely on the Executive Committee to ensure that the offerings complied with the law or whether, as a director on a small corporate board, he had an obligation personally to review documents and oversee communications (Tucker's alleged expertise notwithstanding).

Turcotte was not a Board member, but he admits that he was himself an investor and "was also responsible for bringing other investors into Xentex."Cohen Defs. Statement of Facts ¶¶ 47, 54. A reasonable inference is that he had access to the information being

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

used to sell stock. Also, his job at Xentex included preparation of financial materials for the Board. *Id.* ¶ 46.Thus, there is an issue of material fact as to whether Turcotte "did not know, and in the exercise of reasonable care could not have known" that Xentex was using materially misleading financial information to solicit sales.

Therefore, summary judgment on this basis is denied as to all defendants.

3. *Whether There Was A Primary Violation of Securities Laws by Xentex*

Flanagan and the Cohen Defendants repeat the arguments they made for the 1933 Act, namely: (1) Plaintiffs cannot survive summary judgment because of cautionary statements in the Information Statement and a lack of disputed facts regarding the truthfulness of statements; (2) Plaintiffs suffered no economic loss; (3) Plaintiffs cannot establish loss causation.

The court has already addressed the first argument and sees no basis for changing its conclusion here: [FN16] the "bespeaks caution" doctrine does not apply here because the Plaintiffs raise questions of material (hard) fact which are not cancelled out by cautionary statements. The third argument is easily dispensed with because loss causation is not an affirmative defense to claims under the VSA.[FN17] *See Dunn v. Borta,* 369 F.3d 421, 432-33 (4th Cir.2004) (declining to read the elements of reliance and causation into § 13.1-522(A) of the VSA); *see also* 12 Joseph C. Long, Blue Sky Law § 9:117.41 (2007) (concluding that the Uniform Securities Act § 410(a)(2), on which § 13.1-522(A) is modeled, does not require loss causation).

FN16. The parties do not fully address whether the doctrine is applicable to the VSA, under Virginia law, as well as to the 1933 Act. The court declines to decide the issue given the lack of briefing.

FN17. Even if it was, the affirmative defense here would fail for the same reasons as it did under the 1933 Act claim.

In addition to the common law arguments about economic loss made by the Cohen Defendants and already dispensed with in § II(B)(3) (c), *supra,* Flanagan makes an additional statutory argument that requires further analysis. Flanagan argues that Plaintiff's "claim is expressly barred by § 13.1-522(D)" because Xen rejected Premier's rescission offer. Flanagan Reply at 13. Section 13.1-522(D) provides that:

> No suit shall be maintained to enforce any liability created under this section unless brought within two years after the transaction upon which it is based; provided, that, *if any person liable* by reason of subsection A, B or C of this section *makes a written offer, before suit is brought, to refund the consideration paid and any loss due to any investment advice provided by such person,* together with interest thereon at the annual rate of six percent, less the amount of any income received on the security or resulting from such advice, or to pay damages if the purchaser no longer owns the security, *no purchaser or user of the investment advisory service shall maintain a suit under this section who has refused or failed to accept such offer within thirty days of its receipt.*

***19** Va.Code Ann. § 13.1-522(D) (emphasis added). Thus, the intent of the statute-plain on its face-is to bar investors from filing suit *after* they have rejected a settlement offer. Flanagan's argument is specious in light of the undisputed fact that this case was filed two and a half years *before* the November 2004 settlement and at least three months before the SCC investigation even began. *See* Pls.' Resp. to Flanagan Statement of Facts ¶ 141; Pls.' Statement of Facts (Flanagan), Tab 80. Summary judgment is denied on this ground.

D. Plaintiffs' Claims Under The VSA For "Materially Aiding" Xentex

In addition to seeking to hold Flanagan liable as a "control person" in Count VIII, Plaintiffs also allege in Count IX that Flanagan is not only a control person but that he also "directly and indirectly controlled Xentex" and that he "materially aided" Xentex in making the purported misrepresentations.3d Am. Compl. ¶¶ 31-32, 127. Count VIII (*see* § II(C) *supra*) alleges a violation of the VSA in regard to Xen's initial stock purchase and Count IX, at issue here, alleges a violation in regard to TMB's purchase of the promissory note and Xen's additional stock pur-

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

chases. Both claims are made pursuant to § 13.1-522(C).

Flanagan argues that Plaintiffs cannot state a claim under § 13.1-522(C) because Flanagan is not an "employee, investment advisor, or agent" of Xentex. Flanagan is correct that, under the plain language of § 13.1-522(C), he does not hold a position where he can be held liable for "materially aid[ing]" a seller of securities. *See*§ 13.1-522(C) ("Every person who ... controls a person liable ..., including every ... director of such a person, ..., every employee ...*who materially aids* in the conduct giving rise to the liability, and every broker-dealer, investment advisor, investment advisor representative or agent *who materially aids* in such conduct shall be liable ...." (emphasis added)). Therefore, Plaintiffs may not hold him liable for material misstatements on that basis.

However, that does not end the matter of liability. Flanagan is a director, and, as explained in § II(C)(1), he is liable as a control person for the alleged illegal conduct of Xentex, whether or not he "materially aid[ed]" Xentex in its conduct.[FN18]Therefore, the court extends its holding that Plaintiffs have raised a triable issue of fact as to Flanagan's control person status and that Flanagan has failed to meet his burden for an affirmative defense to these claims also and denies summary judgment as to Count IX.

FN18. In a previous opinion in this case, while discussing the existence of a right of contribution under the VSA, this court noted that it read § 13.1-522(C)"to mean that liability ... is created as to two groups: (i) persons who control (directly or indirectly) a person (Xentex) liable under § 13.1-522(A) or (B), including, among others, officers and directors of the liable person; and/or (ii) employees, brokers, investment advisors and other agents who aid the person liable under § 13.1-522(A) or (B) in the violative conduct." *Premier Capital Mgmt., LLC v. Cohen,* 02 C 5368, 2005 WL 1564926, *3 (N.D.Ill. July 1, 2005).

E. Breach of Fiduciary Duty[FN19]

FN19. Flanagan asserts, and Plaintiffs do not dispute, that under Illinois choice of law principles, this claim is governed by the law of the state of incorporation of the allegedly culpable corporation, in this case Delaware.

Plaintiffs allege that Flanagan, Kim and Turcotte breached their fiduciary duty to Xen and TMB. Flanagan argues that: (1) he did not owe a fiduciary duty to either company at the time of the alleged fraud; (2) Plaintiffs have suffered no unique harm; and (3) the exculpatory clause in Xentex's certificate of incorporation insulates him from liability. The Cohen Defendants similarly argue that Kim and Turcotte: (1) had no fiduciary duty to Plaintiffs until after the alleged fraud; (2) did not knowingly make any false representations; and (3) are insulated by the exculpatory clause. The court has already held that "to the extent that [P]laintiffs' breach of fiduciary duty claims are based on defendants' conduct prior to [P]laintiffs' purchase of Xentex stock [or on derivative harm], those claims must be dismissed."*See* *Premier Capital Mgmt. ., LLC,* 2004 WL 2203419 at *16-17. Thus, Plaintiffs' claims may be based on Flanagan, Kim and Turcotte's conduct only as it relates to their actions *after* a director-shareholder relationship had been established between Plaintiffs and Xentex.

1. *TMB's Claims*

***20** It is undisputed that TMB invested only once with Xentex, making a $650,000 loan in exchange for a promissory note that could be exchanged for stock. Flanagan argues that summary judgment should be granted because: (1) no duty was owed to TMB before it made the loan and it made no further investments in Xentex; and (2) Flanagan never owed a fiduciary duty to TMB itself because its members held shares in Xentex and TMB held only the promissory note. Similarly, the Cohen Defendants contend that TMB cannot maintain a claim against them based on a fiduciary relationship established through Xen.

Plaintiffs attempt to establish that Flanagan, Turcotte and Kim owed a fiduciary duty to TMB *before* TMB made the loan, arguing that because Todd Copeland was a principal of both Xen and TMB, defendants' fiduciary duty attached to both Xen and TMB as soon as Xen purchased stock. The court has already addressed Plaintiffs' argument at length in its companion order that deals with the summary judgment motion made by Northview and Robinson and it refers the parties to § II(B)(1) of that opinion for further

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

details. *See* Memorandum Opinion and Order at 5-7 (March XX, 2008). Suffice it to say here that Plaintiffs fail to provide any basis under Delaware law that changes the court's conclusion, reached pursuant to Illinois law, that a fiduciary duty does not attach to a company before it has formed its *own* director-shareholder relationship simply because a member of that company has a pre-existing fiduciary relationship through a *different* LLC. Therefore, Flanagan, Kim and Turcotte's motion for summary judgment on TMB's claim is granted.

2. *Xen's Claims*

It is well-established that under Delaware law, directors of corporations stand in a fiduciary relationship to the stockholders and owe them the duties of due care, good faith, and loyalty. *Malone v. Brincat,* 722 A.2d 5, 10 (Del.1998). In their response brief, Plaintiffs rely on *Johnson v. Shapiro,* Civ. A. 17651, 2002 WL 31438477, *4 (Del.Ch. Oct.18, 2002), for the proposition that a director has an obligation to make previously omitted information available to shareholders. It is true that "[t]he duty of disclosure obligates directors to provide stockholders with accurate and complete information material to a transaction [and] the director['s] fiduciary duties include the duty to deal with their stockholders honestly." *Malone,* 722 A.2d at 10. However, this duty of disclosure arises only in the context of a request for shareholder action. *Id.; Jackson Nat'l Life Ins. Co. v. Kennedy,* 741 A.2d 377, 388-89 (Del.Ch.1999) (noting that "the duty of disclosure is merely a specific application of the more general fiduciary duty of loyalty that applies only in the setting of a transaction or other corporate event that is being presented to the stockholders for action"); *Johnson,* 2002 WL 31438477 at *4 (discussing information presented to shareholders considering a buyout and self-tender offer). Where there is no such request, a director's actions may breach the more general fiduciary duty of care or loyalty only where he or she "knowingly disseminate[s] false information that results in corporate injury or damage to an individual stockholder." *Malone,* 722 A.2d at 9; *Jackson Nat'l Life Ins. Co.,* 741 A.2d at 390 (reasoning that omission of material information constituted a similar breach of the duty of loyalty).

***21** Plaintiffs' reliance on the duty of disclosure is misplaced in light of the fact they allege no vote, no transaction requiring shareholder approval, no need for ratification of an investment decision, and nothing that constitutes "shareholder action." They simply allege Xen made additional purchases of stock, which is not "shareholder action" for the purposes of disclosure requirements. Thus, Plaintiffs' claim arises under the more general breach of the duty of care or loyalty, and, to survive summary judgment, they must raise a question of material fact regarding whether Flanagan, Kim and Turcotte knowingly disseminated false information to them.

a. *Flanagan*

In the Third Amended Complaint, Plaintiffs allege that "Flanagan allowed Xentex to make ... misrepresentations" and that he "had the ability to prevent Xentex from making ... misrepresentations." 3d Am. Compl. ¶ 134-35. These allegations and the disputed facts underlying them are discussed in § II(B)(3) *supra.*A review of the record shows that the only dishonest action Plaintiffs directly attribute to Flanagan occurred during several telephone conversations. *See* 3d Am. Compl. ¶ 3 1(e); Pls.' Resp. to Flanagan Statement of Facts ¶¶ 111 (calls to Robert Copeland), 113 (calls to Todd Copeland); 114 (calls to Reyna). It is undisputed that Flanagan's call to Todd Copeland took place before Xen decided to invest. Pls.' Resp. to Flanagan Statement of Facts ¶ 113. Another call was between Flanagan and Reyna and Robert Copeland in late May 2001. The parties dispute whether Flanagan misrepresented various facts about the finances and production schedule of Xentex during this conversation. *See* Pls.' Statement of Facts (Flanagan) ¶ 39(d) (outlining details from a "phone conversation with Reyna on May 30, 2001"). However, the call could not have influenced Xen's investment decisions because it is undisputed that the last time Xen purchased Xentex stock was in February 2001, at least three months before the conversation. Flanagan Statement of Facts ¶ 95. The only call (for which Plaintiffs provide details) upon which a breach of duty claim *could* rest is the call with Robert Copeland in late November 2000. However, Copeland himself said that he was unaware of any misrepresentations being made during that call. *See* Flanagan Statement of Facts, Ex. 7 at 133:12-18 (Copeland's March 2005 deposition). Thus, Plaintiffs present no evidence to show that Flanagan "knowingly disseminate[d] false information" after his fiduciary duty attached.

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

Plaintiffs also incorporate the arguments they used to refute Flanagan's federal affirmative defense under § 77o (*see* § II(B) (3)(b) *supra*). However, their reliance is misplaced. This section of Plaintiffs' brief focuses on events before Flanagan's fiduciary duty attached, and also, as we discussed, *supra,* the scienter required here is higher because liability attaches under § 77o for *negligent* conduct, but only attaches for a breach of care or loyalty for *knowing* conduct. *See* Malone, 722 A.2d at 14 ("When the directors are not seeking shareholder action, but are *deliberately* misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty."(emphasis added)). Although Plaintiffs raised a sufficient question of fact as to Flanagan's negligence to survive summary judgment for their § 77o claim, they have produced insufficient evidence to establish knowing conduct.[FN20]Given Flanagan's limited direct contact with the Plaintiffs, a rational fact-finder could not conclude that Flanagan deliberately withheld or misrepresented known negative information. Summary judgment is granted as to Xen's claims for breach of fiduciary duty also.

FN20. It is also unclear that a state law claim that so closely parallels a federal claim would be allowed by Delaware courts. *See, e.g., Arnold v. Soc'y for Sav. Bancorp, Inc.,* 678 A.2d 533, 539 (Del.1996) (declining to create a "new cause of action which would replicate, by state decisional law, the provisions of ... the 1934 Act"); *In re Oracle Corp.,* 867 A.2d 904, 931 (Del.Ch.2004) (observing that holdings such as that in *Malone* threaten that "a narrow and fixed 'Delaware carve-out' [allowing state shareholder class actions] for traditional fiduciary duty claims [will become] an expanding excavation site that unsettles the structure of federal securities law").

b. *Kim and Turcotte*

***22** Plaintiffs allege that Turcotte and Kim "allowed Xentex to make each of the misrepresentations" in the Information Statement and oral representations, had the "ability to prevent Xentex from making the misrepresentations," and "continu[ed] to conceal the false nature of [Xentex's] earlier misrepresentations." 3d Am. Compl. ¶¶ 89-92, 187-90.

As discussed above, Plaintiffs' incorporation of arguments made under § 77o and the VSA is misplaced because defendants may be held liable for negligent conduct under the securities laws, but only for knowing conduct under these common law claims. Plaintiffs also point to Turcotte's involvement in preparing the Information Statement and his failure to disclose errors and omissions and argue that Kim had an obligation to correct misstatements from the meeting he had with them in early November 2000. However, both of these allegations implicate the duty of disclosure and, as discussed above, no shareholder action exists upon which to base such a breach. Plaintiffs do not allege a single conversation or communication with either Kim or Turcotte after November 22, 2000, the date on which their fiduciary duty to Xen first arose. Therefore, there is no material issue of fact in dispute and summary judgment is granted on Counts VI and XV.

F. Claims For Common Law Fraud/Actual Fraud and Constructive Fraud

1. *Actual Fraud*[FN21]

FN21. The parties agree that Virginia law applies to the actual fraud claims.

Under Virginia law, "[t]he elements of actual fraud are: (1) a false representation, (2) of a material fact, (3) made intentionally and knowingly, (4) with intent to mislead, (5) reliance by the party misled, and (6) resulting damage to the party misled." *Winn v. Aleda Constr. Co.,* 227 Va. 304, 315 S.E.2d 193, 195 (Va.1984). The false representation or concealment must be of an existing fact because "fraud cannot be predicated upon what amounts to a mere expression of an opinion." *Poe v. Voss,* 196 Va. 821, 86 S.E.2d 47, 49 (Va.1955) (internal citations and quotation marks omitted). In determining whether a statement is of opinion or fact, "the subject matter, the form of the statement, the attendant circumstances, and the knowledge of the parties must be considered."*Id.*

a. *Flanagan*

Flanagan argues that Plaintiffs cannot meet their burden to show he falsely represented a material fact to TMB because he was simply expressing opinions

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

and, even if he was expressing facts, he did not know they were untrue and did not intend to mislead. Flanagan also argues that TMB did not rely on his statements because it had already made its decision and initial preparations to invest in Xentex before Reyna spoke to Flanagan. Finally, he argues that Plaintiffs have no evidence that he intentionally concealed anything from them.

Here, the parties dispute what was said during a phone call between Flanagan and Reyna on May 30, 2001, the day after a Board meeting and before TMB made its investment in Xentex. They dispute the circumstances and events relating to each element of a claim for actual fraud. For example, Plaintiffs (citing to interrogatory answers) allege that Flanagan told Reyna that Xentex was able to pay its bills and was not in financial difficulties. Flanagan says Reyna's evasive answers during his deposition, where he simply referred back to his interrogatory answers and provided very little additional information, show that he did not discuss such matters with Flanagan. Flanagan argues that TMB did not rely on the phone call because it had already placed funds in escrow before that. Plaintiffs say the phone call with Flanagan was a determinative factor in their decision to go forward. However, determining whether Flanagan said what Reyna claims and how much TMB relied on what Reyna was told requires a weighing of credibility, which is an inappropriate task when considering a summary judgment motion. *See, e.g., JPM, Inc. v. John Deere Indus. Equip. Co.,* 94 F.3d 270, 273 (7th Cir.1996) (observing that the need for a credibility determination does not preclude summary judgment where the disputed fact is not material to the outcome). Thus, summary judgment is denied.

b. *Turcotte*

***23** Turcotte argues that Plaintiffs cannot make out a *prima facie* case against him because: (1) there is no evidence he knew his internal accounting statements would be used in the Information Statement: (2) he did not know that the information he put in the documents was false; and (3) Plaintiffs do not establish reasonable reliance where they had their own accountant to review the financial information.

Plaintiffs rely exclusively on the financial information contained in the Information Statement they received in November 2000 as the basis for their actual fraud claim against Turcotte. Therefore, the evidence they offer regarding conversations, letters, discoveries, and affidavits from 2001-02 have no relevance as it, at most, proves knowledge *after* the alleged misrepresentation. Discarding those, the only facts that remain concern the manner in which Turcotte disclosed Batio's use of company funds on financial documents and the accuracy of the tooling figure in the Information Statement. Pls.' Statement of Facts (Cohen Defs.) ¶¶ 3-4. The issues, therefore, are: (1) whether Turcotte knew Batio was misappropriating funds and knowingly covered it up on balance sheets; and (2) whether Turcotte knew that the correct tooling figure was $1.45 million, not $4.25 million, at the time he prepared the balance sheet.

Plaintiffs attempt to truncate Turcotte's deposition testimony so that it reads otherwise, but a close review shows that he stated that did *not* know that his entries in the financial statements were false or misleading at the time he made them. In regard to Batio's misappropriations, he stated that, although he knew Batio was using company funds for personal use, he treated the expenses as loans (which was his understanding of what they were), included them on Xentex's balance sheets, and "absolutely" believed Batio would repay the money to Xentex once it became profitable. *Id.,* Tab 13 at 101:23-102:16. In regard to the tooling figures, Turcotte stated that he included a tooling figure of $4.25 million on the balance sheet because he understood that was what the agreement with KDS provided and that he corrected the statement after he was informed that the number was actually $1.45 million. *Id.* at 86:17-87:9, 259:10-261:1.

Plaintiffs argue that Turcotte must have made the alleged misrepresentations knowingly, but they offer no evidence in support of this. Their argument rests on nothing more than a "hindsight is twenty-twenty" inference, which is backward looking and does not show Turcotte's knowledge of falsity at the time the representations were made. A reasonable jury could not, based on his deposition testimony and nothing more, conclude that Turcotte made a knowing misrepresentation. Summary judgment is granted.

c. *Kim*

Plaintiffs rest their actual fraud claim against Kim on the allegation that he "told Todd Copeland and Reyna

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

that the development of Voyager was complete and that mass production of the computers would occur shortly."Pls.' Resp. in Opp'n to Cohen Defs.' Mot. for Summ. J. at 29. Kim argues that Plaintiffs cannot prevail in their actual fraud claim against him because what he told them during the meeting in early November 2000 was factually true, and even if it was not, Plaintiffs cannot establish reasonable reliance and offer no facts to show that Kim intended to mislead them. Thus, the content of the conversation is undisputed; at issue is its truthfulness.

***24** Plaintiffs point to three paragraphs in their Statement of Facts to show that Kim knew that his statements were untrue when he said them. The first paragraph discusses KDS funding and Xentex's debts to vendors, neither of which are at issue here, and events that post-date the meeting with Kim. *See* Pls.' Statement of Facts (Cohen Defs.) ¶ 8 (discussing revelations in meetings and memoranda after early November 2000). Another paragraph, rather than presenting additional facts, presents inferences and legal argument that are almost identical to those in Plaintiffs' brief. *See id.* ¶ 14 (making, among others, the conclusory statement that "Kim told [Plaintiffs] that the development of the computer was complete and that mass production was going to occur shortly."). Neither paragraph helps Plaintiffs defeat summary judgment. The remaining "paragraph" discusses Kim's interactions with Xentex and its suppliers and various production glitches before November 2000. *See id.* ¶ 10.The Cohen Defendants dispute that, even cumulatively, these events and problems negate the truthfulness of Kim's statements. They argue that "[t]he design of the Voyager computer was completed even though improvements still needed to be made," and "Plaintiffs could not have expected mass production to begin for at least four months."Cohen Defs.' Reply at 13-14.

Drawing inferences in favor of the Plaintiffs, it is possible that the numerous problems and delays identified, which Kim knew about at the time of the meeting, were significant enough that the Voyager could not have been complete and/or that mass production of the computers could not have been imminent. Thus, a reasonable jury could conclude that Kim knowingly misrepresented the status of production at the meeting. Summary judgment is denied.

2. *Constructive Fraud*[FN22]

> FN22. The parties agree that Virginia law applies to the constructive fraud claim.

Flanagan argues that he is entitled to summary judgment because he did not make any of the representations in the initial offering and had limited contacts with the Plaintiffs. Under Virginia law, a constructive fraud claim requires the plaintiff to "prove ... by clear and convincing evidence: that there was a material false representation, that the hearer believed it to be true, that it was meant to be acted on, that it was acted on, and that damage was sustained." *Nationwide Ins. Co. v. Patterson,* 229 Va. 627, 331 S.E.2d 490, 492 (Va.1985). Concealment gives rise to constructive fraud only where there is a duty to disclose the concealed fact. *Cohn v. Knowledge Connections, Inc.,* 266 Va. 362, 585 S.E.2d 578, 581 n. 2 (Va.2003)."Constructive fraud differs from actual fraud in that the misrepresentation of material fact is not made with the intent to mislead, but is made innocently or negligently although resulting in damage to the one relying on it." *Id.* at 582 (internal citations and quotations omitted).

Plaintiffs' Third Amended Complaint and response to the motion for summary judgment allege that Flanagan is liable for constructive fraud based on the content of the Information Statement and associated financial disclosures presented at the November 2000 meeting. However, Plaintiffs do not dispute that Flanagan did not personally attend the meeting and did not personally present Plaintiffs with an offer to invest. Pls.' Resp. to Flanagan Statement of Facts ¶ 65. Thus, the sole remaining potentially tortious act is Flanagan's alleged negligent oversight of the preparation of the Information Statement. This does not constitute a representation for purposes of a fraud claim. *See, e.g., Atocha Ltd. P'ship,* 65 Va. Cir. at 227 (finding for defendants on a claim for actual fraud where there was no evidence that the individual directors had made any direct representations to investors). Thus, Flanagan's motion for summary judgment based on these allegations is granted.

***25** Plaintiffs also allege that certain material facts were omitted from the Information Statement and subsequent communications. In *Atocha Ltd. P'ship,* the court found that a "duty to reveal ... omitted facts was imposed by provisions of the VSA." 65 Va. Cir. at 227. To prevail, Plaintiffs must provide sufficient

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

evidence for the inference that there was a causal connection between Flanagan's actions and their injury. *See Cohn,* 585 S.E.2d at 369 (discussing the need for evidence on causation that is "sufficient to take the question out of the realm of mere conjecture, or speculation, and into the realm of legitimate inference."). However, notwithstanding his possible liability as a control person, the evidence does not show that Flanagan's role in the Xentex board was sufficiently central to allow such an inference. Given that Plaintiffs had little contact with Flanagan, especially compared to other Xentex directors, and that Flanagan was not a member of the Executive Committee that made most of the decisions regarding stock sales, a reasonable jury could not find that Flanagan's personal actions were the reason that Plaintiffs invested in Xentex to their detriment. Therefore, summary judgment as to these allegations is also granted.

The only direct contact upon which Plaintiffs bring their constructive fraud claims is the May 30, 2001 phone call between Flanagan and Reyna. As discussed in § II(F)(1) *supra,* these claims hang on a credibility determination. Therefore, summary judgment is denied as to the parts of this count that parallel TMB's actual fraud claim.

3. *Negligent Misrepresentation/Constructive Fraud*[FN23]

FN23. The parties agree that Illinois law applies to this claim.

Plaintiffs allege that Turcotte negligently made false financial disclosures in the Information Statement regarding the quantity of tooling assets, Batio's misappropriation of corporate funds, and Xentex's underfunding.3d Am. Compl. ¶¶ 80-85. The Cohen Defendants assert that: (1) the facts Turcotte included in his financial reports were true; (2) as an employee of Xentex, Turcotte owed Plaintiffs no duty; and (3) Turcotte was not in the business of providing information to shareholders such as Plaintiffs because his job was to prepare financial statements for Xentex's internal use only. Plaintiffs devote two scant paragraphs to this claim in their response, citing to *First Midwest Bank* to establish the elements of the claim, and arguing, in conclusory terms, that the issue of Turcotte's duty to Plaintiffs "is a disputed issue of fact because, according to Tucker, it was part of Turcotte's job to prepare financial statements for Xentex to tender to prospective investors."Pls.' Resp. in Opp'n to Cohen Defs.' Mot. for Summ. J. at 29.

Under Illinois law, a claim of negligent misrepresentation requires a plaintiff to prove: "(1) a false statement of material fact; (2) carelessness or negligence in ascertaining the truth of the statement by the party making it; (3) an intention to induce the other party to act; (4) action by the other party in reliance on the truth of the statement; (5) damage to the other party resulting from such reliance; and (6) a duty on the party making the statement to communicate accurate information." *First Midwest Bank, N.A. v. Stewart Title Co.,* 218 Ill.2d 326, 300 Ill.Dec. 69, 843 N.E.2d 327, 334-35 (Ill.2006) (citing *Bd. of Educ. of the City of Chi. v. A, C. & S, Inc.,* 131 Ill.2d 428, 137 Ill.Dec. 635, 546 N.E.2d 580, 591 (Ill.1989)). Where a plaintiff seeks purely economic damages, there is no duty on a party to avoid negligently conveying false information unless "the party is in the business of supplying information for the guidance of others in their business transactions." *Id.* at 335 (citing *Brogan v. Mitchell Int'l, Inc.,* 181 Ill.2d 178, 229 Ill.Dec. 503, 692 N.E.2d 276, 278 (Ill.1998); *Moorman Mfg. Co. v. Nat'l Tank Co.,* 435 N.E.2d 442, 452 (Ill.1982))."[I]f the intended end result of the plaintiff-defendant relationship is for the defendant to create a product, a tangible thing, then the defendant will not fit into the 'business of supplying information' negligent misrepresentation exception." *Tolan & Son, Inc. v. KLLM Architects, Inc.,* 308 Ill.App.3d 18, 241 Ill.Dec. 427, 719 N.E.2d 288, 297 (Ill.App.1999).

***26** The case law regarding negligent misrepresentation under the "supplying information" exception indicates that no claim can be brought if the defendant is not in the business of purely supplying information or where the information is "merely ancillary to the sale of a product." *First Midwest Bank,* 300 Ill.Dec. 78, 843 N.E.2d at 334-35, 341 (concluding that a title insurance company is not in the business of supplying information).*Compare* *2314 Lincoln Park West Condo. Ass'n v. Mann, Gin, Ebel & Frazier, Ltd.,* 136 Ill.2d 302, 144 Ill.Dec. 227, 555 N.E.2d 346 (Ill.1990) (no claim against an architect because, although an architect supplies information, "the character of that function should not be overstated"), *and* *Anderson Elec., Inc. v. Ledbetter Erection Corp.,* 115 Ill.2d 146, 104 Ill.Dec. 689, 503 N.E.2d 246 (Ill.1986) (no claim possible against a

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

contractor who installed electrical units), *with* *Perschall v. Raney,* 137 Ill.App.3d 978, 92 Ill.Dec. 431, 484 N.E.2d 1286 (Ill.1985) (claim possible against a home inspector), *and* *Duhl v. Nash Realty Inc.,* 102 Ill.App.3d 483, 57 Ill.Dec. 904, 429 N.E.2d 1267 (Ill.1981) (claim possible against an appraiser).

Illinois courts have recognized that between the "pure" information providers (such as accountants and attorneys) and the obvious tangible good providers (such as computer software manufacturers) lie a range of businesses that do both. *See* *Tolan & Son, Inc.,* 241 Ill.Dec. 427, 719 N.E.2d at 296-97. Xentex's sale of stock seems to be an obvious example of something in between the two extremes: stock is a product that can be sold, yet information on the value of the stock is a key component. Despite the obvious ambiguity over the legal status of the product in this case, Plaintiffs offer no argument as to why Xentex and Turcotte are in the business of supplying financial information to them and no facts to support such a conclusion.

Even if the court were to conclude that Xentex was in the business of selling information, which it declines to do in the absence of briefing on the issue, Plaintiffs' challenges do not end there. Plaintiffs seek not only to extend the reach of Illinois tort liability to a new type of product, but they also seek to extend it to a new type of defendant. Here, Plaintiffs do not seek to impose liability on the person who allegedly misrepresented facts to them, namely Xentex. Rather they seek to impose liability on Xentex's employee for making allegedly negligent misrepresentations to Xentex, which then allegedly passed them on to Plaintiffs. Yet, they offer no legal argument on why this court should extend tort liability to breach the protective shell of incorporation and impose liability on an employee in the absence of any direct tortious contact between the employee and the Plaintiffs. Absent a compelling argument and citation to controlling Illinois authority, the court declines to extend the reach of the doctrine of negligent representation this far. Summary judgment is granted.

G. Premier's Claims

Plaintiffs argue that Flanagan and the Cohen Defendants waived their arguments against Premier because they did not move for summary judgment as to any claims filed by Premier. Pls.' Resp. in Opp'n to Flanagan Mot. for Summ. J. at 35 (citing to this court's opinion in *Koren v. Eagle Ins. Agency, Inc.,* 03 C 4261, 2005 WL 589755, *3 n. 3 (N.D.Ill. Mar.11, 2005), which itself cites to *Duncan v. State of Wis. Dep't of Health and Family Servs.,* 166 F.3d 930, 934 (7th Cir.1999)); Pls.' Resp. in Opp'n to the Cohen Defs .' Mot. for Summ. J. at 35 (same).

***27** In a footnote, the Cohen Defendants assert that they "except Premier ... from the definition of 'Plaintiffs' and further, seek summary judgment as to all claims asserted against them by Premier, as Premier neither purchased any stock in Xentex nor engaged in any transaction with Xentex or [the Cohen Defendants] which may be deemed as involving a sale of 'securities.' " Cohen Defs.' Mem. in Supp. of Mot. for Summ. J. at 8-9 n. 1. No further argument on Premier's status is offered in the 25-page brief. Flanagan, again in a footnote but this time in a reply brief, does not contend that he raised any arguments as to Premier but notes that "the claims against Premier necessarily would fail for the same reasons as those set forth above, and for the additional reasons set forth in Section J of the Reply of [the Cohen Defendants] ...." Flanagan Reply at 15 n. 17. (Section J sets out the factual bases for the Cohen Defendants' earlier conclusory argument. *See*Cohen Defs.' Reply at 22.)

Even if Premier's claims could fail on the basis of the law and facts asserted, Flanagan and the Cohen Defendants denied Premier the opportunity to respond to the arguments and to gather facts to defend against summary judgment by failing to brief the issue in their over-sized memoranda in support of their motions for summary judgment. Additionally, Flanagan and the Cohen Defendants specifically sought summary judgment against either Xen or TMB in certain counts. Raising arguments and asserting facts against Premier in a reply is simply too late. *See* *Gold v. Wolpert,* 876 F.2d 1327, 1331 n. 6 (7th Cir.1989) ("It is well-settled that new arguments cannot be made for the first time in reply. This goes for new facts too."(internal citations omitted)). Therefore, the court finds that Flanagan and the Cohen Defendants have waived all arguments as to Premier for summary judgment purposes and that Premier may proceed, on its own behalf, with any of the original claims for which it can establish independent standing.

III. CONCLUSION

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

As to Flanagan's motion, the court: denies summary judgment on Counts VII-IX (violations of the 1933 Act and the VSA) and on TMB, LLC's claims in Count XI (fraud); and grants summary judgment on Count X (breach of fiduciary duty) and Zen Investors, LLC's claims in Count XI (fraud). As to the Cohen Defendants' motion, the court: denies summary judgment on Counts II-III (VSA/Turcotte), XII (1933 Act/Kim), XIII-XIV (VSA/Kim), XVI (actual fraud/Kim), and XIX-XX (VSA/Cohen); and grants summary judgment on Counts I (1933 Act/Turcotte), IV (actual fraud/Turcotte), V (negligent misrepresentation/Turcotte), VI (fiduciary duty/Turcotte), and XV (fiduciary duty/Kim). Premier Capital Management, LLC may pursue, on its own behalf, any of the original claims for which it can establish independent standing. Finally, Plaintiff is ordered to show cause, within 14 days of this order, why defendant Jung Koh (Counts XVII-XVIII) should not be dismissed.

N.D.Ill.,2008.
Premier Capital Management, LLC v. Cohen
Slip Copy, 2008 WL 4378300 (N.D.Ill.)

END OF DOCUMENT

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

TAB 14

Only the Westlaw citation is currently available.
United States Court of Appeals, Seventh Circuit.
STARK TRADING and Shepherd Investments International Ltd., Plaintiffs-Appellants,
v.
FALCONBRIDGE LIMITED and Brascan Corporation, Defendants-Appellees.
No. 08-1327.

Argued Sept. 8, 2008.
Decided Jan. 5, 2009.

Background: Hedge fund investors filed action against corporations alleging securities fraud in violation of federal law. Parties consented to final disposition by magistrate judge. The United States District Court for the Eastern District of Wisconsin, Aaron E. Goodstein, United States Magistrate Judge, 2008 WL 153542, dismissed action. Funds appealed.

Holdings: The Court of Appeals, Posner, Circuit Judge, held that:
(1) investors, as minority shareholders, who were aware of alleged fraud as it was being perpetrated by controlling shareholder with regard to tender offer, did not rely on that fraud in their subsequent tender of shares, and
(2) investors had to allege that they sold their shares at loss, among other elements, in order to state claim that registration statement was false.

Affirmed.

West Headnotes

[1] Securities Regulation 349B 60.48(1)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(1) k. In General. Most Cited Cases
Sophisticated hedge fund investors, as minority shareholders, who were aware of alleged fraud as it was being perpetrated by controlling shareholder with regard to tender offer, did not rely on that fraud in their subsequent tender of shares, as required for federal securities fraud claim. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[2] Securities Regulation 349B 60.19

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.19 k. Particular Conduct. Most Cited Cases
Federal securities fraud does not include the oppression of minority shareholders. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[3] Securities Regulation 349B 60.22

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.17 Manipulative, Deceptive or Fraudulent Conduct
349Bk60.22 k. Mergers, Reorganizations or Tender Offers. Most Cited Cases
Federal securities fraud does not include unsound or oppressive corporate reorganizations. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[4] Securities Regulation 349B 60.48(3)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance

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

349Bk60.48(3) k. Fraud on the Market. Most Cited Cases
If a fraud affects the price of a publicly traded security, investors will be affected even if they trade without knowledge of the misrepresentations that influenced the price at which they traded; they are "relying," albeit indirectly, on the misrepresentations. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[5] Securities Regulation 349B 60.48(1)

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.43 Grounds of and Defenses to Liability
349Bk60.48 Reliance
349Bk60.48(1) k. In General. Most Cited Cases
Under federal securities law, reliance does not refer to the investor's state of mind but to the effect produced by a material misstatement or omission; reliance is the confluence of materiality and causation. Securities Exchange Act of 1934, § 10, 15 U.S.C.A. § 78j; 17 C.F.R. § 240.10b-5.

[6] Securities Regulation 349B 25.25

349B Securities Regulation
349BI Federal Regulation
349BI(B) Registration and Distribution
349BI(B)4 Registration Statements
349Bk25.25 k. Pleading. Most Cited Cases
Sophisticated hedge fund investors had to allege that they sold their shares at loss, among other elements, in order to state claim that registration statement was false. Securities Act of 1933, §§ 11(a, e), 15 U.S.C.A. §§ 77k(a, e).

[7] Securities Regulation 349B 25.21(3)

349B Securities Regulation
349BI Federal Regulation
349BI(B) Registration and Distribution
349BI(B)4 Registration Statements
349Bk25.17 False Statements or Omissions; Accuracy
349Bk25.21 Grounds of and Defenses to Liability
349Bk25.21(3) k. Materiality; Reliance. Most Cited Cases
A claim that a registration statement was false does not require proof of reliance. Securities Act of 1933, § 11(a), 15 U.S.C.A. § 77k(a).

[8] Federal Civil Procedure 170A 1772

170A Federal Civil Procedure
170AXI Dismissal
170AXI(B) Involuntary Dismissal
170AXI(B)3 Pleading, Defects In, in General
170Ak1772 k. Insufficiency in General. Most Cited Cases
A complaint in a complex case must, to avert dismissal for failure to state a claim upon which relief can be granted, include sufficient allegations to enable a judgment that the claim has enough possible merit to warrant the protracted litigation likely to ensue from denying a motion to dismiss. Fed.Rules Civ.Proc.Rule 12(b)(6), 28 U.S.C.A.

Christopher J. Barber (argued), Peter J. Meyer, Chicago, IL, for Plaintiffs-Appellants.
Gregory A. Markel (argued), Cadwalader, Wickersham & Taft, Joseph S. Allerhand (argued), Weil, Gotshal & Manges, New York, NY, Christopher J. Barber, Chicago, IL, William J. Mulligan, Davis & Kuelthau, Milwaukee, WI, for Defendants-Appellees.

Before POSNER, KANNE, and TINDER, Circuit Judges.

POSNER, Circuit Judge.
***1** The plaintiffs have appealed from the dismissal, for failure to state a claim, of their securities fraud suit. The suit is based primarily on the Securities and Exchange Commission's Rule 10b-5. The claims they make under other provisions of federal securities law-all but section 11 of the Securities Exchange Act, 15 U.S.C. § 77k, which we discuss at the end of this opinion-fall with the 10b-5 claim.

The parties have spent too much time in this court, as they did in the district court, arguing over whether the typically Brobdingnagian complaint (289 paragraphs sprawling over 85 pages) adequately alleges scienter, as required by 15 U.S.C. § 78u-4(b)(2). (The

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

suit is more than three years old, yet it has not progressed beyond the motion to dismiss stage.) A claim of fraud fails if there is no proof that the plaintiff relied to his detriment on the's misrepresentations or misleading omissions. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 511 U.S. 164, 180, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994); *Isquith v. Caremark Int'l, Inc.,* 136 F.3d 531, 534, 536 (7th Cir.1998).“[W]ithout reliance, fraud is harmless.” *Dexter Corp. v. Whittaker Corp.,* 926 F.2d 617, 619 (7th Cir.1991). So implausible is an inference of reliance from the complaint in this case when read in conjunction with documents of which the court can take judicial notice, *Deicher v. City of Evansville,* 545 F.3d 537, 541-42 (7th Cir.2008); *Bryant v. Avado Brands, Inc.,* 187 F.3d 1271, 1278 (11th Cir.1999), that the dismissal of the 10b-5 claim must be affirmed without regard to scienter or the other issues that the parties have spent years jousting over.

The complaint tells the following story. Brascan Asset Management, Inc. (now called Brascan Corporation) owned 41 percent of the common stock of Noranda, Inc., which in turn owned 59 percent of Falconbridge, Inc., both being large Canadian mining companies. Brascan wanted to get out of Noranda. It was able to cause Noranda to offer Noranda's common stockholders, who of course included Brascan, preferred stock in exchange for their common stock. (That is called an issuer bid.) Noranda agreed to redeem the preferred stock for cash, at a price of $25 a share, which exceeded the current market value of the common stock. By redeeming, Brascan would be able to exchange its shares for cash and thus achieve its objective of getting out of Noranda. Why it didn't cause Noranda simply to offer $25 per share to all the common stockholders, thus cutting out the intermediate swap of common for preferred, is not explained, but probably was connected with the next and critical transaction, for which Noranda needed a lot of its common stock.

For on the same day that it announced the issuer bid (March 9, 2005), Noranda also announced that it would offer every minority shareholder in Falconbridge 1.77 shares of Noranda common stock for each share of Falconbridge common stock that the shareholder tendered. The offer was conditioned on being accepted by more than half the minority shareholders (the half being weighted of course by number of shares).

***2** The offer succeeded, and the two hedge funds that are the plaintiffs in this case were among the minority shareholders who tendered their stock by the expiration date, May 5. Three months later, Noranda and Falconbridge merged. The resulting firm was named Falconbridge Limited, and was eventually acquired by a Swiss mining company named Xstrata. But in October 2005, before that acquisition, another mining company, Inco, offered to buy Falconbridge Limited at a price substantially above the tender-offer price (1.77 shares of Noranda common stock for every share of Falconbridge common stock) that the plaintiffs had received for their Falconbridge stock.

The plaintiffs had begun buying that stock on March 17; they do not say when they stopped, except that it had to be before the May 5 deadline for tendering. They had bought into Falconbridge because they thought the company was worth more than its current capitalization by the stock market. At the same time that they had bought Falconbridge shares they had sold some Noranda stock short, apparently as a hedge. According to the complaint, Falconbridge was Noranda's major asset (how major, no one has bothered to tell us), so if its shares fell in value or even just failed to rise Noranda's share price would probably fall and the plaintiffs would obtain some profits from their short sales to offset the lack of profit from being long in Falconbridge. By the same token, if Falconbridge's stock rose in price Noranda's stock price probably would rise too and if it did the plaintiffs would lose money from their short sale. But they thought Falconbridge stock more likely to rise, and so invested much less in selling stock in Noranda short than in buying stock in Falconbridge.

Brascan states in its brief that the plaintiffs hoped to make money both from Falconbridge's stock price rising and Noranda's falling. That's a misunderstanding of hedging. The prices of the two companies were going to move in the same direction, but by going long in one and short in the other the plaintiffs were reducing the variance in the expected return on their investments. That is what hedging means. But this is an aside.

In a typical Rule 10b-5 case, the plaintiff buys stock at a price that he claims was inflated by misrepresen-

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

tations by the corporation's management and sells his stock at a loss when the truth comes out and the price plummets. Our plaintiffs believed they were buying an undervalued stock, and events after their purchase, culminating in Xstrata's purchase of Falconbridge Limited (Falconbridge's successor) at a high price, proved them correct. They do argue that the issuer bid (the offer to swap preferred stock in Noranda for common stock) inflated the apparent value of Noranda stock, and therefore made the offer of Noranda stock for Falconbridge stock look generous. But they were not fooled. They knew that the tender offer undervalued Falconbridge-that Noranda was trying to buy out the minority shareholders (thus including the plaintiffs) cheap.

***3** They admit that before the period for tendering their Falconbridge shares to Noranda expired, they “became aware of some of the inaccuracies in the offering documents”-and that is an understatement. On April 29, a week before the deadline in the tender offer, they wrote a letter to the Ontario Securities Commission that alleges, and in considerable detail (the letter, including enclosures, runs to 21 pages, much of it in fine print), most of the facts that their complaint charges as fraud, such as: (1) concealing a conflict of interest of the investment bank that had provided a valuation of Falconbridge for the tender offer, and of the special committee of Falconbridge that had advised Falconbridge's minority shareholders to accept the offer on the basis of the investment bank's valuation, and (2) overstating Noranda's value, thus enabling Noranda to pay for Falconbridge in a thoroughly debased currency (Noranda's overvalued stock), which further reduced the real price at which Noranda was able to buy out Falconbridge's minority shareholders.

The plaintiffs must have been gratified to learn, from their perceiving the “inaccuracies” in the tender-offer registration statement, that they had been right that Falconbridge was undervalued; their letter to the securities commission was calculated to force Noranda to sweeten its offer (though that never happened). But they say in paragraph 205 of the complaint, which is the heart of their case, that they were afraid that the tender offer would succeed and that unless they tendered their shares they would be squeezed out and Canadian law, which governs the squeezing out of minority shareholders in a Canadian corporation, would not protect them, as U.S. law does, from a predatory majority shareholder.

The mystery deepens. Since the tender offer would have failed by its own terms had not a majority of the minority shareholders tendered, why didn't the plaintiffs try to dissuade the other minority shareholders from tendering? Why didn't they mail them copies of the letter to the securities commission or publicize the letter in the financial press? The minority shareholders owned in the aggregate some 78 million shares, 5.5 million of which were owned by the plaintiffs. Noranda needed to obtain at least 39 million shares for the tender offer to succeed. If the plaintiffs refused to tender, Noranda would have to obtain 54 percent of the shares held by the remaining minority shareholders, and it might fail to do so in the face of a vigorous campaign of public opposition to the offer, mounted by the plaintiffs.

[1][2][3] Whatever the plaintiffs were thinking-the complaint says virtually nothing about their strategy-we cannot find any basis for inferring that they relied on the defendants' bad mouthing of Falconbridge. They knew better. They knew Falconbridge was worth a lot-that's why they invested. They thought the tender offer price was too low and that Noranda had resorted to fraud to make it succeed. They had known they were buying into a company that had a majority shareholder, that it was a Canadian company, and therefore that a minority shareholder would not have the same legal protections (such as appraisal rights) that minority shareholders in U.S. corporations have. They also had to know that since they thought Falconbridge undervalued, so would Noranda, which would therefore try to buy out the minority shareholders before the market revalued Falconbridge upward. That would not be a nice way to treat minority shareholders but “securities fraud does not include the oppression of minority shareholders.... No more does securities fraud include unsound or oppressive corporate reorganizations.” *Isquith v. Caremark Int'l, Inc., supra,* 136 F.3d at 535; see *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 473-77, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977). And a week before the deadline for tendering their shares, the plaintiffs revealed in their letter to the securities commission the evidence that Brascan and Noranda were trying to pull a fast one on the minority shareholders.

***4** But though the plaintiffs didn't rely on Noranda's undervaluation of Falconbridge, maybe other minor-

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

ity shareholders did and foolishly tendered, as a result of which the tender offer succeeded and the plaintiffs were left in the vulnerable position of minority shareholders (where of course they had been from the start). But believing that Falconbridge was undervalued and that the value estimates publicly disseminated by Noranda were inaccurate, why, to repeat, didn't the plaintiffs communicate their belief directly or indirectly to the Wall Street analysts? Such information spreads fast and would have given the other minority shareholders pause.

This assumes that the plaintiffs knew something about the tender offer that other investors did not know. That is unlikely, since the plaintiffs were not insiders. Almost certainly there was no deception but just a difference of opinion in the investor community about the significance of the widely known circumstances of the tender offer. And if there *was* deception and the other minority shareholders were too dumb to perceive it even after being warned, why didn't the plaintiffs sue to enjoin the tender offer?

[4][5] If contrary to the common sense of the situation other minority shareholders were fooled even though the plaintiffs were not, this might seem to allow the plaintiffs recourse to the doctrine of fraud on the market. *Basic Inc. v. Levinson,* 485 U.S. 224, 243-47, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). If a fraud affects the price of a publicly traded security, investors will be affected even if they trade without knowledge of the misrepresentations that influenced the price at which they traded. They are "relying," albeit indirectly, on the misrepresentations. " '[R]eliance' is a synthetic term. It refers not to the investor's state of mind but to the effect produced by a material misstatement or omission. Reliance is the confluence of materiality and causation. The fraud on the market doctrine is the best example; a material misstatement affects the security's price, which injures investors who did not know of the misstatement." *Eckstein v. Balcor Film Investors,* 58 F.3d 1162, 1170 (7th Cir.1995); see *Isquith v. Caremark Int'l, Inc., supra,* 136 F.3d at 536; cf. *Plaine v. McCabe,* 797 F.2d 713, 717 (9th Cir.1986).

So suppose some of the minority shareholders were induced by Noranda's misrepresentations to tender their shares, and others, though unaware of any representations, tendered their shares as well. They too would be victims of deception, because had the market known the truth the tender offer would have failed. Cf. *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970). But no one who saw through the fraud would be able to sue for fraud, for he could not have relied directly or indirectly. And that was the plaintiffs' position. Sophisticated investors, they must have considered the combination of the tender-offer price and a later suit (this suit) against the defendants a better deal than holding on to their shares and by doing so, and disseminating their doubts, trying to defeat the tender offer. That is not a strategy that the courts should reward in the name of rectifying securities fraud.

***5** So even if the other minority shareholders were blind sheep and the law impotent to prevent a dishonest tender offer, the plaintiffs would not have a claim under Rule 10b-5, or any other securities law requiring proof of reliance, because they were never deceived. At worst they were minority shareholders victimized by a heartless majority shareholder (remember that Noranda owned 59 percent of the common stock of Falconbridge), and as we noted earlier the federal law of securities fraud does not provide a remedy for oppression of minority shareholders. The lack of merit of the 10b-5 claim would be obvious had the plaintiffs refused the tender offer and later been squeezed out, as in the *Santa Fe Industries* case; but there is no pertinent difference between the two types of case.

[6][7] This leaves for consideration the plaintiffs' claim under section 11 of the Securities Exchange Act, which does not require proof of reliance. Section 11 provides that "in case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person [with an immaterial exception] acquiring such security" may sue. 15 U.S.C. § 77k(a). But the plaintiff in such a suit may recover (so far as pertains to this case) only "such damages as shall represent the difference between the amount paid for the security ... and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit."§ 77k(e).

The plaintiffs gave up each of their Falconbridge shares for 1.77 Noranda shares. On May 5, 2005, the

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

date the tender offer expired, Falconbridge stock was trading at $39.59 (Canadian), so that was the price that the plaintiffs paid for the Noranda shares that they received in exchange. On November 7, 2005, the date on which they filed their lawsuit, a share in Falconbridge Limited (the new Falconbridge, after its merger with Noranda) was trading at C $34.43, so that the 1.77 Noranda shares that the plaintiffs had received in exchange for each share of Falconbridge were now worth C$60.94, which exceeded by C$21.35 what they had paid for the shares when they accepted the tender offer. The plaintiffs coyly suggest that maybe they sold their shares, or some of them, before they sued, and sustained a loss. But this is nowhere suggested in the complaint, or in the brief that the plaintiffs filed in the district court after the defendants pointed out that the plaintiffs had failed to allege that they had sold any of their shares at a loss. It would not make sense for them to have sold their shares at a loss, since they were convinced that Falconbridge was undervalued.

[8] The complaint's silence is deafening. Even notice pleading requires pleading the elements of a tort, and one element of the section 11 tort is sale at a loss. Moreover, the complaint in a complex case must, to avert dismissal for failure to state a claim, include sufficient allegations to enable a judgment that the claim has enough possible merit to warrant the protracted litigation likely to ensue from denying a motion to dismiss. *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007); *Limestone Development Corp. v. Village of Lemont,* 520 F.3d 797, 802-03 (7th Cir.2008). This suit was dismissed by the district court in January 2008, more than two years after it had been filed. Just imagine how long it would have taken to dispose of the case by summary judgment after the usual pretrial discovery in a big commercial case. Defendants are not to be subjected to the costs of pretrial discovery in a case in which those costs, and the costs of the other pretrial maneuvering common in a big case, are likely to be great, unless the complaint makes some sense. If after 85 pages of huffing and puffing in the complaint, and another 83 pages of appellate briefs, sophisticated investors cannot make their case seem plausible, the litigation must end then and there.

***6** AFFIRMED.

C.A.7 (Wis.),2009.

Stark Trading v. Falconbridge Ltd.
--- F.3d ----, 2009 WL 18140 (C.A.7 (Wis.)), Fed. Sec. L. Rep. P 95,028

END OF DOCUMENT

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

TAB 15

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 CTA6 Rule 28 and FI CTA6 IOP 206 for rules regarding the citation of unpublished opinions.)

United States Court of Appeals, Sixth Circuit.
Frank STAVROFF, et al., Plaintiffs-Appellants,
v.
Raymond D. MEYO, et al., Defendants-Appellees.
No. 95-4118.

Nov. 12, 1997.

On Appeal from the United States District Court for the Northern District of Ohio.

Before: GUY, RYAN and COLE, Circuit Judges.

R. GUY COLE, JR., Circuit Judge.

***1** Plaintiffs, investors in the common stock of Telxon Corporation, are certified class representatives in this suit against Telxon and two of its officers, alleging: (1) securities fraud in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5; and (2) negligent misrepresentation under Ohio law. Plaintiffs appeal the district court's grant of summary judgment in favor of defendants and the district court's denial of their motion to file a second amended complaint For the following reasons. we affirm the judgment of the district court.

I. BACKGROUND

Telxon Corporation (“Telxon”) designs, manufactures and sells portable, batch and wireless teletransaction systems for use in bar code data capture applications, such as those used at grocery store check-out counters. Defendant Raymond D. Meyo was Telxon's president and chief executive officer from November 1981 until his resignation on October 14, 1992. Defendant Dan R. Wipff was, at all times relevant, Telxon's chief operating officer and chief financial officer.

In a press release issued in May 1992, Telxon reported that it anticipated record earnings and revenues for the fourth quarter of fiscal year 1992.[FN1] In reporting that its fiscal year 1992 revenues of $215 million exceeded the prior year's revenues by 16.5%, the press release stated that Telxon expected this record-setting performance to continue throughout fiscal year 1993. In June 1992, Telxon filed its 1992 Form 10-K with the Securities and Exchange Commission (“SEC”) and its 1992 Annual Report to Shareholders, reporting the 16.5% increase in revenues and predicting the same earnings growth to continue throughout fiscal year 1993. In August 1992, Telxon filed with the SEC its Form 10-Q report for the first quarter of fiscal year 1993, ending June 30, 1992. It reported a 37.4% increase in consolidated revenues for that quarter and projected a 20% increase in consolidated revenues for fiscal year 1993 During this time period, several analysts who followed Telxon's stock issued various positive reports, predicting increased revenues and earnings growth.

FN1. Telxon's fiscal year begins April 1 and ends March 31.

The first negative report was released on October 8, 1992, when Telxon issued a press release that revised its earnings per share downward from a range of $0.30 to $0.36 to a range of $0.24 to $0.28 for the second quarter of fiscal year 1993, ending September 30, 1992. Telxon's stock immediately fell $3.10 per share. In a press release issued on October 9, 1992, Meyo reiterated his confidence in Telxon's long-term business prospects, but lowered the forecast for annual revenues from a range of § 265 million to 5275 million to a range of $255 million to $265 million. Telxon's stock price dropped from $17 to $13.375 per share, but rebounded to $15.75 per share by December 11, 1992.

On December 14, 1992, Robert Meyerson, who replaced Meyo as Telxon's chief executive officer, issued a press release projecting even lower revenues of between $235 million to $242 million for fiscal year 1993. The press release attributed this further reduction in forecasted revenues to lower-than-

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

expected sales, an increase in marketing and product expenses and one-time, non-recurring costs. Meyerson also announced a redirection of Telxon's resources and steps to ensure resumed growth in the second half of fiscal year 1994.

***2** Upon this news, trading in Telxon stock was halted. The next day, December 15, 1992, Plaintiff Frank Stavroff, an individual shareholder purporting to represent other shareholders, filed suit against Telxon, Meyo and Wipff. A second lawsuit was filed by Plaintiff James Walker on December 17, 1992, and a third by Plaintiff Jack Ebert on December 18, 1992.

On January 18, 1993, Telxon released third quarter results for fiscal year 1993, reporting a $0.63 loss per share compared to a $0.31 net income per share for the same period in fiscal year 1992, and revenues of $48.5 million as compared to $53.2 million for the third quarter of fiscal year 1992. Wipff was quoted as sayingi that the third quarter results were due to "non-recurring costs [that are] directly attributable to implementation of [Telxon's] new business strategy." Excluding the unusual items, Wipff stated that Telxon's operating income was at an approximate break-even level for the quarter.

Plaintiffs filed an amended and consolidated class action complaint on February 1, 1993, which asserted two causes of action based on the same factual allegations: 1) violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, codified at 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder; and 2) a claim for negligent misrepresentation under Ohio law. The focus of plaintiffs' amended complaint alleged that defendants, knowing that Telxon was not doing as well as anticipated, continued to predict growth and record-breaking earnings, doing so, at least in part, to allow Meyo and Wipff to divest themselves of approximately 60,000 shares of stock at a significant personal profit. In December 1993, the district court certified Stavroff, Walker and Ebert as representatives of a class which included all purchasers of Telxon common stock during the class period, defined as the time period between May 20, 1992 through December 14, 1992

On February 14, 1995, following extensive discovery by the parties and numerous continuances of various deadlines set by the district court, the plaintiffs sought leave to file a second amended complaint The district court denied plaintiffs' motion, but allowed additional discovery limited to the issue of Telxon's accounting practices. The defendants thereafter filed individual motions for summary judgment and after plaintiffs responded, Telxon filed a motion to strike the affidavits of two purported experts, which were attached to plaintiffs' memorandum in opposition to defendants' motions for summary judgment. The district court held a hearing on the motions, and on September 14, 1995, granted summary judgment in favor of all defendants. In its memorandum and order granting summary judgment, the district court did not rule on the merits of Telxon's motion to strike the expert affidavits. but denied the motion as moot stating that it did not rely upon the challenged affidavits in making its decision Plaintiffs now appeal the district court's denial of their motion to file a second amended complaint and its grant of summary judgment in favor of defendants.

II. LEAVE TO AMEND

***3** Pursuant to the Federal Rules of Civil Procedure, leave to amend a complaint "shall be freely given when justice so requires." Fed.R.Civ.P. 15(a). A motion for leave to amend a complaint should be denied, however, if the amendment is brought in bad faith or for dilatory purposes, results in undue delay or prejudice to the opposing party, or would be futile. *Crawford v. Roane,* 53 F.3d 750, 753 (6th Cir.1995), *cert. denied,* 116 S.Ct. 1354 (1996); *Marx v. Centran Corp.,* 747 F.2d 1536, 1550 (6th Cir.1984). We review a district court's denial of a motion for leave to amend a complaint for abuse of discretion. *Foman v. Davis,* 371 U.S. 178, 182 (1962); *Marx,* 747 F.2d at 1551. Discretion is abused when the appellate court is left with "a definite and firm conviction that the court below committed a clear error of judgment." *Taylor v. United States Parole Comm'n,* 734 F.2d 1152, 1155 (6th Cir1984) (citations omitted).

In the present case, the district court conducted a hearing on plaintiffs' motion for leave to amend their complaint, and in a written order, determined that plaintiffs' proposed second amended complaint constituted "little, if anything, more than a further detailing of the facts supporting plaintiffs' claims of securities violations and misrepresentation." The district

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

court noted that the only arguably “new” matter alleged in the proposed second amended complaint was the allegation that Telxon's accounting practices violated generally accepted accounting principles (“GAAP”); however, the court believed that this allegation was within plaintiffs' original claim of misrepresentation. The court nonetheless allotted further discovery, limited to the GAAP allegation.

We do not believe that the district court committed a “clear error in judgment” in denying plaintiffs leave to file a second amended complaint. *See Taylor,* 734 F.2d at 1155. The district court found that the second amended complaint failed to add anything of significance to the first amended complaint; thus, amendment would have been futile. *See Frank v. D'Ambrosi,* 4 F.3d 1378, 1386 (6th Cir.1993) (holding that leave to amend would be futile when amended complaint failed to add new allegations). Accordingly, we find that the district court did not abuse its discretion in denying plaintiffs leave to amend their complaint a second time.

III. SUMMARY JUDGMENT

A. Standard of Review

We review a district court's grant of summary judgment de novo, using the same standard employed by the district court. *Moore v. Philip Morris Cos.,* 8 F.3d 335, 339 (6th Cir.1993); *Kraus v. Sobel Corrugated Containers, Inc.,* 915 F.2d 227, 229 (6th Cir.1990). Summary judgment is appropriate when the evidence “show[s] that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.” Fed.R.Civ.P. 56(c). “ ‘The mere existence of a scintilla of evidence in support of the plaintiffs position will be insufficient; there must be evidence on which the jury could reasonably find for the plaintiff.’ ” *Street v. J.C. Bradford & Co.,* 886 F.2d 1472, 1477 (6th Cir1989) (citation omitted). In deciding upon a motion for summary judgment, we must review the evidence and draw all reasonable inferences therefrom in favor of the nonmoving, party. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 587 (1986).

B. Alleged Securities Fraud

1. Applicable Law

***4** In order to prevail on a claim of securities fraud under Section 10(b) and Rule 10b-5, a plaintiff must establish the following elements: (1) a misrepresentation or omission, (2) of a material fact, (3) made with scienter, (4) justifiably relied on by plaintiffs, and (5) proximately causing them injury. *See Aschinger v. Columbus Showcase Co.,* 934 F.2d 1402, 1409 (6th Cir.1991); 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. However, when the fraud alleged is “fraud on the market,” FN2 reliance will be presumed if there exists a sufficient allegation that the misrepresentation is material. *Basic, Inc. v. Levinson,* 485 U.S. 224, 227 (1988). A misrepresentation is material if it alters the total mix of information available to the investing public. *Id.* at 231-32; *see also TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976).

FN2. A “fraud on the market” theory of liability arises from misleading statements made in an open securities market, based upon the hypothesis that the price of a company's stock is determined by the available information regarding the company and its business. *Peil v. Speiser,* 806 F.2d 1154, 1160 (3d Cir.1986). Thus, when fraud on the market occurs, a misleading statement can defraud purchasers of stock even if the purchasers did not directly rely on the misstatements. *See Basic,* 485 U.S. at 227.

Misrepresentations are not material, however, if the investing public is privy to the truth. *Basic,* 485 U.S. at 231-32. Further, statements of general “puffery” are not material, because those types of optimistic statements predicting growth generally do not affect market price. *Raab v. General Physics Corp.,* 4 F.3d 286, 289-90 (4th Cir.1993). In addition, under the “bespeaks caution” doctrine, an optimistic, concrete prediction is immaterial if it is sufficiently accompanied by cautionary language. *Sinay v. Lamson & Sessions Co.,* 948 F.2d 1037, 1040 (6th Cir.1991); *see also Mayer v. Mylod,* 988 F.2d 635, 639 (6th Cir.1993). Finally, with respect to omissions, an omission is material if there is “a substantial likelihood that the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information available.” *TSC Indus.,* 426 U.S. at 449; *Basic,* 485 U.S. at 231-32.

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

Plaintiffs allege "fraud on the market" in that, during the class period, Telxon: (1) made recklessly high revenue and earnings projections for fiscal year 1993; (2) unjustifiably failed to disclose that revenues and earnings were decreasing; and (3) used improper accounting practices to artificially inflate revenues. Plaintiffs also claim that defendants Meyo and Wipff knew, or should have known, that their initial projections for Telxon had "no reasonable basis in fact," yet made the projections for the purpose of artificially inflating the price of Telxon stock in order to sell their personal stock holdings at a profit. We will consider each of plaintiffs' allegations.

2. Revenue Projections

Plaintiffs allege that Telxon's forecasts of a range of increased revenues from 16.5% to 23% for fiscal year 1993, both in its press releases and public filings, constituted material misrepresentations. Telxon indeed expressed promising growth projections; however, Telxon never guaranteed a particular increase in revenues, nor did it guarantee that any particular result would occur. Moreover, the numbers that Telxon relied upon in formulating its predictions were based on past years actual revenues. A violation of federal securities law cannot be premised upon Telxon's disclosure of accurate historical data. *In re Sofamor Danek Group, Inc,* 123 F.3d 394, 401 n. 3 (6th Cir1997).

***5** With respect to the revenue projections, the district court determined that the bulk of the contested statements consisted of immaterial "puffery." The district court further concluded that to the extent that Telxon's predictions and growth forecasts rose above the level of puffery, those statements were not actionable because cautionary statements were made at the same time, thereby rendering the optimistic statements immaterial under the "bespeaks caution" doctrine. *See* *Sinay,* 948 F.2d at 1040; *see also* *Mayer,* 988 F.2d at 639. To determine whether statements fall under the bespeaks caution doctrine, we review the statements in context and examine the "total mix" of information available to the reasonable investor. *Sinay,* 948 F.2d at 1040. Looking at the total mix of information available, we agree with the district court that the bespeaks caution doctrine was applicable in this case. The "misleading" economic forecasts that plaintiffs challenged were countered with cautionary warnings; for example, the district court noted the numerous instances in which analysts issued cautionary reports throughout the class period. We believe that considering the total mix of information available, a reasonable investor could recognize the proper context of Telxon's optimistic forecasts.

Further, when Telxon encountered financial difficulty, Telxon immediately made public the effect that these changes would have on the company's earnings. As soon as Meyerson became chief executive officer, he repeatedly warned the investment community that he would need time to review and assess the company's financial status. On October 21, 1992, for example, he said, "[I] want to hold fast to a steady growth plan after determining our starting point within the next few months." These cautionary statements from the company itself, combined with the cautionary statements made by independent analysts, bespoke caution, and thus, were not actionable.

Perhaps more important, we note that there is simply no evidence whatsoever that Telxon's earning projections were made recklessly or falsely. The evidence in this case indicates that Telxon made projections based on its past performance and such projections were sufficiently countered with cautionary language. Accordingly, there is no genuine issue of material fact that these statements constituted material misrepresentations. The district court properly granted summary judgment in favor of Telxon with respect to the revenue projections.

3. Omissions

Plaintiffs allege that the defendants knew early on about Telxon's faltering financial status and failed to disclose such knowledge. As evidence of this assertion, plaintiffs point to Telxon's internal forecasting tools, which typically are not released to the public.[FN3] Plaintiffs contend that these forecasting tools made defendants aware that the company was doing poorly, yet defendants failed to disclose this knowledge. Again, we disagree. There is no indication that these forecasting tools were anything more than internal planning documents, and no indication that these documents were evidence of defendants' knowledge that the company was failing, which they failed to disclose. The record simply does not support this allegation, to the contrary, the record establishes that as soon as defendants had definitive information regarding the decrease in the earnings projections,

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

defendants released that information to the public. There is no evidence in the record to support plaintiffs' allegations that defendants had prior knowledge that they failed to disclose.

> FN3. Specifically, plaintiffs contend that Telxon's Budget, Quota and Build Plan and Revenue Recaps, which were not released to the public, were evidence that defendants knew the company was not doing as well as expected.

***6** Further, a company's overall conduct is relevant in determining the existence of the scienter necessary for a failure to disclose information in violation of Section 10(b) and Rule 10b-5. If a company or its officers' overall conduct is inconsistent with securities fraud, no liability will attach. *In re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1117-18 (9th Cir.1989) (defendants' overall pattern of conduct, including massive investment in company's products, demonstrates good faith); *In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1420 (9th Cir.1994) (company's implementation of business plan is inconsistent with securities fraud).

Here, even if there had been a failure to disclose information, the evidence indicates that defendants did not have the scienter required for a securities violation based on a failure to disclose that the company was doing poorly. For example, every indication showed that Telxon was poised for additional future growth after several years of record-setting growth. Defendants Meyo and Wipff created budget revenue goals and a national sales forecast for Telxon in excess of $270 million after extrapolating from past years' successes. Defendants also planned to expand resources for the construction of two manufacturing and service facilities at the cost of$11.3 million. These actions indicated that the company was anticipating growth. Thus, Telxon and its officers' overall conduct in fiscal year 1993 demonstrates no failure to disclose information; further, even if there had been a failure to disclose information, there is no evidence of the scienter required for a violation of the securities laws.

4. Accounting Practices

In alleging that Telxon's accounting practices violated securities laws because the practices were not in accordance with GAAP, plaintiffs claim that Telxon's accounting practices (1) improperly recognized revenue from specific transactions, (2) failed to establish properly an accrual for product warranty costs, and (3) overstated inventory and income as a result of accounting for merchandise traded in by Wal-Mart,[FN4] which was obsolete and should have been written off at the time of the return. In support of their allegations, plaintiffs presented the affidavit of an accounting expert, Melvin E. Gavron, who stated that these practices were not in accordance with GAAP. In its defense, Telxon argued that its independent auditors, Coopers & Lybrand, determined that Telxon had fairly and accurately presented its financial position and that Telxon's accounting practices were in accordance with GAAP.

> FN4. Wal-Mart was a principal customer of Telxon.

Courts have determined that GAAP violations, standing alone, are not tantamount to securities fraud. *Adams v. Standard Knitting Mills, Inc.,* 623 F.2d 422, 432-33 (6th Cir.1980); *In re Software Toolworks, Inc.,* 50 F.3d 615, 627 (9th Cir.1994) (a failure to follow GAAP, without more, does not establish scienter); *Vosgerichian v. Commodore International,* 832 F.Supp. 909, 915 n. 8 (E.D.Pa.1993), *vacated on other grounds,* 862 F.Supp. 1371 (E.D.Pa.1994). Further, a company's reliance on the guidance of outside auditors is inconsistent with the intent to defraud. *Provenz v. Miller,* 1994 WL 485925, at *3 (N.D. Cal. June 27, 1994) (stating that the use of GAAP is not mandated, management may choose to use other reasonable methods). Lastly, differences of opinion in the use of GAAP do not constitute material omissions or misstatements. *Adams,* 623 F.2d at 432-33, *Mathews v. Centex Telemanagement, Inc.,* 1994 WL 269734, at *4 (N.D. Cal. June 8, 1994) ("This court need not reconcile those differences of opinion [as to accounting practices], because they are just that; that is, differences of opinion. They are not evidence of misstatements or material omissions"); *Worlds of Wonder,* 35 F.3d at 1426 (" '[Scienter] requires more than a misapplication of accounting principles. The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all.' " (citation omitted)).

***7** Based on the foregoing, even if Telxon's accounting practices were not in accordance with GAAP,

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

these actions, standing alone, would not constitute a violation of the securities laws. Thus, plaintiffs' claims regarding Telxon's accounting practices lack merit.

5. Summary

In its comprehensive and well-written opinion, the district court concluded that defendants were entitled to summary judgment After a thorough review of the record, we conclude likewise. There is no genuine issue of material fact; plaintiffs' allegations do not amount to violations of Section 10(b) and Rule 10b-5.[FN5] We therefore affirm the district court's grant of summary judgment in favor of defendants.

> FN5. Plaintiffs also alleged violations of Section § 20(a) of the Securities and Exchange Act of 1934. Section 20(a) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78t(a) provides in part:
>
> 15 U.S.C. § 78t(a): *see also* *Herm v. Stafford,* 663 F.2d 669, 679 (6th Cir.1981). Liability under this theory requires factual allegations showing that the named defendants had "the practical ability to direct the actions of the people" who committed the violation. *Schlifke v. Seafirst Corp.,* 866 F.2d 935, 949 (7th Cir.1989). Because we have determined that there was no securities fraud committed in this case, there was no violation of section 20(a).

IV. EXPERT AFFIDAVITS

Plaintiffs argue that in granting summary judgment in favor of defendants, the district court erroneously excluded affidavits from two expert witnesses, Z. Lew Melnyk and Melvin E. Gavron. Telxon had filed a motion to strike the affidavits; however, the district court never ruled on the merits

> 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 ... 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. of Telxon's motion, instead denying the motion as moot because it did not rely upon the challenged affidavits in granting summary judgment. Plaintiffs now argue that the district court, in effect, granted Telxon's motion and improperly disregarded the affidavits. We disagree.

Plaintiffs construe the district court's statement that it "did not rely upon any of the challenged affidavits or exhibits in making its decision" as meaning that the district court failed to consider the affidavits; however, the district court obviously considered the affidavits as evidenced by specific references to the Gavron affidavit in its order granting summary judgment. It is apparent that the district court considered the affidavits but chose not to rule on the merits of Telxon's motion, because it had no need to do so after determining that summary judgment was appropriate. We find that the district court did not fail to consider the experts' affidavits, nor did the court err in disposing of Telxon's motion to strike as it did.

Moreover, upon review of the affidavits, we find no evidence precluding the district court's grant of summary judgment. Plaintiffs' accounting expert, Gavron, expressed an opinion that Telxon's accounting practices were not in accordance with GAAP. As previously discussed, even if we accept Gavron's conclusory' opinion as entitled to any weight, failure to comply with GAAP does not constitute a securities violation Likewise, plaintiffs' other expert, Melnyck, concluded that the public was misled by Telxon's statements and projections during the class period. Melnyk's statements are wholly conclusory and unsupported. Accordingly, we find that plaintiffs' arguments regarding the experts' affidavits lack merit.

V. NEGLIGENT MISREPRESENTATION

***8** In their motion for summary judgment, plaintiffs also alleged state-law claims of negligent misrepresentation. For the sake of judicial economy and because the state-law claims arose from the same facts as the federal claims, the district court exercised supplemental jurisdiction pursuant to 28 U.S.C. § 1367(a) to dispose of the state-law claims. Plaintiffs have not raised the issue of the district court's disposition of their state-law claims in their appeal to this court; accordingly, that issue is not before us and we need not address it. *See* *Priddy v. Edelman,* 883 F.2d 438, 446 (6th Cir.1989) (declining to consider issues not raised in appellant's brief).

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

VI. CONCLUSION

For the foregoing reasons, we AFFIRM the district court's denial of plaintiffs' motion for leave to file a second amended complaint and the district court's grant of summary judgment in favor of defendants.

NOTE: JAMES L. RYAN, Circuit Judge, concurs in the judgment only.
C.A.6 (Ohio),1997.
Stavroff v. Meyo
129 F.3d 1265, 1997 WL 720475 (C.A.6 (Ohio))

END OF DOCUMENT

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

TAB 16

LEXSEE 2005 U.S. DIST. LEXIS 38001

JOHN H. WALDOCK, et al., Plaintiffs, v. M.J. SELECT GLOBAL, LTD., et al., Defendants.

No. 03 C 5293

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

2005 U.S. Dist. LEXIS 38001*; *Fed. Sec. L. Rep. (CCH) P93,624

December 27, 2005, Decided
December 27, 2005, Filed

PRIOR HISTORY: *Waldock v. M.J. Select Global, Ltd., 2005 U.S. Dist. LEXIS 26790 (N.D. Ill., Nov. 7, 2005)*

COUNSEL: [*1] For John H Waldock, solely as Trustee of the John H. Waldock Trust, Mary Jane S Hill, John E Rosino, solely as Trustees of the Andrew W. Waldock Trust, John H. Waldock, Jr. Trust, Julia Wright Waldock Trust, Cameron Douglas Waldock Trust, Gary Phillip Liebenthal, II Trust, Samuel Louis Waldock Trust, Benjamin Nicholas Waldock, 766347 Ontario Ltd, a Canadian corporation, James Boughner Foundation, a Canadian corporation, Ed Pettegrew, Sr, David Miller, John A Copeland, as Trustee under a trust agreement dated 04/18/88, Jack C Kenning, Barbara Straka-Kenning, Robert M Warner, Sr, individually and as beneficiary of Independent Trust Corporation Trust, for Adam Scott Warner and Andrew Robert Warner, George Lukas, Plaintiffs: Constantine John Gekas, Gekas & Associates, Ltd., Chicago, IL.

For M.J. Select Global, Ltd., a Bahamian investment company now in Liquidation, Defendant: Thomas Michael Lynch, Kenneth M. Gorenberg, Wildman, Harrold, Allen & Dixon, Matthew Mark Garrett, Chicago, IL.

For Oceanic Bank and Trust Limited, a Bahamian company, in its own right and as successor to New World Trustees (Bahamas) Limited formely known as Rawson Trust, both Bahamian companies, Defendant: [*2] Peter Vincent Baugher, Jason M. Rosenthal, Jose A. Lopez, William Butler Berndt, Schopf & Weiss LLP, Chicago, IL; Christopher James Murdoch, Edward F. Ryan, Matthew Ignatius Farmer, Holland & Knight LLC, Chicago, IL; John Thomas Archer, Holland & Knight, LLP, Washington, DC.

For Terah Rahming, Kenneth Clowes, Defendants: Peter Vincent Baugher, Jason M. Rosenthal, Jose A. Lopez, William Butler Berndt, Schopf & Weiss LLP, Chicago, IL; Abraham D. Sofaer, Stanford University, Palo Alto, CA.

For Michael Coglianese, C.P.A., P.C., an Illinois professional corporation, Michael Coglianese, Gina Coglianese, Commodity Compliance Services, Inc., an Illinois corporation, GLC Services, Inc., formerly known as CCS Financial Services, Inc., Defendants: Robert Montell Stephenson, John Donovan Lien, Nathaniel Lee Strup, Foley & Lardner, Chicago, IL.

For Landmark Management S.A.M., John Caseley, an individual of unknown residence who is one of the principals of Global Arbitrage Development and Landmark Management S.A.M., Defendants: Gerald Haberkorn, Martin W. McManaman, Robert Hill Smeltzer, Lowis & Gellen, Chicago, IL; John J Montone, Sheldon H Elsen, Orans, Elsen & Lupert, LLP, New [*3] York, NY.

For Southridge Capital Management, LLC, Stephen

Hicks, Defendants: Stewart D. Aaron, Arnold & Porter, New York, NY; Nancy Anne Temple, Nancy A. Temple, Esq., Chicago, IL.

For Dan Pickett, Defendant: Stewart D. Aaron, Arnold & Porter, New York, NY; Robert J Bergson, Abrams Garfinkel Margolis Bergson, LLP, New York, NY.

For Jeffrey K Vorisek, Vorisek & Company, LLC, an Illinois limited liability company, Defendants: Peter D. Sullivan, Barry Francis Mac Entee, Hinshaw & Culbertson, Chicago, IL.

JUDGES: AMY J. ST. EVE, United States District Court Judge.

OPINION BY: AMY J. ST. EVE

OPINION

MEMORANDUM OPINION AND ORDER

Plaintiffs have filed a Third Amended Complaint ("TAC") against multiple Defendants alleging a fraudulent investment scheme in connection with the purchase of shares of M.J. Select Global, Ltd. ("M.J. Select"), a Bahamian mutual fund. Plaintiffs have sued Defendants Landmark Management, S.A.M. ("Landmark") and John Caseley ("Caseley"), (collectively, the "Landmark Defendants"). Additionally, Plaintiffs have sued Oceanic Bank and Trust Limited ("Oceanic"), Terah Rahming ("Rahming") and Kenneth Clowes ("Clowes"), (collectively, the "Oceanic Defendants"), [*4] and others for losses resulting from their investments in M.J. Select. The Landmark Defendants [1] and Oceanic Defendants move to dismiss all of the federal and state claims against them for failure to state a claim. As discussed below, their motions are granted in part and denied in part.

1 The Landmark Defendants assert that they seek to "adopt all pertinent arguments made by their co-defendants in their motions to dismiss." (R. 287-1; Landmark Defs.' Mot. Dismiss at 25.) The Landmark Defendants do not indicate what arguments they would like to adopt or which Defendants made those arguments. The Court, therefore, denies the Landmark Defendants' request, and will address only the arguments contained in their motion to dismiss. *See Zurich Capital Markets Inc. v. Coglianese, 332 F. Supp. 2d 1087, 1100 n.2 (N.D. Ill. 2004)* (citing *United States v. Dunkel, 927 F.2d 955, 956 (7th Cir. 1991)* ("Judges are not like pigs, hunting for truffles buried in the briefs.")).

BACKGROUND

[*5] **I. Plaintiffs**

Plaintiffs in this case invested in M.J. Select and lost all or substantial portions of their investments. Plaintiffs include: John H. Waldock, solely as Trustee of the John H. Waldock Trust; Mary Jane S. Hill and John E. Rosino, solely as Trustees of the Andrew W. Waldock Trust, John H. Waldock, Jr. Trust, Julia Wright Waldock Trust, Cameron Douglas Waldock Trust, Gary Phillip Liebenthal, II Trust, Samuel Louis Waldock Trust, Benjamin Nicholas Waldock Trust, Dustin J. Houck Trust, Daniel R. Houck Trust, Erik J. VanDootingh Trust, Ian A. VanDootingh Trust, John H. Waldock, III Trust, Andrew W. Waldock, Jr. Trust, Christopher J. Waldock Trust; 766347 Ontario Ltd., a Canadian Corporation; the James Boughner Foundation, a Canadian corporation; Ed Pettegrew, Sr., a citizen of Florida; David Miller, a citizen of California; John A. Copeland, as Trustee under a trust agreement dated April 18, 1988; Jack C. Kenning and Barbara Straka-Kenning, citizens of Ohio; Robert M. Warner, Sr. individually and as beneficiary of Independent Trust Corporation Trust, for Adam Scott Warner and for Andrew Robert Warner, Account No. 180 in the name of Robert Warner, Account No. 263 [*6] in the name of Adam S. Warner and Account No. 264 in the name of Andrew Robert Warner; and George Lukas, a citizen of New Jersey. Collectively, these individuals are referred to as "Plaintiffs." (R. 251-1, TAC at PP 16-45.)

II. The Landmark Defendants

Landmark is a corporation with its principal place of business in Monte Carlo, Monaco. (*Id.* at P 83.) Landmark operates and administers Global Arbitrage Development, Ltd. ("GAD"), which is an unregistered open-end investment company/mutual fund. (*Id.* at PP 80, 83.) Caseley, a domiciliary and citizen of Monaco, is or was a director and principal of Landmark. (*Id.* at P 85.)

III. The Oceanic Defendants

Oceanic is a bank and trust company that has its principal offices in the Bahamas. (*Id.* at P 47.) Oceanic

acquired New World Trustees Limited ("New World"), effective May 1, 1998. (*Id.*) Oceanic and New World merged under the name of Oceanic Bank and Trust Limited, effective December 31, 1999. (*Id.*) Rahming, a resident, domiciliary and citizen of the Bahamas, was an officer and employee of Oceanic. (*Id.* at P 49.) In 1997, Oceanic appointed Rahming as its Manager of Fund Services. (*Id.* [*7]) Rahming was also a director of M.J. Select, and administered its affairs. (*Id.*) Additionally, Rahming is a graduate of Florida Memorial College and licensed as a certified public accountant by the Board of Accountancy of the State of Colorado. (*Id.*) Clowes, a resident, domiciliary and citizen of the Bahamas, was the Chief Operating Officer of Oceanic. (*Id.* at P 50.) Clowes also served as a director of M.J. Select, and administered its affairs. (*Id.*)

IV. Alleged Scheme

The Court has set forth the alleged fraudulent scheme in other opinions in this case and its related case, *Zurich Capital Markets Inc. v. Coglianese, 383 F. Supp. 2d 1041*, (the "ZCM Case"). The Court will not restate the facts in detail here. For a complete factual background, *see Zurich Capital Markets Inc. v. Coglianese, 332 F. Supp. 2d 1087 (N.D. Ill. 2004)* (the "August 2, 2004 Opinion"); *Zurich Capital Markets Inc. v. Coglianese, 388 F. Supp. 2d 847 (N.D. Ill. 2004)* (the "September 22, 2004 Opinion"); *Waldock v. M.J. Select Global, Ltd., 2004 U.S. Dist. LEXIS 23844, No. 03-5239, 2004 WL 2278549 (N.D. Ill. Oct. 6, 2004)* (the "October 6, 2004 Opinion"); *Zurich Capital Markets Inc. v. Coglianese, 2005 U.S. Dist. LEXIS 16702, No. 03-7960, 2005 WL 1950653* [*8] *(N.D. Ill. Aug. 12, 2005)* (the "August 12, 2005 Opinion"); *Waldock v. M.J. Select Global, Ltd., 2005 U.S. Dist. LEXIS 24610, No. 03-5239, 2005 WL 2737502 (N.D. Ill. Oct. 24, 2005)* (the "October 24, 2005 Opinion"); and *Waldock v. M.J. Select Global, Ltd., 2005 U.S. Dist. LEXIS 26790, No. 03-5239, 2005 WL 2978895 (N.D. Ill. Nov. 7, 2005)* (the "November 7, 2005 Opinion").

Plaintiffs allege that they lost approximately $ 9.8 million through a complex fraudulent investment scheme carried out by all Defendants in this case, including the Landmark and Oceanic Defendants. (R. 251-1, TAC at P 12.) They contend that Michael Coglianese ("Coglianese") and other Defendants organized M.J. Select, (*id.* at P 277(c)), Oceanic was the administrator of M.J. Select, (*id.* at P 47), and Rahming and Clowes served as directors of M.J. Select. (*Id.* at PP 49, 50.) Plaintiffs allege that Defendants used false and misleading offering memoranda and marketing materials to induce Plaintiffs to invest in M.J. Select. (*Id.* at P 9.) Plaintiffs further allege that Defendants falsely represented that M.J. Select invested in liquid investments and that investors could redeem their investments upon fifteen days notice. (*Id.* [*9] at P 10.) According to Plaintiffs, Defendants transferred their investments to foreign entities that then placed Plaintiffs' investments into illiquid investments. (*Id.*) Specifically, they contend that certain Defendants directed the transfer of Plaintiffs' investments in M.J. Select into GAD. (*Id.* at PP 152, 220-25.) Landmark operated and administered GAD, and Caseley was a director and principal of GAD. (*Id.* at PP 83, 85.) GAD, in turn, allegedly used Plaintiffs' money to invest in Dominion Capital Fund Limited ("Dominion"), a fund that purchased illiquid securities, even though M.J. Select's offering memoranda represented that its investments would be placed in liquid, market neutral securities that its investors could redeem on fifteen days notice. (*Id.* at P 165(a).)

ANALYSIS

I. Legal Standard

The Landmark and Oceanic Defendants bring their motions pursuant to *Federal Rule of Civil Procedure 12(b)(6)*. A *Rule 12(b)(6)* motion tests whether plaintiff has "state[d] a claim upon which relief can be granted." *Fed. R. Civ. P. 12(b)(6)*. When deciding a motion to dismiss [*10] pursuant to *Rule 12(b)(6)*, the Court views "the complaint in the light most favorable to the plaintiff, taking as true all well-pleaded factual allegations and making all possible inferences from those allegations in his or her favor." *Lee v. City of Chicago, 330 F.3d 456, 459 (7th Cir. 2003)*.

II. Federal Securities Fraud Claims -- Count I

Count I is premised on a violation of *Section 10(b)* of the Securities and Exchange Act of 1934 (the "Exchange Act"), *15 U.S.C. § 78j(b)*, *Rule 10b-5* promulgated thereunder, and Section 20(a) of the Exchange Act, *15 U.S.C. § 78t*.

A. Statute of Repose

Both the Landmark and Oceanic Defendants argue that many of Plaintiffs' claims under Count I are

time-barred. [2] For the reasons set forth in the Court's Order dated December 7, 2004, (R. 190-1, Dec. 7, 2004 Order at 6), and the November 7, 2005 Opinion, *Waldock, 2005 U.S. Dist. LEXIS 26790, 2005 WL 2978895, at *3*, with the exception of the August 14, 2000 purchase as to John Copeland and the June 1, 2000 purchase as to Jack C. Kenning and Barbara Straka-Kenning, Plaintiffs' *Section 10(b)* and *20(a)* claims are time-barred. Accordingly, [*11] the Court will analyze the Landmark and Oceanic Defendants' remaining arguments to dismiss Count I only as to Copeland, Kenning and Straka-Kenning.

> 2 Plaintiffs assert that under *Federal Rule of Civil Procedure 12(g)*, the Oceanic Defendants may not raise arguments "concerning the applicability of the three-year limitation period that applied before Sarbanes-Oxley was enacted on July 30, 2002" because their previous motion to dismiss did not raise that argument. (R. 337-1, Pls.' Opp'n Oceanic Defs.' Mot. at 14.) Because the Oceanic Defendants previously contested Count I on statute of limitations grounds and because this issue was previously before the Court, *Rule 12(g)* does not prevent the Oceanic Defendants from asserting this argument.

B. Section 10(b)

The Landmark Defendants argue that Plaintiffs have not adequately pleaded a *Section 10(b)* violation. The "basic elements" of a *Section 10(b)* claim include: (1) a material misrepresentation or omission, (2) "scienter, [*12] *i.e.*, a wrongful state of mind," (3) a connection with the purchase or sale of a security, (4) "reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as transaction causation,'" (5) economic loss, and (6) loss causation. *Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 125 S. Ct. 1627, 1631, 161 L. Ed. 2d 577 (2005)* (citations omitted).

The strict pleading mandates of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), *15 U.S.C. § 78u-4, et seq.*, apply here. "The PSLRA creates rules that judges must enforce at the outset of the litigation." *Asher v. Baxter Int'l Inc., 377 F.3d 727, 728 (7th Cir. 2004)*. The PSLRA requires a plaintiff to "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." *15 U.S.C. § 78u-4(b)(1)*. Additionally, a 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)*.

Furthermore, the heightened pleading requirements of *Rule 9(b)* [*13] apply to the TAC. *Fed. R. Civ. P. 9(b)*. *Rule 9(b)* dictates that a plaintiff plead "the circumstances constituting fraud . . . with particularity." *In re HealthCare Compare Corp. Sec. Litig., 75 F.3d 276, 281 (7th Cir. 1996)* (citing *Fed. R. Civ. P. 9(b)*). According to the Seventh Circuit, "this means the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990)*.

1. Whether Plaintiffs Have Alleged a Section 10(b) Violation by the Landmark Defendants through the Purported Agency of Coglianese

Plaintiffs allege that the Landmark Defendants have violated *Section 10(b)* through the agency of Michael Coglianese. (R. 251-1, TAC at P 273(c).) An agency relationship results from the "manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." [3] *Rest. 2d Agency § 1*. "When the plaintiff relies upon the same circumstances to establish both the alleged fraud and the agency relationship [*14] of a defendant," plaintiff must plead agency with particularity. *Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777, 783 (7th Cir. 1999)*. Furthermore, the Court has previously explained that

> the mere use of the label "agent" does not sufficiently establish an agency relationship in order to impose liability under *Rule 9(b)* or the PSLRA where the agency relationship and the fraud claims are intertwined. A plaintiff must plead facts showing the existence and scope of the agency relationship in order to establish primary liability under *Section 10(b)*, especially where, as here, the agency relationship is not based on the classic corporation/employee model where a corporation can only act[] through its employees and agents.

ZCM, 332 F. Supp. 2d at 1106; *see also Waldock, 2005 U.S. Dist. LEXIS 24610, 2005 WL 2737502 at *3*.

> 3 For the reasons set forth in the August 12,

2005 Opinion, *ZCM, 2005 U.S. Dist. LEXIS 16702, 2005 WL 1950653, at *3 n.2*, and the October 24, 2005 Opinion, *Waldock, 2005 U.S. Dist. LEXIS 24610, 2005 WL 2737502, at *3 n.3*, the Court applies the law of agency from the Restatement in deciding this motion.

[*15] According to Plaintiffs, the basis for the alleged agency relationship is as follows: (1) Coglianese was an investment advisor for the Landmark Defendants; (2) the Landmark Defendants granted Coglianese the authority to investigate and recommend funds for investment in GAD; (3) Coglianese located investments, such as Dominion, into which he recommended the Landmark Defendants place GAD's funds and assets; and (4) Coglianese received compensation for referring investments to Dominion. (R. 251-1, TAC at PP 185-89.) Because these agency allegations are intertwined with Plaintiffs' fraud allegations, Plaintiffs must plead agency with particularity. *See Lachmund, 191 F.3d at 783*; *see also Waldock, 2005 U.S. Dist. LEXIS 24610, 2005 WL 2737502 at *4*.

Plaintiffs have not pleaded with particularity facts alleging the existence of an agency relationship. Plaintiffs have failed to allege, even in a conclusory manner, that the Landmark Defendants had the power to control Coglianese, which is an essential component of an agency relationship. *See Rest. 2d Agency § 1*. Moreover, Plaintiffs concede that their "factual allegations concerning Coglianese's [*16] agency for Landmark . . . [are] not as detailed as those against Southridge." (R. 322-1, Pls.' Opp'n Landmark Defs.' Mot. at 4.) On October 24, 2005, the Court held that the Southridge Defendants did not establish an agency relationship with Coglianese. *Waldock, 2005 U.S. Dist. LEXIS 24610, 2005 WL 2737502, at *4*. Accordingly, Plaintiffs have not adequately pleaded the existence of an agency relationship, and the Court will not impute Coglianese's alleged violations of *Section 10(b)* to the Landmark Defendants.

2. Whether Plaintiffs Have Alleged a Section 10(b) Violation by the Landmark Defendants as Principals

Additionally, Plaintiffs assert that the Landmark Defendants have violated *Section 10(b)* on their own accord. (R. 251-1, TAC at P 273(c).) The Landmark Defendants argue that Plaintiffs have not adequately pleaded that the they, as principals, committed any *Section 10(b)* violations. The Court disagrees.

(a) Scienter

The Landmark Defendants argue that Plaintiffs have "failed to allege scienter with the particularity required by the PSLRA." (R. 287-1, Landmark Defs.' Mot. Dismiss at 4.) The PSLRA requires that a plaintiff "state with particularity facts giving rise to a strong [*17] inference that the defendant acted with the required state of mind." *15 U.S.C. § 78u-4(b)(2)*. As the Court has previously held, "a plaintiff may use motive and opportunity' or circumstantial evidence' to establish scienter under the PSLRA, so long as Plaintiffs' allegations support a strong inference that the defendant acted recklessly or knowingly." *766347 Ontario Ltd. v. Zurich Capital Markets Inc., 249 F. Supp. 2d 974, 987 (N.D. Ill. 2003)* (citations omitted). The allegations must support a strong inference of scienter as to each Defendant. *Johnson v. Tellabs, Inc., 303 F. Supp. 2d 941, 953 (N.D. Ill. 2004)*.

Plaintiffs' allegations, viewed in the light most favorable to Plaintiffs, support a strong inference of scienter as to the Landmark Defendants. *See Lee, 330 F.3d at 459*. Plaintiffs have alleged that the Landmark Defendants "were specifically aware of, or recklessly disregarded, facts and information from which they knew that the M.J. Select Global, Ltd. offering documents and other marketing materials were false and materially incomplete." (R. 251-1, TAC at P 177.) In particular, the Court infers [*18] from Plaintiffs' allegations that the Landmark Defendants knew that M.J. Select's offering memoranda and marketing materials represented that all investments in M.J. Select would be invested in liquid securities and redeemable within fifteen days. (*Id.* at PP 179, 180.) According to Plaintiffs, the Landmark Defendants, despite having this knowledge, submitted to certain Defendants performance figures, track records and monthly financial information regarding GAD that failed to disclose that GAD invested in illiquid securities. (*Id.*) The Landmark Defendants allegedly provided this information to these Defendants with the understanding that it would be included in M.J. Select's offering memoranda and marketing documents that were sent to Plaintiffs. (*Id.* at PP 164(a), 168(a).) Additionally, Plaintiffs have alleged that GAD's redemption policy allowed for the investment in illiquid securities, in direct conflict with M.J. Select's offering memoranda and other marketing materials. (*Id.* at PP 156-57, 179(a), 180(a).) Plaintiffs have further alleged that the Landmark Defendants submitted to Coglianese and other Defendants the following false and materially incomplete

statement: [*19] "GAD strictly limits their trading activities to arbitrage type trades, or the simultaneous purchase of one instrument and sale of another which produces a locked in profit, with no risk of market direction (market neutral)." (*Id.* at PP 179(e), 180(e).) Lastly, Plaintiffs have alleged that although the Landmark Defendants were aware that Dominion invested in illiquid securities and that M.J. Select's offering memoranda and marketing materials represented that investments in M.J. Select be placed in liquid securities, GAD nevertheless invested Plaintiffs' money in Dominion. (*Id.* at PP 165(a), 169(a), 179, 180.) These allegations create a strong inference of scienter.

(b) Duty to Disclose

The Landmark Defendants argue that Plaintiffs have failed to adequately allege that they had a duty to disclose to Coglianese or to M.J. Select that GAD transferred Plaintiffs' investments in M.J. Select into illiquid securities. A duty to disclose can arise "if omitting particular facts makes some existing statement misleading." *Anderson v. Abbott Labs., 140 F. Supp. 2d 894, 903 (N.D. Ill. 2001)*. Thus, "if one speaks, he must speak the whole truth." *Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1331 (7th Cir. 1995)*. [*20] Plaintiffs have alleged that the Landmark Defendants provided allegedly false performance figures, track records and monthly financial information regarding GAD to certain Defendants with the specific understanding that such information would be included in M.J. Select's offering memoranda and marketing documents. (R. 251-1, TAC at PP 164, 168.) According to Plaintiffs, these representations were misleading because the Landmark Defendants did not disclose the true nature of GAD's investments. These allegations are sufficient to allege a duty to disclose at this stage.

(c) Reliance

Lastly, the Landmark Defendants argue that Plaintiffs have failed to allege with the requisite particularity their reliance on the purported misstatements or omissions. A plaintiff must allege that he or she relied upon the misstatement or omission of material fact and that reliance was the proximate cause of plaintiff's injuries to state a valid *Section 10(b)* claim. *In re Healthcare Compare Corp. Secs. Litig., 75 F.3d at 280*. Here, Plaintiffs have specifically alleged that they relied on GAD's performance figures and track records, which the Landmark Defendants transmitted to various [*21] Defendants on or before November 25, 1994, June 1, 1997, June 10, 1999, and April 1, 2000 for inclusion in M.J. Select's offering memoranda and marketing documents. (R. 251-1, TAC at PP 164, 168.) Additionally, Plaintiffs have alleged that they relied on GAD's monthly profit and loss records, which the Landmark Defendants transmitted to various Defendants each month from 1994 to at least 2001 for inclusion in M.J. Select's offering memoranda and marketing materials. (*Id.* at PP 165, 169.) Plaintiffs have further alleged that they relied on the Landmark Defendants' statement that "GAD strictly limits their trading activities to arbitrage type trades, or the simultaneous purchase of one instrument and sale of another which produces a locked in profit, with no risk of market direction (market neutral)." (*Id.* at PP 166, 170.) These allegations are sufficient to allege reliance at this stage. Therefore, the Court denies the Landmark Defendants' motion to dismiss Count I as to Plaintiffs' *Section 10(b)* claim.

C. Section 20(a)

In order to allege a *Section 20(a)* claim under the Exchange Act, Plaintiffs must allege: (1) a primary securities violation; (2) each of the individual [*22] defendants exercised general control over the operations of M.J. Select; and (3) each of the individual defendants "possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 881 (7th Cir. 1992)*. Plaintiffs' allegations must comply with *Rule 9(b)*'s particularity mandates because their *Section 20(a)* claim is based on fraud. *Johnson, 303 F. Supp. 2d at 969*. The Landmark Defendants challenge Plaintiffs' *Section 20(a)* claim for failure to allege with the requisite particularity that they exercised general control over M.J. Select and specific control over the activity upon which Plaintiffs predicate their *Section 10(b)* action. The Oceanic Defendants argue that Plaintiffs' *Section 20(a)* claim fails because Plaintiffs have not alleged that M.J. Select, the entity that Plaintiffs claim the Oceanic Defendants controlled, committed a primary securities law violation.

1. The Landmark Defendants

Regarding "general control" under *Section 20(a)*, Plaintiffs must plead that the Landmark Defendants [*23] "actually participated in, that is, exercised control over, the operations of [M.J. Select] in general." *Harrison, 974*

F.3d at 881. "While mere allegations of titles are insufficient to state a claim for control person liability under *Section 20(a)* . . . allegations of both title and responsibilities may be sufficient to establish control." *ZCM, 2005 U.S. Dist. LEXIS 16702, 2005 WL 1950653, at *6* (citations omitted).

In support of their *Section 20(a)* claim against the Landmark Defendants, Plaintiffs have alleged that GAD had "control over the trading of all investments and other funds into which the investments of plaintiffs and other investors deposited into M.J. Select Global, Ltd." by virtue of its position as "trading advisor" of M.J. Select. (R. 251-1, TAC at P 152.) Plaintiffs have further alleged that Landmark controlled M.J. Select's assets "as the Administrator of GAD," and Caseley controlled M.J. Select's assets as a "principal and Director of both GAD and Landmark." (*Id.* at PP 153-54.) Plaintiffs also allege that the Landmark Defendants "prepared for dissemination to plaintiffs and others the false and materially incomplete performance and track records of GAD [*24] for inclusion in M.J. Select Global, Ltd. offering memorandums and other marketing documents." (*Id.* at P 181.) Additionally, Plaintiffs allege that the Landmark Defendants "were at all times relevant hereto each a controlling person' of M.J. Select Global, Ltd. within the meaning of *Section 20(a)* of the 1934 Act." [4] (*Id.* at P 279(a).)

4 Plaintiffs also allege that the Landmark Defendants are liable under *Section 20(a)* through the agency of Coglianese. This purported agency relationship, however, cannot serve as the basis for Plaintiffs' *Section 20(a)* claim because, as addressed earlier, Plaintiffs have failed to adequately allege the existence of such a relationship.

These allegations are insufficient to allege "general control." Plaintiffs have pleaded no allegations establishing that the Landmark Defendants participated in or exercised general control over M.J. Select. Instead, Plaintiffs' general allegations that the Landmark Defendants provided information to M.J. Select and had control over investments [*25] that M.J. Select transferred to GAD only show that the Landmark Defendants had business dealings with M.J. Select. *See Johnson, 303 F. Supp. 2d at 969-970* (holding that plaintiffs failed to plead general control). Moreover, Plaintiffs' conclusory allegation that the Landmark Defendants were control persons within the meaning of *Section 20(a)* does not comply with *Rule 9(b)*'s particularity requirements. *See id. at 969*. Because Plaintiffs have failed to adequately allege general control, the Court need not address whether Plaintiffs have adequately alleged specific control. For these reasons, the Court grants the Landmark Defendants' motion as to Plaintiffs' *Section 20(a)* claim.

2. The Oceanic Defendants

The Oceanic Defendants argue that Plaintiffs have failed to establish control person liability because they have not alleged with particularity a primary securities violation by M.J. Select. The Court disagrees. Plaintiffs have pleaded sufficient allegations to allege that M.J. Select violated the Exchange Act. For example, Plaintiffs have alleged the following: (1) M.J. Select's prospectuses and marketing material dated June 1, 1997, June 10, 1999 and [*26] April 1, 2000 were "false, misleading and materially incomplete" because they "falsely described the investment program to be followed and falsely identified the person who would control and implement the investment decisions," (R. 251-1, TAC at P 9); (2) M.J. Select "illegally operated in the United States by the solicitation and sale of investment shares based on false and materially misleading solicitations," (*id.* at P 46); (3) Plaintiffs relied on M.J. Select's disclosure documents, (*id.* at PP 10, 253-54); (4) "the proceeds of the fraudulent sales were misappropriated and secretly funneled through a series of foreign entities" in violation of M.J. Select's offering materials and oral statements, (*id.* at P 10); and (5) "the purpose and effect of the illegal, unregistered and fraudulent sale of the investments and the misappropriation of the proceeds thereof was at least in part to generate exorbitant commissions and fees," (*id.* at P 11). Therefore, viewing the Complaint as a whole and in the light most favorable to Plaintiffs, Plaintiffs have adequately alleged that M.J. Select committed a primary securities violation. Moreover, for the reasons set forth in the October 6, 2004 Opinion, [*27] Plaintiffs have sufficiently alleged both general and specific control on behalf of the Oceanic Defendants. *ZCM, 388 F. Supp. 2d at 866-67*; *Waldock, 2004 U.S. Dist. LEXIS 23844, 2004 WL 2278549 at *4*. The Court, therefore, denies the Oceanic Defendants' motion to dismiss Plaintiffs' *Section 20(a)* claim.

III. Investment Company Act of 1940 -- Counts II and II-A

Counts II and II-A seek rescission and recovery of damages pursuant to Sections 7(d), 47 and 48(a) of the Investment Company Act of 1940 ("ICA"). *15 U.S.C. §§ 80a-7*, *80a-46*, *80a-47*. *Section 7(d) of the ICA* provides that

> No investment company, unless organized or otherwise created under the laws of the United States or of a State . . . shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer.

15 U.S.C. § 80a-7(d).

A. Count II

Plaintiffs have repleaded Count II, which the Court dismissed as to the Landmark Defendants on November 1, 2004, (R. 186-1, Nov. 1, 2004 Order), [*28] and as to the Oceanic Defendants on October 6, 2004, *Waldock, 2004 U.S. Dist. LEXIS 23844, 2004 WL 2278549, at *5*. Plaintiffs do not move for reconsideration of the Court's rulings. Therefore, for the reasons set forth in the Court's November 1, 2004 Order and October 6, 2004 Opinion, the Court dismisses Count II as to the Landmark and Oceanic Defendants.

B. Count II-A

In the TAC, Plaintiffs have added Count II-A, which is an additional cause of action under the ICA. According to Plaintiffs, Count II-A alleges that the Landmark and Oceanic Defendants are liable under the ICA as "controlling persons" under *Section 48(a) of the ICA*. (R. 322-1, Pls.' Opp'n Landmark Defs.' Mot. at 7); (R. 337-1, Pls.' Opp'n Oceanic Defs.' Mot. at 20). *Section 48(a) of the ICA* states:

> It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this subchapter or any rule, regulation, or order thereunder.

15 U.S.C. § 80a-47(a). The Oceanic Defendants argue that the Court should dismiss Count II-A because there is no private [*29] right of action under *Section 48(a)*, and because the applicable statute of limitations bars Plaintiffs' claim. The Landmark Defendants do not question the existence of a private right of action under *Section 48(a)*, and instead challenge Count II-A on sufficiency and statute of limitations grounds. The Court will address first the Oceanic Defendants' argument that no private right of action exists to enforce *Section 48(a)*.

The Supreme Court has made clear that "private rights of action to enforce federal law must be created by Congress." *Alexander v. Sandoval, 532 U.S. 275, 286, 121 S. Ct. 1511, 1519, 149 L. Ed. 2d 517 (2001)*. In *Olmsted v. Pruco Life Ins. Co. of New Jersey, 283 F.3d 429, 432-36 (2d Cir. 2002)*, the Second Circuit, following the reasoning set forth in *Alexander*, found that no private right of action exists to enforce *Sections 26(f)* and *27(i) of the ICA*. In *DH2, Inc. v. Athanassiades, 359 F. Supp. 2d 708, 714-15 (N.D. Ill. 2005)*, the Court relied on the analysis set forth in *Olmsted* to find that *Section 17(j) of the ICA* does not contain a private right of action. Here, the Court looks to the reasoning set forth [*30] in *Alexander* and *Olmsted* to determine whether a private right of action exists under *Section 48(a) of the ICA*.

To determine whether a private right of action exists, the Court begins "with the text and structure" of the statute. *Alexander, 532 U.S. at 288, 121 S. Ct. at 1520. See also Exxon Mobil Corp. v. Allapattah Services, Inc., -- U.S. --, --, 125 S. Ct. 2611, 2620, 162 L. Ed. 2d 502 (2005)*. The text of *Section 48(a)* does not explicitly provide a private right of action. Nor does *Section 48(a)* contain rights-creating language. *Section 48(a)* only describes the actions that are prohibited, it does not reference the individuals that its seeks to protect. "Statutes that focus on the person regulated rather than the individuals protected create no implication of an intent to confer rights on a particular class of persons."' *Id. at 289, 121 S. Ct. at 1521* (citing *California v. Sierra Club, 451 U.S. 287, 294, 101 S. Ct. 1775, 1779, 68 L. Ed. 2d 101 (1981))*.

Next, the Court examines whether the ICA provides for enforcement of its provisions other than through a private right of action because "the express provision of one method [*31] of enforcing a substantive rule suggests that Congress intended to preclude others." *Alexander, 532 U.S. at 290, 121 S. Ct. at 1521-22*. Indeed, "sometimes the suggestion is so strong that it

precludes a finding of congressional intent to create a private right of action, even though other aspects of the statute . . . suggest the contrary." *Id. at 290, 121 S. Ct. at 1522*. The ICA does provide for the enforcement of its provisions other than through a private right of action. As the Second Circuit recognized in *Olmsted*, "§ 42 of the ICA (*15 U.S.C. § 80a-41*) explicitly provides for enforcement of all ICA provisions . . . by the Securities and Exchange Commission . . . through investigations and civil suits for injunctions and penalties." *283 F.3d at 433*.

Finally, the Court looks to whether Congress explicitly provided for a private right of action to enforce other provisions of the ICA, as "Congress's explicit provision of a private right of action to enforce one section of a statute suggests that omission of an explicit private right to enforce other sections was intentional." *Id.* (citing T*ouche Ross & Co. v. Redington, 442 U.S. 560, 572, 99 S. Ct. 2479, 2487, 61 L. Ed. 2d 82 (1979)* [*32] ("Obviously . . . when Congress wished to provide a private damage remedy, it knew how to do so and did so expressly.")). Here, in contrast to *§ 48(a)*, "Congress explicitly provided in *§ 36(b) of the ICA* for a private right of derivative action for investors in regulated investment companies alleging that investment advisors breached certain fiduciary duties." *Olmsted, 283 F.3d at 433*.

All of the *Olmsted factors*, taken together, indicate that *Section 48(a)* does not create a private right of action. [5] Moreover, *In re Eaton Vance Mutual Funds Fee Litig., 380 F. Supp. 2d 222 (S.D.N.Y. 2005)*, lends support for this finding. The *Eaton Vance* court, relying on *Alexander* and *Olmsted*, found that "the absence of rights-creating language, the existence of an alternative method of enforcement, and the existence of an explicit private right of action for another provision of the statute creates the strong presumption that Congress did not intend to create private rights of action under *§ . . . 48(a)*." *Eaton Vance, 380 F. Supp. 2d at 232*. The Court, therefore, dismisses Count II-A as to all Defendants on the basis that *Section 48(a)* [*33] contains no private right of action. [6]

5 Plaintiffs, in opposition to the Oceanic Defendants' argument that no private right of action exists, provide the Court with only two sentences of analysis and citation to six cases. The cases upon which Plaintiffs rely were decided before *Alexander*, when "courts had more latitude to weigh statutory policy and other considerations than they do now." *Olmsted*, 283

6 Because the Court concludes that no private right of action exists to enforce *Section 48(a) of the ICA*, the Court need not address the Landmark and Oceanic Defendants' sufficiency and statute of limitations arguments. Furthermore, although the Coglianese, Gina Coglianese and Landmark Defendants did not properly raise the issue of the existence of a private right of action to enforce *Section 48(a)* in their motions to dismiss, the Court, *sua sponte*, dismisses Count II-A as to those Defendants.

IV. State Law Claims

A. Standing

Both the Landmark and Oceanic Defendants challenge [*34] Plaintiffs' standing to bring certain claims. The Landmark Defendants argue that under the Illinois shareholder loss rule, Plaintiffs do not have standing to assert their unjust enrichment claim. The Oceanic Defendants assert that the Illinois shareholder loss rule bars all of Plaintiffs' state law claims. The Oceanic Defendants further argue that the Bahamian no reflective loss rule governs the issue of F.3d at 434. Indeed, "past decisions reflecting judicial willingness to make effective [statutory] purpose' in the context of implied rights of action belong to an *ancien regime*.'" *Id.* (citing *Alexander, 532 U.S. at 287, 121 S. Ct. at 1520* (internal citations omitted)). *See also Exxon Mobil Corp., 125 S.Ct. at 2620*. Plaintiffs' cases, therefore, do not indicate that a private right of action exists. Moreover, it is noteworthy that Plaintiffs, in a separate section of their response brief, rely on *Olmsted* for the proposition that "there are no implied private rights of action in the ICA." (R. 337-1, Pls.' Opp'n Oceanic Defs.' Mot. at 16.) shareholder standing. [7]

7 The Oceanic Defendants argue that the Bahamian no reflective loss rule bars all of Plaintiffs' claims, including their federal claims. Because federal claims arise from federal law, not foreign or state law, the Court will analyze the Oceanic Defendants' argument regarding the applicability of Bahamian law only as to Plaintiffs' state law claims. *See Nelson v. Stewart, 422 F.3d 463, 467 (7th Cir. 2005)* (citing *Caterpillar Inc. v. Williams, 482 U.S. 386, 393,*

107 S. Ct. 2425, 2430, 96 L. Ed. 2d. 318 (1987) (stating in the preemption context that a federal claim arises from federal law)).

[*35] The Oceanic Defendants and Plaintiffs disagree as to what law governs the issue of shareholder standing. The Oceanic Defendants argue that the Bahamian no reflective loss rule applies, while Plaintiffs argue that the Illinois shareholder loss rule applies. The Court addressed this choice of law issue on November 22, 2005. (R. 381-1, Nov. 22, 2005 Order at 2-3.) In its Order dated November 22, 2005, the Court held that Illinois law, the law of the forum state, applies because there is no conflict between the Illinois shareholder loss rule and the Bahamian no reflective loss rule. (*Id.* at 3.) For the reasons stated in the November 22, 2005 Order, the Illinois shareholder loss rule applies.

The Oceanic and Landmark Defendants argue that Plaintiffs lack standing to assert their state law claims under the Illinois shareholder loss rule. The Illinois shareholder loss rule "is a longstanding equitable restriction that generally prohibits shareholders from initiating actions to enforce the rights of the corporation unless the corporation's management has refused to pursue the same action for reasons other than good-faith business judgment." *Cashman v. Coopers & Lybrand, 251 Ill. App. 3d 730, 733, 191 Ill. Dec. 317, 319, 623 N.E.2d 907, 909 (2d Dist. 1993)* [*36] (citations omitted). The Landmark and Oceanic Defendants rely on the Court's December 7, 2004 Order dismissing a number of Plaintiffs' state law claims for lack of standing to support their argument that the Illinois shareholder loss rule bars Plaintiffs' state law claims. (R. 190-1, Dec. 7, 2004 Order at 11-12.) On November 7, 2005, however, the Court addressed the issue of shareholder standing based on the new allegations in the TAC and Plaintiffs' new arguments. *Waldock, 2005 U.S. Dist. LEXIS 26790, 2005 WL 2978895, at *13-15*. In the November 7, 2005 Opinion, the Court found that "Plaintiffs have sufficiently alleged that M.J. Select acted in equal fault with the other Defendants." *2005 U.S. Dist. LEXIS 26790, [WL] at *15*. Therefore, in accordance with the doctrine of *in pari delicto*, the Court held that Plaintiffs had standing to bring their state law claims against other Defendants. *2005 U.S. Dist. LEXIS 26790, [WL] at *14-15* ("when a corporation acts *in pari delicto*, shareholders have standing to sue the third parties who injured them"). Here, Plaintiffs argue that because M.J. Select was an allegedly fraudulent entity involved in the purported fraud, they were the victims of the alleged fraud and have standing to assert their state [*37] law claims. For the reasons set forth in the November 7, 2005 Opinion, Plaintiffs have standing to pursue their state law claims against the Landmark and Oceanic Defendants.

B. Illinois Securities Law -- Count III

Count III alleges that Landmark [8] and the Oceanic Defendants violated the Illinois Securities Law of 1953 (the "Act"), *815 ILCS 5/12* & *5/13* (2002). The Act imposes joint and several liability on "the issuer, controlling person, underwriter, dealer or other person by or on behalf of whom said sale was made." *815 ILCS 5/13(A)*.

8 Plaintiffs do not allege that Caseley violated the Act.

1. The Landmark Defendants

Plaintiffs have alleged that Landmark, along with other Defendants, "were a group of persons who acted in concert among themselves and with the other defendants in the offer and sale of the securities of M.J. Select Global, Ltd., and as such were controlling persons within the meaning of Section 2.4 of the Illinois Securities [*38] Act, *815 ILCS § 5/2.4*." (R. 251-1, TAC at P 334.) In their response to the Landmark Defendants' motion to dismiss, Plaintiffs explain that "although Paragraph 334 is not artfully drawn, it is meant to allege principal liability against Landmark through the agency of Michael Coglianese." [9] (R. 322-1, Pls.' Opp'n Landmark Defs.' Mot. at 11.) Plaintiffs, however, have not adequately alleged the existence of an agency relationship between Landmark and Coglianese. Because Plaintiffs rely exclusively on a theory of agency to support their claim against Landmark under the Act, the Court grants the Landmark Defendants' motion to dismiss Count III.

9 The Landmark Defendants, in their opening brief, contest the sufficiency of Count III on the ground that Plaintiffs have failed to plead sufficient allegations to establish that Landmark was a controlling person, as defined by the Act. Plaintiffs, in their response brief, explain that they do not seek to impose liability under the Act on the theory that Landmark was a controlling person. Instead, Plaintiffs allege liability on the theory that Coglianese was a controlling person who, as Landmark's agent, sold investments in

M.J. Select on Landmark's behalf. Plaintiffs further argue that the Landmark Defendants' failure to contest Plaintiffs' agency theory of liability in their opening brief constitutes a waiver. The Court disagrees. Plaintiffs, as they themselves acknowledge, did not clearly articulate their agency theory of liability in the TAC. Therefore, the Court will not punish the Landmark Defendants for failing to address a theory of liability of which they were arguably not on notice.

[*39] **2. The Oceanic Defendants**

Plaintiffs have repleaded the same claims under the Act that the Court dismissed on October 6, 2004 for failure to provide timely notice and for failure to comport with the applicable statute of limitations. The Oceanic Defendants ask the Court to dismiss those claims again. In the October 6, 2004 Opinion, the Court dismissed Count III as to Plaintiff David Miller, and dismissed the Count III claims of Plaintiffs 766347 Ontario Ltd., James Boughner Foundation, John H. Waldock, Mary Jane S. Hill, and John E. Rosino as they relate to Clowes. *Waldock, 2004 U.S. Dist. LEXIS 23844, 2004 WL 2278549, at *6*. Additionally, the Court held that "any purchases made before July 30, 1998 are . . . time-barred." *Id.* Plaintiffs concede that the Court's October 6, 2004 ruling controls and do not move for reconsideration. Therefore, the Court's October 6, 2004 ruling regarding the timeliness of Plaintiffs' claims under the Act stands.

The Oceanic Defendants also argue that they are not liable for the remaining claims under the Act as controlling persons because "M.J. Select shares do not have voting rights," and as such, "owning shares in M.J. Select would not permit Oceanic [*40] to elect directors." (R. 300-1, Oceanic Defs.' Mot. Dismiss at 19.) The Act defines a "controlling person" as:

> any person offering or selling a security, or group of persons acting in concert in the offer or sale of a security, owning . . . such number of outstanding securities of the issuer of such security as would enable such person, or group of persons, to elect a majority of the board of directors or other managing body of such issuer.

815 ILCS 5/2.4. In the October 6, 2004 Opinion, the Court held that "because Plaintiffs allege that Oceanic, Rahming and Clowes owned beneficially such number of outstanding securities that enabled them to elect a majority to the board of directors of M.J. Select,' Plaintiffs have alleged that each of the Oceanic Defendants is a controlling person' as defined by the Act." *Waldock, 2004 U.S. Dist. LEXIS 23844, 2004 WL 2278549, at *5* (citing *815 ILCS 5/2.4*). In the TAC, Plaintiffs have repleaded essentially the identical allegations against the Oceanic Defendants that the Court previously held was sufficient to allege control person liability under the Act. (*See* R. 251-1, TAC at P 333.) [*41] Moreover, the Oceanic Defendants' contested assertion that they did not have the power to elect directors of M.J. Select because M.J. Select's shares purportedly did not contain voting rights is an issue of fact that the Court will not resolve on a motion to dismiss. *See Waldock, 2004 U.S. Dist. LEXIS 23844, 2004 WL 2278549, at *5* ("Defendants' allegations that they did not own any shares of M.J. Select raise an issue of fact that is not appropriate for the Court to determine at this stage."). Therefore, Plaintiffs have sufficiently pleaded that the Oceanic Defendants are liable as controlling persons under the Act.

C. Unjust Enrichment-Count VII

Count VII alleges unjust enrichment against the Landmark Defendants. The Landmark Defendants challenge Plaintiffs' unjust enrichment claim for failure to comply with the heightened pleading requirements of *Rule 9(b)* or the federal notice pleading test. [10] For the reasons that follow, Plaintiffs' unjust enrichment claim survives.

10 Additionally, the Landmark Defendants argue that Plaintiffs lack standing to assert their unjust enrichment claim. For the reasons stated above, Plaintiffs have standing to assert this claim.

[*42] The Landmark Defendants argue that the heightened pleading requirements of *Rule 9(b)* apply to Plaintiffs' unjust enrichment claim, and that Plaintiffs' allegations fail to comply with those requirements. In making this argument, the Landmark Defendants ignore the Court's previous ruling that "Plaintiffs need only plead unjust enrichment under the federal notice pleading requirements." *ZCM, 332 F. Supp. 2d at 1119*. The Court subsequently reaffirmed this holding in the August 12, 2005 Opinion. *ZCM, 2005 U.S. Dist LEXIS 16702, 2005*

*WL 1950653, at *10* ("in its August 2, 2004 *Rule 12(b)(6)* ruling the Court held that *Rule 8(a)* governs Defendants unjust enrichment claims . . . the Court declines to reconsider its previous ruling"). The Court will not revisit this issue.

The Landmark Defendants assert that even if *Rule 9(b)* does not apply, Plaintiffs' allegations in support of their unjust enrichment claim "fail[] the federal notice pleading test." (R. 287-1, Landmark Defs.' Mot. Dismiss at 17.) "Federal notice pleading requirements . . . only require Plaintiffs to plead a short and plain statement of the claim showing that the pleader is entitled to relief . . . " *ZCM, 332 F. Supp. 2d at 1119* [*43] (citing *Fed. R. Civ. P. 8(a)(2)*). In support of Count VII, Plaintiffs have alleged that the Landmark Defendants "have improperly and unjustly obtained property and assets that properly belong to plaintiffs and which were misappropriated by the illegal conduct" alleged in the TAC. (R. 251-1, TAC at P 389.) Plaintiffs have further alleged that "retention by defendants of that property and assets would be an unjust retention of a benefit by those defendants against the fundamental principles of justice, equity and good conscience." (*Id. at P 390*.) In the August 2, 2004 Opinion, the Court upheld a claim for unjust enrichment based on practically identical allegations. *ZCM, 332 F. Supp. 2d at 1119*. For the reasons set forth in the August 2, 2004 Opinion, the Court denies the Landmark Defendants' motion to dismiss as to Plaintiffs' unjust enrichment claim.

D. Equitable Accounting -- Count VIII

The Landmark Defendants challenge Plaintiffs' entitlement to the award of an equitable accounting. To allege the remedy of an equitable accounting, Plaintiffs "must allege the absence of an adequate remedy at law and one of the following: [*44] (1) a breach of fiduciary relationship between the parties; (2) a need for discovery; (3) fraud; or (4) the existence of mutual accounts which are of a complex nature." *Hartigan v. Candy Club, 149 Ill. App. 3d 498, 501, 501 N.E.2d 188, 190, 103 Ill. Dec. 167, 169 (1st Dist. 1986)*. Plaintiffs have alleged that they do not have an adequate remedy at law. Additionally, the Court holds that Plaintiffs have sufficiently alleged against the Landmark Defendants a securities fraud claim under *Section 10(b)* of the Exchange Act and a common law fraud claim. Furthermore, in the October 6, 2004 Opinion, the Court upheld Plaintiffs' request for an equitable accounting. *Waldock, 2004 U.S.Dist. LEXIS 23844, 2004 WL 2278549, at *6* (noting that "courts have broad discretion to determine whether an equitable accounting is warranted"). For these reasons, and for the reasons set forth in the October 6, 2004 Opinion, the Court denies the Landmark Defendants' motion to dismiss as to Count VIII.

E. Breach of Contract -- Counts IX and X

The Oceanic Defendants seek to dismiss Counts IX and X. Count IX is a breach of contract claim premised on the subscription agreements Plaintiffs executed in [*45] accordance with M.J. Select's offering memorandum. Count X is a breach of contract claim premised on a third-party beneficiary theory under the Administration, Registrar & Transfer Agency Agreement between Oceanic and M.J. Select. To state a breach of contract claim, a plaintiff must allege: (1) the existence of a valid and enforceable contract; (2) plaintiff's performance in accordance with the contract; (3) defendant's breach of the contract; and (4) damages as a result of the breach. *D.S.A. Fin. Corp. v. County of Cook, 345 Ill. App. 3d 554, 559, 801 N.E.2d 1075, 1079, 280 Ill. Dec. 130, 134 (1st Dist. 2003)* (citations omitted).

1. Count IX

In Count IX, Plaintiffs allege that they entered into subscription agreements pursuant to M.J. Select's offering documents, and that the Oceanic Defendants were "counter-parties" to the subscription agreements and breached their obligations thereunder. (R. 251-1, TAC at PP 402, 408, 412-13.) The Court dismissed Count IX without prejudice on October 6, 2004. *Waldock, 2004 U.S. Dist LEXIS23844, 2004 WL 2278549, at *7*. After reviewing the subscription agreements, the Court held that "Oceanic is not a party to the subscription agreements, [*46] and Plaintiffs have not alleged any other basis to support their breach of contract claim." *Id.* The Oceanic Defendants request that the Court again dismiss Count IX for the reasons set forth in the October 6, 2004 Opinion. Plaintiffs respond that "a corporate officer can be held personally liable for contractually incurred corporate obligations if the corporate officer [was] fraudulently involved in the wrongdoing leading to a plaintiff's loss." (R. 337-1, Pls.' Opp'n Oceanic Defs.' Mot. at 22.) The two cases to which Plaintiffs cite in support of this proposition, however, do not address holding an officer or a director of a corporation liable for breach of contract. Indeed, *National Acceptance Co. of Am. v. Pintura Corp., 94 Ill. App. 3d 703, 418 N.E.2d*

1114, 50 Ill. Dec. 120 (2d Dist. 1981), states that "although a corporate officer is not generally liable for breach of contract, his status does not shield him from liability for tortious acts from which the breach proximately resulted." *94 Ill. App. 3d at 707, 418 N.E.2d at 1117, 50 Ill. Dec. at 123*. Therefore, Plaintiffs have not provided the Court with a viable basis to support a breach of contract [*47] claim against the Oceanic Defendants, who were not parties to the subscription agreements. For these reasons, and for the reasons set forth in the October 6, 2004 Opinion, the Court grants the Oceanic Defendants' motion to dismiss Count IX.

2. Count X

Count X alleges that Oceanic breached the Administration, Registrar & Transfer Agency Agreement it entered into with M.J. Select for the benefit of M.J. Select investors. (R. 251-1, TAC at PP 431-39.) The Oceanic Defendants move to dismiss Count X on the ground that Bahamian law "does not confer rights or impose obligations on any person except the parties to the contract." (R. 300-1, Oceanic Defs.' Mot. Dismiss at 20.) Because the Oceanic Defendants assume that Bahamian law governs the interpretation of the Administration, Registrar & Transfer Agency Agreement without engaging in a choice-of-law analysis, they "have failed to lay the proper ground work for the court to address their argument." *In re Air Crash Disaster, at Sioux City, Iowa, on July 19, 1989, 17538, No. 90-2255, 1991 WL 268656, at *2 (N.D. Ill. Dec. 4. 1991)* (addressing defendants' failure to conduct a choice-of-law analysis); *see also See United States v. Berkowitz, 927 F.2d 1376, 1384 (7th Cir. 1991)* [*48] ("We repeatedly have made clear that perfunctory and undeveloped arguments, and arguments that are unsupported by pertinent authority, are waived."). The Court, therefore, denies the Oceanic Defendants' motion to dismiss Count X.

F. Conspiracy to Defraud -- Count XII

Count XII alleges a conspiracy to defraud against the Landmark Defendants, Oceanic and Rahming. To state a claim for conspiracy to defraud in Illinois, Plaintiffs must allege: "(1) a conspiracy; (2) an overt act of fraud in furtherance of the conspiracy; and (3) damages to the plaintiff as a result of the fraud." *Bosak v. McDonough, 192 Ill. App. 3d 799, 803, 549 N.E.2d 643, 646, 139 Ill. Dec. 917, 920 (1st Dist. 1989)*.

1. The Landmark Defendants

Plaintiffs have sufficiently alleged a conspiracy to defraud against the Landmark Defendants. As discussed in connection with Counts I and XII-A, Plaintiffs, in pleading their fraud allegations, have complied with *Rule 9(b)*. Moreover, Plaintiffs have alleged that certain Defendants, including the Landmark Defendants, "knowingly and intentionally conspired, between and among themselves, with M.J. Select Global, Ltd., Martin James Allamian and Martin [*49] James Capital Management, Inc. and with others unknown to plaintiffs, to defraud plaintiffs." (R. 251-1, TAC at P 459.) Plaintiffs have also alleged numerous facts demonstrating the Landmark Defendants' knowledge and involvement in the purported fraud. (*See, e.g., id.* at PP 159, 164-173, 175-177, 179-180.) These facts constitute circumstantial evidence of the existence of a conspiracy. *See State Farm Mut. Auto. Ins. Co. v. Abrams, 2000 U.S. Dist. LEXIS 6837, No. 96 C 6365, 2000 WL 574466, at *20 (N.D. Ill. May 11, 2000)* ("Because a conspiracy by nature is secretive, direct evidence is rarely available, and therefore a plaintiff is entitled to prove a conspiracy by circumstantial evidence."). For these reasons, the Court denies the Landmark Defendants' motion to dismiss as to Count XII.

2. Oceanic and Rahming

The Court has already held that Plaintiffs have pleaded their claim for conspiracy to defraud against Oceanic. *Waldock, 2004 U.S. Dist LEXIS 23844, 2004 WL 2278549, at *7* ("Count XII pleads a conspiracy to defraud case against Defendant Oceanic"); *see also ZCM, 383 F. Supp. 2d at 1051-52* ("the Oceanic Defendants' motion to dismiss ZCM's conspiracy to defraud allegations [*50] fails"). As to Plaintiffs' claim of conspiracy to defraud against Rahming, Plaintiffs assert that "the allegations against Ms. Rahming are nearly identical to those already sustained against Oceanic." (R. 337-1, Pls.' Opp'n Oceanic Defs.' Mot. at 23.) The Court agrees. Therefore, for the reasons set forth in the October 6, 2004 and August 22, 2005 Opinions, the Court denies the Oceanic Defendants' motion to dismiss Count XII.

G. Common Law Fraud -- Count XII-A

Count XII-A alleges a common law fraud claim against the Landmark Defendants, [11] Oceanic and Rahming. The Landmark and Oceanic Defendants argue that the Court should dismiss Count XII-A for failure to meet the heightened pleading requirements of *Rule 9(b)*. "The elements of a claim for fraud in Illinois are: (1) a

false statement of material fact; (2) knowledge or belief of the falsity by the party making the statement; (3) intention to induce the other party to act; (4) action by the other party in reliance on the truth of the statements; and (5) damage to the other party resulting from such reliance." *ZCM, 388 F. Supp. 2d at 868* (citations omitted).

> 11 Count XII-A alleges that the Landmark Defendants committed fraud on their own accord, as principals, and through the agency of Coglianese. Because Plaintiffs have failed to adequately allege an agency relationship between the Landmark Defendants and Coglianese, the Court analyzes Count XII-A only with respect to Plaintiffs' allegations against the Landmark Defendants as principals.

[*51] **1. The Landmark Defendants**

The Landmark Defendants argue that Count XII-A "is deficient for the same reasons as Count I." (R. 287-1, Landmark Defs.' Mot. Dismiss at 23.) The Court, however, does not dismiss Count I because Plaintiffs have adequately alleged a violation of *Section 10(b)* of the Exchange Act. Therefore, for the reasons stated above, Count XII-A stands.

2. Oceanic and Rahming

On September 22, 2004, the Court upheld ZCM's common law fraud claim against the Oceanic Defendants. *ZCM, 388 F. Supp. 2d at 868*. The Oceanic Defendants ignore the Court's holding in the ZCM case and argue that the Court should dismiss Count XII-A because Plaintiffs "impermissibly lump together 15 defendants and the fraud allegations against those defendants." (R. 300-1, Oceanic Defs.' Mot. Dismiss at 22.) The Court disagrees. Plaintiffs have pleaded specific allegations identifying Oceanic's and Rahming's involvement in the alleged fraud. (*See, e.g.*, R. 251-1, TAC at PP 122, 123, 126, 138, 140-48, 283, 466(b).) The Oceanic Defendants further assert that because they "only forwarded Coglianese's statements to shareholders," Plaintiffs fail to adequately allege [*52] the first element of a claim for fraud, a false statement of material fact. (R. 300-1, Oceanic Defs.' Mot. Dismiss at 22.) The Oceanic Defendants, however, do not cite any cases in support of their theory that a defendant must physically create the allegedly false statements of material fact to be liable for fraud. The Seventh Circuit has repeatedly "made clear that . . . arguments that are unsupported by pertinent authority[] are waived." *See Berkowitz, 927 F.2d at 1384*; *see also Estate of Moreland v. Dieter, 395 F.3d 747, 759 (7th Cir. 2005)* ("Perfunctory or undeveloped arguments are waived."). Moreover, in *Renovitch v. Kaufman, 905 F.2d 1040 (7th Cir. 1990)*, the Seventh Circuit suggested that distribution of false statements of material fact is sufficient to establish the first element of a common law fraud claim. In *Renovitch*, the Seventh Circuit found that plaintiffs failed to establish that defendants made any false statements of material fact because defendants had not "prepared, authorized, or *distributed* the brochures [that contained several misrepresentations]." *905 F.2d at 1049* (emphasis added). [*53] For these reasons and the reasons set forth in the September 22, 2004 Opinion, the Court denies the Oceanic Defendants' motion to dismiss Count XII-A.

H. Illinois Uniform Fraudulent Transfer Act -- Counts XVI, XVII and XVIII

Plaintiffs have alleged three causes of action against the Landmark and Oceanic Defendants under the Illinois Uniform Fraudulent Transfer Act ("IUFTA"). According to Plaintiffs, the Landmark and Oceanic Defendants violated *Sections 5(a)(1)* (Count XVI), *5(a)(2)* (Count XVII) and *6(a)* (Count XVIII) of the IUFTA. "This statute protects against two kinds of fraudulent transfers: transfers with an actual intent to defraud and transfers which the law considers fraudulent." *General Elec. Capital Corp. v. Lease Resolution Corp., 128 F.3d 1074, 1078 (7th Cir. 1997)*.

1. Statute of Limitations

Both the Landmark and Oceanic Defendants argue that Plaintiffs' claims under the IUFTA that are based on investments made prior to July 30, 1999 are barred by the applicable statute of limitations. Plaintiffs, in their response to the Oceanic Defendants' motion to dismiss, concede that the applicable four-year statute of limitations bars transfers made [*54] on or before July 30, 1999 as to Counts XVII and XVIII. [12] Indeed, on November 7, 2005, the Court, in resolving other Defendants' motions to dismiss, held that "the statute of limitations that applies to Counts XVII and XVIII is four years . . . [and] all of Plaintiffs' claims based on transfers made before July 30, 1999 are dismissed as to Counts XVII and XVIII." *Waldock, 2005 U.S. Dist. LEXIS 26790, 2005 WL 2978895, at *17* (citations omitted). The Court, however, denied without prejudice those

Defendants' motions to dismiss Count XVI because "the IUFTA incorporates the discovery rule into the statute of limitations that applies to [Count XVI]," and "the Court cannot determine at this point when Plaintiffs gained sufficient knowledge to start the statute of limitations running." *Id.* For the reasons stated in the November 7, 2005 Opinion, the Court dismisses Plaintiffs' claims based on transfers made before July 30, 1999 only as to Counts XVII and XVIII.

> 12 Plaintiffs, in their response to the Landmark Defendants' motion to dismiss, argue that the Landmark Defendants' failure to develop their statute of limitations argument constituted a waiver. Because this issue was previously before the Court, however, the Court will address it here.

[*55] **2. The Landmark Defendants**

Additionally, the Landmark Defendants move to dismiss all three causes of action on a variety of other grounds, including that the IUFTA does not apply because Plaintiffs are not "creditors," M.J. Select is not a "debtor," Plaintiffs' investments in M.J. Select are not "debts," and the Landmark Defendants are not "transferees" or "insiders" under the IUFTA. The Landmark Defendants also argue that Plaintiffs fail to meet the heightened pleading requirements of *Rule 9(b)*. In support of these arguments, the Landmark Defendants only cite to two cases -- one for the proposition that *Rule 9(b)* standards apply, and one for the proposition that the alleged transferee must have sufficient knowledge of the purported fraud. Moreover, the Landmark Defendants do not address individually Plaintiffs' three causes of action under the IUFTA. The Landmark Defendants' failure to develop any meaningful factual or legal analysis results in a waiver of their arguments challenging Counts XVI, XVII and XVIII. *See Berkowitz, 927 F.2d at 1384* ("We repeatedly have made clear that perfunctory and undeveloped arguments, and arguments that are unsupported by pertinent [*56] authority, are waived."); *Estate of Moreland, 395 F.3d at 759* ("Perfunctory or undeveloped arguments are waived.").

3. The Oceanic Defendants

The Oceanic Defendants also move to dismiss all three of Plaintiffs' IUFTA claims on the ground that "plaintiffs do not allege that Oceanic received any of the alleged fraudulently transferred assets." (R. 300-1, Oceanic Defs.' Mot. Dismiss at 24.) This argument assumes that the IUFTA only imposes liability on "transferees" who receive the fraudulently transferred assets. The Seventh Circuit, however, has recognized that "*740 ILCS 160/8* provides the creditor with various equitable remedies for the acts of debtors' and transferees,'" and that *Section 740 ILCS "160/9* permits a money judgment against (1) the first transferee of the asset or *the person for whose benefit the transfer was made*; or (2) any subsequent transferee other than a good-faith transferee.'" *APS Sports Collectibles, Inc. v. Sports Time, Inc., 299 F.3d 624, 630 (7th Cir. 2002)* (citing *740 ILCS 160/8*, *9*) (emphasis added). Indeed, even *Amoco Chem. Co. v. Tex Tin Corp., 925 F. Supp. 1192 (S.D. Tex. 1996),* [*57] the only case the Oceanic Defendants cite in their opening brief to support their argument, acknowledges that a court can hold liable under the Uniform Transfer Act an individual who benefitted from the transfer. *925 F. Supp. at 1209*. Accordingly, at this stage in the case, the Oceanic Defendants' argument that they were not "transferees," without more, does not require the dismissal of Plaintiffs' IUFTA claims.

CONCLUSION

For these reasons, the Landmark and Oceanic Defendants' motions to dismiss are granted in part and denied in part. The Landmark Defendants' motion is denied with respect to Counts I (in part), VII, VIII, XII, XII-A, XVI, XVII (in part), and XVIII (in part), and granted with respect to Counts I (in part), II, II-A, III, XVII (in part), and XVIII (in part). The Oceanic Defendants' motion is denied with respect to Counts I (in part), III (in part), X, XII, XII-A, XVI, XVII (in part), and XVIII (in part), and granted with respect to Counts I (in part), II, II-A, III (in part), IX, XVII (in part), and XVIII (in part). The Court has afforded Plaintiffs four opportunities to plead their case against the Landmark and Oceanic Defendants. Moreover, the [*58] Court has provided Plaintiffs with detailed guidance both in this case and in the ZCM case regarding what they must plead to state their claims. Certain pleading deficiencies, however, still remain. *Rule 15(a)* states that a court should freely grant a party leave to amend pleadings "when justice so requires." *Fed. R. Civ. P. 15(a)*. "A court, however, need not provide a plaintiff with that opportunity if the court finds undue delay, bad faith or dilatory motive, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment,

or futility." *Waldock, 2005 U.S. Dist. LEXIS 26790 at *53, 2005 WL 2978895, at *17* (citing *General Elec. Capital Corp., 128 F.3d at 1085*). Because the Court has allowed Plaintiffs four opportunities to plead their case and has provided Plaintiffs with detailed notice of their pleading deficiencies, the Court dismisses Counts I (in part), II, II-A, III, XVII (in part), and XVIII (in part) with prejudice as to the Landmark Defendants, and the Court dismisses Counts I (in part), II, II-A, III (in part), IX, XVII (in part), and XVIII (in part) [*59] with prejudice as to the Oceanic Defendants.

Dated: December 27, 2005

ENTERED:

AMY J. ST. EVE

United States District Court Judge