UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

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

APPENDIX OF UNREPORTED AUTHORITIES IN SUPPORT OF DEFENDANTS' MOTIONS FOR JUDGMENT AS A MATTER OF LAW PURSUANT TO RULE 50(b) OR, IN THE ALTERNATIVE, FOR A NEW TRIAL PURSUANT TO RULE 59

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August 3, 2009

UNREPORTED AUTHORITIES

Cases **Tab**

Pattern Jury Instructions

Verdict Forms

TAB 1

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
In re AIR CRASH DISASTER AT SIOUX CITY, IOWA, ON JULY 19, 1989.
Nos. MDL-817, 89 C 8082.

Dec. 26, 1991.

MEMORANDUM OPINION AND ORDER

CONLON, District Judge.

***1** McDonnell Douglas moves *in limine* to exclude from trial evidence of five prior aircraft accidents and incidents on the grounds that these prior occurrences are not substantially similar to the Sioux City crash and that the evidence is therefore irrelevant and inadmissible pursuant to Fed.R.Evid. 402. Alternatively, McDonnell Douglas asserts that even if evidence of these prior incidents is relevant, it is unfairly prejudicial and likely to create confusion in the minds of the jurors and thus should be excluded pursuant to Fed.R.Evid. 403. Additionally, McDonnell Douglas moves to bar plaintiffs' expert witnesses from directly referring to the prior accidents.

BACKGROUND

On July 19, 1989, United Airlines Flight 232 crashed at Sioux City, Iowa, following a total loss of the hydraulic powered flight controls in the McDonnell Douglas designed and manufactured DC-10. The DC-10 operated with three separate and independent hydraulic systems. Each hydraulic system had its own separate fluids and pumps and was powered by a separate engine. The three-system design incorporated a degree of redundancy into the DC-10's hydraulic systems. The failure of any one of the three hydraulic systems could be compensated for by the operation of the remaining two systems.

The loss of hydraulic power in Flight 232 occurred as a result of a catastrophic, uncontained explosion of the DC-10's second engine, located at the rear of the plane. The engine explosion occurred as a result of a metallurgical flaw in the fan disk of the plane's rear engine. The metallurgical flaw caused a high-energy discharge of engine debris that apparently severed hydraulic fluid lines running to all three hydraulic systems. Consequently, the engine explosion triggered a total loss of hydraulic fluid from all three of the DC-10's hydraulic systems. The flight crew was unable to manipulate any of the aircraft's flight controls. The crew maneuvered the plane by using differential engine power from the DC-10's two remaining engines and ultimately brought the aircraft in for a crash landing at Sioux City, Iowa. Of 296 people on board, 112 were killed in the crash. Plaintiffs have filed various suits against McDonnell Douglas. Trial begins on January 13, 1992. McDonnell Douglas now moves *in limine* to exclude evidence of prior aircraft accidents, including any direct references to the prior accidents by plaintiffs' expert witnesses in explaining the bases for their opinions.

DISCUSSION

McDonnell Douglas moves *in limine* to exclude evidence of five aircraft accidents or incidents pre-dating the crash of Flight 232. A motion *in limine* serves to exclude irrelevant or otherwise inadmissible evidence that may prejudice or confuse a jury, rather than requiring a party to rely on sustained objections and curative instructions at trial. To exclude evidence before trial, evidence must clearly be inadmissible on all possible grounds. Evidence is relevant if it has a tendency to make the existence of any material fact more probable or less probable. Fed.R.Evid. 401. Relevant evidence may be excluded only if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues or misleading of the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence. Fed.R.Evid. 403.

***2** A trial court judge has broad discretion to determine the relevance of proffered evidence. *Hamling v. United States,* 418 U.S. 87, 124-25 (1974); *United States v. Laughlin,* 772 F.2d 1382, 1392 (7th Cir.1985).

Rulings on admissibility of evidence ordinarily should be deferred until trial, so that questions of foundation, relevancy, and potential prejudice may be resolved in proper context. Evidence should not be excluded unless it is clearly inadmissible on all possible grounds. A ruling on a motion *in limine* is subject to change as events at trial unfold. *Moore v. General Motors Corp., Delco Remy Div.,* 684 F.Supp. 220 (S.D.Ind.1988).

I. Motions to Exclude Prior Accident Evidence

McDonnell Douglas contends that plaintiffs have failed to establish that the five previous incidents are substantially similar to the crash of Flight 232. Evidence of other accidents in products liability cases is relevant for the purposes of demonstrating the cause of an accident, the existence of a danger alleged to have caused the accident, or that the defendant had notice of the danger. *Nachtsheim v. Beech Aircraft Corp.,* 847 F.2d 1261, 1268 (7th Cir.1988) (citations omitted). “However, before such evidence will be admitted, the proponent must show that the other accidents occurred under *substantially similar circumstances.*” *Id.* (emphasis in original) (citation omitted).

The focus of an inquiry into the substantial similarity of a prior accident to the accident at issue is a function of the theory of the case advanced by the proponent of the prior accident evidence. *Wheeler v. John Deere Co.,* 862 F.2d 1404, 1406 (10th Cir.1988). Additionally, the degree of similarity necessary to meet the foundational requirements for the introduction of prior accident evidence varies with the purpose for which the evidence is being proffered.

Evidence proffered to illustrate the existence of a dangerous condition necessitates a high degree of similarity because it weighs directly on the ultimate issue to be decided by the jury. The [substantial similarity] requirement is relaxed, however, when the evidence of other accidents is submitted to prove notice or awareness of the potential defect. *Exum v. General Elec. Co.,* 819 F.2d 1158, 1162-63 (D.C.Cir.1987).

Id. at 1406-07. *See also Nachtsheim,* 847 F.2d at 1268 n. 9; *Jackson v. Firestone Tire & Rubber Co.,* 788 F.2d 1070, 1083 (5th Cir.1986); J. Weinstein & M. Berger, *Weinstein's Evidence* ¶ 401[10] at 401-67 to -68 (1991). In evaluating the degree of similarity between a previous accident and the accident at issue, the court, as an initial matter, must determine (1) the theory of the case advanced by plaintiffs and (2) the purpose for which plaintiffs proffer their prior accident evidence.

Plaintiffs proffer all of the challenged evidence to show that McDonnell Douglas had notice of various critical matters. Thus, the “relaxed” similarity requirement applies with regard to all of the challenged evidence. Plaintiffs seek to employ the prior accident evidence in support of differing components of their case, involving various theories of the case. Thus, plaintiffs' theories shall be discussed in the context of each of the prior accidents.

1. 1985 Japan Airlines Boeing 747 Crash

***3** McDonnell Douglas moves to exclude evidence of the 1985 crash of a Japan Airlines 747. The Japan Airlines accident occurred when an aft pressure bulkhead failed, causing the depressurization of the cabin in the vertical tail of the aircraft. The loss of pressure in the plane's vertical tail led to a structural failure in the tail and a resulting loss of all four of the aircraft's hydraulic systems that ran through the tail. The loss of all four hydraulic systems rendered the plane's flight controls unmaneuverable, resulting in a crash. Boeing, the manufacturer of the 747, subsequently remedied the total loss of hydraulic power problem by incorporating hydraulic flow rate fuses that confined a loss of hydraulic fluid to only damaged segments of the hydraulic lines of a 747.

McDonnell Douglas contends that liability in the present action may be premised only upon its failure to have addressed the loss of hydraulic power occurring specifically as a result of an uncontained rear engine explosion as occurred in Flight 232. The Japan Airlines accident did not involve an engine explosion, but rather occurred as a result of a failure in a structural component of the 747 entirely removed from the engine. McDonnell Douglas also points out more obvious differences in the two accidents, the most notable of which is the fact that the two accidents involved different types of aircraft produced by different manufacturers. According to McDonnell Douglas, the differences in the two planes are numerous and substantial. The Boeing 747 is powered by four engines all located on the wings of the plane, while the DC-10 is powered by three engines, one on each wing and one in the vertical tail. Additionally, the 747 runs all of its four redundant hydraulic systems into the vertical tail, while the DC-10 runs only two of its three hydraulic systems through the tail end of the plane. McDonnell Douglas contends that the configuration of the DC-10 hydraulic system renders it invulnerable to a Japan Airlines-type loss of hydraulic power.

Plaintiffs proffer the evidence of the Japan Airlines crash for two purposes: first, to show that McDonnell Douglas had knowledge of the vulnerability of its hydraulic system due to a catastrophic flight occurrence; and second, to show that McDonnell Douglas had knowledge of safety measures that might prevent a total loss of hydraulic power. Plaintiffs' theory of the case plainly involves the contention that McDonnell Douglas should have implemented safety measures employed elsewhere in the industry to prevent a total loss of hydraulic power necessary to manipulate the DC-10's flight controls. As for the first of these two purposes, the Japan Airlines accident evidence is not relevant. The design differences in the DC-10 and the Boeing 747 do not render a comparison of the vulnerability of the hydraulic systems of the two planes appropriate. *See Lewy v. Remington Arms Co.,* 836 F.2d 1104 (8th Cir.1988) (prior accidents involving rifles produced by same manufacturer not admissible because prior accidents involved different product models with differing design features).

***4** On the other hand, because both accidents involved a total loss of hydraulic power, McDonnell Douglas' knowledge of Boeing's installation of hydraulic flow rate fuses to contain fluid loss in the event that the hydraulic fluid lines are severed at any point is relevant to the present case. Although the designs of the DC-10 and the Boeing 747 differ, they are both wide-bodied planes that require hydraulic power to manipulate the flight controls. Accordingly, both the DC-10 and the Boeing 747 are rendered ineffectual by a total loss of hydraulic power. McDonnell Douglas' knowledge of available measures taken by an industry competitor to correct a potentially serious problem that in theory might strike its own aircraft is therefore central to the question of its liability for the Sioux City accident. In this critical respect, the Japan Airlines and Sioux City accidents meet the substantial similarity requirement.

All of the remaining and significant differences between the two accidents and planes go to factors that lay outside the substantial similarity determination. As noted above, plaintiffs proceed in part upon a theory that McDonnell Douglas failed to undertake safety measures that would contain the loss of hydraulic fluid, and thus hydraulic power. The differences in the designs of the DC-10 and the Boeing 747, and the triggering event causing the loss of hydraulic fluid and power in the Japan Airlines and Sioux City crashes, are not central to the theory upon which plaintiffs proceed. This is not to say that the differences are insignificant to the ultimate determination of liability. Rather, "[a]ny differences in the accidents not affecting a finding of substantial similarity go to the weight of the evidence." *Jackson v. Firestone Tire & Rubber Co.,* 788 F.2d at 1083 (5th Cir.1986).

McDonnell Douglas alternatively contends that evidence of the Japan Airlines accident should be excluded as unfairly prejudicial and likely to require an undue expenditure of trial time in the litigation of collateral issues. McDonnell Douglas cites *Nachtsheim* as the principal basis for its undue prejudice argument. In *Nachtsheim,* the Seventh Circuit regarded evidence of a prior aircrash of the same model aircraft as likely to create confusion and require litigation of collateral issues because the cause of the prior accident had never been determined. The Seventh Circuit concluded that introduction of evidence of the prior crash likely would have led the jury to infer that the prior crash was caused by the same factors as the crash at issue. The prior crash evidence would thus have triggered litigation over the collateral issue of the cause of the *prior* crash. *Nachtsheim,* 847 F.2d at 1269. Unlike the prior accident at issue in *Nachtsheim,* the cause of the Japan Airlines crash has been established and therefore is not susceptible of the type of collateral litigation threatened by the prior accident evidence in *Nachtsheim.*

2. 1979 Air Canada Incident

***5** McDonnell Douglas moves to exclude evidence of a 1979 incident involving an Air Canada DC-9 plane manufactured by McDonnell Douglas. Shortly after takeoff from Boston, Massachusetts, the DC-9 sustained a failure of aft pressure bulkhead, resulting in the rapid depressurization of the passenger and flight crew compartments. Although the plane experienced limited mechanical damage to certain flight controls, the remaining flight controls remained operational, permitting the crew to safely land the plane with only one minor passenger injury. The loss of pressure was caused by a metal fatigue fracture in the aft bulkhead access door.

Plaintiffs contend that the Air Canada incident is relevant for the purpose of showing that McDonnell Douglas had notice of the vulnerability of flight control systems at the tail end of its aircraft. This claimed purpose sweeps too broadly and does not relate specifically to any of the links in the chain of causation resulting in the Sioux City crash. The Air Canada incident particularly did not involve either of two critical elements in the chain of causation leading to the Sioux City crash, an uncontained engine failure or a total loss of hydraulic power.

Plaintiffs note that both the Air Canada and Sioux City incidents originated with metal fatigue fractures. The Air Canada incident involved a metal fatigue fracture in a bulkhead access door. The Sioux City crash, on the other hand, originated with a metallurgical flaw in an engine fan disk, an entirely remote component from a bulkhead access door. Moreover, following the Air Canada incident, the entire DC-9 fleet was inspected for fatigue cracks in the aft bulkhead area.

As McDonnell Douglas notes, the only common element in the Air Canada and Flight 232 incidents is that both involved McDonnell Douglas-manufactured aircraft. The Air Canada incident notably did not involve a McDonnell Douglas DC-10, the model involved in the Sioux City crash, but the much smaller DC-9 aircraft. Evidence of prior incidents involving vastly differing product models produced by the same manufacturer are inadmissible. *See Levy v. Remington Arms Co.,* 836 F.2d 1104 (8th Cir.1988) (prior incidents involving different model rifle with different safety component from rifle model alleged to have improperly discharged was not admissible).

3. 1972 Windsor, Ontario and 1974 Turkish Airlines Accidents

McDonnell Douglas moves to exclude evidence of two additional aircraft accidents occurring in the 1970's. In 1972, an American Airlines DC-10 sustained damage when an aft cargo compartment door separated from the aircraft, causing rapid depressurization and the collapse of the cabin floor. The collapse of the floor disrupted various control cables to the rear engine and tail section flight controls that ran under the cabin floor. However, the crew retained control over the aircraft and landed the plane safely.

The second incident occurred in 1974. A Turkish Airlines DC-10 crashed outside of Paris, France shortly after takeoff when its aft cargo door failed. Rapid depressurization of the cabin occurred, again collapsing the cabin floor and damaging flight and engine control cables routed beneath the floor. In this incident, the pilots were unable to safely land the plane. Both the Windsor and Turkish Airlines incidents were traced to a failure by a ground handler to properly latch the cargo doors. Modifications to the DC-10 cargo door locks were made in response to these incidents.

***6** Plaintiffs again contend that evidence of the Windsor and Turkish Airlines incidents are relevant to show that McDonnell Douglas had notice of the vulnerability of flight control systems at the tail of the DC-10. The only difference between these two incidents and the Air Canada incident is that the Windsor and Turkish Airlines incidents involved DC-10's, the same model McDonnell Douglas plane involved in the Sioux City crash. Like the Air Canada incident, neither the Windsor nor Turkish Airlines incidents involved an engine failure or total loss of hydraulic power. Additionally, neither incident originated with metallurgical flaws. In this respect, the Windsor and Turkish Airlines incidents are even more causally remote from the Sioux City crash than is the Air Canada incident. Finally, the Windsor and Turkish Airlines incidents preceded the Sioux City crash by seventeen and fifteen years, respectively. They are therefore too remote in time to be deemed relevant to the Sioux City crash. *See Hicks v. Six Flags Over Mid-America,* 821 F.2d 1311 (8th Cir.1987) (evidence of factually similar accident occurring six years prior to accident in question properly excluded as too remote in time).

4. American Airlines Accident

McDonnell Douglas seeks to exclude evidence of a 1979 crash of an American Airlines DC-10 near Chicago's O'Hare International Airport. The plane crashed after a wing engine separated from the wing because of metal fatigue and cracks in an engine pylon, a structural component that attaches the engine to the wing. When the engine and pylon ripped away from the wing, the American Airlines DC-10 suffered a failure in one of its three hydraulic systems. However, the other two hydraulic systems remained unaffected and the pilots retained power over most flight controls. Investigators determined that the crew could have landed the plane safely had it been aware of the separation of the No. 1 engine. But because a warning light failed, the pilots did not take available corrective measures that would have avoided the crash. The investigators further determined that the originating cause of the accident, a crack in an engine mount, was deemed to have been the result of faulty maintenance and inspection procedures rather any design defect in the DC-10.

Plaintiffs generally contend that evidence of the American Airlines accident is relevant to show that McDonnell Douglas and co-defendants had knowledge of the catastrophic dangers that might follow from a failure to detect metal fatigue or cracks in plane parts. First, with regard to both McDonnell Douglas and United Airlines, evidence that undetected metal fatigue or cracks in airplane parts may have catastrophic results "adds nothing to the obvious." *See McGonigal v. Gearhart Indus., Inc.,* 851 F.2d 774, 778 (5th Cir.1988) (previous accident evidence inadmissible for the general purpose of demonstrating notice of the dangers inhering in undetected flaws in grenades because that evidence "add[ed] nothing to the obvious" and was not relevant to real issue of whether the assembler and inspector was negligent in failing to detect the particular flaw at issue).[FN1] As to McDonnell Douglas' liability, plaintiffs themselves characterize the evidence of the American Airlines accident as relating to the issue of the proper maintenance and inspection of the DC-10 in the present action. Responsibility for regular maintenance and inspection of that aircraft, however, lay principally with the owner of the aircraft, United Airlines. Thus, the American Airlines accident is not relevant to the issue of McDonnell Douglas' liability.

***7** Plaintiffs alternatively contend that the American Airlines accident is evidence that McDonnell Douglas had notice of the risk of total hydraulic system failure associated with engine failure. First, plaintiffs' attempt to suggest a similarity between the American Airlines and Sioux City accidents by characterizing the former as involving an engine failure is reaching. Plaintiffs do not contest McDonnell Douglas' assertions that the originating cause of the accident was a failure in a structural component, the engine mount, rather than a failure in the engine itself. Relatedly, plaintiffs do not contest McDonnell Douglas' assertions either that the flaw in the American Airlines DC-10 engine mount did not originate from a design defect that might have been attributable to McDonnell Douglas.

Second, the American Airlines crash did not involve a total loss of hydraulic power as was the case in the Sioux City crash. Notably, plaintiffs do not contest McDonnell Douglas' assertion that the American Airlines DC-10 ultimately crashed not because of a total loss of hydraulic power, but because of human error resulting from a failure in the warning lights that should have notified the crew of the engine separation. Underlying plaintiffs' theory in the present action is the assertion that McDonnell Douglas should have designed the DC-10 so that a catastrophic engine event would not destroy all hydraulic capabilities necessary to maintaining flight controls. The American Airlines accident suggests that the design of the DC-10 met that purpose, for the total separation of the wing engine led to the loss of only one of the redundant hydraulic systems and left the crew with the flight controls largely operable. The American Airlines accident, therefore, is not relevant for the purpose of showing that McDonnell Douglas had notice that an engine failure, in plaintiffs' words, could result in a *total* loss of hydraulic power. The evidence of the American Airlines accident is therefore not admissible.

II. Motion to Preclude Plaintiffs from Introducing Evidence of Other Prior Accidents Without Prior Notice to McDonnell Douglas

McDonnell Douglas requests that plaintiffs be required to provide McDonnell Douglas with notice of any intention to introduce evidence of other unspecified prior accidents. McDonnell Douglas also requests that plaintiffs be required to make an accompanying offer of proof and that McDonnell Douglas be given an opportunity to raise "substantial similarity" objections before the evidence is introduced. Plaintiffs accede to these requests.

III. Motion to Bar References to Injuries or Loss of Lives in Prior Accident for which Evidence Is Permitted

McDonnell Douglas moves to exclude all references to injuries or loss of lives inflicted in the Japan Airlines crash as unfairly prejudicial. McDonnell Douglas baldly asserts that plaintiffs would introduce these facts solely to inflame the passions of the jury, inducing the jury to reach verdicts on an improper basis. The introduction of facts for this purpose is grounds for exclusion. *See United States v. Medina,* 755 F.2d 1269 (7th Cir.1985). But the concern raised by McDonnell Douglas is one best addressed in the context of the trial. Pretrial exclusion of all references to the fact that the Japan Airlines crash involved injury or a loss of life would unduly sanitize plaintiffs' use of evidence of that prior crash. The fact that the Japan Airlines crash involved a loss of life is relevant to demonstrating the gravity of the notice provided McDonnell Douglas of the implementation of safety measures that might contain a catastrophic impairment of the DC-10's hydraulic systems. McDonnell Douglas may raise a timely objection at trial to any attempt to improperly inflame the passions of the jury with collateral information.

IV. Motion to Exclude Certain Expert Testimony

1. Expert Witness References to Excluded Prior Accidents

***8** McDonnell Douglas moves *in limine* to exclude the testimony of plaintiffs' expert witnesses James Foody and Dr. Donald Kemp to the extent that the testimony concerns inadmissible prior accident evidence. McDonnell Douglas contends that the exclusion of prior accident evidence on relevancy grounds has no meaning if plaintiffs are permitted to bring it in through expert testimony introduced pursuant to Fed.R.Evid. 703. Plaintiffs respond that their experts' testimony is admissible regardless of the inadmissible nature of the information upon which the experts have relied in forming their opinions, so long as the facts or data relied upon by the experts in forming their opinions is "of a type reasonably relied on by experts in the particular field." Fed.R.Evid. 703; *Nachtsheim,* 847 F.2d at 1270.

In *Nachtsheim,* the Seventh Circuit reviewed the same issue now raised by McDonnell Douglas in a case involving a product liability action against an airplane manufacturer for strict liability and negligence following an air crash. The Court affirmed the district court's exclusion of evidence of a prior accident as unfairly prejudicial. The plaintiffs then attempted to introduce the excluded evidence through the testimony of an expert witness who had relied on the excluded prior accident evidence in forming an opinion about the causes of the crash at issue. The district court permitted the expert to state his opinions based on the excluded evidence, but disallowed testimony in which the expert spoke directly of the excluded prior accident evidence.

The Seventh Circuit, after reviewing the relationship between Fed.R.Evid. 403 and 703, affirmed the district court's partial disallowance of the expert's testimony. The Court stated that "to say that Rule 703 permits an expert to base his opinions upon materials that would otherwise be inadmissible does not necessarily mean that materials independently excluded by reason of another rule of evidence will automatically be admitted under Rule 703." *Id.* at 1270 (citation omitted). Thus, Rule 703 should not be regarded as a general exception to otherwise applicable evidentiary limitations. Indeed, *Nachtsheim* expressly restated the Seventh Circuit's position that " 'expert testimony is subject to Rule 403's general bar on the admission of unduly prejudicial evidence.' " *Id.* at 1270, quoting *Kladis v. Brezek,* 823 F.2d 1014, 1019 (7th Cir.1987) (additional citations omitted).

The deposition testimony of Foody and Dr. Kemp is based upon both the 1985 Japan Airlines accident that the court has held to be admissible and at least two of the excluded prior accidents. Discussion of the excluded prior accidents in the context of the experts' testimony would unfairly prejudice McDonnell

Douglas by the introduction of evidence of no relevance to the issue central to the case that may confuse or misdirect the jurors. The availability of admissible evidence as a basis for inquiry into the opinions of Foody and Dr. Kemp, on the other hand, suggests that plaintiffs will not be unfairly hindered in the presentation of their experts' testimony by the exclusion of references to the otherwise excluded prior accidents. Accordingly, plaintiffs' experts may present opinions formed in part upon the basis of inadmissible prior accident evidence. However, plaintiffs' experts may not discuss or refer to any of the excluded prior accidents.

2. Expert Witness Legal Conclusion Testimony

***9** Plaintiffs' experts Foody and Dr. Kemp each has testified during depositions that McDonnell Douglas engaged in "willful" and/or "wanton" conduct. McDonnell Douglas moves to exclude this testimony as impermissible because it constitutes the legal conclusions of the experts. McDonnell Douglas further contends that the testimony should be excluded as speculative.

Fed.R.Evid. 704 provides that an expert witness may express an opinion on the "ultimate issue to be decided by the trier of fact." Fed.R.Evid. 704(a); *United States v. Baskes,* 649 F.2d 471, 479 (7th Cir.1980), *cert. denied,* 450 U.S. 1000 (1981). "Rule 704, however, does not provide that witnesses' opinions as to the legal implications of conduct are admissible." *Baskes,* 649 F.2d at 479 (citation omitted); *see Elco Indus., Inc. v. Hogg,* 713 F.Supp. 1215, 1218 (N.D.Ill.1989).

Plaintiffs' experts employ peculiarly legal terminology in stating their opinions regarding various aspects of McDonnell Douglas' conduct. This language certainly gives the experts' opinions the facial character of legal conclusions. Additionally, plaintiffs' experts' opinions regarding McDonnell Douglas' purported wilfulness facially appear to lack a proper foundation.[FN2] Plaintiffs' experts shall not be permitted to testify to any legal conclusions at trial. However, the problems presently raised by McDonnell Douglas regarding the character of the testimony of plaintiffs' experts are best resolved upon timely objection at trial, where the true nature of the testimony and its foundational basis may be more readily discerned.

CONCLUSION

McDonnell Douglas' motions *in limine* regarding prior accident evidence are granted in part and denied in part. McDonnell Douglas' motion to exclude evidence of the 1985 Japan Airlines crash involving a Boeing 747 is denied. McDonnell Douglas' motion to exclude evidence of the 1972 Windsor, Ontario, 1974 Turkish Airlines, 1979 Air Canada and 1979 American Airlines incidents is granted. McDonnell Douglas' motion to require plaintiffs to provide prior notice and an offer of proof of any other prior accident evidence before introducing it at trial is granted. McDonnell Douglas' motion to bar all references to injury or loss of life inflicted in the 1985 Japan Airlines accident is denied. McDonnell Douglas' motion to bar plaintiffs' experts from discussing or referring to the 1972 Windsor, Ontario, 1974 Turkish Airlines, 1979 Air Canada and 1979 American Airlines incidents is granted. McDonnell Douglas' motion to bar testimony of plaintiffs' experts concerning legal conclusions is granted.

FN1. It is not clear from plaintiffs' opposing brief whether plaintiffs intend to introduce evidence of the American Airlines accident as proof of other issues in their claims against United Airlines. To the extent plaintiffs may intend to introduce the American Airlines incident as evidence of United's negligence in detecting the metallurgical flaw in the fan disk of the downed DC-10, *McGonigal* counsels against its admissibility. In *McGonigal,* a military serviceman sued a hand grenade assembler/inspector in negligence for injuries he sustained when a grenade prematurely exploded. The plaintiff contended that the assembler/inspector was negligent in failing to detect the flaw in the grenade. The plaintiff sought to introduce evidence of previous grenade accidents. The court held that evidence of previous accidents involving grenades assembled by another company was not relevant to the issue of the defendant's negligence in inspecting its own grenades and thus should not have been admitted at trial. The logic of *McGonigal* suggests that the admission of evidence of an

American Airlines failure to detect a metallurgical flaw should be barred as evidence of United's failure to do the same. Additionally, the American Airlines accident involved a failure to detect a flaw in an entirely unrelated plane component from the metallurgically flawed fan disk involved in the present case.

FN2. Both Foody and Dr. Kemp each have stated that they have no actual knowledge of McDonnell Douglas' reasons for deciding not to install hydraulic flow rate fuses after learning of the 1985 Japan Airlines accident and Boeing's subsequent remedial measures.

N.D.Ill.,1991.
In re Air Crash Disaster at Sioux City, Iowa, on July 19, 1989
Not Reported in F.Supp., 1991 WL 279005 (N.D.Ill.)

END OF DOCUMENT

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 summary 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 Company 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 pre-packaged 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. 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).

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%.

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

B. Scienter

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

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

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

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

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

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 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

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

(CCAC ¶¶ 121-174.)

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

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

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

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

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

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

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

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

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

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

DISCUSSION

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

FN4. Rule 10b-5 provides:

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

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

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

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

Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is possible to hypothesize a set of facts, consistent with the complaint, that would entitle the plaintiff to relief, the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading-one that exceeds even the particularity requirement of [Rule] 9(b). Under the PSLRA, a securities fraud complaint must (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."15 U.S.C. § 78u-4(b)(1), (2). In other words, plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that the defendants likely intended to deceive, manipulate, or defraud.

Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 594 (7th Cir.2006) (citations and some internal quotation marks omitted).

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

A. *Scienter*

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

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

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

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

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

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

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

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

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

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

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

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

Nevertheless, for purposes of this motion and so we do not have to revisit this issue, we will consider the complaint as incorporating the press release. We do not believe it assists the plaintiffs in raising an inference of scienter. First of all, the findings are vague and unspecific, and many of the terms, such as "aggressive accounting" and "aggressively optimistic," are imprecise. None of the alleged errors, aggressively optimistic positions, improper conduct, or deficiencies in controls constitute particularized allegations. And contrary to plaintiffs' argument, the fact that Bally acknowledged that false statements were made is not equivalent to admitting scienter. A false statement is one element of a securities fraud claim; scienter is a wholly separate element. The Audit Committee's findings are essentially of negligence, but not scienter. It is important to remember that simple negligence and even "inexcusable negligence" does not amount to scienter. What is required to be shown is an *extreme* departure from the standards of ordinary care. The findings do not rise to this level. Another reason why the press release does not support an inference of scienter is that the findings are simply hindsight conclusions. They do not assist in determining the state of mind behind the misstatements at the time they were made. *See generally* *DiLeo,* 901 F.2d at 628 ("There is no 'fraud by hindsight' ...."); *Sundstrand,* 553 F.2d at 1045 n. 19 ("[T]he circumstances must be viewed in their contemporaneous configuration rather than in the blazing light of hindsight."); *Davis v. SPSS, Inc.,* 385 F.Supp.2d 697, 714 (N.D.Ill.2005) ("Permutations of 'fraud by hindsight' do not create an inference, much less a strong inference, of *scienter."*).

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

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

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

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

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

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

***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. 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 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 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 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

TAB 4

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
BASF CORPORATION, Plaintiff,
v.
THE OLD WORLD TRADING COMPANY, INC., Defendant.
No. 86 C 5602.

Sept. 8, 1992.

MEMORANDUM OPINION AND ORDER

LEINENWEBER, District Judge.

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

Rule 59(e) Motion

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

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

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

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

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

***2** BASF next argues that the records Old World produced and identified through Jeff Grizzle at his deposition show that all of Old World's blenders continued to blend the Dearborn formula for varying periods of time after April 1, 1987, up until July, 1987. However, these records were to the best of the court's knowledge not submitted to the court as part of the record in the case. These records, at least the summary prepared and submitted by BASF, does not tell to whom the antifreeze was sold. The evidence was that the heaviest call for antifreeze commenced in late July or early August (Tr. 458). Finally, the customers claimed lost by BASF were aware of BASF's pending lawsuit against Old World and the charge that the Old World antifreeze did not meet its claims. It is hard to believe that BASF lost any sales because of the false claims of Old World after April 1, 1987.

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

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

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

***3** It was clear from the testimony of representatives of each of the customers in question who were called to testify by BASF and Old World, that each was angered at BASF because of perceived price inflexibility, that each had a relationship with one or more of BASF's other private label competitors before it purchased from Old World, that each considered others at the time it was considering purchasing from Old World, and that some of them did purchase a portion of their requirements from others besides Old World. In fact, both Citgo and Phillips had actually terminated BASF as a supplier before awarding the business to Old World. Phillips said it would not have purchased from BASF under any circumstances. Findings of Fact Nos. 50 and 51. The court rejected Old World's argument that it should award BASF nothing for these accounts (and the five others to which there was no testimony) because it was possible in a market where Old World was not making misrepresentations that BASF might well have been more competitive (Finding of Fact No. 54). However, being competitive is not the same as getting orders. It is not enough to say that the accounts had they not gone to Old World would have gone (or remained) with BASF. “*Post hoc* *ergo propter hoc* will not do....” *Schiller & Schmidt, Inc. v. Nordisco Corporation,* Nos. 91-2195, 91-2781, slip op. 10-11(7th Cir. July 23, 1992). The short of the matter is that BASF presented damage opinion evidence that gave the court no alternative short of total victory, to which it was clearly not entitled. The court attempted to fashion as fair an award as possible under the circumstances and the evidence. This is all it was required to do. *Otis Clapp,* at 744. The court declines to alter the award of damages or the Findings of Fact in support of them.

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

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

Old World's Counterclaim

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

Rule 52(b) Motion

Request to Amend Findings

Finding No. 4

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

Finding No. 37

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

Finding No. 33

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

Finding No. 17

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

Finding No. 34

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

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

Finding Nos. 37 and 38

The court declines to make any changes in Finding

Nos. 37 and 38.

CONCLUSION

The court amends the Rule 58 judgment entered in the case as described in paragraph 1 above. The court also amends the last sentence of Finding of Fact No. 34. The remainder of BASF's motion is denied.

IT IS SO ORDERED.

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

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

END OF DOCUMENT

TAB 5

Only the Westlaw citation is currently available.

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

April 29, 2006.

Benjamin Obi Nwoye, Mendoza & Nwoye, P.C., Chicago, IL, for Plaintiff.

Daniel J. Zollner, Ross Dixon & Bell, LLP, Chicago, IL, for Defendant.

MEMORANDUM OPINION

CHARLES P. KOCORAS, Chief District Judge.

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

BACKGROUND

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

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

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

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

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

Discovery was initially set to close on July 11, 2003. It was extended three times, to September 15, then November 17, and finally to December 1. On December 8, 2003, Primerica moved for summary judgment, and Carolyn followed suit at the end of the following February. In support of her motion, Carolyn supplied a four-paragraph affidavit from Baggett wherein he conclusorily opined that the August 23 signature was in fact a forgery. Primerica moved to strike the affidavit on the grounds that it was insufficient to satisfy Fed.R.Evid. 702. In conjunction with the reply for her motion for summary judgment, Carolyn filed a "supplemental" affidavit from Baggett, which set forth the same opinion embodied in the prior affidavit and provided some indication of the methods Baggett used to come to his conclusions. We ordered that Carolyn produce Baggett for a voir dire hearing to allow us to determine if Baggett was qualified to provide expert testimony. The hearing was postponed a number of times and as yet has not taken place.

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

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

LEGAL STANDARDS

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

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

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

DISCUSSION

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

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

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

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

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

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

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

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

CONCLUSION

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

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

END OF DOCUMENT

TAB 6

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois,
Eastern Division.
General John T. CHAIN, Jr. (USAF, Retired), Plaintiff,
v.
LAKE FOREST PARTNERS, LLC, a Nevada corporation; Christopher T. French, Albert J. Montano, and Mark D. Weissman, M.D., Defendants.
No. 07 C 6317.

Nov. 3, 2008.

Jonathan M. Cyrluk, Henry M. Baskerville, Mariah E. Moran, Stetler & Duffy, Ltd., Chicago, IL, for Plaintiff.

Jillian Stacey Cole, John Michael Riccione, Paul Andrew Greenberg, Aronberg Goldgehn Davis Garmisa, Louis David Bernstein, Christopher James Petelle, Lorne Todd Saeks, Much Shelist Freed Denenberg Ament & Rubenstein, PC, Martin J. Bishop, Foley & Lardner, Chicago, IL, for Defendants.

MEMORANDUM OPINION AND ORDER

RONALD A. GUZMAN, District Judge.

***1** General John T. Chain, Jr. has sued Lake Forest Partners, LLC ("Lake Forest"), Christopher T. French, Albert J. Montano and Mark D. Weissman, M.D. for breach of two loan agreements and common law fraud. Before the Court is plaintiff's motion for judgment on the pleadings pursuant to Federal Rule of Civil Procedure ("Rule") 12(c) as to his claims against Lake Forest for breach of contract based on its failure to repay his loans, plus interest. For the reasons provided herein, the Court grants plaintiff's motion.

Facts

In 2005, Grand Prairie Ventures, Inc. assigned an agreement for the purchase and sale of three islands to Royal Island, LLC, of which Lake Forest is a member. (Answer ¶ 1.) The three islands were located in the Commonwealth of the Bahamas, and were collectively known as Royal Island ("Island"). (Compl.¶ 1.) Royal Island, LLC planned to develop Island into a luxury community. (*Id.*) Pursuant to two separate loan agreements, Chain loaned a total of $3.5 million to Lake Forest, to go toward marketing and developing the Island endeavor.(*Id.* ¶¶ 18-22.)On August 11, 2005, Chain, French, Montano, Weissman and Lake Forest entered into the first loan agreement. (Compl., Ex. 1, Loan Agreement.) The first loan agreement provided that Lake Forest would repay Chain's $3 million loan with interest by August 14, 2006. (*Id.* ¶¶ 2, 5.) It also provided that if the defendants defaulted on the loan, an additional interest rate would be applied to the outstanding amount. (*Id.* ¶ 6.) Under the first loan agreement, French, Montano and Weissman agreed to be held jointly and severally liable for repayment. (*Id.* ¶ 3.) On October 26, 2005, Chain, French, Montano, Weissman and Lake Forest entered into the second loan agreement. (Compl., Ex. 2, Loan Agreement.) It provided that Lake Forest would repay Chain's $500,000.00 loan with interest by January 26, 2006. (*Id.* ¶¶ 2, 5.) The second loan agreement provided that, in the event of default, an additional interest rate would be applied to the outstanding portion of the loan. (*Id.* ¶ 6.) French, Montano, and Weissman also agreed to be held jointly and severally liable for repayment of the second loan. (*Id.* ¶ 3.)

By August 14, 2006, Lake Forest had not yet repaid any part of Chain's $3 million loan or paid any interest pursuant to the first loan agreement. (*Id.* ¶ 24.)By January 26, 2006, Lake Forest had not yet repaid any part of Chain's $500,000.00 loan or paid any interest pursuant to the second loan agreement.(*Id.* ¶ 23.)On August 18, 2006, French communicated to Chain in writing that Lake Forest was no longer participating in the Island project and was exploring different options for repaying its creditors. (*Id.* ¶ 25.)Over eight months later, on April 24, 2007, French notified Chain in writing that Lake Forest still could not pay Chain. (*Id.* ¶ 26.)French also explained to Chain that another individual would be contacting Chain within two weeks to discuss a loan repayment plan. (*Id.*) To date, Lake Forest has not repaid Chain any portion of either loan or any interest. (*Id.* ¶ 28.)

Discussion

***2** In ruling on a motion for judgment on the pleadings, a court must view all facts in the "light most favorable to the non-moving party ." *United States v. Wood,* 925 F.2d 1580, 1581 (7th Cir.1991). In doing so, it is only appropriate for a district court to "grant the motion if it is beyond doubt that the non-movant can plead no facts that would support his claim for relief."*Id.* In determining whether to grant the motion, the district court cannot look any further than the pleadings. *Id.* The pleadings are deemed to include the complaint, the answer and written instruments, such as loan documents, attached as exhibits." *N. Ind. Gun & Outdoor Shows, Inc. v. City of S. Bend,* 163 F.3d 449, 452-53 (7th Cir.1998) (citing Fed.R.Civ.P. 10(c)).

I. Breach of the Loan Agreements

In Counts I and II of his complaint, Chain alleges that each of the individually named defendants breached the first and second loan agreements by not repaying Chain's loans, plus interest, or providing Chain with lots on the Island worth $2 to $3 million dollars. (Compl.¶¶ 32, 38.) Chain's motion for judgment on the pleadings is limited to Lake Forest's breach of the loan agreements by failing to repay Chain's loans, plus interest. (Pl.'s Mot. Default J. ¶ 14.)

In a case that comes to federal court under diversity jurisdiction, the "federal court applies federal procedural but state substantive law." *Bourke v. Dun & Bradstreet Corp.,* 159 F.3d 1032, 1036 (7th Cir.1998). In the state of Illinois, to recover on a breach of contract claim, "a plaintiff must prove: (1) the existence of a valid and enforceable contract; (2) substantial performance by the plaintiff; (3) a breach by the defendant; ... (4) resultant damages," *W.W. Vincent & Co. v. First Colony Life Ins. Co.,* 351 Ill.App.3d 752, 286 Ill.Dec. 734, 814 N.E.2d 960, 967 (Ill.App.Ct.2004), as well as "a reasonable basis for computation of those damages," *TAS Distrib. Co. v. Cummins Engine Co.,* 491 F.3d 625, 632 (7th Cir.2007) (quotation omitted). Chain has alleged the existence of valid and enforceable agreements, that he performed all of his obligations under both loan agreements, that Lake Forest breached both loan agreements and that Chain was damaged by the breaches, and Chain has also provided a reasonable basis for computing his damages. (Compl. ¶ ¶ 30-32, 34, 36-38, 40; Pl.'s Mot. Default J. ¶ 14.)

Judicial admissions are defined as "formal concessions in the pleadings, or stipulations by a party or its counsel, that are binding upon the party making them. They may not be controverted at trial or on appeal." *Keller v. United States,* 58 F.3d 1194, 1198 n. 8 (7th Cir.1995). Judicial admissions ultimately remove a fact from being contested. *Id.* They are so influential that a defendant cannot later deny liability on the basis that his or her admission was mistaken, after he or she admits liability in his or her answer to a complaint. *Murrey v. United States,* 73 F.3d 1448, 1455 (7th Cir.1996). Lake Forest, in its answer to Chain's complaint, admitted that both loan agreements were executed between Chain and Lake Forest. (Answer ¶ 3.) Lake Forest also admitted that the loans provided for repayment and interest. (*Id.*) Furthermore, Lake Forest admitted that the money Chain loaned to Lake Forest was not used to repay Chain. (*Id.* ¶ 5.) Lake Forest acknowledged that it has not repaid the $500,000.00, with interest, that was due on January 26, 2006.(*Id.* ¶¶ 23, 28.)In addition, Lake Forest acknowledged that it has not repaid the $3 million, with interest, that was due on August 14, 2006. (*Id.* ¶¶ 24, 28.)Lake Forest admits that it breached both loan agreements. (*Id.* ¶ ¶ 32, 38.)Lake Forest's judicial admissions have therefore removed from contention the facts that it executed the loan agreements, the agreements required it to repay the principal with interest and it failed to do so, thereby breaching the agreements. Although Lake Forest has denied that the loan agreements were valid and enforceable, it has admitted that Chain performed his obligations under both of the loan agreements and it breached both loan agreements. (*Id.* ¶¶ 30-32, 36-38.)

II. Lake Forest's Affirmative Defense

***3** Lake Forest contends, however, that the loan agreements are unenforceable because "[c]ertain provisions ... are indefinite, unclear, and do not provide the court with a means of determining the intent of the parties. The essential terms are so uncertain that there is no basis for deciding whether the agreement has been kept or broken."(Answer at 15-16.)

A contract is unenforceable due to being indefinite "when it leaves out (1) a crucial term that (2) a court cannot reasonably be asked to supply in the name of interpretation," such as contract price. *Haslund v. Simon Prop. Group, Inc.,* 378 F.3d 653, 655 (7th Cir.2004). It is the trial judge's responsibility to determine whether a contract is ambiguous, as a matter of law, when interpreting a written contract. *Hickey v. A.E. Staley Mfg.,* 995 F.2d 1385 (7th Cir.1993). Furthermore, " '[a] term is ambiguous [only] if it is subject to reasonable alternative interpretations.' "*Id.* (quoting *Taylor v. Cont'l Group Change in Control Severance Pay Plan,* 933 F.2d 1227, 1232 (3rd Cir.1991)).

Neither of the loan agreements executed by Chain and Lake Forest leave out crucial terms. They both clearly provide the names of the parties entering into the agreements, the amounts being loaned from Chain to Lake Forest, what the loaned amounts were to be used for, the amounts to be repaid to Chain, the dates by which the loans were to be repaid and what would happen if the loans went into default. (Compl., Ex. 1, Loan Agreement; *id.,* Ex. 2, Loan Agreement.) None of the terms of the loan agreements is subject to reasonable alternative interpretations, which means that the terms at issue in this motion are not ambiguous.

Lake Forest admitted in its answer that it entered into the first loan agreement, which provided that Chain would loan $3 million to Lake Forest and Chain would eventually receive the $3 million back, plus interest. (Answer ¶ 19.) Lake Forest also admitted in its answer that it entered into the second loan agreement, which provided that Chain would loan $500,000.00 to Lake Forest and Chain would eventually receive the $500,000.00 back, plus interest.(*Id* . ¶¶ 21-22.)In addition, Lake Forest admitted that it breached both loan agreements by failing to repay the money, plus interest, to Chain. (*Id.* ¶¶ 32, 38.)Because Lake Forest admits in its answer that it entered into both loan agreements, failed to repay Chain and breached both loan agreements, Lake Forest has undercut its argument that the loan agreements had indefinite terms. *Cf. Ill. Conference of Teamsters & Employers Welfare Fund v. Steve Gilbert Trucking,* 71 F.3d 1361, 1366 (7th Cir.1995) (stating that defendant's admission that he had entered into a contract and was obligated to pay sums under the contract undercut his affirmative defense that the agreement was unenforceable). Thus, the Court grants plaintiff's motion for judgment on the pleadings as to Lake Forest's breach of both loan agreements by not repaying Chain $3.5 million, plus interest. As of September 15, 2008, the total amount of principal and interest Lake Forest owes Chain on the first loan agreement is $5,330,859.79. (Pl.'s Mot. Default J. Def. Lake Forest Partners, LLC, Ex. 5, Braun Decl. ¶ 3.) Until it is repaid, Lake Forest will owe Chain an additional $2,268.49 per day in interest on the amount due under the first loan agreement. (*Id.*) As of September 15, 2008, the total amount of principal and interest Lake Forest owes Chain on the second loan agreement is $738,642.40.(*Id.* ¶ 4.) Until it is repaid, Lake Forest will owe an additional $195.89 per day in interest on the amount due under the second loan agreement. (*Id.*)

Conclusion

***4** For the reasons set forth above, the Court grants plaintiff's motion for judgment on the pleadings as to its breach of contract claims against Lake Forest based on its failure to repay Chain's loans plus interest. As of September 15, 2008, the total amount of principal and interest Lake Forest owes Chain on the first loan agreement is $5,330,859.79. Until the first loan is repaid, Lake Forest will owe Chain an additional $2,268.49 per day in interest on the amount due under the first loan agreement. As of September 15, 2008, the total amount of principal and interest Lake Forest owes Chain on the second loan agreement is $738,642.40. Until the second loan is repaid, Lake Forest will owe an additional $195.89 per day in interest on the amount due under the second loan agreement. (*Id.*) Issues that remain include whether: (1) other defendants are liable for breach of the loan agreements; (2) all defendants, including Lake Forest, breached both loan agreements by failing to provide Chain with two lots on the Island; and (3) all defendants are liable for common law fraud.

SO ORDERED.

N.D.Ill.,2008.
Chain v. Lake Forest Partners, LLC

Slip Copy, 2008 WL 4831707 (N.D.Ill.)

END OF DOCUMENT

TAB 7

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
Joardis DAVIS, Plaintiff,
v.
Harold M. ROWE, individually and doing business as Rowe Company Fine Arts; and the Rowe Company Fine Arts, Inc., an Illinois corporation, Defendants.
No. 91 C 2254.

Feb. 10, 1993.

MEMORANDUM OPINION

KOCORAS, District Judge:

***1** This matter comes before the Court on defendants' six motions in limine seeking to prohibit the plaintiff from presenting certain evidence and witness testimony at trial. For the following reasons, the motion is granted in part and denied in part.

First Motion in Limine: The Hartford Letter, the Rowe Statement, and the Davis Letter

Plaintiff, Joardis Davis ("Davis"), filed this suit to recover for the loss of art she had consigned to defendants, Harold M. Rowe, individually and doing business as Rowe Company Fine Arts, and the Rowe Company Fine Arts, Inc. (collectively referred to as "Rowe"). The art was destroyed in a fire on April 15, 1989. Under the Illinois Consignment of Art Act, Rowe is responsible to Davis for the fair market value of the Davis art in its possession at the time of the fire. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(5) (Smith-Hurd Supp.1992). In addition, Rowe is responsible for paying Davis a portion of the insurance proceeds it received due to an insurance contract that Rowe procured in fulfillment of a consignment agreement between Davis and Rowe. On May 20, 1992, this Court denied Rowe's motion for summary judgment, finding that Davis' claims depended upon the fair market value of the art lost and that the fair market value of the consigned art at the time of the fire was an issue of fact to be determined by the jury at trial.

Citing Federal Rule of Evidence 408, Rowe asks this Court to prohibit Davis from submitting several statements made by Rowe concerning the value of the Davis art collection that was lost in the fire. The first statement that Rowe seeks to exclude from the jury was made October 19, 1989 by Harold M. Rowe ("the Hartford letter"). Harold Rowe indicated that "the value of the collection was $4,635,000." He later affirmed this under oath ("the Rowe statement"). Rowe secondly seeks to exclude a letter that was sent by the Rowe Company to Davis ("the Davis letter"), which states, "The total value of the art library and the works of art destroyed in the Rowe Company Gallery far exceeded the insurance coverage." [FN1] The Davis letter additionally states that "the parties ... recognize and acknowledge that the value of the consigned works of art of Warren Davis far exceeded $250,000."

Before we determine the merits of Rowe's motion in limine as to these statements, we first shall recount the principles of law that apply under Rule 408.

A. *The Legal Standard Under Rule 408*

Rule 408 makes inadmissible evidence of offers, acceptances, conduct, or statements made during settlement negotiations that are presented to prove a party's liability for or the invalidity of a claim or its amount.[FN2] Rule 408"does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness...."

In *Kritikos v. Palmer Johnson, Inc.,* 821 F.2d 418 (7th Cir.1987), the Seventh Circuit commented upon the policy behind Rule 408 in addressing the situation of a plaintiff who had refused to accept late delivery of a yacht from the defendant shipbuilder on the ground that the yacht failed to meet specifications. Shortly after the plaintiff refused to accept late delivery of the yacht, the plaintiff's representative wrote letters summarizing discussions with the boat architects, discussions which indicated that the defendant was not responsible for all of the delays in delivery. The court held that the letters were not admissible under Rule 408 because they were written with the objective of advising the plaintiff of a possible compromise solution before legal action was commenced. According to the court, the purpose of Rule 408 is "to encourage settlements. The fear is that settlement negotiations will be inhibited if the parties know that their statements may later be used as admissions of liability." *Kritikos,* 821 F.2d at 423 (quoting, *Central Soya Co., Inc. v. Epstein Fisheries, Inc.,* 676 F.2d 939 (7th Cir.1982)); *see also, U.S. v. Lorince,* 773 F.Supp. 1082, 1101 (N.D.Ill.1991). In view of this policy, documents prepared in connection with settlement efforts should not be admitted as evidence. *Lorince,* 773 F.Supp. at 1101 (citing, *Blu-J, Inc. v. Kemper C.P.A. Group,* 916 F.2d 637, 642 (11th Cir.1990) (holding that an independent evaluation prepared for purpose of exploring settlement was inadmissible under Rule 408; *Ramada Development Co. v. Rauch,* 644 F.2d 1097 (5th Cir.1981) (finding a report detailing flaws in construction of motel, which was commissioned as a basis for settlement negotiations, inadmissible)).

***2** Therefore, if we find that the statements that Davis seeks to admit into evidence were made within the context of settlement efforts, we shall exclude them under Rule 408. The question presented by the parties is how broadly to construe the term "settlement efforts." As Judge Moran noted in *Prudential Ins. Co. v. Curt Bullock Builders, Inc.,* 626 F.Supp. 159, 164 (N.D.Ill.1985), the admission of any statement made during, or any document prepared for, any kind of conciliation effort raises a Rule 408 issue. However, in order for this evidence to be excluded, a claim must actually be in dispute at the time the statement was made or that the document was prepared. *Id.* Several courts have found that an actual dispute existed sufficient to invoke Rule 408 even though the parties had not yet asserted their claims. *See e.g., E.E.O.C. v. Gear Petroleum, Inc.,* 948 F.2d 1542, 1544-45 (10th Cir.1991) (refusing to admit a letter from the defendant even though it was sent prior to the completion of the EEOC investigation); *Mundy v. Household Finance Corp.,* 885 F.2d 542, 546-47 (9th Cir.1989) (upholding the exclusion of a settlement offer to a former employee made after the employee's termination and after he had retained legal counsel, but prior to the employee's filing his claim). In addition, although Rule 408 applies where an actual dispute exists, an apparent difference of opinion between the parties as to the validity of a claim is enough to call the Rule into play. *Alpex Computer Corp. v. Nintendo Co.,* 770 F.Supp. 161, 163-65 (S.D.N.Y.1991) (citing, *Dallis v. Aetna Life Ins. Co.,* 768 F.2d 1303, 1307 (11th Cir.1985); 2 J. Weinstein and M. Berger, *Weinstein's Evidence,* ¶ 408[01] at 408-10 (1990)).

For the reasons stated below, we find that at the time Rowe made the statements at issue, an adversarial relationship existed between the parties that can be deemed an actual dispute. On this basis, we conclude that Rule 408 prohibits the statements' admission into evidence.

B. *The Hartford Letter and the Rowe Statement*

At the time of the fire on April 15, 1989, the Rowe gallery contained art belonging to Rowe and contained art it had received on consignment from other individuals, including art created by Warren Davis, now deceased, and owned by Joardis Davis. Prior to the Davis consignment, Rowe had secured business interruption insurance and insurance covering furniture and fixtures from Hartford. Harold M. Rowe also had insurance from Hartford that would cover his and his wife's personal property located in the gallery. After executing the consignment agreement with Davis, the Rowe Company secured an additional $250,000 of fine arts insurance from Lloyds.

On May 24, 1989, Rowe's counsel gave formal notice to Hartford of its claim under the business interruption insurance. The business interruption insurance covered losses incurred by Rowe equal to its net income for a year after the fire. The business interruption insurance policy did not include any recovery limitations based upon Rowe's prior operating history. Thus, Rowe indicated to Hartford that it intended to include in its claim projected sales from art collections from which it had never sold art prior to the fire. These projected sales would include future sales from the Davis art collection, which was a collection from which Rowe had never sold art prior to the fire.

***3** Hartford responded to Rowe's assertion by hiring counsel and an accounting firm. Hartford made it clear that it would oppose any Rowe claim that included projected sales and that did not stem from historical experience. Counsel for Rowe responded by sending a letter to Hartford on October 20, 1989 ("the Hartford letter"). In the letter, Harold M. Rowe stated that "the value of the collection was $4,635,000." According to Rowe, the purpose of this letter was to convince Hartford that the Rowe Company could have sold some art in the year after the fire from art collections from which it had never sold previously. Rowe suggests that it was attempting to settle the business interruption claim without suit.

After sending the Hartford letter, Rowe and its counsel participated in meetings and telephone negotiations with an adjuster and an attorney for Hartford. During the course of these discussions, Hartford's attorney requested that Rowe provide a sworn statement ("the Rowe statement") in connection with the projected sales figures earlier given to Hartford. Rowe did provide such a statement under oath.

Notwithstanding these efforts, the parties could not reach an agreement over the interpretation of the business interruption policy. Hartford continued to take the position that the Davis art had no value prior to its consignment and could not have been sold or promoted successfully. Suit was filed, and Rowe and Hartford settled, "primarily on the basis of the Rowe Company's actual sales prior to the fire."

Davis asks this Court to admit the Hartford letter and Rowe statement into evidence. Davis argues that the letter and statement were made solely for the purpose of supporting Rowe's claim under the business interruption insurance policy. Under the terms of the policy, the insured, that is Rowe, possessed a duty in case of loss to prepare an inventory of damaged property and to submit a signed, sworn statement of loss incurred. According to the policy, fulfilling these duties was a condition precedent to filing suit. Hence, Davis argues that the Hartford letter and the Rowe statement were not documents or statements made during a negotiation effort, and thus excludable under Rule 408, but rather, were made as a *pro forma* step in asserting a claim under the policy. Davis argues that the Hartford letter was not made in an effort to compromise a disputed claim, but rather was made to fulfill the terms of the policy that required such information from a claimant in order to process a claim for insurance benefits. According to Davis, no actual dispute arose concerning the amount of benefits payable under the policy until this information was provided and considered by the insurer.

We reject Davis' contention. The relationship between a claimant and its insurer is inherently adversarial and can generally be assumed to be clothed in continual negotiation and conciliation efforts. When Rowe realized that it would be disallowed from including projected sales figures into its claim under the business interruption insurance, an actual dispute arose between Rowe and Hartford to which Rule 408 applied. It was at that time that Hartford engaged counsel and an accounting firm to defend its position that the claim's parameters would be set by prior operating history only. Moreover, Rowe claims that in the Hartford letter and the Rowe statement, it was providing Hartford with projected sales figures, that is, what the art could have been worth in light of Rowe's sales and promotional efforts. Without the inflation caused by Rowe's sales and promotional efforts, Rowe contends that the valuation of the Davis art is much lower. We conclude that Rule 408 precludes the admission of the Hartford letter because it was prepared as part of a negotiation effort. Davis' motion in limine is therefore granted.

C. *The Davis Letter*

***4** After the fire on April 15, 1989, Rowe communicated with all persons who had art in the gallery at the time of the fire. Rowe had numerous discussions with the plaintiff.

Rowe describes what followed next in this way. According to Rowe, during the phone conversations, Davis demanded payment of the entire $250,000 of insurance provided under the consignment agreement, and also discussed strategies whereby she and Rowe could claim additional amounts for the Davis art from those responsible for causing the fire. Rowe contends that it never agreed that Davis was contractually entitled to the $250,000, and in any event was unwilling to make any payment to Davis without a full release from liability. On May 31, 1991, Rowe prepared a letter ("the Davis letter"), which Rowe deems a settlement proposal. The draft proposed to meet plaintiff's demand in exchange for a complete release of the defendants from any further liability.

The draft included what Rowe claims was a self-serving recital, that the Davis art in the gallery at the time of the fire was worth more than the $250,000 of insurance agreed upon in the consignment contract. It said, "The total value of the art library and the works of art destroyed in the Rowe Company Gallery far exceeded the insurance coverage." This was followed by an offer to pay Davis $210,000 (the $250,000 amount less $40,000 advanced to Davis earlier). Davis seeks to admit this statement into evidence.

The draft sent to Davis was not signed by the defendants. It was delivered to Davis in June of 1989. Davis' attorney contacted defendants' counsel directly on June 27, 1989. Thereafter, several revised settlement proposals were exchanged between the attorneys. The parties signed none of these proposals.

Davis contends that, until the May 19, 1989 letter was sent to her indicating that the amount of Davis' loss "far exceeded the insurance proceeds," she had not threatened litigation. She therefore concludes that the letter was sent prior to the existence of an actual dispute between the parties. She claims that she was merely seeking the insurance proceeds that both parties agreed were payable under the consignment agreement. Only later did she retain a lawyer to obtain insurance proceeds she believed were due to her.

We again must reject Davis' contentions. Davis claims that prior to the Davis letter she was merely seeking the insurance proceeds that both parties agreed were payable under the consignment agreement. Although both parties may have agreed that Davis was owed some amount under the agreement, the parties were not in agreement over the exact amount owed at the time the Davis letter was sent, and indeed, are still in dispute over that issue. We determine that this request for a release from liability in exchange for a payment of $250,000 was a negotiation effort. In the Davis letter, Rowe did not say we agree that we owe you $250,000, but said that we "agree to make payment to you of" the $250,000. There is a subtle distinction. Rowe did not recognize that it was responsible for that liability, but merely offered to pay that amount in exchange for a release. After the Davis letter, Davis wrote two letters further demanding that the insurance proceeds payable under the consignment agreement be paid to her. The amount demanded by Davis was never paid, and we subsequently held that the amount owed to Davis depends upon the value of the art, a question that is to be determined by the finder of fact at trial. Because we believe that the Davis letter was written in an effort to settle an actual dispute, we decline to admit it in evidence.

D. *Use of the Evidence for Purposes Other Than to Prove the Claim*

***5** Rule 408 provides that exclusion of evidence is not required when the evidence is offered for a purpose other than to prove a claim amount, such as proving bias or prejudice of a witness...." Davis argues that Rowe's "receipt of insurance proceeds from Hartford Insurance in the case at bar in an amount in excess of the $250,000 insurance coverage agreed upon in the consignment agreement, and their subsequent failure to pay all of such proceeds renders Harold Rowe's expected testimony at trial concerning the value of the destroyed Warren Davis art works to be far less credible than it may otherwise appear to a jury." Davis suggests that Harold Rowe's testimony will be biased, and that the statements need to be admitted to establish this bias.

Davis' argument is off the mark. Because Harold Rowe is a defendant and is the president of the corporate defendant to the suit, he will not be testifying as a disinterested witness; his bias will be assumed. Hence, Davis need not introduce Rowe's statements to illustrate his bias. Furthermore, Davis may not use the statements to impeach Rowe. Inconsistent conduct or statements made in connection with compromise negotiations may not be used for impeachment purposes. *E.E.O.C.,* 948 F.2d at 1545 (citing, M. Graham, *Federal Rules of Evidence* 116 (2d ed. 1987)).

Davis additionally argues that this Court must admit the Hartford letter as evidence to show Rowe's intent to defraud and convert the insurance proceeds. This argument is unfounded. The value of the art, and thus, the amount of money that Rowe owes Davis for it, is the factual question central to the claims in this dispute. We held above that Rowe's statements are inadmissible to help prove the amount of Rowe's liability to Davis. Davis attempts to subvert our holding and the policies of Rule 408 by introducing the Hartford letter under the guise of proving claims of fraud and conversion, both of which depend upon the outcome of the factfinder's determination regarding the value of the art. We therefore reject Davis' argument that the evidence should be admitted to prove her claims of fraud and conversion. In doing so, we abide by the admonition of the Tenth Circuit in *Bradbury v. Phillips Petroleum Co.* According to the *Bradbury* court, "when the issue is doubtful, the better practice is to exclude evidence of compromises or compromise offers." *Bradbury v. Phillips Petroleum Co.,* 815 F.2d 1356, 1364 (10th Cir.1987).

To summarize, based on the facts as presented by the parties, we decline to admit either the Hartford letter, the Rowe statement, or the Davis letter into evidence. We find that the statements were made in the midst of settlement negotiations, and that admission for other purposes poses too great a risk that the evidence will be used by the fact finder in evaluating the value of the art.

The Second Motion in Limine: Amount of Insurance Received

Rowe also seeks to exclude evidence of any insurance claimed or collected by it, other than the $250,000 of insurance specified in the consignment contract. Davis responds that this information should be allowed because "[m]ost of those funds were received *only* because defendant was in possession of the plaintiff's artwork." Davis again argues that evidence of the existence of these insurance proceeds is necessary in proving her claims of fraud and conversion of those same proceeds.

***6** Unless events suggest otherwise at trial, we shall exclude all evidence of Rowe's receipt of insurance proceeds beyond the $250,000. This evidence is irrelevant to the question of the value of the Davis art. It is this question upon which the success of Davis' claims under the consignment agreement and under the Illinois Consignment of Art Act rests. Although this evidence would be relevant to claims for fraud or conversion should these claims be of merit, we hold that allowing such evidence would mislead the jury in their determination of the value of the Davis art and, thus, may be excluded under Federal Rule of Civil Procedure 403.

The Third Motion in Limine: Use of Funds Received

Rowe also asks this Court to refuse to admit evidence illustrating how Rowe used the insurance funds it received, in ways other than making payments to Davis. For example, Davis seeks to tell the jury about babysitting and hairdresser expenses paid with the proceeds of the insurance funds. Davis contends that evidence of Rowe's use of the funds should be admitted because the contract compelled the insurance to be paid over to Davis. Moreover, Davis portrays Rowe as a trustee for the funds that are owed to her and suggests that Rowe's use of the funds for purposes other than for payment to Davis violated that trust arrangement.

The Illinois Consignment of Art Act says that works of fine art received by art dealers are held in trust for the owners. The art dealer is trustee for the benefit of the artist until the work of fine art is sold to a bona fide purchaser or is returned to the artist. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(3) (Smith-Hurd Supp.1992). The proceeds of the sale of a work of fine art are trust property and the art dealer is trustee for the benefit of the artist until the amount due the artist from the sale is paid in full. Ill.Ann.Stat. ch. 121 1/2 , para. 1402(4). We have not been asked to decide and shall not decide in the present motion to what extent Rowe possessed a duty to maintain insurance proceeds that it received due to the destruction of art which it held in trust, in particular, in a case where the question of the value of the art so held is in contention. We do hold, however, that until the value of the art is determined by the fact finder at trial, we shall not admit evidence of how Rowe used funds it received as a result of the fire. This information would be prejudicial and is therefore excludable under Rule 403.

Fourth Motion in Limine: Testimony of Kenneth Cone

Rowe argues that Davis' proposed witness Kenneth Cone should not be allowed to testify. According to Rowe, Kenneth Cone is merely an economist, and he has no knowledge or familiarity with art. He allegedly intends to apply the Consumer Price Index and Sotheby's Index of Contemporary American Art to 19 pieces of Davis art. Rowe points to a myriad of evidentiary problems with Cone's use of these two indices.

We decline to exclude Cone's testimony at this juncture of the litigation. At trial, we of course, shall demand compliance with Federal Rule of Civil Procedure 703. If we deem Cone's testimony admissible after a proper showing, Rowe will be allowed to cross examine Cone in order to expose the purported weakness in his testimony. Accordingly, Rowe's motion in limine as to this evidence is denied.

Fifth Motion in Limine: Testimony of Linda Durham

***7** Rowe asks the Court to exclude the testimony of Linda Durham, an expert witness who will testify as to the value of the Davis art. Rowe contends that Durham has changed the basis of her opinion in this case from that previously stated during her deposition and requests that we exclude any testimony different from that previously testified to in her deposition.

Davis responds by arguing that Durham has not changed the basis of her opinion as set forth in the deposition. She has completed a piece by piece appraisal of the artwork based upon photos, her knowledge of the artwork, and on other information previously set forth in her answer to Rowe's interrogatory. Durham's appraisal was prepared at Davis' request, and Davis asserts that the final appraisal report will be sent to Rowe's counsel as soon as it is completed.

We decline to decide at this time whether testimony not given by Durham in her deposition will be excluded at trial. Because Davis contends that she shall provide Rowe with additional information obtained from Durham in accordance with Federal Rule of Civil Procedure 26(e)(2), we feel that it would be better to hold off on our determination. Moreover, we choose not to make such a decision based solely on a page or two of written argument, and instead, shall hear from the parties in person on this issue.

Sixth Motion in Limine: Davis' Income Tax Returns

Rowe complains that Davis has not furnished copies of her income tax returns and has failed to sign IRS forms allowing Rowe to obtain copies of the returns. Rowe argues that Davis should not be allowed to proceed with this action until her income tax returns are furnished.

According to Davis, the forms requesting copies of the returns from the IRS are being forwarded to Rowe. Therefore, unless we are otherwise advised, there seems to be no remaining basis for Rowe's request, and we deny Rowe's motion as to this matter.

CONCLUSION

For the reasons stated above, Rowe's first, second, and third motions in limine are granted and Rowe's fourth, fifth, and sixth motions in limine are denied.

FN1. Although in our Memorandum Opinion, we commented in *dictum* that this statement could later be used by Davis to prove the value of the art, we now decline to allow this statement into evidence. Upon further consideration of the policies behind Rule 408 and the context within which this statement was offered, we find this statement inadmissible.

FN2. Rule 408 of the Federal Rules of Civil Procedure provides the following:

> Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible. This rule does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negativing a contention of undue delay, or proving an effort to ob-

struct a criminal investigation or prosecution.

N.D.Ill.,1993.
Davis v. Rowe
Not Reported in F.Supp., 1993 WL 34867 (N.D.Ill.)

END OF DOCUMENT

TAB 8

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
Velma DICKER, Patricia Hood, and Rhonda Moore, Plaintiffs,
v.
ALLSTATE LIFE INSURANCE COMPANY, Defendant.
No. 89 C 4982.

April 9, 1997.

MEMORANDUM OPINION AND ORDER

REBECCA R. PALLMEYER, United States Magistrate Judge.

***1** Plaintiffs Velma Dicker, Patricia Hood, and Rhonda Moore represent a class of black persons employed in nonexempt positions in the Underwriting Department at Defendant Allstate Life Insurance Company in 1988 and 1989. Plaintiffs claim Allstate's performance evaluation system had a disparate impact on black employees, resulting in lower wage growth and lower promotion rates for black employees. Plaintiffs Dicker, Hood, and Moore each also allege disparate treatment; that is, each believes she was treated less favorably than similarly situated white employees on the basis of race.

In June 1989, Plaintiffs filed this lawsuit under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000, *et seq.,* and 42 U.S.C. § 1981 on behalf of themselves and other black employees in June 1989. Their amended complaint, filed in August 1989, alleges, in Count I, that Defendant violated Title VII by refusing to promote class members on the basis of race; paying class members less than similarly-situated white employees; utilizing different standards to evaluate class members in comparison to similarly-situated whites; failing to provide adequate training; and condoning racial harassment. Count II alleges that Defendant discriminated against named Plaintiffs and the class in promotion determinations on the basis of race in violation of 42 U.S.C. § 1981.

In October 1989, Judge Suzanne Conlon granted summary judgment in favor of Defendant on Count II, on the basis that post-hiring or post-contract formation claims are not actionable under 42 U.S.C. § 1981. (Memorandum Opinion and Order of 10/19/89, at 10.) Several months later, on July 11, 1990, Judge Conlon denied Plaintiffs' motion for certification of a class with respect to their disparate treatment claims. (Memorandum Opinion and Order of 7/11/90, at 11.) Judge Conlon granted the motion for class certification with respect to the disparate impact claims, however. Specifically, she certified a class of "[a]ll black nonexempt employees at Allstate's Personal Life Service Center employed beetween January 31, 1988 and June 21, 1989," characterizing the question these class members have in common as "whether the summary rating system disfavors blacks and disproportionately excludes blacks from promotions and salary increases." *Id.* at 10.)

In December 1990, the parties consented to proceed before a U.S. Magistrate Judge pursuant to 28 U.S.C. § 636(c). The case was assigned to this court in February 1992. On March 4, 1993, the court denied Defendant's motion for summary judgment on Plaintiffs' disparate impact claims. (Memorandum Opinion and Order of 3/4/93.) Beginning in August of that year, the court conducted a lengthy bench trial. Following an extended briefing schedule and the court's own delays, the matter is ready for decision.

FINDINGS OF FACT

I. *Background Facts*

Plaintiffs' Positions; Organization of the PLSC

1. Velma Dicker, Patricia Hood, and Rhonda Moore are black citizens who were employed by Defendant Allstate Life Insurance Company ("Allstate") at Allstate's Personal Life Services Center (the "PLSC") in Deerfield, Illinois. Plaintiffs represent a class of all black nonexempt persons employed at the PLSC be-

tween January 31, 1988 and June 21, 1989. Each of the three named Plaintiffs also brings an individual disparate treatment claim.

***2** 2. The PLSC processes applications for life insurance and performs underwriting of policies sold by Allstate agents throughout the United States. From the time an Allstate agent receives an application until the time the company chooses whether or not to accept it, Allstate is bound to provide coverage for the applicant, even if the applicant is ultimately deemed an excessive risk and the application is rejected. In addition, if no underwriting decision is made within 60 days of the policy application, it is deemed accepted. To minimize the risk to Allstate and promote customer satisfaction, Allstate emphasizes speed in the underwriting process. Because of the importance and sensitivity of information in an insurance application, the accuracy with which such an application is processed is also critical.

3. Between 1984 (when the PLSC began operations) and 1989 (when the Department was reorganized), the Underwriting Department of the PLSC was divided into three territories, East, West, and Central. Although there was some variation in the types of products sold and the processing of applications, the work of the nonexempt employees in the three territories was essentially the same. Each of the three divisions consisted of several units of nonexempt employees, including one or two Clerical units, a Data Preparation unit, and the Quality Verification ("QV") unit. As explained below, these employees were responsible for inputting data from each insurance application into the computer system, obtaining relevant medical information, and preparing and sending the written policy to the insured. In addition, other nonexempt employees worked in the Department, including secretaries and Underwriting Communication Assistants ("UCUs").

4. Nonexempt employees occupied grades 1-8 of the employment hierarchy at Allstate. Exempt employees were those above grade 8, who performed supervisory or underwriting functions. The vast majority of exempt employees were underwriters, many of whom, as part of their training, served for brief periods as supervisors of clerical employees.

5. During the time periods at issue in this case, each unit of clerical employees was typically supervised by an underwriter or underwriter trainee. Each unit supervisor typically served in that role for a period of six to twelve months before being assigned to another responsibility. The unit supervisors were themselves supervised by a unit manager who in turn reported to a department imanager. UCUs were supervised by field underwriting managers, and secretaries by the department manager.

6. The three named Plaintiffs were hired in 1984 for lower-level nonexempt positions in the Eastern Underwriting territory at the PLSC. Velma Dicker and Pat Hood remained in pay grade 4 during the relevant time period (January 1988 through June 1989). Rhonda Moore was employed at pay grade 6 for most of the time she worked at Allstate. Each of the three Plaintiffs filed a charge of discrimination with the Equal Employment Opportunity Commission ("EEOC") on December 1, 1988. As of the August 1993 trial date, Ms. Hood and Ms. Moore had resigned, but Ms. Dicker remained employed at Allstate.

Clerical Job Functions

A. *Data Prep*

***3** 7. Data Preparation unit employees performed "data collection"-that is, these employees transferred information from handwritten or typed application forms to various computer screens. At the direction of the underwriters, Data Prep employees also made the appropriate computer entry when an application was accepted, thus generating a printed policy ("issue"), or when an insurance application was withdrawn by the applicant or denied by Allstate, generating a letter declining coverage ("drop"). A Data Prep A had a job grade of 1, 2, 3, or 4 and spent 90% of her time entering data from life insurance applications and generating issues or drops. The position of Data Prep B had a job grade of 6, 7, or 8. In addition to entering data and working on issues and drops, a Data Prep B's responsibilities included performing "complex change re-issues," training the Data Prep As on various job functions, and assisting the supervisor in performing spotchecks on the work of the Data Prep As.

B. *Clerical*

8. Clerical unit employees were responsible for two functions: Clerical "mail match" employees were responsible for opening mail, date-stamping it, identifying the corresponding life insurance application, and making a computer record of the material received. The mail match employee would then place the mail in the appropriate underwriting file. Underwriting files were maintained in alphabetical order, and each mail match employee was responsible for files in one section of the alphabet. Clerical "mechanized" employees were assigned to one of several tasks, including (i) comparing the computer-generated letter denying coverage with the underwriter's directions, and insuring the correct amount on the refind check (a job assignment referred to as "drop desk"); (ii) typing a six-digit code into a computer terminal that communicates with an industry-wide data base (referred to as "medical information bureau"); (iii) making a computer record of any request by an underwriter for particular information; (iv) reviewing the computer-generated letters to physicians requesting information pursuant to the underwriter's requests (known as attending physician services or "APS"); and (v) maintaining records of bills and payments to outside vendors. Persons employed in this unit had the title of Record Clerk B or Record Clerk C and job grades of 1, 2, 3, or 4. 9.

C. *Quality Verification ("QV")*

9. QV employees assembled policies. First, employees in the QV units received files from the underwriters containing the application and other underwriting information. In addition, the QV unit received computer-generated documents from the Data Entry unit, an information card about each insured, and a "pick list" which directed the QV employee as to which forms were needed in order to assemble the policy. The QV employee was responsible for pulling printed policy pages that had been generated overnight on the Allstate computer, and for checking each policy against the original application to be sure that there were no misspelled words or other inaccuracies. Once the policy was checked for accuracy, the QV employee would assemble and staple the printed pages, fold them, and place them into a vinyl jacket for issuance.

D. *UCU and Others*

***4** 10. Underwriting Communications Unit employees ("UCUs") worked closely with underwriters. UCUs were responsible for reviewing and underwriting certain simple applications of limited value, responding to questions from field agents, and communicating with agents and insureds on underwriting issues. The job required considerable telephone work.

11. In addition, other clerical employees included secretaries to department managers and ASAP processors ("ASAPers") who took applications on which underwriters had questions and called insureds for the answers.

Career Paths at Allstate

12. A common career path in the Underwriting Department included promotion from a lower-graded record clerk, typist, or QV position to the position of Data Prep A. An employee could obtain an in-grade promotion from the position of Record Clerk A to Record Clerk B or from B to C simply in recognition of the employee's increased job knowledge. To be promoted to Data Prep A, on the other hand, an employee would have to compete for an available vacancy. From the position of Data Prep A, an employee could advance to a position as Data Prep B (a grade 6 job) or to a UCU position (grades 6 and 8). Data Prep B, UCU A, and UCU B were the highest positions within nonexempt underwriting. From these positions, an employee could seek promotion to the exempt position of associate underwriter, assuming he or she desired to pursue the training needed for that position. Nonexempt employees in the Underwriting Department could also seek promotions outside of the Department.

13. By 1986, Allstate had begun posting positions that were not in-grade promotions, at least in circumstances in which no employee had expressed an interest in a vacant position. Prior to that time, at least some promotions were awarded by managers who decided on their own which employee was most qualified for an available vacancy. Beginning in 1986, open positions were posted on a bulletin board outside the employee cafeteria. An employee seeking a position through a posting was required to submit a "career

opportunities” form to her supervisor, who wrote a recommendation based upon the employee's performance in her current position.

II. *Facts Concerning Disparate Impact Claim*

The Progress Development Summary (“PDS”) System

14. At regular intervals, supervisors at the PLSC prepared a written performance evaluation for each nonexempt employee. This evaluation, known as the Progress Development Summary (“PDS”), resulted in one of four possible performance ratings:

- Performance consistently and significantly exceeds expected level for position (an “exceeds” rating).

- Performance meets expected level for the position (a “meets” rating).

- Performance is acceptable but needs improvement to meet the expected level for the position (a “needs improvement” rating)

- Performance requires immediate improvement to achieve an acceptable level for the position (an “RII” rating)

***5** After the supervisor prepared a PDS, it was reviewed both by a unit manager and a department manager, who checked to be sure the performance rating was warranted by the narrative description of the employee's performance and by any available records concerning his or her performance. Following these reviews, the PDS was reviewed by a human resources manager. At the time the PDS was administered, the employee was permitted to take it home, review it, and discuss any issues with the supervisor before signing and returning it.

15. With certain exceptions, supervisors understood they were expected to evaluate employees on four parameters: quantity or productivity; quality of work; attendance; and deportment. For quantity and quality, each underwriting unit had written standards; Allstate had a company-wide attendance policy. As more fully described below, supervisors utilized point totals to assess the quantity of work performed, based upon the employee's own report on numbers of work units completed. Similarly, supervisors assessed the quality of employees' work as a percentage of errors identified in spotchecks and QV review. Quantity point totals and quality ratings translated into ratings of “exceeds,” “meets,” and “needs improvement” on these parameters. Generally, there was no actual PDS rating for deportment, but there often were positive or negative comments about deportment. All four of these parameters were to be considered together in awarding an overall PDS rating.

16. Supervisors were expected to maintain a written monthly record of each employee's quality and quantity scores and attendance data, and to meet with each employee monthly on an individual basis to review that employee's progress. These monthly meetings, as well as the individual monthly records maintained by the supervisor and copied for the employee herself, were referred to as “one-on-ones.” Employees were entitled to, and did on occasion, question the production and quality figures maintained by the supervisor and discussed at the one-on-one meeting. It was expected that the monthly one-on-one performance ratings would be factored into the overall PDS rating. Although there was no formal policy for exchange of information between supervisors, in situations where a supervisor was new to the position, he or she would often obtain information concerning the employee to be evaluated from the previous supervisor and from notes or files maintained at the supervisor's desk, including a file containing these monthly one-on-ones.

17. An employee at the PLSC received an initial PDS after nine months of employment and approximately every 12 months thereafter. An employee who had not had her first evaluation or whose previous evaluation was not at least at a “meets” level was not eligible for promotion. If an employee was promoted at a time other than when her annual PDS was administered, the supervisor usually prepared a PDS to update the information from the annual evaluation and make a salary increase recommendation. The supervisor then forwarded these promotion materials for review and approval by the Underwriting Department territory manager and by the Human Resources Department. A promotion had the effect of resetting the date for the employee's next PDS.

***6** 18. In addition to the regularly-scheduled PDS, a supervisor would issue an off-schedule “attendance PDS” to an employee whose attendance was particularly poor. Such a PDS ranked the employee as “RII” (requires immediate improvement) with respect to attendance and set a period of time in which the employee was expected to improve her attendance. Such an “RII” attendance PDS ordinarily did not affect the PDS schedule, except that an employee could not receive an annual performance PDS until the probationary attendance period had been successfully completed.

Training of Supervisors

19. When the PLSC began operations in 1984, Allstate hired supervisor trainees and provided them with classroom training. After the PLSC was in operation, supervisors received minimal formal training; instead, they received primarily on-the-job training from the outgoing supervisor and/or the unit manager on supervisory functions, such as writing evaluations, timekeeping, and one-on-ones. Regarding the actual clerical job functions, the supervisor often received instructions from the nonexempt employees themselves. Allstate conducted occasional formal training sessions and provided printed materials on How to Write a PDS, Timekeeping, and Salary Administration.

20. Supervisors of nonexempt underwriting units often were underwriter trainees who rotated between underwriting assignments and supervisory assignments. Even after a supervisor had rotated out of the unit, he or she was often within close physical proximity of the new supervisor and was available to answer questions and otherwise assist.

The Salary Planning Process

21. In the fall of each year, in order to estimate its wage costs for the coming year, Allstate directed its supervisors and managers to engage in a salary planning process. As part of the process, the supervisor would review each employee's current salary and recent salary history, and make a notation concerning the employee's expected salary increase and any expected promotion, based on the supervisor's prediction concerning the employee's likely PDS rating. The unit manager, department manager, and Human Resources Division manager approved and signed each supervisor's salary planning documents. The following year, approximately 45 days prior to each employee's scheduled PDS date, Human Resources forwarded to the employee's supervisor a notice that the PDS form was due. The notice also set forth the previous fall's plan concerning that employee's expected PDS rating, expected salary increase, and any planned promotion. When the supervisor believed an employee was entitled to a salary increase different from the one projected on the notice from Human Resources, the supervisor was required to cross out the projected salary increase and fill in the new amount, and to submit an additional form.

22. Supervisors and unit managers testified uniformly that the salary planning process was intended as an estimate of salary growth, not as a guide to the supervisor in evaluating the employee's performance. Every supervisor who testified understood that he or she was required to evaluate each employee on the basis of that employee's actual performance, without regard to the estimate used for the previous fall's salary planning process. The fact that a work unit did or did not maintain its projected budget had no effect on the evaluation of the supervisor's performance, nor were supervisors required to explain any decision to vary from the plan. The evidence showed that in numerous instances supervisors did in fact depart from the salary plan, both by awarding overall ratings other than what had been projected, and by awarding merit increases in amounts other than what had been projected. Defendant demonstrated that these departures from the plan benefited and disadvantaged both white and non-white employees.

Impact of PDS Ratings on Promotions

***7** 23. As a matter of Allstate policy and practice, an employee could not be promoted unless he or she had received either an “exceeds” or a “meets” rating on the most recent PDS. Thus, there was a substantial relationship between an employee's overall PDS rating and the likelihood that he or she would be promoted. Promotions were often awarded at or near the time of the employee's scheduled PDS evaluation. If an employee received a promotion at some other time, the supervisor would prepare a PDS at the time of the promotion. This "promotional PDS" provided a vehicle for awarding the promoted employee, who would otherwise be required to wait for the completion of a new PDS cycle before receiving a merit increase, the pro rata portion of any merit increase he or she had earned in the previous position.

24. Of 474 PDSs administered from 1985 through 1988, 93 were contemporaneous with promotions. Forty-four percent (44%) of those employees who received an "exceeds" PDS rating were promoted, as were 14% of those who received a "meets" rating. No employee whose overall rating was lower than "meets" received a promotion. Similarly, in the period from February through November 1988, 55% of those employees with "exceeds" ratings were promoted, as were 11 % of those rated "meets," but none of those employees having "needs improvement" or "requires immediate improvement" scores was promoted. In addition to the employee's performance as reflected in the PDS, factors relevant to a promotion decision included the employee's tenure with Allstate and his or her ability to perform the work in the new position-for example, keyboard skills would be helpful to an employee seeking promotion to a position in Data Entry.

Impact of PDS Ratings on Wage Growth

25. As a matter of Allstate policy, there was a direct causal link between an employee's overall PDS rating and his or her merit increase. Pursuant to written policy directives, employees were awarded prescribed percentage increases at the time of their performance evaluations, based on their overall PDS ratings. Generally, an employee who had earned an overall "exceeds" rating was entitled to a merit increase of 8 to 11%; an employee with a "meets" rating earned a 5 to 7% increase; and a "needs improvement" rating resulted in a zero to 4% raise. The precise increase awarded to an employee was also influenced by his or her "compra ratio" (the relationship between the employee's salary and the midpoint salary range for his or her position) and by the length of time that had passed since the employee's last PDS.

Non-Merit Pay Adjustments

26. On occasion, Allstate raised the minimum base pay for its entry-level positions in order to keep salaries competitive. When this occurred, any incumbent employee in such a position whose pay rate fell beneath the new minimum had his or her pay raised to the new level. Such increases were termed "salary adjustments" and did not affect the employees' next scheduled merit increase. Where an employee scheduled for a merit increase was also entitled to an adjustment in his or her base pay, the employee's base pay would first be adjusted to the new minimum, and the merit increase then calculated on the basis of the new minimum. Neither the Human Resources Department, nor any of the PLSC managers, participated in the decision to make an adjustment to the minimum salary levels.

Plaintiffs' Statistical Analysis:

Comparison of PDS Ratings for Black and White Employees

***8** 27. Raymond Mendel, Ph.D., Plaintiffs' expert witness, reviewed the 474 PDS evaluations (330 for whites, 144 for blacks) completed from January 1, 1985 through December 31, 1988. Dr. Mendel concluded that black nonexempt employees at Allstate received significantly lower PDS ratings than whites during the period from 1985 through 1988 and within 300 days of the filing of the EEOC charges in this case. Thus, of the 330 PDSs administered to whites, 33% resulted in an "exceeds" rating, compared with only 20% of those administered to black employees. White employees received "needs improvement" ratings only 10% of the time, compared with approximately 21% the PDSs administered to blacks. If the two lowest categories of "needs improvement" and "requires immediate improvement" are combined, the record shows that only 15% of the PDSs administered to whites, as opposed to 30% of those administered to black employees, resulted in such scores. These results, Dr. Mendel testified, are significant at the p <.0001 level; that is, the chance that such a disparity in scores would occur by chance is one in 10,000. Such results fall well beyond the standard p <.05 threshold for statistical significance (*i.e.,* possibility less than one in 20 that the observed results would occur by chance).

28. Analysis of the 113 PDSs issued in the 300-day period prior to the filing of the EEOC charge (Febru-

ary 1, 1988 through November 30, 1988) showed similar disparities. Whites received “exceeds” ratings 23% of the time, while only 6% of blacks received such a rating. When the “needs improvement” and “requires immediate improvement” ratings are combined, only 19% of whites received those low ratings as compared with 30% of blacks. According to Dr. Mendel, these results are also statistically significant (p <.02).

Promotions and Wage Growth

29. To compare the rate of promotion between black and white employees, Dr. Mendel examined the number of grades advanced for all nonexempt underwriting employees having at least six months tenure from January 1985 through December 1988. Of 193 employees, 37% received promotions from January 1985 through December 1988, most of those promotions (85%) occurring in the four bottom grades. A higher percentage of black underwriting employees was employed in these lower grades (83% of blacks were employed in grades one through four, as compared with only 71% of whites). Still, Dr. Mendel's analysis showed that 42% of all white employees were promoted during this period, as compared with only 29% of blacks. Only 5% of black employees were promoted to grade 6, a position that Dr. Mendel believes is a springboard to greater advancement; 20% of whites achieved promotion to grade 6. Dr. Mendel's analysis found a small but statistically significant difference between the two groups: the t-statistic (a measure of standard deviation in which any departure of two or more standard deviations is viewed as significant) was just under 2, and the p value (the probability of the results occurring by random chance) was <.05.

***9** 30. Dr. Mendel limited his subject pool to persons employed for at least six months and considered only those PDSs administered through December 31, 1988. Thus, as Defendant notes, Dr. Mendel's analysis excluded all persons employed in nonexempt Underwriting after July 1, 1988. Defendant contends that Dr. Mendel's use of the Kruskall-Wallace statistical test is inappropriate for the kind of data Dr. Mendel considered. Defendant further criticizes Dr. Mendel's reliance on a “one-tailed” standard of significance, a less conservative standard that assumes any differences between the observed results and those that would be expected by chance will be differences in one direction only (that is, that any differences from a purely random distribution of scores will be unfavorable to blacks). In addition, Defendant urges that Dr. Mendel's analysis is flawed in that it assumes that the length of time that it takes for an individual to achieve a promotion is irrelevant (that is, it assumes that an individual employed for six months but not promoted is in a more favorable position than one promoted only once in four years). Most significantly, Dr. Mendel's analysis excluded from consideration any promotions to positions outside nonexempt Underwriting. Defendant's statistical expert, Robert Topel, Ph.D., demonstrated that if such promotions are included, then there is no statistically significant difference in pay grades advanced between blacks and whites, even when Dr. Mendel's Kruskall-Wallace test is used. And, even when utilizing Dr. Mendel's subject pool and statistical analysis, Dr. Topel demonstrated that the black-white difference in promotions is rendered far below significance when controlling for starting grades and attendance.

31. Plaintiffs did not offer a statistical analysis of the race differences in wage growth as part of their case in chief. As described *infra,* Findings ¶ ¶ 74-80, Defendant's expert found no statistically significant difference between wage growth among black employees and white employees.

PDS Performance Criteria

32. No witness was able to explain the origin of the criteria used in preparing PDSs. Quality of work, quantity of work, and attendance were evaluated in each of the three underwriting territories. There were some variations in the standards for measuring quality and quantity among the territories, but no evidence that these variations could have had any racial impact, as black employees were distributed randomly throughout the territories.

A. *Quality Assessment*

33. Both parties agree that quality or accuracy of work performed is an appropriate job-related criterion for performance evaluation. Plaintiffs insist, however, that the quality criterion was invalid and unreliable.

34. Supervisors in the Underwriting Department attempted to measure and rate the quality of nonexempt work by (a) randomly selecting and checking a portion of the employee's work output for errors on a monthly basis, a process called “spotchecks”; (b) determining an accuracy percentage ratio, either by dividing the number of files in which errors were found by the total number checked (*e.g.,* 3 files out of 100 in error = 97% accuracy ratio), or by assigning points for particular errors and subtracting the points from the total (*e.g.,* errors totaling 60 points out of 2,000 possible = 97% accuracy ratio); and then (c) rating the employee on the basis of accuracy percentage standards (*e.g.,* an accuracy ratio between 98.5 and 100% would earn an exceeds rating, 97.0 to 98.5% was meets, etc.) Occasionally, supervisors exercised discretion to round the accuracy ratio percentages up or down.

***10** 35. After May 1988, the quality standards were made uniform across all three territories as follows: 98.5% and above earned an “exceeds” rating; 69.5% through 98.4% earned “meets”; 95% to 96.4% merited an “acceptable, needs improvement” rating; and accuracy ratios below 95% were deemed unacceptable. Prior to May 1988, the standards for rating employees showed minor differences from one unit or territory to another. There is, however, no evidence that persons of one race were more likely to be assigned to units utilizing more lenient accuracy standards than persons of any other race.

36. In addition to the spotchecks, data entry employees' work was checked as part of the QV process. If a QV employee detected errors in the final printed policy, the file containing the error would be returned to the data entry unit for review by a Data Prep B. By comparing the information input in data entry with the application and the underwriter's instruction, the Data Prep B determined whether an error had been made and made a record of the error. An employee who disagreed with a co-worker's error determination could appeal the issue to a supervisor. Because every issued policy was reviewed in the QV unit, 100% of issues were checked for accuracy.

37. For clerical employees, spotcheck procedures were designed to review the work performed in the employee's particular job assignment. To check the mail match employees' work, the supervisor determined whether a tag was made for each file; whether the files were in alphabetical order, in the appropriate Pendaflex divider; whether the files were in the file tubs; and whether all the mail had been forwarded to the underwriter.

38. For QV employees, the supervisors spotchecked work by simply re-doing the QV work on a random sample of files already processed by the employee.

39. Supervisors did not consider quality ratings for months during which an employee was in training to learn a new job function.

40. No supervisor described any routine process for selecting the files to be checked; several supervisors explained that they simply selected a number of files at random, without advance warning. Supervisors themselves performed the spotchecks, except that, as described above, Data Prep Bs performed the spotchecks for Data Prep As. Where the spotcheck revealed an error with respect to the clerk's processing of a file, it was counted as an error regardless of whether the employee's job assignment required as many as 11 tasks with respect to that file or as few as three. To the extent this difference resulted in employees assigned to perform 11 tasks per file being “graded” more harshly than those with less difficult assignments, Dr. Mendel characterized the circumstance as reflecting “opportunity bias” in favor of certain employees at the expense of others. There was no evidence that employees of any race were more likely to be assigned to the more detailed assignments than others, however. Similarly, although Plaintiffs note that at one time, different quality standards were in place in different territories, there was no evidence that employees of one race were more likely to be assigned to territories where evaluations were more generous than employees of other races.

***11** 41. In Dr. Mendel's view, the number of files on which each employee is spotchecked is too small to rely on as a meaningful measure of the quality of that employee's work. For example, clerical employees worked on 3,000 to 4,000 files per month, but were spotchecked on only 100 per month. For QV employees, 50 files were checked each month, and for data prep employees, 20 were checked per month, again, a very small fraction of the month's work. In order to generate a fair measure of performance, Dr. Mendel testified, approximately 1,500 files would have to be checked for each PDS period. Allstate demonstrated, however, that in order to spotcheck 1,500 files for each employee, supervisors would be required to devote all of their working time to checking their subordinates' work.

42. Dr. Mendel compared quality accuracy ratios for Data Preps as determined in the QV process (which checked 100% of all files processed) with those developed from the employees' spotchecks. Dr. Mendel believes such scores should have been very close to one another. In fact, Plaintiffs observe, in 1988 Data Preps in the Eastern Territory had different ratings for spot checks than for QV more than half of the time. Allstate pointed out that in some instances one Data Prep would perform data collection for a particular file, but another employee would perform other tasks on the same file, with the result that more than a single employee's work might be reflected in a file reviewed in the QV unit.

43. Given the comparatively small number of files spotchecked each month, Dr. Mendel believes that the numeric standards used to distinguish “exceeds” performance from “meets” and “meets” from “acceptable” are too fine to distinguish accurately between employees.

B. *Assessment of Work Quantity*

44. With the exception of mail match employees and secretaries, Allstate supervisors assessed the productivity of nonexempt employees by assigning points to each job function and maintaining records of the number of points earned by each employee for a particular time period. The goal in assigning points to particular tasks was to approximate a point for each minute of work. Secretaries were not evaluated on the basis of quantity of performance.

45. For mail match employees, supervisors evaluated the quantity of work performed simply by observing whether the employee was able to process the mail promptly and stay current with respect to the filings in that portion of the files. Although Plaintiffs have suggested that more precise numerical standards were available for assessing the work of mail match employees, there is no evidence that utilization of such standards would have resulted in more accurate measurement of their performance. Nor is there any evidence that employees advantaged (or disadvantaged) by their assignment to mail match were more likely to be of one race than another.

46. For those employees whose production was based on points earned for performance of particular job functions, Allstate relied on production tallies maintained by the employees themselves on a daily basis, and then totaled by supervisors for each week and each month. Plaintiffs note that there was no “consistent process” for checking the accuracy of point totals recorded by employees, nor any procedure for ensuring that workers did not overstate their production numbers. Indeed, although Allstate could have checked these figures by comparing the tallies maintained by the employees themselves with computer records of work performed, such checks were not done on a routine basis. There was no evidence of any widespread over-reporting of work performed, however, nor any evidence to suggest that employees of one race were more likely to “pad” their records than employees of any other race. Nor was there any evidence of complaints by employees concerning the accuracy of the point totals that they themselves maintained.

***12** 47. Plaintiffs challenge the point system as arbitrary. They point out that Allstate had no documentation to establish that the points assigned for particular tasks were well-suited to that goal, and note that some of the point values assigned to particular tasks differed from one territory to another. Plaintiffs point out, further, that supervisors had some discretion to change the points assigned to particular tasks. For example, supervisor Vicki Kummer testified that she changed the number of points assigned to a particular task in 1987 when she learned that employees were unwilling to perform that task because their point totals suffered when they did. Similarly, Janine French, another supervisor, raised the number of points assigned to a particular task because she believed the task took more time than the points reflected. No employee complained about the new point values assigned to particular tasks. Furthermore, employees rotated to various job assignments within the unit. Because employees of one race were no more likely than those of any other race to be assigned to perform particular tasks or to be assigned to one territory than another, Plaintiffs have not demonstrated how this claimed flaw in the evaluation system could have resulted in race differences in PDS scores.

48. Early in 1987, the Underwriting Department formed a “Data Entry Improvement Team” (“EIT”) to review the quantity point system for data entry work across the three regional territories. The team consisted of seven volunteers from among the three data entry units, including named Plaintiff Rhonda Moore, who met regularly under the leadership of unit manager Deborah Lorch. The EIT was assigned to review the point system and recommend changes, if appropriate. Although the team had the authority to recommend that the point system be abolished, it chose not to do so. Relying on their own data entry experience, the team members developed a standardized point system for use in all three data entry units, then sought the views of other Data Preps by means of a survey. After reviewing the survey results, the team made final recommendations to entry supervisors and unit managers. By March 1987, a new point system was approved and implemented, and the team then monitored the impact of the new system on performance ratings. Team members concluded that the new point system did not require an adjustment to the rating standards (*i.e.,* number of points needed for an “exceeds” rating).

49. There were no specific guidelines for combining separate quantity ratings for different jobs within an evaluation period to determine an overall quantity rating; that process was left to the supervisor's discretion.

50. Employees assigned to training others or to receiving training themselves, or assigned to assist in other departments, were awarded “general points” of one point per minute. Because a full day of general points yielded a total meriting an “exceeds” performance rating on the production criterion, assignments to perform work earning general points were desirable. Supervisors exercised discretion to assign employees to assignments earning general points, but there is no evidence that such discretion was exercised in favor of white employees; in fact, named Plaintiff Rhonda Moore earned 85% of all general time points assigned to Data Preps in the Eastern Underwriting territory. There is no evidence that any other employee, white or black, received such a disproportionate allocation of general time assignments.

C. *Assessment of Attendance*

***13** 51. Jane Alexander, Allstate's Human Resources manager, issued attendance rating standards applicable to nonexempt Underwriting Department employees. The standards were distributed in June 1984 and again in May 1986 when Ms. Alexander learned that a number of supervisors were not familiar with the standards. Under those standards, employees who had no more than two absence occurrences in a year were ranked as “exceeds” for this criterion; those with three or four occurrences were ranked as “meets”; those with five or six occurrences were ranked as “acceptable”; and those having seven or more occurrences were ranked as “unacceptable.” In preparing a PDS, the supervisor was expected to consider the employee's attendance during the previous twelve months. In determining whether disciplinary measures were necessary, the supervisor sometimes would consider the number of occurrences over a shorter period of time.

52. Pursuant to Allstate policy, an absence due to illness constituted an absence occurrence, whether that absence was for a single day or for several consecutive days. Where an employee experienced non-consecutive absences that were related to the same illness, some Allstate supervisors exercised discretion to determine whether those absences would count as a single occurrence or multiple occurrences. To determine whether differences in the way supervisors counted absence occurrences had a racial impact, Defendant's expert witness, Dr. Topel, analyzed the raw data on attendance, applying a non-discretionary standard to count absence occurrences. Dr. Topel's analysis demonstrated that the exercise of discretion in counting occurrences did not have a disproportionate impact on blacks. It is undisputed that black employees had poorer attendance records than whites, and Plaintiffs offered no evidence that supervisors' evaluations exacerbated the differences between attendance ratings of blacks and whites.

53. According to Jane Alexander, tardies were not considered in a PDS unless they were at an unacceptable level.[FN1] In some circumstances, an employee could use "emergency time" rather than have a tardy counted against him or her. Supervisors exercised discretion in determining whether a tardy would be recorded at all and in determining whether the employee might use "emergency time" or work late to make up the time and avoid being recorded as tardy.

> FN1. Thus, unit manager Eric Hjerpe testified that Vivian Wilson, whose performance merited a "meets" on quantity and "exceeds" for quality and attendance, nevertheless received an overall "meets" rating on her January 1988 PDS because she had eight tardies.

54. Supervisors treated attendance in different ways on the PDS and in determining an overall rating. Some supervisors believed that unless the employee's attendance was below the "meets" level, it had no effect on his or her overall rating. Others believed attendance did not have to be mentioned in the PDS at all. Indeed, Plaintiffs demonstrated that attendance data was missing from a number of PDSs (31 of the 158 PDSs in the data base considered by Dr. Topel). There was no evidence, however, that any supervisors considered attendance in preparing the PDS for employees of any one race but not those of another race. Further, black employees were distributed randomly between territories and units; thus, the fact that one supervisor may have given credit for good attendance and another did not could not have had any race-based impact on overall PDS scores. As noted, Dr. Topel found that black employees were in fact absent more often than whites.

***14** 55. Plaintiffs believe that supervisors had the discretion to manipulate the importance of employee attendance data in order to benefit their favorites. They cite as an example the fact that Gigi Soeder, a white clerical employee in the Eastern territory who received her previous PDS in August 1977, did not receive her next PDS until September 1988. There is no evidence of the reason for this delay, and Defendant contends that Allstate's policy allowed for a PDS cycle to last as long as 15 months. Plaintiffs point out, however, that Ms. Soeder had several attendance occurrences prior to September 1987; due to the fact that the PDS was not administered until September 1988, those older attendance occurrences were not considered for purposes of her overall PDS rating, and Ms. Soeder was promoted.

D. *Deportment*

56. Supervisors described the deportment criterion in different terms. Supervisor Linda Shumilas explained that it meant cooperation and demeanor, or office conduct. Eric Hjerpe, a unit manager, testified that this criterion included the employee's office attire, relationships with his or her supervisor and department manager, and "general office conduct."

57. Supervisory personnel differed in the weight to be given to deportment in the overall PDS rating. Deportment was not ordinarily the subject of a specific subrating, as were quantity and attendance. Instead, the supervisor often simply commented in the PDS on the employee's willingness to work toward unit goals. Where the supervisor did not view the employee's deportment as particularly positive or negative, there might be no mention of that factor in the PDS, suggesting that at least some supervisors relied on the deportment factor as a kind of tie-breaker to justify a particular overall rating in situations where the factors of quantity and quality were inconsistent. Because deportment was not precisely defined for purposes of evaluation, it provided a ready vehicle for the exercise of supervisory discretion in favor of some employees at the expense of others. Defendant does not argue that the "deportment" criterion was job-related. Instead, as described below, Defendant offered evidence that the more objective factors of quality, quantity, and attendance accounted for a significant proportion of the race differences in overall PDS scores.

58. At least some supervisors testified that yet another criterion, that of "extraordinary customer service," emerged over the years as a factor in employee evaluations. Like the comportment criterion (with which it appeared to overlap to some degree),[FN2] the criterion of extraordinary customer service was not addressed in every PDS and may have been used to break the tie in determining an overall evaluation where the more objective factors were on the border of

a particular rating.

FN2. For example, Vicki Kummer explained that extraordinary customer service was subsumed in the deportment criterion.

E. *Overall Rating*

59. The Underwriting Department had no specific guidelines for weighing or combining the four factors in determining an overall rating. The weight of the evidence supports a finding that, although supervisors and other managers testified to a variety of approaches to weighing the components in determining an appropriate overall rating, all viewed quality and quantity as central to the overall performance evaluation. Thus, for example,

***15** -Janine French, a supervisor in the Eastern Territory, testified that quality and quantity were the major components, and that attendance did not affect the overall rating unless it was below a "meets" level.

-Christine Swiss, another Eastern Territory supervisor, believed that quality, attendance, customer service, and deportment were all of equal importance in determining the overall PDS rating.

-Deborah James, a supervisor in the Eastern Territory's quality verification unit, weighed quality, quantity, attendance, and extraordinary customer service equally.

-Thomas Price, another Eastern Territory supervisor, was uncertain about the relative weights of quality, quantity, and attendance, but believed they were of equal importance in the overall rating, with deportment having less importance.

-Mary Sobeski, a unit supervisor in the Western Territory, at first believed that quality was more important than quantity, but later concluded these two factors had equal weight (together accounting for 60% of the overall rating) and were more important than attendance and deportment (together accounting for 30%). Later, when Ms. Sobeski became a unit manager in the Eastern Territory, she began considering the factor of extraordinary customer service, ultimately giving that factor equal weight to quantity and quality.

-Karl Friedman, manager of the Western Territory, identified quality, quantity, attendance, and deportment as factors to be considered in the overall PDS rating, with quality and quantity being most important. He identified extraordinary customer service as an additional factor, one he characterized as broader than deportment and including assessments of quality and quantity.

-Cynthia Polakis, initially a supervisor in the Western Territory, learned that quality, quantity, attendance, and deportment were all weighed equally. Later, when Ms. Polakis became a unit manager in the Western Territory, she instructed supervisors to weigh each of the four factors equally.

-Deborah Lorch, who served as a supervisor and as a unit manager in the Western Territory, considered quality and quantity the most important factors in determining the overall PDS rating, with attendance and deportment to be considered only if they fell below a "meets" level.

-Central Territory manager Eugene O'Neill believed that quantity, quality, and attendance should be rated equally, and that deportment should seldom be mentioned in a PDS.

-Dan McCarran, supervisor of QV employees in the Central Territory, considered quality, quantity, attendance, and deportment, and provided ratings in the PDS for all of them. McCarran believes he had discretion as a supervisor to determine the weight to be accorded to each of the four factors.

60. Plaintiffs pointed out numerous instances in which the overall PDS score awarded to an employee appeared to be inconsistent with the supervisor's own description of his or her evaluation practices. The most frequently occurring situation was one in which the supervisor relied on the employee's deportment or attendance to explain the decision to award a particular overall rating, where that rating otherwise appeared to be inconsistent with the employee's quality and quantity rating (or inconsistent with the overall rating given another employee having identical quality and

quantity ratings). With respect to one PDS rating, Defendant's witnesses explicitly acknowledged that the employee's overall rating was probably too high, when viewed in light of the individual components of that employee's rating.

***16** 61. Because Allstate had no written or oral rules for combining the underlying criteria into a single overall PDS score, Dr. Mendel believes there are “as many PDS systems as there [were] supervisors at various points in time.” Dr. Mendel characterized the discretion exercised by supervisors in assigning overall PDS scores as a “huge loophole in the performance measurement system,” enabling a supervisor to grant a higher score to a personal favorite by deciding to emphasize one of the underlying criteria over another.

Dr. Mendel's Criticisms of the PDS System

62. In addition to his statistical analysis, Plaintiffs offered Dr. Mendel as an expert on the job-relatedness of the PDS system. Dr. Mendel is a professor of industrial psychology at Western Kentucky University and a licensed industrial psychologist. Dr. Mendel has taught courses on industrial psychology, equal employment opportunity, and statistics, and has performed research on, among other topics, the job-relatedness of procedures used for selection of clerical employees in the insurance industry. He has published articles on his research in the area of performance appraisal and selection devices, and has been retained by both plaintiffs and defendants as an expert on the job-relatedness and adverse impact of various performance measures.

63. Dr. Mendel examined the job-relatedness of the PDS system, specifically assessing its validity (*i.e.,* accuracy) as a measure of current job performance, and its validity as a predictor of performance in a position to which the assessed individual is promoted. Dr. Mendel's analysis was based on two generally-recognized sets of standards for evaluating employee assessment measures, the *Uniform Guidelines on Employee Selection Procedures* published by the EEOC (the “Uniform Guidelines”), and the *Principles for the Validation and Use of Employee Selection Procedures* published by the Society of Industrial and Organizational Psychologists.

64. In Dr. Mendel's view, an assessment of the job-relatedness of a particular measure of performance must address issues of validity, reliability, standardization, representativeness, norming, and fairness. Dr. Mendel understands validity as the accuracy of the measure; that is, the degree to which the measure accurately predicts job performance. A measure is reliable if the performance being assessed draws the same score, even when evaluated by different raters (or by the same rater, at different points in time). A standardized measure is one that is administered in the same way and under the same conditions to each person whose performance is being assessed. Representativeness requires that each of the component ratings or criteria used in the performance measure contribute to the overall rating in proportion to its importance to the job. Norming is the process by which data is collected so as to ensure that the employee's performance is not affected by factors that are not fairly attributable to him or her. Dr. Mendel described fairness as the absence of systematic under-or over-prediction of an employee's performance as a function of race or gender.

***17** 65. Under the Uniform Guidelines, the validity of a performance evaluation may be determined either by way of a content-oriented strategy or a criterion-related strategy. A content-oriented assessment focuses on the knowledge, skills, and abilities needed to do the job and on a ranking of the tasks to be performed. Dr. Mendel explained that the first step in developing a content-oriented measure is a careful job analysis in which information is gathered from job incumbents, and a detailed job description is developed.[FN3]

FN3. Criterion-related tests measure the characteristics or traits (for example, intelligence) believed relevant to job performance. Thus, a criterion-related validation study determines whether the test is correlated with the applicant's future job performance. The Uniform Guidelines do not favor reliance on criterion-related validity. *See Gillespie v. State of Wisconsin,* 771 F.2d 1035, 1040 n. 3 (7th Cir.1985).

66. Prior to this litigation, Allstate had neither con-

ducted a study to determine whether the PDS evaluation system had an adverse impact based upon race, nor assessed the job-relatedness of the system. Dr. Mendel criticized the system as needlessly subjective. He identified several specific deficiencies:

a. The salary planning process generated a predicted PDS rating which was communicated to the supervisor before the actual evaluation was prepared, thus potentially influencing the supervisor's evaluation. Supervisors were aware that the predicted performance evaluation, salary increase, and promotion, if any, had been approved by the previous supervisor, unit manager, and territory manager during the previous year's planning process.

b. Allstate supervisors, most of them relatively recent college graduates, had limited supervisory experience, little formal training, and brief supervisory tenure before being rotated to another job assignment. A clear majority of the supervisors of nonexempt employees in the Underwriting Department from 1985 through 1988 were white. Because of the frequent turnover, supervisors were often called upon to prepare PDSs for employees whom they had supervised for only a small part of the time period on which the employees were evaluated.

c. Dr. Mendel expressed concern that supervisors had discretion to adopt their own standards regarding the criteria to be considered in preparing the PDS and in weighing those criteria. He was particularly critical of Allstate's failure to establish rules for combining the individual component ratings into the overall PDS score. That failure, Dr. Mendel observed, permitted supervisors to exercise discretion in favor of an employee "simply by deciding that one particular category for that particular individual was more important and thereby adjust the ratings."

d. With respect to the quantity and quality ratings assigned by supervisors, Dr. Mendel believed the distinctions were often too fine to measure meaningful differences in job performance. For example, as Dr. Mendel observed, 80% of Allstate's nonexempt Underwriting employees are ranked as either "meets" or "exceeds." An employee whose overall PDS rating is "exceeds" is more than twice as likely to be promoted as a "meets" employee. Yet the distinctions between employees rated as "meets" and those rated as "exceeds" were often very fine ones; most quality ratings were in the high 90% range. Given the great significance of very small distinctions in ratings, Dr. Mendel believes Allstate had a duty to exercise "tighter control over the measurement process."

***18** 67. In numerous instances, individual PDSs did not include a rating for each of the four criteria, or included a rating without the underlying raw data to support the particular rating assigned. By design, an attendance PDS addressed only the employee's attendance problem and made no mention of the quality, quantity, or deportment criteria. Where a PDS was prepared at the time of an off-cycle promotion, that PDS did not always make mention of each of the criteria. Even with respect to annual performance PDSs, Plaintiffs demonstrated that in at least some instances, data concerning quality, quantity, or attendance appears to be missing.

Allstate's Expert Witness on Job-Relatedness of the PDS System

68. Kathleen Goeppinger, Ph.D., is an Associate Professor of Human Resources Management, Industrial Relations and Organization Development at the Graduate School of Loyola University of Chicago. Dr. Goeppinger earned her Ph.D. in comparative international policy in Loyola's School of Education. Prior to her teaching career, Dr. Goeppinger was an executive in human resources at Carson Pirie Scott & Co. Defendant Allstate called Dr. Goeppinger as an expert witness on the job-relatedness of the PDS system.

69. Prior to her testimony in this case, Dr. Goeppinger had testified as an expert in employment discrimination cases, but not on the issue of job-relatedness of a company's employee selection procedures or performance appraisal systems. She is not an industrial psychologist and has no familiarity with the *Principles for the Validation and Use of Employee Selection Procedures* published by the Society of Industrial and Organizational Psychologists, nor with the strategies identified in those principles for assessing the job-relatedness of employee selection devices. Indeed, in attempting to explain the definition of reliability as used in those principles and in the professional literature, Dr. Goeppinger appeared to confuse reliabil-

ity with validity. Similarly, Dr. Goeppinger had limited familiarity with the EEOC's Uniform Guidelines, although she did recall having used them in validating a test while employed at Carson Pirie Scott.

70. Like Dr. Mendel, Dr. Goeppinger believes that careful job analysis is necessary to ensure that the requirements established for a job are those that have an impact on job performance. Nevertheless, Dr. Goeppinger pointed out that many organizations do not perform a formal job analysis but, instead, look only at the business needs of the organization in developing an evaluation mechanism. According to Dr. Goeppinger, job analysis is not necessary in order to establish that a particular evaluation procedure is job-related. It is undisputed that Allstate did not perform any formal job analysis prior to or during the 1985-1988 period during which it used the PDS for evaluation of employee performance.

71. Defendant asked Dr. Goeppinger to determine whether Allstate's PDS system was consistent with the performance evaluation systems of other large corporations having large clerical functions, and whether the PDS system was job-related. Dr. Goeppinger testified that she considered six criteria in evaluating the PDS system. These six criteria were: (1) whether employees were aware of the standards and received ongoing feedback during the evaluation process; (2) whether the criteria bore a relationship to the business and the ability to be measured; (3) whether controls were placed on the supervisory personnel administering the evaluations; (4) whether managers reviewed the evaluation; (5) whether there was a process for appealing the evaluation rating; and (6) whether employees and supervisors were trained to use the evaluation process.

***19** 72. Dr. Goeppinger concluded that the PDS system was business-related because it focused on quality and quantity of performance and measured attendance and deportment. She believed the performance criteria were consistently applied within units, that the manner in which supervisors evaluated employees was appropriate, and that employees and management supported the process. In reaching her conclusions, Dr. Goeppinger relied in part on what she called inherent or facial validity; that is, acceptance of the process by employees and managers. According to Dr. Mendel, such a factor has no support in the professional literature as a measure of the job-relatedness of an employee selection device. Dr. Goeppinger performed no tests to determine whether the points and rating scales used at Allstate accurately measured performance. (Dr. Mendel also performed no such tests.) Dr. Goeppinger did not address Dr. Mendel's criticism of Allstate's failure to specify how the criteria were to be combined in determining an employee's overall PDS rating. Plaintiffs note that Dr. Goeppinger's testimony reflected that she was apparently unfamiliar with the fact that not all supervisors included all four evaluation criteria in every PDS. Further, she was unaware that at least some supervisors believed deportment was to be given equal weight in the overall evaluation as quantity and quality of work performed. Despite having interviewed supervisor Mary Sobeski, Dr. Goeppinger was unaware that Ms. Sobeski believed extraordinary customer service was a separate criterion, to be considered equally with quantity and quality of work to develop the overall PDS rating.

Defendant's Statistical Analyses

73. Defendant's statistical expert, Robert H. Topel, Ph.D., is the Brown Professor of Urban and Labor Economics at the University of Chicago. Dr. Topel earned his undergraduate degree at the University of California at Santa Barbara and his Ph.D. from UCLA in 1981. Dr. Topel concentrates his research in labor economics and has recently performed research on wage trends, the increasing wage inequality in the United States, and the evolution of labor markets in the United States and abroad. He teaches graduate level courses on microeconomics; work place management (in which he teaches matters including the effect of wage growth on employee turnover); labor markets; and pay and promotion practices. Dr. Topel is the editor of the Journal of Political Economy; serves on the editorial board of the Journal of Business Economics; and has served on the board of editors of the American Economic Review and the Journal of Labor Economics. Dr. Topel has performed research for the U.S. Department of Labor on the unemployment insurance system and on changes in labor markets and their effects on unemployment and wage growth in the United States. Since 1985, Dr. Topel's research has been supported by grants from the National Science Foundation. He has testified before the

Senate Finance Committee on ways to reform the unemployment system in the United States. All of Dr. Topel's research employs empirical statistical methods to analyze data concerning individuals.

A. *Wage Growth*

***20** 74. In Dr. Topel's view, wage growth is a more accurate measure of advancement than promotion rates. As described below, Dr. Topel found that the difference in wage growth between white employees and black employees was statistically insignificant. To perform his analysis, Dr. Topel compared the wage rate of each employee at the beginning of a job with that employee's wage rate at the time the employee left the job, either by termination, promotion, transfer, leave of absence, or demotion. Dr. Topel referred to each such period as a “job spell.” He then calculated the wage growth for the job spell as the difference between the beginning and ending wage rate, deflated by the Consumer Price Index. For this analysis, Dr. Topel considered only those employees who had five months of seniority in the Underwriting Department and had received at least one PDS. For the period from January 1, 1985 through October 24, 1989, Dr. Topel found the average real wage growth for all employees (within the certified class and similarly situated whites employed during the class period) was 4.8%. The black-white difference was .005 and the “t-statistic” (a measure of standard deviation, with 1.96 as a threshold for statistical significance) was 0.58, well below any statistical significance.

75. Because Plaintiffs had offered some statistical evidence that also included persons who worked in nonexempt underwriting positions outside the court-defined class period, Dr. Topel performed another analysis that considered those persons, as well, referring to them as “others.” When he looked at the court-certified class, comparable whites, and others employed at any time in the same time period, Dr. Topel found a black-white difference of .007 and a t-statistic of 0.82, not a significant finding.

76. In another analysis, Dr. Topel used a regression calculation to compare the wage progress between blacks and whites when controlling for starting pay grade, years of service, and absence days per months. Controlling for those factors, Dr. Topel found the black-white difference in wage growth was virtually eliminated. For class members, comparable whites, and others, the black-white difference was .002, and the t-statistic was 0.24.

77. To eliminate the effect, if any, of corrective efforts Allstate may have made to “clean up its act” in 1989, after the filing of these charges, Dr. Topel performed the same analysis but eliminated data that post-dated the filing of Plaintiff's EEOC charges. Again, Dr. Topel found no statistically significant black-white difference: the difference was .015, with a t-statistic of 1.7 when comparing class members and comparable whites, and .015, with a t-statistic of 1.67 when class members, comparable whites, and others were included. Once again, when he controlled for the factors of starting pay, seniority, and attendance, Dr. Topel found the black-white difference declined further: For the court-certified class and comparable whites, the difference was .012 with a t-statistic of 1.43; when looking at the certified class, comparable whites, and others, the difference was .011 with a t-statistic of 1.19.

***21** 78. Dr. Topel performed another analysis, in which he looked at all those employed from January 1985 through October 1989, regardless of whether they had received a PDS. Again, the differences between blacks and whites were not statistically significant. Among the court-certified class and comparable whites, he found a race difference of .010, with a t-statistic of .08. Adding the others to the analysis, Dr. Topel found a black-white difference of .012 and a t-statistic of 1.37. Again, when he controlled for starting pay, seniority, and attendance, the black-white difference was eliminated.

79. Finally, Dr. Topel studied class members and comparable whites during the period from January 1, 1985 through November 1988, and found a black-white wage growth difference of only .009, with a t-statistic of 1.03. When he included others in the analysis, the black-white difference was .013 with a t-statistic of 1.38. Controlling for starting pay, seniority, and attendance reduced the black-white difference to .002, with a t-statistic of .28 for class members and comparable whites, and to .005 with a t-statistic of .52 for class members, comparable whites, and others. These findings reflected no statistically significant

differences.

80. Plaintiffs criticize Dr. Topel's work on the ground that his analysis examined overall wage increases without eliminating the "salary adjustments" described in paragraph 26 above, which were unrelated to the merit increases associated with PDS evaluations. According to Dr. Topel, salary adjustments must be included in the analysis. Eliminating such adjustments, he testified, would skew the results because some adjustment increases were subsumed in merit increases and not coded separately. The court's statistical sophistication is limited. Given that the inquiry here focuses on differences in wage growth rather than differences in wage levels between the two groups, Plaintiffs' criticism of Dr. Topel's failure to eliminate adjustments appears to the court to be a valid one. Unfortunately, Plaintiffs themselves performed no wage growth analysis and therefore offered no evidence that eliminating salary adjustments would have yielded significant differences in wage growth between the two groups.

B. *Promotion Rates*

81. In addition to the wage growth analysis described above, Dr. Topel performed a statistical analysis of the differences in promotion rates between whites and blacks. In spite of the conceded race disparities in overall PDS scores, Dr. Topel found no statistically significant differences in the promotion rates of whites and blacks from 1985 through 1988. As with his wage growth analysis, Dr. Topel's analysis began by addressing periods of employment ending in termination, promotion, transfer, leave of absence, or demotion, referred to as "job spells." He found no statistically significant difference between blacks and whites in the number of job spells that ended in promotion. For the period from January 1, 1985 through October 24, 1989, looking at black class members and comparable whites, Dr. Topel found a chi square statistic [FN4] of .003, yielding a *p* value of .96 (that is, a 96% probability that the small black-white difference in promotion rates would have occurred by chance). When he considered the certified class, comparable whites and others,[FN5] the chi square statistic was .05, yielding a *p* value of .82.

FN4. The chi square is a numerical measure of differences between the values actually observed and those expected by chance, which permits comparison of the performance of one group with another. *Smith v. Salt River Project Agricultural Improvement and Power District,* --- F.3d ----, No. 95-16951, 1997 WL 129035, *3 (9th Cir. Mar.24, 1997). By reference to a standard statistical table, the chi square statistic allows the researcher to determine whether differences between the groups are statistically significant. *See* *N.A.A.C.P. v. City Of Mansfield,* 866 F.2d 162, 167 (6th Cir.1989); *Coates v. Johnson & Johnson,* 756 F.2d 524, 537, n. 11, 13 (7th Cir.1985); *Chisholm v. U.S. Postal Serv.,* 665 F.2d 482, 496 n. 21 (4th Cir.1981).

FN5. See Finding ¶ 75.

***22** 82. In an alternative version of this analysis, Dr. Topel excluded the time period after November 30, 1988, to eliminate the effect of any efforts on Allstate's part to improve its record. For class members and comparable white employees, Dr. Topel found that job spells ended in promotions for white employees 36% of the time, and 34% of the time for blacks. The *p* value for this finding was .72 and the chi square statistic was .12. When he looked at the experience of class members, comparable whites, and others, Dr. Topel found similar results. Nor did he find a statistically significant black-white difference in promotion rates when he excluded all lateral transfers from consideration.

83. Dr. Topel found no statistically significant difference in the distribution of blacks and whites in their starting pay grade. Nevertheless, his study addressed the possibility that blacks were over-represented in the lower pay grades, in which one might expect a higher proportion of promotions. Accordingly, he compared the promotion rates for the certified class and comparable whites, controlling for the employees' starting pay grade. For the period from January 1, 1985 through October 1989, he found a black-white difference in promotion rates, but it was not statistically significant ($p = .24$). Limiting the time period to November 30, 1988 also did not change the outcome. Finally, when he controlled for number of days absent from work, Dr. Topel concluded that the difference in

rates of promotions between blacks and whites was "virtually zero."

84. Dr. Topel believes that actual salary increases are the most relevant measure of differences in treatment. Nevertheless, he looked at changes in pay grades (rather than salaries) in order to respond to Dr. Mendel's pay grade analysis. Specifically, Dr. Topel compared each employee's pay grade from the time he or she began in Underwriting to the time the employee left the department. He found no statistically significant black-white difference, regardless of whether he examined the period ending in 1989 or in 1988, and regardless of whether the population examined included class members and comparable whites, or class members, comparable whites, and others. Similarly, when Dr. Topel controlled for the time an employee had spent in a given grade, he again found no statistically significant difference in the change in job grade per year between blacks and whites.

85. Dr. Topel counted all job spells at the end of 1988, regardless of the length of time, as non-promotions; but given that he did so for both blacks and whites, Plaintiffs' suggestion that this practice reduced the racial variance is unsupported. Most unpersuasive to this court is Plaintiffs' argument that Dr. Topel erred in considering promotions outside the Underwriting Department. Although the Underwriting Department supervisor did not make final decisions concerning such promotions, it is undisputed that an employee's performance record, including past PDSs, was considered in such a decision. Notably, as discussed infra ¶¶ 121-22, named Plaintiff Rhonda Moore herself complains of Allstate's failure to promote her outside the Department to a position in Acceptance Testing.

C. *Overall PDS Ratings*

***23** 86. As described above, Dr. Topel found no statistically significant difference in the wage growth rates or rates promotion between black and white employees. Dr. Topel does agree with Dr. Mendel that the overall PDS ratings show a statistically significant difference between black and white employees. Further, in published work, Dr. Topel has acknowledged that supervisors can manipulate apparently objective elements in a performance appraisal system so as to maximize the likelihood of favoring some subordinates over others. Dr. Topel performed certain additional analyses to test Plaintiffs' contention that such manipulation occurred at Allstate.

87. To do so, Dr. Topel collected a sample of PDSs prepared for 158 employees during the period from 1988 through 1989 in order to determine (i) whether the less objective factors in the overall PDS were responsible for the PDS system's disparate impact; (ii) whether the more objective factors were weighted differently for blacks than for whites in determining the overall PDS rating; and (iii) whether, in evaluating the more objective factors, supervisors applied the standards differently for blacks than for whites. Dr. Topel limited his sample to the period from 1988 to 1989, the court-certified class period. He noted, however, that the black-white difference in the distribution of performance ratings in his sample was greater than the difference for all blacks and whites employed in nonexempt Underwriting from January 1985 through October 1989. Thus, Dr. Topel believes his sample selection exaggerates any disparate impact that exists.

88. From his PDS sample, Dr. Topel created a database in which he listed the ultimate rating and, where available, the underlying subratings on quality, quantity, and attendance. To ensure accuracy, Dr. Topel read nearly every one of the PDSs included in his sample. In any situation where the supervisor had made a specific quality or quantity rating, Dr. Topel placed that rating in the database. Where the supervisor provided neither a rating nor a numerical score for quality or quantity, no rating was recorded in the database. In situations where the supervisor had placed quantity or quality raw scores on the PDS, but no rating, Dr. Topel supplied the rating from the unit guidelines, if they existed. In situations where there were two ratings for quality and quantity in a single PDS (for example, where an employee had worked on two job assignments during the evaluation period), but no final rating for that component, Dr. Topel averaged them and rounded down. He did not include a rating for deportment.

89. Dr. Topel found, first, that there was no statistically significant difference between blacks and whites in the probability that they would receive an overall "meets" rating. He did find significant differences in

the high and low ratings, however; blacks were more likely to receive an "acceptable, needs improvement" rating, whites more likely to receive an "exceeds." "Requires immediate improvement" ratings were nearly always given because of attendance or tardiness problems. Of the employees who received "acceptable, needs improvement" ratings, most had at least two such low ratings on quantity, quality, or attendance. When Dr. Topel controlled for receiving two "needs improvement" ratings in quantity, quality, or attendance, and for receiving a special "attendance PDS," [FN6] he found no remaining significant difference between blacks and whites in the likelihood of getting an overall "needs improvement" rating.

> FN6. See Finding ¶ 18.

***24** 90. Dr. Topel next examined the group of employees ranked as "meets" and "exceeds." When he controlled for whether the individual had at least two "exceeds" ratings in the underlying quantity, quality, and attendance criteria, Dr. Topel found that the black-white difference in probability of getting an overall "exceeds" rating was reduced below statistical significance (t = 1.33).[FN7] From this data, Dr. Topel concluded that supervisors apply the underlying ratings on quality, quantity, and attendance in similar ways when assigning overall ratings to black and white employees. Thus, according to Dr. Topel, there is no statistically significant difference in the manner in which supervisors evaluated more subjective factors, such as deportment, for black and white nonexempt employees.

> FN7. In response to this testimony, however, Dr. Mendel pointed out that for employees who received only one underlying "exceeds" rating, the odds of receiving an overall "exceeds" rating varied significantly by race. Thus, of 32 whites who had received one underlying "exceeds" rating, 11 were awarded "exceeds" ratings overall; of 13 blacks who received one underlying "exceeds" rating, none received an overall "exceeds."

91. Dr. Topel also addressed the question of whether supervisors exercised discretion in favor of whites with respect to attendance ratings. To do so, Dr. Topel reviewed attendance records compiled from each employee's own weekly record of his or her absences. Rather than accepting the supervisors' evaluations of the attendance data, which Plaintiffs suspect may reflect the exercise of discretion for or against individual employees, Dr. Topel applied a mechanical rule, counting consecutive days of absence as a single occurrence. Dr. Topel found no statistically significant difference between the number of occurrences as counted by supervisors and the number counted by a mechanical rule (the difference was .018, t-statistic = 0.06).

92. Plaintiffs challenge the job-relatedness of the PDS system on the ground (among others) that the PDS rating does not accurately predict performance in a job to which the employee is promoted. To evaluate this challenge, Dr. Topel compared the PDS rating last received prior to an employee's promotion with the first performance rating in the new position. Of 55 employees who were promoted during the class period, 40 were rated "exceeds" in their last PDS, and 15 were rated "meets." In their subsequent PDSs, 21 of the 40 who had "exceeds" ratings were rated as "meets" in their new position; the remaining 19 received "exceeds" ratings. Of the 15 who were rated "meets" prior to their promotions, only one received an "exceeds" rating in the first PDS following the promotion; 12 were rated "meets"; and two received "requires immediate improvement" ratings. These results established a statistically significant ($p < .003$) relationship between the before- and after-promotion PDS ratings, with a chi square of 11.71 and a t-statistic of more than 3 standard deviations. Dr. Topel concluded that the PDS issued immediately prior to an employee's promotion was a strong predictor of performance in the new position.

93. Dr. Topel concluded that the PDS system did not cause a statistically significant difference in the wage growth or promotion rates between black and white nonexempt employees in the Underwriting Department. He concluded, further, that there is no evidence that supervisors applied subjective evaluations of deportment differently between blacks and whites, nor that supervisors combined the subratings in different fashion as between blacks and whites. Finally, Dr. Topel found no evidence that supervisors calculated the underlying ratings differently for whites than for

blacks.

***25** 94. Plaintiffs criticize Dr. Topel's analysis on several grounds; as set forth below, the court concludes that these criticisms do not undermine the analysis:

a. Plaintiffs note, first, that where underlying ratings for quality, quantity, and attendance were missing from the PDSs, Dr. Topel in some instances imputed such a rating. As Defendant notes, however, Dr. Topel did so only where the PDS included raw data from which the appropriate underlying rating could be determined.

b. Plaintiffs further criticize Dr. Topel's practice of applying a standardized rule in the situation where an employee received more than one quality or quantity rating and the supervisor did not combine that rating into a single score for the criterion. Plaintiffs are correct that Allstate practice permitted the supervisor to exercise discretion in such a situation-indeed, the discretion available to supervisors is a key target of Plaintiffs' disparate impact claim here. Dr. Topel's effort was to determine whether, if such discretion were eliminated, racial disparities would also be diminished. Applying a standardized rule was necessary in order to make that determination.

C. For the same reason, Plaintiffs' criticism of Dr. Topel's use of other rules to determine an appropriate PDS rating where data was missing falls short.

d. Plaintiffs criticize Dr. Topel's use of a sample of PDSs rather than all of those administered during the relevant time period, but there was no evidence that Dr. Topel's sample was not representative; indeed, as noted earlier, his own analysis suggested that the sample he selected placed Defendant in a worse light than would the overall database from which his sample was drawn.

e. In particular, the fact that Dr. Topel compared some of the sampled PDSs to themselves in determining the sample's representativeness does not provide grounds for criticism; where a sample is drawn from a larger population, that sample will by definition include individuals who are part of the larger population.

f. Plaintiffs are correct that, because in 1989 supervisors began including more underlying ratings in their PDSs, Dr. Topel's database included more PDSs that contained ratings on the underlying criteria. They did not demonstrate, however, that this change so altered the evaluation practices that Dr. Topel's analysis has no weight.

III. *Facts Concerning the Named Plaintiffs' Disparate Treatment Claims*

95. In addition to their disparate impact claim, each of the three named Plaintiffs brought a claim of disparate treatment. Each Plaintiff adduced evidence in support of that claim, discussed below. All three also emphasize a 1987 incident involving a black doll as “an example of racial animus or insensitivity at Allstate.” In this incident, which occurred during the summer of 1987, several white employees, including one supervisor, were involved in taking the doll from the desk of supervisor Janine French, to whom it belonged, and hanging it from a stanchion in public view. When Plaintiff Velma Dicker saw the doll hanging from the stanchion, she complained to Ms. French, who immediately removed the doll. Ms. Dicker acknowledged that she did not bring the matter to the attention of Vicki Kummer, at that time the unit manager in the Eastern Territory. Ms. Dicker explained that she did not do so because she believed that Ms. Kummer had reacted to the doll with laughter (Ms. Kummer denied this) and because she believed that Ms. Kummer had made a racially-stereotyped comment to a black Allstate employee on a prior occasion.

***26** 96. Janine French concluded that the incident was a practical joke, apparently intended to echo a previous incident in which co-workers had taken Vicki Kummer's teddy bear and “held it hostage.” When Ms. Kummer, the unit manager, observed the doll, she recalls feeling annoyed; the workload was heavy and there was little time for joking. Plaintiffs Velma Dicker and Rhonda Moore testified that they were deeply upset upon seeing the doll. Ms. Moore recalled that the doll had paper clips stuck into its chest. Christina Farina, one of the co-workers responsible for the incident, became upset and cried upon learning of Ms. Dicker's reaction. Ms. Farina then met with Ms. Dicker and told her she had not meant to convey any racial message, and apologized to her.

97. Although Ms. Dicker did not bring this incident to the attention of Allstate management, Ms. Moore raised the issue in a meeting with Ms. Alexander of Human Resources. Upon learning about it, Eric Hjerpe investigated and concluded that "there was no racial motivation" behind the incident. In a memo dated August 17, 1987, Hjerpe reported to William A. Knapp, Jr., Director of Underwriting, that "[t]here was a pin or paperclip stuck in the doll," and observed, "Needless to say, this was done in very poor taste and several employees took offense." Hjerpe recalled that when he discussed the matter with Ms. Farina, she became very upset and apologetic, insisting she had no intention to hurt anyone's feelings. Nevertheless, both Eric Hjerpe and Vicki Kummer apologized to Ms. Dicker. None of the white employees involved in the incident was disciplined, nor was any mention made of the incident in the employees' subsequent PDSs. Indeed, two of the white employees involved, including Ms. Farina, were promoted soon after their next PDSs. Ms. French, their supervisor, testified credibly and at length under cross-examination that she felt great remorse about the offense the incident had engendered, but that she was certain that it was not intended to have racial connotations and reflected, at worst, poor judgment rather than malice.

Velma Dicker

98. Plaintiff Velma Dicker, a high school graduate, has taken college-level courses, including sociology and psychology. She has served as an elected school board member, is an active church member, and has done volunteer work at Great Lakes Naval Base. Prior to beginning work with Allstate, Ms. Dicker was employed by School District No. 64 in North Chicago, Illinois as a liaison between school administrators and parents. In April 1984, Ms. Dicker began working for Allstate, initially at a facility on Old Skokie Road and, six months later, at the PLSC in Deerfield, Illinois. Soon after transferring to the PLSC, Ms. Dicker was assigned to the position of Record Clerk B in the mail match department of the Eastern Underwriting territory. She remained in that position until April 1987, when she was promoted to Record Clerk C. In July 1987, Ms. Dicker was promoted to the position of Data Prep A. She worked as a Data Prep A until 1987.

***27** 99. From 1984 through 1988, Ms. Dicker was evaluated on the quality and quantity of her work, as well as her attendance. She was not told directly or indirectly what weight each of these components had in her overall PDS rating. Although she knew that comments concerning her on-the-job conduct appeared in her PDSs, she was not told explicitly that she was being evaluated on the parameter of "deportment." Nevertheless, Ms. Dicker testified that she agreed with her PDS rating of "meets" for the period 1984 through January 1985 and with the rating of "meets" for the period from January 1985 through October 1985. During the period January 1985 through October 1985, Ms. Dicker was awarded the Allstate Good Hands Award, an award Allstate makes to one of its employees for his or her community service. Gigi Soeder, a white employee hired after Ms. Dicker, was promoted in 1985 to the position of Record Clerk C.

100. During the period covered in her next PDS, from October 1985 through July 1986, Ms. Dicker had two different job assignments. In the first of those jobs, the "drop desk," her production points put her at an "exceeds" level, but her quality ratings averaged 95.5% (unacceptable). In February 1986, Ms. Dicker rotated to the mechanized desk, where her production merited a rating of "meets," but her quality was 96.5%, at the "acceptable, needs improvement" level. Although she acknowledged having one-on-one meetings with her supervisor to discuss her performance during this period, she was surprised by the "acceptable, needs improvement" rating on her July 1986 PDS.[FN8] Ms. Dicker made no written comments on the PDS, but complained to unit manager Joy Reveal that the rating was unfair because her supervisor, Victoria Kummer, had changed the point values for her job assignments in the middle of the evaluation period. Ms. Dicker believes the changes made it more difficult for her to earn points for job functions she was performing. Because the point changes applied to all employees, including a white employee doing the same work as Ms. Dicker, Ms. Reveal declined to alter the PDS rating. In any event, the court notes that despite the point changes, Ms. Dicker's production was at an "exceeds" level; thus her overall "needs improvement" rating was a product of her low quality rating, not her production rating.

FN8. Plaintiffs contrast this rating with the "meets" rating Ms. Dicker was awarded in October 1985; from June to October of that year, she had a 92% error rate (an unacceptable quality level) and production at the "meets" level. As Defendant observes, however, Ms. Dicker's performance during the earlier portion of that evaluation period (January through May 1985) had been at the "meets" level. The court finds no inconsistency in the two overall PDS ratings.

101. After the July 1986 PDS, Ms. Kummer met with Ms. Dicker to discuss ways to improve her performance. Because Ms. Dicker had difficulty with typing, Ms. Kummer moved her to the APS desk, where less typing was required. During a one-on-one session, Ms. Dicker told Ms. Kummer that she did not want to go into the Data Entry unit because of the typing skills required, and instead preferred promotion to the QV unit.

102. Ms. Dicker recalled one incident in 1986 in which Vicki Kummer assigned one of Ms. Dicker's white co-workers, either Janice Letteri or Christina Farina, to take some materials to the mailroom. When that co-worker refused to run the errand, Ms. Kummer said she would make Plaintiff Dicker do it, and did so. Nevertheless, the PDSs for both of these workers covering at least some portions of 1986 contained no negative deportment references. (*See* Letteri PDS, 4/86-1/1/87 (referring to Ms. Letteri as a "team player"); Farina PDS 9/85-6/86 (characterizing Ms. Farina as "very valuable").)

***28** 103. Ms. Dicker believes that Ms. Kummer chastised her, but not her white co-workers, for taking personal phone calls. On one occasion when Ms. Dicker had taken a call concerning teacher contract negotiations, she pointed out to Ms. Kummer that co-worker Janice Letteri had made wedding plans over the telephone at work. Ms. Kummer replied that the rules applied to everybody, but Ms. Dicker challenged this, observing that other employees in the unit had made calls without comment from Ms. Kummer. Under cross-examination, however, Ms. Dicker acknowledged that she did not know whether Ms. Kummer had reprimanded other employees for personal phone calls.

104. Approximately one month before her April 1987 PDS, Ms. Dicker had a conversation with her supervisor, Janine French, in which Ms. French told her that Anita Hartmann (a co-worker who was also Ms. French's cosmetologist) and Christina Farina would be promoted to Record Clerk C, and that Maryann Ciaja (white) would be promoted to Data Prep A, but that Ms. Dicker herself would not be promoted. Ms. Dicker, who had trained all three of these employees, believed it unfair that they were to be promoted before her. Ms. Dicker complained to Eric Hjerpe, the unit manager. Hjerpe advised her that it was not "her tam" to be promoted; Defendant explains that Ms. Dicker's "acceptable, needs improvement" rating on her July 1986 PDS was a bar to promotion and that Ms. Dicker was not eligible for promotion until she earned a "meets" or better on her PDS. On her April 1987 PDS, Ms. Dicker did earn a "meets" rating and won a promotion to Record Clerk C. Three months later, in July 1987, Ms. Dicker was again promoted, this time to the position of Data Prep A.

105. Having received a promotion in July 1987, Ms. Dicker was not scheduled for another PDS until July 1988.[FN9] She believed that she was entitled to a review in April 1988, however, and requested a PDS from her supervisor, John Mueting. When Mr. Mueting told her that a PDS was not due, Ms. Dicker insisted she was entitled to one. After that conversation, Ms. Dicker was summoned to Mr. Hjerpe's office. Hjerpe also told her that she was not entitled to a PDS in April 1988, and that she should have accepted Mr. Mueting's explanation. Mr. Hjerpe then arranged for Ms. Dicker to see Ms. Alexander, the Human Resources director. Although Defendant denies that Mr. Hjerpe referred to Ms. Dicker's conduct as insubordinate, Defendant has provided no other explanation for the direction that she see Ms. Alexander.

FN9. As support for her claim that she was entitled to a PDS in April 1988, Plaintiff relies on notations in her monthly reviews in April 1987 and May 1987. (*See* Plaintiffs' Proposed Findings of Fact ¶ 208.) The court notes, however, that each of those reviews preceded Ms. Dicker's July 1987 promotion to Data Prep A.

106. When Ms. Dicker met with Ms. Alexander the following day, she asked why she had been required to attend a meeting to discuss her request for a PDS when, in contrast, employees who had been involved in an incident with a black doll had not been called to Human Resources. Ms. Dicker noted that she had not been disrespectful in regard to her request for a PDS. Ms. Alexander, until then unaware of the black doll incident, asked Ms. Dicker for details. Although Mr. Hjerpe had told Ms. Dicker that he planned to file a report concerning the black doll incident with Ms. Alexander, at the time Ms. Dicker met with her, Ms. Alexander was unaware of any such reports.

***29** 107. Ultimately, Ms. Dicker did receive a PDS reviewing her performance in April 1988, but did not receive a salary increase. In August 1988, Ms. Dicker received a PDS and salary increase. As of the time she filed her charge of discrimination at the end of November 1988, Ms. Dicker and Plaintiff Patricia Hood were the highest-paid Data Prep As in the Eastern division.

108. Ms. Dicker recalls that on one occasion, Gigi Soeder, a white employee, complained to her supervisor, John Mueting, that she had been incorrectly charged with an error by the Data Prep B who had spotchecked Ms. Soeder's work. Mueting agreed to change the record and remove the error notation. Ms. Dicker told Mueting that she also had been charged with the same error, but Mueting refused to change the record for Ms. Dicker as he had for Ms. Soeder, purportedly because Ms. Dicker would not have known about the error had Ms. Soeder not raised the issue.

109. Ms. Dicker believes she was discriminated against with respect to training in at least two respects. First, she claims that she was denied training on work involving applications from New York. According to Defendant, New York law requires that insurance application files from that state be kept separate from files of other states; Allstate complied with this requirement and assigned a single individual to process all New York files (rather than an alphabetical section of the remaining files), but the work involved was otherwise the same as what all other mail match employees performed. Second, Ms. Dicker believes that Chris Carlstrand, a white employee, was trained before she was. The record shows that Ms. Carlstrand became employed with Allstate's Midwest Regional Life Office beginning in May 1983 and moved to the PLSC when it opened. Thus, the fact that Ms. Carlstrand received some training before Ms. Dicker is not indicative of discrimination.

110. In June 1988, Janice Letteri was promoted from the Data Prep A position to a UCU. Letteri's PDS rated her as “meets” overall, with underlying scores of “meets” for production; “exceeds” for quality (although, as Plaintiffs note, her QV rating of 97.6% fell just below the 98% required for an “exceeds” according to Allstate's standards); “meets” in attendance; and positive comments for extraordinary customer service. In Ms. Dicker's August 1988 PDS, she also received a “meets” overall, with underlying scores of “meets” for production; “exceeds” for quality as measured by spotchecks and “meets” as measured by QV errors; and very positive comments concerning extraordinary customer service. Ms. Dicker, who had been promoted to the position of Data Prep A before Ms. Letteri, believes she was more qualified for promotion to UCU than was Ms. Letteri. The position was one for which Ms. Letteri posted, however; Ms. Dicker did not post for the position. Mr. Hjerpe filled another UCU position during 1988 by hiring a black female from outside Allstate because none of the Data Preps was interested in transferring to that position.

***30** 111. Ms. Dicker understood that it was standard practice for employees in Underwriting to assist clerks in mail match in keeping current with the incoming mail. Nevertheless, Ms. Dicker claims that her supervisor, Janine French, instructed her not to assist employees in the mail match unit during the time that Monique Gregory, a black woman, was a supervisor in that unit. The court does not find Ms. Dicker's testimony concerning this purported instruction not to help credible. Defendant offered evidence that in September, 1987, Ms. French prepared a PDS for Christina Farina, specifically thanking her for helping Monique Gregory's unit.

112. At some point during the course of Plaintiffs' employment, Mr. Hjerpe asked Patrice Boone, a black supervisor new to Allstate, to help him communicate with Plaintiffs Velma Dicker and Rhonda Moore. Ms. Boone was new to Allstate. Ms. Dicker recalls that Ms.

Boone believed Eric Hjerpe wanted her, Ms. Boone, to be a “hatchet person” with respect to black employees, and that Ms. Boone warned that Mr. Hjerpe was looking for any excuse to terminate Plaintiffs Dicker and Moore. Ms. Boone took no action against either Ms. Dicker, who continued to work for Allstate as of the time of the hearing, or Ms. Moore, who resigned voluntarily in April 1990.

113. In August 1989, Plaintiff Dicker was rated “exceeds” and promoted to the Data Prep B position. She remains employed at Allstate.

Rhonda Moore

114. Plaintiff Rhonda Moore was employed by Allstate from January 1984 until April 1990, when she resigned voluntarily. At the time she testified in August 1993, Ms. Moore was employed by Wright Video Services America in Deerfield, Illinois, as a customer service representative. During her two and one-half years with Wright, Ms. Moore has been promoted twice. Ms. Moore was active in community work during her employment with Allstate, serving as president of the PTA of her children's school, running a support group for dysfunctional families, and volunteering time to prepare food baskets for the needy.

115. Ms. Moore was hired into the position of Data Prep A in the Midwest Regional Office, and was among the first employees transferred to the PLSC when it formed. She was assigned to train other data prep employees hired at the PLSC and was responsible, as well, for training new supervisors on the daily procedures at the PLSC. Other employees who started with her were Karen Levek, Sandy Wright, Peggy Labus, Alberta Cruz, and Lois Newberry, all white employees, as well as black employees Patty Jones and Carey Earl. Two other white employees, Chris Fortmiller and Janice Letteri, began working in Ms. Moore's unit shortly after the PLSC opened. Ms. Moore recalls that soon after she began work at the PLSC, a supervisor informed her that it was not possible for an employee to be promoted from the position of Data Prep A to that of UCU. Instead, the employee would first have to be promoted to Data Prep B and then make a lateral move to the UCU slot. According to Ms. Moore, this supervisor also told her she could not be promoted for at least nine months.

***31** 116. From the beginning of her employment with Allstate, Ms. Moore was instructed to keep a record of her production and was aware that she received a certain number of points for each task. Ms. Moore's work was spotchecked nearly each month; her desk files revealed that she had regular monthly one-on-one meetings with her supervisor. Nevertheless, although aware that she was keeping production records and being spotchecked, Ms. Moore testified that it “never crossed her mind” that these records were being maintained in order to evaluate her performance. Thus, before receiving her first PDS for the period from February through November 1984, she claims she was unaware that she would be evaluated on the basis of quantity, quality, and attendance.

117. Ms. Moore was unhappy about the frequent changes in supervisors and complained about the matter to Human Resources, but the practice of rotating underwriter trainees into these supervisory positions continued. Ms. Moore recalls being under the supervision of three different supervisors during the seven-month period covered by the November 1984 PDS; the record shows, however, that Thomas Price was her supervisor for at least six of the seven months, beginning in June 1984 and continuing as her supervisor through April 1985.

118. In September 1985, Ms. Moore received a second PDS covering the period from December 1984 through September 1985. Thomas Pludray, the supervisor who signed that PDS, had supervised Ms. Moore for a portion of that period, as had Thomas Price and Stephanie Baker. Ms. Moore's overall evaluation was “exceeds,” and she was promoted to the position of Data Prep B. This was Ms. Moore's last promotion while employed at Allstate; although managers approached her about promotion into the UCU position, Ms. Moore chose instead to wait for a promotion outside the department.

119. One of the responsibilities of a Data Prep B was “complex change re-issues.” White employees Karen Levek, Lois Newberry, and Peggy Labus performed this work, but Ms. Moore had not yet been trained on the task as of June 1986, nine months after being promoted to Data Prep B. She brought this issue to the attention of her supervisor, Tom Pludray, and to Alton

Grant, a black employee then working as unit manager. Ms. Moore received a "meets" rating overall on her May 1986 PDS, but was rated "exceeds" in her next PDS in March 1987. Like Ms. Moore, Lois Newberry, a white employee promoted in August 1985 to Data Prep B, was not trained on a function (in her case, QV errors) until nine months after her promotion to Data Prep B. Defendant attributes the nine-month delay in training Ms. Moore to the time of year in which she took on the new position, just prior to the fall. At that time every year, Allstate gears up for a "fall promotion," the company's busiest season and a time when few supervisors or co-workers can be spared from their own job responsibilities to train other workers. Ms. Moore ultimately was trained on complex change re-issues in June 1986. Karen Levek, who had started working for Allstate at the same time as Ms. Moore, was her trainer. Levek and Newberry had both been trained on this task before Ms. Moore.

***32** 120. From September 1, 1985 through May 1, 1986, Ms. Moore was supervised by Kim Graham and Stephanie Baker. She contends that during the period covered by her May 1986 PDS, she expressed confusion to supervisor Tom Pludray [FN10] and unit manager Alton Grant concerning the assignment of points for "general time," but that neither Pludray nor Grant responded prior to May 1986. By June 1986, however, Ms. Moore understood that whenever she worked on something that did not have a specific point value assigned to it, the work was credited with one point per minute.

FN10. In paragraph 236 of her Proposed Findings of Fact, Ms. Moore refers to Mr. Pludray as her supervisor at the time of the May 1986 PDS; in paragraph 234, however, she refers to Ms. Graham and Ms. Baker as her supervisors from September 1985 through May 1986.

121. In addition to her concerns about training, Ms. Moore was troubled by the fact that she was not provided with information from the Acceptance Testing unit at Allstate, information that she understood was being provided informally to her white co-workers. In August 1987, Ms. Moore met with Mr. Hjerpe to discuss this issue and others. Mr. Hjerpe recalls that Ms. Moore told him that an employee who had worked previously in the Eastern underwriting territory had transferred to Acceptance Testing, and had been making calls to her friends in Eastern underwriting, providing them with problem-solving suggestions and new procedures. She told him, as well, that all of the supervisors she had worked for were racist; that she had been misinformed about evaluation standards; and that she believed there was unfair treatment at Allstate with respect to compensation and promotions. With respect to evaluation, Ms. Moore told Mr. Hjerpe that she believed supervisors inappropriately emphasized quantity and quality ratings, although she had been led to believe that deportment would also be an important factor in evaluation. With respect to racism on the part of supervisors, Ms. Moore specifically mentioned the delay in training while she was supervised by Mr. Pludray. Ms. Moore told Mr. Hjerpe that she did not believe he himself was racist, but refused to discuss other supervisors or managers. At the conclusion of the conversation, Mr. Hjerpe encouraged Ms. Moore to contact him again to resume the conversation. He also called a division manager or unit manger in the Acceptance Testing unit to tell that person that "if there are new procedures or any things of that nature, you need to [communicate the information to everyone]."

122. Also in 1987,[FN11] Ms. Moore had a conversation with Eric Hjerpe about the possibility of transferring to a position in UCU. Mr. Hjerpe pointed out that such a job change would be a lateral move, without a corresponding pay increase. He also warned her that it was possible her evaluation would be at an "acceptable, needs improvement" level initially. Ms. Moore, whose most recent evaluation had been "exceeds," claims she felt discouraged by this conversation from seeking transfer to UCU. In fact, however, as she testified at her deposition, Ms. Moore did not want a lateral transfer to UCU during 1986 or 1987; instead, her preferred next step was to the Acceptance Testing unit. Ms. Moore told Joy Reveal and John Mueting that she was not interested in UCU because of the telephone work involved.

FN11. Hjerpe recalls that this conversation occurred in 1988.

***33** 123. In 1987, Ms. Moore told her unit manager, Joy Reveal, of her desire to be promoted to a position in Acceptance Testing. Along with 40 other employees, Ms. Moore applied for one of two posted positions in the Acceptance Testing unit. Although Ms. Moore's supervisor wrote a glowing recommendation for her, she was not promoted. Instead, the positions were awarded to two white employees. Christine Carlstrand, a white employee in the Eastern territory who also applied and had an "exceeds" rating, was denied the Acceptance Testing position as well.

124. In 1987 or 1988, Ms. Moore complained about unfair work distribution to black and white employees. In addition to speaking to Rodney Daniels of Human Resources and William A. Knapp, Jr., Director of Underwriting, Ms. Moore raised the issue with Jane Alexander. In a meeting in Ms. Alexander's office, Ms. Moore said she believed whites were being treated more favorably with respect to work assignments and were disrespectful to black supervisors without repercussions. She told Ms. Alexander that she believed blacks were not being trained in a timely fashion, and suggested that all job information be communicated in writing to make sure everyone had access to it.

125. Ms. Moore was rated as "exceeds" in her PDS for the period from March 1987 to March 1988 and was awarded a 10.1% pay increase. Nevertheless, she refused to sign the employee signature line on the PDS because it contained what she believed to be an untrue statement: that she was unwilling to perform tasks assigned by her supervisor when she believed them to be inappropriate or inimical to her personal goals. Significantly, the PDS also commended Moore's "positive attitude" as "displayed in her willingness to assist peers, supervisors and other department members" and noted that she had received the Chairman's Award for outstanding service. Ms. Moore believed that the 10.1% increase was insufficient; she believed she was entitled to a 20% raise, although, as she acknowledged at trial, it is "probably" true that no employee had ever been given a merit increase of that size. On her next PDS, in March of 1989, Moore was rated "exceeds" and received another 11% increase.

126. On one occasion, after a meeting of unit employees, Stephanie Baker asked Ms. Moore for suggestions on work efficiency. Ms. Moore, who was at this time a Data Prep B, suggested that only Data Prep As should be assigned to work on a project involving pre-authorized check payment of insurance premiums ("PAC"). Ms. Baker rejected the suggestion. Ms. Moore recalls that she was not disrespectful to Ms. Baker and that Ms. Baker was not angry with her; nevertheless, the following Monday Ms. Moore was summoned to meet with Mr. Hjerpe, who told her that he understood she "had a problem with work flow." Ms. Moore denied having any such problem. Her PDS for that time period rated Ms. Moore as "exceeds."

127. On one occasion, a few minutes before the scheduled start of the work day, John Mueting, at that time a supervisor in another unit, asked Ms. Moore to help him with some work. Ms. Moore declined, explaining that the system was down and that she was busy preparing to do her Data Prep B work. Mr. Mueting repeated his request more than once, but Ms. Moore continued to refuse it. Shortly thereafter, Vicki Kummer, the unit manager, directed Ms. Moore to meet with Ms. Kummer and Mr. Mueting in an empty office. Ms. Kummer asked Ms. Moore whether she understood Allstate policy on insubordination. Ms. Moore denied having been insubordinate, but Ms. Kummer stated that she had been, and asked whether Ms. Moore understood. Rather than saying that she understood, Ms. Moore only responded, "I hear you." Ultimately, Ms. Kummer referred Ms. Moore to Human Resources; when Ms. Moore explained the events to Rodney Daniels in Human Resources, Mr. Daniels concluded she had not been insubordinate.

***34** 128. In spite of the fact that Mr. Mueting himself considered Ms. Moore to be an excellent employee, he never recommended her for a promotion. According to Defendant, the only position for which he could have recommended her was UCU, a position she did not want. In fact, in 1988, Eric Hjerpe approached every one of the Data Prep Bs in the Eastern Territory, including Ms. Moore, and asked whether he or she would accept a transfer to UCU. All declined. Mr. Hjerpe then posted the position. Janice Letteri, a white employee who began working at Allstate at the same time that Ms. Moore did but whose most recent PDS ratings were not as high as Ms. Moore's, applied for the posted position and was awarded the posting effective June 1988. Also in 1988, Mr. Hjerpe hired a black employee from outside Allstate for another vacant UCU slot. It is undisputed that Ms. Moore was qualified for the position.

129. In 1987 or 1988, Ms. Moore complained to Jane Alexander in Human Resources about what she perceived to be an unequal distribution of general time points. Moore claimed that whites received more opportunities to receive such points than did blacks. Ms. Alexander discovered, on performing a spotcheck, that Ms. Moore herself had performed far less data collection work (for which specific points were assigned) than her co-workers, but received far more general time points than other data preps.

130. As of December 20, 1988, Ms. Moore was the highest paid Data Prep B, with the exception of a white woman hired by Allstate one year before her. On her March 1989 PDS, Ms. Moore was again rated "exceeds" and awarded an 11% salary increase. After her transfer to the UCU position, Ms. Moore voluntarily terminated her employment with Allstate in 1990.

Pat Hood

131. Plaintiff Pat Hood, a registered cardiology technician, began working for Allstate in October 1984 as a claims examiner. By January 1988, Ms. Hood was working as a Data Prep A. She had moved to that Grade 4 position from a Grade 3 position as Data Processor A, but did not receive a salary increase. Ms. Hood's first supervisor as Data Prep A was John Mueting. Mr. Mueting told Ms. Hood in January 1988 that Lois Newberry would be her trainer. Ms. Newberry was not present at the time, however, so Mr. Mueting directed Ms. Hood to sit with any available Data Prep B to begin learning the Data Prep A functions. Two or three weeks later, Ms. Hood began her formal training. At or about the same time, Anita Hartmann, a white employee, entered the unit and was assigned to be trained by Peggy Labus.

132. Lois Newberry, Ms. Hood's trainer, left the unit in April 1988 and was on sick leave for part of the time prior to that. Ms. Hood herself was out on sick leave from February 2, 1988 through March 4, 1988. Soon after she began working in the unit, Ms. Hood complained to Mr. Mueting about inadequate training. She claims that the only assistance he provided was an instruction that when Ms. Newberry was unavailable, Ms. Hood should sit with other employees to get training. In a note written to Ms. Hood in April 1988, Mr. Mueting asked whether she needed any additional training; Ms. Hood did not respond. She did initial forms acknowledging having received training, but explains that she did so even though she had not actually received the training because Mr. Mueting assured her she would eventually receive the necessary instruction. As of September 1988, her training was still not complete.

***35** 133. After Lois Newberry's promotion, Ms. Hood received some training from Peggy Labus and other training from other employees when they were available to assist her. In June 1988, supervisor Christine Swiss again asked Ms. Hood what additional training she needed. Subsequently, Ms. Swiss arranged for additional training for Ms. Hood on "short downs" and "sales suspense" tasks. At trial, Ms. Hood testified that she complained to her supervisor that Lois Newberry was a bad trainer; in her deposition, Ms. Hood testified that she never complained about Ms. Newberry. Similarly, Ms. Hood testified at trial that she complained about her training to Christine Swiss, but in her deposition she denied making any such complaints.

134. Like Plaintiffs Dicker and Moore, Ms. Hood complains of Janice Letteri's promotion to the UCU position in June 1988. Ms. Hood notes that Ms. Letteri had lower production figures than Ms. Hood did. Like Plaintiff Dicker and Moore, however, and unlike Ms. Letteri, Ms. Hood did not post for the UCU slot.

135. Ms. Hood's first PDS while in Underwriting in December 1988 rated her as "acceptable, needs improvement." Ms. Hood refused to sign the PDS. She believed that it unfairly penalized her for Allstate's failure to provide her with effective training. She noted that one of the functions described in the PDS as among her responsibilities ("APS check reversal") was one on which she had not yet been trained. Anita Hartmann, the white employee who started in the unit at the same time as Ms. Hood, received a PDS for the period January 1988 through January 1989 that reflected that she had received training on this assignment. Ms. Hood acknowledged, however, that that function constituted only a small part of her job.

136. As of December 20, 1988, Patricia Hood was the

highest paid Data Prep A in the Eastern Territory.

137. Ms. Hood never posted for any available UCU positions. In December 1989, she tendered her resignation, but subsequently changed her mind and remained employed there, was promoted in March 1990, and ultimately resigned later that year to pursue employment closer to her home. She testified that she did not feel she was treated unfairly after she filed her charge in 1988.

DISCUSSION

I. *Disparate Impact Claim*

A. *Standards of Proof*

Although the parties differ sharply concerning the appropriate statistical analysis of the evidence in this case, they agree that the controlling law is set forth in *Wards Cove Packing Co. v. Atonio,* 490 U.S. 642, 109 S.Ct. 2115, 104 L.Ed.2d 733 (1989). In *Wards Cove,* a class of non-white workers at an Alaska salmon cannery brought a disparate-impact challenge to their employer's hiring and promotion practices. Plaintiffs claimed these practices resulted in a racial stratification in which white workers predominated in skilled positions and non-whites were overrepresented in the unskilled cannery jobs. 490 U.S. at 646-48. In reversing and remanding a judgment in favor of the plaintiffs, the Supreme Court acknowledged that statistical proof alone can establish that an employer's hiring practices have a disparate racial impact. *Id.* at 650. Such proof is insufficient, however, the Court concluded, if the statistical analysis ignores the possibility that the racial imbalance is caused by factors beyond the employer's control-for example, the racial imbalance in the pool of qualified jobseekers. *Id.* at 651-652.

***36** The Court then went on to discuss other arguments raised by defendant. First, the Court noted, the plaintiff in a disparate impact case bears the burden of "'identifying the specific employment practices that are allegedly responsible for any observed statistical disparities.' " *Id.* at 656 (quoting *Watson v. Fort Worth Bank and Trust,* 487 U.S. 977, 994, 108 S.Ct. 2777, 101 L.Ed.2d 827 (1988)). The Court referred to this issue as "the question of causation," and emphasized that plaintiffs in a disparate impact case must "demonstrate that the disparity they complain of is the result of one or more of the employment practices that they are attacking here...." *Id.* at 656, 657. To assist them in making that demonstration, the Court suggested, employees may need to consider records maintained by employers pursuant to EEOC regulations. *Id.* at 657-58.

If the plaintiff demonstrates that an employer's practices cause racial disparities, the court's inquiry shifts to the business justification offered by the employer for using the challenged practices. This analysis has two components: consideration of the justification offered by the employer, and the availability of alternative business practices with less racial impact. *Id.* at 658. Although the employer must offer more than "a mere insubstantial justification," the Court distanced itself from any suggestion that the challenged practice must be "essential" or "indispensable" in order to survive a disparate-impact challenge. Instead, according to the Court, "the dispositive issue is whether a challenged practice serves, in a significant way, the legitimate employment goals of the employer." *Id.* at 659. The employer must offer evidence on this matter, but it is plaintiffs who bear the burden of persuasion. If the plaintiffs cannot meet the burden of proving that the challenged practice does not serve legitimate goals, they may nevertheless prevail by offering alternatives that are "equally effective" in achieving the employer's goals without the undesirable racial effect, bearing in mind the attendant costs and burdens. *Id.* at 660-61.

Disparate impact challenges are often leveled at objective performance measures, such as the standardized tests at issue in *Melendez v. Illinois Bell Tel. Co.,* 79 F.3d 661 (7th Cir.1996) and *Allen v. Seidman,* 881 F.2d 375 (7th Cir.1989). As the Supreme Court recognized in *Watson,* however, a subjective hiring or evaluation practice may also be subject to such a challenge. Thus, in *Mozee v. American Commercial Marine Serv. Co.,* 940 F.2d 1036 (7th Cir.1991), plaintiffs demonstrated the unlawful disparate impact of defendant's practice "of allowing its foremen complete discretion in their choice of whom to promote." *Id.* at 1044, 1045-46. In this case, Plaintiffs challenge a performance evaluation system that has both objective and subjective components.

To make out a prima facie case, Plaintiffs bear the burden of proving that the practice they challenge has caused the loss of pay increases or promotions. To do so, they must present evidence of statistical disparities between racial groups that are "sufficiently substantial that they raise such an inference of causation." *Watson,* 487 U.S. at 995; *see also* *Cox v. City of Chicago,* 868 F.2d 217, 220 (7th Cir.1989) (effect of challenged rule must be "'significant' or 'substantial' ") (citing *Griggs v. Duke Power Co.,* 401 U.S. 424, 426, 91 S.Ct. 849, 28 L.Ed.2d 158 (1971)); *Morgan v. Harris Trust and Sav. Bank,* 867 F.2d 1023, 1028 (7th Cir.1989) ("[i]t is well settled that evidence of statistical disparity must be significant or substantial to establish that an otherwise neutral employment practice results in a discriminatory impact").

***37** Statisticians consider whether a significant difference between groups is shown by reference to the "standard deviation": a measure that "quantifies the degree to which disparities spread out above and below the mean of distribution...." *Coates v. Johnson & Johnson,* 756 F.2d 524, 537 n. 11 (7th Cir.1985). The higher the number of standard deviations, the lower the probability that the result occurred by chance. *Waisome v. Port Auth. of New York and New Jersey,* 948 F.2d 1370, 1376 (2d Cir.1991).

Both parties' statistical experts in this case recognized two standard deviations between the groups being compared as a minimum standard of statistical significance. The Seventh Circuit, likewise, has endorsed this standard. *See* *E.E.O.C. v. Chicago Miniature Lamp Works,* 947 F.2d 292, 300 n. 4 (7th Cir.1991) (citing *Hazelwood School Dist. v. United States,* 433 U.S. 299, 308 n. 14, 97 S.Ct. 2736, 53 L.Ed.2d 768 (1977) for the proposition that "the hypothesis that decisions were made without regard to a protected characteristic is suspect if there are more than two standard deviations between the actual value and the expected value"). *But see* *Coates,* 756 F.2d at 547 n. 22 (courts should use caution in drawing conclusions of statistical significance at a two to three standard deviation level); *E.E.O.C. v. Sears, Roebuck & Co.,* 628 F.Supp. 1264, 1286-87 (N.D.Ill.1986), *aff'd,* 839 F.2d 302 (7th Cir.1988) (differences that exceed three standard deviations may be statistically significant); *E.E.O.C. v. Western Elec. Co.,* 713 F.2d 1011, 1018 (4th Cir.1983) ("courts 'should be extremely cautious in drawing any conclusions from standard deviations in the range of one to three' ") (quoting *E.E.O.C. v. American Nat'l Bank,* 652 F.2d 1176, 1192 (4th Cir.1981)).

Another way of assessing statistical significance focuses on the "*p* value"-a measure of the likelihood that a given result will occur by chance. Where the probability (*p* value) that the differences between two groups of subjects is merely a product of chance falls below .05, the court will reject the chance hypothesis and conclude that a statistically significant showing has been made. *See, e.g.* *Daniels v. Pipefitters' Ass'n Local Union No. 597,* 945 F.2d 906, 924 (7th Cir.1991), *cert. denied,* 503 U.S. 951, 112 S.Ct. 1514, 117 L.Ed.2d 651 (1992); *Ottaviani v. State Univ. of New York at New Paltz,* 875 F.2d 365, 371-72 (2d Cir.1989); *Segar v. Smith,* 738 F.2d 1249, 1282 (D.C.Cir.1984). The court refers to both methods of assessing significance in its discussion of Plaintiffs' claims that the PDS system had an adverse effect on their wage growth and promotion rates.

B. *Wage Growth*

Plaintiffs here offered no statistical evidence of any difference in the wage growth of white and black nonexempt employees. Instead, to prove their wage growth claim, Plaintiffs rely on the statistical disparity between overall PDS ratings awarded to black employees and those awarded to whites. Wage increases at Allstate were explicitly linked to PDS scores, Plaintiffs note; it logically follows that a disparity in overall PDS ratings must translate into a disparity in wage increases as between whites and blacks.

***38** In fact, however, several factors other than PDS scores alone influenced wage increases at Allstate. For example, the employee's "compra ratio" (*see* Findings ¶ 25) and the length of time since the employee's last increase had an influence. Further, Allstate made salary adjustments from time to time that affected all employees within a particular pay grade.

Plaintiffs suggest that, to the extent these other factors "corrected" the disparate impact of PDS scores on wage growth, they should not bar a finding of liability.

In *Connecticut v. Teal,* 457 U.S. 440, 102 S.Ct. 2525, 73 L.Ed.2d 130 (1982), the plaintiff challenged a Connecticut state agency's requirement that candidates for a supervisory position pass a written examination that had a significantly lower pass rate for blacks than for whites and that was not shown to be job related. *Id.* at 443-44. In defense of its procedure, the state agency noted that additional factors in the promotion process resulted in promotion of a greater percentage of black than white candidates, with the result that the "bottom line" of the promotional process-that is, the numbers of persons selected for promotion-reflected racial balance. *Id.* at 444.

The Court was not persuaded. Title VII guarantees *each individual* a fair promotional opportunity, the Court observed. *Id.* at 453-54. Because the written examination was an absolute barrier to further consideration for individual applicants, and had a significant adverse effect on minorities, defendant's practice denied an employment opportunity to those candidates who did not pass. The fact that defendant had evidence of racial balance in the "bottom line" numbers of promotees did not constitute a defense to plaintiff's disparate impact showing. *Id.* at 455-56.

The situation in *Teal* was different from this one, however, in that the employer in that case made a conscious effort to achieve racial balance, apparently by manipulation of the factors other than the promotional examination. In this case, there is no basis for a conclusion that any of the non-PDS factors in the wage increase equation-the employee's "compra" ratio; the length of time since the employee's last PDS; the across-the-board adjustment-were the product of efforts to eliminate whatever effect the PDS had on wages. Thus, if the PDS had a disparate effect on wage growth, that effect should remain apparent, in spite of the other factors involved in determining any individual employee's wage increase.

Yet Defendant's statistical analysis found no statistically significant difference in the wage growth of black and white employees. As noted (*see* Findings ¶ 75), Dr. Topel found only a small (.007%) difference in the average wage growth between blacks and whites. That difference, less than half a standard deviation, falls well below the standard for statistical significance. These results were the same whether or not Dr. Topel included within his analysis persons who worked in nonexempt underwriting positions outside the court-defined class period, and whether or not he ended the analysis at the time that Plaintiffs filed their charge. Dr. Topel concluded that the PDS ratings did not create a statistically significant difference in the wage growth of black and white nonexempt employees in the Underwriting Department. Plaintiffs criticize Dr. Topel's analysis on the basis that he did not exclude the effect of Department-wide salary "adjustments," non-merit wage increases which improved the lot of all employees (white and black), and might, Plaintiffs suggest, have masked the effect of black-white disparities in wage increases. Thus, for example, Plaintiffs contend that Dr. Topel "simply ignored the impact of the PDS scores on wage growth by refusing to isolate their influence on merit increases and remove non-merit-related factors." (Plaintiffs' Post-Trial Reply Brief, at 11.) Unfortunately, however, Plaintiffs themselves performed no wage-growth analysis at all. Thus, Plaintiffs offer nothing to support their suspicion that, had Dr. Topel removed "non-merit-related factors" from his analysis, the result would reflect disparate impact.

***39** The court concludes that Plaintiffs have not met their burden of showing a statistically significant difference in wage growth among black and white employees. Plaintiffs' claim that the PDS system resulted in such a difference is dismissed.

C. *Promotional Opportunity*

Defendant argues that Plaintiffs' promotional opportunity claim must also be dismissed. First, Defendant points to the results of its expert's statistical analysis of the likelihood that a "job spell" would end in promotion. Within the relevant time frame, job spells ended in promotion 36% of the time for white employees, and 34% of the time for blacks-not a statistically significant difference. To satisfy a concern that the employee's job grade, PDS rating, or number of days absent might exert enough of an influence over likelihood of promotion as to mask the race effect, Dr. Topel controlled for those factors, but still found no statistically significant difference in the likelihood of promotion for blacks and whites. Notably, when Dr. Topel controlled for job grade and absences, but not for PDS ratings, he found no statistically significant difference in the likelihood of promotion between blacks and whites. Thus, the difference between black and white employees in average pay grades advanced per year was virtually zero if the number of days of absence were held constant.

Plaintiffs' expert, Dr. Mendel, did find a significant difference in those promotion rates, but the court finds his statistical analysis less persuasive for several reasons. First, as Dr. Topel explained, Dr. Mendel utilized a test statistic, the Kruskall-Wallis, that is more appropriate for ordinal data. The data Dr. Mendel considered is, strictly speaking, ordinal because he counted the number of promotions each employee received and assumed that an employee who was promoted more often had received more favorable treatment than one promoted less often. That assumption does not fit the facts of this case well, however; a person promoted only once after four years on the job cannot fairly be said to have received more favorable treatment than an employee who has never been promoted but has been on the job for only a few months.

Further, both experts acknowledged that the Kruskall-Wallis test statistic must be adjusted to account for ties in the data. Here, the number of ties (*i.e.,* the number of persons in the sample who had been promoted the same number of times) was quite large, requiring that the Kruskall-Wallis statistic be adjusted by 37%, a correction that Dr. Topel testified credibly was large enough to render the statistical results suspect. When Dr. Mendel's data was evaluated using the chi square statistic utilized by Dr. Topel, there was no statistically significant difference in the number of pay grades advanced by black and white nonexempt employees in the Underwriting Department.

Beyond these concerns regarding the appropriateness of the Kruskall-Wallis statistic, the court finds certain of Dr. Mendel's factual assumptions puzzling. Most important, in counting promotions, Dr. Mendel excluded any promotions to positions outside the Underwriting Department. The result of this exclusion was that persons promoted outside the Department were counted as having received no promotion at all. Such a result appears inappropriate because the evidence shows that promotion to a position outside the Department required a favorable recommendation from the employee's supervisor. Moreover, Plaintiffs themselves appeared to understand promotion outside the Department as a positive outcome: named Plaintiff Rhonda Moore repeatedly voiced her desire for a position in Acceptance Testing in lieu of promotion within the Underwriting Department and claimed that Defendant's failure to award her the Acceptance Testing position was a product of discrimination. If promotions outside the Department are considered, then there is no statistically significant difference in promotion rates for blacks and whites, even under Dr. Mendel's analysis.[FN12]

FN12. After hearing some of Defendant's evidence, Dr. Mendel performed an additional analysis, utilizing the chi square analysis relied on by Dr. Topel, rather than the Kruskall-Wallis test. According to Dr. Mendel, this analysis revealed a statistically significant black-white differential in numbers of pay grades advanced, controlling for the employees' starting grade and tenure with Allstate. Defendant argues that this analysis itself is flawed because it failed to measure the difference between blacks and whites in numbers of pay grades advanced per unit of time. In any case, as Defendant demonstrated, when promotions outside the Underwriting Department are included, then even under Dr. Mendel's model there is no statistically significant black-white difference in pay grades advanced.

***40** The court-certified class consists of black nonexempt employees in the Underwriting Department through June 21, 1989. Because Plaintiffs filed their EEOC charges on December 1, 1988, however, Dr. Mendel's statistical analysis excluded all data after that time. The rationale for such an exclusion is straightforward: After being placed on notice of Plaintiffs' claims, Allstate might be expected to make particular efforts to eliminate the effects of past discrimination by more favorable treatment of black employees. Yet in this case there was no evidence that such efforts were made; indeed, Plaintiffs offered no evidence that any of the first-line supervisors who made PDS ratings decisions were even aware of the filing of the charges. Thus, this court concluded that the exclusion of data from 1989 was inappropriate.

In addition to his exclusion of post-November 1988 data, Dr. Mendel's analysis utilized a "six-month filter"-that is, Dr. Mendel included within his analysis only those employees who had been on the job for at least six months. As a result of the exclusion of 1989 data and of the six-month filter, all of Dr. Mendel's analyses excluded data concerning persons who were first employed at any time after July 1, 1988, a large chunk of the court-certified class.

Dr. Mendel believes the criticisms leveled by Defendant at the Kruskall-Wallis test are somewhat irrelevant because he believes the data in this case will reveal significant race disparity if analyzed using a "one-tailed" standard for statistical significance. Unlike the more common "two-tailed" standards, which assess the likelihood that any differences between two groups would occur by chance, a one-tailed standard assumes that any deviation from what might be predicted by chance will be in only one direction. For purposes of this case, a one-tailed standard assumes that any differences in outcomes for white and black employees reflect more favorable outcomes for whites. Even if one assumes the truth of this assumption,[FN13] this court is unwilling to relax the standards necessary for a showing of statistical significance as Dr. Mendel suggests. The Court of Appeals for the District of Columbia addressed this issue at some length in *Palmer v. Shultz,* 815 F.2d 84 (D.C.Cir.1987). In that case, female foreign service officers challenged the State Department's promotional practices and argued, *inter alia,* that any statistical difference in promotion rates could only reflect adverse results for women. 815 F.2d at 89, 114. Thus, plaintiffs argued, a one-tailed standard was appropriate, and where the probability that women would be underselected to the extent shown by the evidence was only four percent, the court should find a statistically significant sex effect. The court was unwilling to adopt this approach, however:

FN13. The assumption has common sense appeal. Although Plaintiffs challenge the PDS system under a disparate impact theory, their claim assumes that individual subjective decisions were adverse to blacks. The majority of supervisors and managers were white and college-educated, and a far larger proportion of the nonexempt employees were black. Nevertheless, the court notes that the assumption is subject to at least some further scrutiny. The black doll incident in the spring of 1987 undoubtedly made at least some supervisors aware that their conduct could have racial impact. The evidence shows that in June 1988 Eric Hjerpe was conscious enough of race issues at Allstate that he asked a black supervisor, Patrice Boone, to assist him in communicating with black employees. Defendant points out that Allstate supervisors and unit managers were evaluated on their ability to help their minority employees develop additional skills and suggests that "Allstate unit supervisors and unit managers had a direct incentive tied to their own PDS rating to promote and further the careers of their black employees." (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 34, n. 25 (emphasis in original).) And Plaintiffs themselves have suggested that the court should disregard statistical information that post-dates the filing of their charges of discrimination, a tacit acknowledgment that Allstate may have made conscious efforts after that point to eliminate the adverse race impact of the PDS system. The assumption that differences between the treatment of blacks and whites prior to that date must have favored white employees is, thus, not a perfectly safe one.

Even if in the case before the court the disparity disfavors women and not men, how can the court ignore the possibility that the case might still be one of the 8% cases in which a fair selection process would by chance produce disparities in this magnitude or greater? Thus, we think a court should generally adopt a two-tailed approach to evaluating the probability that the contested disparity resulted by chance...... Consequently, if plaintiffs come into court relying *only* on evidence that the underselection of women for a particular job measured 1.75 standard deviations, it seems improper for a court to establish an inference of disparate treatment on the basis of this evidence alone. ***41** *Id.* at 96. The court went on in a footnote to observe that under Supreme Court precedent, it is improper to lower the threshold for statistical significance below 1.96 standard deviations, "whether one views this number as signifying a 5% probability of randomness using a two-tailed approach or a 2.5% probability of randomness using a one-tailed approach." *Id.* at 96 n. 9.

This court finds the *Palmer* court's analysis sound. Indeed, insistence on use of a "two-tailed" standard is arguably more appropriate here than in *Palmer,* where plaintiffs argued that they were victims of disparate *treatment;* here, where Plaintiffs claim that a facially neutral (albeit subjective) practice had a disproportionate impact, they must demonstrate that the effect is robust enough to meet standards commonly relied on by social scientists. To the extent that Dr. Mendel's analysis does not result in a finding of significance at the $p < .05$ level, his findings cannot be shored up by reliance on a "one-tailed" standard.

As with the wage growth claim, Plaintiffs have argued that Defendant improperly relies on overall statistics showing the apparent absence of any statistically significant differences in promotional rates. Under *Teal,* a "bottom line" defense is unavailable to defeat a showing that the PDS has a disparate impact on promotional opportunities based on race. Thus, the argument proceeds, the fact that Defendant may have succeeded in eliminating the effects of the PDS on overall promotion rates should not constitute a defense. Defendant devotes significant attention to this argument in its opening brief (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 31-33), distinguishing *Teal* on several bases: First, unlike *Teal,* an individual disparate impact case, the Plaintiffs here must demonstrate that the PDS denied opportunities to a class. Thus, as the court observed in *E.E.O.C. v. Andrew Corp.,* 51 Empl. Prac.Dec. (CCH) ¶ 39,364 (N.D.Ill.1989), "Whereas the *Teal* court was troubled because a 'bottom-line' defense in that case precluded valid individual claims, in this case the EEOC's proof of adverse impact necessarily depends upon the fortune of the group." Defendant argues, further, that if Plaintiffs rely on *Teal,* they must identify at least some individual class members who were denied promotions that, but for the PDS system, they would have received.

This court is not prepared to accept the argument that *Teal* has no application in a class action. Nevertheless, the court concludes, as with respect to the wage claim, that *Teal* does not provide a basis for ignoring the showing Defendant has made that there is no statistically significant difference in promotional opportunities between whites and blacks. *Teal,* again, presented a situation in which the employer made efforts to achieve racial balance in promotions in spite of the fact that a promotional examination eliminated black candidates in significantly greater numbers than whites. The fact that blacks who did pass the examination were more likely to be promoted than whites did not ameliorate the effect of the exam on blacks who did not pass. Here, in contrast, although there certainly were individual black employees who were passed over for promotion on the basis of a poor PDS score, there is no basis for a conclusion that blacks who did achieve high PDS scores were more likely to be selected for promotion than whites.[FN14] Nor is there any basis for suspicion that any non-PDS-related factors in promotion decisions were aimed at *eliminating* the racial disparatures in PDS scores. Thus, if there is no overall showing of a significant race difference in promotional opportunities at Allstate, the court must conclude that the PDS system does not have an adverse impact on the promotional opportunities of blacks at Allstate.

> FN14. Plaintiffs' disparate treatment claims urge that the contrary is true. (*See,* for example, Plaintiffs' Proposed Findings of Fact and Conclusions of Law ¶¶ 239, 249.)

***42** Dr. Topel's analysis found no statistically significant difference in the promotion rates of blacks and whites, and no difference at all when he controlled for job grades and days of absence. Dr. Mendel's analysis did reveal a difference, but for the reasons described above, the court finds his analysis flawed. In particular, Dr. Mendel's decision to include promotions outside the underwriting department is inappropriate and inconsistent with a central claim of one of the named Plaintiffs. The court concludes that Plaintiffs have not met the burden of showing a statistically significant difference in promotion rates among black and white employees. Their claim that the PDS system produced such a difference is dismissed.

D. *Disparate Impact of Overall PDS Ratings*

As noted, Plaintiffs have focused their attention in this case on the overall PDS ratings themselves. For the reasons described above, the statistical evidence appears to support Defendant's argument that Plaintiffs have not demonstrated that the PDS system harmed them because they have not shown that PDS ratings mapped into significant race differences in wage growth and promotional opportunities. Nevertheless, both parties have devoted considerable attention to the overall PDS ratings themselves, litigating and briefing the issue of whether the PDS system was applied equally to black and white nonexempt Underwriting employees. Indeed, in Plaintiffs' view, "[e]ven if [Defendant's] promotional and wage growth analyses were correct, ..., they cannot undermine the undisputed *prima facie* case that the PDS scores *themselves* are discriminatory and have a direct and substantial relationship to salary increases and promotions." (Post-Trial Brief for Plaintiffs, at 3.)

It is undisputed that black employees in Allstate's Underwriting Department had lower PDS scores than did whites. Whites substantially outnumber blacks (33% to 20%) in receiving an "exceeds" rating, and twice as many blacks (30%) as whites (15%) received "needs improvement" or "requires immediate improvement" ratings. Although, for the reasons discussed above, there appears to be no statistically significant difference in the promotion rates of whites and blacks, Plaintiffs urge that the link between PDS scores and promotional opportunities is also undisputed. They note that a much greater percentage of those employees rated "exceeds" (44%) on the most recent PDS were promoted than those rated "meets" (14%), and that no employee with a "needs improvement" or "requires immediate improvement" rating was promoted. (*Id.* at 8.) They point out, further, that Allstate's written directives link higher salary increases with higher PDS ratings.

Defendant concedes the substantial race differences in PDS scores, but argues that the race effect is reduced to statistical insignificance if the analysis controls for the individual subratings of quality scores, quantity scores, and attendance. According to Dr. Topel, the ratings an employee received on quality, quantity, and attendance explained away the significant race difference between the chances of receiving a "needs improvement" or an "exceeds" rating. As the Seventh Circuit has observed, successful performance on an evaluation mechanism may be influenced by factors other than race; if these other factors account for enough of the variance as to render any race effect statistically insignificant, then there is "no proof of disparate impact." *Allen v. Seidman,* 881 F.2d at 378.[FN15]

FN15. Plaintiffs suggest that Dr. Topel's analysis must be disregarded for the reason, among others, that the three factors he considered accounted for only 33% of the variance. In the cases they cite, however, courts concluded that *plaintiffs* had not proven their claims by means of studies that accounted for only 45% (*Griffin v. Board of Regents,* 795 F.2d 1281, 1291 (7th Cir.1986)) or 52% (*Wilkins v. University of Houston,* 654 F.2d 388, 403-4 (5th Cir.1981), *vacated on other grounds,* 459 U.S. 809, 103 S.Ct. 34, 74 L.Ed.2d 47 (1982)) of the variance between performance of the protected group and others. As noted, in *Allen* the Seventh Circuit recognized that if an analysis accounts for enough of the variance that no significant race effect remains, there is no showing of disparate impact. Thus, if Dr. Topel's analysis is otherwise legitimate, the fact that other factors account for enough of the variance as to reduce the disparate impact showing below statistical significance will constitute a defense to Plaintiffs' claims.

***43** Plaintiffs insist this type of analysis is inappropriate. Although it may make sense to control for "independent and neutral factors such as education, seniority, age, job title and hiring qualifications," Dr. Topel's analysis here is flawed, say Plaintiffs, because the three subratings themselves are "subjective and prone to discrimination." (Post-Trial Brief for Plaintiffs, at 13, 14.) In *James v. Stockham Valves & Fittings Co.,* 559 F.2d 310 (5th Cir.1977), a class of black workers alleged that defendant employer had discriminated against them in promotions and job assignments. *Id.* at 313. Reversing a judgment for defendant, the court specifically rejected a statistical analysis aimed at isolating the effects of various factors in the plaintiffs' slow advancement. The court noted that defendant's expert had included, among the purported objective variables, factors that plaintiff believed were themselves the product of supervisory bias-for example, "skill level," which was a function of the employee's job assignment, and "merit rating," which was the product of the supervisor's subjective evaluation. *Id.* at 332. In addition, defendant's expert included, as a purported objective factor, the employees' educational level, although it was not a job requirement. The court concluded that the fact that plaintiffs' poor progress could be attributed to these factors did not defeat a showing of disparate racial impact. *Id.* For related reasons, the court in *Bouman v. Block,* 940 F.2d 1211 (9th Cir.1991) was unmoved by evidence that female plaintiffs' poor performance on a promotional examination correlated with "the supposedly neutral factors of years of experience and familiarity with departmental examinations." *Id.* at 1229 n. 3. The court refused to assume without question the notion that years of experience and familiarity with the examination were associated with better performance in the desired position.

Certainly Plaintiffs in this case are correct that a regression analysis can be inappropriate where the factors considered as potential explanations for the disparate racial impact are themselves a product of discriminatory policies. The Seventh Circuit has acknowledged this, *Griffin v. Board of Regents,* 795 F.2d 1281, 1289-90 (7th Cir.1986), but appears to assign to the plaintiff the task of demonstrating the impropriety of the analysis. Thus, where a defendant offers a non-discriminatory factor as an explanation for a statistical disparity, plaintiff must demonstrate "that that factor was itself tainted with discrimination." *Mozee,* 940 F.2d at 1049 (citing *Coates,* 756 F.2d at 544.) [FN16] With this burden in mind, the court addresses Plaintiffs' challenge to the subratings below.

FN16. *Wilkins,* cited by Plaintiffs, also reflects the court's understanding that plaintiffs must prove that the purported independent factors (in that case, experience as an associate professor) were themselves a product of discrimination. *Wilkins,* 654 F.2d at 404.

1. Quantity Ratings

As noted, Plaintiffs argue that the individual subratings, including the quantity subrating, were themselves subjective; thus, the fact that these subratings explain a significant proportion of the race variance in PDS scores does not defeat the disparate impact claim.

***44** With respect to the quantity subrating, the argument finds little support in this record. Plaintiffs do not challenge the notion that an employee's productivity is an appropriate measure of her performance. At least one court has characterized "job knowledge, accuracy and productivity" as "the most concrete criteria upon which to base a promotion decision." *Grant v. Morgan Guaranty Trust Co.,* 638 F.Supp. 1528, 1537 (S.D.N.Y.1986) (citing *Sweeney v. Research Found. of State Univ. of New York,* 711 F.2d 1179, 1185 (2d Cir.1983)). Nor is there any basis for suspicion that the quantity measures utilized by Allstate in this case were inappropriate criteria. As described in the Findings of Fact, Allstate assigned points to various tasks in an effort to measure the work performed by each employee. The employees themselves kept tabs of the points they had earned; although Plaintiffs suggest that this system invited abuse, they offered no basis for a conclusion that white employees were more likely than black employees to over-report their productivity. There is no evidence that the employees themselves believed that assigning point totals to their work was inappropriate or inaccurate. Indeed, as Defendant notes, named Plaintiff Rhonda Moore had point totals far in excess of most of her peers. Certainly Moore would not argue that her high totals did not reflect superior work performance.

In 1987, several data entry employees in the three regions worked on a team to evaluate the point assignment system. The Entry Improvement Team, on which Plaintiff Moore participated, concluded that the point system should remain in effect, although certain of the points assigned to various tasks required adjustment. When the EIT presented its proposals to all data entry employees, none objected to reliance on such a system for measuring productivity. Employees met with their supervisors on a regular basis to discuss their progress, as reflected in part by their quantity scores. Again, there is no evidence that any employee objected to his or her quantity score as an inaccurate measure of performance.

Plaintiffs themselves have not explicitly argued that the quantity measure discriminated against black employees. They argue, instead that "there is no evidence to prove these subratings [quality, quantity and attendance] are not susceptible to or infected by discrimination." (Post-Trial Brief for Plaintiffs, at 14.) On this record, the court finds no basis for suspicion that the quantity rating was so infected. Although Plaintiffs point out that the quantity measure was vulnerable to abuse by employees, there was no evidence that employees did, in fact, over-report their production. More importantly, there was no evidence that white employees were more likely than blacks to inflate their productivity scores. Finally, Plaintiffs have offered no argument or evidence that the quantity measure is unrelated to Allstate's legitimate goals. *Ward's Cove* teaches that Plaintiffs might nevertheless prevail if they can offer an alternative standard that would have met Allstate's goals. Here, however, Plaintiffs have not suggested what alternative standards would serve Allstate's objective of promoting productivity among its nonexempt employees. Their criticism of the quantity standard fails.

2. Quality Ratings

***45** The quality of most nonexempt employees' work was assessed in two ways: by means of "spotchecks," and as part of the "quality verification" process in issuance of the policy. Again, Plaintiffs do not argue that assessment of the accuracy of the work performed is inappropriate. Instead, Plaintiffs have argued that, as Dr. Mendel testified, the quality measures did not function effectively to reflect actual differences between employees. Dr. Mendel noted, for example, that all quality scores were clustered in the very high percentages, and that very slight differences in quality scores translated into different ratings. *See* Findings ¶ 66d. In order for such fine distinctions to measure meaningful differences, Dr. Mendel testified, Allstate would need to evaluate much more of the work performed by each employee than it did. In addition, Dr. Mendel suggested that the quality or accuracy scores were poor measures because in some instances, a given task presented a number of error possibilities; other tasks included comparatively fewer specific steps, with less opportunity for error. Yet employees assigned to error-intensive tasks were compared with employees whose assignments were less likely to yield high error scores.

Defendant argues that the quality scores nevertheless serve legitimate objectives. First, the fact that employees' performances were checked for accuracy would, presumably, impress upon them the need for accuracy and blunt the temptation to sacrifice accuracy in favor of high scores. Second, Defendants note, employees themselves did not perceive the quality assessment mechanism as unfair or inaccurate. Pat Hood, for example, who received a low quality score during one evaluation period, complained that her low score was the result of inadequate training, not that the score itself was inaccurate. As with the quantity ratings, the Entry Improvement Team chose to continue with the spotcheck procedure, and no employee objected to this measure.

Again, Plaintiffs have not suggested a practicable alternative measurement of the accuracy of nonexempt employees' work. In order for the accuracy scores to have the degree of validity that Dr. Mendel believes is necessary, he testified, Allstate would need to check approximately 1,500 files per employee per month. Allstate contends that such extensive checking would have been wholly impracticable. There simply were not enough supervisory staff to do such checking. Courts do recognize that the practicability of the evaluation mechanism is a relevant factor in determining job-relatedness. *See Robinson v. Talladega Revenue Comm'n,* 1987 U.S.Dist. LEXIS, at *9 n. 12 (N.D.Ala.1987) (spotcheck procedure was job-related where "the quantity of the records made it impracticable to check all records every day"). *Wards Cove* recognized that a proposed alternative to the employer's challenged practice must take into account the costs and burdens of the alternative. 490 U.S. at 660-61. This court concludes that Plaintiffs' challenges to the quality performance measure do not survive scrutiny.

3. Attendance Ratings

***46** Again, Plaintiffs do not dispute the propriety of evaluating employees on the basis of their attendance. Nor do they raise any challenge to the accuracy of the attendance calendars, which were composed from data reviewed by employees themselves. Plaintiffs do argue that Allstate's measurement of attendance was not job-related because supervisors exercised discretion in counting absence occurrences. Granting such discretion to first-line supervisors, most of whom were white, provided an avenue for treating black employees less favorably, Plaintiffs believe.

Plaintiffs' suspicion is understandable. Supervisors testified to a variety of approaches in making determinations concerning numbers of absences and tardies. And, although Allstate had written attendance policies, supervisors' testimony reflected poor understanding of the written standards. Nevertheless, the record does not support the conclusion that the exercise of discretion operated to disfavor blacks. Although supervisors testified to inconsistent policies, there was no evidence that any individual supervisor applied his or her own policy inconsistently. Nor is there any evidence that black employees were more often assigned to work under supervisors having more stringent attendance practices. Most significantly, Dr. Topel performed an analysis of attendance records in which non-consecutive absences were always treated in the same fashion. His analysis found no difference in treatment between whites and blacks.

This court concludes that Plaintiff has not shown that any of the subratings discriminated against blacks.

D. *Job-Relatedness of the PDS*

For reasons discussed above, the court concludes that the individual components of the PDS score-quantity of work, quality of work, and attendance [FN17] -"serve[ ], in a significant way, the legitimate employment goals of the employer." *Wards Cove,* 490 U.S. at 659. Allstate argues that the overall PDS evaluation system is also job-related. Defendant contends that overall PDS scores not only fairly measure performance in the assigned job, but also provide a reliable prediction of performance after a promotion. Plaintiffs' own expert has concluded that whether the overall PDS may predict performance in a promotion position "bears directly on the job relatedness/validity/business necessity question."

FN17. Defendant does not challenge Plaintiffs' criticisms of the "deportment" factor of the overall PDS score, but argues that the three remaining factors account for enough of the variance that no statistically significant race impact remains.

The only evidence in the record on this question supports Defendant's position. Dr. Topel examined PDS ratings at the time of promotion (or just prior to the promotion date) with the first PDS after the promotion. He found a strong correlation between the two scores. *See* Findings ¶ 92. The court agrees that an accurate prediction of job performance in a new position is a legitimate employment goal.[FN18] *Cf. Melendez v. Illinois Bell Tel. Co.,* 79 F.3d at 669 (7th Cir.1996) (plaintiff's disparate impact claim supported by expert testimony that there is no correlation between performance on challenged test and performance in job for which applicant is being tested).

FN18. Plaintiffs concede as much by offering an analysis that they believe demonstrates the opposite-that is, that PDS scores do not accurately predict performance following promotion. Plaintiffs ultimately withdrew that analysis because of inaccuracies in the database.

***47** There is, to be sure, much to criticize in Allstate's performance evaluation system. Most serious, in this court's view, was the "churning" of inexperienced young workers into supervisory positions. These young people, often fresh from college or other professional training, were assigned to supervise and evaluate far more seasoned clerical workers. Supervisors lacked any formal training in supervision and often relied on their own subordinates for training in the jobs being performed in their work units. Supervisors were frequently called upon to write annual performance evaluations on employees they had supervised for only a few weeks or months. The fact, emphasized by Allstate, that the previous supervisor(s) in each unit was ordinarily in close physical proximity to the new supervisor, could not completely ameliorate this structural problem. Although supervisors utilized "desk file" and past "one-on-one" records, there were numerous instances in which those files were at least partially incomplete.

Finally, Allstate presents no argument at all for utilization of the "salary planning" targets in the performance evaluation process. As noted (Findings ¶ 22), no supervisor felt bound by the previous fall's prediction concerning an individual employee's performance, nor was any supervisor required to account for his or her decision to depart from the prediction set forth in the plan. Under these circumstances, there would appear to be no need at all to provide plan data to the evaluating supervisor, with the attendant risk that the PDS score becomes no more than a self-fulfilling prophesy.

There were at the same time, however, notable strengths in the PDS process. Each employee received monthly feedback on his or her performances, both in writing and in a private meeting with his or her supervisor. These "one-on-one" meetings addressed the same performance factors that weighed heavily in the annual PDS. Although Plaintiffs make much of the variations in the descriptions provided by supervisors of their evaluation process (*see* Findings ¶ 61), this court concludes that there was in fact significant consistency from one supervisor to the next. Every supervisor focused on quantity and quality of work performed; and, while Plaintiffs argue that these measures have not been properly validated pursuant to EEOC regulations,[FN19] they offer nothing to suggest that the production measure was not an accurate assessment of comparatively simple tasks. Unlike the kinds of measures that ordinarily fall to disparate impact scrutiny, measures of quality, quantity, and attendance are directly related to job performance. Indeed, Plaintiffs do not argue otherwise.

> FN19. Plaintiffs suggest that Allstate's failure to perform a formal job analysis is itself an indication that the PDS is not job-related. The court cannot accept the suggestion that the absence of a job analysis establishes liability. *See Tye v. City of Cincinnati,* 794 F.Supp. 824, 833 (S.D.Ohio 1992) ("[w]e refuse to adopt the rigid requirement that a hiring process cannot be job-related unless a job analysis is done"). *See also Aguilera v. Cook County Police and Corrections Merit Bd.,* 760 F.2d 844, 847 (7th Cir.1985), where the court observed that educational requirements for promotion are sometimes rejected where they have not been validated pursuant to EEOC guidelines, but noted that "the guidelines ... do not have the force of law" and that in some situations "the appropriateness of an educational requirement is sufficiently obvious to allow dispensing with empirical validation." *Id.* at 847. Although the quantity, quality, and attendance measures are not educational requirements, Defendant here argues that their propriety is sufficiently obvious that formal validation ought not be required.

Plaintiffs do present numerous examples of what they characterize as "play" in the system-*i.e.,* situations in which persons with similar underlying ratings on factors of quantity, quality, attendance, or deportment nevertheless received different overall PDS scores. Indeed, in their reply brief, Plaintiffs characterize "needless subjectivity" in the PDS system as the "central issue" concerning job relatedness. (Plaintiffs' Post-Trial Reply Brief, at 3.) This kind of subjectivity is troublesome, but significant here only if Plaintiffs demonstrate that it resulted in unfairness to blacks. Plaintiffs believe they have done so by offering evidence of overall racial disparities, but this begs the question of whether the overall disparities are a function of the exercise of discretion or of legitimate differences in valid performance measures. Under *Wards Cove,* it is Plaintiffs who must bear the burden of proving that the PDS system does not serve legitimate goals. Anecdotal evidence that Allstate made mistakes on occasion does not amount to proof that the overall PDS process was not job-related. *Tye,* 794 F.Supp. at 834. Alternatively, Plaintiffs may prevail by demonstrating that "other tests or selection devices without a similar undesirable racial effect would also serve the employer's legitimate interests...." *Gillespie,* 771 F.2d at 1045. Although Plaintiffs leveled effective criticisms of the PDS System, they offered no genuine proposal for a less-flawed system that would effectively evaluate job performance and otherwise serve Allstate's legitimate goals of encouraging employees to work quickly and accurately.

***48** The court concludes Plaintiffs have not met the burden of proving their disparate treatment claims.

II. *Disparate Treatment Claims*

Each of the three named Plaintiffs also brings an individual disparate treatment claim. The standards for proving such a claim are well-established and familiar.

Plaintiffs must present a *prima facie* case of disparate treatment by offering evidence that, left unexplained, gives rise to an inference of discrimination. In this case, a *prima facie* case would likely consist of evidence that similarly situated white employees were treated more favorably than Plaintiffs. If Plaintiffs make such a showing, Defendant may present evidence of legitimate, non-discriminatory factors that explain the difference in treatment; Plaintiffs then rebut such a showing by offering evidence that Defendant's purported reasons for its action are pretextual, and that discrimination more likely than not infected the decision. *See* *St. Mary's Honor Ctr. v. Hicks,* 509 U.S. 502, 506-07, 113 S.Ct. 2742, 125 L.Ed.2d 407 (1993); *McDonnell Douglas Corp. v. Green,* 411 U.S. 792, 802, 93 S.Ct. 1817, 36 L.Ed.2d 668 (1973).

Although Plaintiffs offered proposed findings on the individual disparate treatment claims, they make no other mention of those claims in their post-trial opening brief or reply brief, choosing instead to focus on the disparate impact claims. The court addresses each of the individual claims below.

A. *Velma Dicker*

Velma Dicker claims that she was treated unfairly in a variety of ways. From the testimony and proposed findings, the court gleans the following claims: (1) Gigi Soeder, a white employee hired after Ms. Dicker, was promoted before her in 1985; (2) Ms. Dicker's “acceptable/needs improvement” rating in July 1986 was too low; (3) supervisor Vicki Kummer assigned Ms. Dicker, but not two white co-workers, to run an errand, and chastised Ms. Dicker but not her co-workers for personal phone calls; (4) two white co-workers were promoted one month before Ms. Dicker in 1987; (5) Ms. Dicker was denied a review due in April 1988; (6) Ms. Soeder, but not Ms. Dicker, was granted a requested change in an error record; (7) Ms. Dicker was denied training; (8) Janice Letteri, but not Ms. Dicker, was promoted to the position of UCU in 1988; and (9) Eric Hjerpe instructed a black supervisor to be his “hatchet person.”

Defendant Allstate argues that the first four of these claims are untimely. Title VII requires an employee who believes she has suffered discrimination to file a charge with the EEOC within 300 days of the alleged wrong. *See*42 U.S.C. § 2000e-5(e). Plaintiff Dicker filed her charge on November 30, 1988. Thus, to the extent that Dicker's failure to promote claims, her challenge to her July 1986 PDS rating, and her claim of discriminatory treatment by Vicki Kummer are intended as independent claims for relief, they are dismissed. Moreover, for the reasons explained in Findings ¶ 100 this court concludes that Dicker's July 1986 PDS rating was not a product of discrimination. Allstate has offered a legitimate, non-discriminatory reason for its promotion of Dicker's two white co-workers one month before she herself was promoted-Dicker's July 1986 PDS rating-and Dicker has offered no evidence that that reason was pretextual.

***49** As explained in Findings ¶ 105, although Dicker believes she was entitled to an annual performance evaluation and raise in April 1988, the court concludes she was mistaken; in any event, Allstate did provide Dicker with a PDS in April 1988, though she received no salary increase until July of that year. As explained in Findings ¶ 110, Allstate has articulated a legitimate, non-discriminatory reason for the promotion of Janice Letteri to UCU in July 1988: Ms. Letteri posted for the position, but Ms. Dicker did not. Plaintiff has offered no evidence that Mr. Hjerpe's selection of Ms. Letteri was a function of her race rather than a function of her posting. *See* *Jones v. Flagship Int'l,* 793 F.2d 714, 724 (5th Cir.1986), (female employee who did not apply for position cannot claim that hiring of male was discriminatory). Indeed, the evidence shows that Mr. Hjerpe filled another UCU position at the same time by hiring a black employee from outside the company when he could find no other internal applicants. As explained in Findings ¶ 109, the court concludes that neither the fact that Ms. Dicker did not receive training concerning New York applications, nor the fact that Chris Carlstrand received training before Ms. Dicker did, are indications of discrimination. Further, for reasons explained in Findings ¶ 112, the court finds that the testimony concerning a “hatchet person” comment does not support a finding of discrimination on the part of Mr. Hjerpe.

What remains of Ms. Dicker's claims of discrimination is her contention that Ms. Soeder received more favorable treatment with respect to an error in her work. Without intending to trivialize this assertion, the court concludes that unless the incident was reflected in a particular poor PDS rating or loss of pay raise or promotion, the assertion does not support a claim of disparate treatment on the part of Allstate. No such results were demonstrated here. Velma Dicker's individual disparate treatment claims are dismissed.

B. *Rhonda Moore*

Rhonda Moore began employment with Allstate in February 1984 as a Data Prep A. In September 1985, Ms. Moore was rated "exceeds" and promoted to the position of Data Prep B. In spite of several more "exceeds" ratings, Ms. Moore was not again promoted during her tenure with Allstate. She alleges that she was treated less favorably than her white colleagues with respect to training; with respect to communication from employees in the Acceptance Testing Unit; and with respect to promotions.

The court concludes that Moore's failure-to-promote claims must be dismissed. The evidence reflects that on several occasions, Moore's supervisors approached her regarding a transfer to UCU; on each occasion, Moore declined such a move, preferring instead to wait for an open position in Acceptance Testing. At some point in 1987 or 1988, Ms. Moore claims, Eric Hjerpe discouraged her interest in a transfer to UCU by warning her that she might not receive "exceeds" PDS evaluations immediately after such a move. Allstate suggests the comment "makes sense" in the context that Ms. Moore had previously told Hjerpe she needed "exceeds" ratings because she wanted the highest possible raises. (Post-Trial Brief of Defendant Allstate Life Insurance Company, at 64-65.) In any event, as she acknowledged, Ms. Moore at all times preferred a transfer to Acceptance Testing. In 1988, for example, Eric Hjerpe made a particular effort to fill positions in UCU by directing inquiries to each of the Data Prep B employees regarding such a transfer. Ms. Moore did not post for the position, but Janice Letteri did and was ultimately transferred to UCU. Mr. Hjerpe hired a black female from outside Allstate for another UCU slot.

***50** Ms. Moore did post for an Acceptance Testing position in 1987; she believes her failure to receive the position is a product of discrimination. In fact, a white employee who, like Ms. Moore, had an "exceeds" rating on her most recent PDS, was awarded the job. Significantly, however, the evidence shows that Moore was one of 40 applicants for the position and that her own supervisor, Joy Reveal, provided a strong recommendation for her. Moreover, because this failure to promote occurred more than 300 days before the filing of her charge of discrimination on November 30, 1988, such a claim is time-barred.

Similarly, Moore's claims that she was not trained promptly on all Data Prep B functions prior to June 1986 are untimely. Allstate explains that the delay in training Ms. Moore on the "complex change re-issue" function was a result of the busy fall promotion schedule. Allstate notes, further, that the alleged delay in her training had no serious consequences in Ms. Moore's work performance; by March 1987, Ms. Moore was rated "exceeds" in her work as a Data Prep B.

Ms. Moore complained in August 1987 to Mr. Hjerpe about her perception that she was being left "out of the loop" with respect to information from persons in Acceptance Testing. Mr. Hjerpe promptly contacted a division manger in that unit to explain that information should be provided to all employees when appropriate. Ms. Moore expressed concern about the assignment of "general time points," but a spotcheck revealed that Moore herself had earned far more such points than any of her co-workers. Moore consistently received high salary increases and, by the time of the filing of her charge, was earning more than any other Data Prep B, with the exception of one person hired a year earlier than she.

The evidence does not support a claim of disparate treatment of Rhonda Moore on the basis of race.

3 *Patricia Hood*

Patricia Hood's claim is that she did not receive adequate training following her promotion to the position of Data Prep A in January 1988. She claims, further, that Allstate failed to promote her. Although her trial testimony focused on the unavailability of the person assigned to train her, Lois Newberry, she testified in her deposition that she had never complained about Ms. Newberry. To the extent that Ms. Newberry's absence was a problem for Ms. Hood, the court notes that Ms. Hood herself was absent from work throughout the month of February 1988. At trial, Ms. Hood claimed she had complained to her supervisor, Christine Swiss, about the lack of training; in her deposition, she stated that she had never done so.

The record demonstrates that Hood's supervisors offered her additional training during her one-on-one meetings, but that Ms. Hood did not respond. She in fact acknowledged having received training on several functions by initialing the relevant forms, although she claimed at trial that she had not in fact received such training.

***51** With respect to her failure to promote claim, Ms. Hood identifies Janice Letteri's promotion to the UCU position as an example of discrimination. Like Ms. Dicker and Ms. Moore, however, Ms. Hood did not post for the UCU position and therefore cannot establish that Allstate's stated reason for choosing Ms. Letteri for the position is pretextual. In any event, Ms. Hood's PDS rating of "acceptable/needs improvement" precluded promotion in 1988. As of December 20, 1988, Ms. Hood was the highest paid Data Prep A employee in the Eastern Territory. Although she resigned in December 1989, Ms. Hood changed her mind and remained at work, where she was promoted four months later.

The evidence does not support Ms. Hood's claims of discrimination.

CONCLUSION

Plaintiffs have established that black nonexempt employees in Allstate's Underwriting Department received significantly lower overall PDS scores than did white employees. The evidence does not, however, establish that these overall PDS scores resulted in decreased wage growth or diminished promotional opportunities for black employees. The evidence shows, further, that underlying factors of quality of work performed, quantity of work performed, and work attendance accounted for enough of the variance in PDS scores that no statistically significant race effect remains; and Plaintiffs did not meet their burden under *Wards Cove* of demonstrating that those underlying factors were not job-related. The court dismisses with prejudice the class claims of disparate impact.

Plaintiffs Dicker, Moore, and Hood also presented evidence in support of their claims of individual disparate treatment. Having examined that evidence, the court concludes that it does not support the claims of any of the individual Plaintiffs. Their disparate treatment claims are, therefore, dismissed with prejudice.

N.D.Ill.,1997.
Dicker v. Allstate Life Insurance Co.
Not Reported in F.Supp., 1997 WL 182290 (N.D.Ill.)

END OF DOCUMENT

TAB 9

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

July 16, 2007.

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

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

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

JEREMY FOGEL, United States District Judge.

I. BACKGROUND

1. Procedural Background

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

Defendant	**Role at the Company**
Timothy K. Montgomery	President, CEO, and director, September 1998 to present.
	Chairman of the Board of Directors ("the Board"), October 1999 to present.
	Senior Vice President of Sales and Marketing, November 1997 to September 1998.
Gregory M. Avis	Director, February 1997 to present.
	Member, Compensation Committee, 1999 to present.
William A. Hasler	Director, May 1997 to present.
	Member, Compensation Committee, at least 1999 to present.
	Member, Audit Committee, at least 1999 to present.
Andrei M. Manoliu	Director, June 2000 to present.
	Member, Audit Committee, 2003 to present.
Edwin L. Harper	Director, December 2002 to present.
David M. Sugishita	Director, February 2003 to present.
	Member, Audit Committee, 2003 to present; Chair of Audit Committee, 2004 to present.
Serge Stepanoff	Vice President of Engineering & Development for Echo Cancellation Products, September 1996 to May 2002.

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

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

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

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

2. Allegations Made in the Complaint

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

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

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

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

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

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

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

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

Purported Date	Recipient	Number of Options	Exercise Price
5/18/04	Tamblyn	125,000	$13.37
5/18/04	Transgrud	125,000	$13.37
5/18/04	Aras	100,000	$13.37

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

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

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

Director	**Reasons for Lack of Independence and Disinterestedness**
Montgomery	• Received backdated stock options. • Sold Ditech stock for proceeds in excess of $39 million on the basis of inside information.
Avis	• Sold Ditech stock for proceeds in excess of $43 million on the basis of inside information. • Knowingly and deliberately backdated stock option grants as a member of the Compensation Committee, and is substantially likely to be held liable for breaching his fiduciary duties. • Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently. • Has served as Managing Partner of Summit, a venture capital and private firm, since 1990. Summit invested in Ditech in 1997 and is still listed as a Summit portfolio company.
Hasler	• Sold Ditech stock for proceeds in excess of $4.4 million on the basis of inside information. • Knowingly and deliberately backdated stock option grants and approved, signed, and disseminated false financial statements and other false SEC filings as a member of the Audit and Compensation Committees, and is substantially likely to be held liable for breaching his fiduciary duties. • Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently.
Manoliu	• Sold Ditech stock for proceeds in excess of $441,000 on the basis of inside information. • Knowingly and deliberately approved, signed, and disseminated false financial statements and other false SEC filings as a member of the Audit Committee, and is substantially likely to be held likely for breaching his fiduciary duties. • Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently.
Sugishita	• Sold Ditech stock for proceeds in excess of $516,000 on the basis of inside information. • Knowingly and deliberately approved, signed, and disseminated false financial statements and other false SEC filings as a member

and Chair of the Audit Committee, and is substantially likely to be held liable for breaching his fiduciary duty.

- Colluded with the Officer Defendants, demonstrating that he is unable or unwilling to act independently.

***4** *Id.*

II. LEGAL STANDARD

1. Motion to Dismiss

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

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

2. The Demand Requirement

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

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

III. DISCUSSION

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

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

i. Sufficiency of the Allegations

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

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

Opposition to Motion One 18.[FN5]

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

Section 10(b) makes it unlawful

[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 makes it unlawful for any person to use interstate commerce
(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240. 10b-5. In cases involving publicly-traded securities and purchases or sales in public securities markets, the elements of an action under Section 10(b) and Rule 10b-5 are: (1) a material misrepresentation or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341-42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

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

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

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

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

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

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

15 U.S.C. § 78u-4b(1)-(2).

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

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

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

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

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

> FN7. The Court does not hold that a plaintiff must allege a pattern of backdating in order to state a claim under Section 10(b), to establish demand futility, or to state a claim for breach of fiduciary duty. *See CNET,* 483 F.Supp.2d at 956-58 (describing analytical methods as one way to support an inference of illegal conduct when "direct evidence is rare and difficult to uncover"). For ex-

ample, a plaintiff likely could proceed past the pleading stage by alleging sufficient factual detail as to the mechanics of an option backdating scheme, including the specific roles and mental states of the various participants. In such a case, the fact that the defendants only backdated one option grant or did not grant themselves the largest possible benefit (and thus failed to generate a statistically implausible pattern) would not be an automatic bar to liability.

ii. Statute of Limitations

[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of-

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation.

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

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

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

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

***8** Plaintiffs also appear to suggest that the Individual Defendants violated Section 10(b) by disseminating false financial statements. However, as noted above, Plaintiffs state in opposition to the instant motion that they do not assert a claim under Rule 10b-5(b), which makes it unlawful to make an untrue statement or to omit a material fact. Opposition to Motion One 18. Consequently, it is by no means clear how the alleged fraudulent financial statements fit into the first claim. Plaintiffs have not pled them as an independent violation of Section 10(b); indeed, they appear to acknowledge their failure to do so by disclaiming any need to plead the elements of a violation of Rule 10b-5(b).*See* Opposition to Motion One 18. While Plaintiffs refer to a fraudulent scheme in the Complaint, *see e.g.* Complaint ¶¶ 2-4, they do not allege such a scheme with any particularity and, as noted above, fail to allege with any factual detail the involvement of a large number of the Individual Defendants. In light of these inadequacies, the Court concludes that it is premature to rule out the possibility that Plaintiffs will be able to plead a violation of Section 10(b) based upon fraudulent financial statements that is not time-barred. In reaching this conclusion, the Court notes the Individual Defendants' argument that the period of repose starts when the misrepresentation is made for the first time. At least one court in this district has accepted this argument, *see* *Zoran,* 2007 WL 1650948 *21(citing *Asdar Group v. Pillsbury, Madison, and Sutro,* 99 F.3d 289, 294-95 (9th Cir.1996) ("[A] statute of limitations [for a Section 10(b) claim] ordinarily begins to run when an act occurs that gives rise to liability ....")) FN10 As it indicated at oral argument, the Court is highly skeptical of a continuing wrong theory FN11 that would allow the revival of a time-barred claim under Section 10(b) upon the issuance of a further financial statement that failed to correct the prior false statement. Such a theory appears to approximate the effects of the fraudulent concealment doctrine of equitable tolling, a doctrine that does not apply in the Section 10(b) context.

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

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

iii. Leave to Amend

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

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

Rule 14a-9 provides:

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

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

The Individual Defendants argue that the extended limitations period under 28 U.S.C. § 1658 does not apply to actions under Section 14(a), and that a Section 14(a) claim must be filed one year after discovery of the facts constituting the violation, and in no event more than three years following publication of the false statement. Individual Defendants' Motion 8 (citing *In re Exxon Mobil Corp. Sec. Litig.,* 387 F.Supp.2d 407, 424 (D.N.J.2005); *In re Global Crossing, Ltd. Sec. Litig.,* 313 F.Supp.2d 189, 196-97 (S.D.N.Y.2003). Plaintiffs do not respond to this argument, and the Court concludes that it should apply the one/three-year limitations period. *Accord* *Zoran,* 2007 WL 1650948 * 24. The last proxy statement containing an allegedly false statement was filed on August 8, 2001, Complaint ¶ 61, and the initial complaint was filed on August 23, 2006. Plaintiffs provide no specific argument explaining why the Section 14(a) claim is not time-barred, but they appear to imply that it survives under a continuing wrong theory. However, nothing is pled that would support such a theory, as even the part of the fraudulent scheme pled with respect to that claim apparently ends in 2001, outside the three-year period of repose. *See* Complaint ¶ 106. Moreover, it is unclear how false statements in financial filings other than proxy statements (such as Form 4's) could revive a claim under Section 14(a), which pertains to proxy statements. Accordingly, the Court concludes that claim two is time-barred as currently pled and should be dismissed with leave to amend.

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

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

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

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

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

i. Statute of Limitations

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

ii. Sufficiency of the Claims

(1) Claims Four and Seven: Accounting and Rescission

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

(2) Claim Five: Breach of Fiduciary Duty

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

(3) Claim Six: Unjust Enrichment

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

(4) Claim Eight: Insider Selling

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

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

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

The Complaint alleges that the Individual Defendants "breached their fiduciary duties by ... engaging in a scheme to grant spring-loaded stock options to themselves and/or certain other officers and directors of the Company and cover up their misconduct."Complaint ¶ 122.[FN14]The Complaint alleges that Tamblyn, Transgrud, and Aras received springloaded options on May 18, 2004. Complaint ¶ 49. The Complaint also alleges that "the Individual Defendants agreed to and did participate with and/or aided and abetted one another in a deliberate cause of action designed to divert corporate assets to themselves and/or other Company insiders."Complaint ¶ 123.[FN15]However, the Complaint does not allege which defendants authorized the grants, approved the grants, or intended or had knowledge that the grants were springloaded. Nor does the Complaint allege the specific material information that had not been made public previously. As is the case with the fifth claim, because the springloading claim sounds in fraud, *see* Complaint ¶ 128 (describing stock option grants in the relevant period as obtained by fraud), Plaintiffs must plead the circumstances of the fraud with particularity. Fed.R.Civ.P. 9(b); *see also* *Atlantis Plastics Corp.,* 558 A.2d at 1066 (stating same rule under Delaware law). Plaintiffs fail to do so here. While it is not clear that Plaintiff will be able to state a claim for breach of fiduciary duty by identifying only one allegedly improper grant date, the law in this area is still developing and the Delaware Chancery has permitted at least one claim for breach of the duty of loyalty and good faith to proceed on a springloading theory. *See* *In re Tyson Foods,* 919 A.2d 563, 593 (Del.Ch.2007). Accordingly, the claim will be dismissed with leave to amend.

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

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

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

2. Motion to Dismiss for Failure to Make Demand

a. *Standing Under Rule 23.1*

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

b. *Disinterestedness and Independence*

Ditech argues that Plaintiffs have failed to allege sufficient facts to raise a reasonable doubt as to the disinterestedness and independence of a majority of the present Board. Ditech concedes that Montgomery is not independent or impartial, and Plaintiffs do not argue that Harper cannot act independently or impartially. Accordingly, the question as to the independence and disinterestedness of the Board revolves around four members: Avis, Hasler, Manoliu, and Sugishita. Hasler and Avis were on the Board during the entire period of alleged backdating. Complaint ¶¶ 25-26. Manoliu joined the Board prior to the final alleged backdated grant. Complaint ¶ 28. Sugishita joined the Board prior to the alleged springloaded grant. Complaint ¶ 29. Ditech points out that the Company's policy that the compensation committee makes option grant decisions would limit the challenged decisions to a subset of the existing Board. Motion Two 22. However, Plaintiffs allege that this policy was not followed in multiple respects and that, while the Compensation Committee backdated the grants, the other members of the Board had knowledge and approved of the backdating. Complaint ¶ 37. Accordingly, assuming that an amended complaint alleges with sufficient particularity that each of these directors approved the option grants or otherwise participated in wrongful conduct, Plaintiffs may be able to plead demand futility on the basis of an insufficient number of disinterested and independent directors. However, the Court concludes that it is premature to make such a determination because Plaintiffs have failed to allege with sufficient particularity that any options backdating or other actionable misconduct occurred at Ditech.

c. *The Business Judgment Rule*

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

IV. ORDER

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

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

END OF DOCUMENT

TAB 10

Only the Westlaw citation is currently available.

United States District Court, N.D. Illinois, Eastern Division.
Ronald J. DRANCHAK, Plaintiff,
v.
AKZO AMERICA, INC., Defendant.
Civ. A. No. 92-C-1295.

Aug. 7, 1995.

MEMORANDUM OPINION AND ORDER GRANTING DEFENDANT'S MOTION FOR JUDGMENT AS A MATTER OF LAW OR FOR A NEW TRIAL

GADOLA, District Judge, Sitting by Designation.

***1** Plaintiff Ronald Dranchak filed suit against defendant Akzo America, Inc. pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001-1461, the Age Discrimination in Employment Act ("ADEA"), 29 U.S.C. § 623, and state law contract claims. Plaintiff alleges that he was discharged because of his age and that defendant retaliated against him because he filed an ADEA claim. In addition, plaintiff is seeking recovery of benefits and other relief based upon defendant's employee benefit plan under ERISA and state contract law.

A trial was held in April and May of 1994 in which the contract and ADEA claims were presented to a jury, and the ERISA claims were presented to this court.[FN1] After the close of proofs, defendant moved for judgment as a matter of law. The court took defendant's motion under advisement pending the decision of the jury. The jury returned a verdict in favor of plaintiff for $1,985,038 on his state contract claim and in favor of plaintiff for $1,108,018 on the ADEA retaliation claim. The jury also made a special finding of willfulness on the retaliation claim. A mistrial was declared on the age discrimination claim when the jury was unable to agree on a verdict.

Following the verdict, defendant filed a renewed motion for judgment as a matter of law or, in the alternative, for a new trial. In a prior opinion, this court granted defendant's motion for judgment as a matter of law on plaintiff's state law contract claim. The court will now consider defendant's motion as it relates to the age discrimination and ADEA retaliation claims, as well as the remaining contract claim issues. For the reasons discussed below, the court will grant defendant's motion.

I. Background

Plaintiff was defendant's vice president of human resources until he was fired in January 1992. At the time that he was fired plaintiff was fifty-three years old. In April 1988, Akzo Chemicals, Inc., defendant's predecessor company, had hired plaintiff as the director of human resources. When he was hired, plaintiff was guaranteed certain severance benefits set forth in an April 13, 1988 letter agreement. The agreement provided that plaintiff would receive no benefits should he be fired for cause. In April 1991, at the age of fifty-two, plaintiff was promoted to become defendant's vice president in charge of human resources. As vice president, plaintiff was in charge of compensation packages for defendant's executives.

On January 28, 1992, Richard Clarke, defendant's sixty year old chairman and chief executive officer, told plaintiff that he was terminated from the company. On January 31, 1992, Clarke gave plaintiff a formal letter listing the reasons for the termination. Defendant contends that the termination resulted from plaintiff's attempt to defraud the company into giving him an extremely favorable pension and severance package. These benefits are embodied in two letter agreements dated September 11 and 12, 1991.

***2** The events surrounding these two letter agreements form the basis upon which defendant claims it fired plaintiff. On September 9, 1991, Clarke told John Jadel, the then company president, that he was fired. Jadel testified that either later that morning or the next day he told plaintiff that he had been fired by Clarke. Plaintiff testified that he did not learn of Jadel's termination until the morning of September 13, 1991. However, in defendant's exhibit 61, a note from plaintiff to Jadel dated September 10, which concerns plaintiff's desire to get a severance agreement, plaintiff stated as follows: “Our discussion today made it more of a priority that we resolve some agreement.”He went on to say that “*I really* [need] *your help on this before it's too late. It's important to Pat & me!*” (emphasis in original). Both plaintiff and Jadel agree that on September 10, 1991 they began discussing a retention agreement for plaintiff that provided certain pension and severance benefits.

A letter agreement guaranteeing numerous benefits for plaintiff was signed by Jadel and plaintiff on September 11, 1991. Jadel testified that plaintiff asked him to back-date the agreement to a date prior to Jadel's termination on September 9, 1991. Jadel refused and said that the agreement would be dated September 11, 1991, the actual date, and that he would sign the agreement in whatever capacity and authority he still had following his termination. Jadel told plaintiff that any future dispute over his authority to give plaintiff severance and pension benefits could be worked out later based upon the truth of what happened that week. During his testimony, plaintiff denied that he ever asked Jadel to back-date the agreement or that he was aware that Jadel had been terminated.

At some later time, a second letter agreement was signed by Jadel and plaintiff that provided additional severance and pension benefits to plaintiff. The agreement is dated September 12, 1991 and plaintiff testified that it was signed on that date. However, defendant has presented substantial evidence that indicates that it was signed sometime on or after September 26, 1991. Jadel's handwritten draft of the agreement is dated “9/26.” Jadel is not sure of the date that the second agreement was signed. In addition, according to Jadel's secretary, the September 12, 1991 agreement must have been drafted sometime after September 16, 1991 because of an internal numbering system. As did the April 1988 letter agreement, the September 11 and 12, 1991 agreements provide that plaintiff will receive none of the relevant benefits if he is fired for cause.

In Counts I and II of his complaint, plaintiff is seeking recovery of the benefits promised in the April 13, 1988, September 11, 1991, and September 12, 1991 letter agreements. Count I is based upon state contract law, and Count II is based upon ERISA. The September 1991 agreements provide a number of severance and pension benefits. At the time that they were signed, plaintiff had been employed by the company for a total of forty-one months. Under the two severance packages, plaintiff would receive thirty-four and a one-half months of severance pay should he leave the company other than for cause. In addition, the agreements gave plaintiff ten years of pension credit and an exemption from the forty-two percent actuarial penalty for retirement at age fifty-five.

***3** Following Jadel's termination, Clarke informed the top executives of the company, including plaintiff, of the firing during a telephone conference allegedly on the morning of September 12, 1991. Clarke then asked plaintiff to negotiate on behalf of the company with Jadel for a severance agreement for the former president. Clarke wanted plaintiff to come up with a fair package for Jadel and the company now that Jadel was leaving. In the meeting between Clarke and plaintiff, Clarke never asked, and plaintiff did not volunteer, that plaintiff had just negotiated, one or two days before, a favorable severance package for himself with Jadel.

The telephone conference between Clarke and company executives is a subject hotly disputed by the parties. Clarke, as well as two company vice presidents, Peter Gold and Eileen Keller, all testified that the conversation occurred on the morning of September 12, 1991. In addition, defendant introduced two faxes concerning Jadel's severance package and a proposed staff announcement of Jadel's termination allegedly drafted by Dranchak that are dated September 13, 1991 at nine o'clock in the morning, thus indicating that Clarke informed company executives on the morning of September 12, 1991. However, plaintiff testified that the telephone conference occurred on September 13, 1991 and that this was the first time that he learned of Jadel's termination.[FN2]

After meeting with Jadel, plaintiff reported back to Clarke that Jadel wanted a 36-month lump sum payment. Upset at the amount, Clarke asked plaintiff whether other people had received similar deals.

Plaintiff told Clarke that a former employee named Ed Morrison had received more than Jadel was requesting, but did not refer to his own severance package. Defendant's general counsel, Peter Gold, also asked plaintiff whether anyone else had received a package similar to Jadel's. Again, plaintiff did not mention his own agreement. Ultimately, Clarke approved the 36-month lump sum payment, and signed Jadel's severance agreement on September 17, 1991. Plaintiff contends that Clarke knew about the September 11 and 12, 1991 agreements when he signed Jadel's agreement.

Clarke testified, however, that he only learned of plaintiff's September 11, 1991 severance agreement on October 9, 1991 in a memorandum from Jadel.[FN3] Clarke was upset by the agreement, and he believed that plaintiff had a conflict of interest when he negotiated on the company's behalf with Jadel for Jadel's severance package. Clarke also testified that he told plaintiff that he did not believe that the agreement was valid and that he considered plaintiff's conduct improper. He then asked plaintiff to prepare a proposal to the personnel committee of a much less generous severance package that would apply to all three company vice presidents equally, Gold, Keller, and plaintiff.

After it became apparent to Clarke that plaintiff was unwilling to recognize that his agreement had been wrongly obtained or to do anything to correct the situation, Clarke fired plaintiff at their January 28, 1992 meeting. Clarke testified that he told plaintiff that he was being fired because he had engaged in self-dealing and a breach of fiduciary duty. Plaintiff testified that Clarke also made the following comment to him at the meeting: “I know how you feel. I was fired once because of age myself.”During his testimony, Clarke denied making the statement. Instead, Clarke asserted that he had merely told plaintiff that at a similar point in his career, he had lost his job, but had been able to pick himself up and eventually become a successful chief executive officer.

***4** Clarke's version of events is supported by the fact that during plaintiff's March 1992 deposition, when asked why he thought he had been fired, plaintiff did not mention age bias as a reason for the termination. Furthermore, plaintiff took extensive contemporaneous notes at the time of the January 1992 meetings. Clarke's alleged statement or the fact that plaintiff believed he was being fired because of his age is not mentioned anywhere in his copious notes. Two months later, however, plaintiff filed an “amendment” to his deposition testimony in which he sought to add the words “I also believe I was terminated because of my age” to the transcript of his deposition.

In this context, plaintiff claims that he was terminated by defendant because of his age. In addition, plaintiff alleges that defendant retaliated against him because he filed an ADEA discrimination claim. Plaintiff stated that Jadel and Conrad Kent, an Akzo Chemicals executive, refused to give him letters of reference while his lawsuit was pending. Furthermore, plaintiff claims that his friends from the company were told by company executives not to socialize with him or his wife because of the lawsuit. Finally, plaintiff claims defendant retaliated against him by not paying him 1991 and pro rata 1992 bonuses, filing a counter-claim against him, and by threatening to “drag him through the mud.”

Plaintiff also sought to present to the jury his claim that defendant terminated him because he opposed company policies and conduct that discriminated against other employees based upon age in violation of ADEA. However, the court found that there was insufficient evidence for plaintiff's “opposition” claim of retaliation to go before the jury. Instead, the court allowed plaintiff's claim of retaliation by the company following the filing of his ADEA claim to go to the jury for decision while taking defendant's motion for judgment as a matter of law on that issue under advisement.

As indicated above, following deliberations, the jury deadlocked on the age discrimination issue and found in favor of plaintiff on his ADEA retaliation claim. In addition, the jury found in favor of plaintiff on his contract claim. Pursuant to Rule 50, defendant filed a motion for judgment as a matter of law or, in the alternative, for a new trial. The court has already granted defendant's renewed motion for judgment as a matter of law on plaintiff's contract claim based upon ERISA preemption. In this memorandum opinion, the court will decide defendant's motion as it relates to plaintiff's age discrimination and ADEA retaliation claims.

Furthermore, the court will conditionally address defendant's motion for a new trial as it relates to plaintiff's contract claim.

II. Motion for Judgment as a Matter of Law

A. Standard of Review--Judgment as a Matter of Law

Defendant has renewed its motion for judgment as a matter of law pursuant to Rule 50(b) of the Federal Rules of Civil Procedure. Rule 50(b) provides as follows:

***5** Renewal of Motion for Judgment After Trial; Alternative Motion for New Trial. Whenever a motion for a judgment as a matter of law made at the close of all the evidence is denied or for any reason in not granted, the court is deemed to have submitted the action to the jury subject to a later determination of the legal questions raised by the motion. Such a motion may be renewed by service and filing not later than 10 days after entry of judgment.... If a verdict was returned, the court may, in disposing of the renewed motion, allow the judgment to stand or may reopen the judgment and either order a new trial or direct the entry of judgment as a matter of law.

Id.

When considering a motion for judgment as a matter of law, the standard is "whether the evidence presented, combined with all reasonable inferences permissibly drawn therefrom, is sufficient to support the verdict when viewed in a light most favorable to the party against whom the motion is directed." *Tice v. Lampert Yards, Inc.,* 761 F.2d 1210, 1213 (7th Cir. 1985)."The district judge is not to resolve conflicts in testimony or weigh and evaluate the evidence, functions that are reserved to the factfinder." *Anderson v. Gutschenritter,* 836 F.2d 346, 348 (7th Cir. 1988). The court does, however, "weigh the evidence to the extent of determining whether the evidence to support the verdict is substantial; a mere scintilla of evidence will not suffice." *La Montagne v. American Convenience Prods., Inc.,* 750 F.2d 1405, 1410 (7th Cir. 1984).

B. ADEA Retaliation

Defendant contends that it deserves judgment as a matter of law on plaintiff's ADEA retaliation claim because the alleged retaliatory conduct is not actionable under ADEA. In addition, defendant claims that plaintiff failed to offer any proof of when he filed or threatened to file his age discrimination complaint. Finally, defendant alleges that there is no substantial evidence to support plaintiff's claim that the alleged retaliatory conduct was causally connected to plaintiff's ADEA claim.

1. Post-Termination Retaliation

Plaintiff argues that defendant retaliated against him because he filed an age discrimination claim alleging that the company discharged him in January 1992 because of his age. Plaintiff claims that defendant retaliated by failing to give him job references, filing a meritless counter-claim, ordering employees to socially shun plaintiff and his wife, failing to pay his 1991 and 1992 bonuses, and threatening to "drag him through the mud" if he followed through with his lawsuit.

Under the retaliation provision of ADEA,

[i]t shall be unlawful for an employer to discriminate against any of his employees or applicants for employment ... because such individual ... opposed any practice made unlawful by this section, or because such individual ... has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or litigation under this Act.

***6** 29 U.S.C. § 623(d). It is based upon plaintiff's claim that defendant discriminated against him because he made an ADEA charge that plaintiff's retaliation claim went before the jury under section 623(d).

Defendant contends that it deserves judgment as a matter of law on this portion of plaintiff's claim because plaintiff was not an employee or an applicant for employment at the time of the alleged retaliation. Thus, his retaliation claim is not cognizable under the language of section 623(d). In response, plaintiff argues that section 623(d) encompasses post-termination retaliatory conduct because of the remedial nature of the statute.

The court finds as a matter of law, however, that plaintiff's retaliation claim under section 623(d) is not legally cognizable.[FN4] The Seventh Circuit has held that post-termination conduct does not constitute an adverse employment action supporting a retaliation claim. *Koelsch v. Beltone Elecs. Corp.,* 46 F.3d 705, 709 (7th Cir. 1995); *Reed v. Shepard,* 939 F.2d 484, 492-93 (7th Cir. 1991).

In *Reed,* a former employee sued her employer for sex discrimination and harassment. In retaliation for her refusal to drop her lawsuit, her employer allegedly made threatening night-time phone calls, sponsored a physical attack, initiated a grand jury investigation, and engaged in a drive-by shooting. Because all of these events occurred after her termination as an employee, the court found that the retaliatory conduct could not support a claim because "it is an employee's discharge or other employment impairment that evidences actionable retaliation, and *not* events subsequent to and unrelated to his employment."*Id.* at 493 (emphasis in original).

Similarly, in *Koelsch,* the company president gave a negative job reference about a former female employee who had filed a sex discrimination suit in which he alleged that she would be likely to sue if she were hired. The court found that the negative job reference did not constitute retaliatory conduct against an *employee.*The Seventh Circuit stated that "[t]he law in this circuit is quite clear ... that post-termination events are not actionable under [Title VII's retaliation provision]." *Koelsch,* 46 F.3d at 709;*see* *Betts v. Illinois,* No. 94-242, 1994 WL 714545, at *2, 1994 U.S. Dist. LEXIS 18205, at *5 (N.D. Ill. Dec. 19, 1994) (no actionable retaliation where employer gave inaccurate information to unemployment office about fired employee in order to retaliate for Title VII complaint; Seventh Circuit "provides no remedy for retaliation occurring subsequent to the termination of employment"); *Veprinsky v. Fluor Daniel, Inc.,* No. 92-8271, 1994 WL 174136, at *5, 1994 U.S. Dist. LEXIS 5881, at *14-15 (N.D. Ill. May 4, 1994); *Pelech v. Klaff-Joss, LP,* 828 F. Supp. 525, 533 (N.D. Ill. 1993) (following *Reed*).

***7** Plaintiff argues that *Reed* and *Koelsch* are inapplicable to this lawsuit because they involve Title VII retaliation and not ADEA. However, section 2000e-3(a) of Title VII contains language that is identical to the language of section 623(d) of ADEA. Furthermore, in *Gantchar v. United Airlines, Inc.,* No. 93-1457, 1995 WL 137053, at *13, 1995 U.S. Dist. LEXIS 3910, at *45 (N.D. Ill. March 24, 1995), a district court applied the holding in *Reed* to a post-termination ADEA retaliation claim. As a result, the court does not hesitate in finding that the Seventh Circuit would come to the same conclusion under ADEA that it reached in the context of Title VII. This is especially true given the fact that both statutes share a similar remedial purpose concerning discrimination and the protection of those who seek relief under the anti-discrimination laws.

In this context, the court finds that plaintiff's retaliation claim is not cognizable. After he was terminated by defendant, plaintiff filed an ADEA claim. Any actions that defendant may have taken against its *former* employee in retaliation for the filing of this claim do not state a claim under section 623(d) of ADEA.[FN5] Section 623(d) only provides a remedy for discrimination against employees or applicants for employment. Because plaintiff does not qualify under the unambiguous language of the statute, he cannot seek relief under section 623(d).[FN6] As a result, the court will grant defendant's motion for judgment as a matter of law on plaintiff's retaliation claim.[FN7]

2. "Opposition" Theory

Plaintiff contends that the jury's verdict on the ADEA retaliation claim does not rest solely on an allegation of post-termination retaliatory conduct based upon plaintiff's filing of an age discrimination claim. Instead, plaintiff argues that the jury's verdict is also supported by a finding that defendant terminated plaintiff in January 1992 in retaliation for his active opposition to unlawful age discrimination at the company during his tenure as vice president in charge of human resources.

The problem with plaintiff's argument is that the court did not allow his retaliatory-discharge/opposition theory to go to the jury. At different points during the trial, at the close of proofs, and in preparing jury instructions, the court informed counsel for both parties that plaintiff had failed to present sufficient proof in order for the opposition claim to go to the jury.FN8 Instead, the court allowed plaintiff's claim for retaliation because of the filing of an age discrimination claim to go to the jury subject to a later ruling on defendant's motion for judgment as a matter of law. In these circumstances, the jury's verdict on the retaliation claim cannot be supported by reference to any evidence that purportedly supports an "opposition" theory of retaliation.

***8** The court refused to instruct the jury on plaintiff's opposition theory because there was no evidence to support such a claim. Plaintiff presented no evidence showing that his alleged opposition activity was in any way causally connected to defendant's decision to terminate him. *See* *Samuelson v. Durkee/French/Airwick,* 976 F.2d 1111, 1115 (7th Cir. 1992) (plaintiff must show causal connection between protected activity and adverse employment action). In addition, plaintiff failed to show that he ever acted to oppose any practice that could reasonably be construed as unlawful. *See, e.g.,* *Reeder-Baker v. Lincoln Nat'l Corp.,* 649 F. Supp. 647 (N.D. Ind. 1986), *aff'd,* 834 F.2d 1373 (7th Cir. 1987). Instead, plaintiff presented anecdotes in which he discussed the use of age with company officials and where he examined forms which listed the ages of employees. As this court has already found, such mere references to age, without more, is not evidence of discriminatory conduct. This is especially true in this case where plaintiff's job as vice president in charge of human resources naturally led him to train, educate, and instruct company managers about the antidiscrimination laws of the United States.FN9 Thus, it was not unusual when plaintiff told company managers not to use age when they made personnel decisions. Such mere training and guidance does not amount to a reasonable belief that unlawful conduct has or will occur that can support an opposition claim.

Additionally, many of the examples of "unlawful" conduct cited by plaintiff that he alleges he "opposed" are distant in time and are separated from plaintiff's termination by a promotion and repeated raises, bonuses, and positive performance reviews. In *Maldonado v. METRA,* 743 F. Supp. 563 (N.D. Ill. 1990), the court found that a five month gap between the opposition activity and the retaliatory discharge breaks the chain of causation when trying to show an indirect link. In this case, much of plaintiff's alleged opposition activity is separated from his discharge by the passage of more than five months from his termination. Furthermore, during his employment with defendant, plaintiff received raises on January 1, 1989, January 1, 1990, and January 1, 1991, as well as a promotion to vice president and a large raise on April 1, 1991. At the very least, any causal link between the alleged opposition activity prior to April 1991 is belied by the fact that plaintiff was promoted after his alleged opposition to "widespread" company abuses was well established. Under these circumstances, plaintiff failed to provide sufficient evidence to raise the inference that the protected activity was the likely reason for his discharge. Plaintiff cannot infer causation where a connection cannot reasonably be ascertained.

***9** Plaintiff's opposition theory is also undermined by the plethora of opposition activity that he alleges he engaged in from the moment he joined the company in 1988. Plaintiff claims that throughout his time with the company he consistently and repeatedly opposed conduct that violated ADEA. However, as has already been pointed out, plaintiff was repeatedly given raises and bonuses, as well as a promotion during his tenure with the company. Thus, rather than retaliating against him for his opposition activity, it appears that the company rewarded him for doing his job as the man in charge of human resources.

In *Hamann v. Gates Chevrolet, Inc.,* 910 F.2d 1417 (7th Cir. 1990), the plaintiff claimed that he was retaliated against because he refused to illegally alter the titles to cars throughout his employment. The court found that instead of raising an inference of retaliation, the fact that plaintiff's conduct occurred repeatedly over many years created a reasonable inference that plaintiff's ethical stance did not bother his employer. *Id.* at 1421.This case goes further in that defendant's conduct towards plaintiff indicates that it rewarded him for his activity and not merely that it tolerated his conduct. In addition, plaintiff has presented no evidence that his opposition conduct reached a crisis point near in time to his termination or that defendant had finally become disgusted with his continued opposition as was considered by the court in *Hamann.*These facts merely make plaintiff's retaliation claim based upon opposition activity more implausible.

The overwhelming evidence in this case indicates that plaintiff was not fired because of any opposition to company practices that are unlawful under ADEA. Instead, the evidence from both sides indicates that plaintiff's termination stemmed from a dispute over plaintiff's September 1991 severance agreements.[FN10] There was no evidence of any causal link between the alleged opposition activity and the decision to terminate. In these circumstances, the court refused to instruct the jury on plaintiff's opposition theory of retaliation.

C. Age Discrimination

Defendant contends that it deserves judgment as a matter of law on plaintiff's mistried age discrimination claim because plaintiff failed to present substantial evidence at trial showing that age was a determining factor in its decision to terminate plaintiff. As Judge Aspen indicated in his opinion denying defendant's motion for summary judgment and as this court repeatedly indicated during trial, plaintiff's age discrimination claim hangs upon the "slender thread" of the remark attributed to defendant's chairman and chief executive officer, Richard Clarke. Viewed from this light, defendant contends that Clarke's alleged statement to plaintiff upon his termination, "I know how you feel, I was once fired for age myself," does not amount to substantial evidence from which a reasonable trier of fact could enter a verdict in plaintiff's favor.

***10** In response, plaintiff argues that by itself, Clarke's remark is enough to defeat defendant's motion. However, plaintiff contends that his case does not rest on Clarke's statement alone, but rather that he has presented substantial circumstantial evidence of a general age bias among defendant's executives that supports the direct statement of age bias indicated by Clarke's remark. In this context, the court must decide defendant's motion.

The court finds that plaintiff has failed to present substantial evidence showing that age was a determining factor in his termination. Contrary to plaintiff's assertions, the court continues to find that his case rests upon the statement that he attributes to Clarke. However, this self-serving allegation is insufficient to demonstrate that age was a determining factor in the decision to terminate.

The court makes this finding with great care and after careful consideration. This decision is also made in light of the fact that a court "cannot supplant its view of witness credibility for that of the jury." *EEOC v. Century Broadcasting Corp.,* 957 F.2d 1446, 1455 (7th Cir. 1992). This is especially true in evaluating credibility issues in the context of employment discrimination cases. *Id.* (citing *Hybert v. Hearst Corp.,* 900 F.2d 1050, 1054 (7th Cir. 1990)). Although the jury was unable to reach a verdict in this case, the same principles guided this court in reaching its decision on this issue. However, as the court indicated in *Perfetti v. First National Bank of Chicago,* 950 F.2d 449, 452 (7th Cir. 1991), *cert. denied,* 120 L. Ed. 2d 871 (1992) where the Seventh Circuit overturned a jury's verdict, a determination of whether there was substantial evidence to support a claim of discrimination is not necessarily a determination of credibility.

The alleged Clarke statement rests solely upon plaintiff's testimony. Clarke flatly denies that he said it. During his March 1991 deposition testimony, plaintiff did not even claim that he was fired because of his age. In addition, plaintiff took extensive contemporaneous notes of what occurred during his meeting with Clarke and there is no mention of the alleged remark.

Finally, plaintiff's termination cannot be viewed in a vacuum. The circumstances of his termination and of the events over the prior nine months all indicate that age was not a determining factor. Instead, as the court has already indicated, the facts all support a finding that plaintiff's termination stemmed from the dispute over his September 1991 agreements. In essence, defendant has demonstrated that it had a legitimate, non-discriminatory reason for discharging plaintiff. Plaintiff has failed to show that defendant's non-discriminatory reasons for his termination are factually false or unworthy of belief. His rebuttal evidence does not address the reasons proffered for the termination, but instead dwell upon the salary increases and positive performance reviews he received that are unrelated to the dispute concerning the September 1991 severance agreements and the negotiations with Jadel. Whether plaintiff breached his fiduciary duty or engaged in self-dealing, whether defendant fired him "for cause," and whether it fired him in order to avoid giving him the benefits promised in the agreements are issues centering upon ERISA and contract law, and the existence of these issues and charges merely militates against any finding that age was a determining factor in his discharge.

***11** The fact that plaintiff was hired at age forty-nine, promoted at age fifty-two, and continued to receive bonuses and salary increases thereafter must be part of the context in which plaintiff's claim, that he was terminated at age fifty-three because of his age, is considered. In *Rand v. CF Industries, Inc.,* 42 F.3d 1139, 1147 (7th Cir. 1994), the plaintiff who brought an age discrimination claim was hired at age forty-seven and then fired at age forty-nine. The court indicated that these circumstances created a strong inference against discrimination. In this case, plaintiff was promoted to the position of vice president and received a substantial raise some nine months before he alleges he was fired because of his age. Plaintiff also had been hired at age forty-nine and his termination occurred when he was fifty-three. Thus, the same strong inference against age discrimination is presented in this instance as in the *Rand* case.

The court's finding that plaintiff's age discrimination claim is not supported by substantial evidence is sustained by decisions in other courts involving similar claims that rest upon the self-serving allegations of a plaintiff. In *Koelsch v. Beltone Electronics Corporation,* 46 F.3d 705 (7th Cir. 1995), the court entered judgment for defendant in a Title VII retaliation suit even though the plaintiff stated in her deposition that her supervisor told her that her job was in trouble because she had complained about sexual harassment from another supervisor. Viewing the facts in the light most favorable to plaintiff, the court held that plaintiff's "self-serving deposition testimony standing alone is insufficient to demonstrate a causal link between her report of purported sexual harassment and her termination." *Id.* at 709.In ignoring the plaintiff's deposition testimony, the court instead relied upon the testimony of her supervisors and the surrounding circumstances. Similarly, plaintiff's age discrimination claim in this case is not supported by substantial evidence because it hinges upon the remark attributed to Clarke by plaintiff that is rendered implausible by the surrounding circumstances.

In *Selsor v. Callaghan & Co.,* 609 F. Supp. 1003, 1010 (N.D. Ill. 1985), a former employee sued his employer under ADEA alleging discriminatory discharge. In an affidavit, the employee alleged that his supervisor told him that he had been fired because he was older and closer to retirement. In granting the employer's motion for summary judgment, the court noted that "[a]lthough our duty in ruling on this summary judgment motion is to resolve issues of credibility in [the non-movant's favor], this duty extends only to plausible issues of credibility. Where as here, 'an offer of evidence ... is too incredible to be believed,' the court may disregard it." *Id.* at 1010 (quoting 10A Wright et al., *Federal Practice and Procedure* § 2727, at 169-70 (1983) and citing *598 Cases of Tomatoes v. United States,* 211 F.2d 249, 251 (7th Cir. 1954)). In the same way, plaintiff has sought to "amend" his deposition testimony in this case to add his "belief" that he was fired for age. This self-serving addition, given the circumstances, does not create a plausible issue of credibility to go before the jury.

***12** The court also agrees with defendant's contention that the Clarke remark, even if it was actually made to plaintiff, is not sufficient to show that age was a determining factor in the discharge decision. Rather than a statement of discriminatory intent, it was more of an expression of sympathy that requires more evidence and inferences than are present in this case to make a claim of age discrimination plausible. In *Ballwanz v. Travenol Laboratories, Inc.,* 701 F. Supp. 627 (N.D. Ill. 1988), the court granted defendant's motion for summary judgment on an age discrimination claim where the plaintiff's supervisor is alleged to have made a remark similar to that attributed to Clarke. In that case, the plaintiff offered the following account of a conversation with her supervisor: "[Finding a new job] probably won't be easy at your age! I said you'd better be careful of [what] you say. He agreed and said yes, you could file suit." *Id.* at 629.The court held that the statement did not constitute evidence of age discrimination or pretext, but merely was an expression of sympathy by a supervisor for a distressed employee. *Id.* Clarke's statement, "I know how you feel, I was fired once because of age myself," is on a similar level. It requires an inference which is not supported by substantial evidence in order to amount to more than a mere scintilla of evidence in support of plaintiff's ADEA claim.

Although it finds that plaintiff's claim hinges upon the Clarke statement, the court will also address some of the other issues raised by plaintiff in support of his contention that his age discrimination claim is more broad-based. For example, during the trial plaintiff sought to introduce various and sundry company forms that have blank spaces for the date of birth of the employee filling out the form and biographical profiles of employees that list their ages. The court found the documents inadmissible on various grounds including the fact that mere references to age, without more, are not relevant. *See Parker v. Federal Nat'l Mortgage Ass'n,* 741 F.2d 975, 980 (7th Cir. 1984). As was noted in that decision, a court is "not required to evaluate every conceivable inference which can be drawn from evidentiary matter, but only reasonable ones."*Id.* (emphasis in original).

Plaintiff also attempts to support his case with reference to training and incentive programs, such as the "Young Tigers" and "high potentials," which are designed for lower-level executives and managers. However, the problem with this evidence, as with most of plaintiff's attempts to broaden his discrimination claim, is that there is no nexus between this evidence and his termination. *See Dale v. Chicago Tribune Co.,* 797 F.2d 458, 465 (7th Cir. 1986), *cert. denied,* 479 U.S. 1066 (1987). Plaintiff was a high-level executive at the very top of the Akzo corporate ladder. He was not even eligible for the programs that he cites, and he has never claimed that he was denied the benefit of a training or incentive program. As a result, there is no connection between the evidence cited by plaintiff concerning training programs for beginning managers and the company's decision to terminate him.

***13** A similar "nexus" problem arises with regard to plaintiff's testimony about conversations with various Akzo officials about the alleged use of or reference to age in connection with employment decisions. These statements were made by or about people who played no role in the decision to terminate. *See Fortino v. Quasar Co.,* 950 F.2d 389, 395 (7th Cir. 1991). In addition, the comments cited were made well before the adverse employment action complained of in this case occurred, and they relate to employment decisions that are significantly different and distant from the kind of decision made here. *See also Box v. A & P Tea Co.,* 772 F.2d 1372, 1379 (7th Cir. 1985) (statistics showing discriminatory promotions not relevant where claim arose from discriminatory disciplinary practices), *cert. denied,* 478 U.S. 1010 (1986). For example, plaintiff seeks to rely upon decisions made by defendant relating to the closing of two company facilities in which a list of managers who were under consideration for upcoming layoffs included their ages. Such decisions concerning layoffs and plant closings are different from the decision to fire a top executive. In addition, the evidence itself, the mere listing of the ages of managers, is just as consistent with an intent to avoid the chance of any violation of ADEA as with an intent to layoff the oldest managers. As a result, this evidence lacks the necessary connection to plaintiff's discharge decision and thus cannot serve as evidence that age was a determining factor.

Based upon this examination of all of the evidence presented at trial in the light most favorable to plaintiff, the court finds that plaintiff has failed to present substantial evidence showing that age was a determining factor in his discharge. Much of the evidence cited by plaintiff lacks the necessary nexus to his discharge. The statement attributed to Clarke is based upon a self-serving allegation by plaintiff that is not supported by other evidence or circumstances. Furthermore, even if true, Clarke's statement requires an inference of discrimination that is not supported by the record and that is not plausible given the nature of the real dispute at issue between plaintiff and defendant that lies at the heart of all of the actions taken in this matter. In this regard, plaintiff has failed to present substantial evidence to dispute the reasons given by defendant for his termination.[FN11]On this basis, the court will grant defendant's motion for judgment as a matter of law on the mistried age discrimination claim.

III. Motion for a New Trial

Even though it will grant defendant's motion for judgment as a matter of law on the ADEA retaliation claim and has already entered judgment in favor of defendant on the state law contract claim, this court must still consider defendant's motion for a new trial on these issues. According to Rule 50(c)(1),

***14** [i]f the renewed motion for judgment as a matter of law is granted, the court shall also rule on the motion for a new trial, if any, by determining whether it should be granted if the judgment is thereafter vacated or reversed, and shall specify the grounds for granting or denying the motion for a new trial. If the motion for a new trial is thus conditionally granted, the order thereon does not affect the finality of the judgment.

Id. Under these circumstances, the court will address the various arguments raised by defendant in support of its motion for a new trial on the ADEA retaliation and state law contract claims.

A. Standard of Review--New Trial

Defendant's motion for a new trial is governed by Rule 59(a)(1) of the Federal Rules of Civil Procedure, which provides as follows:

(a) Grounds. A new trial may be granted to all or any of the parties and on all or part of the issues (1) in an action in which there has been a trial by jury, for any of the reasons for which new trials have heretofore been granted in actions at law in the courts of the United States.

Id. The trial court has broad discretion when ruling on a motion for a new trial. *Sellers v. Baisier,* 792 F.2d 690, 693 (7th Cir. 1986).“In determining whether a new trial is warranted, the trial judge must decide if the verdict is against the weight of the evidence, the damages are excessive, or if for other reasons the trial was not fair to the moving party.” *Forrester v. White,* 846 F.2d 29, 31 (7th Cir. 1988). In addition, “the judge may consider the credibility of witnesses, the weight of the evidence, and anything else which justice requires.” *Spanish Action Comm. of Chicago v. City of Chicago,* 766 F.2d 315, 321 (7th Cir. 1985).

B. New Trial and ADEA Retaliation

In support of its motion for a new trial on plaintiff's ADEA retaliation claim, defendant argues that (1) the jury's verdict was against the weight of the evidence; (2) the jury instructions on retaliation were clearly erroneous and unfairly prejudicial; (3) the damages awarded were excessive and based upon invalid calculations; and (4) defendant was deprived of a fair trial because of plaintiff's conduct during the trial.[FN12]

After a careful and thorough review of the trial record in this case, the court finds that the jury's verdict on plaintiff's retaliation claim is against the weight of the evidence. Based upon the totality of the facts presented, the court finds that the clear weight of the evidence demonstrates that defendant had a legitimate, non-retaliatory reason for the actions it took against plaintiff following his termination. Plaintiff failed to show that defendant's reason was a pretext and was not to be believed. In addition, the court finds that there was no evidence presented to the jury to show any causal connection between the allegedly retaliatory conduct and plaintiff's protected activity. As defendant points out, plaintiff presented no evidence to show when he filed such a claim or when defendant became aware of such a filing. As a result, the jury must have resorted to speculation when it came to the conclusion that retaliation for the filing of a discrimination claim was linked to defendant's conduct at various points in the history of this litigation. Under these circumstances, the court will grant defendant's motion for a new trial.

***15** The strongest basis supporting the court's conclusion in this regard is that the clear weight of the evidence at trial established that plaintiff was terminated because of problems relating to the September 1991 severance agreements and for no other reason.[FN13]There is no evidence to support plaintiff's claim that defendant's conduct was done in retaliation for the filing of an ADEA claim. In fact, the evidence presented by both sides indicates that the circumstances of plaintiff's termination were inextricably linked to the dispute over the severance and pension agreements.

Any conduct by defendant towards plaintiff following the termination, including a refusal to give job references and social ostracism for example, stemmed from the severance and pension dispute between plaintiff and the company. By all accounts, the company's decision to terminate plaintiff came as a result of his refusal to give up his September 1991 severance agreements and the way those agreements were signed.

Whether Jadel had the authority to enter into these agreements with plaintiff, whether defendant had cause to terminate plaintiff under the agreements, or whether plaintiff engaged in improper self-dealing, the fact remains that the dispute between the parties was enmeshed in these questions.

As to Jadel's refusal to sign a letter of reference for plaintiff, a proper reason for the refusal is readily apparent. After plaintiff's termination, he asked Jadel to sign a reference letter that stated that plaintiff had voluntarily elected to leave the company. In these circumstances, rather than retaliatory, Jadel's refusal to sign the letter was merely a refusal to lie.[FN14]

It is apparent to the court that the essence of plaintiff's complaint is that he is seeking to recover the benefits guaranteed in his severance and pension agreements. Defendant's conduct towards plaintiff resulted from this dispute and not as a result of any age discrimination claim. There is no evidence before the court that connects defendant's post-termination conduct with the fact that plaintiff filed his ADEA claim.[FN15]As a result, the court will grant defendant's motion for a new trial on the basis that the jury's verdict in this matter is against the weight of the evidence.

C. New Trial and Contract Claim

In support of its motion for a new trial on the contract claim, defendant contends that (1) the jury's verdict is against the weight of the evidence; (2) the jury instructions are faulty; (3) the contract damages awarded are excessive; and (4) defendant was deprived of a fair trial because of plaintiff's conduct. Because it finds that defendant deserves a new trial on plaintiff's contract claim because the jury was not properly instructed, the court finds it unnecessary to address defendant's arguments as they relate to the weight of the evidence and damages. The court will also discuss whether defendant was deprived of a fair trial in the next section of this memorandum opinion as it relates to defendant's motion for a new trial on both the ADEA retaliation and state contract claims.

***16** In attacking the instructions given the jury by the court, defendant claims that the court should have given an instruction on unconscionability and that the breach of fiduciary duty instruction was insufficient. The court will address each of these claims in turn.

1. Unconscionability

Following the close of proofs, plaintiff moved to strike the affirmative defense of unconscionability. The court denied plaintiff's motion and found that there was sufficient evidence in the record from which a jury could find that the September 1991 agreements were unconscionable. However, the court later refused defendant's request pursuant to Rule 51 to include its supplemental instruction on the issue of unconscionability. Defendant argues that the court erred when it failed to instruct the jury on this issue.

The court agrees. The jury should have been instructed on unconscionability, and defendant's proposed instruction was proper. The court is not persuaded by plaintiff's argument that defendant waived its right to the instruction through its failure to include it in the final pretrial order. Defendant consistently pressed its unconscionability argument throughout the litigation. Furthermore, to treat the lack of such an instruction in the pretrial order as a waiver when defendant claimed that it was an issue for the court would only serve to compound the error made by the court on this issue during the charging conference. As a result, the court will grant defendant's motion for a new trial on plaintiff's contract claims.

2. Fiduciary Duty

Defendant also claims that the court erred in not including its supplemental instruction on breach of fiduciary duty. As plaintiff correctly points out, however, the court did instruct the jury on fiduciary duty in the instruction dealing with just cause to terminate. In this context, it would have been unnecessarily duplicative to have given defendant's additional instruction on the issue. The court also is satisfied that its rejection of defendant's proposed instruction was proper because the instruction was argumentative when compared to the charge given under just cause. For these reasons, defendant does not deserve a new trial based upon the court's failure to include defendant's supplemental breach of fiduciary duty instruction.

D. Unfair Prejudice

In support of its motion for a new trial on both the contract and ADEA retaliation claims, defendant contends that plaintiff and his counsel injected unfair prejudice into the trial during closing argument and in the course of the presentation of evidence. Defendant cites the following incidents as examples of unfair prejudice: (1) reference was made to the suicide of plaintiff's son; (2) plaintiff made an untimely and incomplete production of mitigation evidence; (3) Clarke's deposition testimony was misrepresented in closing argument; (4) comments were made to the jury about unfavorable evidentiary rulings; (5) plaintiff's counsel implied that defendant's counterclaim had been dismissed as baseless during closing argument; and (6) references were made to the substance of settlement discussions. In response, plaintiff rejects as meritless defendant's claims of unfair prejudice. He argues that defendant failed to properly object in some instances, and that the jury instructions removed any unfair prejudice that may have resulted from the alleged incidents.

***17** The court finds, however, that in some of the instances cited by defendant, plaintiff unfairly prejudiced defendant's case so as to deprive it of a fair trial. As a result, the court will grant defendant's motion for a new trial on the ADEA retaliation and state contract claims for this additional and alternate reason. The court will first consider those instances that it finds do not justify a new trial. Subsequently, the court will discuss the basis upon which it will grant defendant's motion.

1. Conduct Insufficient to Justify New Trial

With regard to the suicide of plaintiff's son, only a brief reference was made to the incident during plaintiff's testimony. In addition, plaintiff is correct when he argues that defendant invited and elicited the reference because of its implication during cross-examination that plaintiff had left C-TEC, a former employer, under suspicious circumstances. Although defendant contends that plaintiff was forced to leave C-TEC, plaintiff's testimony about his son's suicide apparently was an attempt to explain why he left the company. The court is also not convinced that plaintiff's brief mention of a suicide in his family engendered such prejudice so as to result in an unfair trial. For these reasons, the court is unwilling to find that the suicide reference denied defendant a fair trial.

The court similarly finds that defendant's claim that plaintiff's counsel unfairly characterized Clarke's deposition testimony is not sufficiently prejudicial to support a motion for a new trial. The limited reference to Clarke's deposition testimony was made in passing and as plaintiff correctly points out, the reference was merely a comment that Clarke "said one thing in his deposition" and that "he said another thing on the stand."Tr. at 1876. Defendant has failed to establish that plaintiff's assertion that there were some discrepancies between Clarke's trial testimony and his deposition was unfairly prejudicial. In addition, the court is willing to give counsel some latitude in commenting on the evidence during closing arguments. As a result, the court finds that defendant has not established that the reference was unfair or, even if unfair, that it rose to such a level of prejudice as to justify overturning a jury's findings.

The court also finds that defendant has failed to establish that it suffered unfair prejudice as a result of the late production of mitigation evidence by plaintiff. Defendant was able to utilize the material during cross-examination, and it has failed to demonstrate persuasively that plaintiff has intentionally withheld additional discovery material. Under these circumstances, the court will not grant defendant's motion for a new trial on this basis.

2. Conduct Sufficient to Justify a New Trial

Defendant's strongest argument in support of its motion for a new trial regarding unfair prejudice concerns the introduction by plaintiff of information concerning settlement negotiations that occurred between the parties. This incident relates to testimony given by plaintiff about a January 31, 1992 meeting that he had with Clarke and defendant's general counsel, Peter Gold. At the meeting, Clarke gave plaintiff a letter that listed the reasons why he had been fired on January 28, 1992. During the meeting, plaintiff, Clarke, and Gold discussed a possible settlement of the dispute that existed between plaintiff and the company.

***18** When the subject of this meeting arose during plaintiff's testimony, defendant asked for a conference with the court outside of the presence of the jury. Pursuant to Rule 408 of the Federal Rules of Evidence, defendant asked the court to order plaintiff not to mention during his testimony any of the settlement discussions that occurred at the January 31, 1992 meeting. The court ruled that the settlement discussions were inadmissible and ordered plaintiff not to discuss anything that was said during the meeting that related to settlement. Following a request from plaintiff's counsel, the court expressed its willingness to review any legal authority that he would like to submit supporting the admission of the settlement discussions in this instance. Defendant then asked the court to specifically instruct plaintiff to its ruling.

In order to completely understand the circumstances of the comments and statements complained of by defendant, the court will present the bulk of the discussion that occurred below:

MR. CASTEL [defense counsel]: Your Honor, might I ask you to instruct the witness before the jurors come in as to your ruling?

THE COURT: I will do that.

Mr. Dranchak, in the absence of the jury, you were here during the discussions that I had with counsel.

You understand that counsel are going to try to produce some authority for me on the point about settlement negotiations tomorrow morning.

But, in the meantime, *you are not to make any reference in your testimony to any discussion of settlement of your dispute with the defendant corporation.*

A. No numbers

THE COURT: *No numbers, no discussion at all that you even discussed settlement of this matter.*

A. All right.

MR. FOX [plaintiff's counsel]: Can he testify to the conversation?

THE COURT: *Not if it involved any settlement proposals or offers or suggestions, anything of that kind.*

MR. FOX: No, no, take that out. But there are other things that happened.

THE COURT: Well, if the other things at the meeting are admissible evidence, then we will receive it.

MR. FOX: Okay. Do you understand the admonition?

A. Yes, sir.

MR. FOX: Stay away from their asking you how much you want and you asking them how much he thought you had coming.

THE COURT: *No, beyond that -- beyond that, any -- avoid any discussion at all that they even had any conversation about settling the dispute.*

MR. FOX: Correct.

A. Yes, sir.

MR. FOX: Can you do that and still testify to this conversation?

A. Yes, I can.

Tr. at 274-75 (emphasis added). At this point in the proceedings, the jury was brought back into the courtroom and testimony continued.
MR. FOX: Mr. Dranchak, on January 31st, 1992, did you have that meeting in New York with Mr. Clarke?

A. Yes, I did.

Q. And who else was present?

A. Mr. Gold.

***19** Q. All right. *Now, you understand the limitations on what you are supposed to say now?*

A. I believe I do, yes, sir.

Q. Okay. *Eliminating any reference to the discussions that are excluded from this conversation,* tell me what was said by all parties?

Id. at 276-77 (emphasis added). Soon thereafter, however, even with all of the coaching provided by the court and his counsel, plaintiff proceeded to describe what was said by the parties concerning the pending dispute. Plaintiff testified that Clarke told him that "if you take us to court, we will tarnish you."*Id.* at 278.Plaintiff's counsel then asked if there was "anything else said that you can recall *other than the discussions that are precluded?" Id.* (emphasis added). In response, plaintiff testified that Clarke also told him that

if you take us to court, we will drag you through mud. We will drag you through the mud and all it will cost us is time for our attorneys. We will get up and walk away, dust ourselves off. We want you to sign a release.

Id. Plaintiff was then asked by his counsel if he could remember anything else from the meeting. He responded as follows: "Yes. There were other things but I can't cite them, because of the ruling."*Id.*

This issue arose again during the testimony of Richard Clarke. During cross-examination, plaintiff's counsel sought to question Clarke about the comments that he is alleged to have made to plaintiff during the January 31, 1992 meeting. Following argument by the parties outside of the presence of the jury, the court ruled that Clarke's comments were made in the context of settlement negotiations and could not be brought before the jury. In addition, the court ordered the parties not to mention Clarke's comments during closing arguments.

Defendant now contends that it deserves a new trial because plaintiff testified to statements that were made in the context of settlement negotiations. In addition, defendant complains of the fact that plaintiff and plaintiff's counsel intentionally led the jury to believe that certain information from the January 31, 1992 meeting was being withheld from them. Defendant claims that plaintiff and his counsel misled the jury by informing them directly and indirectly that other information could not be disclosed to them because of the court's rulings.

The court finds that because plaintiff and his counsel presented to the jury extremely prejudicial discussions that occurred during settlement negotiations, in direct violation of the court's order, defendant did not receive a fair trial.[FN16]The unfairness to defendant was only exacerbated by plaintiff counsel's intentional effort to inform the jury that important facts were being withheld from them by the court.

The court does not hesitate from concluding that plaintiff's counsel acted intentionally because of the circumstances of the incident as fully described in the portion of the transcript presented above. The court and plaintiff's counsel had explicitly and repeatedly informed plaintiff of the restrictions imposed upon his testimony by the court's order. Defendant's counsel had even asked the court to so instruct plaintiff in order to avoid any possibility of confusion or mistake. After having done so, and more importantly, after the jury returned, plaintiff's counsel proceeded to repeat the exact same admonitions to his witness in the very presence of the jury. Based upon these facts, the court can only conclude that plaintiff's counsel acted intentionally to inform the jury that the court was preventing him from revealing important information.

***20** The statements about which plaintiff testified were especially prejudicial with reference to his ADEA retaliation claim. It is easy to see that the hard bargaining that characterized Clarke's remarks during the settlement negotiations could have been construed by the jury as a threat of retaliation against plaintiff for the filing of a claim. In a sense, the jury was led to believe that because plaintiff filed a lawsuit, defendant tried to drag him through the mud, and that, therefore, defendant must have retaliated against plaintiff under ADEA.

In this context, the importance of the strictures of Rule 408 are patently obvious. The rules of evidence encourage parties to openly and candidly discuss settlement by shielding such discussions from the jury. The fact that aggressive comments like those made by Clarke occurred during settlement negotiations is simply an indication that the rules have worked to encourage the parties to engage in free-wheeling discussions when attempting to resolve their differences through negotiation before resorting to the courts. Defendant was entitled to rely upon the protections of Rule 408 and to expect that the direct order of the court concerning settlement negotiations would be respected during the course of plaintiff's testimony. Rather than be respected, however, the court's order was used by plaintiff's counsel as a weapon to mislead the jury into believing that it was being deprived of important evidence helpful to plaintiff.

Plaintiff's counsel committed a similar wrong during closing arguments when he told the jury about certain evidence that the court had specifically ordered excluded from the case. During trial, plaintiff sought to introduce various forms or lists that referred to employees' ages or dates of birth. The court found this evidence irrelevant under Rule 401 and inadmissible under Rule 403. In closing argument, plaintiff's counsel stated as follows:

Were [references to age] on all their forms? We haven't burdened the record with every form they have. We weren't allowed to on the basis that they are not relevant, but those forms that are in evidence showed that they asked for the age of the employees.

Tr. at 1883. In this way, the court's order excluding the forms and lists was treated as a nullity.[FN17] While the excluded material mentioned by plaintiff's counsel was of some prejudicial value, the unfairness that resulted derived from the perception that the court was hiding something from the jury, just as had been done with plaintiff's testimony regarding settlement discussions. The irony of the situation is that nothing about the settlement discussions, other than specific monetary figures, was withheld from the jury. As a result, defendant's case was prejudiced and it was denied a fair trial on the merits.

Defendant also complains of another statement made by plaintiff's counsel during closing arguments. In this instance, defendant had filed a counter-claim against plaintiff for allegedly taking confidential material from the company. At the conclusion of proofs, the court granted plaintiff's motion for judgment as a matter of law on the counter-claim based upon defendant's failure to demonstrate any damages. During his closing argument, plaintiff's counsel stated as follows:

***21** Finally -- and this has been a little swept under the carpet during this trial -- Mr. Dranchak was being sued in this Court by Akzo for stealing documents.

That suit was nothing but retaliation for him filing his claim for age discrimination. Nothing more than that. It had no basis whatsoever.

The documents had been shipped to him by Akzo themselves. He packed them up and left them there, and a week later they shipped them to him.

They know it so well you are not going to be asked to rule on that because that case has been dismissed. It's no longer here. But keep in mind --

MR. CASTEL: I request an instruction to the jury.

MR. FOX: Keep in mind that that suit is no longer pending and it was pending all of the time that Ron was looking for a job.

What else could it have been for but to stop him from getting a job, because he had the nerve to sue Akzo and get them to honor the promises that they had made to him in writing.

Tr. at 1886. As defendant correctly points out, the argument of counsel implies that the counter-claim was dismissed as baseless. Pursuant to defendant's request, the court instructed the jury not to speculate on the reasons why the counter-claim was dismissed. However, the clear implication was left with the jury that plaintiff had been retaliated against by defendant's filing of a counter-claim that the court ruled to be baseless.

From these circumstances, the court finds that the prejudice to defendant as a result of the conduct of plaintiff's counsel is apparent and deprived defendant of a fair trial. The unfair comments made about defendant's counter-claim also go particularly to plaintiff's retaliation claim. Even with the jury instruction, the jury was left with the impression that defendant filed a baseless counter-claim against plaintiff, possibly in retaliation for his age discrimination claim.

Such an impression reaches the heart of plaintiff's retaliation claim and precludes defendant from receiving a fair hearing on the merits of this particular claim.

In the context of the unfair prejudice suffered by defendant, the court will conditionally grant defendant's motion for a new trial on plaintiff's ADEA retaliation and state contract claims. As a result of the conduct of plaintiff and his counsel in direct conflict with the court's specific instructions, the jury was told about sensitive and highly prejudicial settlement discussions. Furthermore, the jury was led to believe that additional, damaging information about the January 31, 1992 meeting was withheld from them. The prejudice to defendant resulting from these occurrences was only heightened and enhanced by the discussion of excluded documentary material and a "baseless" counter-claim during closing arguments. Given all of these factors combined, the court will grant defendant's motion for a new trial.

ORDER

NOW, THEREFORE, IT IS HEREBY ORDERED that defendant's motion for judgment as a matter of law on plaintiff's ADEA retaliation claim is GRANTED.

***22** IT IS FURTHER ORDERED that the judgment rendered on May 19, 1994 for $1,108,018 for ADEA retaliation contained in Count III based upon the jury's verdict is hereby VACATED.

IT IS FURTHER ORDERED that defendant's motion for judgment as a matter of law on plaintiff's age discrimination claim is GRANTED.

IT IS FURTHER ORDERED that defendant's motion for a new trial on plaintiff's ADEA retaliation claim is conditionally GRANTED.

IT IS FURTHER ORDERED that defendant's motion for a new trial on plaintiff's state law contract claim is conditionally GRANTED. SO ORDERED.

FN1. Plaintiff waived any right he may have had to a jury trial on the ERISA claims. The court's findings of fact and conclusions of law on plaintiff's ERISA claims will be considered in a separate opinion.

FN2. The date of the telephone conference is significant because of its relationship to plaintiff's September 12, 1991 severance agreement. If company executives were informed of Jadel's termination on the morning of September 12, 1991, then this fact may undermine plaintiff's claim for benefits under this agreement because Jadel may have lacked the necessary authority to sign it (assuming he signed it on that date). If the conference occurred on the morning of September 13, 1991, then plaintiff can claim that he had no knowledge of Jadel's termination when he and Jadel signed the September 12, 1991 agreement.

FN3. Clarke also testified that he only learned of the September 12, 1991 agreement after plaintiff's termination.

FN4. Plaintiff claims that the court should not address defendant's argument because the magistrate judge already addressed the issue in his report and recommendation regarding jury instructions. In his report, the magistrate judge found that post-termination retaliatory conduct was actionable under ADEA based upon various persuasive authority from outside the Seventh Circuit. This court, however, after examining the relevant Seventh Circuit precedents, finds that the magistrate's recommendation is contrary to this authority and contrary to the clear language of section 623(d). In addition, this particular issue was never specifically raised before the court except in the context of defendant's original motion for judgment as a matter of law which the court took under advisement. As a result, the court is not bound by the prior ruling concerning jury instructions in this matter.

FN5. In response to defendant's motion, plaintiff has tried to resuscitate his retaliation claim by alleging that he *threatened* to bring an action under ADEA at various times before he was terminated in January 1992. Plaintiff claims that defendant then retaliated against him because of these threats. Not only does this contradict plaintiff's claim as it was charged to the jury, and thus cannot serve as a basis for the jury's verdict, it also is not supported by the evidence. In particular, plaintiff cites a December 6, 1991 meeting that he had with Clarke. During the meeting in which plaintiff's September 1991 pension and severance agreements were discussed, plaintiff told Clarke that his wife and his lawyer knew about the agreements and would sue if they were violated. Similarly, plaintiff alleges that during the meetings in late January 1992 he threatened to sue. However, all of these threats did not involve a threat of an ADEA action, but were instead threats to sue over the enforcement of the September 1991 contracts. Plaintiff cannot transform a threat to sue on a contract into a threat to sue for age discrimination. *See, e.g., Sundaram v. American Flange & Mfg. Co.,* No. 92-7094, 1994 WL 27889, at *11-12, 1994 U.S. Dist. LEXIS 842, at *34 (N.D. Ill. Jan. 28, 1994).

This discussion is also relevant to defendant's claim that there is no substantial evidence that plaintiff ever filed or threatened to file an ADEA claim before any of the allegedly retaliatory conduct took place. During oral argument, plaintiff admitted that there was nothing in the record showing that plaintiff threatened or filed an ADEA claim before April 1992, a date before which the alleged post-termination retaliatory conduct took place. Instead, plaintiff argues that defendant, as a sophisticated corporation, simply would have feared an age discrimination suit whenever it fired an older employee. The court finds, however, that such speculation cannot serve as a substitute for actual evidence. As a result, the court will grant defendant's motion for judgment as a matter of law on the ADEA retaliation claim on the alternative grounds that plaintiff failed to show the filing or threatened filing of an ADEA action prior to any retaliatory conduct.

FN6. Plaintiff may claim that defendant's allegedly retaliatory refusal to pay his 1991 and pro rata 1992 bonuses amounts to actionable retaliation because the payment of a bonus is so interrelated to the employment relationship. However, the only evidence presented during the trial on this issue was that defendant's employees only received their bonus for a prior year if they were still employed by the company on February 28 of the following year. In this instance, plaintiff was terminated before February 28, 1992, and thus was not eligible for his 1991 bonus or for any portion of his 1992 bonus. Thus, even if defendant's refusal to pay a bonus is cognizable in this context under section 623(d), the unrebutted evidence indicates that plaintiff was ineligible for a bonus for reasons unrelated to any retaliation.

FN7. Because it will grant defendant's motion based upon the reasoning set forth in this section, the court finds it unnecessary to address defendant's claim that plaintiff failed to demonstrate a causal link between defendant's allegedly retaliatory conduct and any ADEA-protected activity by plaintiff.

FN8. In its instructions, the court described plaintiff's retaliation claim to the jury as follows:

Plaintiff claims that after he told the defendant that its decision to discharge him was discriminatory because of his age and that he intended to file a charge of discrimination with the Government alleging age discrimination, the defendant retaliated against him.

Defendant denies that it retaliated and claims that it had a legitimate reason for the actions that it took with respect to the plaintiff.

Tr. at 1960. The court did not instruct the jury that plaintiff claimed that he was fired in retaliation for his opposition to age discrimination.

However, plaintiff points out that the prima facie case set forth in the jury instructions mentions "complaining about age discrimination" as a protected activity for which defendant could not retaliate against plaintiff. Plaintiff claims that this language is sufficiently broad to encompass his opposition theory.

As plaintiff himself points out, the court refused his request to add opposition conduct to the jury instructions. In the context of the court's description of plaintiff's claim, the words "complaining about age discrimination" clearly refer to plaintiff's "complaint" that defendant's decision to discharge him was discriminatory because of his age. Any attempt to read an "opposition" theory into the jury's verdict is contrary to the court's rulings before the case went to the jury and is contrary to the jury instructions. As a result, there is no need for the court to rule on defendant's motion as it relates to an opposition claim because it never went before the jury.

FN9. Many of the age-related conversations that plaintiff relies upon as examples of his opposition activity took place with company officials who played no role in the decision to terminate him. *See La Montagne v. American Convenience Prods., Inc.,* 750 F.2d 1405, 1412 (7th Cir. 1984) (plaintiff must show nexus between nondecision-makers and adverse employment action). For example, the cited discussions with Kortenhorst and Kent, two company officials who were not decision-makers, are not connected to the adverse employment action taken against plaintiff. Plaintiff has failed to present any evidence that ties his discussions about age with Kent and Kortenhorst to defendant's decision to terminate him. As a result, this and similar evidence cannot serve as the basis for an opposition claim of ADEA retaliation.

FN10. Plaintiff also seeks to rehabilitate his retaliation claim, post-trial and post-verdict, by recharacterizing his September 1991 severance agreements as opposition conduct. Under this convenient and novel theory, plaintiff argues that he wanted to get the severance package in order to oppose his imminent termination which he thought likely because he feared that Clarke wanted to replace him with a younger rival in the company. When defendant fired him later because of his severance package, under plaintiff's theory, this action amounted to retaliation for plaintiff's opposition activity of seeking severance protection.

Again, this theory of pre-termination retaliation was not before the jury when it reached its verdict. The court also finds that the procuring of the September 1991 agreements does not amount to protected activity under ADEA based upon the evidence presented to the jury. As a result, this alternative theory cannot serve as a basis for a retaliation claim.

FN11. To a large extent the claims and evidence raised by plaintiff in support of his ERISA and contract claims merely support defendant's proffered reasons for his discharge. Plaintiff has argued vociferously that the real reason that the company wanted to fire him was because it wanted to prevent him from getting the benefits promised in the September 1991 agreements. This theory obviously clashes to a certain degree with the idea that plaintiff was fired because of a wide-spread bias in favor of youth. Although plaintiff is certainly free to offer alternative claims and explanations for his termination, the problem then arises that the evidence and arguments he raises in support of his ERISA and contract claims may be so persuasive as to undermine the inferences and evidence offered on the age discrimination claim.

FN12. Obviously, the court addresses defendant's motion for a new trial on plaintiff's retaliation claim based upon an assumption that post-termination conduct can support such a claim. Furthermore, because it will grant defendant's motion for a new trial based upon the weight of the evidence and the unfair prejudice at trial, the court finds it unnecessary to address the issues relating to damages and jury instructions. The court will address the issue of unfair prejudice in a later section concerning the contract and retaliation claims.

FN13. Whether the termination was for cause and whether the agreements were even valid are questions that the court will address in another decision delineating its findings of fact and conclusions of law on the ERISA issues.

FN14. Sometime in February 1992, Conrad Kent, another company executive, refused to write a letter of reference for plaintiff. This refusal coincides with Jadel's decision not to sign the letter proffered by plaintiff. As defendant rightly points out, plaintiff failed to present any evidence indicating that in February 1992 he had filed or threatened to file an ADEA claim or that Jadel and Kent were even aware of such a filing. As a result, the refusal to give letters of reference in this case cannot serve as evidence of retaliation for this additional reason.

FN15. The only arguable connection that exists may be the alleged comments made by Clarke concerning age bias at the January 28, 1992 meeting. Assuming the company fired plaintiff because of his age, plaintiff could argue that the company may have retaliated against him when he filed his age discrimination claim. However, as the court has already indicated, plaintiff's discrimination claim rests upon his own testimony as to what Clarke said when he fired plaintiff. Based upon this conclusion, the court finds that there is not sufficient evidence to connect defendant's post-termination conduct towards plaintiff with the fact that plaintiff filed an age discrimination claim.

FN16. Plaintiff contends that because defendant failed to seek a motion to strike the testimony concerning settlement discussions, it has waived its right to a new trial based upon unfair prejudice. However, as the court pointed out during discussions with the parties concerning jury instructions, any immediate motion by defendant to strike during plaintiff's testimony would only magnify the prejudice to defendant and enhance the impression that the court is hiding important information from the jury. In addition, defendant raised the entire issue with the court before the issue arose during plaintiff's testimony. As a result, the court specifically and painstakingly instructed plaintiff that he could not go into any of the settlement discussions. Defendant was entitled to rely upon the court's order and in fact would have acted improperly if it had objected to the innocuous questions posed by plaintiff's counsel (“anything else that you can recall?” for example), which were answered with prejudicial material from plaintiff. A motion to strike and an instruction to disregard after the material was before the jury in the circumstances of this case only would have resulted in greater prejudice.

FN17. The court can imagine a situation where, during closing argument in a murder trial, a prosecutor tells the jury “hey, I'd like to tell you about the defendant's confession, but the judge excluded it as violative of the Fifth Amendment, and hey, I'd love to tell you about the murder weapon with defendant's fingerprints on it, but the judge excluded that as well because of the Fourth Amendment.”While the example is obviously extreme and it contains a higher degree of prejudice, it contains a similar disregard for the orders of the court that is present in this case, a disregard based upon advocacy without limits.

N.D.Ill.,1995.
Dranchak v. Akzo America, Inc.

Not Reported in F.Supp., 1995 WL 470245 (N.D.Ill.)

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TAB 11

Only the Westlaw citation is currently available.

United States Court of Appeals,
Second Circuit.
In re FLAG TELECOM HOLDINGS, LTD. SECURITIES LITIGATION
Peter T. Loftin, Norman H. Hunter, and Joseph Coughlin, individually and on behalf of all others similarly situated, Plaintiffs-Appellees,
v.
Andres Bande, Edward McCormack, Edward Mcquaid, Philip Seskin, Daniel Petri, Dr. Lim Lek Suan, Larry Bautista, and Citigroup Global Markets Inc., formerly known as Salomon Smith Barney Holdings Inc., Defendants-Appellants.
Docket Nos. 07-4017-cv (L), 07-4025-cv (CON).

Argued: April 23, 2009.
Decided: July 22, 2009.

Background: Investors brought securities fraud class action against corporation providing fiberoptic capability to communications carriers, lead underwriter for corporation's initial public offering (IPO), and individual officers of corporation, alleging false registration statement and other false statements that caused artificial inflation of corporation's stock price, and asserting claims under Securities Act and Securities Exchange Act. After dismissal of claims against corporation, 352 F.Supp.2d 429, the United States District Court for the Southern District of New York, William C. Conner, J., 245 F.R.D. 147, certified class, and defendants appealed.

Holdings: The Court of Appeals, Sweet, District Judge, sitting by designation, held that:
(1) district court did not abuse its discretion in concluding that typicality requirement for class certification was met, and
(2) investors who sold their stock before alleged corrective disclosures were made did not satisfy typicality or adequacy requirements for class certification.

Affirmed in part and vacated in part.

West Headnotes

[1] Federal Courts 170B 0

170B Federal Courts
In reviewing class certification, Court of Appeals applies abuse of discretion standard to both lower court's ultimate determination on certification, as well as to its rulings that individual requirements for class certification have been met. Fed.Rules Civ.Proc.Rule 23, 28 U.S.C.A.

[2] Federal Courts 170B 0

170B Federal Courts
Factual findings underlying district court's class certification ruling are reviewed for clear error, and whether correct legal standard was applied is reviewed de novo. Fed.Rules Civ.Proc.Rule 23, 28 U.S.C.A.

[3] Federal Courts 170B 0

170B Federal Courts
Where appeal challenges lower court's grant of class certification, Court of Appeals accords district court noticeably more deference than when it reviews denial of class certification. Fed.Rules Civ.Proc.Rule 23, 28 U.S.C.A.

[4] Federal Civil Procedure 170A 0

170A Federal Civil Procedure
To establish typicality required for class certification, party seeking certification must show that each class member's claim arises from same course of events and each class member makes similar legal arguments to prove defendant's liability. Fed.Rules Civ.Proc.Rule 23(a)(3), 28 U.S.C.A.

[5] Federal Civil Procedure 170A 0

170A Federal Civil Procedure
In evaluating adequacy of representation required for class certification, court must consider whether: (1)

plaintiff's interests are antagonistic to interest of other class members, and (2) plaintiff's attorneys are qualified, experienced, and able to conduct litigation. Fed.Rules Civ.Proc.Rule 23(a), 28 U.S.C.A.

[6] Federal Civil Procedure 170A 0

170A Federal Civil Procedure
District court did not abuse its discretion in concluding that typicality requirement for class certification was met in securities fraud action despite fact that complaint alleged that artificial inflation of corporation's stock price was based on both false registration statement and post-initial public offering (IPO) actions, even though Securities Act precluded recovery if decline in stock price was due to something other than alleged misstatements concerning pre-sales, while Securities Exchange Act required proof that decline in stock price was due to failure to appropriately disclose reciprocal transactions that took place after initial public offering (IPO); it was possible that decline in stock's value was caused by both alleged fraud relating to reciprocal transactions and alleged misstatements relating to pre-sales found in registration statement. Securities Act of 1933, §§ 11(e), 12(b), 15 U.S.C.A. §§ 77k(e), 77*l*(b); Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b-5; Fed.Rules Civ.Proc.Rule 23(a)(3), 28 U.S.C.A.

[7] Federal Civil Procedure 170A 0

170A Federal Civil Procedure
Investors who sold their stock before alleged corrective disclosures were made were required to show that it was likely, rather than merely conceivable, that they could establish loss causation in order to satisfy typicality or adequacy requirements for class certification in securities fraud action. Fed.Rules Civ.Proc.Rule 23(a), 28 U.S.C.A.

[8] Federal Civil Procedure 170A 0

170A Federal Civil Procedure
Investors who sold their stock before alleged corrective disclosures were made did not satisfy typicality or adequacy requirements for class certification in securities fraud action alleging artificial inflation of corporation's stock price, even if it was conceivable that investors could establish loss causation, where there was no evidence that information that leaked into the market before corrective disclosures revealed truth with respect to specific misrepresentations alleged in complaint. Fed.Rules Civ.Proc.Rule 23(a), 28 U.S.C.A.

Appeal from an order entered in the United States District Court for the Southern District of New York (William C. Conner, Judge) certifying a single class of plaintiffs alleging claims under both the Securities Act of 1933 and the Securities Exchange Act of 1934. Because we find that the district court did not abuse its discretion in concluding that the requirements of Rule 23 were satisfied with respect to the single class, we AFFIRM the order granting certification, but we VACATE that portion of the order which includes as members of the class individuals who sold their shares prior to February 13, 2002, and REMAND for further proceedings.Arthur R. Miller, Milberg LLP, New York, NY, (Brad N. Friedman, Matthew A. Kupillas, and Arvind B. Khurana, on the brief) for Plaintiffs-Appellees.

Jerome S. Fortinsky, Sherman & Sterling LLP, New York, NY, (Daniel H.R. Laguardia and Jeffrey J. Resetarits, on the brief) for Defendants-Appellants Andres Bande, Larry Bautista, Lim Lek Suan, Edward McCormack, Edward McQuaid, Daniel Petri, and Philip Seskin.

Douglas W. Henkin, Milbank Tweed Hadley & McCloy LLP, New York, NY, (James N. Benedict, C. Neil Gray, and Kevin M. Ashby, on the brief) for Defendant-Appellant Citigroup Global Markets, Inc.

Before POOLER, HALL, Circuit Judges, and SWEET, District Judge. FN*

SWEET, District Judge:

***1** Defendants Andres Bande, Larry Bautista, Dr. Lim Lek Suan, Edward McCormack, Edward McQuaid, Daniel Petri, and Philip Seskin (the "Individual Defendants") and Citigroup Global Markets Inc. ("Citigroup") (collectively, the "Defendants") appeal from an order of the United States District Court for the

Southern District of New York (Conner, J.) certifying the proposed class and appointing Peter T. Loftin, Norman H. Hunter and Joseph Coughlin ("Plaintiffs") to serve as class representatives and Milberg Weiss LLP to serve as class counsel.

This appeal raises issues implicating both the substance of the often overlapping requirements of typicality and adequacy laid out in Rule 23(a) of the Federal Rules of Civil Procedure and the correct standard of proof to be applied by courts in this context. We conclude that while the district court did not abuse its discretion in granting certification of a class encompassing members who allege claims under both the Securities Act of 1933 (the "'33 Act") and the Securities Exchange Act of 1934 (the "'34 Act"), it did err in certifying as members of the class those individuals who sold their stock prior to the February 13, 2002 close of the class period.

BACKGROUND

In February 2000, Flag Telecom Holdings, Ltd. ("Flag" or the "Company"), a self-described telecommunications "carriers' carrier" whose business involved the sale of access to its telecommunications network, offered its shares to the public in an initial public offering ("IPO").*See* *In re Flag Telecom Holdings, Ltd. Sec. Litig. ("In re Flag"),* 245 F.R.D. 147, 151-52 (S.D.N.Y.2007). In the prospectus, which was incorporated into the registration statement filed with the U.S. Securities and Exchange Commission in connection with the IPO, Flag stated that it had obtained $600 million in bank financing and presales of $750 million to construct the Flag Atlantic-1 cable system (the "FA-1 system"), a fiber-optic submarine cable connecting Paris and London to New York.

According to Plaintiffs, despite an over-supply of fiber optic capacity in the market generally, Defendants made various misstatements and omissions in the prospectus and during the two years following the IPO, assuring investors that demand for Flag's cable remained strong. On February 13, 2002, the Company disclosed, *inter alia,* that approximately 14% of the Company's GAAP revenues for the year ending December 31, 2001, were associated with so-called "reciprocal transactions." Described by the lower court as "swaps of telecommunications capacity between competitors," reciprocal sales

> may be entered into for legitimate reasons, i.e. to acquire access on networks in a market that a company wishes to enter in exchange for capacity that has yet to be sold and is not otherwise in use ("dark fiber") ... [or] can also be utilized by a company seeking to defraud investors or its creditors to create the impression that the company is selling capacity when it is merely unloading useless dark fiber on one of its networks in exchange for useless dark fiber on a competitor's network.

***2** *In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 352 F.Supp.2d 429, 461 (S.D.N.Y.2005). Following the announcement, Flag stock dropped 46% from its closing price on February 12, 2002, to $0.36 per share on February 13, 2002.

Shortly after, on April 1, 2002, Flag filed its 10-K report for fiscal year 2001, disclosing that the asset value of its FA-1 system was impaired and that it was forced to recognize an impairment charge of $359 million. On April 12, 2002, the Company filed its Chapter 11 bankruptcy petition. Before being canceled pursuant to Flag's court-approved Chapter 11 plan in September 2002, the Company's common stock was trading at $0.002 per share, having traded as low as $0.0001 per share during the bankruptcy.

The first of several securities class actions was filed against Defendants in connection with these events in April 2002. In October 2002, the Honorable William C. Conner consolidated several of the actions and appointed Loftin, who purchased approximately 1.7 million shares of Flag common stock between July 17, 2000, and September 22, 2000, Lead Plaintiff and Milberg Weiss Bershad Hynes & Lerach LLP Lead Counsel. Plaintiffs filed a Consolidated Amended Complaint on March 20, 2003, and a Second Consolidated Amended Complaint on December 1, 2003. Judge Conner dismissed the Second Consolidated Amended Complaint without prejudice, and a Third Consolidated Amended Complaint was filed on April 14, 2004, adding Hunter, who purchased 200 shares of Flag stock in the IPO, as a plaintiff.

Plaintiffs bring the instant action on behalf of those who purchased or otherwise acquired Flag common stock between February 11, 2000, and February 13, 2002 (the "Class Period") for violations of §§ 11, 12(a)(2), and 15 of the '33 Act (the "'33 Act Plaintiffs") and §§ 10(b) and 20(a) of the '34 Act and Rule 10b-5 promulgated thereunder (the "'34 Act Plaintiffs"). Plaintiffs allege that as a result of Defendants' materially false and misleading statements in the Company's registration statement, SEC filings, and press releases, the value of Flag stock was artificially inflated during the Class Period. Specifically, the '33 Act Plaintiffs allege that Defendants' statements in the prospectus regarding the FA-1 system and the $750 million in presales were misleading in that certain of the presales were entered into to ensure financing and did not accurately represent profit or demand.[FN1] The '34 Act Plaintiffs allege that the Individual Defendants made false and misleading statements regarding the Company's profitability, most notably by falsely reporting the types of reciprocal sales described above.

In an Amended Opinion and Order dated January 23, 2006, Judge Conner denied Defendants' motion to dismiss, holding that Defendants had not satisfied their burden to establish negative causation with respect to the '33 Act Plaintiffs' claims as required by 15 U.S.C. §§ 77k(e) and 77l(b). *See In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 411 F.Supp.2d 377, 383-84 (S.D.N.Y.2006). The district court rejected Defendants' argument that since the '33 Act Plaintiffs did not learn of the allegedly misleading pre-sale until after the November 2003 filing of a complaint in a related state court action,[FN2] at which time Flag common stock had been cancelled and was already worthless, none of the decline in the stock's value could be attributed to those misstatements. The court found that Defendants had not "demonstrate[d] that the decline was not due, at least in part, to the alleged misrepresentations concerning pre-sales in Flag's Prospectus, which presumably inflated the price level attained in the IPO and thereby heightened the loss when the price fell virtually to zero." *Id.* at 384. With the court's approval, Plaintiffs filed a Fourth Consolidated Amended Complaint on October 15, 2007.

***3** In September 2007, the district court granted Plaintiffs' motion for certification pursuant to Fed.R.Civ.P. 23 and appointed Loftin, Hunter, and Coughlin [FN3] class representatives and Milberg Weiss LLP class counsel. Judge Conner defined the certified class as follows:

> All persons or entities who purchased common stock of Flag Telecom Holdings, Ltd. ("Flag" or the "Company") between March 6, 2000 and February 13, 2002, inclusive, as well as those who purchased Flag common stock pursuant to or traceable to the Company's initial public offering between February 11, 2000 and May 10, 2000, inclusive (collectively, the "Class Period"), but shall exclude: (1) defendants herein, members of each individual defendants' immediate family, any entity in which any defendant has a controlling interest, and the legal affiliates, representatives, heirs, controlling persons, successors and predecessors in interest or assigns of any such extended party; (2) Verizon Communications, Inc.; and (3) entities that had the right to appoint a director to Flag's Board of Directors and proceeded to make such an appointment (or, for reasons unique to them, chose not to exercise such right), such as Dallah Albaraka Holding Company, Telecom Asia Corporation Public Co. Ltd., Marubeni Corporation, the Asian Infrastructure Fund and Tyco International Ltd.

In re Flag, 245 F.R.D. at 174. In determining that Plaintiffs had established each of the Fed.R.Civ.P. Rule 23(a) and (b)(3) requirements, the lower court rejected several of Defendants' arguments now before us on appeal.

With respect to the typicality requirement of Rule 23(a)(3), Judge Conner concluded that "the typicality requirement is met because plaintiffs ... like the putative class members, will attempt to prove that they purchased Flag common stock during the Class Period and were injured by defendants' false and misleading representations made in the Registration Statement and throughout the Class Period in violation of the securities laws." *Id.* at 159. In so doing, the lower court rejected Defendants' argument that a "fundamental conflict" exists between the '33 Act and '34 Act Plaintiffs. *Id.* Recognizing that the '33 Act Plaintiffs are subject to a "negative causation" affirmative defense under 15 U.S.C. §§ 77k(e) and 77*l* (b), which precludes recovery where defendants can show "that the decline in Flag's stock price was due to something other than the alleged misstatements concerning the pre-sales," while the '34 Act Plaintiffs are required to prove "loss causation," or "that the decline in Flag's stock price was due to, *inter alia,* the failure to appropriately disclose the reciprocal transactions that took place after the IPO," the district court concluded that "the two sets of claims are not antagonistic to each other because proof of one does not negate an essential element of the other."*Id.* at 160.

Judge Conner also rejected Defendants' several challenges to the adequacy of the class representatives. Of particular relevance to Defendants' appeal, the district court found that the class properly included those purchasers who sold their Flag shares before February 13, 2002, the last day of the Class Period and the date on which Plaintiffs allege Flag disclosed the truth behind the alleged misstatements to the public. According to Judge Conner, Plaintiffs sufficiently demonstrated that the truth regarding Flag's financial condition began leaking into the market prior to February 13, 2002. Based on various allegations and an event study submitted by Plaintiffs' expert, the district court held it "conceivable that in-and-out purchasers asserting claims under both the '33 and '34 Act may be able to overcome defendants' affirmative defense of negative causation and prove loss causation, respectively, notwithstanding that the February 13, 2002 announcement is the most critical corrective disclosure."*Id.* at 167.

***4** On September 19, 2007, Defendants sought leave to appeal the district court's grant of Plaintiffs' motion for class certification pursuant to Fed.R.Civ.P. 23(f) and Fed. R.App. P. 5, which we granted on December 12, 2007.

DISCUSSION

[1][2][3] In reviewing class certification under Rule 23, we apply an abuse-of-discretion standard to both the lower court's ultimate determination on certification, as well as to its rulings that the individual Rule 23 requirements have been met. *In re Initial Pub. Offerings Sec. Litig. ("In re IPO"),* 471 F.3d 24, 31-32 (2d Cir.2006). The factual findings underlying the ruling are reviewed for clear error, and we review de novo whether the correct legal standard was applied. *Id.* at 40-41.Where, as here, the appeal challenges the lower court's grant of class certification, "we accord the district court noticeably more deference than when we review a denial of class certification." *In re Salomon Analyst Metromedia Litig.,* 544 F.3d 474, 480 (2d Cir.2008) (citation omitted).

Rule 23(a) sets out the requirements for class certification:

(1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class.

Fed.R.Civ.P. 23(a). We recently set forth the standard of proof governing class certification as follows:

(1) a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met; (2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met; (3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement; (4) in making such determinations, a district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement;....

In re IPO, 471 F.3d at 41. In a later clarification, we further described "the standard of proof applicable to evidence proffered to meet" the requirements of Rule 23 as a "preponderance of the evidence." *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.,* 546 F.3d 196, 202 (2d Cir.2008).

[4][5] To establish typicality under Rule 23(a)(3), the party seeking certification must show that "each class member's claim arises from the same course of events and each class member makes similar legal arguments to prove the defendant's liability." *Robidoux v. Celani,* 987 F.2d 931, 936 (2d Cir.1993). Adequacy "entails inquiry as to whether: 1) plaintiff's interests are antagonistic to the interest of other members of the class

and 2) plaintiff's attorneys are qualified, experienced and able to conduct the litigation." *Baffa v. Donaldson, Lufkin & Jenrette Sec. Corp.,* 222 F.3d 52, 60 (2d Cir.2000). The focus is on uncovering "conflicts of interest between named parties and the class they seek to represent." *Amchem Prods., Inc. v. Windsor,* 521 U.S. 591, 625, 117 S.Ct. 2231, 2250, 138 L.Ed.2d 689 (1997). In order to defeat a motion for certification, however, the conflict "must be fundamental." *In re Visa Check/MasterMoney Antitrust Litig. ("In re Visa"),* 280 F.3d 124, 145 (2d Cir.2001) (internal quotations and citation omitted), *abrogated in part by In re IPO,* 471 F.3d 24.

I. Disabling Intra-Class Conflict

***5** [6] On appeal, Defendants renew their argument that the class suffers from a fundamental conflict rendering it uncertifiable because "success for the '34 Act plaintiffs necessarily precludes recovery by the '33 Act plaintiffs and vice-versa."Citigroup Br. at 31. We do not find, however, that the district court abused its discretion in concluding that the typicality requirement is met in this case despite the conflict described by Defendants. Although Judge Conner did not directly address the conflict issue in connection with the adequacy requirement, we also find that the court did not abuse its discretion in determining that any antagonistic interests with respect to causation do not constitute the type of "fundamental" conflict that renders the class uncertifiable. *See id.*

It is well-established that plaintiffs alleging claims under Section 10(b) of the '34 Act must prove loss causation. *See*15 U.S.C. § 78u-4(b)(4) ("[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages."); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.,* 552 U.S. 148, 128 S.Ct. 761, 768, 169 L.Ed.2d 627 (2008) (describing six elements of typical 10(b) claim as "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation"). To prove loss causation, a plaintiff must demonstrate "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 173 (2d Cir.2005). By contrast, under the '33 Act, it is the defendant who bears the burden of demonstrating that something other than the misstatement at issue caused plaintiff's loss. *See*15 U.S.C. §§ 77k(e), *77l* (b); *Akerman v. Oryx Commc'ns, Inc.,* 810 F.2d 336, 340-42 (2d Cir.1987) (describing defendants' "heavy burden" of proving negative causation under § 11 of the '33 Act).

As the lower court recognized, we have repeatedly analogized the concept of loss causation to proximate cause. *See, e.g., Lentell,* 396 F.3d at 173 (stating that although "the tort analogy is imperfect," "a misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor" (emphasis in original)); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.,* 343 F.3d 189, 197 (2d Cir.2003) ("We have often compared loss causation to the tort law concept of proximate cause, meaning that the damages suffered by plaintiff must be a foreseeable consequence of any misrepresentation or material omission."(internal quotations and citation omitted)). In relying on this familiar concept, Judge Conner found fault with Defendants' argument which, the court concluded, mistakenly "overlooks that the decline in value of Flag stock may have been caused by *both* the alleged fraud relating to the reciprocal transactions and the alleged misstatements relating to pre-sales found in the Registration Statement." *In re Flag,* 245 F.R.D. at 159-60 (emphasis in original).

***6** Defendants take issue with the lower court's application of proximate cause to the facts here, namely, its conclusion that the decline in value of Flag stock "may have been caused by either or both of [the] alleged acts of deception." *In re Flag,* 245 F.R.D. at 160. They argue that under the Supreme Court's holding in *Dura Pharmaceuticals., Inc. v. Broudo,* 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005), loss causation and negative causation add up to a "zero-sum game," and that by establishing loss causation, the '34 Act Plaintiffs will necessarily undermine the '33 Act Plaintiffs' ability to rebut Defendants' negative causation defense. Individual Defendants Br. at 20.

We agree with the lower court that the '34 Act Plaintiffs can establish "the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff," *Emergent Capital Inv. Mgmt.,* 343 F.3d at 197, without threatening the interests of the '33 Act Plaintiffs to such a degree as to render the certified class representatives atypical or inadequate. *Dura* stands for the proposition that in fraud-on-the-market cases, "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." 544 U.S. at 342, 125 S.Ct. 1627, 161 L.Ed.2d 577. Rather, to establish loss causation, *Dura* requires plaintiffs to disaggregate those losses caused by "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events," from disclosures of the truth behind the alleged misstatements. *Id.* at 342-43, 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577;*see* *Lattanzio v. Deloitte & Touche LLP,* 476 F.3d 147, 157-58 (2d Cir.2007) (finding plaintiffs failed to allege sufficient facts to show that defendant's misstatements were the proximate cause of plaintiffs' losses where non-party's misstatements could also have caused the loss and plaintiffs did not "allege[ ] facts that would allow a factfinder to ascribe some rough proportion of the whole loss to [defendant's] misstatements").

Although Defendants have contended to the contrary, it is not inconsistent with *Dura* to permit both the '33 and '34 Act Plaintiffs to proceed as a single class in establishing that each of the misstatements alleged in the complaint was the proximate cause of some portion of Plaintiffs' losses. Securities class actions involving more than one misstatement are far from unusual, and both Plaintiffs and Defendants cite several post-*Dura* examples of district courts granting certification where plaintiffs alleged claims under both the '33 and '34 Acts. *See, e.g., In re Vivendi Universal, S.A. Sec. Litig.,* 242 F.R.D. 76 (S.D.N.Y.2007); *In re Initial Pub. Offering Sec. Litig.,* 243 F.R.D. 79 (S.D.N.Y.2007); *In re Tyco Int'l, Ltd.,* 236 F.R.D. 62 (D.N.H.2006). Defendants attempt to distinguish these cases from the instant case on the grounds that they "involved allegations of misstatements made in a single document or allegations of a series of misstatements regarding the same subject," while the allegations here involve unrelated misstatements. Individual Defendants Br. at 24-25 n. 19. While the relatedness of the alleged misstatements may be relevant to the typicality inquiry generally, *see, e.g., Robidoux,* 987 F.2d at 936-37, we fail to see how this distinction implicates *Dura.*Defendants point out that "disaggregation requires that a cause be assigned to each piece of a stock price decline and precludes assigning two different causes to the same quantum of loss."Individual Defendants Br. at 22. This is true; however, in every litigation of this type, the pool of money available for each individual class member's recovery is limited to the loss that the individual actually incurred. We see nothing in the record before us that indicates that in these circumstances, where certain plaintiffs are subject to a negative causation affirmative defense, such a requirement precludes the certification of a single class.

***7** In affirming Judge Conner's order with respect to certification of a single class of '33 and '34 Act Plaintiffs, we do not suggest that the issue described by Defendants does not deserve the careful and continued attention of the district court, but merely that it does not inevitably lead at the present time to the decertification of the class. As the lower court recognized, if Plaintiffs are able to prove loss causation with respect to both the '33 and ' 34 Act claims, then it will be necessary for a jury "to determine the extent of harm caused by each [misstatement], and "it is here that the interests of class members could diverge." *In re Flag,* 245 F.R.D. at 160. We are confident in the lower court's wisdom and ability to utilize the available case management tools to see that all members of the class are protected, including but not limited to the authority to alter or amend the class certification order pursuant to Rule 23(c)(1)(C), to certify subclasses pursuant to Rule 23(c)(5), and the authority under Rule 23(d) to issue orders ensuring "the fair and efficient conduct of the action."Advisory Committee Note on Subdivision (d); *see* *Marisol A. v. Giuliani,* 126 F.3d 372, 379 (2d Cir.1997) (per curiam) (describing "ample tools" available to district court "to fulfill its responsibility" under Rule 23).

II. In-and-Out Traders

Defendants next argue that the lower court abused its discretion by including as members of the certified class those investors who sold their stock before the

February 13, 2002 alleged corrective disclosures were made. Class Representative Hunter, who purchased 200 shares in the IPO and sold them in November 2001, several months before the February 13, 2002 disclosures, is one such purchaser. We consider Defendants' argument with respect to these so-called "in-and-out" traders as implicating the court's authority to define the class, pursuant to Fed.R.Civ.P. 23(c)(1)(B), and the typicality and adequacy of representation requirements of Rule 23(a).

Before addressing whether the lower court erred by certifying in-and-out traders in this case, we must first briefly address Plaintiffs' argument that this issue is not properly before us on Defendants' Rule 23(f) appeal.Rule 23(f) gives this court the authority to "permit an appeal from an order granting or denying class-action certification under this rule."Fed.R.Civ.P. 23(f). Plaintiffs contend that Defendants' argument with respect to the in-and-out traders goes solely to loss causation, a merits issue properly raised in an appeal of a motion to dismiss or summary judgment order, rather than an appeal of an order granting class certification. We do not agree that Defendants' arguments with respect to the in-and-out traders in this context can be so cleanly separated from class certification as to render the issue outside the scope of our Rule 23(f) review.

Given the district court's careful attention to the issue, the lower court clearly considered the in-and-out traders' ability to prove loss causation as relevant to Plaintiffs' certification motion. *See* *In re Flag,* 245 F.R.D. at 165-68. Under *In re IPO,* lower courts have an "obligation" to resolve factual disputes relevant to the Rule 23 requirements and to determine whether the requirements are met, an obligation "not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement." 471 F.3d at 41. To the extent the lower court was required to make factual findings or conclusions of law with respect to any of the Rule 23 requirements, including the definition of the class, those determinations are reviewable here.[FN4] *Id.* at 42 ("[W]e decline to follow the dictum in *Heerwagen [v. Clear Channel Commc'n,* 435 F.3d 219 (2d Cir.2006)], suggesting that a district judge may not weigh conflicting evidence and determine the existence of a Rule 23 requirement just because that requirement is identical to an issue on the merits.").

***8** Defendants again rely on *Dura* to argue that any purchaser who sold his or her stock prior to Flag's February 13, 2002 announcement cannot prove loss causation, and is, at minimum, subject to unique defenses. Judge Conner concluded that since it was "conceivable" that in-and-out traders "may be able" to defeat Defendants' negative causation defense and prove loss causation "notwithstanding that the February 13, 2002 announcement is the most critical corrective disclosure," they were properly included in the certified class. *In re Flag,* 245 F.R.D. at 167.

Defendants argue, and we agree, that the district court's "conceivable" standard of proof does not satisfy the preponderance of the evidence standard set forth in *In re IPO* and its progeny. *See* *Bombardier,* 546 F.3d at 202 ("[T]he preponderance of the evidence standard applies to evidence proffered to establish Rule 23's requirements."). While applying a more rigorous standard to the other Rule 23 requirements, the district court quoted *Roth v. Aon,* 238 F.R.D. 603, 607-08 (N.D.Ill.2006), in support of the proposition that courts facing a challenge to the inclusion of in-and-out traders must only determine whether these traders "could conceivably satisfy the requirement of loss causation, and [should] therefore [be] included in the proposed class." *In re Flag,* 245 F.R.D. at 167 (quotations and citation omitted) (alterations in original).

[7] While we do not disagree with the premise that it may be "premature for courts to attempt to determine whether in-and-out traders have suffered losses at the class certification stage of the game," *Roth,* 238 F.R.D. at 608,"*In re IPO* makes clear that courts may resolve contested factual issues where necessary to decide on class certification, and when a claim cannot succeed as a matter of law, the Court should not certify a class on that issue." *McLaughlin v. Am. Tobacco Co.,* 522 F.3d 215, 228 (2d Cir.2008) (quotations and citation omitted). To the extent that the district court relied on a lesser standard in drawing its conclusion that the in-and-out traders could prove loss causation as a matter of law, we find it abused its discretion.

Plaintiffs urge us to reject the approach taken by the Fifth Circuit Court of Appeals in *Oscar Private Equity*

Inv. v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir.2007), requiring proof of loss causation at the class certification stage, and instead follow the courts in this Circuit that have rejected such attempts by defendants to require such proof for certification. *Compare* *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.,* 487 F.3d 261, 269 (5th Cir.2007) ("We hold hence that loss causation must be established at the class certification stage by a preponderance of all admissible evidence."), *with* *Wagner v. Barrick Gold Corp.,* 251 F.R.D. 112, 118-19 (S.D.N.Y.2008) (concluding that in order to trigger the fraud-on-the-market presumption and thereby satisfy the predominance requirement of Rule 23(b)(3), plaintiffs need not prove loss causation at the class certification stage); *Darquea v. Jarden Corp.,* 06 Civ. 722(CLB), 2008 WL 622811, at *4 (S.D.N.Y. Mar. 6, 2008) (rejecting *Oscar* and holding that to show predominance, "[p]laintiff[s] in the Second Circuit may benefit from the fraud-on-the-market presumption of reliance at the certification stage based solely on a showing that they made purchases or sales in an efficient market, and need not show that they specifically relied on the allegedly fraudulent conduct, as reliance-an element of a 10(b) claims-is presumed."); *In re Omnicom Group, Inc. Sec. Litig.,* No. 02 Civ. 4483(RCC), 2007 WL 1280640, at *8 (S.D.N.Y. Apr.30, 2007) (rejecting loss causation challenge to predominance as "an attempt to litigate class certification on the merits of the action"). Each of these cases, however, including *Oscar,* discusses proof of loss causation in the context of the Rule 23(b)(3) predominance requirement, and the cases cited from this Circuit represent the position that a plaintiff is entitled to a presumption of reliance at the certification stage that does not require the court to make a conclusive finding as to loss causation in order to trigger the fraud-on-the-market presumption laid out in *Basic Inc. v. Levinson,* 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988), an issue that is not before us here.

***9** By contrast, whether or not Plaintiffs here have met their burden in establishing that the in-and-out traders will be able to show loss causation is relevant to Rule 23(a) for reasons that do not implicate either predominance or *Basic.*Since the lower court appointed Hunter, an in-and-out trader, as Class Representative, Judge Conner was required to find, by a preponderance of the evidence, that he is both an adequate and typical representative of the class and not subject to any "unique defenses which threaten to become the focus of the litigation." *Baffa,* 222 F.3d at 59.

[8] Rather than remand this issue to the district court to consider whether the in-and-out traders were properly included in the class, we conclude that Plaintiffs have not presented sufficient evidence to demonstrate that the in-and-out traders will even "conceivably" be able to prove loss causation as a matter of law, and that they therefore should not have been included in the certified class. *See* *McLaughlin,* 522 F.3d at 228.

In *Dura,* the Supreme Court rejected the view that an inflated purchase price is sufficient to plead loss causation on 10(b) claims. 544 U.S. at 340, 125 S.Ct. 1627, 161 L.Ed.2d 577. In so doing, the Court recognized that while "an initially inflated purchase price *might* mean a later loss ... that is far from inevitably so." *Id.* at 342, 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577 (emphasis in original). Indeed, "that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." *Id.* at 343, 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577.

The Supreme Court's holding in *Dura* did not represent a break from this Circuit's approach to loss causation, but rather reaffirmed the analysis we laid out in *Lentell,* 396 F.3d at 173 (holding that to prove loss causation, a plaintiff must allege "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security"). In *Lentell,* we described the two requirements necessary to establish loss causation: 1) the loss must be foreseeable, and 2) the loss must have been caused by the materialization of the concealed risk. *Id.* In order to satisfy the foreseeability prong, a plaintiff must prove that the risk "was within the zone of risk *concealed* by the misrepresentations and omissions alleged by the disappointed investor."*Id.* (emphasis in original).

The standards laid out in *Dura* and *Lentell* are relevant to the in-and-out traders because in order to prove loss causation, any plaintiff who sold their stock prior to the February 13, 2002 disclosure must prove that the loss they suffered was both foreseeable and caused by the "materialization of the concealed risk." The leakage theory put forth by Plaintiffs,[FN5] and accepted as "conceivable" by the lower court, is based on evidence that "the truth regarding Flag's financial condition began to leak into the market prior to the February 13, 2002 announcement, causing the value of Flag common stock to decline." *In re Flag,* 245 F.R.D. at 166. In support of this theory, Plaintiffs point to an "event study" prepared by Plaintiffs' expert, Dr. Hakala, and several "industry events" that occurred prior to the Company's own February 13, 2002 announcement, that they claim sufficiently establish loss causation for the in-and-out traders' claims.[FN6]None of this evidence, however, satisfies *Lentell* because Plaintiffs have failed to demonstrate that any of the information that "leaked" into the market prior to February 13, 2002, revealed the truth with respect to the specific misrepresentations alleged. *Lentell,* 396 F.3d at 175.

***10** According to Plaintiffs, "the truth about demand and profitability began to leak into the market as early as February 2001 through 'industry events' " and "by August 2001, specific news concerning Flag began to leak into the market and depressed Flag's share price further." Plaintiffs Br. at 17-18. However, rather than providing evidence of corrective disclosures, the industry events cited by Plaintiffs appear in their complaint in the context of Defendants' misleading statements themselves. *See* Third Consolidated Amended Complaint ¶ 113 ("[D]efendant McCormack's statements about the Company's supposedly 'enviable' position were an attempt to inaccurately and misleadingly create the impression that FLAG was not in the unenviable position of its competitors, who were being adversely affected by the glut of bandwidth supply, falling prices and raising costs."); ¶ 119 ("FLAG's purpose in providing guidance to analysts to adjust forecasts upward was to distinguish itself from its competitors who, at the same time, were providing much gloomier guidance concerning the state of the telecom industry and the outlook for future results ."); ¶ 172 ("FLAG thus continued to issue false and misleading statements about its condition and prospects, even though its competitors were beginning to acknowledge the difficulties they were facing."). Plaintiffs cannot have it both ways. They cannot allege that Defendants made certain misstatements, namely, that Flag was doing well compared to its competitors, and simultaneously argue that the misstatement itself constituted a corrective disclosure, that is, the fact that the other companies were not doing well exposed the public to the truth about Flag's misstatements. *See* *Lentell,* 396 F.3d at 173. To permit Plaintiffs to do so in this context would "tend to transform a private securities action into a partial downside insurance policy." *Dura,* 544 U.S. at 347-48, 125 S.Ct. 1627, 161 L.Ed.2d 577.

Plaintiffs further fail to connect the decline in the price of Flag stock to any corrective disclosures as required by the second prong of *Lentell.*While the event study links the decline in value of Flag common stock to various events, Plaintiffs have not presented sufficient evidence on which the lower court could conclude that any of the events revealed the truth about the subject of any of Defendants' alleged misstatements. Given that the '33 and '34 Act Plaintiffs primarily allege misstatements with respect to the pre-sale and subsequent reciprocal sales, nothing submitted by Plaintiffs link any disclosure prior to February 13, 2002, to either of these alleged misrepresentations. Without more, we conclude that Plaintiffs have not put forth sufficient evidence on which the in-and-out traders could establish loss causation, and they must therefore be excluded from the certified class. Accordingly, Hunter may not serve as class representative.

III. Remaining Arguments

Defendants raise additional issues challenging the lower court's grant of certification. Since we find these arguments to have no merit, we address them only briefly here.

***11** In addition to the challenges to the adequacy of the class representatives discussed above, Defendants claim that Hunter and Coughlin lack the basic familiarity and involvement with the class required under Rule 23(a)(4).[FN7]*See* *Maywalt v. Parker & Parsley Petroleum Co.,* 67 F.3d 1072, 1077-78 (2d Cir.1995) ("[C]lass certification may properly be denied where the class representatives ha[ve] so little knowledge of and involvement in the class action that they would be unable or unwilling to protect the interests of the class against the possibly competing interests of the attorneys."(internal quotations and citation omitted) (alteration in original)). Given our general disfavor of "attacks on the adequacy of a class representative based on the representative's ignorance," *Baffa,* 222 F.3d at 61, we do not conclude that the lower court abused its discretion in finding that the class representatives "are sufficiently knowledgeable and involved to adequately represent the putative class." *In re Flag,* 245 F.R.D. at 162.

Similarly, we reject Defendants' argument that the district court erred in including in the class '33 Act Plaintiffs who purchased common stock in the secondary market traceable to the Company's IPO as late as May 10, 2000.[FN8] Despite Defendants' evidence that on March 17, 2000 and March 23, 2000, Flag employees exercised "a significant amount of stock options" pursuant to the Company's Long Term-Incentive Plan ("LTIP"), the court concluded that since Defendants had produced no evidence that LTIP shares were actually sold in the market prior to the May 10, 2000 cut-off, it was "inclined to resolve the dispute in favor of plaintiffs." *In re Flag,* 245 F.R.D. at 173. Because we do not conclude that this factual determination constitutes clear error, we affirm this aspect of the certification order.

Finally, Defendants challenge the fairness of the briefing process below on due process grounds. We do not find that the lower court abused its "ample discretion" to limit both discovery and the extent of the hearing on Rule 23 requirements, *In re IPO,* 471 F.3d at 41, and we therefore also reject Defendants' due process challenge to the certification order.

CONCLUSION

For the reasons stated above, the district court's order granting class certification is affirmed with the exception of that portion of the order that includes in the class those individuals who sold their Flag stock prior to February 13, 2002. To the extent the certified class includes such individuals, that portion of the order is vacated, and the case is remanded to the district court for further proceedings.

FN* The Honorable Robert W. Sweet, of the United States District Court for the Southern District of New York, sitting by designation.

FN1. Citigroup served as the lead underwriter of the IPO, and the Individual Defendants all served as directors or officers of Flag around the time of the IPO.

FN2. The "*Rahl* Complaint," filed in the Supreme Court of New York State, New York County, on November 19, 2003, by the Trustee of the Flag Litigation Trust, asserts various claims for breaches of fiduciary duties against several defendants, including several of the Individual Defendants named in this action. *See* *Rahl v. Bande,* 316 B.R. 127 (S.D.N.Y.2004).

FN3. Coughlin, who purchased 250 shares in the IPO on February 23, 2000, and 100 shares in the market on July 3, 2001, brings claims under both the '33 and '34 Acts.

FN4. Defendants also seek review of the district court's denial of its motion to dismiss the '33 Act Plaintiffs' claims. *See* *In re Flag Telecom Holdings, Ltd. Sec. Litig.,* 411 F.Supp.2d 377. According to Defendants, we are permitted under Rule 23(f) to "address issues that should have resulted in the dismissal of some or all claims prior to class certification to the extent that such dismissal would have precluded class certification."Citigroup Br. at 25. We disagree. Defendants' interpretation of the scope of Rule 23(f), even in light of *In re IPO,* goes too far, and we therefore do not reach the lower court's motion to dismiss on this appeal. *See also* *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.,* 482 F.3d 372, 380 (5th Cir.2007) (acknowledging that although "[t]he fact that an issue is relevant to both class certification and the merits ... does not preclude review of that issue,""the text of [Rule 23(f)] makes plain that the sole order that may be appealed is the class certification").

FN5. We do not take issue with the plausibility of Plaintiffs' "leakage" theory. Indeed, in *Lentell,* we explicitly acknowledged that loss causation can be established by a "corrective disclosure to the market" that "reveal[s] ... the falsity of prior recommendations." *Lentell,* 396 F.3d at 175 n. 4. And nowhere does either *Dura* or our precedent suggest that such disclosures must come from the Company itself.

FN6. According to Plaintiffs' expert witness, the purpose of the event study was to "assess the reaction of Flag Telecom's share price to relevant news events."Hakala Decl. ¶ 15.

FN7. We have already found that Hunter cannot serve as a class representative for reasons unrelated to his knowledge and competence. Thus, the remainder of our analysis concerns only Coughlin.

FN8. Neither party disputes "that shares that are bought on the market after unregistered shares have entered the market cannot be traced back to the IPO." *In re Flag,* 245 F.R.D. at 173.

C.A.2 (N.Y.),2009.
In re Flag Telecom Holdings, Ltd. Securities Litigation
--- F.3d ----, 2009 WL 2169197 (C.A.2 (N.Y.))

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TAB 12

United States District Court,
D. New Jersey.
Mary Ann GALATI, Individually and on behalf of all others similarly situated, Plaintiffs,
v.
COMMERCE BANCORP, INC., et al., Defendants.
No. Civ. 04-3252(RBK).

filed July 2, 2004.
Nov. 7, 2005.
terminated Nov. 7, 2005.
last filing Dec. 2, 2005.

Edwin Joseph Jacobs, Jr., Jacobs & Barbone, Atlantic City, NJ, Attorney to be Noticed, for Ronald A. White, (Defendant).

Tina Moukoulis, Law Office of Bernard M. Gross, PC, Philadelphia, PA, Lead Attorney, Attorney to be Noticed, for Jimmy Grossman, (Consol Plaintiff).

William M. Tambussi, Brown & Connery, LLP, Westmont, NJ, Attorney to be Noticed, for Commerce Bancorp, Inc., (Defendant).

OPINION

KUGLER, United States District Judge:

***1** This matter comes before the Court upon separate motions by Defendant Ronald A. White, Defendants Glen K. Holck and Stephen M. Umbrell, and Defendants George E. Norcross, III, Vernon W. Hill, II, Commerce Bancorp, Inc., and Douglas J. Pauls to dismiss Plaintiffs' consolidated complaint for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6). For the reasons set forth below, Defendants' motions will be granted.

I. Background

Plaintiffs bring this securities fraud class action on behalf of all persons, excluding Defendants, who purchased the publicly traded stock of Commerce Bancorp, Inc. ("Commerce Bank"), during the period from June 1, 2002, through June 28, 2004. Commerce Bank is a bank holding company located in Cherry Hill, New Jersey, that operates three hundred retail bank branches in New Jersey, Pennsylvania, Delaware, and New York. Defendants include Commerce Bank and a number of directors and officers of Commerce Bank and its subsidiary Commerce Bank/Pennsylvania (collectively, "Defendants"). Plaintiffs allege that Defendants violated §§ 10(b) and 20(a) of the Securities and Exchange Act of 1934 ("Securities Act") by failing to disclose bid-rigging and other unlawful practices committed on behalf of Commerce Bank during the relevant period.

The allegations arise out of the events surrounding the June 28, 2004, indictment of three Commerce Bank/Pennsylvania executives and directors for employing illegal practices to obtain lucrative business with the City of Philadelphia. Specifically, Ronald A. White ("White"), Glenn K. Holck ("Holck"), and Stephen M. Umbrell ("Umbrell"), in their respective capacities as Commerce Bank/Pennsylvania director, president, and regional vice-president, bestowed a number of personal benefits upon Philadelphia Treasurer Cory Kemp ("Kemp") in exchange for Kemp's influence to secure contracts and other official actions favoring Commerce Bank. Also named as Defendants are Vernon W. Hill, II ("Hill"), the Chief Executive Officer and Chairman of Commerce Bank, George E. Norcross, III ("Norcross"), the Director of Commerce Bank, Director of Commerce Bank/New Jersey, and Chairman and Chief Executive Officer of Commerce Insurance Services, Inc., and Douglas J. Pauls ("Pauls"), the Chief Financial Officer of Commerce Bank. Plaintiffs claim that all Defendants had independent actual knowledge of the unlawful activities that gave rise to the indictment.

Plaintiffs' consolidated complaint focuses almost exclusively on the illegal interactions between Kemp, White, Holck, and Umbrell. Plaintiffs thoroughly describe the relationship between Kemp and Commerce Bank/Pennsylvania, and enumerate in great detail the numerous personal benefits that Holck, Umbrell, and White conferred on Kemp to obtain City accounts and bond deals.[FN1] In exchange for these favors, Kemp channeled City business to Commerce Bank, including a $1.5 million City account in May 2002, $50 million in City deposits in March 2003, priority in several City bond deals, and inside bidding assistance for a $30 million line of credit to finance activities associated with the Mayor of Philadelphia's Neighborhood Transformation Initiative. Plaintiffs also identify specific communications between Commerce Bank/Pennsylvania and Defendant Hill, which they allege put Hill on notice of these practices.

FN1. Plaintiffs allege that Holck and Umbrell waived conditions and otherwise assisted Kemp in securing two mortgage loans in December 2002, which Kemp could not otherwise have obtained due to his poor credit and clear inability to repay, an automobile loan in March 2003, a $480,000 construction loan for a church where Kemp was a trustee in May or June 2003, and an unsecured loan for Kemp's brother-in-law. Commerce Bank also endowed Kemp with several other benefits including expensive dinners and athletic tickets. (Consol.Compl.¶ 37-45)

***2** Plaintiffs claim that Defendants' illegal activities caused considerable harm to shareholders, including losses of approximately $705 million and a drop in value of 23% in the two days following disclosure of the indictment on June 28, 2004. Allegedly in response to the indictment, the value of Commerce Bank's shares dropped 23% from December 29, 2004, through July 30, 2005.

In addition to their account of Defendants' bid rigging and other unlawful activities, Plaintiffs devote a section of their complaint to enumerate their claims of "false and misleading statements [made] during the class period."These statements consist entirely of Commerce Bank quarterly earnings releases, signed and certified by Defendants Hill and Pauls, and filed with the Securities and Exchange Commission ("SEC") from August 14, 2002, through May 10, 2004. Plaintiffs allege no statements made by any Defendants other than Hill and Pauls.

Plaintiff Mary Ann Galati filed suit against Defendants on July 2, 2004. On November 23, 2004, the Honorable Joel B. Rosen ordered consolidation of her suit with a number of complaints by subsequent Plaintiffs. Plaintiffs then filed a consolidated complaint on January 24, 2005, on behalf of all individuals similarly situated, alleging that Defendants failed to disclose illegal conduct in violation of §§ 10(b) and 20(a) of the Securities Act. (Consol.Compl.¶ 4).[FN2] Defendants now move to dismiss the consolidated complaint for failure to state a claim under Federal Rule of Civil Procedure ("Rule") 12(b)(6).

FN2. In addition to the bid-rigging, Plaintiffs claim that Commerce Bank and Defendant Pauls, the treasurer of Commerce Bank's state and federal Political Action Committees (PACs), engaged in other "illegal, undisclosed, unsustainable activities" including numerous violations of federal election laws and elaborate schemes to launder funds to avoid limitations imposed on political contributions. However, Plaintiffs allege no misleading statements related to these practices, nor do they mention Commerce Bank's campaign contributions in their section on "False and Misleading Statements During the Class Period" (Consol.Compl.¶ 120-123). Consequently, for the purpose of deciding Defendants' motions to dismiss, the Court will disregard these factual allegations as surplusage.

II. Standard

A. Rule 12(b)(6)

A motion to dismiss under Rule 12(b)(6) should be granted only if "it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *In re Rockefeller Ctr. Properties, Inc., Sec. Litig.,* 311 F.3d 198, 215 (3d Cir.2002); *Klein v. General Nutrition Co.,* 186 F.3d 338, 342 (3d Cir.1999). A motion to dismiss "tests the legal sufficiency of the complaint." *In re ATI Tech., Inc., Sec. Litig.,* 216 F.Supp.2d 418, 427 (E.D.Pa.2002) (citing *Holder v. City of Allentown,* 987 F.2d 188, 194 (3d Cir.1993))."The inquiry is not whether plaintiffs will ultimately prevail in a trial on the merits, but whether they should be afforded an opportunity to offer evidence in support of their claims." *In re Rockefeller,* 311 F.3d at 215.

Consequently, the Court must "accept all well-pleaded allegations in the complaint as true and to draw all reasonable inferences in favor of the non-moving party." *Id.* at 215 (citing *Scheuer v. Rhodes,* 416 U.S. 232, 236 (1974)); *In re Burlington Coat Factory Sec. Litig.,* 114 F.3d 1410, 1420 (3d Cir.1997). However, the court need not credit a plaintiff's "bald assertions" or "legal conclusions draped in the guise of factual allegations."*Id.*

B. Rule 9(b) and the Private Securities Litigation Reform Act

Rule 9(b) imposes a heightened pleading requirement on allegations of fraud, including claims brought under § 10(b) of the Securities Act. *SeeIn re Rockefeller,* 311 F.3d at 216 ("Rule 9(b)'s heightened pleading standard gives defendants notice of the claims against them, provides an increased measure of protection for their reputations, and reduces the number of frivolous suits brought solely to extract settlements."). Under Rule 9(b), plaintiffs must state with particularity "the circumstances constituting fraud or mistake."Fed.R.Civ.P. 9(b). To satisfy the particularity requirement, the complaint should include "all of the essential factual background that would accompany 'the first paragraph of any newspaper story'-that is, the 'who, what, when, where and how' of the events at issue."*Id.* at 217 (quoting *In re Burlington,* 114 F.3d at 1422). Boilerplate allegations are insufficient. *Id.*

***3** In addition to satisfying Rule 9(b), allegations of securities fraud must accord with the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (PLSRA).15 U.S.C. § 78u-4(b)(1), (b)(2). Under the PSLRA the complaint must "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading." *In re Rockefeller,* 311 F.3d at 217 ("The particularity described in § 78u-4(b)(1) extends that of Rule 9(b) and requires plaintiffs to set forth the details of allegedly fraudulent statements or omissions, including who was involved, where the events took place, when the events took place, and why any statements were misleading."). Plaintiffs must also plead with particularity facts supporting a "strong inference" of scienter. *In re Advanta Corp. Sec. Litig.,* 180 F.3d 525, 530, 534 (3d Cir.1999).

III. Discussion

Section 10(b) of the Securities Act makes it illegal to "use or employ, in connection with the purchase or sale of any security ..., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."15 U.S.C. § 78j(b). Under 17 CFR section 240.10b-5 ("Rule 10b-5"), it is "unlawful for any person, directly or indirectly ... [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."17 CFR § 240.10b-5.[FN3]

FN3. Rule 10b-5 reads in its entirety:

> 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 CFR § 240.10b-5

To establish a claim for violation of Rule 10b-5, the plaintiff must allege with particularity that: (1) the defendant "made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading"; (2) the "defendant acted with scienter"; and (3) the plaintiff's reliance on defendant's misstatement or omission injured the plaintiff. *In re Burlington,* 114 F.3d at 1417 (citing *In re Phillips Petroleum Sec. Litig.,* 881 F.2d 1236, 1243 (3rd Cir.1989)); *see also* *In re Advanta,* 180 F.3d at 537.

A. Material False or Misleading Statement or Omission

Defendants argue that they are not liable under Rule 10b-5 because they neither made a misleading statement, nor had a duty to disclose the illegal conduct. Plaintiffs claim: (1) Defendants misleadingly attributed Commerce Bank's success to its unique business model and convenience when "its pattern of bribery and bid-rigging fueled the Company's results" (Pls. Opp. at 16-17); (2) Defendants' quarterly earnings release statements, including positive commentary and specific reports of government deposits, were misleading without full disclosure of the illegal practices; and (3) the failure to reveal criminal conduct is inherently misleading. As set forth more fully below, none of these allegations amounts to a materially misleading statement or omission for the purposes of Rule 10b-5.[FN4]

FN4. Plaintiffs allege no misleading statements other than the SEC filings signed by Defendants Hill and Pauls. Because liability for violation of Rule 10b-5 rests exclusively on misleading statements and omissions, Plaintiffs have therefore failed to plead a violation by any Defendants other than Hill and Pauls. However, because this Court finds that none of the alleged statements were in fact materially misleading, the Court will dismiss the consolidated complaint in its entirety without addressing Plaintiffs' failure to plead violations by particular Defendants.

1. Materiality

***4** Regardless of its falsity, a misleading statement or omission is not actionable unless it is material. A misrepresentation "is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act]." *EP Medsystems, Inc. v. EchoCath, Inc.,* 235 F.3d 865, 872 (3d Cir.2000) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976)); *see also* *Basic, Inc. v. Levinson,* 485 U.S. 224, 232 (1988) (relating this standard specifically to Rule 10b-5). Omitted information is material if there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Craftmatic Sec. Litig. v. Kraftsow,* 890 F.2d 628, 639 (3d Cir.1989) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976)). While determinations of materiality are typically reserved for the trier of fact, "complaints alleging securities fraud often contain claims of omissions or misstatements that are obviously so unimportant that courts can rule them immaterial as a matter of law at the pleading stage." *In re Burlington,* 114 F.3d at 1426.

The Third Circuit has consistently held that "[v]ague and general statements of optimism," known as "puffery," are not material since a reasonable investor would be unlikely to rely on them to make decisions. *Id.* Similarly, "statements of subjective analysis or extrapolations, such as opinions, motives and intentions, or general statements of optimism" do not alter the total mix of relevant information available, and therefore are not material. *In re Advanta,* 180 F.3d at 538 (quoting *In re Burlington,* 114 F.3d 1410, 1428 n. 14). Such statements are not actionable under Rule 10b-5 as a matter of law.*Id.*

In support of their claim, Plaintiffs allege that Defendant Hill made remarks attributing Commerce Bank's success to its "unique business model" and "convenience." (Pls. Opp. at 16-17). Plaintiffs claim that Hill's comments were materially misleading because Commerce Bank's success was actually "fueled by repeated criminal conduct." [FN5]However, the context of these statements makes it clear that a reasonable investor would view them as no more than boilerplate rhetoric. Although they do not say so explicitly, Plaintiffs appear to glean these quotes from a number of quarterly earnings releases filed with the SEC during the relevant period. The allegedly misleading language is contained in several releases, which repeat: "Chairman Hill indicated 'America's Most Convenient Bank' continues to produce record results" (see earnings releases from Q3:02, Q4:02, Q1:03, Q2:03). In the same manner, several of the reports state: "Vernon W. Hill, II, Chairman, commenting on the Company's financial results said, 'in the most difficult low-rate operating environment in the last 45 years, the unique Commerce business model continues to produce strong top-line revenue growth."(See earnings releases from Q3:03, Q4:03, Q1:04).

> FN5. These statements are buried in the consolidated complaint in four pages of dense bullet points. (Consol.Compl.¶ 120-121). Plaintiffs do not explain in their complaint "why the statement[s] [are] misleading," *In re Rockefeller,* 311 F.3d at 217, nor do they make their "business model" arguments until their opposition to Defendants' motion to dismiss. Consequently, these statements likely are not pleaded with particularity sufficient to satisfy Rule 9(b) and the PLSRA. Nevertheless, because this Court now holds that these statements are immaterial, it will not reach the issues presented by Rule 9(b) and PLSRA.

***5** These remarks are exactly the sort of vague, general, optimistic commentary that the Third Circuit has deemed immaterial puffery. Commerce Bank's slogan "America's Most Convenient Bank" and its claim to a "unique" business model are simply too vague and subjective to influence reasonable investors or "alter the total mix of information available."*See e.g., In re Advanta,* 180 F.3d at 539 (holding as immaterial optimistic statements such as "[o]ur superior cost structure for delivering and servicing financial products allows us to achieve outstanding returns with highly competitive pricing and flexibility"). Consequently, these statements are not actionable under Rule 10b-5.

In addition to Defendants' allegedly misleading comments about Commerce Bank's business model, Plaintiffs contend that Defendants' failure to disclose bid-rigging and other criminal conduct was a material omission in light of their positive earnings statements. Specifically, Plaintiffs claim that Defendants were obligated to disclose (1) "the corrupt, illegal and unsustainable means that Commerce Bank ... was utilizing to develop banking business with state, city and municipal authorities"; and (2) "the attendant risks that such practices were creating for the future prospects of the Company."(Consol.Compl.¶ 48). As explained below, Defendants' illegal activities were material, but the failure to disclose "the attendant risks" of those activities was not.

Information about a corporation's illegal conduct is inherently material for the purposes of Rule 10b-5. *See e.g., Roeder v. Alpha Indus., Inc.,* 814 F.2d 22, 26 (1st Cir.1987) (holding that a company's practice of bribery is material information, even if the criminal conduct has not yet become the subject of investigation). Naturally, a reasonable investor would give considerable weight to a corporation's unlawful practices. As the First Circuit explained in the oft-cited opinion *Roeder v. Alpha Industries, Inc.,* 814 F.2d at 26,"Management's willingness to engage in practices that probably or obviously are illegal, and its decision to put the corporation at risk by so doing, may be critically important factors to investors," particularly since "[i]nvestors may prefer to steer away from an enterprise that circumvents fair competitive bidding and opens itself to accusations of misconduct."*Id.*

Defendants argue that the Bank's bid-rigging practices were immaterial because they relate to a negligible portion of Commerce Bank's business and contribute only a small percentage to Commerce Bank's total deposits and revenue. However, the materiality of criminal activities is unaffected by the extent of the illegal conduct; after all, "[i]llegal payments that are so small as to be relatively insignificant to the corporation's bottom line can still have vast economic implications," as they may endanger all of a corporation's business if they are discovered. *Id.* Furthermore, "[i]nformation about bribery is relevant to important questions about the competency of management."*Id.* Consequently, a corporation's unlawful practices are material, even if the practices relate to only a minor aspect or portion of the business.

***6** However, while omissions regarding criminal conduct are material, omissions relating to "the attendant risks" or unsustainability of criminal conduct are not. Even if a corporation is engaging in illegal practices, predictions of future events such as criminal indictments are too speculative to be material. *See Craftmatic,* 890 F.2d at 640-41. The Third Circuit addressed precisely this point in *Craftmatic* when plaintiffs alleged that that the corporation's "advertising and marketing program was based on deceptive, illegal sales practices that 'would and did result in serious charges being brought against Craftmatic."The Court dismissed plaintiffs' claim, holding that the possibility of criminal charges was "sufficiently speculative and unreliable to be immaterial as a matter of law."*Id.* at 644.The Court then employed the same reasoning to dismiss allegations that Craftmatic's unlawful practices created serious risks for the corporation and were "not sustainable." *Id.*

Consequently, as a matter of law, the risks inherent in Commerce Bank's unsustainable illegal practices were too speculative to be material. Only information regarding Defendants' illegal conduct itself is material under Rule 10b-5.

2. Misleading Statement or Omission

Although Rule 10b-5 prohibits corporations from making material misstatements of fact, corporations need not actively disclose information-even material information-unless there exists a "duty to speak." *Chiarella v. United States,* 445 U.S. 222, 235 (1980); *In re Burlington,* 114 F.3d at 1432 ("Except for specific periodic reporting requirements ... there is no general duty on the part of a company to provide the public with all material information."). Only misleading statements are actionable under Rule 10b-5, and silence, "absent a duty to disclose," is not inherently misleading. *Basic,* 485 U.S. at 239 n. 17. Consequently, although information concerning Commerce Bank's illegal practices was material, Defendants were nevertheless under no obligation to reveal the information unless they had a preexisting duty to do so.

In circumstances where there is no insider trading or statute requiring disclosure, a duty to disclose likely exists only in the presence of "an inaccurate, incomplete or misleading prior disclosure." *Oran v. Stafford,* 226 F.3d 275, 285-86 (3d Cir.2000); *In re Campbell Soup Co. Sec. Litig.,* 145 F.Supp.2d 574, 583 (D.N.J.2001) (holding that once a corporation has chosen to make a disclosure, "the disclosing party has an obligation to ensure that the representations are accurate") (citing *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083, 1098 n. 7 (1991)). Consequently, Defendants are liable under Rule 10b-5 for failure to disclose their illegal practices only if Plaintiffs can point to a statement that was rendered inaccurate or misleading by the omission.

For the purposes of Rule 10b-5, "[a] statement is false or misleading if it is factually inaccurate, or additional information is required to clarify it." *In re Nice Sys., Ltd. Sec. Litig.,* 135 F.Supp.2d 551, 573 (D.N.J.2001). A statement is also misleading if "when viewed in the light of the circumstances under which it was made, [it] presented a false report of the facts." *Jaroslawicz v. Engelhard, Corp.,* 704 F.Supp. 1296, 1306 (D.N.J.1989) (citing *Associated Builders, Inc. v. Alabama Power Co.,* 505 F.2d 97, 101 (5th Cir.1974).

***7** Plaintiffs allege that Defendants' "positive statements about growth in Commerce Bank's government and public deposits" and "positive statements about growth in Commerce Bank's investment banking fees at Commerce Capital Markets" created a duty to tell the "whole truth" about Defendants' illegal activities. (Consol.Compl.¶ 122). In support of this claim, Plaintiffs list a number of excerpts from Commerce Bank's quarterly filings with the SEC. (Consol.Compl. ¶ 120-121). These filings are composed primarily of empirical listings of Commerce Bank's deposits, revenue, and percentages of growth. Accompanying these financial performance figures are self-congratulatory comments such as "dramatic deposit growth," "record growth," "record deposits growth," and "strong top-line revenue growth" (Pls. Opp. at 15). Plaintiffs allege that these positive reports were misleading without the disclosure of Defendants' criminal conduct.

However, as long as they are accurate, earnings statements themselves do not create liability under Rule 10b-5. *See e.g., In re ATI Technologies, Inc. Sec. Litig.,* 216 F.Supp.2d 418, 433 (E.D.Pa.2002) (holding that "ATI's announcements of its quarterly and yearly earnings, gross margins, sales, etc., were not material misrepresentations"). To hold otherwise would be to establish per se liability under Rule 10b-5 for any material information related to corporate earnings releases-a result that would be almost indistinguishable from creating a general duty of disclosure.

The Third Circuit has made it clear that corporations are not liable merely for reporting past successes. *See e.g., In re Advanta,* 180 F.3d at 538 ("Factual recitations of past earnings, so long as they are accurate, do not create liability under Section 10(b)); *In re Burlington,* 114 F.3d at 1432 ("Equally well settled is the principle that an accurate report of past successes does not contain an implicit representation that the trend is going to continue, and hence does not, in and of itself, obligate the company to update the public as to the state of the quarter in progress."). Statements claiming deposit growth of 48% or total revenues of "$8.1 million for the second quarter of 2002 compared to compared to $5.3 million for the second quarter of 2002, a 54% increase," (Consol.Compl.¶ 121), state nothing more than empirical facts. So long as those numbers are accurate, they cannot create Rule 10b-5 liability.

Nor are Defendants liable for vague positive remarks accompanying earning releases. In *Advanta,* plaintiffs claimed that a number of statements in letters to shareholders, annual reports, and other publications were misleading in light of the corporation's questionable business techniques and the deterioration in credit quality attributable its "aggressive efforts to attract new customers." *In re Advanta,* 180 F.3d at 538. However, in examining the allegedly misleading statements, the Third Circuit found that each statement was non-actionable as either an accurate report of past earnings or an expression of optimism.[FN6]

> FN6. These statements include, "Advanta's credit quality continues to be among the best in the industry. Our emphasis on gold cards-and targeting of high quality customer prospects with great potential for profitability-sets us apart from other credit card issuers"; "The Company is among the most efficient producers in the credit card industry. Our superior cost structure for delivering and servicing financial products allows us to achieve outstanding returns with highly competitive pricing and flexibility"; "Our emphasis on gold cards-and targeting of better quality customers-helps us maintain an enviable credit quality profile. Gold cards made up 82% of our credit card balances in 1995, nearly double the industry average"; "Despite industry-wide pressure on credit card asset quality, Advanta continued to produce better-than-industry credit measures, and achieved excellent growth and returns throughout our core businesses"; "The Company's credit card asset quality statistics continue to be better than industry averages"; and touting of Advanta's strengths, including "an experienced management team, technological expertise ... and expanding distribution channels." *In re Advanta,* 180 F.3d at 539.

***8** Plaintiffs' argument that the failure to reveal criminal conduct is per se misleading is also without merit. Plaintiffs cite *In re Initial Public Offering Sec. Litig.,* 241 F.Supp.2d 281, 381-82 (S.D.N.Y.2003), for the proposition that concealing illegal activity is inherently misleading. However, *In re Initial Public Offering* addressed market manipulation, holding only that "[w]here a defendant has engaged in conduct that amounts to 'market manipulation' under Rule 10b-5(a) or (c), that misconduct creates an independent duty to disclose."*Id.*

Although there is no Third Circuit case directly addressing a corporation's obligation to disclose criminal conduct, the First Circuit held in *Roeder* that the defendant corporation's failure to disclose its practice of paying bribes to obtain subcontracts was not inherently misleading. *Roeder,* 814 F.2d at 22. Additionally, the Third Circuit has observed that "the nondisclosure of a statutory violation *may* be an omission of information necessary to make other statements not misleading," suggesting that the failure to disclose criminal conduct is not necessarily misleading in itself. *Craftmatic,* 890 F.2d at 640 (emphasis added).

Furthermore, "the private cause of action under § 10(b) and Rule 10b-5 is designed to implement the Congressional intent to regulate securities transactions." *Straub v. Vaisman & Co., Inc.,* 540 F.2d 591, 599 (3d Cir.1976). Rule 10b-5 was not intended to provide shareholders with an avenue for relief against executives for alleged illegal practices or corporate mismanagement. *See e.g., In re Citigroup, Inc., Sec. Litig.,* 330 F.Supp.2d 367 (S.D.N.Y.2004) ("The securities laws were not designed to provide an umbrella cause of action for the review of management practices."). Consequently, the illegality of Defendants' conduct does not establish a Rule 10b-5 violation unless Defendants made a misleading statement in conjunction with the conduct.

As Plaintiffs have failed to specify any material misstatement or omission sufficient to establish liability under Rule 10b-5, Plaintiffs' allegations under Rule 10b-5 must be dismissed.[FN7]

> FN7. Because this Court now finds that Plaintiffs alleged no statement or omission sufficient to create liability under Rule 10b-5, the Court will not reach Defendants' arguments regarding scienter, reliance, or causation.

B. Control Person Liability

In addition to their claims under Rule 10b-5, Plaintiffs allege that Defendants are liable under § 20(a) of the Securities Act. Section 20(a) provides for derivative liability of "control persons" in the event of a violation of the Securities Act. 15 U.S.C. § 78t. A cause of action for control person liability requires plaintiffs to establish: "(1) an underlying violation by a controlling person or entity; (2) that the defendants are 'controlling persons;' and (3) that the defendants were in some meaningful sense culpable participants in the fraud." *In re Digital Island Sec. Litig.,* 223 F.Supp.2d 546, 560 (D.Del.2002) (quoting *In re Party City Sec. Litig.,* 147 F.Supp.2d 282, 317 (D.N.J.2001)).

Where plaintiffs cannot establish "an underlying violation" of the Securities Act, a § 20(a) claim must be dismissed since "[l]iability under section 20(a) is predicated upon an independent violation of 'this chapter or the rules or regulations thereunder." ' *In re Advanta,* 180 F.3d at 541 (quoting 15 U.S.C. § 78t); *see also* *Greebel v. FTP Software, Inc.,* 194 F.3d 185, 207 (1st Cir.1999) (holding that absent an underlying violation of the securities laws, a § 20(a) claim cannot stand).

***9** Accordingly, because this Court now finds that Plaintiffs have not stated a claim under Rule 10b-5, Plaintiffs allegations of control person liability under § 20(a) must be dismissed for lack of an underlying violation of the Securities Act.

The accompanying Order shall issue today.

D.N.J.,2005.
Galati v. Commerce Bancorp, Inc.
Not Reported in F.Supp.2d, 2005 WL 3797764 (D.N.J.), Fed. Sec. L. Rep. P 93,610

END OF DOCUMENT

TAB 13

Only the Westlaw citation is currently available.

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

Jack E. GRANT, Plaintiff,
v.
CHEMREX, INC., Defendant.
No. 93 C 0350.

April 28, 1997.

MEMORANDUM OPINION AND ORDER

MAROVICH, District Judge.

***1** Plaintiff Jack Grant ("Grant") filed a three-count Complaint against Chemrex, Inc. ("Chemrex") alleging injuries to his liver, heart and lungs from an exposure to Chemrex's product, Kure-N-Seal, and seeking $4.5 million in damages. Grant's Complaint presents three legal theories for recovery based upon negligence (Count I), breach of implied warranty of merchantability (Count II) and strict product liability (Count III). Chemrex has moved for summary judgment on all three counts asserting that Grant cannot establish that Chemrex's product caused his injuries. In conjunction with this motion, Chemrex has moved to strike the testimony of Grant's treating physicians and expert witness. As set forth below, the Court grants Chemrex's motions to strike. As a result, the Court also grants Chemrex's motion for summary judgment.

BACKGROUND

Grant worked for Pacific Fasteners Corporation ("Pacific") as a warehouse manager. In March 1991, Pacific moved into a new warehouse in Lincolnshire. In June 1991, as part of an attempt to "spruce up" the warehouse for the upcoming visit of the company chairman, Grant along with a co-worker, Jim Ringman ("Ringman"), was asked to seal the warehouse floor. Grant's supervisor purchased paint rollers and several five gallon drums of Chemrex's Kure-N-Seal Gray. Kure-N-Seal Gray is a pigmented ready-to-use acrylic curing and sealing system specifically designed for interior and exterior concrete masonry floors. The solvents in the Kure-N-Seal produce an odor.

One of the employees of the hardware store came to the warehouse and instructed Grant as to how to apply the sealant using a paint roller. The paint store employee recommended that they keep the loading dock doors open for ventilation while applying the Kure-N-Seal. Before he began using Kure-N-Seal, Grant read the label which he recalls warned him to keep the area ventilated to avoid fumes. The warning label for the Kure-N-Seal used by Grant read as follows:

WARNING-COMBUSTIBLE

CONTAINS: MINERAL SPIRITS, AROMATIC 100

May cause skin irritation. Prolonged contact of liquid or vapor with eyes may cause injury. Prevent contact with skin and eyes. If contact occurs, flush affected area(s) thoroughly with plenty of water. May cause respiratory irritation or intoxication with headaches, nausea, and central nervous system depression. Repeated or prolonged overexposure may cause injury to the kidneys, central nervous system, or formed elements of the blood. Avoid breathing vapor/mist. If inhaled, remove to fresh air. If breathing is difficult, give oxygen. If not breathing administer artificial respiration. May cause irritation if ingested. DO NOT take internally. If ingested, DO NOT induce vomiting. Small amounts of liquid aspirated into lungs may cause serious pulmonary injury. SEEK MEDICAL ATTENTION FOR ALL OVEREXPOSURES.

Use only with adequate ventilation. Keep containers closed.

Keep away from sources of ignition.

***2** KEEP OUT OF REACH OF CHILDREN

RECOMMENDED SAFETY EQUIPMENT Use impervious gloves, goggles, and if applied in areas of poor or inadequate ventilation, use NIOSH/MSHA approved organic vapor respirator.

While he applied the sealant, Grant made sure that the dock doors, which are eight feet by eight feet, and the bay door, which is ten feet by twelve feet, remained open and that the dock area exhaust fan was running. In addition, Grant used two large floor fans to push the fumes out of the warehouse. The Pacific warehouse is about 200 feet long by approximately 100 feet wide. Working normal hours of 8:00 a.m. to 5:00 p.m., it took Grant and Ringer three full days and a part of a fourth day to complete the project. While he was applying the sealant, Grant had headaches, but experienced no other problems. According to Grant, Ringer did not have a headache or experience any other problems.

Approximately two weeks later, on June 28, 1991, Grant went to the emergency room of Sherman hospital complaining of right side chest pain. Dr. Mohammad Zahid ("Dr.Zahid"), an emergency room physician, admitted him to the hospital. Grant was also examined by a number of other physicians. Dr. Deepak Khurana ("Dr.Khurana"), a gastroenterologist, was consulted because Grant's liver function test results were abnormal. After examining Grant, Dr. Khurana opined that he doubted that Grant suffered from toxic hepatitis, based upon the type of exposure and time frame of response, but instead opined that Grant suffered from a viral illness.

Dr. Lee Lichtenberg ("Dr.Lichtenberg"), who is board certified in rheumatology and internal medicine, was consulted because Grant had inflammation of the pleural cavity and pericardial cavity and at least one abnormal blood test for rheumatic disease. Dr. Lichtenberg was asked to determine if there was a medical causation between the toxic exposure and Grant's condition. Dr. Lichtenberg opined that if this was Grant's first exposure to Kure-N-Seal, then it was an unlikely cause of his medical symptoms.

Dr. Zahid, who is board certified in internal medicine, was not able to make any specific diagnosis of Grant's condition, but was willing to consider a toxic nature to his illness. Dr. Zahid indicated that he would rely upon the opinion of Dr. Zubair Ahmad ("Dr.Ahmad") as a pulmonary specialist, who also treated Grant during his stay at Sherman hospital. According to Dr. Zahid, Dr. Ahmad ruled out the possibility of Kure-N-Seal exposure as a cause of Grant's injury due to the presence of pleural pericardial effusion (fluid around the heart)

Dr. Ahmad, who is board certified in pulmonary and critical care, was asked to consult on Grant's case because of his pulmonary problems. At the time he treated Grant during Grant's hospitalization, Dr. Ahmad opined that chemical exposure was not the cause of Grant's medical problems. Later, at his deposition, Dr. Ahmad testified that he found, to a reasonable degree of medical certainty, that the pleural thickening in just one lung was not caused by an inhalation of hydrocarbons, but that further study would be required to completely rule out inhalation as the cause of Grant's condition.

***3** Grant was also under the care of his treating physician, Dr. Irving Bush ("Dr.Bush"). Dr. Bush, a professor of surgery in the field of urology at Chicago Medical School and an adjunct professor of biology at Northern Illinois University, opined that Grant had a fibrous reaction and pleurisy from the Kure-N-Seal exposure which led to the decortification of Grant's lungs in 1993. Dr. Bush further found that Grant suffered from liver toxicity from inhaling the Kure-N-Seal fumes.

Expert Testimony

Chemrex offered the following expert testimony from John Bederka, Ph.D. and David Cugell, M.D. Dr. Bederka, a toxicologist, chemist and pharmacologist, reviewed Grant's records from Sherman hospital, Dr. Bush's medical records, the Kure-N-Seal label provided by Grant, the Material Safety Data Sheet ("MSDS") for Kure-N-Seal, the construction handbook and other material related to the product and produced by Chemrex, the Complaint, the depositions of Grant, Dr. Bush, Dr. Lichtenberg, Dr. Ahmad, Dr. Zahid, and Dr. Khurana. Dr. Bederka also inspected the Pacific warehouse, measuring its dimensions and the area that was sealed and the dock doors that were used for ventilation, and performed calculations of the amount of product that Grant was exposed to during his work day based on his visit to the warehouse, Grant's deposition testimony, and the Kure-N-Seal Gray specification sheet. Based on his review of the information, and his experience and training, Dr. Bederka concluded "that the product, Kure-N-Seal concrete sealer, is safe; the labeling is appropriate; the material data safety sheets are appropriate; and there is no probable connection between Mr. Grant's exposure to this product and his subsequent medical problems." Dr. Bederka noted that Grant had a history of an abnormal left lung and found that Grant's lung problems "had nothing to do with any exposure to a chemical." In addition, Dr. Bederka concluded that the "two week interval between exposure and the hospital admission make it highly unlikely that the chemicals are a cause."

Dr. Cugell, a professor of pulmonary diseases at Northwestern University, after examining the same materials as Dr. Bederka, concluded as follows:

I do not believe that there is any connection between the application of Kure-N-Seal sealer to a cement floor in June 1991 and Mr. Grant's multiple medical problems that occurred thereafter for the following reasons:

a. According to his deposition, Mr. Grant used large, mobile fans in the area where he was applying the sealer and the overhead doors to the warehouse were kept open to enhance ventilation.

b. According to the material safety data sheets, this concrete sealer can exert an irritant effect on the eyes, skin and respiratory tract. If so, adverse effects would be maximal at the time of the exposure and diminish thereafter. Mr. Grant did not experience any symptoms at the time he was handling the floor sealer.

c. Although no definite diagnosis was established during the June 1991 admission to Sherman Hospital, neither the pattern of complaints nor the pattern of abnormal laboratory tests, or the gradual resolution of many of the abnormal findings is consistent with a prior exposure to injurious chemicals. An infectious cause for his symptoms seems most probable, particularly in view of the blood oxygen values that were significantly reduced when he was admitted to the hospital, and had returned to normal by the time of discharge. In July 1993 Mr. Grant underwent surgery for removal of scar tissue surrounding his left lung. His prior medical records indicate that he sustained a left lung collapse in conjunction with an appendectomy done many years previously. The 1993 chest surgery was the result of this prior left lung injury or collapse that occurred many years earlier and the fluid or pneumonia in 1991.[FN1]

FN1. Neither Dr. Bederka nor Dr. Cugell was deposed by Grant's counsel during discovery.

***4** In rebuttal, Grant offers the opinions of his treating physicians-Drs. Bush, Lichtenberg, Khurana, Ahmad and Zahid-and though belatedly, Dr. Samuel Epstein ("Dr.Epstein"). Dr. Epstein, a medical doctor with expertise in the field of cancer, opines that Kure-N-Seal was defective and unreasonably dangerous because it failed to list hazardous components in its MSDS, misrepresented Threshold Limit Values ("TLV") (maximum safe exposure) of its various components and was never tested to determine the synergistic effects of mixing its individual components; Dr. Epstein opined that these product defects caused Grant's injuries. In addition, Dr. Epstein opined that the warnings on Kure-N-Seal failed to disclose the hazards of using the product or the conditions under which it could be safely used-it misleadingly implied that one could apply the product without breathing vapors and failed to make clear that normal ventilation would be inadequate. Dr. Epstein attaches to his his report and opinion the report of Alan Todd ("Todd"), an industrial hygienist retained to provide an estimate of the levels of exposure to the chemicals contained in Kure-N-Seal. As Dr. Epstein stated, ascertaining the level of exposure (along with the product ingredients) was a "prerequisite to my being able to develop a position on causation." In addition, Dr. Epstein reviewed the depositions of Grant, Dr. Ahmad, Dr. Bush, Dr. Khurana, Dr. Zahid, and the records from Sherman hospital. Dr. Epstein did not visit the Pacific warehouse.

Procedural History

This case has a rather tortured history that is important to recount because it serves, at least in part, as a basis for the Court's decision. Grant's Complaint was filed on January 20, 1993 and, after several status conferences, this Court ordered Grant to disclose any medical experts by September 7, 1993. Because of various failures of the discovery process, this goal was not met, resulting in the following court-ordered schedule: Chemrex was to respond to all outstanding discovery requests within thirty days; the parties were to depose Dr. Bush by February 10, 1994 and all treating physicians and occurrence witnesses by May 12, 1994. The Court also referred further discovery issues to Magistrate Judge Guzman.

On March 11, 1994, Magistrate Judge Guzman entered the following discovery schedule: “all written discovery to be completed by 7/15/94. Non-expert depositions to be completed by 10/15/94. Rule 26(a)(2)(B) reports to be exchanged by the parties by 11/15/94 and all expert depositions to be taken by 12/15/94.” These deadlines came and went without Grant ever disclosing his expert witnesses or deposing Chemrex's properly-disclosed expert witnesses. In addition, Grant did not seek an extension of time or seek to compel any outstanding discovery from Chemrex. On December 19, 1994, with discovery closed, Magistrate Judge Guzman ordered all dispositive motions to be brought by January 13, 1995.

***5** Chemrex filed its motion for summary judgment on December 20, 1994, alleging that Grant could not establish causation because he had no expert testimony. Grant did not respond to the motion directly, but instead moved the Court to compel Chemrex to disclose the specific percentages of Kure-N-Seal ingredients, something he had been seeking from Chemrex since April 1994. Grant claimed that his expert could not provide any opinion without the specific chemical make-up of Kure-N-Seal. The Court again referred the matter to Magistrate Judge Guzman who denied the motion to compel without prejudice.

Grant then filed a partial response to the motion for summary judgment, but moved the Court to reopen discovery to allow him to disclose his expert witness, Dr. Epstein. On March 10, 1995, Magistrate Judge Guzman granted Grant's motion. Because discovery had been reopened, the motion for summary judgment was withdrawn on March 21, 1995.

On May 23, 1995, Magistrate Judge Guzman ordered Chemrex to produce the MSDSs for Kure-N-Seal. The Court also advised Grant that if he needed any more information to notify Chemrex by June 2, 1995. No such notification was made, nor were any motions to extend discovery brought. After several status hearings, on September 21, 1995, Magistrate Judge Guzman ordered Grant to disclose Todd's report by October 3, 1995 and to take Dr. Epstein's deposition by October 31, 1995. Finally, the Magistrate Judge ordered Chemrex to file its summary judgment motion by November 3, 1995.

Chemrex filed its summary judgment motion as directed. Thereafter, Grant filed his opposition to the motion, relying principally on the opinion of Dr. Epstein who, in turn, relied on Todd's findings. Grant, however, never disclosed Todd as an expert witness and, thus, Todd was never deposed by Chemrex. It is for these reasons that Chemrex moved for leave to file several motions to strike the expert testimony that Grant offered in his response to the motion for summary judgment. This Court, after a pretrial conference with the parties, granted Chemrex the requested leave and allowed Grant an opportunity to respond to the motions.

DISCUSSION

I. *Summary Judgment Standards*

Summary judgment is appropriate when “the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and the moving party is entitled to a judgment as a matter of law. Fed.R.Civ.P. 56(c); *Serfecz v. Jewel Food Stores,* 67 F.3d 591, 596 (7th Cir.1995). A material fact is one that may affect the outcome of the suit under the governing law. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). Once the moving party has shown that no issue of material fact exists, the opposing party must come forward with specific evidence showing that there is a genuine issue for trial. *Celotex Corp. v. Catrett,* 477 U.S. 317, 324, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). The nonmovant may not rest upon mere allegations in the pleadings or upon conclusory statements in affidavits; rather he must go beyond the pleadings and support his contentions with proper documentary evidence. All reasonable inferences must be made in favor of the nonmoving party. *McCoy v. WGN Continental Broadcasting Co.,* 957 F.2d 368, 371 (7th Cir.1992).

***6** The plain language of Rule 56(c) mandates the entry of summary judgment against a party who fails to establish the existence of an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex,* 477 U.S. at 322. In such a situation there can be no genuine issue as to any material fact, since a complete failure of proof concerning an essential element of the nonmoving party's case necessarily renders all other facts immaterial. *Id.* at 323.

Chemrex contends that it is entitled to summary judgment because Plaintiff cannot show causation. In addition, Chemrex has moved to (1) bar the expert opinions of Todd; (2) strike those opinions of Dr. Epstein which rely on the evidence supplied by Todd; (3) strike the testimonies of Grant's treating physicians regarding medical causation; (4) strike the testimony of Dr. Epstein regarding medical causation; and (5) strike the opinions of Dr. Epstein regarding product defect. As these motions to strike impact the summary judgment motion, they are considered first.

II. *Motions to Strike*

A. *Motion to Bar the Opinions of Todd*

Todd is an industrial hygienist hired by Grant after the close of discovery to render opinions on the chemical composition of Kure-N-Seal, the adequacy of the warnings and the MSDSs, and Grant's level of exposure to those chemicals. His report, which is included only as an appendix to Dr. Epstein's report, comments on the product, its warning label, and its MSDS. The report also estimates the levels of Grant's exposure, both as a whole, and with regard to the product's individual components.

Chemrex moves to strike Todd's report, arguing that Todd's report constitutes expert testimony that should have been disclosed to the opposing party as part of the discovery process pursuant to Rule 26(a)(2) of the Federal Rules of Civil Procedure. Rule 26(a)(2) also requires that this disclosure be accompanied by a written report prepared and signed by the witness. Moreover, Chemrex claims that to allow Grant to rely upon Todd's opinion without timely disclosure would prejudice Chemrex because Todd has not been deposed. Rule 26(b)(4) provides that "A party may depose a person who has been identified as an expert whose opinions may be presented at trial." Without a chance to depose Todd, Chemrex argues, the bases for his opinions and conclusions would be left unexamined.

The Court may exclude the testimony of witnesses who were not disclosed in a timely manner. *See Hill v. Porter Memor'l Hosp.,* 90 F.3d 220, 224 (7th Cir.1996); In re *Maurice,* 21 F.3d 767, 773 (7th Cir.1994). Here, Grant failed to disclose *any* experts, much less Todd, by the deadline imposed by the Court. Yet, after failing to meet this initial discovery deadline, Grant did manage to successfully petition the Court for another chance to disclose Dr. Epstein and thus, allow Chemrex to depose him. Grant neglected to do the same for Todd, however, despite being given lengthy discovery extensions and an opportunity in open court. To admit Todd's testimony without providing Chemrex the opportunity to examine Todd on the basis of his opinions would be unfair and prejudicial.

***7** Grant's counsel admits that Plaintiff "dropped the ball" in failing to properly disclose Todd as an expert but contends that this mistake was the product of Chemrex's belligerence and, thus, should be excused. Specifically, Grant claims that he repeatedly requested that Chemrex disclose the specific ingredients of Kure-N-Seal and that Todd could not render an opinion without such data. While this delay might excuse Grant's failure to offer Todd's report at the initial discovery deadline, it does not excuse his failure to file a timely petition with this Court or the Magistrate Judge seeking an extension of time to disclose Todd. Moreover, Plaintiff's excuse for his failure to disclose Todd is particularly unpersuasive when one considers that Dr. Epstein refers to and relies on Todd's report in forming his own opinion. As such, Todd's report must have been completed before Dr. Epstein's, and therefore, could have been disclosed at the same time as Dr. Epstein's, if not sooner. In short, if Grant intended to rely upon Todd's opinion, he had at least as much time to disclose Todd as a testifying expert, following whatever delays Chemrex may have caused, as he had for Dr. Epstein. Given the many opportunities Grant was given to present this issue to the Court, and his failure to do so, Grant must now proceed without Todd's input.

"Adherence to established deadlines is essential if all parties are to have a fair opportunity to present their positions." Hill, 90 F.3d at 224. Without such compliance, the decision-making process is severely hindered. Indeed, this case provides a clear example of the problems attendant to failure to adhere to court imposed deadlines. As Judge Easterbrook warned,

Ignoring deadlines is the surest way to lose a case. Time limits coordinate and expedite a complex process; they pervade the legal system, starting with the statute of limitations.... "Lawyers and litigants who decide to play by rules of their own invention will find that the game cannot be won."

United States v. Golden Elevator, Inc., 27 F.3d 301, 302 (7th Cir.1994) (quoting *Northwestern Nat'l Ins. Co. v. Baltes,* 15 F.3d 660, 663 (7th Cir.1994)).

For the above reasons, Chemrex's motion to bar the expert opinion testimony of Todd is granted.

B. Motion to *Strike Dr. Epstein's Opinions Which Rely on Todd*

Chemrex also moves to strike the opinions of Dr. Epstein which rely upon Todd's report, arguing that Plaintiff should not be able to present the hearsay opinions of Todd-an undisclosed expert-on the chemical composition of Kure-N-Seal and the amount of Grant's exposure to the chemicals through Dr. Epstein.

Hearsay is defined as an out-of-court statement offered for the truth of the matter asserted. Todd's report certainly falls within this definition and thus, standing alone is inadmissible. Expert witnesses, however, are allowed to rely on hearsay in forming their opinions, as long as their opinions are based on the type of evidence reasonably relied on by experts in that particular field. Fed.R.Evid. 703 [FN2]; *see, e.g., AMPAT/Midwest, Inc. v. Illinois Tool Works, Inc.,* 896 F.2d 1035, 1045 (7th Cir.1990); *Janopoulos v. Harvey L. Walner & Assocs., LTD.,* 866 F.Supp. 1086, 1095 (N.D.Ill.1994); Weinstein & Margaret A. Berger, 3 Weinstein's Evidence § 703 [03] at 703-18 (1993).

FN2. Federal Rule of Evidence 703 provides:

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences on the subject, the facts or data need not be admissible in evidence.

***8** As the Seventh Circuit has instructed:

An expert is of course permitted to testify to an opinion formed on the basis of information that is handed to rather than developed by him-information of which he lacks first-hand knowledge and which might not be admissible in evidence no matter by whom presented. Fed.R.Evid. 703. And in explaining his opinion an expert witness normally is allowed to explain the facts underlying it, even if they would not be independently admissible.

In re James Wilson Assocs., 965 F.2d 160, 172 (7th Cir.1992). Nonetheless, "[t]he fact that inadmissible evidence is the (permissible) premise of the expert's opinion does not make that evidence admissible for other purposes, purposes independent of the opinion." *Id.* at 173. An expert may not be used "as a vehicle for circumventing the rules of evidence" to introduce inadmissible evidence for its own sake. *Id.* Thus, while Dr. Epstein could use the information contained in the industrial hygienist report to offer an opinion within Dr. Epstein's "domain of expertise", if possible, he could not testify for the purpose of "vouching for the truth of what [Todd] told him-of becoming in short [Todd's] spokesperson." *See id.*

Here, Chemrex argues that Dr. Epstein should not be allowed to rely on Todd's estimated levels of exposure as a basis for his own expert opinion because Dr. Epstein, as medical doctor, does not have the ability to evaluate the truth of Todd's conclusions. This Court agrees. Dr. Epstein is not an industrial hygienist, he did not perform any of his own studies regarding the Kure-N-Seal product, and he lacks the "technical expertise to determine the volume of the chemical components of Kure-N-Seal" and "arrive at a reasoned estimate of exposure" to the chemicals. (Dep. of Dr. Epstein, p. 60). Moreover, by his own admission, Dr. Epstein's "professional knowledge and ability" do not permit him to evaluate Todd's calculations and opinions regarding Grant's exposure levels. (Dep. of Dr. Epstein, p. 66).

An "expert witness must rely on his own expertise in reaching his opinion and may not simply repeat the opinions of others." *Faulkner v. Markkay of Ind., Inc.,* 663 N.E.2d 798, 801 (Ind.Ct.App.1996). To allow Dr. Epstein to introduce the findings of Todd as true, and rely on those findings in forming his own opinion on causation would allow the plaintiff to circumvent the rules of evidence by admitting Todd's conclusions-conclusions Dr. Epstein is unable to evaluate the accuracy and reliability of-through the back door; in effect, this would permit Dr. Epstein to become "[Todd's] spokesperson." *See* *James Wilson,* 965 F.2d at 173; *Gong v. Hirsch,* 913 F.2d 1269, 1272-73 (7th Cir.1990); *cf* *Janopoulos,* 866 F.Supp. at 1095.

Therefore, Dr. Epstein's testimony which relies upon Todd's report is hereby stricken.

C. *Treating Physicians' Opinions on Medical Causation*

Chemrex has moved to strike the opinions regarding causation of the physicians who treated Grant, arguing that such testimony is insufficient to establish medical causation and/or unacceptable under the standard set forth in *Daubert v. Merrell Dow Pharmaceutical, Inc.,* 509 U.S. 579, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993).

***9** The admissibility of expert testimony in federal court proceedings is governed by Federal Rule 702, as interpreted by the Supreme Court in *Daubert.* In Daubert, the Supreme Court held that Rule 702 requires the trial judge to "ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable." 113 S.Ct. at 2795. The Seventh Circuit, interpreting *Daubert,* has established that when evaluating the admissibility of proffered testimony, district courts are to undertake a two-step inquiry:

Daubert first "directs the district court to determine whether the expert's testimony pertains to scientific knowledge. This task requires that the district court consider whether the testimony has been subjected to the scientific method; it must rule out 'subjective belief or unsupported speculation.' " Second, the district court must "determine whether the evidence or testimony assists the trier of fact in understanding the evidence or in determining a fact in issue. That is, the suggested scientific testimony must 'fit' the issue to which the expert is testifying."

O'Connor v. Commonwealth Edison Co., 13 F.3d 1090, 1106 (7th Cir.1994) (quoting *Porter v. Whitehall Labs., Inc.,* 9 F.3d 607, 613 (7th Cir.1993) (citations omitted)). The party who proffers an expert's testimony bears the burden of establishing its admissibility by a preponderance of proof. *Dukes v. Illinois Central R.R. Co.,* 934 F.Supp. 939, 946 (N.D.1996) (citations omitted)

Furthermore, the Seventh Circuit has offered the following admonition regarding expert testimony on medical causation:

An expert witness cannot guess or base an opinion on surmise or conjecture,.... Moreover, courts must be particularly wary of unfounded expert opinion testimony when medical causation is the issue. As we have previously noted, "There is not much difficulty in finding a medical expert witness to testify to virtually any theory of medical causation short of the fantastic."

Cella v. United States, 998 F.2d 418, 423 (7th Cir.1993) (citations omitted). With these standards in mind, the Court turns first to the physicians who treated Grant at Sherman Hospital, and then to his regular physician, Dr. Bush.

To begin, the medical causation testimonies of Grant's treating physicians are unavailing because none of them even offer an opinion as to the medical cause of Grant's injuries.[FN3] Drs. Ahmad (Pulmonary and Critical Care), Khurana (Gastroenterology), and

Lichtenberg (Rheumatology) each testified that they had no opinion relating to medical causation between a toxic exposure and Grant's symptoms or had insufficient information to render a competent medical opinion. In addition, Dr. Zahid, Grant's attending physician, admitted that he was not capable of making a specific diagnosis because he was neither a toxicologist nor a pulmonary specialist.[FN4]

> FN3. The Court does not distinguish the treating physician from other experts when the treating physical is offering expert testimony regarding medical causation. *O'Connor,* 13 F.3d at 1105 n. 14.

> FN4. Furthermore, Plaintiff's Response refers solely to Dr. Bush's medical opinions and does not object to Chemrex's motion to strike the medical causation testimony of Dr. Lichtenberg, Dr. Khurana and Dr. Ahmad.

On the other hand, Dr. Bush, Grant's general physician and a urologist, opines that the combination of the exposure, temporally connected to symptoms provides a sufficient basis for causation when other causes or contributing factors have been eliminated. (Dep. of Dr. Bush, pp. 41, 76). The Court rejects Dr. Bush's testimony as to medical causation, however, because it finds that his methodology was not sufficiently scientific in nature to render such an opinion and he lacks the expertise to assist the trier of fact in understanding the evidence. *See Wintz v. Northrop,* 110 F.3d 508, 1997 WL 155272, at *5 (7th Cir. Apr.4, 1997).

***10** There is no evidence that Dr. Bush's testimony is based on sound scientific methodology. He arrived at his opinion by treating Plaintiff, and reviewing Plaintiff's medical records, the MSDS and the reports of the other treating physicians. Dr. Bush testified that he did not perform any independent studies, or review any research for the purpose of reaching his opinion. (Dep. of Dr. Bush, pp. 13, 50-51). Dr. Bush has not presented any technique or methodology by which his conclusions can be scientifically and objectively tested. Further, despite the fact that Plaintiff's treating physicians and hired experts agree that information regarding the level of chemical exposure is necessary to render a competent medical opinion, Dr. Bush lacked this information. (Dep. of Dr. Bush, pp. 8, 24). Dr. Bush is unable to meet the Daubert requirements because he has no factual or scientific basis or empirical data to support his opinions, but rather his conclusions are based on his own subjective observations. *See Dukes,* 934 F.Supp. at *949; O'Connor* 13 F.3d at 1106-07; *Deimer v. Cincinnati Sub-Zero Prods. Inc.,* 58 F.3d 341, 341 (7th Cir.1994) (affirming exclusion of doctor's testimony regarding causation because doctor did not conduct any studies or analysis to substantiate his opinion or provide any supporting methodology or protocol).

Even assuming that Dr. Bush's methodology was sufficiently grounded in scientific methodology to be admissible, the Court does not believe that Dr. Bush's testimony would be helpful to the trier of fact. “Whether a witness is qualified as an expert can only be determined by comparing the area in which the witness has superior knowledge, skill, experience, or education with the subject matter of the witness's testimony.” *Carroll v. Otis Elevator Co.,* 896 F.2d 210, 212 (7th Cir.1990). Indeed, “[a] medical degree ‘alone does not qualify [an expert] to give an opinion on every conceivable medical question.’ ” *O'Connor v. Commonwealth Edison Co.,* 807 F.Supp. 1376, 1390 (C.D.Ill.1992) (citation omitted), aff'd, 13 F.3d 1090 (7th Cir.1994)).

Dr. Bush is a specialist in urology, not pulmonary medicine, or gastroenterology. Although Dr. Bush's claims experience and/or expertise based on the fact that he did a rotation through pulmonary medicine during his residency and has participated in an advisory committee on gastroenterology, in comparison to the other specialist in the fields of rheumatology, gastroenterology, pulmonary and critical care who could not reach an opinion regarding the medical cause of Grant's symptoms within a reasonable degree of medical certainty, the Court does not find that someone with Dr. Bush's knowledge on the relevant subject matter would assist the trier of fact.

Accordingly, for the above reasons, Bush's testimony is inadmissible.

D. *Dr. Epstein's Opinions on Medical Causation*

Similarly, the Court finds that Dr. Epstein's opinions regarding causation are speculative and inadmissible and that, even if admissible, they are insufficient to create a genuine issue of fact regarding causation. According to Dr. Epstein himself, evidence regarding the amount of chemicals that Plaintiff was exposed to is "critical" to his ability to express a valid position on causality. In fact, as he admits, evidence of chemical exposure was "a prerequisite to [his] being able to develop a position on causality." Specifically, Dr. Epstein states in his deposition:

***11** A: As soon as I got involved in the case *I emphasized that there were two pieces of information which were critical [ ] to be able to express a scientifically valid position on causality.*

One was the ingredients in the Gray Kure-N-Seal. And it was clear to me that the M.S.D.S. which I'd been provided was not, to say the least candid, on this. The second is estimated levels of exposure, which is a specialty of industrial hygienists, and after a time, Mr. Todd on my recommendation was brought in to provide advice and guidance on these matters.

Q: When did you first express the need to have the two components of that analysis looked at?

A: Almost immediately .... it's a routine prerequisite to find out what chemicals you're dealing with and roughly ballpark levels of exposure....

And almost, I would say, within a month or so of getting involved in the case *I stressed that these were a prerequisite to my being able to develop a position on causation.*

(Dep. of Dr. Epstein, p. 62) (emphasis added).[FN5]

FN5. In addition, "the Federal Judicial Center's Reference Manual on Scientific Evidence (1994) notes that the following three 'preliminary assessments' should be made by an expert toxicologist as premises for an opinion:

> First, the toxicologist should analyze whether the disease can be related to chemical exposure by a biologically plausible theory. Second, the expert should examine if the plaintiff was exposed to the chemical in a manner that can lead to absorption into the body. Finally, the expert should offer an opinion as to whether the dose to which the plaintiff was exposed to is sufficient to cause the disease."

Wintz, 110 F.3d 508, 1997 WL 155272, at *5.

Unfortunately for Plaintiff, however, Dr. Epstein has not conducted any studies of the Kure-N-Seal product or the levels of Grant's exposure himself (nor does he have the expertise to do so). Moreover, as discussed above, he is barred from accepting Todd's estimates of chemical exposure as true in offering his opinion. Thus, as a result, Dr. Epstein, by his own admission, lacks information "critical" to his opinion of medical causation and cannot "express a scientifically valid position on causality."

Furthermore, although Plaintiff argues that Dr. Epstein's opinions do not stand or fall on Todd's report, Dr. Epstein's deposition testimony, considered in its entirety, belies that argument. Despite Dr. Epstein's grasp of the scientific knowledge regarding chemicals and adverse toxic reactions, he refers to and relies on Todd's exposure calculations, as he must, in forming his opinion. It is true that Dr. Epstein also opines that there was a "direct temporal relationship" between the unknown level of exposure and Plaintiff's medical symptoms, and "no other known [cause] in [Grant's] medical records." (Dep. of Dr. Epstein, pp. 170, 183). Yet, regardless of the strength of these conclusions, before Dr. Epstein actually reaches his opinions regarding causation, he considers Todd's estimates of exposure.[FN6] Epstein notes that "the Todd estimates of exposure, [ ] make it clear that on a quantitative level [Plaintiff's] exposures were extremely high," (Dep. of Dr. Epstein, pp. 183-84), and he relies on this information in his analysis. As Dr. Epstein admits, without scientific facts regarding the exposure level, he is unable to establish the necessary causal link between the Kure-N-Seal Product and Plaintiff's injuries. See *Waldridge v. American Hoechst Corp.,* 1992 WL 612252, at *9-10 (S.D.Ind. Oct.6, 1992)(expert "did not possess sufficient information regarding the particular facts of Plaintiff's exposure to render a probative, admissible opinion that [ ] [chemical] exposure caused her injuries"), *aff'd,* 24 F.3d 918 (7th Cir.1994); *Wintz,* 110 F.3d 508, 1997 WL 155272, at *4-6.

FN6. Further, to the extent that Plaintiff relies on Dr. Epstein's opinion that there is a direct temporal relationship between Plaintiff's exposure and his medical symptoms to establish causation, Chemrex correctly notes that "it is well settled that a causation opinion based solely on a temporal relationship is not derived from scientific method and is therefore insufficient to satisfy the requirements of Fed.R.Evid. 702." *Schmaltz v. Norfolk & W. Ry.,* 878 F.Supp. 1119, 1122 (N.D.Ill.1995); *see also Porter, 9 F.3d at 611;* In re "Agent Orange" Prod. Liab. Litig., 611 F.Supp. 1223, 1248 (E.D.N.Y.1985) (finding Dr. Samuel Epstein's testimony to be inadmissible and insufficient as a basis for a finding of causality), *aff'd,* 818 F.2d 187 (2d Cir.1987).

III. *Absence of a Genuine Issue of Fact Regarding Causation*

***12** Grant seeks to recover against Chemrex on claims of claims of negligence, strict product liability and breach of warranty. Although the elements in each of the three theories are somewhat different, in order to recover under any of these theories, Plaintiff must show that the product is unreasonably dangerous and there is a causal relationship between his injury and the defective product.[FN7]

FN7. In a product liability cause of action based on negligence, a plaintiff must establish: the existence of a legal duty owed to the plaintiff by the defendant; a breach of that duty; a resulting compensable injury to the plaintiff; and the breach must have been the proximate cause of the plaintiff's injury. *Miller v. Dvornik,* 149 Ill.App.3d 883, 890, 501 N.E.2d 683, 687 (1st Dist.1986). To recover under strict product liability, a plaintiff must plead and prove: 1) a manufacturing defect in the product that renders it unreasonably dangerous; 2) the presence of the defect in the product at the time the product left the manufacture's control; and 3) that the defective condition of the product was the cause of the injury. *Cozzi v. North Palos Elementary Sch. Dist. No. 117,* 232 Ill.App.3d 379, 384-85, 173 Ill.Dec. 709, 597 N.E.2d 683, 687 (1st Dist.1992). As to the breach of warranty claim, there is considerable similarity in analysis in evaluating a strict liability claim and a warranty claim. *Roback v. V.I.P. Transp., Inc.,* 1994 WL 327414 (N.D.Ill. Jul.6, 1994), *aff'd,* 90 F.3d 1207 (7th Cir.1996). In fact, "[b]reach of implied warranty and strict liability are nearly identical; the distinguishing feature is that warranty is based on contract and strict liability is based on tort." *Id.* (citing *Garcia v. Edgewater Hosp.,* 244 Ill.App.3d 894, 184 Ill.Dec. 651, 613 N.E.2d 1243 (1st Dist.1993)).

A causal relationship is more than the mere possibility that the product caused the injury; there must be evidence justifying an inference of probability that the product caused the injury. *Tragarz v. Keene Corp.,* 980 E.2d 411, 418 (7th Cir.1992). The plaintiff must introduce evidence with reasonable probative force as to this probability, as juries will not be permitted to engage in "mere speculation or imagination." *Parker v. Freightliner Corp.,* 940 F.2d 1019, 1026 (7th Cir.1991); *see Tragarz,* 980 F.2d at 418. Moreover, expert testimony usually is necessary to establish a causal connection between an injury and its source "unless the connection is a kind that would be obvious to laymen, such as a broken leg from being struck by an automobile." *Schmaltz v. Norfolk & Western Ry. Co.,* 896 F.Supp. 180, 182 (N.D.Ill.1995).

In this case, Chemrex has presented the affidavits of two experts which sufficiently counter the allegations set forth in Grant's Complaint. Dr. Bederka, an expert in toxicology, pharmacology and chemistry, performed an inspection of the premises and scientific calculations of Grant's exposure and concluded that Kure-N-Seal is safe as manufactured, that the information contained on the label and MSDSs are appropriate indicators of the product's hazards, and that Grant's injuries were not caused by Kure-N-Seal. Dr. Cugell, a specialist in pulmonary medicine, reviewed the relevant medical records, Grant's medical history, and the depositions of all the parties involved, and concluded that Grant's lung problems were the likely result of an infection stemming from a collapsed lung injury which occurred many years earlier. Thus, through Drs. Bederka and Cugell, Chemrex has offered evidence that Grant's medical problems were not the result of his exposure to the Chemrex product.

Plaintiff's ability to establish an issue of fact of whether his injuries were caused by exposure to Chemrex's Kure-N-Seal, however, has been detrimentally affected by his failure to properly disclose an expert necessary to prevail. Todd's conclusions as an industrial hygienist were critical to Plaintiff's demonstration of a causation, yet he was never disclosed as an expert and his deposition was never taken. Grant, who must prove causation, has presented no admissible evidence regarding his exposure, and thus is unable to establish a causal link between his use of the Kure-N-Seal product and his subsequent medical problems. Such opinion testimony which is scientifically non-founded is insufficient to controvert the defenses of Chemrex and its experts. Accordingly, Chemrex's motion for summary judgment is granted.

CONCLUSION

***13** For the reasons set forth above, the Court grants Chemrex's motions to exclude the opinions of Todd, to strike the opinions of Dr. Epstein which rely on Todd, and to strike Plaintiff's expert testimony regarding causation.[FN8] Thus, because Plaintiff is unable to demonstrate any issue of material fact on the causation issue, Chemrex's motion for summary judgment is granted.

FN8. As the issue of causation is dispositive, Chemrex's motion regarding product defect is rendered moot.

N.D.Ill.,1997.
Grant v. Chemrex, Inc.
Not Reported in F.Supp., 1997 WL 223071 (N.D.Ill.)

END OF DOCUMENT

TAB 14

Only the Westlaw citation is currently available.

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

Jan. 3, 2007.

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

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

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

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

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

JAMES WARE, District Judge.

I. INTRODUCTION

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

II. BACKGROUND

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

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

tegic Alliance Agreement ("SAA") with Impax in June 2001. The SAA granted Teva exclusive U.S. prescription-marketing rights for six Impax products, including Wellbutrin and Zyban generics, and provided for the two companies to share profits. (SAC ¶¶ 39-41.) Non-party Andrx Corporation ("Andrx") was also a signatory to the SAA. (SAC ¶ 6.)

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

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

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

III. STANDARDS

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

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

Moreover, claims brought under Section 10(b) and Rule 10b-5 must also meet the stringent pleading standards of the Private Securities Litigation Reform Act of 1995. To plead a violation of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, a plaintiff must allege

(1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss. *Dura Pharm., Inc. v. Broudo,* 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005). The PSLRA amends the Exchange Act to require that a private securities fraud litigation complaint "plead with particularity both falsity and scienter." *In re Daou,* 411 F.3d at 1014.Specifically, a complaint alleging securities fraud must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."15 U.S.C. § 78u-4(b) (1); *In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1085 (9th Cir.2002).

IV. DISCUSSION

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

A. *Loss Causation*

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

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

> [A]t the moment that the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value. Moreover, the logical link between the inflated share purchase price and any later economic loss is not invariably strong. Shares are normally purchased with an eye toward a later sale. But if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss. If the purchaser sells later after the truth makes its way into the market place, an initially inflated purchase price might mean a later loss. But this is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, or other events, which taken separately or together account for some or all of that lower price.

Id. at 342-43.

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

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

1. Impax's November 3 Press Release

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

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

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

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

2. Andrx's November 3 Disclosure

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

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

(SAC ¶¶ 202-03.)

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

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

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

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

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

(SAC ¶¶ 204-05.)

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

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

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

4. Impax's Other Announcements on November 9

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

> In the November 9, 2004 conference call, defendants disclosed for the first time that it [sic] had submitted an ANDA [abbreviated New Drug Application] for the generic version of Concerta to the FDA. Impax also confirmed that it had received ANDA approval for two drugs during the third quarter, the 500 mg version of Wellbutrin SR and a generic version of 80 mg Oxycontin. By revealing these positive milestones for the Company on November 9, 2004,

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

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

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

B. ***Scienter***

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

C. ***Control Person Liability***

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

V. CONCLUSION

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

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

END OF DOCUMENT

TAB 15

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois,
Eastern Division.
In re JPMORGAN CHASE & CO. SECURITIES LITIGATION.
This document relates to
Hyland v. Harrison, C.A. No. 06 C 4675
Hyland v. J.P. Morgan Securities, Inc. C.A. No. 06 C 4676.
MDL No. 1783.
C.A. No. 06 C 4674.

Dec. 18, 2007.

MEMORANDUM OPINION AND ORDER

DAVID H. COAR, District Judge.

***1** This is a Multi-District Litigation, under Master Docket No. 06 C 4674, consisting of three separate cases: *Blau, et al. v. Harrison, et al.,* No. 04 C 6592 (or "Blau"); *Hyland v. Harrison et al.,* No. 06 C 4675 (or "Hyland I"); and *Hyland v. J.P. Morgan Securities Inc.,* No. 06 C 4674 (or "Hyland II"). To date, these three cases have been consolidated for discovery purposes only. On April 4, 2006, Blau filed the Second Amended Class Action Complaint For Violations of Federal Securities Laws, alleging two claims: (I) Violations of Section 14(a) of the Exchange Act and Rule 14a-9 of the SEC (Against All Defendants) and (II) Violation of Section 20(a) of the Exchange Act (Against the Individual Defendants). Hyland I and Hyland II consolidated their cases, and on September 25, 2006, they filed their Consolidated Amended Class Action Complaint, alleging six counts: (I) Against JPMC and the Individual Defendants for Violations of Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 14a-9 Thereunder; (II) Against Harrison, JPMC, JPMSI and Dimon for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder; (III) Against Individual Defendants for Liability Under Section 20(a) of the Exchange Act; (IV) Against the Director Defendants for Breach of Fiduciary Duty; (V) Against JPMSI For Aiding and Abetting Breach of Fiduciary Duty; and (VI) Against JPMSI For Civil Conspiracy.

On October 23, 2006, Defendants filed a Motion to Dismiss Hyland Plaintiffs' Consolidated Amended Complaint. This action is against the Hyland Plaintiffs only, and does not affect the Blau case. This opinion addresses solely Defendants' Motion to Dismiss Hyland Plaintiffs' Consolidated Amended Complaint. For the reasons set forth below, Defendants' motion to dismiss is granted in part and denied in part.

I. FACTS

The Parties

Hyland Plaintiffs claim in this case that there was a deceptive scheme executed by the Chief Executive Officers of J.P. Morgan Chase & Co. ("JPMC") and Bank One Corporation ("Bank One") in connection with the 2004 merger of those two companies. This court takes as true the following facts asserted by the Plaintiffs. This case pertains to the merger between JPMC and Bank One in 2004.

The Hyland Plaintiffs owned JPMC common stock at all relevant times, including on April 2, 2004. Plaintiff Samuel I. Hyland sold his JPMC shares on August 13, 2004.

JPMC, a financial holding company incorporated under Delaware law in 1968 with its principal executive offices in New York, is a global financial services firm involved in investment banking, financial services for consumers and businesses, financial transaction processing, investment management, private banking, and private equity. As of April 30, 2004, prior to the consummation of the Merger, there were 2.08 billion shares of the Company's common stock outstanding. JPMC common stock is listed and traded on the New York Stock Exchange.

***2** Defendant J.P. Morgan Securities, Inc. ("JPMSI"), a Delaware corporation, is a wholly-owned subsidiary of J.P. Morgan Securities Holdings LLC, which, in turn, is a wholly-owned subsidiary of JPMC. JPMSI is a broker-dealer registered with the Securities and Exchange Commission and is a member of the National Association of Securities Dealers, Inc., the New York Stock Exchange and other exchanges. JPMSI acts as a primary dealer in U.S. government securities; advises on business strategies; makes markets in money market instruments and U.S. government agency securities; underwrites and trades corporate debt- and asset-backed securities, municipal bonds and notes, common and preferred stock, and convertible bonds offerings; and structures derivative transactions.

Defendant Harrison served as CEO and Chairman of the Board of Directors of JPMC since 1999, and was instrumental in negotiating the 2004 merger ("Merger") and signed the Proxy Statement issued in connection therewith. Harrison relinquished the CEO title at the end of 2005.

Defendant Dimon was Chairman and CEO of Bank One prior to the Merger and currently serves as the CEO of JPMC. Other named Defendants were, during the relevant time, directors of JPMC ("Director Defendants") and signed the Proxy Statement issued in connection with the Merger. Defendant Dimon and the Director Defendants are collectively referred to as "Individual Defendants."

The Negotiations

In November 2003, Harrison and Dimon commenced negotiations concerning the possibility of a merger between JPMC and Bank One. The negotiations took place at an apartment in the Waldorf Towers, a few blocks from JPMC's midtown headquarters. The meetings were conducted in "secret." According to the Proxy Statement, Dimon and Harrison periodically updated members of their respective Boards of Directors about their negotiations. Plaintiffs assert that the Director Defendants either were fully aware of the details of the negotiations between Harrison and Dimon or, as directors, had the opportunity and obligation to monitor and inquire into the details of such negotiations.

On November 18, 2003, Harrison briefed the full Board on his discussions with Dimon, and the Board, consisting of Director Defendants, authorized Harrison to continue discussions regarding a possible business combination with Bank One. At some point in November 2003, each party retained legal and financial advisors in connection with the merger discussions. JPMC retained JPMSI as its financial advisor for a $40 million fee.

During December 2003, Dimon and Harrison continued their negotiations on the key terms of the financial transaction, and periodically updated their respective boards on these communications. During the course of these discussions, Bank One CEO James Dimon offered to do the deal with no premium (the additional price paid above the value of the stock) if he could become the chief executive officer immediately. However, Harrison wanted to keep his CEO title for two more years, and agreed to a deal with a 14 percent (approximately $7 billion) premium in exchange for retaining his CEO position for another two years. Hyland Plaintiffs allege this to be an unfair exchange ratio.

Shareholder Approval

***3** Shareholder approval was necessary to complete the Merger. Despite the alleged rejection of the zero premium opportunity, JPMSI recommended the merger to the shareholders as economically fair. The Director Defendants also approved the Merger. After the close of trading on January 14, 2004, JPMC and Bank One issued a joint press release ("Press Release"). The press release reported the details of the deal, including the 14 percent premium, but omitted the no-premium offer. On April 21, 2004, the JPMC Board of Directors disseminated the Proxy Statement to the shareholders. The Proxy Statement listed the factors that the board considered in approving the merger, but did not disclose Dimon's offer to transact the merger without a premium if Dimon were appointed CEO of the merged company immediately. The shareholders voted on the Merger without knowledge of the no-premium offer. On May 25, 2004, JPMC released the results that shareholders approved the merger with 68 percent of the votes outstanding. On July 1, 2004, the merger was completed, including a premium of approximately 14 percent for Bank One shares. The merger agreement included a provision that Harrison would remain CEO of JPMC for two years after completion of the merger, and Dimon would serve as President and Chief Operating Officer until Harrison's CEO tenure was up, at which point Dimon would become CEO of the merged company.

Newspaper Articles

On June 27, 2004, a New York Times article by journalist Landon Thomas, Jr. reported that:

> During the negotiations with Mr. Dimon, [Harrison] fought hard to give himself the two extra years, to secure a smooth transition, although he may have cost J.P. Morgan shareholders extra money in doing so. Mr. Dimon, always the tough deal maker, offered to do the deal for no premium if he could become chief executive immediately, according to two people close to the deal. When Mr. Harrison resisted, Mr. Dimon insisted on a premium, which Mr. Harrison was able to push down to 14 percent. The two men declined to comment on the specifics of their negotiations.

Hyland Plaintiffs allege that this was the first opportunity for JPMC stockholders to discover that Harrison had turned down a no-premium opportunity and engaged in a deceptive entrenchment scheme. Landon Thomas, Jr. conducted an independent investigation by interviewing individuals with personal knowledge of the Merger negotiations. Hyland Plaintiffs assert that this account of the "no premium deal" and the "two-year compromise" were corroborated by other articles, including, *inter alia,* a January 15, 2004 CBS Marketwatch.com article, a January 26, 2004 FORTUNE article, a July 3, 2004 The Financial Times (London) article, and a December 29, 2004 Wall Street Journal article.

Damages

Plaintiffs assert that the omission of the no-premium offer harmed JPMC share holders who were duped into funding a Merger exchange ratio that heavily favored Bank One's shareholders. Instead of owning 61 percent of the combined company, they ended up with 58 percent. Plaintiffs assert that omission of negotiations and the rejected nil-premium opportunity throughout the solicitation of votes violated the JPMC directors' fiduciary duty to disclose all material facts about the Merger to allow shareholders to vote for or against it with full knowledge of relevant information. As outlined above, Plaintiffs also seek relief in connection with Defendants' violations of federal securities laws.

II. LEGAL STANDARD

***4** In deciding a motion under 12(b)(6), the court considers the allegations in the complaint to be true and views all well-pleaded facts and any reasonable inferences drawn from the facts in the light most favorable to the plaintiff. *See* *Maple Lanes, Inc. v. Messer,* 186 F.3d 823, 824-5 (7th Cir.1999). The court should grant a motion to dismiss for failure to state a claim only if "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."*See* *id.* at 825 (quoting *Conley v. Gibson,* 355 U.S. 41, 45-6, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957))."The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Caremark, Inc. v. Coram Healthcare Corp.,* 113 F.3d 645, 648 (7th Cir.1997) (quoting *Scheuer v. Rhodes,* 416 U.S. 232, 236, 94 S.Ct. 1683, 40 L.Ed.2d 90 (1974)). Nevertheless, in deciding upon a motion to dismiss for failure to state a claim, the court need not ignore allegations that undermine the plaintiff's complaint, or assign any weight to unsupported conclusions of law. *See* *Northern Indiana Gun & Outdoor Shows, Inc. v. City of South Bend,* 163 F.3d 449, 452 (7th Cir.1998).

III. ANALYSIS

A. Newspaper sources under PSLRA

Defendant moves to dismiss the Consolidated Amended Class Action Complaint on the ground that the Plaintiffs did not plead with sufficient particularity so as to satisfy the heightened pleading requirements under the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "the Reform Act"). The PSLRA requires that "in any private action arising under [the Exchange Act] in which the plaintiff alleges that the defendant made an untrue statement of a material fact ... 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."15 USCS § 78u-4(b)(1). Further, the Reform Act requires particularized pleading of scienter: "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)(a)(2).

Defendants claim that the New York Times article reporting the alleged omission does not satisfy the pleading requirements under the PSLRA. The Seventh Circuit has not specifically addressed whether media and newspaper reports satisfy the heightened PSLRA pleading requirements of "particularity." However, other district courts have considered this issue. In particular, Third Circuit district courts have treated this issue at length. In *Tracinda Corp. v. DaimlerChrysler AG (In re DaimlerChrysler AG Sec. Litig.),* a Delaware district court found that "Class Plaintiffs' allegations, to the extent that they clearly identify the media sources upon which they rely, are sufficient ... to satisfy the heightened pleading standard under the securities laws." 197 F.Supp.2d 42, 79 (D.Del.2002). The court in *Tracinda Corp.* relies on Third Circuit precedent, which reasoned that "reliance on an article in The Wall Street Journal is not reliance on an insubstantial or meaningless investigation. Plaintiffs and their attorneys need not make further expenditures to prove independently that which may be read with some confidence of truthfulness and accuracy in a respected financial journal." *Lewis v. Curtis,* 671 F.2d 779, 788 (3d Cir.1982). The *Lewis* decision addressed pleading verification under Rule 23.1. Its rationale was applied to the heightened pleading requirement under the PSLRA in *Tracinda Corp. Tracinda,* to the effect that a reputable newspaper article by itself may be sufficient to satisfy the PSLRA requirement. Even if it does not go so far, *Tracinda Corp. Tracinda* concluded that when class plaintiffs do not solely rely on newspaper articles, but conduct an independent investigation which corroborated the articles, the complaint allegations derived from reputable media sources were sufficient to meet the requirement of the PSLRA. 197 F.Supp.2d 42, 81 (D.Del.2002).

***5** A Northern California district court has also opined that newspaper articles that "corroborate plaintiff's own investigation and provides detailed factual allegations" may be used as a basis for an inference of scienter. *In re McKesson Hboc Secs. Litig.,* 126 F.Supp.2d 1248, 1271 (D.Cal.2000).*In re McKesson Hboc* cautions, however, that "newspaper articles should be credited only to the extent that other factual allegations would be-if they are sufficiently particular and detailed to indicate their reliability. Conclusory allegations of wrongdoing are no more sufficient if they come from a newspaper article than from plaintiff's counsel."*Id.* Nonetheless, "if the newspaper article includes numerous factual particulars and is based on an independent investigative effort, it is a source that may be credited in determining whether plaintiffs have alleged facts sufficient to raise a strong inference of scienter."

Taking these rationales into account, at a minimum, newspaper articles satisfy the heightened PSLRA pleading requirements if (1) they are based on an independent investigative effort, (2) they are sufficiently particular and detailed to indicate their reliability, and (3) Plaintiffs' counsel conducted its own independent investigation which corroborates the information in the article.

In the present case, the Plaintiffs have asserted, which this court must accept as true, that an independent investigation was conducted by journalist Landon Thomas, Jr., who interviewed several individuals with personal knowledge of the merger. The article provided detail about the people involved (Mr. Dimon and Mr. Harrison) and the details of the negotiations, including where and when the negotiations took place, the existence of the no-premium offer, and terms of the final deal: Mr. Harrison would remain CEO for two years in exchange for a 14 percent premium. The article did not simply state that securities fraud or a misstatement was committed, but gave the details of the deal, indicating reliability. Further, the New York Times is a well-known and reputable paper, read nationally and internationally. The newspaper article is both independent and reliable. Finally, Hyland Plaintiffs' counsel has alleged that they conducted a thorough investigation of all reasonably available sources of information, including: public filings of JPMC, JPMSI and Bank One, securities analysts' reports and investor advisory services concerning JPMC and Bank One, pleadings in other related cases, JPMC and Bank One press releases and other publically disseminated statements, reports concerning JPMC, JPMSI and Bank One in print and electronic media, and interviews of relevant witnesses. Plaintiffs present evidence of email correspondences, other articles and related documents that corroborate the article's allegations. Accordingly, Plaintiffs allegations satisfy the heightened pleading requirements under the PSLRA.

Defendants rely on *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir.2006), in arguing that Plaintiffs must describe confidential sources with "sufficient particularity 'to support the probability that a person in the position occupied by the source would possess the information alleged.' " Defendants argue that because the sources of the New York Times are confidential, they do not meet this requirement. *Makor,* however, is not directly applicable to the present case. In *Makor,* the standard is applied to plaintiffs counsels' confidential sources, not the confidential sources of a reliable and independent newspaper. A reputable newspaper, where an independent investigation was conducted, provides an additional layer of reliability in reporting. Further, the confidential nature of a journalist's source is used to encourage reporting and accuracy. In the present case, the confidential source is the informant to a newspaper, not to the Plaintiffs' counsel directly. In such a case, *Makor* is inapposite, and the Third Circuit cases are more appropriately applied.

B. Rule 9(b) Pleading Requirements

***6** Defendants move to dismiss on the ground that Plaintiffs' claims sounding in fraud lack the particularity required by Rule 9(b). Rule 9(b) applies to "all averments of fraud or mistake."In such cases, "the circumstances constituting fraud or mistake shall be stated with particularity."Fed.R.Civ.P. 9(b). With respect to securities fraud cases, Rule 9(b) requires that the essential element of scienter be pled with a sufficient level of factual support: "the complaint ... must afford a basis for believing that plaintiffs could prove scienter." *DiLeo v. Ernst & Young,* 901 F.2d 624, 629 (7th Cir.1990), *Moss v. HealthCare Compare Corp. (In re HealthCare Compare Corp. Sec. Litig.),* 75 F.3d 276, 281 (7th Cir.1996). The Seventh Circuit states, "We have said that a sufficient level of factual support may be found where the circumstances are pled "in detail." This means the who, what, when, where, and how: the first paragraph of any newspaper story."*Id.*

As an initial matter, Hyland Plaintiffs suggest that Defendants ask this court to apply Rule 9(b) indiscriminately to all claims. This is incorrect. Defendants have asked to apply Rule 9(b) to claims sounding in fraud only. Further, according to this court's reading to the Consolidated Amended Complaint, Hyland Plaintiffs have specifically segregated the negligence claims (Count I, alleging violations of § 14(a), "not sounding in fraud") from fraud claims (Count II, alleging violations of § 10(b) against Harrison, Dimon, JPMC and JPMSI).

The Defendants contend that every claim that sounds in fraud is subject to the heightened pleading requirement of Rule 9(b) and must be stated with particularity. In the Seventh Circuit, this means that the complaint must include the "who, what when, where and how" of the alleged fraud in order to give sufficient factual support for the scienter. The Consolidated Amended Class Action Complaint fulfills this requirement. The "who" are Harrison, Dimon, JPMSI and JPMC. The "what" and "when" surrounds the negotiations between Harrison and Dimon in December of 2003, and the non-disclosure of the alleged no-premium offer to the shareholders. The merger deal that was presented for shareholder approval included a 14 percent premium in exchange for Harrison remaining as CEO for two additional years. The "where" includes the Waldorf Tower apartments and the conference room of Bank One's M & A law firm, Wachtell Lipton Rosen & Katz. The "how" involved the negotiations, the communication with the Directors, the Proxy Statement and Press release, and the non-disclosure of the alleged no-premium deal to the shareholders. The complaint includes sufficient detail and factual support to satisfy Rule 9(b) pleading requirements for claims of fraud or mistake.

C. Mental States of Negligence

Defendants move to dismiss the Director Defendants from charges under Count I of the Consolidated

Amended Complaint ("CAC") on the ground that Plaintiffs failed to allege with particularity of fact to give rise to a strong inference that the Director Defendants acted with the required state of mind, specifically, negligence. Count I of the CAC alleges that JPMC and the Individual Defendants violated Section 14(a) of the Exchange Act and Rule 14a-9 thereunder, when they negligently omitted to state material facts necessary (namely, the no-premium offer) in the Proxy Statement. Under the PSLRA, any action brought under the Exchange Act, "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 the [Act], state with particularity facts giving rise to a strong inference that the defendants acted with the required state of mind."15 U.S.C. § 78u-4(b)(2). Defendants claim that Plaintiffs did not allege with particularity to give a strong inference of negligence.

***7** Plaintiffs argue that (1) negligence is not a state of mind, and therefore does not require a pleading of particular facts to give strong inference, and (2) even if it were, the pleadings are sufficient. There seems to be some discrepancy on how a 14(a) negligence allegation should be treated under 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit has not ruled on whether the PSLRA applies to Section 14(a) cases. The district courts in this circuit have been split on the issue. In *Blau v. Harrison,* Judge Hibbler stated that "Plaintiffs' Section 14(a) allegations are not required to meet the PSLRA particularity requirement because these claims are based on averments of negligence." 2006 U.S. Dist. LEXIS 18785, 2006 WL 644016 (N.D.Ill., 2006). Judge Hibbler reasoned that because the Seventh Circuit ruled that Rule 9(b) pleading requirements were not applicable to negligence claims, the PSLRA heightened requirements would not be applicable either. *Id.; Kennedy v. Venrock Assocs.,* 348 F.3d 584, 593 (7th Cir.2003). Judge Leinenweber disagreed with the ruling in *Blau,* concluding that "the Seventh Circuit's opinion in [*Kennedy*] ... never addressed the PSLRA at all," but only stated that Rule 9(b)'s heightened pleading standards did not apply to Section 14(a) claims unless those claims charged fraud, as opposed to negligence. *Beck v. Dobrowski, et al.,* 2007 U.S. Dist. LEXIS 84093, 2007 WL 3407132 (N.D.Ill.2007). Judge Leinenweber found that this analysis was inapplicable to the PSLRA, because Rule 9(b) was "expressly limited to claims of fraud or mistake," whereas the PSLRA encompasses negligence claims as well. *Id.* Judge Leinenweber states the following, specifically finding that negligence constitutes a "state of mind":

> The Court concludes that the PSLRA governs Plaintiff's claim. Although the Seventh Circuit has not decided whether the PSLRA applies to Section 14(a) cases, the statutory language is unambiguous. All relevant sections of the Act commence with the phrase, *"in any private action arising under this chapter,"*15 U.S.C. § 78u-4(b)(1),(2). & (4) (emphasis added). The Act contains no exceptions based on considerations of scienter or previous common law causation rules. Indeed, the Act's pleading standard provisions are to the contrary. Section(b)(2) applies to actions for money damages requiring proof of only "a particular state of mind." Since negligence is a state of mind, the language of Section (b) (2) by its terms encompasses negligence-based securities actions.

Id. The circuit courts have not definitively addressed the issue of whether negligence constitutes a "state of mind" under the PSLRA, but the majority have applied 15 U.S.C. § 78u-4(b)(2) to Rule 14(a) claims of negligence. See, e.g., *Knollenberg v. Harmonic, Inc.,* 152 Fed. Appx. 674, 682 (9th Cir.2005); *Hayes v. Crown Cent. Petroleum Corp.,* No. 02-2190, 78 Fed. Appx. 857, 861 (4th Cir.2003); *Cal. Pub. Emples'. Ret. Sys. v. Chubb Corp.,* 394 F.3d 126, 144 (3d Cir.2004). This court agrees with the reasoning and conclusion of *Beck v. Dobrowski, et al.,* and joins the majority of courts in finding that the PSLRA standards apply to all claims under the Exchange Act, including Section 14(a) claims of negligence.

***8** The question then becomes whether Plaintiffs' pleadings are sufficient to give rise to a strong inference of negligence on the part of the Director Defendants. Paragraph 78 of the CAC allege that "Dimon and Harrison periodically updated members of their respective Boards of Directors about their negotiations," and that the Director Defendants were "either fully aware of the details of the negotiations between Harrison and Dimon or, as directors, had the opportunity and obligation to monitor and inquire into the details of such negotiations."That is, Plaintiffs have alleged that Director Defendants were in regular contact with Harrison and Dimon, and had opportunity to monitor and inquire. Whether or not they actually inquired, or acted reasonably in their roles as Director, are questions on the merits. The pleadings allege sufficient facts regarding the interaction between the Directors and Harrison and Dimon to support an inference that the Director Defendants "knew or should have known" about the no-premium offer. The Plaintiffs' CAC sufficiently pled violations of Section 14(a).

D. Mental States of Scienter

As to Count II claims of fraud or deceit against Harrison, Dimon, JPMC and JPMSI, Plaintiffs are required to "state with particularity facts giving rise to a strong inference that the defendants acted with [a fraudulent] state of mind."15 U.S.C. § 78u-4(b)(2). The Seventh Circuit has concluded that "the 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. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 601 (7th Cir.2006). Motive and opportunity are useful indicators of a fraudulent state of mind, though they may not be necessary or sufficient. *Id.*

Defendants argue that the claims against Harrison and Dimon fail to adequately plead scienter because they are based on no more than supposed motives to increase incentive compensation and reputation/prestige. First, the Seventh Circuit has established motive as a "useful indicator," and should not be taken lightly. In fact, the Second and Third Circuit found that motive and opportunity alone are sufficient to satisfy 15 U.S.C. § 78u-4(b)(2). Although the Seventh Circuit does not take this position, it does acknowledge motive and opportunity to be important factors. As such, the fact that the pleadings allege that Harrison was motived to increase his incentive compensation and to guild his reputation are important considerations. Further, Plaintiffs allege that Dimon wanted to "reclaim the mantle of Wall Street superstar," and was motivated to increase his prestige and reputation. While these facts taken separately may not be sufficient, they do go to show motive for engaging in the alleged fraud, and serve as "useful indicators." In addition to motive, Plaintiffs have also alleged opportunity and acts of concealment by Harrison and Dimon. As mentioned above in the Rule 9(b) discussion, Plaintiffs have alleged the who, what, where, when and how of the no-premium offer and concealment, and has shown that Harrison and Dimon had the opportunity to negotiate in secret. Further, Plaintiffs include in their complaint specific incidents where Harrison and Dimon allegedly evaded and failed to disclose the no-premium offer and the two-year compromise, even when asked directly about it. *See* CAC ¶¶ 134-141. Plaintiffs specifically claim that this shows "they were conscious of their wrongdoing, and, in particular, well aware of the need to conceal their [secret] deal."CAC ¶ 139. Taking Plaintiffs allegations as true, and viewing the allegations collectively-that Harrison and Dimon had motive and opportunity to deceive, and that they took steps towards concealing and deceiving to their own advantage-this court finds that the Hyland Plaintiffs have alleged with particularity facts giving rise to a strong inference that Harrison and Dimon acted with an intent to deceive, manipulate or defraud.

***9** Defendants also argue that Plaintiffs failed to allege scienter for JPMC, because the scienter of Harrison cannot be imputed on JPMC. This issue was directly addressed in *In re Sourcecorp Sec. Litig .,* 2006 U.S. Dist. LEXIS 41381 (D.Tex.2006). Although this court is not bound by the decision of other district courts, it will give due weight to their reasoning. In *In re Sourcecorp Sec. Litig.,* the court concluded, "In determining whether to impute an executive's scienter to the company, this Court looks to whether an executive's fraud operates to benefit the company or whether the fraud is committed against the company."*Id.; see also* *FDIC v. Shrader & York,* 991 F.2d 216, 224-25 (5th Cir.1993); *In re Cendant Corp. Sec. Litigation,* 109 F.Supp.2d 225, 233 (D.N.J.2000) (fraud imputed when officer's conduct was "for the benefit of the corporation."); *In re Kidder Peabody Securities Litig.,* 10 F.Supp.2d 398, 415-417 & n. 17 (S.D.N.Y.1998) (finding evidence to support a reasonable inference of corporation's scienter where a securities analyst had openly reported hundreds of millions of dollars in false profits, but not deciding imputation issue because of dispute as to whether trader was acting adversely to corporation's interests). This court finds this rational and analysis persuasive.

In the present case, Plaintiffs allegations that Harrison agreed to remain as CEO for two years in exchange for a 14 percent premium against JPMC in the merger clearly did not benefit the company. In fact, the allegations suggest that Harrison enriched himself at the expense of the corporate entity. Therefore, Count II is dismissed as to Defendant JPMC only.

Defendants further assert that Plaintiffs failed to allege scienter for JPMSI, because they only pleaded motive for compensation (a high fee) and reputation (to increase their ranking based on the dollar value of deals they participated in). See CAC ¶ 170-77. Pleading motive for compensation and reputation alone may not be sufficient to satisfy the PSLRA heightened pleading requirements on scienter. However, Defendants misstate Plaintiffs' claim: they also allege facts that suggest that the Merger exchange ratio exceeded a range of reasonableness under various objective metrics (see CAC ¶ 114-20), and yet was still approved by JPMSI. This allegation that JPMSI endorsed an "unfair" ratio, together with the allegations that give rise to motive, suggest a strong inference of a fraudulent state of mind, sufficient to satisfy the PSLRA pleading requirements under 15 U.S.C. § 78u-4(b)(2).

E. Losses, Loss Causation, or Reliance

Defendants move to dismiss on the ground that Plaintiffs failed to allege any cognizable losses in their § 10(b) claim. Defendants argue that federal securities laws only allow victims to recover actual damages, not merely stock prices that are not as high as they otherwise could be. Defendants cite to *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.* in arguing that damages cannot encompass potential "profit," but only "out of pocket" losses. 910 F.2d 1540, 1552 (7th Cir.1990). In the present case, unlike *Astor Chauffeured Limousine Co.,* the damages alleged are not hypothetical investment profits, but rather are clear figures negotiated in exchange for Harrison's two year CEO tenure. In other words, according to Plaintiffs' allegations, in exchange for Harrison's two year CEO tenure, Plaintiffs had to pay "out-of-pocket" a 14 percent premium. The Supreme Court has concluded that damages should be measured by "the difference between the fair value of all ... that the seller received and the fair value of what he would have received had there been no fraudulent conduct." *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 154, 92 S.Ct. 1456, 31 L.Ed.2d 741 (U.S.1972). In the present case, the actual loss is quantifiable and cognizable. Taking Plaintiffs' allegations as true, the shareholders received 58 percent of the combined company in the Merger with the alleged fraudulent omission, but they would have received 61 percent if they had known about the no-premium offer and voted in favor of the no-premium deal. Put another way, JPMC stock sellers would have received $7 billion more had there been no fraudulent conduct. This allegation constitutes a cognizable loss.

***10** Defendants further claim that Plaintiffs did not show loss causation. Under the PSLRA, a plaintiff must prove that the "omission of the defendant alleged to violate [the Exchange Act] caused the loss for which the plaintiff seeks to recover damages."15 U.S.C. § 78u-4(b)(4). Plaintiffs allege that the omission of the no-premium offer caused the shareholders to approve the 14 percent premium deal instead of the no-premium deal. As a result of the omission, the Plaintiffs received 58 percent of the combined company instead of 61 percent, an amount approximately $7 billion in value. The CAC clearly alleges the causal connection between the loss ($7 billion) and the fraudulent omission. Defendants cite to several cases that are fact-specific, and not applicable to the present case.

Finally, Defendants argue that Plaintiffs must also plead reliance. Defendants cite to *Dura Pharms., Inc. v. Broudo,* in arguing that Plaintiff must allege that they bought their shares in reliance of the no-premium offer omission. 544 U.S. 336, 125 S.Ct. 1627, 161 L.Ed.2d 577 (U.S.2005). As an initial matter, the facts in *Dura Pharms., Inc.* differ from the present case. In *Dura Pharms., Inc.,* the plaintiffs bought stock after an alleged misrepresentation caused the stock prices to be artificially inflated. After they bought the stock in reliance of the misrepresentation, the stock prices fell. The loss suffered by the plaintiffs in *Dura Pharms., Inc* were due to the fact that they bought stock in reliance of the misrepresentation. The fact scenario is different in the present case, where Plaintiffs approved the terms of the merger in reliance of a misrepresentation (or omission). Under Plaintiffs' theory, the omission cost the shareholders collectively approximately $7 billion in stock value, because the Plaintiffs allege they would not have approved the merger had they known about the availability of the no-premium option. Reliance is satisfied in this case, because the loss was not from purchasing stock, but from the terms of the merger itself. Thus, the fact that plaintiffs purchased their stock prior to January 2004 is not relevant in this case. This court finds that Plaintiffs sufficiently pleaded reliance.

F. Fairness Opinion by JPMSI

Defendants claim that Plaintiffs failed to plead misstatement in its § 10(b) claim against JPMSI on the fairness opinion prepared by JPMSI in the Proxy Statement. Statements of opinion or belief are actionable only if they are both objective and subjectively false. *Va. Bankshares v. Sandberg,* 501 U.S. 1083, 1095, 111 S.Ct. 2749, 115 L.Ed.2d 929 (U.S.1991).“To plead the falsity of a statement of opinion, a plaintiff must plead with particularity why the statement of opinion was objectively and subjectively false. A fairness opinion is objectively false if the subject matter of the opinion is not, in fact, fair, and is subjectively false if the speaker does not, in fact, believe the subject matter of the opinion to be fair.” *Shurkin v. Golden State Vintners, Inc.,* 2005 U.S. Dist. LEXIS 39301, 2005 WL 1926620 (D.Cal.2005). In the present case, Plaintiffs have pled both. First, Plaintiffs have pled that the subject matter of JPMSI's fairness opinion is objectively false. Plaintiffs present figure charts that show JPMSI's analysis provided that the Merger exchange ratio exceeded the highest point in the range of reasonableness and/or fairness despite JPMSI's endorsement of the Merger. Second, Plaintiffs also pled subjective falsity, alleging that JPMSI knew of the unfair ratio but endorsed the merger in an effort to collect compensation and further its own ranking amongst its competitors. Whether these allegations are true, and to what extent the numbers are accurate, are questions on the merits. As to the pleading requirements at issue in a motion to dismiss, Plaintiffs have sufficiently pleaded misstatement by JPMSI for a § 10(b) claim.

G. Materiality

***11** Defendants move to dismiss on the ground that the omission of the no-premium offer is not material. The Supreme Court teaches that

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills'* general description of materiality as a requirement that “the defect have a significant *propensity* to affect the voting process.”It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of 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 Indus. v. Northway, 426 U.S. 438, 448, 96 S.Ct. 2126, 48 L.Ed.2d 757 (U.S.1976). Under this standard, an omission of an offer that would have resulted in a $7 billion difference in merger compensation would be considered important in deciding how to vote. Further, if, as Plaintiffs allege, Dimon offered to consummate the transaction for no premium and the only reason Harrison rejected the offer was to retain a position as CEO of the merged company, that may be a fact that has a “substantial likelihood” of changing a reasonable shareholder's vote. While not every detail of the negotiations is required to be disclosed, given the large dollar amount involved and the personal nature of the two-year compromise, there is a substantial likelihood that the omission of the no-premium offer in the Proxy Statement would have altered the mix of available information. The alleged omission is material.

H. State Claims

Count IV of the CAC alleges breach of fiduciary duty against the Director Defendants. This claim is brought pursuant to Delaware common law. In Delaware state court, Plaintiffs brought a similar suit alleging breach of fiduciary duty by the Director Defendants. *See In re J.P. Morgan Chase & Co. S'holder Litig.,* 906 A.2d 808, 818 (Del.Ch.2005). This claim was dismissed by the state court because Plaintiffs failed to first make a demand on the Board, as required by Delaware's Court of Chancery Rule 23.1. Under Rule 23.1, a plaintiff shareholder must make a demand upon the corporation's current board to pursue derivative claims owned by the corporation before a shareholder is permitted to pursue legal action on the corporation's behalf. The plaintiff may argue demand futility under the two-prong test of *Aronson v. Lewis,* 473 A.2d 805, 813 (Del.1984). The first prong of the *Aronson* test is whether "a shareholder [has pled] with particularity facts that establish that demand would be futile because the directors are not independent or disinterested."*Id.* The second prong of the test is whether "a reasonable doubt is created that ... the challenged transaction was otherwise the product of a valid exercise of business judgment."*Id.* The two prongs of the *Aronson* test are disjunctive, meaning that if either part is satisfied, demand is excused." *Id.*

***12** The Delaware Court of Chancery determined that the suit was derivative, despite Plaintiffs attempt to frame it as a direct challenge. The alleged harm (loss of $7 billion worth of stock) was against JPMC, and any potential recovery of stock would be received by JPMC, not the shareholders directly. The Delaware Court of Chancery also determined that the Plaintiffs did not meet the demand futility requirements. Conducting a thorough analysis of the Director Defendants, the Delaware Court of Chancery determined that the majority of the board of JPMC were independent. Thus, Plaintiffs failed to satisfy the first prong of the *Aronson* test that shareholders must plead with particularity of facts establishing that demand would be futile because the directors were not independent or disinterested. The Delaware Court of Chancery also found that the Plaintiffs failed to call into question the Directors' good faith, honesty or lack of adequate information, and thus did not show why the board's decision is not protected by the business judgment rule. As such, Plaintiffs failed to satisfy prong two of ths *Aronson* test, and the demand was found not to be futile. Because the suit was derivative, and the demand was not futile, Plaintiffs were required to place a demand with the current board before bringing legal action. The Delaware Court of Chancery dismissed the breach of fiduciary claim, because Plaintiffs had not made such a demand. *In re J.P. Morgan Chase & Co. S'holder Litig.,* 906 A.2d 808, 818 (Del.Ch.2005).

This ruling is applicable to the present case. Plaintiffs make essentially the same breach of duty claim. The facts alleged on the individual Directors are essentially the same. While the federal complaint may include some more details, the pertinent facts are sufficiently similar that this court's analysis mirrors that of the state court. *See In re J.P. Morgan Chase & Co. S'holder Litig.,* 906 A.2d 808, 818 (Del.Ch.2005). The differences between the federal complaint and the state complaint listed by Vice Chancellor Lamb do not change the analysis or conclusion of the Delaware Court of Chancery. Thus, Count IV of the complaint is dismissed, as legal action is not sanctioned before a demand is made on the current board.

Because Count IV is dismissed, Count V against JPMSI for aiding and abetting the breach of fiduciary duty and Count VI against JPMSI for civil conspiracy are similarly dismissed.

IV. CONCLUSION

For the foregoing reasons, Defendant's motion to dismiss is granted in part and denied in part. Defendant's motion to dismiss is granted as to Count II against JPMC only. Defendant's motion to dismiss is also granted as to Count IV, V and VI. Defendant's motion to dismiss is denied as to all other claims.

N.D.Ill.,2007.
In re JPMorgan Chase & Co. Securities Litigation
Not Reported in F.Supp.2d, 2007 WL 4531794 (N.D.Ill.)

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TAB 16

Only the Westlaw citation is currently available.

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

Sept. 21, 2000.

ORDER

GETTLEMAN, District J.

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

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

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

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

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

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

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

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

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

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

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

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

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TAB 17

C
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 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.

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 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 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 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' 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

TAB 18

Only the Westlaw citation is currently available.

United States District Court,
N.D. Illinois,
Eastern Division.
In re NEOPHARM, INC. SECURITIES LITIGATION.
No. 02 C 2976.

Feb. 23, 2007.

Eric Belfi, Murray, Frank & Sailer LLP, Joel P. Laitman, Jay P. Saltzman, Schoengold and Sporn, P.C., New York, NY, Christopher B. Sanchez, Miller Faucher and Cafferty, LLP, Amelia Susan Newton, Leigh R. Lasky, Norman Rifkind, Lasky & Rifkind, Ltd., Chicago, IL, William S. Lerach, David A. Thorpe, Helen J. Hodges, Steven W. Pepich, Nicholas J. Licato, Lerach Coughlin Stoia Geller Rudman & Robbins, San Diego, CA, for Plaintiff.

Leann Pedersen Pope, Stephen Ryan Meinertzhagen, Burke, Warren, MacKay & Serritella, P.C., David H. Kistenbroker, Leah J. Domitrovic, Katten Muchin Zavis Rosenman, Chicago, IL, Dylan J. Liddiard, Lloyd Winawer, Wilson, Soncini, Goodrich & Rosati, Palo Alto, CA, for Defendant.

MEMORANDUM OPINION AND ORDER

JOAN HUMPHREY LEFKOW, United States District Judge.

***1** The lead plaintiff in this class action lawsuit, Operating Engineers Construction Industry and Miscellaneous Pension Fund (Local 66-Pittsburgh) ("plaintiffs"), is suing NeoPharm, Inc. ("NeoPharm") and two individual defendants for securities fraud (collectively, "defendants" or "NeoPharm"), specifically, for violation of Section 10(b) of the Securities Exchange Act of 1934, codified at 15 U.S.C. § 78(j), and Rule 10(b)-5 promulgated thereunder, codified at 17 C.F.R. § 240.10b-5. Plaintiffs have also sued the individual defendants as alleged "control persons" for violation of Section 20(a) of the 1934 Act, codified at 15 U.S.C. § 78(t).

Currently before the court is plaintiffs' motion for "Summary Adjudication of Issues Based on Collateral Estoppel."Dkt No. 106 (Jan. 26, 2005). Invoking Rule 56, plaintiffs ask the court to preclude NeoPharm from relitigating various "factual issues" that they contend were resolved in an arbitration between NeoPharm and a third party, Pharmacia & Upjohn Company ("Pharmacia"). Plaintiffs have also moved for leave to amend their complaint. Dkt. No. 106 (Jan. 26, 2005). They seek to add Dr. John Kapoor, who was dismissed from this case without prejudice in this court's order of February 7, 2003, Dkt. No. 45, as an individual defendant, and to reallege that certain statements that the company made before the class period, which were dismissed with prejudice in that same order of February 7, 2003, were false or misleading at the time that they were made. Finally, plaintiffs want to add allegations based on the factual findings from the arbitration decision as well as information from NeoPharm's internal documents produced in discovery. For the following reasons, plaintiffs' motions are denied.

I. Background

NeoPharm is a publicly owned biopharmaceutical company that researches and develops experimental drugs for the treatment of cancer. NeoPharm's Response to Plaintiffs' Motion for Summary Adjudication of Issues Based on Collateral Estoppel, Dkt. No 119 (March 9, 2005) ("NeoPharm's Response"), at 2. Liposome Encapsulated Paclitaxel ("LEP") is one of its star prospects. NeoPharm's Response, at 2; http://www.neopharm.com (last visited Feb. 15, 2007). NeoPharm licensed the rights to develop and market LEP to Pharmacia pursuant to an agreement reached in February of 1999 (the "License Agreement"). NeoPharm's Statement of Add'l Facts ("NeoPharm's Statement"), at ¶ 13. Pharmacia was obligated under the License Agreement to use "reasonable efforts" to bring LEP to market. NeoPharm's Statement, at ¶ 14. During the class period (between October 31, 2001 and April 19, 2002), NeoPharm made various statements to the public in which it discussed the potential benefits of LEP and some positive results from early testing. Plaintiffs' complaint alleges that these statements were false or misleading because NeoPharm concealed serious problems in the LEP development process.

On April 19, 2002, NeoPharm announced that it had concerns over Pharmacia's work on LEP, and that it had commenced arbitration against Pharmacia for breach of the License Agreement. NeoPharm's Answer to Plaintiff's Consolidated Amended Class Action Complaint ("NeoPharm's Answer"), at ¶ 49; NeoPharm's Statement, at ¶ 40; Lead Plaintiff's Motion for Summary Adjudication of Issues Based on Collateral Estoppel, Dkt. No. 106 ("Plaintiffs' Motion"), Ex. 2, at 1 (arbitration decision). After this announcement, the price of NeoPharm's stock dropped significantly. Plaintiffs filed their complaint on April 25, 2002. Complaint, Dkt. No. 1 (April 25, 2002).

***2** In the arbitration, NeoPharm alleged, *inter alia,* that Pharmacia did not use reasonable efforts to develop LEP and that it misrepresented and concealed facts from NeoPharm concerning the status of the development. Plaintiffs' Motion, Ex. 2, at 2. For example, NeoPharm alleged that Pharmacia unreasonably abandoned NeoPharm's formulation of LEP ("LEP-s") in favor of a reformulation ("LEP-ns"), entered Phase II trials with LEP-ns instead of LEP-s, used the "maximum tolerated dose" determined in Phase I trials for LEP-s on LEP-ns, and ran the LEP-ns Phase II trial at the same time as the LEP-ns Phase I trial.*Id.* at 20-21;*cf.* Defendants' Response, at 6 n. 4.[FN1] Pharmacia counter-claimed for rescission, arguing that NeoPharm induced it to enter into the Agreement by misrepresenting and concealing material facts about LEP.*Id.* at 2.

FN1. Defendants characterize the arguments that they made in the arbitration somewhat differently, but the distinctions are immaterial for purposes of this case.

After a lengthy proceeding involving 46 days of sworn testimony and hundreds of exhibits, the arbitrators denied both parties' claims in a 34-page decision. The alleged "facts" that plaintiffs seek to preclude defendants from relitigating and the additional allegations that they seek leave to add to their complaint are taken from that decision. *Id.* at 33; Plaintiffs' Statement of Material Facts in Support of Motion ("Plaintiffs' Statement"), at ¶¶ 6-9.

II. Motion for Summary Adjudication of Issues Based on Collateral Estoppel

A. Summary Judgment Standards

Summary judgment obviates the need for a trial where there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c). The party seeking summary judgment bears the initial burden of proving that there is no genuine issue of material fact. *Celotex Corp. v. Catrett,* 477 U.S. 317, 323-24, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986). In plaintiffs' motion for summary adjudication of issues based on collateral estoppel, they are not asking the court for judgment on their securities fraud claims. Instead, they are requesting that the court enter an order precluding defendants from contesting or relitigating factual issues that they argue were resolved in the context of NeoPharm's arbitration with Pharmacia. Plaintiff's Memorandum in Support of its Motion, at 1.

Rule 56 does not provide a mechanism for a court to enter summary judgment on facts that are not dispositive of an entire claim, count, or affirmative defense.[FN2]Fed.R.Civ.P. 56; *Petroff Trucking Co., Inc. v. Envirocon, Inc.,* 2006 WL 2938666, at *3 (S.D.Ill. Oct.13, 2006); *Rubin v. Islamic Republic of Iran,* 408 F.Supp.2d 549, 552 (N.D.Ill.2005) (citations omitted) ("A motion for partial summary judgment that partitions a single claim for relief into constituent parts and then seeks partial summary judgment on some but not all of the constituent parts is not permitted."); *O'Phelan v. Fed. Express Corp.,* 2005 WL 2387647, at *8 (N.D.Ill. Sept.27, 2005); *Ting v. Chicago Mercantile Exchange, Inc.,* 2005 WL 2335584, at *7 (N.D.Ill. Sept.21, 2005); *Allen v. Chicago Transit Authority,* 2000 WL 1139898, at *3 (N.D.Ill. Aug.10, 2000); *Softa Group, Inc. v. Taylor,* No. 92 C 2420, 1992 U.S. Dist. Lexis 8713, at *1-*2 (N.D.Ill. June 24, 1993) (Lefkow, Exec.Mag. J.); *Quintana v. Byrd,* 669 F.Supp. 849, 850 (N.D.Ill.1987) (Ann C. Williams, J.); *Arado v. General Fire Extinguisher Corp.,* 626 F.Supp. 506, 508-09 (N.D.Ill.1985); *Capital Records, Inc. v. Progress Record Distributing, Inc.,* 106 F.R.D. 25, 28-29 (N.D.Ill.1985). This principle is grounded in the need to conserve judicial resources. If parties could bring piecemeal motions for summary judgment, the courts would be overwhelmed with constant requests to resolve factual issues. *Capitol Records,* 106 F.R.D. at 29. "Such adjudications would not dispose of a claim or even become final until trial, and would waste judicial resources in almost every case."*Id.*

FN2. Plaintiffs argue that issue preclusion, as opposed to claim preclusion, is available to resolve individual factual issues that amount to less than a whole claim. The real question here, however, is not a comparison of issue and claim preclusion; it is whether *summary judgment* can be granted on parts of a claim that are not dispositive of the whole. The only case that plaintiffs cite on this point does not support their request for an order of collateral estoppel here; in *Axa Corp. Solutions v. Underwriters Reins. Co.,* 2004 U.S. Dist. Lexis 22609 (N.D.Ill. Nov. 9, 2004) (Lefkow, J.), this court considered motions for summary judgment that were properly brought on entire claims and used collateral estoppel to establish certain elements within those claims.

***3** Federal Rule of Civil Procedure 56(d) also does not typically provide a vehicle for the relief that plaintiffs seek. It provides the following:

Case Not Fully Adjudicated Upon Motion. If on motion under this rule judgment is not rendered upon the whole case or for all the relief asked and a trial is necessary, the court at the hearing of the motion, by examining the pleadings and the evidence before it and by interrogating counsel, shall if practicable ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It shall thereupon make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings in the action as are just. Upon the trial of the action the facts so specified shall be deemed established, and the trial shall be conducted accordingly.

Fed.R.Civ.P. 56(d). This provision is usually understood to come into play only after a proper motion for summary judgment under Rule 56(a) or (c) as to an entire count or claim is denied on its merits, with a purpose of salvaging some of the judicial resources that are expended in considering such a motion. *Lovejoy Elec., Inc. v. O'Berto,* 616 F.Supp. 1464, 1473 (N.D.Ill.1985); *Rubin,* 408 F.Supp.2d at 552; *Capitol Records,* 106 F.R.D. at 29-30 ("A fair reading of Rule 56(d)... is that it does not allow a party to bring a motion for a mere factual adjudication. Rather, it allows a court, on a proper motion for summary judgment, to frame and narrow the triable issues if the court finds that such an order would be helpful to the progress of the litigation."); *Mendenhall v. Barber-Greene Co.,* 531 F.Supp. 947, 948 (N.D.Ill.1981).

Some judges in this circuit have taken the position that in certain situations, Rule 56(d) may be independently invoked to request an interlocutory order finding certain facts to be conclusively established for the remainder of a case. *Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co., Inc.,* 313 F.3d 385, 391 (7th Cir.2003); *Northeast Ill. Regional Commuter RR Corp. v. Kiewit Western Co.,* 396 F.Supp.2d 913, 921 (N.D.Ill.2005); *In re Doctors Hospital of Hyde Park,* 330 B.R. 689, 698 (N.D.Ill.2005). In each of these cases, however, the courts explained that the merits of the parties' motions could be considered and ruled on because doing so would promote judicial economy. *Zapata,* 313 F.3d at 391;*Kiewit Western Co.,* 396 F.Supp. at 922; *Doctors Hospital of Hyde Park,* 330 B.R. at 698.

Similarly, in *Oberweis Dairy, Inc. v. Assoc. Milk Producers, Inc.,* 553 F.Supp. 962, 965 (N.D.Ill.1982), the court received a motion for summary judgment seeking to use collateral estoppel to preclude the other party from relitigating certain specific facts and issues from a prior action, even though those issues did not resolve an entire claim. Although the court held that Rule 56 was the wrong procedural vehicle to use, it interpreted the request as one under Rule 16 and considered it on the merits. *Id.* Significantly, the previously litigated claims and the claims at issue were both for violations of the antitrust laws. *Id.* at 964-65.After considering whether offensive collateral estopped was appropriate, the court found that the previous litigation's specific findings on several of the common elements of the antitrust claims would be given preclusive effect. *Id.* at 970.

***4** Here, the court will examine the proposed facts that plaintiffs seek to preclude defendants from relitigating and determine whether those facts establish the elements of their securities fraud claims, entitling them to summary judgment. If plaintiffs are not entitled to summary judgment, the court will go on to consider the possibility of an order under Rule 56(d) or Rule 16.

B. Discussion

To establish liability under Section 10(b) and Rule 10b-5, a plaintiff must prove "(1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale or securities (5) upon which the plaintiff justifiably relied (6) and that the false statement proximately caused the plaintiff's damages."Mem. Op. And Order, Dkt. No. 45, at 17 (February 7, 2003) (citing *Caremark, Inc. v. Coram HealthCare Corp.,* 113 F.3d 645, 648 (7th Cir.1997); *Searls v. Glasser,* 64 F.3d 1061, 1066-67 (7th Cir.1995)); *see also* *Makor Issues & Rights, Ltd. v. Tellabs, Inc.,* 437 F.3d 588, 595 (7th Cir.2006), *cert. granted,* ---U.S. ----, 127 S.Ct. 853, ---L.Ed.2d ----, 75 USLW 3207, 75 USLW 334075 USLW 3349 (U.S. Jan 5, 2007) (NO. 06-484).

Plaintiffs ask this court to find that excerpted quotes from the arbitration decision are "facts" that are "conclusively established in this litigation and defendants are precluded from relitigating these matters here."Plaintiffs' Proposed Order, at 1-3. Included among 16 proposed paragraphs of "facts" are the following (citations to the arbitration award are omitted):

- The sonicated version of LEP (LEP-s) was problematic from the beginning. In May 1999, Pharmacia received 100 vials of LEP from NeoPharm so that it could begin to design a development plan and conduct pre-clinical tests on the material. In one test that was done in May 1999, 10 out of 20 rats died after being injected with LEP-s. In a second test conducted that same month, one of two dogs that were injected with LEP-s died.

- Between July and August 1999, Pharmacia conducted numerous experiments designed to test the encapsulation efficiency of LEP-s. As a result of these tests, Pharmacia determined that encapsulation efficiency for LEP-s was inconsistent from sample to sample, even for those samples reconstituted using the same procedure at the same site. Many of these tests demonstrated that free paclitaxel, in crystalline form, was present in the LEP-s samples.

- Recorded variability of the level of free paclitaxel in reconstituted formulations of LEP-s ranged from zero to 33% free paclitaxel. NeoPharm, and later Pharmacia, specified that the level of free paclitaxel in LEP-s must be no greater than 20%. In another test Pharmacia dosed three dogs with LEP-s and two of the three dogs died prematurely because the LEP-s contained 28% free paclitaxel.

Plaintiffs' Proposed Order, at 1.

These "facts" that plaintiffs ask the court to find do not establish any elements of plaintiffs' claim for securities fraud. Although plaintiffs generally argue that the arbitration findings prove that NeoPharm made false statements to the market, Plaintiffs' Reply, at 3, they have not effectively linked any of the arbitration findings to any of NeoPharm's statements to show how the facts prove that the statements were false or misleading. For example, the following are some of the allegedly false or misleading statements:

***5** •NeoPharm today [October 31, 2001] announced that clinical data for liposome encapsulated paclitaxel (LEP) were presented at the AACR-NCI-EORTC meeting in Miami, Florida on Tuesday. In the study, LEP is administered weekly for six weeks using an intravenous infusion.... LEP is being developed by Pharmacia Corporation under a licensing agreement with NeoPharm. "In the Pharmacia study involving weekly dosing of LEP, an extended terminal half-life was observed," said Imran Ahmad, Chief Scientific Officer of NeoPharm. "This is a significant improvement because more paclitaxel appears to [be] available to attack tumors over the six week administration schedule."

- NeoPharm, Inc. announced today [January 15, 2002] that it met with senior officials of Pharmacia on Monday, January 14, 2002 regarding the LEP (Liposome Encapsulated Paclitaxel) development program. Following that meeting, Pharmacia officials expressed the following points to NeoPharm officials regarding the licensing agreement with NeoPharm:

1) Pharmacia remains fully committed to the development of LEP.

2) Pharmacia is interested in exploring the possibility of licensing other products in the NeoPharm portfolio.

Pharmacia, under a licensing agreement with NeoPharm, currently has all responsibility for development of LEP. As a result, NeoPharm is unable to confirm the clinical development timetable for LEP at this time.

Am. Compl., at ¶¶ 33, 39.

Even if the court were to accept the arbitrators' findings as facts, it would not logically follow that the allegedly fraudulent statements made by NeoPharm were false or misleading. First, in several of the statements, such as "The sonicated version of LEP (LEP-s) was problematic from the beginning," the arbitrators used subjective words whose meaning cannot be commuted from the breach of contract context to this securities fraud case. When the arbitrators said that LEP-s was "problematic," they were considering whether it was reasonable for Pharmacia to reformulate it, not whether NeoPharm could still appropriately discuss its potential with the public or whether NeoPharm's statements were fraudulent. It was not necessary in that context for the arbitrators to be precise in what they meant by "problematic," and this court cannot infuse their words with meaning that was not necessarily intended.

Second, the court is not in a position to evaluate the significance of data such as encapsulation efficiency and the presence of free paclitaxel or the implications of this information on LEP's general potential. For example, it is not for the court to decide that the presence of 28% free paclitaxel in a particular test would render a statement that LEP had performed well in early clinical testing fraudulent.

Third, it is true that "if NeoPharm had knowledge that the Phase II trials were failing to such a great degree that the Phase I results would be affected, and that they were, for all practical matters, back to the drawing board with respect to LEP development, then [statements regarding Phase I success may have] been misleading to investors," as the court stated in its February 7, 2003 order regarding defendants' motion to dismiss. Dkt. No. 45, at 20.Plaintiffs' "facts," however, do not show that LEP-ns's failures in certain Phase II trials rendered the positive Phase I results for LEP-s invalid or irrelevant to LEP's potential. The arbitrators discussed negative results of LEP-ns in Phase II clinical trials for patients with gastric, esophogeal, and bladder cancers, but believed that testing had not yet started for LEP-ns's efficacy in treating breast and small-cell lung cancers, which were the most likely candidates for LEP's success. Plaintiffs' Motion, Ex. 2, at 15-16; Defendants' Response, at 2-3; Defendants' Statement, at ¶¶ 26, 29, 60. Additionally, neither NeoPharm nor Pharmacia knew exactly what the differences were between LEP-s and LEP-ns, Plaintiffs' Response to Defendants' Statement, at ¶ 23, which makes it difficult for anyone, and particularly a court, to draw conclusions from the failures of LEP-ns [FN3] about the viability of LEP in general.

FN3. The court notes that there is some evidence in the record that LEP-s had success in the Phase I trials conducted by Pharmacia that concluded in 2000. Defendants' Statement, at 18-19.

***6** Another key element of plaintiffs' claims is missing: plaintiffs have not shown how their alleged "facts" prove that any of the defendants had the requisite scienter at the time that they made their public statements. "[W]ith respect to each act or omission alleged" as false or misleading, a plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."15 U.S.C. § 78u-4(b)(2). That required state of mind, or scienter, is "the intent to deceive, manipulate, or defraud," *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), or "an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Tellabs,* 437 F.3d at 600 (citations omitted).

Plaintiffs do not effectively link the defendants' knowledge at any particular time to any of the defendants' public statements. Their citation to the arbitrators' conclusion that Pharmacia did not breach its contractual duty to keep NeoPharm adequately informed is insufficient, especially in light of the fact that it was a key point of contention. Plaintiffs' Motion, Ex. 2, at 2. The arbitration decision is not clear as to exactly what information Pharmacia needed to or did convey to NeoPharm, or when, in order to satisfy its contractual requirement; it did not need to make such specific findings in order to resolve the breach of contract claims. In contrast, in order to prevail on their securities fraud claims, the plaintiffs must show that each of the defendants had the requisite scienter at the time that they made each allegedly fraudulent statement. *In re Bally Total Fitness Sec. Litig.,* 2006 WL 3714708, at *7 (N.D.Ill. July 12, 2006); *In re Abbott Labs. Sec. Litig.,* 813 F.Supp. 1315, 1318-19 (N.D.Ill.1992). Additionally, while plaintiffs ask the court to find many "facts" regarding what *Pharmacia* knew or believed about the status of LEP, Pharmacia's knowledge is irrelevant to the question of NeoPharm's scienter unless the plaintiffs can prove that NeoPharm shared relevant and specific knowledge at the times that they made the allegedly fraudulent public statements.

Finally, the arbitration could not have determined the last two elements of plaintiffs' claim under Section 10(b): that the plaintiffs justifiably relied on NeoPharm's statements and that those statements proximately caused them damages. Plaintiffs' proposed findings therefore do not prove their securities fraud claims, or any elements of them, and the court cannot enter summary judgment on those claims.

Even assuming that the court could enter judgment on non-determinative facts, the requirements for offensive collateral estoppel have not been met. The parties are unclear as to which law applies to determine the preclusive effect of the arbitration. Seventh Circuit law and New York state law are the possibilities. These jurisdictions agree on the fundamental requirements for collateral estoppel, and any nuances between them do not affect how the doctrine applies to this case. Both jurisdictions require at least that the issue to be precluded is identical to one from the previous action and that it was necessarily decided in that action, and that the party against whom estoppel is to be applied had a full and fair opportunity to contest the earlier decision. Plaintiffs' Mem., at 9; NeoPharm's Mem., at 13; Plaintiffs' Reply, at 6.[FN4] Ultimately, the court has discretion in determining whether to apply offensive collateral estoppel, especially based on an unconfirmed arbitration decision. *Parklane Hosiery Co. v. Shore,* 439 U.S. 322, 331, 99 S.Ct. 645, 651, 58 L.Ed.2d 552 (1979); *Stulberg v. Intermedics Orthopedics,* 997 F.Supp. 1060, 1066 (N.D.Ill.1998) (emphasis in original) ("courts are not ***required*** to afford previous unconfirmed arbitration awards preclusive effect on later federal proceedings; however, courts ***may impose*** such preclusion in appropriate cases."); 18B Charles Alan Wright, Arthur R. Miller & Edward H. Cooper, Fed. Practice & Procedure § 4475.1 (2006) ("An arbitral award may be even more susceptible to concerns springing from the identity of the parties, and preclusion should be made available for the benefit of a nonparty only with real care.").

FN4. *See also* *Lumbermens Mut. Cas. Co. v. 606 Restaurant, Inc.,* 31 A.D.3d 334, 819 N.Y.S.2d 511, 512 (N.Y.App.Div.2006); *Lang v. City of Round Lake Park,* 87 F.Supp.2d 836, 842 (N.D.Ill.2000) (the law of the state where the judgment was rendered determines the judgment's preclusive effect); *accord* *La Preferida, Inc. v. Cerveceria Modelo, S.A. de C.V.,* 914 F.2d 900, 905-06 (7th Cir.1990) (for collateral estopped to apply, 1) the issue sought to be precluded must be the same as that involved in the prior action, 2) the issue must have been actually litigated, 3) the determination of the issue must have been essential to the final judgment, and 4) the party against whom estoppel is invoked must [have been] fully represented in the prior action); *cf* 18B Charles Alan Wright, Arthur R. Miller, & Edward H. Cooper, Fed. Practice & Procedure § 4475.1, at n.51 (2006) (some courts apply federal law to determine the collateral estoppel effect of prior arbitrations in securities fraud cases).

***7** The status of LEP development was relevant to the breach of contract arbitration and is also relevant to this case, but there is no identity of necessary issues between the two. In the arbitration, the ultimate question was whether Pharmacia complied with its obligations under the license agreement to develop LEP. The arbitrators focused on the reasonableness of Pharmacia's efforts. Here, in contrast, the court must decide whether NeoPharm made fraudulent statements to the market, with scienter, about the progress of LEP development. In such distinct contexts, the decisionmakers must keep very different standards in mind and their statements are not commutable findings of fact. *See Kenny v. New York City Transit Authority,* 275 A.D.2d 639, 713 N.Y.S.2d 173, 174 (N.Y.App.Div.2000); *Harper & Co., Inc. v. Nortek, Inc.,* 104 F.3d 913, 922 (7th Cir.1997); *In re Bozovic,* 2004 WL 1905355 (Bankr.N.D.Ill. Aug, 24, 2004). Additionally, it is not clear that each of the "facts" that plaintiffs ask this court to find were necessary to the arbitrators' decision. The statements do not each constitute conclusions on an element of a breach of contract action, and it is likely that many of them were not essential to the decision and were merely additional observations, or dicta, of the arbitrators. For example, it is implausible that the fact that 10 out of 20 rats died in one particular experiment was dispositive for the arbitrators in their finding that Pharmacia used reasonable efforts to develop LEP.

For all of these reasons, the court declines to exercise its discretion to enter an order under Rule 56(d) or Rule 16 precluding defendants from relitigating the plaintiffs' proposed "facts." Doing so would not further the litigation and it would waste judicial resources for the court to spend time examining the arbitrators' discourse and picking out certain sentences that could be relevant facts.[FN5] As NeoPharm suggested, a better route for the plaintiffs would be to draft requests for admission of concise and discrete points that were determined in the arbitration and are relevant to this case.

FN5. Because the court has determined that collateral estoppel will not be applied against NeoPharm, it is not necessary to determine whether it would be appropriate to apply it against the individual defendants.

III. Motion for Leave to Amend the Consolidated Amended Complaint

Plaintiffs have also moved for leave to amend their complaint. Dkt. No. 106.They want to reallege that Dr. John Kapoor, who was originally named as a defendant in this case but was dismissed without prejudice in the court's February 7, 2003 order, is a controlling person of the company and is individually liable for the securities fraud. They also want to reallege that certain pre-class period statements, dismissed with prejudice in that same order, were false at the time they were made. Finally, plaintiffs want to include new allegations based on the factual findings from the arbitration decision and NeoPharm's internal documents produced through discovery. The quantitative difference between the current complaint and the proposed amended complaint is approximately 20 pages: from 28 pages to 47.

A. Standard

***8** Federal Rule of Civil Procedure 15(a) provides, in relevant part, that "a party may amend the party's pleading only by leave of court or by written consent of the adverse party; and leave shall be freely given when justice so requires."Plaintiffs cite an interpretation of "when justice so requires" from *Foman v. Davis,* 371 U.S. 178, 182, 83 S.Ct. 227, 9 L.Ed.2d 222 (1962):

> If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claim on the merits. In the absence of any apparent or declared reason-such as undue delay, bad faith or dilatory motive on the part of the movant, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, futility of amendment, etc.-the leave sought should, as the rules require, be 'freely given.' Of course, the grant or denial of an opportunity to amend is within the discretion of the District Court, but outright refusal to grant the leave without any justifying reason appearing for the denial is not an exercise of discretion; it is merely abuse of that discretion and inconsistent with the spirit of the Federal Rules.

Defendants' citations are generally in accord, and add that "[i]t is not an abuse of discretion to refuse a request to amend when the proffered amendment merely restates the same facts using different language, or reasserts a claim previously determined."*Wakeen v. Hoffman House, Inc.,* 924 F.2d 1238, 1244 (7th Cir.1983) (citing *Kasey v. Molybdenum Corp. of America,* 467 F.2d 1284, 1285 (9th Cir.), *cert. denied,* 409 U.S. 1063, 93 S.Ct. 571, 34 L.Ed.2d 516 (1972)).

B. Discussion

1. Kapoor

Plaintiffs' proposed amended complaint retains Dr. John Kapoor as an individual defendant, despite the fact that Kapoor was dismissed from this case on February 7, 2003. Mem. Op. And Order, at 27 n. 5, 28 ("the court will dismiss the claims against Kapoor without prejudice."). Defendants object on the basis that the statute of limitations has run for claims against Kapoor. They also object to plaintiffs' undue delay in seeking the amendment and the unfair prejudice that would result from the addition of Kapoor as an individual defendant.

The parties agree that the applicable statute of limitations is "the earlier of two years after discovery of the facts constituting the violations or within five years of the violations," and that it started to run on April 19, 2002. Plaintiffs' Reply to Motion for Leave to Amend the Consolidated Amended Complaint, Dkt. No. 126 (April 12, 2005), at 7 n. 7 ("Plaintiffs' Reply"); Defendants' and Non-Party John Kapoor's Response to Lead Plaintiff's Motion for Leave to Amend the Consolidated Amended Complaint, Dkt. No. 122 (March 9, 2005), at 5 ("Defendants' Response") (citing § 804 of the Sarbanes-Oxley Act of 2002, 28 U.S.C. § 1658(b)). Plaintiffs served their motion to amend on defendants on November 16, 2004. This was two years and almost five months after any potential claims against Kapoor accrued. Plaintiffs argue that the limitations period had not run because Kapoor was named as a defendant in the case when it was originally filed, and his dismissal did not end his exposure to liability. Finally, plaintiffs attempt to rely on principles of relation back and equitable tolling.

***9** The Seventh Circuit has squarely held that "a suit dismissed without prejudice is treated for statute of limitations purposes as if it had never been filed.... [W]hen a suit is dismissed without prejudice, the statute of limitations is deemed unaffected by the filing of the suit, so that if the statute of limitations has run the dismissal is effectively with prejudice." *Elmore v. Henderson,* 227 F.3d 1009, 1011 (7th Cir.2000) (citations omitted); *Muzikowski v. Paramount Pictures Corp.,* 322 F.3d 918, 924 (7th Cir.2003) (same).[FN6] Kapoor's dismissal without prejudice from this case on February 7, 2003 therefore caused the statute of limitations to run as if the case had never been filed. When plaintiffs attempted to retain Kapoor as a defendant in the case on November 16, 2004, they were about five months too late and their claims were barred.

FN6. The court finds plaintiffs' attempts to distinguish these cases, as well as their characterization of defendants' position as "extreme" or "absolutely [without] support," to be unpersuasive. *See* Plaintiffs' Reply, at 5-10.

Alternatively, even if the statute had not run, the court would still deny plaintiffs' amendment adding Kapoor as a defendant because because plaintiffs unduly delayed in seeking the amendment and allowing the amendment would unduly prejudice Kapoor as well as the other defendants in this case. Plaintiffs' primary explanation for why they waited until November of 2004 to file their motion to amend is that they only received a copy of the arbitration decision from defendants in September of 2004. This cannot justify their tardiness in seeking to retain Kapoor as a defendant, however, because Kapoor was not a party to the arbitration, was not a witness, and is not even mentioned in the decision. *See* Plaintiffs' Motion, Ex. 2. Additionally, defendants represent that Kapoor produced 2,205 pages of documents in response to discovery requests in the summer of 2003, Defendants' Response, at 2, more than a year before plaintiffs filed this motion to amend. Plaintiffs' statement that "[a]fter reviewing the new facts from discovery, plaintiff determined that the additional evidence warrants the retention of Kapoor as a defendant" therefore can not justify their delay. *See* Plaintiffs'

Reply, at 5 n. 3.

Although the court is sympathetic to plaintiffs' difficulties in satisfying the strict pleading standards of the PSLRA when information necessary to do so is in the possession of defendants, in this case neither the receipt of the arbitration decision nor the need for discovery can excuse plaintiffs' delay in seeking their amendments. Plaintiffs unduly delayed in seeking amendment, which is a sufficient basis to deny a party's request for leave to amend. *Glatt v. Chicago Park District,* 87 F.3d 190,194 (7th Cir.1996); *Hindo v. Univ. of Health Sciences,* 65 F.3d 608, 615 (7th Cir.1995); *Continental Bank, N.A. v. Meyer,* 10 F.3d 1293, 1298 (7th Cir.1993).

Under these circumstances, granting plaintiffs' request to retain Kapoor as an individual defendant 21 months after he had been dismissed from the case would be unduly prejudicial to him and to the other defendants, as would the resulting necessity of engaging in further discovery regarding Kapoor's liability. *Talton v. Unisource Network Servs., Inc.,* 2004 WL 3119007, at *3 (N.D.Ill., Dec.21, 2004); *Jones v. GES Exposition Servs., Inc.,* 2004 WL 2011396, at *5 (N.D.Ill. Sept.7, 2004) ("Undue prejudice occurs when the amendment 'brings entirely new and separate claims, adds new parties, or at least entails more than an alternative claim or a change in the allegations of the complaint' and when the additional discovery is expensive and time-consuming."). Statutes of limitation serve to "minimize legal uncertainty both about the outcome of eventual litigation and about the existence and scope of the potential defendant's liability." *Elmore,* 227 F.3d at 1013 (citations omitted). As of February 7, 2003, Kapoor was dismissed, meaning that he was relieved of any possibility of personal liability. Any possibility of appeal does not mean than Kapoor is currently subject to liability in this case and does not justify the court's disregard of an applicable statute of limitations or of the negative effect on him that allowing this amendment would cause.

***10** Plaintiffs cannot rely on equitable tolling or the relation back principle. "The running of a statute of limitations can be equitably tolled when through no fault of his own the plaintiff was unable to sue within the limitations period but he sued as soon as he could." *Elmore,* 227 F.3d at 1013 (citations omitted). This does not apply here; plaintiffs were able to sue Kapoor between February 8, 2003 and April 19, 2004. They did not, nor did they sue as soon as they could, as discussed above.

Finally, plaintiffs' amendment is not justifiable under Rule 15(c)'s provisions for relation back of amendments. Plaintiffs' argument that their claim against Kapoor relates back to the filing date of the original complaint is infirm because it cites only part of the applicable rule. Plaintiffs cite only the general relation back standard set forth in Rule 15(c)(2): that "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."Because this is a case seeking to "change[ ] the party or the naming of the party against whom a claim is asserted," however, plaintiffs must satisfy the additional specific requirements of Rule 15(c)(3): that the party to be added "received such notice of the institution of the action that the party will not be prejudiced in maintaining a defense on the merits, *and* [ ] knew or should have known that, *but for a mistake concerning the identity of the proper party,* the action would have been brought against the party."Fed.R.Civ.P. 15(c)(2)-(3) (emphasis added). Plaintiffs argue, without supporting citations, that the additional requirement of a mistake in identity does not apply here. That is incorrect. Plaintiffs' claim against Kapoor does not relate back. For all of these reasons, the court will not exercise its discretion to allow plaintiffs leave to amend their complaint to include allegations of individual liability against Kapoor.[FN7]

> FN7. The court expresses no opinion on whether the claims against Kapoor could survive a motion to dismiss. The possibility of eliciting further motions itself, however, is another basis for denying this motion to amend. *Talton v. Unisource Network Servs., Inc.,* 2004 WL 3119007, at *3 (N.D.Ill.Dec.21, 2004).

2. Pre-class period statements

Plaintiffs seek to reallege that statements made by NeoPharm before the beginning of the class period were materially false at the time that they were made because of their failure to disclose adverse information about LEP development, and that NeoPharm breached its duty to correct these statements. In the court's order of February 7, 2003, it dismissed claims based on these statements *with prejudice* on the basis that they were insufficiently alleged to have been false when they were made, and that therefore NeoPharm had no duty to correct them. Mem. Op. and Order, Dkt. No. 45, at 18 (citing *Stransky v. Cummins Engine Co.,* 51 F.3d 1329, 1331 (7th Cir.1995); *In re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 282 (7th Cir.1996)). Plaintiffs now argue that "the proposed amendment, which is based on the arbitration fact findings, demonstrate[s that] defendants' pre-Class Period statements regarding LEP were not true at the time they were made."Plaintiffs' Reply, at 4. The pre-class period statements in question are as follows:

***11** (1) We also made significant progress in both our pre-clinical and clinical programs and have begun to expand our infrastructure to support our electrostatic liposomal platform development. We plan on placing a number of compounds in our liposomal system in the coming months.

(2) LEP is a liposomal encapsulated formulation of the widely-used cancer drug, paclitaxel. Paclitaxel is marketed by Bristol-Myers Squibb Company under the trade name "Taxol ®" and is used in the treatment of a number of tumors, including breast, ovarian and lung cancer. Despite paclitaxel's wide use and its anti-tumor characteristics, its effectiveness is limited by its side effects, which can include nausea, vomiting, hair loss and nerve and muscle pain. Because of the chemical characteristics of paclitaxel, it cannot be introduced into the body unless it is first formulated in a toxic mixture of castor oil and ethanol which requires premedication of the patient. In addition, paclitaxel must be infused over a period of at least three hours.

We believe our technology may overcome many of the current limitations of paclitaxel by utilizing cardiolipin, a naturally occurring negatively charged lipid found in cardiac tissue, to increase the solubility of paclitaxel. We have been able to standardize the preparation of cardiolipin through the development of a proprietary form of synthetic cardiolipin. Using cardiolipin eliminates the need for administration of castor oil and ethanol and reduces the need for the accompanying premedication. Since paclitaxel has a positive charge and cardiolipin has a negative charge, cardiolipin electrostatically combines with the paclitaxel to form a stable product that can be freeze dried and easily reconstituted. Based on preclinical studies, we believe another potential advantage of LEP may be the ability of cardiolipin to overcome multi-drug resistance, which is the resistance to cancer drugs developed by cells which have been exposed to several rounds of chemotherapy. As a result, we may be able to significantly increase the effectiveness of LEP against tumors, thereby maximizing the killing of otherwise resistant cells.

Development status. LEP is being developed for various solid tumors. We believe LEP is the first, and only, liposomal form of paclitaxel to enter clinical trials. Enrollment of patients in our Phase I/II clinical trials for LEP was completed in April 2000. These Phase I/II trials involved the treatment of 31 cancer patients, none of whom were then responding to other forms of treatment. Our Phase I/II trials have provided evidence that LEP may be able to be administered at higher levels than paclitaxel is currently administered, with fewer side effects. Although not designed to measure efficacy, six patients in the Phase I/II trial experienced tumor reductions greater than 35%. The tumors in twelve other patients did not increase in size after 12 weeks, and in four of these twelve patients, the tumors were still stable in size one year later. Some patients received significantly more cycles of LEP than can be given with unencapsulated paclitaxel, including two patients who received greater than 30 cycles of LEP. None of the patients showed signs of the nerve and muscle pain commonly associated with paclitaxel, and most patients did not experience the hair loss or nausea often associated with paclitaxel treatment.

***12** Currently, our collaboration partner, Pharmacia[,] is initiating large scale multi-center, multinational Phase II/III clinical trials. These Phase II/III trials will assess LEP as both a single and combination therapy for a variety of solid tumors to determine its safety and efficacy.

(3) The year 2000 was a breathrough year for Neo-

Pharm ... our partner, Pharmacia, initiated Phase II/III clinical trials for Liposome Encapsulated Paclitaxel 'LEP,' for which we received a $3 million milestone payment."

(4) [The Company] confirmed ... that the clinical development program for LEP ... is continuing in key oncology indications."

Proposed Amended Complaint, at ¶¶ 69-72.

Under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) ("the PSLRA"), a plaintiff must plead the falsity and materiality of a statement of fact with particularity. *Tellabs,* 437 F.3d at 595. Particularity has been described as "the who, what, when, where, and how: the first paragraph of any newspaper story." *Healthcare Compare,* 75 F.3d at 281 (citing *DiLeo v. Ernst & Young,* 901 F.2d 604, 627 (7th Cir.1990)).

Plaintiffs allege that the four statements set out above were false and material at the time they were made because (1) LEP-s required sonication, rendering it less economically viable, among other problems; (2) LEP was NeoPharm's lead product in development; (3) LEP was "problematic from the beginning;" (4) "early testing" of LEP-s showed it could not be consistently reconstituted and it contained excess amounts of free paclitaxel, which rendered it unsafe, hurt its chances of becoming a successful product, and meant that it needed to be reformulated; (5) Pharmacia ran various tests on LEP-s that had some negative results; (6) Pharmacia had concerns about the viability of LEP-s; (7) NeoPharm and Pharmacia had a meeting in Italy in September 1999 at which they decided on "action items" to resolve problems with LEP-s; (8) Pharmacia decided to reformulate LEP in November 1999 and kept NeoPharm informed of its efforts beginning in January 2000; (9) after a bad test result in November 1999, patients were pre-medicated before taking LEP; (10) Pharmacia considered placing a hold on the Phase I trials and eventually ended them in the summer of 2000; (11) Pharmacia began Phase II trials for LEP-ns relating to gastric, esophogeal, and bladder cancer in late 2000; and (12) Pharmacia communicated some negative results of these trials to NeoPharm in March, April, and June of 2001. Proposed Amended Complaint, at ¶¶ 43-63.

Plaintiffs have alleged nothing that shows that statement (1) was false at the time that it was made. This statement concerned NeoPharm's business as a whole, and said only that NeoPharm had experienced some success in trials, planned to expand its infrastructure, and planned to place compounds in their liposomal system. None of plaintiffs' cited reasons for why the pre-class period statements were false directly addresses this statement or provides specific reasons why it was false when made, and plaintiffs thereby fail in their obligation to plead falsity with particularity. *In re Midway Games, Inc. Sec. Litig.,* 332 F.Supp.2d 1152, 1163-71 (N.D.Ill.2004) (Lefkow, J.). Furthermore, this statement is immaterial in that it is vague and not one on which investors would rely. *Tellabs,* 437 F.3d at 596 ("The crux of materiality is whether, in context, an investor would reasonably rely on the defendant's statement as one reflecting a consequential fact about the company. If the statement amounts to vague aspiration or unspecific puffery, it is not material."); *Davis v. SPSS, Inc.,* 431 F.Supp.2d 823, 829 (N.D.Ill., 2006); *Midway Games,* 332 F.Supp.2d at 1164 (N.D.Ill.2004). Therefore, adding this statement would be futile because it is incapable of surviving a motion to dismiss. *See* Blanchard v. Edgemark Fin. Corp., 2000 WL 33223385, at *2 (N.D.Ill. May 22, 2000) ("An amendment is futile where it is incapable of surviving a motion to dismiss.") (citing *General Elec. Capital Corp. v. Lease Resolution Corp.,* 128 F.3d 1074, 1085 (7th Cir.1997); *Garcia v. City of Chicago,* 24 F.3d 966, 970 (7th Cir.1994)). Plaintiffs are denied leave to reallege its falsity.

***13** Statement (2) must be broken down into manageable parts in order to determine its significance. Plaintiffs should have done this in their complaint pursuant to the requirement that they state with particularity exactly which statements are alleged to be false and the court could deny their motion to amend as futile on that basis alone. *See* Havenick v. Network Exp., Inc., 981 F.Supp. 480, 526 (E.D.Mich. Sept.30, 1997) ("[plaintiffs compiled] a long list of block quotes, many of which contain statements that cannot seriously be regarded as false or misleading, and they line these statements up against a conclusory list of omissions and pronounce that fraud exists. Any notion of particularity and an underlying reason in light of the PSLRA certainly demands more than this.").

There appear to be no allegations that the first paragraph was false; in fact, plaintiffs included substantially the same statements as allegations of their complaint. Proposed Amended Complaint, at ¶¶ 40-41. Similarly, there is nothing in plaintiffs' complaint challenging the last paragraph of the statement, which describes Pharmacia's plans for future testing. In the second paragraph, only the sentence referring to LEP "as a stable product that can be freeze dried and easily reconstituted" is addressed by plaintiffs' allegations of falsity. *See* Proposed Amended Complaint, at ¶ 45 (referencing "early testing" of LEP-s that showed problems with the consistency of LEP's reconstitution); ¶¶ 47-49 (referencing 1999 tests conducted by Pharmacia in which there were problems with LEP's consistency); ¶ 51 (representatives of Pharmacia and NeoPharm met in September of 1999 and discussed "encapsulation issues"); ¶ 54 (Pharmacia had concerns regarding LEP's reproducibility); ¶¶ 55, 58-59 (alleging that "defendants" were aware of Pharmacia's concerns and approved of Pharmacia's decision to reformulate LEP). Statement (2) was part of NeoPharm's 10-Q filing for the quarter ending on September 30, 2000.

Assuming only for the purpose of this decision that plaintiffs' complaint sufficiently alleges this statement's falsity, it would still not survive a motion to dismiss because plaintiffs have failed to adequately allege that it was made with the requisite scienter. It is possible that one could infer that because Pharmacia allegedly decided to reformulate LEP in November of 1999 based on issues with its reconstitution, and NeoPharm approved of that decision, that NeoPharm was aware of Pharmacia's concerns as of November 1999. This line of thinking is inappropriate in the context of the PSLRA, however; "[u]nlike 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." *Tellabs,* 437 F.3d at 594. Without the benefit of inferences such as the above, plaintiffs have failed to create a strong inference that this statement was made with scienter. *See*15 U.S.C. § 78u-4(b)(2). Plaintiffs provided only few and imprecise dates on which NeoPharm received any of the alleged information supporting the statement's falsity, and none of the allegations specify exactly what NeoPharm knew or was told, or *who* at NeoPharm had such knowledge. Alleging generally that NeoPharm was aware of Pharmacia's concerns is insufficient to allege scienter. *In re Abbott Labs. Sec. Litig.,* 813 F.Supp. 1315, 1318-19 (N.D.Ill.1992).

***14** The third paragraph of statement (2) generally touts the benefits that were observed in Phase I/II trials of LEP. It is evident that NeoPharm was referencing Phase I/II trials that it personally conducted, not those that Pharmacia conducted. This is because the referenced tests had been over for more than one year at the time of the September 2000 statement, Proposed Amended Complaint, at ¶ 70 ("the tumors [of some patients] were still stable in size one year later"), and Pharmacia does not appear to have completed any Phase I testing on humans by September of 1999. Proposed Amended Complaint, at ¶¶ 47-48 (Pharmacia conducted experiments on animals in May through August of 1999); Defendants' Mem. Supp. Mot. Dismiss, Dkt. No. 35, at 2, 9 (November 11, 2002) (NeoPharm's Phase I testing of LEP began in September of 1998; NeoPharm conducted "its own Phase I clinical trials"). For the same reasons as mentioned above, plaintiffs' allegations are insufficient to raise a strong inference that defendants made these allegedly fraudulent statements with scienter, because they do not allege who at NeoPharm had any relevant knowledge, what Pharmacia told NeoPharm, or when.[FN8] Therefore, plaintiffs may not amend their complaint to reallege that this statement was false, because it would not survive a motion to dismiss.

FN8. Plaintiffs' proposed amended complaint contains a paragraph that essentially subscribes to the practice of "group pleading." Proposed Amended Complaint, at ¶ 35 ("It is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the false, misleading, and incomplete information conveyed in the Company's public filings, press releases, and other publications as alleged herein-unless attributed to a specific defendant-are the collective actions of the narrowly-defined group of Individual Defendants identified above."*Cf. Chu,* 100 F.Supp.2d at 836 ("plaintiffs maintain that 'it is appropriate to treat the Individual Defendants as a group for pleading purposes.'") While the court found that plaintiffs' allegations were sufficient as of its February 7, 2003 order, plaintiffs must keep in mind the Seventh Circuit's newly articulated standard in *Tellabs* in any further amendments to their complaint. *See Tellabs,* 437 F.3d at 604 ("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.")

Regarding statement (3), plaintiffs have also failed to provide a sufficient explanation for why it was misleading to say that Pharmacia *initiated* Phase II/III clinical trials for LEP and that NeoPharm received a $3 million payment. In fact, earlier in their proposed amended complaint, plaintiffs plead that "Through August 25, 2000, Pharmacia paid to NeoPharm $22 million, including the purchase of $8 million of NeoPharm common stock."Proposed Amended Complaint, at ¶ 42. Plaintiffs are also denied leave to reallege that this statement was false.

Statement (4) could also not survive a motion to dismiss, but for another reason: it is not material. Investors would not find the assertion that the clinical development program for LEP is "continuing in key oncology indications" to be a consequential fact about the company. *See Tellabs,* 437 F.3d at 596. The word "continuing" does not necessarily mean "succeeding." The general lack of specificity of this statement undermines the plaintiffs' argument that it served to buoy NeoPharm's stock price several months after its issuance. *See Searls v. Glasser,* 64 F.3d 1061, 1066 (7th Cir.1995); *Last Atlantic Capital LLC v. Chicago Bd. Options Exchange, Inc.,* 455 F.Supp.2d 788, 801 (N.D.Ill.2006).

For all of these reasons, plaintiffs are denied leave to reallege that these pre-class period statements, which have already been dismissed with prejudice, were fraudulent. *See Wakeen v. Hoffman House, Inc.,* 724 F.2d 1238, 1244 (7th Cir.1983) (affirming a district court's denial of leave to amend when "the proffered amendment merely restates the same facts using different language, or reasserts a claim previously dismissed.").[FN9]

FN9. Defendants oppose the addition of the pre-class period statements based on the law of the case doctrine. The court has not considered the applicability of that doctrine, which could be an alternative basis for its finding, because leave to amend is denied on the merits of the proposed amendments.

3. New Allegations from the Arbitration Decision and NeoPharm's Discovery

***15** The majority of the text of plaintiffs' proposed amendments add factual allegations to flesh out the existing claims. These are based mostly on the findings in the arbitration decision, with a minority coming from defendants' discovery production. Plaintiffs' Reply, at 1. Many of the proposed paragraphs to be added to the complaint are copied from the arbitration decision.*Compare* Proposed Amended Complaint, at ¶¶ 43-67 to Plaintiffs' Proposed Order, at 1-2.

While it may be appropriate to amend the complaint to conform to the results of discovery, the addition of 20 pages' worth of paragraphs copied in form or in substance from the arbitration decision is not the way to accomplish that, and it would waste judicial resources for the court to parse through the additions to separate the good additions from the bad. For reasons discussed above, many of the arbitrators' statements are not relevant or commutable to this case. Additionally, in this context it is inappropriate for plaintiffs to copy the arbitrators' findings instead of reviewing the underlying information and drafting allegations in their own words. *See Taubenfeld v. Career Ed. Corp.* ., 2004 WL 554810, at *4 (N.D.Ill. March 19, 2004) (Lefkow, J.) (citing cases). Therefore, the court denies leave to add these additional allegations at this time.

IV. Order

For the reasons stated above, plaintiffs' motion for summary adjudication of issues based on collateral estoppel and motion for leave to amend [# 106] are denied. Pursuant to the court's order of August 18, 2005, Dkt. No. 130, discovery will cut off four months from the date of this order, which is June 22, 2007. This case will be called for status on March 8, 2007.

N.D.Ill.,2007.
In re Neopharm, Inc. Securities Litigation
Not Reported in F.Supp.2d, 2007 WL 625533 (N.D.Ill.)

END OF DOCUMENT

TAB 19

Only the Westlaw citation is currently available.

United States District Court,
N.D. California.
In re ORACLE CORPORATION SECURITIES LITIGATION.
No. C 01-00988 SI.
Related Cases Nos. C 01-01237-SI, C 01-01263-SI.

June 19, 2009.

ORDER GRANTING DEFENDANTS' MOTION FOR SUMMARY JUDGMENT and DENYING PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT

SUSAN ILLSTON, District Judge.

***1** On February 13, 2009, the Court heard oral argument on defendants' motion for summary judgment and plaintiffs' motion for partial summary judgment. Having considered the arguments of the parties, their papers, the cases submitted after oral argument, and for good cause shown, defendants' motion is GRANTED and plaintiffs' motion is DENIED.

BACKGROUND

1. Procedural Background

This action was filed in March of 2001. Plaintiffs, a number of purchasers of Oracle stock, allege that Oracle Corporation and three of its top executive officers [FN1] violated section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, promulgated thereunder. Plaintiffs further allege control person liability against the individual defendants under section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), and that Henley and Ellison are liable for contemporaneous trading under section 20A of the Exchange Act, 15 U.S.C. § 78t-1(a). After certification and consolidation of related actions, a series of dismissals and filings of amended complaints ensued until, in March 2003, this Court [FN2] dismissed the revised second amended complaint with prejudice for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6), finding that the allegations did not create a strong inference that allegedly false statements were known to be false when made. [Docket No. 166] Plaintiffs appealed, and in November of 2004, the Ninth Circuit reversed the dismissal, holding that the operative complaint met the heightened pleading requirements of the Private Securities Litigation Reform Act ("PSLRA").*See* *Nursing Home Pension Fund, Local 144 v. Oracle Corp.,* 380 F.3d 1226 (9th Cir.2004).

FN1. Lawrence J. Ellison (Chief Executive Officer), Jeffrey O. Henley (Executive Vice President and Chief Financial Officer), and Edward J. Sanderson (Executive Vice President).

FN2. This case was originally assigned to the Honorable Martin J. Jenkins. It was reassigned to this Court after Judge Jenkins' resignation in April of 2008.

On September 2, 2008, this Court issued an order denying plaintiffs' motion for partial summary judgment on the question of whether defendants made false or misleading statements regarding Suite 11i and the company's financial results for 2Q01. The Court also granted in part and denied in part plaintiffs' motion for sanctions. The Court held that plaintiffs are entitled to adverse inference instructions with regard to two categories of evidence: defendant Ellison's email files, and materials created during preparation for the book *Softwar.*The Court determined that it is appropriate to infer that the emails and *Softwar* materials would demonstrate Ellison's knowledge of, among other things, problems with Suite 11i, the effects of the economy on Oracle's business, and problems with defendants' forecasting model.[FN3]The Court held that it would take these adverse inferences into account when deciding the parties' summary judgment motions and directed the parties to revise their briefs in light on this ruling.

FN3. The Court noted that these inferences alone would not assist plaintiffs on all elements of their § 10(b) claims, including particularly the element of loss causation. *See* Sept. 2, 2008 Order, at 12. [Docket No. 1478]

Now before the Court are defendants' revised motion for summary judgment, plaintiffs' revised motion for partial summary judgment against defendant Ellison, and seven *Daubert* motions to preclude expert testimony.

2. Factual Background[FN4]

> FN4. The word "voluminous" does not do justice to the record in this case. Defendants have numbered their exhibits sequentially. For ease of reference, the Court refers to their exhibits as DX___. Plaintiffs have used a variety of different numbering systems. The Court refers to exhibits filed in support of plaintiffs' motion for summary judgment against Ellison as PSJM ___, to the exhibits filed in support of plaintiffs' reply as PReply___, and to the exhibits filed in support of plaintiffs' opposition to defendants' motion for summary judgment as POpp.___.

***2** Oracle is the second largest software company in the world. This case arises from plaintiffs' claims that Oracle and certain of its officers and executives made false and misleading statements about a new product, issued inflated earnings reports for the second quarter of fiscal year 2001, issued a false and misleading forecast about the company's financial condition for the third quarter of fiscal year 2001, and falsely stated during the third quarter that the company was not being affected by the slowing economy. The four quarters of Oracle's 2001 fiscal year were: from June 1 to August 31, 2000 ("1Q01"); from September 1 to November 30, 2000 ("2Q01"); from December 1, 2000 to February 28, 2001("3Q01"); and from March 1 to May 31, 2001 ("4Q01").

A. Oracle's statements about the functionality of Suite 11i.

In May 2000, Oracle released its Applications Suite 11i ("Suite 11i"). "Enterprise applications" are computer programs used to help companies automate their business processes. Enterprise resource planning ("ERP") applications perform functions such as accounting, human resources, and manufacturing. Customer relationship management applications ("CRM") perform functions such as managing call centers. Through the late 1990s, businesses that used enterprise applications software could not obtain ERP and CRM applications from the same vendor. Customers generally followed the "best of breed" strategy, buying different applications from several vendors. They would achieve "systems integration" by hiring software engineers to write custom code that would allow their applications to run together. Suite 11i was marketed as a product that would combine ERP and CRM applications. *See generally,* Decl. of Lawrence J. Ellison in Supp. of Defs. Mot. for Summ. J. ¶¶ 15, 16 ("Ellison Decl."). [Docket No. 932]

Suite 11i was first available for sale in 1Q01. In 1Q01 and 2Q01, Oracle reported a total of $435 million in revenue from applications licenses, marking increases of 42% and 66% over the same quarters in the prior year (the "year over year" comparison). DSJM 25 at 973930, 26 at 976820. In 3Q01, Oracle reported $249 million from applications licenses, a year over year increase of 25%. DSJM 27 at 977030. Plaintiffs contend that Oracle released Suite 11i prematurely, that the parts were neither designed nor engineered to work together, that it did not work in multiple different languages, and that it generally did not work correctly. According to plaintiffs, Oracle officials who knew of these deficiencies nonetheless made repeated statements to the public that misrepresented the functionality of Suite 11i. In the complaint and in the various memoranda concerning the summary judgment motions, plaintiffs cite to the following statements as constituting material misrepresentations about Suite 11i by officers of Oracle.

- On November 29, 2000, Ellison made the following comments at a conference:

> ***3** The right model for enterprise software is "Here are all the pieces. They've all been engineered to work together. No systems integration required. *You can install it in a matter of months in the largest and most complex operations. All the pieces are there:* marketing, sales, web store, service, internet procurement, auctioning, supply chain automation, manufacturing, human resources, everything. *And all the pieces fit together."*

...

> So in the early stages-the very early stages of this release 11i, we're saying, "We're right. The rest of the world is wrong;" where there's all this controversy where we can't show lots and lots of companies up and running-big companies up and running-they're just beginning to come live now, already we're getting tremendous trac-

tion in the market. And *it will be far and away the biggest success in the history of our company, much bigger than the database* .

...

We're trying to make this very, very simple. *You engineer all the pieces to fit together, they come out of the box, and all the pieces fit together.*It's still hard to install. You still have to convert your data and train people and do stuff. It's still not 15 minutes. It's still a real project to install this. This is taking us 6 months to get just the first factory up and running at General Electric. It [is] still not like you just walk in-it's not like installing a new word processor. It's still pretty complicated stuff.

...

[A]nd we're very close. At some time over the next few months, it'll click. I'm serious. *We'll win every deal.*Every deal.

...

[Y]ou can get a small team to build an auctioning system over at Commerce One. You get a small team to build internet procurement over at Ariba. But you can't get a large team to build all of those things such that all of the pieces fit together. And it is a bigger job-you know, building each one of those separately is a smaller job than building each one of those together that work together. That's a much bigger job. But we are bigger.... Our engineering teams are larger. And we've done it. *The pieces actually work together.*And the barrier to entry, I think, is insuperable. I don't think anyone else can do it.

POpp. 405 at 12-14, 37-38, 40, 43-44 (quoted in Plaintiffs' Opposition at 12; plaintiffs cite only the underlined portions of these statements).

•At the December 14, 2000 conference call with analysts, Ellison said, *"[Y]ou can buy our complete E-Business Suite, where all the pieces are designed and engineered to fit together, and no systems integration is required. It's up and running in months. You get the savings in months. It costs you less, and it takes less time to install."*"Demonstrations, we're still tweaking those, we got those all ready now. We finished up all the training ... we're working on partner training. So, yes, I think where we sit right now we're in pretty darn good shape."[FN5]POpp. 26, 234430, 234436 (quoted in Plaintiffs' Opposition at 13).

FN5. The speaker of the latter quote is identified only as "Male."

***4** • Mark J. Barrenechea said at a presentation on February 6, 2001, "I think our applications are written in 23 languages. So not only do we have, you know, for example, an E-business Suite, which I'll tell you more about. But it's *basically ERP and CRM all integrated together.... But we also have taken care of the localization requirements of all these countries around the world as well."*POpp. 156, 3285 (quoted in Plaintiffs' Opposition at 13).

• An Oracle "Technical White Paper" by Mark J. Barrenechea, dated February 6, 2001, reads, *"To install the Oracle CRM suite, no systems integration is required. And because the CRM suite consists of true Internet applications, every application works in every country, every major language, and every major currency."*POpp. 155 at 106691 (quoted in RSAC ¶ 63).

• On February 13, 2001, Sanderson said at a conference, "I think our applications are written in 23 different languages. So not only do we have, you know, for example, an E-Business suite ... but it's *basically ERP and CRM all integrated together.*But it's written in 23 different languages, including Spanish Spanish and Latin American Spanish, Portugal Portuguese and Brazilian Portuguese, as being four languages. *But we also have taken care of the localization requirements of all these countries around the world as well."*POpp. 156 (quoted in Plaintiffs' Opposition at 13).

• On February 21, 2001, Ellison said at the "AppWorld" Conference: *"In fact, we recommend that you start with, you try a component of the suite and then you add it in. Now the nice thing is it's like Lego blocks. Once you have one piece in. the other pieces just snap together. There's no systems integration required.... You just basically turn it on or snap it together." "It is absolutely, all the pieces within the suite are literally plug and play."*POpp. 438, 14:54:52 (quoted in Plaintiffs' Opposition at 13).

B. Defendants' statements about Oracle's financial results for 2Q01.

In a December 14, 2000 press release, Oracle announced 2Q01 earnings of $0.11 per share and 66% growth in sales of Suite 11i applications. POpp. 105, 019764. According to plaintiffs' expert D. Paul Regan, Oracle arrived at the $0.11 figure for per share earnings through an improper accounting method. Decl. of Shawn A. Williams in Supp. of Expert Report of D. Paul Regan, ("Regan Report") ¶ 39. In Regan's opinion, the accurate figure for Oracle's earnings per share was $0.10. *Id.* ¶ 41.By inflating its earnings by a penny, Oracle was able to "beat Wall Street," i.e. exceed the $0.10 earnings per share that analysts had projected. *Id.* Regan also opines that Oracle fabricated the 66% figure for growth in Suite 11i applications. In his opinion, the correct figure was 54%. *Id.* ¶ 62.

C. Oracle's forecast for 3Q01

On December 14, 2000, Oracle also issued its public forecast (or "guidance") for 3Q01. Oracle predicted total license revenue growth of 25%, database revenue growth of 15%-20%, applications revenue growth of 75%, and earnings per share ("EPS") of $0.12. PSJM 1 at 3221-22.

***5** Oracle based its 3Q01 guidance on its internal forecasting method. Oracle used what it calls a "bottom-up" method for deriving its internal forecasts. It began with information from Oracle's salespeople, which was incorporated into a summary of all deals Oracle was working on at a given time. DX 59 at 74.[FN6]Using a computer program called Oracle Sales Online ("OSO"), salespeople would enter the account names of all ongoing deals, the potential dollar amount of each potential sale, and their predictions for when each sale would likely close. *Id.* at 75.The sum of all sales that could close in a quarter-including those that are about to close and those that are still just leads-are referred to as the "pipeline." DX 60 at 93. Regional managers reported information entered by sales representatives in their regions to their supervisors. DX 59 at 75-76. Supervisors recognized that salespeople had a tendency to "sandbag," i.e. significantly underestimate the size of their projected sales in order to ensure that they would meet or exceed expectations. DX 63 at 566-67; 64 at 101. The forecasting method therefore allowed supervisors to take into account, in addition to data in OSO, their own judgment of what sales were likely to be. *Id.* at 565-67.Their judgment was based on direct contact with regional managers, sales representatives, and customers. *Id.* Information was relayed in this way up to the heads of Oracle's business units, each of which would make a forecast for its unit. (For software licensing, those units were North American Sales ("NAS"), Oracle Product Industries ("OPI"), and Oracle Services Industries ("OSI").) The business units would submit their forecasts to Oracle's financial department, which would consolidate them. DSJM 65 at 102-3.

FN6. Plaintiffs object that defendants' characterization of this and other deposition testimony is misleading. The Court has relied on the underlying deposition testimony, not defendants' characterization.

Jennifer Minton, Senior Vice President of Global Finance and Operations, played a central role in the forecasting process by consolidating all the field forecasts into a single report. *Id.* 104-05.Minton then adjusted the consolidated field report to create the "Upside" report, which was Oracle's consolidated or "potential" forecast. *Id.* She arrived at the Upside report by adjusting the field data based on her own judgment, which was informed by her weekly meetings with business unit representatives and her conversations with field finance representatives. *Id.* at 123-23.Another factor Minton considered when preparing the Upside report was the "conversion ratio" (the percentage of the pipeline that was actually converted into sales) from the corresponding quarter in the prior year. *Id.* at 122.Although Minton's adjustment was referred to as "Upside," she would also adjust the consolidated report downward if necessary (for example, if she found out that there had been error in the forecasts submitted to her, or if the historical conversion ratio suggested that the conversion rate for the current quarter would be lower than projected).*Id.* at 137.

***6** During the time period at issue here, Oracle's method for generating the potential forecast had been a reliable but conservative predictor for the company's performance: in the seven quarters before 3Q01, Oracle had met or exceeded its forecast and analyst projections for quarterly earnings per share ("EPS"): [FN7]

FN7.*See* evidence summarized at DX 42, 43. Plaintiffs object to these exhibits as improper summaries of voluminous evidence under Federal Rule of Evidence 1006. The Court disagrees. The declarations of Ivgen Guner [Docket No. 934] and Bruce Deal [Docket No. 931] lay sufficient foundation for these exhibits to be admissible as summaries of voluminous evidence. Plaintiffs' objection is OVERRULED.

Quarter	Date of Estimate	Oracle Internal Forecast EPS	Analyst Forecast EPS	Actual EPS
4Q99	Mar.1999	0.0693	0.080	0.090
1Q00	June 1999	0.0401	0.040	0.040
2Q00	Sept.1999	0.0495	0.050	0.065
3Q00	Dec.1999	0.0553	0.070	0.085
4Q00	Mar.2000	0.1375	0.130	0.155
1Q01	July 2000	0.0761	0.070	0.085
2Q01	Sept.2000	0.0966	0.090	0.110 [8]

FN8. As noted, the accurate figure for Oracle's 2Q01 earnings per share is disputed.

Another dynamic which affected Oracle's ability to forecast its sales is a phenomenon called the hockey-stick effect.[FN9] Knowing that software vendors report their earnings on a quarterly basis, purchasing customers expect that they can extract the lowest possible price for the product by waiting until late in the quarter to finalize deals. DX at 70. This effect is even more exaggerated at the end of the fiscal year, so the most prominent hockey stick effect occurs in the forth quarter. *Id.* Consequently, Oracle generates most of its new license revenue in the last days of each quarter. *Id.*

FN9. Imagine quarterly sales plotted on a chart with a sharp upswing at the end of the quarter. The shape resembles a hockey stick.

Returning to the public guidance for 3Q01 issued on December 14, 2000, Minton's Upside report for December 11, 2000 reflected potential total license revenue growth of 33% and potential EPS of $0.1282. *See* DX 1 at 213092. Oracle's policy was to round earnings to the nearest penny, *see* DX 68 at 329:1-4, so the public guidance from the Upside report should have been $0.13. Instead, Oracle issued a more conservative estimate: earnings per share of $0.12 and total license revenue growth of 25%. Oracle's December 11 “pipeline report” indicated that its total software pipeline was 52% larger than the previous year. DX 11.

D. The Trades

Between January 22 and 31, 2001 Ellison sold 29 million shares of Oracle stock. This amounted to 2.09% of his Oracle holdings. On January 4, 2001, Henley sold 1 million shares of Oracle stock, about 7% of his total Oracle shares. Ellison has filed a declaration stating that he sold his stock in order to exercise options that were going to expire within nine months and could only be sold during certain trading windows within that period. *See* Ellison Deck ¶¶ 9-13 [Docket No. 932]

E. The Crash

On February 25, 2001, three days before 3Q01 ended, Oracle officials received notification that major deals scheduled for 3Q01 had been lost. For example, Oracle's General Business West area reported that it had lost 70 transactions, worth about $10 million, in the past few days. NAS and OSI similarly reported that they were failing to close major deals. Defendants contend that the news of failed sales was a surprise and that until the very last days of the quarter, they had expected Oracle to meet its guidance. According to defendants, the hockey stick effect led them to expect that the majority of 3Q01 deals would be closed at the end of the quarter; the shortfall was caused when major customers decided at the last minute to postpone their purchases. Plaintiffs vigorously dispute defendants' version of the facts. According to plaintiffs, Oracle's internal indicators alerted officials throughout the quarter that it would miss its guidance and that the likelihood of a shortfall was apparent to insiders, but not disclosed to the public.

F. The March 1, 2001 announcement

***7** In a press release dated March 1, 2001, Oracle made the following disclosures "based upon preliminary financial results" for the third quarter of fiscal year 2001: Oracle's earnings per share would be $0.10 (as opposed to the $0.12 it had predicted on December 14, 2000) and applications growth would be 50% (the prediction was 75%). POpp. 196. The press release quoted Ellison as saying "License growth was strong in this first two months of Q3, and our internal sales forecast looked good up until the last few days of the quarter. However, a substantial number of our customers decided to delay their IT spending based on the economic slowdown in the United States. Sales growth for Oracle products in Europe and Asia Pacific remained strong. The problem is the U.S. economy."*Id.* Also on March 1, 2001, Ellison and Henley held a conference call with investors in which they discussed Oracle's earnings miss.

G. The drop in Oracle's stock price

On March 2, 2001, Oracle's stock price dropped to a closing price of $16.88 per share from a closing price of $21.38 per share on March 1, 2001. POpp. 168, ¶ 43. Relying on the expert opinion of Bjorn I. Steinholt, plaintiffs characterize the drop as "highly statistically significant." *Id.*[FN10]

FN10. The Court recognizes that defendants move to exclude the expert report and testimony of Steinholt on damages and loss causation.

LEGAL STANDARD

Summary judgment is proper "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."Fed.R.Civ.P. 56(c). The moving party bears the initial burden of demonstrating the absence of a genuine issue of material fact. *See Celotex Corp. v. Catrett,* 477 U.S. 317, 323 (1986). The moving party, however, has no burden to negate or disprove matters on which the non-moving party will have the burden of proof at trial. The moving party need only demonstrate to the Court that there is an absence of evidence to support the non-moving party's case. *See id.* at 325.

The burden then shifts to the non-moving party to "designate 'specific facts showing that there is a genuine issue for trial.' " *Id.* at 324 (quoting Fed.R.Civ.P. 56(e)). To carry this burden, the non-moving party must "do more than simply show that there is some metaphysical doubt as to the material facts." *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.,* 475 U.S. 574, 586 (1986). "The mere existence of a scintilla of evidence ... will be insufficient; there must be evidence on which the jury could reasonably find for the [non-moving party]." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 252 (1986).

In deciding a summary judgment motion, the evidence is viewed in the light most favorable to the non-moving party, and all justifiable inferences are to be drawn in its favor. *Id.* at 255."Credibility determinations, the weighing of the evidence, and the drawing of legitimate inferences from the facts are jury functions, not those of a judge [when she] is ruling on a motion for summary judgment."*Id.* The evidence presented by the parties must be admissible. Fed.R.Civ.P. 56(e). Conclusory, speculative testimony in affidavits and moving papers is insufficient to raise genuine issues of fact and defeat summary judgment. *Thornhill Publ'g Co., Inc. v. GTE Corp.,* 594 F.2d 730, 738 (9th Cir.1979).

DISCUSSION

1. Defendants' Motion for Summary Judgment

***8** Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful "[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 Commission may prescribe."15 U.S.C. § 78j(b). Pursuant to this section, the Securities and Exchange Commission promulgated Rule 10b-5, which makes it unlawful "[t]o make any untrue statement of fact or to omit to state a material fact necessary to make the statements made, in light of all the circumstances in which they were made, not misleading."17 C.F.R. § 240.10b-5. "The scope of Rule 10b-5 is coextensive with the coverage of § 10(b)." *SEC v. Zandford,* 535 U.S. 813, 815 n. 1 (2002)."In atypical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta,* 128 S.Ct. 761, 768 (2008) (citing *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 341-42 (2005)).

Plaintiffs claim that defendants violated § 10(b) by: (1) falsely reporting Oracle's financial results for 2Q01; (2) misrepresenting the functionality of Suite 11i; (3) issuing forecasts for 3Q01 that had no reasonable basis; (4) repeating the 3Q01 forecast despite their knowledge of facts seriously undermining that forecast; and (5) denying the effects of the slowing economy on Oracle's business.

A. Objections to evidence[FN11]

> FN11. The parties raise numerous objections to evidence submitted in support of the instant motions. Unless otherwise discussed in this order, the Court has either not relied on the disputed evidence or has not used it for the purposes to which either party objects.

Plaintiffs rely on analyst reports and newspaper articles to prove that defendants made false statements about Suite 11i, repeated their 3Q01 forecast throughout the third quarter, and denied that the economic downturn was affecting Oracle. These documents constitute hearsay as they are out of court statements offered to prove the truth of the matter asserted: that Oracle officials made specific fraudulent statements to analysts. *See*Fed.R.Evid. 801(c). They are thus inadmissible and cannot be considered in support of plaintiffs' opposition at summary judgment unless they fall within a hearsay exception. *See In re Cirrus Logic Sec. Litig.,* 946 F.Supp. 1446, 1469 (N.D.Cal.1996) ("It is plainly unfair to hold defendants liable for the reporting of their statements by third parties without independent corroboration of the accuracy of the reported statements."); *see also In re Cypress Semiconductor Sec. Litig,* 891 F.Supp. 1369, 1374 (N.D.Cal.1995) (excluding newspaper articles and analyst reports offered in securities litigation to prove that defendants made purportedly false statements) (citing *Larez v. City of Los Angeles,* 946 F.2d 630, 643 (9th Cir.1991) (holding that newspaper article offered to prove that defendant made statement quoted in article was hearsay)).

***9** Plaintiffs have failed to respond to defendants' objections to this category of evidence and have suggested no hearsay exception whereby the statements by Oracle officials contained in newspaper and analyst reports could be admitted. Accordingly, defendants' objections to the following statements are SUSTAINED:

i. Statements about Suite 11i

- After Oracle Executive Vice President Sandy Sanderson visited the offices of Salomon Smith Barney, the investment firm reported on January 10, 2001 that Suite 11i *"is pre-integrated and fully interoperable out of the box, helping to lower consulting costs and time-to-value."*POpp. 211 (quoted in RSAC ¶ 58) (Plaintiffs also offer this exhibit to prove that Sanderson reiterated the 3Q01 guidance. It is also inadmissible for that purpose.)

- On February 9, 2001, *Bloomberg News* reported, in an article headlined "Oracle Shares Fall on Concern Economic Earnings Outlook May Turn Grim,"*"Oracle is still upbeat about its prospects for earnings growth, which will be fueled by a new suite of Internet-friendly business software dubbed Oracle 11i. spokeswoman Jennifer Glass said. 'We haven't changed our projections at all.'Glass said. 'This slowdown is going to provide new opportunities for Oracle as companies need to streamline and be more strategic about the technology they buy.'"* POpp. 377, 141679 (quoted in RSAC ¶ 65(c)). (Plaintiffs also offer this exhibit, labeled PSJM 3, at ex. D, to prove that Glass stated that the economy was not having a negative effect on Oracle's business. It is also inadmissible for that purpose.)

ii. Statements about the effects of the economy on Oracle's business

- *Bloomberg News* included the following quote in an article that ran on December 14, 2000, *"The economy is slowing.' Henley said in an interview. 'It's just not having a negative impact on our business.'"* PMSJ 3 at ex. A.

- A December 15, 2000 *Bloomberg* article reported: *"The economic slowdown isn't hurting Oracle,* said Oracle Chief Executive Larry Ellison, *because the company has spent the past three years updating its product line to focus on software that helps companies use the Internet* *to cut costs and boost efficiency."*PMSJ 3 at ex. B (quoted in RSAC ¶ 45(d)).

• A January 10, 2001 report by Salomon Smith Barney: *"Oracle sees robust demand for both its database and applications business.... Oracle says it is also seeing sustained demand for its database product, despite industry-wide concern over contracting IT budgets."*PMSJ 7.

• January 10, 2001RealMoney.com interview quoting Sanderson as responding to question about whether Oracle could repeat its performance on applications sales, "You know, it's a big hill to climb. Every year we climb that hill. I expect we'll do it again. *Our pipelines are strong, we're well positioned from a products perspective, and so it's all about execution."*POpp. 208 (also PMSJ 6 at 141677).

***10** • A January 11, 2001 *Bloomberg* article reported, *"Company spokeswoman Stephanie Aas today said Oracle has yet to see any signs that its business is being hurt by the economic slowdown or reported cuts to information-technology budgets."*PSJM 3 at ex. C (also POpp. 207 at ex. C) (quoted in RSAC ¶ 60).

• A February 7, 2001 First Union Securities report stating, *"Oracle is not seeing the effects of a slowing economy at this point, but next several weeks will be critical."*POpp. 215 (quoted in RSAC ¶ 65(a)).

• A February 8, 2001 First Union Securities report that stated, *"Oracle is not seeing the effects of a slowing economy* at this point, but next several weeks will be critical. *CFO* Henley commented that *Oracle is not seeing a decline in sales at this point as a result of reduced corporate spending, although this issue has plagued several other large technology companies. While the sales pipeline apparently shows no signs of weakness at this point,* we note the next several weeks will be critical for the company as many potential customers will likely make decisions to buy or defer purchase during the activity-intensive final weeks of 3Q01."POpp. 209 at 91531-32 (also PSJM 5).

• Deutsche Banc reported on February 8, 2001, after a meeting with Henley, *"According to management, it has yet to see macro-related weakness in its business.*That said, the full impact of the current macro environment may not be evident until the end of the quarter, as revenue is typically back-end loaded for Oracle."*"Barring a severe economic downturn, management sees continued growth driven by strong demand in key segments such as supply chain, customer relationship management, and collaboration."*POpp. 208 (also PSJM 4 at 91536) (quoted in RSAC ¶ 65(b)).

• Portions of various reports on comments made by Henley at the AppsWorld conference in New Orleans on February 21, 2001. *See* PSJM 8 (POpp.216), 10 (POpp.213), 11 (POpp.214), POpp. 212 (PSJM 9).[FN12]

> FN12. Portions of this exhibit would be admissible; this is discussed in more detail *infra.*

iii. Intra-quarter repetitions of the 3Q01 forecast

• January 10, 2001RealMoney.com interview (described above: POpp. 208 / PMSJ 6 at 141677).

• Salomon Smith Barney report dated January 10, 2001 (described above: POpp. 211).

• January 11, 2001 and February 9, 2001 *Bloomberg* articles (described above: PSJM 3 at ex. C / POpp. 207 at ex. C).

• February 7, 2001 First Union Securities report (described above: POpp. 215).

• February 8, 2001 Deutsche Banc report (described above: PSJM 4 at 91536 / POpp. 208).

• February 8, 2001 First Union Securities report (described above: POpp. 209 at 91531-32 / PSJM 5).

• Portions of various reports on comments made by Henley at the AppsWorld conference in New Orleans on February 21, 2001. *See* PSJM 8 (POpp.216), 10 (POpp.213), 11 (POpp.214), POpp. 212 (PSJM 9).

B. Functionality of Suite 11i

i. Falsity

It was no secret before and during 3Q01 that Suite 11i was an imperfect product. The following problems were discussed by analysts and reported in financial publications: FN13

> FN13. These reports are not hearsay to the extent they are offered not for their truth but to prove the reports were made.

***11** •*The inherent instability of a new, untested product, see* DX 127 at 307330 (May 8, 2000 *Business Week* article: "Even after the suite ships, consultants such as Gartner Group Inc. warn corporate customers that it probably won't be stable enough to handle the most crucial jobs until the end of the year."); DX 207 (November 15, 2000 *Business Wire* press release entitled "Oracle Applications Users Ask Oracle Corp. Executives about Quality, Customer Support, Functionality and Pricing:""11i is not yet working optimally."); DX 130 at 5916 (December 13, 2000 CIBC Markets Corp: "We also expect that customers would prefer not to be among the early adopters, waiting until some of the initial bugs get worked out of the software, which may take a quarter or so."); DX 210 at 309148 (February 22, 2001 CIBC World Markets report: "[T]he current version of 11i is noted to have many [ ] bugs (close to 5,000).... We think that the delays in the upgrade cycle pose a near-term risk for applications sales");

•*Unfavorable comparisons with best of breed products, see* DX 245 at 85851 (September 15, 2000 Deutsche Banc report: "some 11i modules still may fall short on functionality compared with best-of-breed rivals");

•*Lack of references, see* DX 149 at 419950 (November 8, 2000 Robertson Stephens, Inc: "Although the company has announced a number of 11i customer wins, none of the bigger names, including BellSouth, GE, and Lucent, have gone live yet. We believe it will take several more quarters for the company to implement these customers and to use them as references to win additional business."); DX 208 at 419977 (December 12, 2000 J.P. Morgan Equity Research: "We believe Oracle's 11i e-business suite continues to have bugs thereby limiting the number of notable customer references for the new product.");

•*Lack of integration, see* DX 140 at 9467 (December 4, 2000 GartnerGroup report: "Release of Oracle Applications r.11i has prompted inquiries about its robustness ... [Oracle's] track record of facilitating integration between multiple products is not strong, nor is Oracle building its ERP and ERP-complimentary applications ... for easy integration with other products.... 11i as a complete ERP suite remains suitable primarily for risk-tolerant, early-adopter-oriented enterprises.").

The fact that problems with Suite 11i were known to the market raises a serious question as to whether plaintiffs can show that any of defendants' purportedly false statements about the product were materially misleading. In a fraud-on-the-market case such as this, "an omission is materially misleading only if the information has not already entered the market." *In re Convergent Techs. Sec. litig.,* 948 F.2d 507, 513 (9th Cir.1991) (citing *In re Apple Computer Sec. Litig.,* 886 F.2d 1109, 1114 (9th Cir.1109)). "If the market has become aware of the allegedly concealed information, 'the facts allegedly omitted by the defendant would already be reflected in the stock's price' and the market 'will not be misled.' " *Id.* (quoting *In re Apple Computer Securities litig.,* 886 F.2d at 1114).

***12** The Court need not decide this issue, however, because the Court agrees with defendants that there is not a genuine factual dispute on loss causation.

ii. Loss causation

The parties dispute plaintiffs' burden at summary judgment in demonstrating the existence of a factual dispute on loss causation, the sixth element of a private § 10(b) action. Loss causation is the causal connection between the defendant's material misrepresentation and the plaintiff's loss. *Metzler Inv. GMBH v. Corinthian Colleges, Inc.,* 540 F.3d 1049, 1062 (9th Cir.2008) (citing *Dura,* 544 U.S. at 342). "A plaintiff bears the burden of proving that a defendant's alleged unlawful act 'caused the loss for which the plaintiff seeks to recover damages.' " *In re Gilead Sciences Sec. Litig,* 536 F.3d 1049, 1055 (9th Cir.2008) (quoting 15 U.S.C. § 78u-4(b)(4)). Put another way, "[t]o establish loss causation, 'the plaintiff must demonstrate a causal connection between the deceptive acts that form the basis for the claim of securities fraud and the injury suffered by the plaintiff.' " *Id.* (citing *In re Daou Sys., Inc.,* 411 F.3d 1006, 1025 (9th Cir.2005)); *see also* *Metzler,* 540 F.3d at 1063 (the plaintiff must show that "the practices that the plaintiff contends are fraudulent were revealed to the market and caused the resulting losses") (discussing

Daou). "The misrepresentation need not be the sole reason for the decline in value of the securities, but it must be a 'substantial cause.' " *Gilead,* 536 F.3d at 1055 (citing *Daou,* 411 F.3d at 1025).

Analysis of loss causation calls on courts to perform a "balancing act" between allowing plaintiffs to link "each and every bit of negative information about a company to an initial misrepresentation that overstated that company's chances for success" and exacting such a high standard as to "eliminate the possibility of 10b-5 claims altogether." *In re Williams Sec. Litig.,* 558 F.3d 1130, 1140 (10th Cir.2009). At one end of the spectrum, it is clear that the plaintiff need not prove that the defendant admitted a fraud. *Metzler,* 540 F.3d at 1064. At the other extreme, it is equally clear that the plaintiff must do more than show that the market was "merely reacting to reports of the defendant's poor financial health generally." *Id.* at 1063.

Plaintiffs argue that Oracle officials' misrepresentations that Suite 11i was fully functional led to unrealistically high earnings expectations, which were corrected when the market recognized the true state of Oracle's flagship product on March 1, 2001. According to plaintiffs, the March 1 analyst call "disclosed the negative effects of 11i" and "communicated to investors that issues concerning the functionality, i.e., bugs and lack of stability of Suite 11i ..., had not in fact been cured as defendants had reported at the end of 2Q01."Pl. Opp. to Def. Mot. for Summ. J. at 46.

This is not an accurate characterization of the content of the phone call. In fact, Ellison repeatedly told analysts that the miss in applications sales was caused by nervousness about the slowing economy, not problems with Oracle's products:

***13** It really appears to be economic factors, where people actually need the database, where actually they were getting ready to sign deals, people just delayed. Where there is no question they were going to buy, they were going to go ahead and buy but they are trying to push it out as long as possible.... [T]his was not a matter of they're not going to buy; they would just like to wait 30 days or 60 days. They're just looking at the economy. Everyone is trying to get a read on this economy and everyone is being slow to act in light of the economy.

DX 393, 419804-05. Later in the call, Ellison said:

I do know that some of these transactions can only be deferred for a short period of time. Because these are projects that are going through an implementation cycle where they actually are using the software, or about to start using the software so they have to buy. On the other hand, there are, you know, other projects that can be deferred for three or six months.

Id. at 419807-08.He repeated that applications sales were delayed only temporarily: "They can only delay so long ... [ ] because they're actually using the software and the applications are growing."*Id.* at 419808.And once more:

All the indications that we have are that people want to do these projects. People want to put in the e-business suite. They're actually-if you look at budgets, the database budgets, are going up with the exceptions of the dot.coms. The database budgets are going up everywhere. So all of that looks very, very good. It's just this umbrella of uncertainty that is causing people to defer decisions.

Id. at 419812.When asked for his impression for now long it was taking for CEOs to decide whether to buy the "suite" (presumably Suite 11i), Ellison responded:

Well, again, some of these guys are moving incredibly fast. So we have an example of going from the first meeting to deal in 30 days or 60 days. We've got several examples of those. We got, you know, my favorite example which I cited, GE Power, from contract to live on manufacturing financial e-business suite, redoing all the business processes in five months. So we are moving very, very quickly with a variety of customers.

Id. at 419814.Ellison also emphasized that Oracle had failed to close deals because of the economy, not because the company was losing out to competitors: "[T]hese were not cases of deals that we lost competitively, or deals are going away. They're just being shut down. At some point they're you know, the customers are going to have to buy."*Id.* at 419815.He repeated this point at the close of the conversation: "These are not deals that we lost competitively. These are not deals where they decided not to buy. These are literally deferrals because of economic uncertainty.... [A]s we wear on in Q4 a bunch of these deals should come in."*Id.* at 419817.At no point during the phone call did Henley or Ellison say that there was anything wrong with the Suite 11i or suggest that the cancelled sales were due to anything other than customers' fear of making a big investment at a time when the economy was uncertain.

***14** Plaintiffs also claim that analyst reports after the March 1 conference call demonstrate that the market understood the announcement to have revealed problems with Suite 11i. Defendants respond with overwhelming evidence that the market understood the announcement as disclosing that the earnings shortfall was caused by the economic downturn. *See* DX 406 (Banc of America Securities), 407 (Bloomberg), 410 (Salomon Smith Barney), 409 (Lehman Brothers), 465 (FAC/Equities), 466 (Prudential), 467 (Wit SoundView).[FN14] Defendants also cite evidence that because analysts interpreted the earnings to be a bad "omen" for other applications vendors, *see* DX 410 at 91361, they downgraded their ratings across the enterprise software industry. *See* DX 451-57.

> FN14. The analyst reports are not hearsay if offered to prove merely that the reports were made.

For the most part, plaintiffs do not accurately describe the evidence they cite in support of their argument that the market recognized the March 1 announcement as revealing problems with Suite 11i. Plaintiffs refer to a March 2, 2001 *Wall Street Journal* article as evidence that analysts attributed the miss to problems with Suite 11i. In fact, the article did not discuss Oracle's applications sales. The relevant portion reads:

> The reasons for the shortfall were at least as troubling to analysts as its magnitude. Oracle's database software, a mainstay product line used as the foundation for many other business programs, had flat to negative growth over the year-earlier period. While database sales have been slowing at Oracle for many quarters, analysts were surprised by the abruptness of the latest downturn.

POpp. 436. That is, the shortfall was "troubling" because it was due to slower sales in Oracle's "mainstay product line" of database software, not because there were problems with Oracle's new applications product.

The same article also reported that Oracle's application software had grown 50%, rather than the 75%-100% predicted. As Ellison and Henley did the day before, the writers attributed the shortfall to the slowdown in the dot.com sector:

> Oracle had already been hurt by a falloff in orders from dot-com start-ups, many of which used Oracle databases to build new Web services. The company had been counting on conventional companies taking up the slack, using Oracle software to develop new electronic-business applications and improve their internal efficiency.
>
> Still, the CEOs held off signing the purchase orders. "That was true, even where it was acknowledged that this deal would save the company money," Mr. Ellison said. "We have a lot of nervous senior executives looking at this economy and being very cautious."
>
> Bob Austrian, a Banc of America Securities analyst who had cut his numbers for Oracle earlier this week, said the announcement showed that "the economic downturn has become severe enough that it has become a shock. And shocks always impair purchasing decisions."

Id.

Plaintiffs' citation to a March 2, 2001 *Los Angeles Times* article is similarly unhelpful. Reporting on the earnings miss, the article repeated Ellison's representations that the shortfall was due to the economy. It concluded, "In December, the company said it wasn't being hurt by the slowdown because corporations were buying its applications software to cut costs and boost efficiency."PReply 173. The writers did not comment on the functionality of Suite 11i.

***15** Out of the flurry of news and analyst reports on Oracle's earnings miss, plaintiffs cite only two that discussed problems with Oracle's applications products. The first is a March 2 report by the financial firm UBS Warburg. The writers thought that Oracle's announcement the day before had put too much emphasis on the economic slowdown and stated, "we believe there may have been further contributors."POpp. 426. According to UBS Warburg, the "major shortfall" came from the "flat to slightly negative" growth in Oracle's database business. *Id.* After a discussion of various factors other than the economy that might have contributed the database shortfall, the writers suggested that problems with Oracle's applications products could been a contributing factor:

> On a somewhat more positive note, the applications business did considerably better than the database business.

> Granted, the applications business missed our estimates as well, but growth for these products came in around 50% year over year.... We also believe that the weakness in Oracle's applications business is because the company's applications are not yet ready for prime time. At Oracle's applications conference last week, we learned that over 200 patches had been developed for the CRM product for the latest version. Furthermore, many customers we talked with indicated that although the CRM product showed promise, the SCM [FN15] products are not even on the radar. Although [f]eedback from these customers suggested that they were impressed with the idea of a fully integrated suite, we were unable to find any that had fully integrated and gone live on the suite.

> FN15. Presumably "supply chain management."

POSJM 426. The second report is a March 16 market research summary by Banc of America Securities. Under the subheading "Are Oracle's problems entirely the economy? We don't think so," the writers state, "[o]n the applications side, especially in light of Oracle's weaker than expected 3Q applications growth, we believe the economy may only explain 20-30% of the weakness. The rest, in our view, is a result of the product set not yet reaching a competitive level of functionality, relative to best-of-breed vendors."PSJM 113 at 2710.[FN16]

> FN16. As evidence that the market linked the shortfall to Suite 11i, plaintiffs also cite an e-mail from Oracle employee Karen Houston stating, "Over the past couple of weeks, several stories have been published on 11i product quality issues.... Additionally, we have seen several stories recently in the U.S. that link our lower than expected apps sales to quality issues of 11i."POpp. 420 at 158596. Defendants object that Houston's statement is hearsay to the extent that it is offered to prove the truth of what the news reports said. *See*Docket No. 1586.The Court agrees that Houston's repetition of the out of court statements in the news reports is inadmissible hearsay. In any event, the e-mail is dated March 21, 2001 and therefore is not evidence of how the market reacted to the March 1 disclosures. In addition, the e-mail does not indicate that the market learned of "product quality issues" with Suite 11i through the March 1 disclosures.

> Plaintiffs also cite to the following passage from *Softwar: An Intimate Portrait of Larry Ellison and Oracle,* a profile by Matthew Symonds: "It didn't take a genius to see that not everything that was going on could be explained by the weakening economy and edgy CEOs waiting for 'visibility' to return. For anyone who wanted to see, there was mounting evidence that it wasn't only the economy that prospective Oracle applications customers wanted to see stabilize."PSJM 12 at 201. Defendants object that Symonds' book is hearsay. *See*Docket No. 1585.The Court agrees. Plaintiffs repeatedly cite to *Softwar* for the truth of the matters asserted therein but offer no basis for the admissibility of these statements. The Court also notes that Symonds' statement about what analysts said is hearsay within hearsay.

> Finally, plaintiffs cite what purports to be an e-mail chain (dated March 22, 2001) of Oracle employees commenting on a draft of an article. The cited portion of the article reads, "Oracle blamed the economic slowdown in the United States for affecting its business, with many of its enterprise customers deferring purchases. However its lowered sales performance across the board also stems from several factors unique to Oracle: database pricing, 11i quality and the suite approach to selling applications."PReply 177. Defendants object that Oracle e-mails about news reports are hearsay. *See*Docket No. 1586 at 5. The Court agrees that the e-mail is hearsay to the extent it is offered to prove what an article stated. In addition, it is also not evident when, if ever, the article was published. In any event, an article from March 22 is not probative of what the market learned from the March 1 disclosures.

> Defendants' objections to these documents are SUSTAINED.

These two reports, neither of which indicates that the writers learned new information about the functionality of Suite 11i through the March 1 conference call, are the closest plaintiffs come to citing evidence that the market recognized that quality problems with Suite 11i contributed to the miss in Oracle's applications forecast. The

Court will assume for the sake of argument that a rational factfinder could conclude from these two reports that the market linked Oracle's miss to the following problems with Suite 11i: that it was "not yet ready for prime time" because it still required patches, that SCM products were not available, that customers had not yet "gone live" with Suite 11i, and that it was not competitive with "best of breed" products. The problem for plaintiffs is that none of these issues had been hidden from the market. As discussed above, defendants have cited abundant evidence that beginning with the release of Suite 11i and continuing through late February of 2001, public reports had discussed these deficiencies with the product. Thus, even those analysts who linked the miss to deficiencies with Suite 11i did not do so on the basis of information that had previously been hidden from the market.

***16** In sum, there is no evidence that on March 1, Oracle revealed previously undisclosed facts about Suite 11i to the market or that the market recognized the earnings miss as being caused by previously undisclosed problems with this product. Plaintiffs' only possible loss causation theory for Suite 11i is therefore that Oracle revealed the truth about Suite 11i on March 1 by announcing that the year over year growth in applications would be 50%, not the 75% the company had projected. Ninth Circuit precedent is clear, however, that an earnings miss *alone* is not sufficient proof of loss causation.

The missing causal link here is similar to that in *Metzler,* in which the alleged fraud involved the manipulation of student enrollment figures to obtain federal funding. The Ninth Circuit held that the plaintiffs had not pled loss causation because they had not alleged facts in support of their claim that a press release revealed the purportedly improper financial aid practices. *See* 540 F.3d at 1063 (plaintiffs must allege that the market learned of and reacted to the fraud, "as opposed to merely reacting to reports of the defendant's poor financial health generally."). It was not sufficient for the plaintiffs to point to a euphemistic reference in a press release to "higher than anticipated attrition" and allege that the market understood this statement to reveal that the defendant company had overstated its enrollments: "So long as there is a drop in a stock's price, a plaintiff will always be able to contend that the market 'understood' a defendant's statement precipitating a loss as a coded message revealing the fraud.... Loss causation requires more." *Id.* at 1064. Here, Henley and Ellison did not make even a euphemistic reference to problems with Suite 11i during the March 1 call. Instead, they repeatedly assured analysts that the only problem was the economy. As a matter of logic, Oracle cannot have revealed the fraud by repeating the purported misrepresentations about the functionality of Suite 11i.

The Ninth Circuit's decisions in *Gilead* and *Daou* confirm that loss causation requires more than a company's announcement of a missed financial projection. The fraud alleged in *Gilead* involved off-label marketing of a drug, a practice that purportedly accounted for 75% to 95% of the defendant company's revenue from the drug and inflated the company's stock price. 536 F.3d at 1058. The plaintiffs pled loss causation through their allegations that the company released an FDA warning letter that disclosed the off-label marketing, causing physicians to write fewer prescriptions for the drug, which in turn led to decreased revenues and ultimately to the company's announcement of lower than expected revenues, after which the stock price dropped. *Id.*

In *Daou,* the alleged fraud was that the company was reporting revenues before they were earned. *Daou* held that loss causation was established through the allegations that the defendants revealed "figures showing the company's true financial condition," including (1) that its operating expenses and margins were deteriorating, (2) that it would have to report a loss of $0.17 a share, and (3) the existence of $10 million in unbilled receivables in its work in progress account. 411 F.3d at 1026. Notably, the $10 million appeared as "the direct result of prematurely recognizing revenue."*Id.* After these revelations, an analyst noted, "You have got to question whether they are manufacturing earnings."*Id.* Thus, the plaintiffs properly alleged that the market recognized the disclosures as revealing the defendants' allegedly improper accounting practices.

***17** In conclusion, there is an absence of evidence that on March 1, Oracle revealed previously concealed information about Suite 11i or that analyst reports about the March 1 announcement linked the miss in Oracle's applications earnings to previously concealed deficiencies with Suite 11i. Plaintiffs' only possible theory for loss causation is that the earnings miss itself revealed the truth about Suite 11i to the market, but plaintiffs cite no case in which an earnings miss alone was sufficient to prove loss causation. Thus, the Court concludes that plaintiffs have not identified evidence that could lead a juror to conclude that defendants' alleged misrepresentations about Suite 11i were a "substantial cause" of the decline in value of Oracle's stock. *See Gilead,* 536 F.3d at 1055. The Court GRANTS defendants' motion for summary judgment on this issue.

C. Oracle's financial results for 2Q01

Plaintiffs contend that Oracle violated Generally Accepted Accounting Principles ("GAAP") in 2Q01 through two accounting frauds. The first alleged accounting fraud involved Oracle's method of accounting for customer overpayments.[FN17] According to plaintiffs' expert D. Paul Regan,[FN18] by 2Q01, Oracle had accumulated at least $144 million in "unapplied cash"-cash receipts that the company could not apply to an invoice. A significant amount of the unapplied cash was from overpayments made by Oracle's customers. Regan opines that Oracle improperly inflated its 2Q01 financial results by transferring the unapplied cash to its bad debt reserve and subsequently applying the overpayments to "debit memo" invoices. The debit memos made the overpayments appear to be refunded or "applied," creating the impression that Oracle had reduced its bad debt reserve by $20 million. The end result was that, in Regan's opinion, Oracle made an improper adjustment of $20 million to its revenue and pre-tax earnings, allowing the company to overstate its earnings per share by $0.01. *See* Regan Report.

FN17. Customer overpayments are caused by mistakes such as duplicate payments of an invoice, payments on amounts that were credited, amounts paid where the debt had been cancelled, and payments of unnecessary tax.

FN18. Defendants have not moved to exclude this expert opinion.

The second purported 2Q01 accounting fraud involved a deal with computer company Hewlett Packard ("HP"). According to Regan, Oracle improperly recognized $19.9 million in revenue and pretax earnings on November 30, 2000 (the last day of 2Q01). Regan opines that HP agreed to buy software that it did not need from Oracle and that it did so pursuant to an agreement that Oracle would buy $30 million in hardware from HP over the following quarter. In Regan's opinion, the evidence shows that products sold to HP under the agreement lacked a valid business purpose. This arrangement, according to Regan, allowed Oracle to overstate its 2Q01 earnings per share by $0.01. *Id.*

In sum, Regan opines that each of the two accounting frauds-overstatement of earnings related to the transfer of customer overpayments and the deal with HP-independently allowed Oracle to overstate its 2Q01 earnings per share by $0.01. Eliminating either one of these improper practices would have caused Oracle to report earnings per share of $0.10, rather than the $0.11 that it did report. *Id.*

i. Pleading

***18** As an initial matter, defendants argue that plaintiffs did not plead these theories of accounting fraud in the operative complaint and may not introduce them into the case at summary judgment. In their revised second amended complaint ("RSAC"), plaintiffs allege that in 2Q01, defendants "created phony sales invoices and improperly recognized revenue from past customer credits and overpayments it had held in reserve without informing its customers.... Oracle held the money in what it called its 'unapplied account.' " RSAC ¶ 8. Plaintiffs also allege that Oracle's practice was to not refund customer overpayments, or to do so only at the request of the customer. *Id.* ¶ 36.The Court finds that plaintiffs sufficiently pled debit memo accounting fraud though these allegations. Defendants point out that the plaintiffs did not specifically allege that the customer overpayments were moved to Oracle's bad debt reserve. This distinction is not dispositive, however, as it can be expected that some details of an accounting fraud will materialize during discovery. The crux of plaintiff's theory was that Oracle created the appearance of revenue through improperly accounting for customer overpayments. This theory was alleged in the RSAC.

In contrast, the Court agrees with defendants that plaintiffs did not allege their second accounting fraud theory-the RSAC is devoid of any reference to HP. Plaintiffs do not dispute that they did not allege the fraudulent HP swap. Instead, they argue that defendants have "been fully aware of the HP allegations for years of litigation" and that plaintiffs detailed this theory in their contention interrogatory responses. Pl. Opp. at 10 n. 15.

The PSLRA amended the Exchange Act to apply a heightened pleading standard to private class actions. *See Oracle,* 380 F.3d at 1230. "To avoid dismissal under the PSLRA, the Complaint must 'specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which the belief is formed.' " *Id.* (quoting 15 U.S.C. § 78u-4(b)(1)). Permitting plaintiffs to add an unpled fraud theory to the case now, when the case is at summary judgment, would effectively dispense with the "formidable" pleading requirements of the PSLRA.[FN19] *See Metzler,* 540 F.3d at 1055; *see also In re Stratosphere Corp. Sec. Litig.,* 66 F.Supp.2d 1182, 1201 (D.Nev.1999) ("To allow [p]laintiffs to amend their [complaint] at this late stage of the proceedings would render the particularity requirement for pleading securities fraud a nullity.").

> FN19. Plaintiffs do not dispute defendants' contention that allowing plaintiffs to amend their complaint at this juncture would be futile in light of the five year statute of repose for § 10(b) claims. *See* 28 U.S.C. § 1658.

Plaintiffs cite *In re JDS Uniphase Corp. Sec. Litig.,* 2007 WL 2429593 (N.D.Cal. Aug. 24, 2007) for the proposition that if defendants cannot show undue delay, bad faith, or dilatory motive, this Court may consider plaintiffs' unpled allegations at summary judgment. *JDS Uniphase* is inapt because the unpled allegations in that case consisted of nineteen purportedly false statements. There was no suggestion that the plaintiffs had failed to allege a fraudulent scheme at issue in the case. Here, the unpled allegation concerns an entirely new theory of accounting fraud. Accordingly, the Court agrees with defendants that the HP swap accounting fraud is unpled and GRANTS defendants' motion for summary judgment on this claim.

ii. Loss causation

***19** Plaintiffs argue that Oracle's debit memo accounting fraud, which purportedly allowed the company to overstate its 2Q01 earnings per share by $0.01, was revealed to the market on March 1 when Oracle reported its earnings miss. According to plaintiffs, the accounting fraud allowed Oracle to conceal the problems with Suite 11i by overstating its applications sales. Importantly, Regan opines that the HP fraud (*not* the debit memo fraud) allowed Oracle to report its 2Q01 applications business growth rate as 66%, while the accurate figure was 54%. *See* Decl. of Shawn Williams in Supp. of Expert Report of D. Paul Regan, ex. 2 (Regan Rebuttal Report) at 6-7. Oracle disclosed this fraud, according to plaintiffs, when it revealed the truth about Suite 11i on March 1. [FN20]

> FN20. Plaintiffs also argue that the false 2Q01 earnings were the basis for Oracle's 3Q01 forecast and rendered the forecast unreliable. According to plaintiffs, the fraud was revealed to the market on March 1 when Oracle announced its earnings miss. The Court considers this theory in more detail in conjunction with plaintiffs' argument that there was no reasonable basis for the 3Q01 forecast.

This theory of loss causation fails for several reasons. First, as discussed above, there is no evidence that the market recognized the March 1 disclosures as revealing previously undisclosed information about Suite 11i. Second, plaintiffs' expert links the inflated applications growth rate to the deal with HP, not the debit memo fraud. As the debit memo fraud is the only 2Q01 accounting fraud that remains in the case, there is no evidence that Oracle misstated its applications revenues in 2Q01. Third, there is no evidence that the market understood the March 1 earnings miss as revealing that Oracle had misstated its earnings for 2Q01. To the contrary, in their post-March 1 reports, analysts continued to report that Oracle's 2Q01 earnings per share were $0.11, not the $0.10 that plaintiffs claim is the accurate figure. *See* DX 465, 466, 473, 475, 478, 480, 482, 483, 484, 485, 486.[FN21] There is no evidence that Oracle has ever restated its 2Q01 earnings.

> FN21. The analyst reports are not hearsay if offered to prove that the reports were made.

None of the cases cited by plaintiffs support their argument that Oracle's 3Q01 earnings miss revealed the 2Q01 accounting fraud. For example, the plaintiffs in *In re Impax Labs., Inc. Sec. Litig.* pled loss causation by alleging that the company revealed the accounting fraud that led to its erroneous revenue statements for 1Q04 and 2Q04 by announcing its actual financial results for those quarters. *See* 2007 U.S. Dist. LEXIS 52356 (N.D.Cal. July 18, 2007) (Ware, J.). The disclosure "explicitly pertained" to the company's results for 1Q04 and 2Q04. *Id.* at *17-18. Here, in contrast, the March 1 disclosure made no mention of Oracle's 2Q01 results.

Accordingly, the Court finds that plaintiffs have failed to establish that there is a triable issue as to whether the inflation of Oracle's 2Q01 earnings per share through the purported debit memo fraud was a substantial cause of plaintiffs' loss. Defendants' motion for summary judgment on this issue is GRANTED.

D. Oracle's December 14, 2000 public guidance for 3Q01[FN22]

> FN22. For the purposes of this discussion, the Court assumes that this projection was not accompanied by meaningful cautionary language and therefore does not fall within PSLRA's "safe harbor" provision for forward looking statements. *See*15 U.S.C. § 78u-5(c); *see also Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.,* 353 F.3d 1125, 1132 (9th Cir.2004).

Plaintiffs argue that Oracle's December 14, 2000 public forecast of its 3Q01 earnings was materially false. In order for a financial projection to give rise to 10b-5 liability, the plaintiff must prove that "(1) the statement is not actually believed, (2) there is no reasonable basis for the belief, or (3) the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy." *Provenz v. Miller,* 102 F.3d 1478, 1487 (9th Cir.1996) (citation omitted); *see also In re Adobe Systems, Inc. Sec. Litig.,* 787 F.Supp. 912, 919 (N.D.Cal.1992) ("10b-5 liability for a projection requires that there be either no reasonable basis for believing that the projection was accurate or the awareness of undisclosed facts tending *seriously* to undermine the accuracy of that projection.") (emphasis in original).

***20** Defendants contend that Oracle's December 14, 2000 public guidance was based on its internal forecast, as compiled by Minton. This forecasting method had proven to be consistently reliable at predicting Oracle's quarterly performance-in the seven quarters before 3Q01, Oracle had met or exceeded the forecast. Defendants argue that because the public guidance was based on Oracle's proven internal forecasting method, there can be no factual dispute that Oracle had a reasonable basis for its public guidance. Plaintiffs respond with five theories for why Oracle had no reasonable basis for the public guidance. The Court will consider each in turn.

i. Defendants' failure to take into account the end of the dot .com boom

Plaintiffs argue that by December of 2000, the speculative period known as the "dot.com bubble" had burst and that the U.S. economy was slowing. Plaintiffs claim that the beginnings of the dot.com bust rendered Oracle's forecast fundamentally unreliable because it was based on the unreasonable assumption that Oracle would convert as much of its pipeline in 3Q01 as it had in the boom economy of 3Q00.

The first point of contention is whether, as plaintiffs claim, the 3Q00 conversion ratio was the "foundation" of Oracle's 3Q01 public guidance. *See* Pl. Reply at 4. Defendants contend that the historical conversion ratio was only one of several factors that Oracle used to arrive at its forecast. They cite Minton's testimony that she considered the conversion ratio in conjunction with conversations with heads of Oracle's business units, field forecasts, and information she received about the status of especially large potential deals. *See* DX 333 at 122-26. Plaintiffs concede that the field reports were a factor that Oracle used in arriving at its internal forecast. *See* Pl. Mot. at 4. The evidence plaintiffs rely on for their characterization of the conversion ratio as the "foundation" of the forecast does not support this point.[FN23]

> FN23. Plaintiffs cite Minton's deposition testimony at 122:1-24, 132:11-136:3 and 157:14-159:17 (PSJM A) in support of their contention that the upside adjustment was entirely based on the prior year's conversion ratio. In fact, in each of the cited portions of her deposition, Minton testified that the historical conversion ratio was one of a variety of factors she considered-"a number of data points," as she put it. PSJM A at 159:17.

Next, the parties dispute how Oracle used the 3Q00 conversion ratio in calculating its 3Q01 public guidance. Plaintiffs contend that Oracle "mechanically" applied the prior year's ratio to the current year's data. Again, plaintiffs' basis for this contention is not clear. The conversion ratio for 3Q00 was 53%, while the conversion ratio Oracle applied on December 11, 2000 was 48%. DSJM 1 at 213095. Plaintiffs do not explain why, if Oracle mechanically applied the prior year's conversion ratio, there was a five percentage point difference between the ratios applied at this point in 3Q00 and 3Q01.

Plaintiffs cite an Oracle e-mail chain from January 8, 2002 that forwarded a message from Jennifer Minton with the following statement:

forecast co[n]version ratios-forecast as a % of pipeline. We track this for every forecast period within a quarter. This enables us to evaluate conversion rates. The conversion rates have been declining over historical periods due to the economic recession. When we were going through the dot.com bubble the field would generally “sandbag” their forecast. By evaluating historical trends, Jeff and I would be able to determine what the true forecast was by applying historical conversion rates to the pipeline. As a side note, my upside analysis was usually spot on!

***21** POpp. 226 at 132078-79.[FN24] This description of the forecasting process gives no information about *how* Minton applied “historical conversion rates” to the pipeline. She does not state, as plaintiffs contend, that she mechanically applied the exact same conversion rate from the prior year without regard to any other factors. There is therefore no factual dispute that the 3Q00 conversion ratio was just one of several factors that Oracle used to determine the 3Q01 public guidance.[FN25]

FN24. Defendants object to that this document is hearsay to the extent it is offered to prove that the forecast was inaccurate. Defendants' objection is OVERRULED. An internal e-mail chain written by Oracle employees is admissible as an admission by a party opponent. *See* Fed.R.Evid. 801(d)(2).

Plaintiffs also cite exhibit 14, which purports to be notes taken in conjunction with Oracle's Special Litigation Committee investigation: “Minton explained that prior to Q3 of FY 2001, Oracle thought that it could model out its business, but with the current economic downturn, no analytical models can predict one quarter to the next.” PSJM 14 at 609541. The Committee's notes are inadmissible hearsay because plaintiffs rely on them to prove the truth of what Minton said.

FN25. The Court recognizes that plaintiffs' expert Alan Goedde opines that the historical conversion ratio was the basis for Minton's forecast. The reliability of Goedde's opinion will be addressed presently.

The parties also dispute whether the end of the dot.com boom necessarily rendered Oracle's forecasting system unreliable. Plaintiffs focus on a statement Ellison made in Matthew Symonds' profile *Softwar:* “LE writes: As I've said before, our forecasting system is not clairvoyant. Our forecasting does statistical extrapolations based on historic trends. If something that's outside our mathematical model of the business changes, like a war in the Middle East, our forecasting becomes inaccurate.” POpp. 17 at 226, fn. Ellison was questioned about this statement at his deposition, as follows:

Q: [Y]ou stand by that?

A: Absolutely.

Q: Now, it wouldn't-a war in the Middle East is just one example. There could be who knows how many examples; right?

A: Price of oil goes over a hundred dollars a barrel, lots of things.

Q: And the point you are making is that while your forecasting system does extrapolations based on historic trends, if something is happening that would suggest that the historical trend is not necessarily reliable, then your forecasting will not be reliable; is that right?

A: Right. Major macroeconomic change; sudden-sudden growth in the economy or sudden shrinkage in the economy would cause-you can't extrapolate anymore.

POpp. J at 384:16-385:7.

Plaintiffs argue that it was evident in December 2000 that the end of the dot.com boom constituted a “major macroeconomic change.” According to plaintiffs, Ellison has therefore admitted that Oracle's 3Q01 forecasting system was unreliable.

Plaintiffs' argument fails for several reasons. First, Ellison did not define the term “major macroeconomic change.” The examples he gave were war in the Middle East and oil prices rising to over a hundred dollars a barrel. There is no evidence that he also meant that Oracle's forecasting system became unreliable during an economic slowdown.

Second, the evidence shows that when it issued its 3Q01 forecast, Oracle had a reasonable basis for believing it could ride out the economic downturn. Plaintiffs cite several indicators that show the economy was slowing, including the precipitous decline of the NASDAQ between 4Q00 and 3Q01 and the Federal Reserve's reduction of the federal funds rate twice in one month (an action it had not taken in ten years).*See* PSJM at exs. 23 & 15 at 15-16 (citing Federal Reserve Board press releases); 16 at ex. 6 (Yahoo! Finance chart showing NASDAQ drop from approximately 5,000 to approximately 2,100). Plaintiffs also cite evidence that Oracle's sales to dot.coms were diminishing. Oracle had already sold its database to the larger dot .coms, so the remaining customers were smaller companies-a “fishing hole [that was] drying up.”PSJM E at 78:7-79:24.[FN26] The difficulty with plaintiffs' focus these indicators is that between 3Q00 and 2Q01, Oracle's license sales had increased despite the declines in the NASDAQ and the declines in revenues from dot.com customers, as summarized in the following table:

FN26. Plaintiffs argue that assistant vice presidents “in NAS ‘began to voice concern’ in December and in January ‘were reluctant to raise their forecast’ as ‘deals began to shrink and get delayed.”Pl. Mot. at 8. They cite exhibit 31, which appears to be a slideshow prepared for a managers' meeting on April 2, 2001. The slide emoted by plaintiffs reads “Month of December ... AVPs beginning to voice concern; Month of January-AVPS reluctant to raise their forecast.”PSJM 13 at 179337. This statement is hearsay to the extent plaintiffs rely on it for the truth of what assistant vice presidents were saying in December, 2000 and January, 2001. Defendants' objection to this evidence is SUSTAINED.

Quarter	NASDAQ average for quarter	Percentage of Oracle revenues from dot.coms	Increase in license growth over prior year
1Q00	2633.25	6.82%	8.2%
2Q00	2951.26	6.37%	17%
3Q00	4044.59	10.63%	29%
4Q00	4085.98	9.56%	21%
1Q01	3927.92	6.61%	30%
2Q01	3413.08	6.01%	24%
3Q01	2591.54	2.89%	5.3%

***22** *See* PSJM 135. As this evidence shows, the pattern did not hold true in 3Q01, but at issue is what Oracle officials knew at the time they issued the forecast. Plaintiffs do not explain why Minton's forecast had been accurate in the first two quarters of 2001, when the economy was already weakening. In addition, Oracle intentionally gave a conservative forecast, projecting earnings per share of $0.12, rather than the $0.1282 (which per Oracle's policy, would have been rounded to $0.13) that Minton had projected.

Finally, plaintiffs do not explain why Oracle's internal forecasting system *should* have taken the end of the dot.com boom into account when applying the 3Q00 conversion ratio to the pipeline. Minton's bottom up analysis began with data from sales representatives and direct contact with potential customers. This approach could reasonably have been expected to account for larger economic changes through the direct input of sales representatives, and in the past had proved effective at doing so.

In sum, plaintiffs have not cited evidence from which a rational factfinder could conclude that the end of the dot.com boom rendered Oracle's internal forecasting system so unreliable that there was no reasonable basis for the forecast Oracle provided to the public on December 14, 2000. Contrary to plaintiffs' assertion, the 3Q00 conversion ratio was only one of several factors that Oracle used to determine its forecast, plaintiffs have not cited evidence that the 3Q00 conversion ratio was “mechanically” applied in 3Q01, Oracle's record leading up to 3Q01 suggested that it would outperform NASDAQ despite its decrease in dot.com customers, and Oracle's bottom up method of forecasting provided a means of taking into account effects that larger economic factors would have on sales.

ii. Defendants' failure to take into account changes in Oracle's products

Plaintiffs claim that Oracle's December 14, 2000 public forecast had no reasonable basis because Oracle failed to take account of the fact that it was selling different products than it had in 3Q00. Specifically, plaintiffs point to evidence that in 3Q00, "applications" products made up 18.6% of Oracle's pipeline (with "technology" making up the remainder); in 3Q01, Oracle predicted that applications would make up 31.5% of its pipeline-an increase of 13%. PSJM 15 at 85. Plaintiffs also cite evidence that Oracle historically had been less successful at selling applications, which consequently had a lower conversion ratio than technology products. PSJM 15 at ex. 7. According to plaintiffs, the larger percentage of applications in the pipeline meant that the 3Q00 conversion ratio was not a reliable predictor of 3Q01 performance.

Plaintiffs' argument suffers from the same flaw as their contention that the dot.com bust rendered the 3Q00 conversion ratio unreliable: plaintiffs have not put forward evidence that the conversion ratio was the "foundation" of the internal forecasting system or that it was applied "mechanically" by Minton. In addition, defendants note that plaintiffs' evidence shows that applications also made up a greater percentage of the pipeline in 1Q01 and 2Q01 than it had the previous year. PSJM 15 at ex. 6. Plaintiffs do not explain why, if an increase in applications made the internal forecast unreliable, Oracle exceeded its internal forecast in 1Q01 and 2Q01 despite the increase in applications. Plaintiffs also do not cite evidence that Oracle *ever* analyzed its pipeline data by applying different conversion rates to its projected applications and technology sales. As discussed above, Oracle's internal forecasting system had proved consistently reliable, even though it did not separate its projections for applications and technology. Plaintiffs cannot create a factual dispute about whether there was any reasonable basis for the December 14 forecast by arguing, with the benefit of hindsight, that Oracle should have used a different formula for analyzing its sales data.

iii. Defendants' failure to take into account deficiencies with Suite 11i

***23** Plaintiffs argue that the December 14 public guidance was fundamentally unreliable because Oracle failed to take into account problems with Suite 11i that indicated that this product would be difficult to sell. According to plaintiffs, Oracle therefore should not have used the 3Q00 conversion rate to project applications sales in 3Q01.

Defendants do not dispute that before and during 3Q01, there were problems with Suite 11i. *See* Def. Opp. to Pls. Mot. for Summ. J. at 22 (citing analyst reports of bugs, the need for patches, functional gaps, advice not to buy the product, and the lack of positive customer references). Plaintiffs' contention that these problems made Oracle's forecast fundamentally unreliable nonetheless fails for at least two reasons. First, according to plaintiffs, Oracle had difficulty selling Suite 11i throughout 1Q01 and 2Q01, but, as noted above, the internal forecasting system for those quarters proved accurate. Second, the Court again returns to the point that the historical conversion ratio was not the only factor that Oracle used to arrive at its internal forecast. If the problems with Suite 11i made it less likely that sales representatives would close deals in 3Q01, the bottom up forecasting process provided a mechanism for Oracle to take that information into account.

iv. Ellison's directive to increase risk

Plaintiffs contend that the December 14, 2000 public guidance had no reasonable basis because of a change Ellison made to Oracle's forecasting system. According to plaintiffs, on October 4-5, 2000, Minton assigned Patricia McManus and James English, both finance personnel, to provide training in a new forecasting technique that radically changed Oracle's forecasting method. PSJM 154. On October 6, 2000, McManus sent the following e-mail to English:

Jim, we can talk through the recommendation, let me know your thoughts ...[FN27]

FN27. All ellipses in original.

Recently Larry [FN28] has changed the way that he is interpreting our forecast. He would like us to reflect our numbers as follows ...

FN28. Ellison stated at deposition this refers to him. PSJM D at 423:24-425:1.

Worst-this is our bottom threshold-minimum 80% probability for opportunity-our old thinking of "commit."

Forecast-some risk included, potentially 50% of the time you make it and 50% of the time you don't-minimum 60% probability for an opportunity

Best-the top threshold for the quarter-minimum 40% probability for an opportunity This is a change from our current thinking in that our forecast has not usually had a significant amount of judgment. It was the amount that you believed you could deliver at a minimum. That emphasis has shifted to "worst" and now our forecast is a number that includes more risk than in the past. Best case should not be our entire quarter pipeline. As deals cross the 40% win probability threshold, they enter our best case. The win probabilities are guidelines and should be adjusted as you move through the quarter. [ ] Obviously, a 60% win probability the last week of the quarter is probably not a "forecast" item. Common sense has to prevail. The win probabilities are in OSO and should be reviewed for accuracy with the reps. The win probabilities have to be updated on a timely basis.

***24** We will incorporate this in our OSO IIi training that is tentatively scheduled the week of 10/23.

Please let me know if you have any questions!

PSJM 17. According to plaintiffs, the McManus e-mail is evidence of a company-wide directive from Ellison for sales people to add "risk" to their forecast-that is, report less conservative sales projections. While divisions had formerly just given their "worst" (or "commit") number, they would now be required to give their "worst," their "forecast" (which would be based on their judgment) and their "best" estimate.FN29 Plaintiffs contend that the directive rendered the 3Q01 public guidance unreliable because Minton continued to add upside to her reports to account for sandbagging, even though sales representatives' tendency to underestimate their sales had now already been accounted for through the new method articulated in the McManus e-mail.

FN29. Defendants contend that no such directive was issued or followed, pointing out that the e-mail itself is the only document which mentions such a directive. Plaintiffs present no evidence that the trainings referred to took place, or what their content was. The Court will assume for the purposes of this discussion that Ellison did issue a directive for sales representatives to include three figures in their forecast and that the directive was followed.

Plaintiffs' argument fails because they cite no evidence that the new system in fact introduced more risk into the forecasts. Plaintiffs do not cite evidence of how Minton used these numbers (e .g. that she made the forecast less reliable by including only the "best" estimates).FN30 In addition, in eight of the nine weeks of 3Q01 that Minton projected a conversion rate, her prediction was equal to or lower than the conversion rate from the same point in 3Q00. DSJM 143. If plaintiffs are correct that Ellison's directive caused sales representatives to report inflated projections, Minton's 3Q01 weekly reports should have shown higher conversion rates than those from 3Q00. Accordingly, plaintiffs' evidence that by October of 2000, Ellison had directed sales representatives to begin reporting their "worst," "forecast," and "best" figures does not create a triable issue on whether Oracle's forecast had no reasonable basis.FN31

FN30. Plaintiffs contend that Minton "took no account of the directive," implying that she proceeded to add upside to the field forecast despite the new reporting, redundantly correcting for sandbagging. Plaintiffs' characterization of the evidence is not accurate. In support of their claim that she specifically ignored the directive, plaintiffs cite a portion of her deposition testimony in which she stated that the "criteria for the forecast column" in her internal forecasting reports did not change during fiscal years 2000 and 2001. *See* PSJM B 19:17-19. Plaintiffs do not cite deposition testimony on the issue of whether she was aware of or responded to a directive from Ellison.

FN31. The Court recognizes that plaintiffs' expert Alan Goedde opines that Ellison's directive had an effect on the field forecasts. The reliability of Goedde's opinion will be addressed presently.

v. Fraudulent 2Q01 accounting

Plaintiffs argue that Oracle's overstatement of its reported revenue in 2Q01 rendered the 3Q01 forecast unreliable. According to plaintiffs, "the falsely reported $0.11 EPS for 2Q01 was undisputedly the false basis for 3Q01 projections of $0.12 EPS[.]" Pls. Opp. to Defs. Mot. for Summ. J., at 47. Plaintiffs point out that in a conference call with analysts discussing the December 14 forecast, Henley linked Oracle's 3Q01 projection of $0.12 cents per share to the company's 2Q01 results:

In the area of per share, we think it would be 12 cents. Now, again, that's based on some models, and I think most of the people's estimates are around that. And also, just historically, the third quarter is slightly better than the second quarter. That's the way, sequentially, it's worked here. And if you look back at the last three years, sequentially, the third quarter, split adjusted, has been one cent a share better than the second quarter. So we did 11 cents in the second quarter. So I would assume, 12 cents would be a reasonable number at this point. I don't think history is going to be a lot different, here.

***25** PSJM 1 at 3222.

Plaintiffs are correct that Henley told analysts that Oracle's 3Q01 earnings per share projection of $0.11 was reasonable because, based on historical patterns, the company could be expected to exceed its 2Q01 earnings per share of $0.11 by a penny. This statement does not demonstrate, however, that Oracle had no other basis for its forecast. In fact, the full quote shows that Henley first stated that the 12 cents projections was "based on some models." To establish the existence of a triable issue as to whether the 3Q01 forecast is actionable, plaintiffs would have to cite evidence showing that those models were without a reasonable basis, which they have failed to do.

vi. Expert opinion of Dr. Alan G. Goedde

Defendants move to exclude the expert testimony and reports of Dr. Alan G. Goedde, who opines that Oracle's 3Q01 forecast lacked a reasonable basis.[FN32] Specifically, they seek to exclude his opinions that (1) "Oracle failed to make adjustments to its forecast process to account for the negative impact of the changes in the economy and the market for Oracle's products in violation of accepted forecast principles" and (2) in 2Q01, "Larry Ellison directed significant changes to Oracle's forecast process that resulted in more 'risk' being included in future Field Forecasts and rendered Jennifer Minton's upside adjustments unreliable."*See* Goedde Report 1, at 4.[FN33]

FN32. Defendants also move to exclude Goedde's opinion that "Oracle was facing a major macroeconomic change heading into Q3 2001 resulting in a decline in the market for its products."Goedde's opinion about the economy in 3Q01 does not create a factual dispute on the issue of whether there was a reasonable basis for Oracle's 3Q01 public guidance. Assuming that Goedde is correct that the economy was changing in 3Q01, he does not explain why these changes would not be accounted for in Minton's "bottom up" forecasting process. In addition, he does not explain how Oracle's forecasting process had proven accurate in previous quarters even though the NASDAQ had already begun to decline.

FN33. All references to Goedde Report 1 are to exhibit 1 to the declaration of Douglas R. Britton in support of the expert report of Alan G. Goedde. The Goedde Rebuttal Report (Goedde Report 2) is attached as exhibit 3 to the same declaration.

Federal Rule of Evidence 702 provides that expert testimony is admissible if "scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue."Fed.R.Evid. 702. Expert testimony under Rule 702 must be both relevant and reliable. *Daubert v. Merrell Dow Pharms., Inc.,* 509 U.S. 579, 589 (1993). When considering evidence proffered under Rule 702, the trial court must act as a "gatekeeper" by making a preliminary determination that the expert's proposed testimony is reliable. *Elsayed Mukhtar v. Cal. State Univ.,* 299 F.3d 1053, 1063 (9th Cir.2002), amended by 319 F.3d 1073 (9th Cir.2003). As a guide for assessing the scientific validity of expert testimony, the Supreme Court provided a nonexhaustive list of factors that courts may consider: (1) whether the theory or technique is generally accepted within a relevant scientific community, (2) whether the theory or technique has been subjected to peer review and publication, (3) the known or potential rate of error, and (4) whether the theory or technique can be tested. *Daubert,* 509 U.S. at 593-94;*see also* *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137 (1999).

a. Timeliness

Goedde's expert opinions became more refined as litigation progressed. On August 26, 2007, after filing his expert report (on May 27, 2007) and his rebuttal report (on June 22, 2007), he supplied a supplemental declaration in which he stated that he had used erroneous calculations when he generated exhibit 4 to his rebuttal report.[FN34] *See* Goedde Report 3. [Docket No. 1030] In conjunction with the August 26 declaration, he submitted a new graph (exhibit 1) and opined that it supported his conclusion that "the prior year conversion rate was the basis for Ms. Minton's Potential Forecast and therefore Oracle's guidance in 3Q FY01."Goedde Report 3 at ¶ 4 & ex. 1.

FN34. Per the parties' stipulation, expert and rebuttal reports were exchanged on May 25, 2007 and June 22, 2007, respectively.

***26** Goedde's third report went beyond merely correcting a computational error in his rebuttal report, however. He also "performed additional analysis to test the correlation" between Minton's forecast and the historical conversion ratio. Goedde Report 3 at exs. 2, 3. To that end, he included two new graphs that purported to prove Minton arrived at her guidance by applying the prior year's conversion ratio to the pipeline. Goedde Report 3 at exs. 2, 3.

Goedde also used his third report to supplement his opinion about how Ellison's purported directive changed Oracle's forecasting method. He stated, "Based upon my review of defendants' rebuttal expert reports, I learned for the first time that defendants are denying that Oracle's sales force actually followed Mr. Ellison's directive."Goedde Report 3 ¶ 7. He therefore performed additional analysis that he claimed supported his conclusion that Oracle's U.S. license division forecasts changed after the directive because more managerial judgment was inserted into the field reports.

On November 6, 2007, Goedde filed a fourth declaration, which contained "more detailed statistical analysis" to supplement his August 26 declaration and address arguments raised in the rebuttal report of defendants' expert. Goedde Report 4 ¶ 5. [Docket No. 1403-2] Specifically, he performed a new computation in his analysis of Minton's forecast that purported to correct for seasonal patterns.

Finally, in conjunction with the renewed summary judgment motions, Goedde filed a fifth declaration, on November 16, 2008, in which he consolidated his opinions from the prior four reports into a single declaration. Goedde Report 5. [Docket No. 1542]

The Court agrees with defendants that Goedde's augmentation of his opinion after he submitted his rebuttal report was not proper. Federal Rule of Civil Procedure 26(e)(1) provides that "[f]or an expert whose report must be disclosed under Rule 26(a)(2)(B), the party's duty to supplement extends both to information included in the report and to information given during the expert's deposition."Thus, after realizing that Goedde's rebuttal report analysis contained a computational error, plaintiffs had a duty to correct the mistake through a supplemental disclosure. Plaintiffs exceeded the permissible scope of a supplemental disclosure, however, by including additional analysis to shore up Goedde's original opinion. Rule 26(a)(2)(B) requires that expert witnesses disclose a report containing "a *complete* statement of all opinions the witness will express and the basis and reasons for them ."*See*Fed. R. Civ. Pro. 26(a)(2)(B)(i) (emphasis added). The expert report therefore defines the metes and bounds of an expert's trial testimony. Here, Goedde's additional analysis vastly complicated his opinion of how Minton arrived at her upside adjustment, with each supplemental declaration containing more involved discussion of his statistical analysis than the last. Rule 26's expert disclosure requirements would be obviated if experts could continually refine their opinions in this manner.

***27** Goedde's additional analysis regarding Ellison's directive is similarly problematic. Originally, Goedde did not use statistical analysis of the field forecasts to support his conclusion that the directive inflated the forecasts; this dimension of his analysis was introduced after the rebuttal reports were exchanged. It is simply not plausible that he did not realize until reading the rebuttal reports of defendants' experts that defendants contend Ellison did not issue a company-wide directive. Goedde's initial report anticipates that the existence of this directive will be disputed. *See* Goedde Report 1 at 22 ("There is no evidence that I have reviewed to indicate that the field did not follow Ellison's directive. To the contrary, there is reason to believe that it did."[FN35]) There is no reason that Goedde could not have performed these computations in his initial analysis.

FN35. In support of this contention, Goedde cited the McManus e-mail and Ellison's deposition testimony that he wanted all three forecast figures (worst, forecast, best) in the system in order to have "more data to work with." Goedde Report 1 at 22.

Accordingly, the Court finds that the new opinions offered in Goedde's third, fourth, and fifth reports are untimely. All of these opinions are STRICKEN, to the extent they include analysis that was extends beyond the analysis Goedde performed in his initial and rebuttal reports. Exhibit 1 to Goedde's third report, which corrected the erroneous exhibit in his rebuttal report, is not stricken.

b. Goedde's opinion that Oracle's 3Q01 forecast was unreliable because Minton did not take economic factors into account

Turning to the elements of Goedde's reports that were timely, the overarching problem is that his opinion is based on a selective reading of the record. A premise of Goedde's analysis is that “[a]ccording to Ms. Minton's testimony, the week 2 conversion rate for [3Q00] multiplied by the Pipeline at week 2 of [3Q01] was the underlying basis for the ‘upside’ portion of the [3Q01] revenue forecast that formed the basis of Oracle's Public Guidance.”Goedde Report 1 at 20. In other words, Goedde relies on Minton's testimony for his conclusion that Minton arrived at her upside by applying the conversion ratio from the prior year. As the foregoing discussion demonstrated, plaintiffs cite no testimony by Minton that the conversion ratio was the *basis* for her upside or that she mechanically applied the conversion ratio from the prior year. Goedde proceeds to opine that “the application of this historical conversion ratio” was flawed because 3Q00 was a boom economy while the economy was in decline in 3Q01, *see* Goedde Report at 20, but provides no further basis for his conclusion about how Minton used the historical conversion ratio or what role this factor played in her upside.

In his rebuttal report (and exhibit 1 of his third report), Goedde for the first time attempted to substantiate his conclusion that the historical conversion ratio was the foundation of Minton's upside. He provided a graph that purports to compare her actual forecasts throughout 3Q01 with what her forecasts would have been if she had used only the historical conversion ratio. *See* Goedde Report 2 at 76 & Goedde Report 3, ex. 1. Tellingly, the graph shows that throughout 3Q01, Minton's actual forecast was *different* from the forecast that Goedde claims she would have arrived at had she mechanically applied the 3Q00 conversion ratio. *See id.*Goedde provides no analysis in his initial or rebuttal reports in support of his conclusion that this chart shows that Minton's upside “was based almost exclusively on historical conversion analysis.”Goedde Report 2 at 76. To the contrary, the graph shows that some factors other than the historical conversion ratio must have played a role in Minton's upside.

***28** The Court finds that Goedde's opinion on how Minton used prior year conversion ratios and the importance of this factor in her upside is not reliable because Goedde ignored deposition testimony by Minton that contradicted his conclusion and because his statistical analysis does not support his conclusion. Accordingly, the Court GRANTS defendants' motion to exclude Goedde's expert reports and testimony on this issue. *See* *Brooke Group, v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 242 (1993) (“When an expert opinion is not supported by sufficient facts to validate it in the eyes of the law, or when indisputable record facts contradict or otherwise render the opinion unreasonable, it cannot support a jury's verdict.”).

c. Goedde's opinion that the 3Q01 forecast was unreliable as a result of Ellison's directive

Defendants move to exclude Goedde's opinion that Ellison's directive for sales representatives to designate their worst, forecast, and best figures (assuming for the sake of argument that the directive was issued) rendered the 3Q01 forecast unreasonable. The Court agrees with defendants that Goedde's opinion on this issue is unreliable. In his initial report, he opines that Minton adjusted for Ellison's change by decreasing and then eliminating her upside adjustment between January 15, 2001 and February 5, 2001. Goedde Report 1 at 23. According to Goedde, Minton's forecast was unreliable before she made these changes. Goedde does not provide any basis for his conclusion that Minton made changes to the upside because of Ellison's directive, rather than because of her own judgment that the additional upside was not warranted. Second, Goedde assumes that Ellison's directive resulted in “the virtual removal of ‘sandbagging,’ “ by sales representatives, thereby rendering Minton's upside redundant. *Id.* at 24;*see also* Goedde Report 2 at 83 (“Mr. Ellison directed the sales force to submit forecasts which exceeded their comfort levels, effectively changing Oracle's forecasting process from a ‘bottom-up’ process to a ‘top-down’ process.”). Goedde points to no evidence supporting this conclusion that the directive had an effect on the field forecast. He therefore assumes what he sets out to prove: that a directive from Ellison changed the behavior of the field.

For these reasons, the Court finds that Goedde's opinions on the effect of Ellison's directive is not based on discernible "methods and methodology" and therefore is not reliable. *Daubert v. Merrell Dow Pharms., Inc.,* 43 F.3d 1311, 1316 (9th Cir.1995). Defendants' motion to strike Goedde's expert reports and exclude his testimony on this issue is GRANTED.

Without Goedde's expert report, there is no factual dispute as to whether any of the factors identified by plaintiffs rendered the 3Q01 forecast without a reasonable basis. Defendants' motion for summary judgment on this issue is GRANTED.

E. Intra-quarter repetitions of the 3Q01 forecast[FN36]

> FN36. Again, the Court assumes without deciding that these statements were not accompanied by meaningful cautionary language and therefore were not subject to PSLRA's safe harbor.

***29** Plaintiffs claim that Oracle repeated the December 14 forecast during 3Q01. *See* POpp. 217 at 3279-80.[FN37] They argue that these repetitions of the forecast were materially false because defendants were "aware of undisclosed facts tending seriously to undermine the [forecast's] accuracy." *Provenz,* 102 F.3d at 1487. Plaintiffs identify three categories of facts that were allegedly known to defendants. The Court will consider each in turn.

> FN37. This transcript of a speech by George Roberts is not dated. Plaintiffs have submitted sufficient other evidence to support a finding that Roberts gave this speech in mid-February 2001. *See* PSJM v. at 341:20-343:6; *see also* PSJM 218.

i. Actual results from flash reports

Plaintiffs contend that Oracle officials learned information from "flash reports"-snapshots of key financial indicators-in 3Q01 that alerted them that the company was likely to miss its public guidance. The first flash report, which reported actual data from December 2000, was issued internally on January 17, 2001. POpp. 277. It reported license revenue growth of 35%; the public guidance had forecast license growth of 25%. *Id.* The January 17 report also showed that in December, Oracle had achieved 19% of the quarterly forecast for license revenue. *Id.* This figure was in line with prior quarterly results: in 3Q00, Oracle had achieved 16% of its forecast license revenue by December; in 3Q99, it had achieved 19% of the forecast license revenue by December.*Id.*

The parties dispute whether the relevant figures in the January 17 flash report should have been adjusted to eliminate the revenue from a deal with internet trading site Covisint. In the first few days of December 2000, Oracle executed a $60 million applications deal with Covisint-the largest transaction in Oracle's history. Plaintiffs argue that the January 17 figures should be adjusted to eliminate revenue from the Covisint deal. According to plaintiffs, quarterly trends were only apparent after Covisint was eliminated from the December data. They cite, for example, deposition testimony by Minton stating that considering the underlying license revenue without the Covisint deal provided another "data point" for analyzing the December results. POpp. GGG at 312:23-313:4.

Although removing an aberrant transaction may allow for a more accurate comparison with historical data, the inquiry here is whether the January 17 flash report confirmed or undermined the 3Q01 public guidance concerning anticipated revenues. There is no question that the Covisint deal, even though it was unusual, would be "booked" as 3Q01 revenue and would therefore help Oracle meet its forecast.

Plaintiffs also note that the January 17 flash report indicated that two of the three U.S. divisions showed negative year over year revenue growth: NAS and OSI reported revenue growth of -24% and -81%, respectively. A second flash report, reporting actual results from January 2001, was issued February 8, 2001. POpp. 281. It indicated that NAS and OSI were still reporting negative revenue growth: -33% and -17% respectively. Both flash reports also reported, however, that OPI, the third U.S. division, was reporting significant growth: 243% in December and 235% in January. Plaintiffs do not explain why negative growth in two U.S. divisions should have alerted Oracle that it would miss its 3Q01 guidance, particularly when a third U.S. division was reporting significant growth.

***30** In sum, if Covisint is not excluded from the flash reports, plaintiffs point to no evidence that the actual results for December and January alerted Oracle that it would miss its 3Q01 forecast. On the contrary, these reports indicate that license revenues were in line with prior years as a percentage of quarterly results and that in December, license revenue growth was exceeding the forecast by 10%.

More fundamentally, plaintiffs' focus on the flash reports does not take into account the hockey-stick effect. Given that Oracle was known to earn the vast majority of its quarterly revenue in the final weeks of a given quarter, it is not apparent that the results from the first or second months of the quarter are good indicators of how the quarter would turn out.

For these reasons, the Court finds that there is no factual dispute as to whether the reports of Oracle's performance in December 2000 and January 2001 contained information that seriously undermined the 3Q01 forecast.

ii. Pipeline growth

Plaintiffs argue that throughout 3Q01, Oracle received weekly data showing that pipeline growth was declining, and that this information warned officials that the company would not meet its forecast. Oracle had forecast license revenue growth of 30% (constant dollars). Oracle's actual pipeline growth (i.e. year over year percentage increase) in the weeks comprising the third quarter is summarized as follows: [FN38]

FN38. *See* PMSJ 16 at ex. 20. Plaintiffs provided the actual dollar amounts of the pipeline. The Court has divided plaintiffs' figures for 3Q01 by their figures for 3Q00 to determine the percentage growth over the prior year. *See also* PSJM 69 at 440076, PSJM 70 at 440093.

12/11/00	**12/25/00**	**1/15/01**	**1/22/01**	**1/29/01**	**2/5/01**	**2/12/01**	**2/19/01**	**2/26/01**	**2/27/01**	**2/28/01% h**
52%	34%	34%	31%	31%	32%	29%	28%	34%	34%	34%

Plaintiffs pay particular attention to the figures from December 25 and February 5, pointing out that pipeline growth had dropped from a high of 52% at the beginning of the quarter to 34% and 32%, respectively. *See* Pl. Mot. for Summ. J. at 23. In other words, plaintiffs argue that Oracle officials should have known that the company would miss its guidance when they learned that the pipeline was growing at 4% and 2% above their projection for license growth. This does not make sense.

Plaintiffs focus on the "comfort gap," which is the difference between the forecasted revenue growth and the pipeline growth. The comfort gap was narrow in 3Q01, particularly between December 25 and January 29, when it did not exceed 4%. Plaintiffs point out that this is a much smaller figure than the average comfort gap for the five quarters prior to 3Q01, which was 13.4%. *See* PSJM 16, ex. 13.

The Court agrees with defendants that plaintiffs do not cite evidence from which a rational factfinder could conclude that a narrow comfort gap alerted Oracle officials that they would miss their guidance. Plaintiffs rely on testimony from Ellison's deposition as evidence that the comfort gap was a figure that Oracle officials relied on to evaluate the reliability of the forecast. Ellison, however, stated only that the relevant information is whether the pipeline exceeds the forecast, not that he used the difference between these figures to assess the accuracy of the forecast. *See, e.g.,* PMSJ C at 420:12-14 ("I would say as long-as long as the pipeline growth is greater than-than the revenue growth, you should be able to meet your numbers.").

***31** Accordingly, the Court finds that there is no triable issue as to whether Oracle's pipeline growth, which exceeded the forecast for all but two weeks of the quarter, provided defendants with information that seriously undermined the 3Q01 forecast.

iii. Pipeline information and forecasts from the U.S. license divisions

Plaintiffs argue that intra-quarter reports from the U.S. license divisions informed Oracle that it would miss its guidance. Plaintiffs cite considerable evidence that NAS and OSI reported negative trends during 3Q01 and that their 4Q01 forecasts showed year over year declines.[FN39] Plaintiffs do not explain, however, why the declines in NAS and OSI would necessarily undermine the

3Q01 forecast, especially in light of the major Covisint deal reported in OPI. In addition, each of the U.S. divisions continued to stick by their forecasts despite reporting declines. *See, e.g.,* POpp. 329(1/17/01 email from OPI finance director to Minton that OPI's forecast "holding at $150M but I'll be a bit more aggressive and say a likely of $150-$170."); POpp. 240 (1/11/01 email from NAS's finance director to Minton, discussing pipe shrinkage, lack of big deals, and drop in technology spending, but stating "[o]ur Q3 forecast of $346M has not changed" and revising only NAS's upside); POpp. 305 (1/18/01 email from OSI finance director saying Nussbaum "still confident in the 225, as long as none of the very large opportunities drop out" and "[M]y sense still is that we'll come out around 210 as it stands today"); POpp. 327 (2/14/01 email from OSI finance director reaffirming that she still thought OSI would come in between $210 and $220 million).

> FN39. Defendants object that exhibit 236, a slideshow apparently presented at a meeting on April 1, 2001, is hearsay to the extent it is offered for the truth of what assistant vice presidents in NAS said in December of 2000. The Court agrees and SUSTAINS defendants' objection.
>
> Defendants also object that POpp. 315, a summary of "lost big deals" in 3Q01, is an improper summary of voluminous exhibits under Federal Rule of Evidence 1006. The Court agrees. The Court agrees that the chart is an improper summary because it contains attorney argument. Defendants' objection is SUSTAINED.

For these reasons, the Court concludes that a reasonable juror could not infer from the data showing losses in OSI and NAS that defendants had information seriously undermining the 3Q01 projection.

Accordingly, the Court finds that plaintiffs have failed to identify the existence of a triable dispute as to whether the Oracle officials had knowledge of actual facts seriously undermining their 3Q01 forecast when they repeated the forecast in 3Q01. Defendants' motion for summary judgment on this issue is GRANTED.

F. Statements about the effect of the economy on Oracle

During 3Q01, defendants made the following statements, which plaintiffs characterize as misrepresentations that the slowing economy was not affecting Oracle:

- In the December 14, 2000 conference call with analysts, Henley said, *"And then lastly .... the economy ... [a]t this point we see no impact or slowing in our business.*We have seen no slowing of our business. We believe that (the U.S. economy) is slowing down, from what we can tell.""So, you know, if we were to have a-I guess, a hard landing, a recession, depression, I mean, certainly, that could have some impact. But as long as we're simply slowing and going into more of a soft landing, we continue to believe that our business should do quite well."POpp. 26 at 234423-24.

***32** • In a December 15, 2000 interview with *Radio Wall Street,* Henley said: *"[T]he economy right now even though it's slowing doesn't seem to be affecting us. We see no difference in demand for our upcoming third fiscal quarter....* If the economy got really really bad then obviously that would probably have some effect on all of us. But so far we look pretty hard at indicators. *We're seeing no softening in our business."*DX 163 at 141660-61.

- In an e-mail dated February 26, 2001, Oracle spokeswoman Stephanie Aas sent an internal e-mail after the AppsWorld conference in New Orleans on February 21, 2001 stating, *"Analysts closely monitored comments on the economy which were consistent with recent statements: we do not expect the slowing economy, barring a serious slide to a recession, to significantly impact near term guidance. These comments were met with a degree of relief, as some analysts were anticipating the event to be an opportunity to take down guidance."See* POpp. 212 (PSJM 9).[FN40]

> FN40. Defendants object that Aas's repetition of analysts' reports of what Henley said constitutes hearsay within hearsay. The Court agrees that the portion of the e-mail that summarizes analyst reports is inadmissible hearsay if offered to prove the truth of what the reports say Henley said. The portion of the e-mail cited above, however, is admissible as proof of Oracle's public statements about the company's financial outlook in February of 2001.

Defendants contend that their statements about the effects of the economy on Oracle's business were forward looking and were therefore subject to the PSLRA safe harbor. According to defendants, the statements about the economy were so "intertwined" with statements about Oracle's ability to make its forecast that they constituted projections. The Court disagrees. Forward-looking statements include statements "containing a projection of revenues, income ..., earnings ... per share," and statements "of future economic performance." 15 U.S.C. § 78u-5(i)(1)(A) & (C). While the statements were made in the context of discussions of the 3Q01 forecast, the speakers were conveying information about whether Oracle was being affected by the slowing economy in the present. FN41

FN41. The Court notes that in the prior round of summary judgment briefs, defendants stated that these were *not* forward-looking statements. *See* Def. Nov. 9, 2007 Mot. at 32. [Docket No. 1406]

As these are not forward-looking statements, plaintiffs must "demonstrate that a particular statement, when read in light of all the information then available to the market, or a failure to disclose particular information, conveyed a false or misleading impression."*In re Convergent Tech. Sec. Litig.,* 948 F.2d 507, 512 (9th Cir.1991). They must also show that defendants engaged in "knowing" or "intentional" conduct or acted with "deliberate recklessness." *See South Ferry LP, No. 2 v. Killinger,* 542 F.3d 776, 782 (9th Cir.2008). In the securities context, "an actor is reckless if he had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although he could have done so without extraordinary effort." *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1063 (9th Cir.2000) (citation and alterations omitted).

The Court finds that plaintiffs have failed to cite evidence from which a reasonable juror could conclude that Henley was deliberately reckless in making these statements. Although plaintiffs cite ample evidence showing that certain sectors in Oracle were losing revenue as a result of dot.coms going out of business, Henley had a basis for believing that Oracle's overall business would be immune from the downturn. As discussed above, Oracle had continued to see substantial year over year increases in license revenue even as NASDAQ and dot.com sales steadily declined. Plaintiffs have failed to show that any of the internal data available to defendants through 3Q01 seriously undermined their forecast for that quarter.

2. Defendants' Motion for Summary Judgment on Plaintiffs' Control Person Claim

***33** Defendants move for summary judgment on plaintiffs' § 20(a) claim against Ellison, Henley, and Sanderson. Plaintiffs do not dispute that § 10(b) liability is a prerequisite for controlling person liability under § 20(a).*See Paracor Finance, Inc. v. General Elec. Capital Corp.,* 96 F.3d 1151, 1161 (9th Cir.1996) ("To establish 'controlling person' liability, the plaintiff must show that a primary violation was committed and that the defendant' directly or indirectly' controlled the violator.") (citation omitted). Accordingly, defendants' motion for summary judgment on this claim is GRANTED.

3. Defendants' Motion for Summary Judgment as to Ellison and Henley

Defendants move for summary judgment on plaintiffs' third cause of action, violation of section 20A of the Exchange Act, which provides a cause of action against "[a]ny person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information."15 U.S.C. § 78t-1(a). The elements of a section 20A violation are "(1) trading by a corporate insider; (2) a plaintiff who traded contemporaneously with the insider; and (3) that the insider traded while in possession of material nonpublic information, and thus is liable for an independent violation of the Securities Exchange Act of 1934." *Simon v. American Power Conversion Corp.,* 945 F.Supp. 416, 435 (D.R.I.1996) (citing *Inre VeriFone Sec. Litig.,* 11 F.3d 865, 872 (9th Cir.1993))."Claims under Section 20A are derivative and therefore require an independent violation of the Exchange Act." *Johnson v. Aljian,* 490 F.3d 778, 781 (9th Cir.2007). Defendants Ellison and Henley argue that if the Court grants summary judgment on plaintiffs' § 10(b) claim, they are also entitled to summary judgment on plaintiffs' § 20A claim because plaintiffs cannot establish an independent violation of the Exchange Act.

Plaintiffs contend that they can demonstrate the "independent violation" required for their § 20A claim by showing that Henley and Ellison engaged in insider trading in violation of Rule 10b-5. Defendants argue that insider trading cannot serve as a predicate offense for section 20A purposes. In *Johnson,* however, the Ninth Circuit held that the plaintiffs had met the "independent violation" requirement of § 20A by alleging that the defendants engaged in illegal insider trading in violation of § 10(b) of the Exchange Act. *See* 490 F.3d at 779;*see also In re JDS Uniphase Corp. Sec. Litig.,* No. C 02-1486, U.S. Dist. LEXIS 76936 *13 (N.D.Cal. Sept. 27, 2007) (holding § 10(b) insider trading claims were sufficient to serve as predicate violation). Defendants therefore are not entitled to summary judgment solely on the basis that plaintiffs' § 10(b) claim for false statement fails.

Henley and Ellison also argue that they are entitled to summary judgment on plaintiffs' § 20A claim because there is no factual dispute that they did not possess "material, nonpublic information" at the time of their trades. *See United States v. O'Hagan,* 521 U.S. 642, 651-52 (1997). Plaintiffs argue that Henley and Ellison possessed the following insider information: (1) data from Oracle's U.S. divisions rendered the 3Q01 forecast unreliable; (2) Oracle's pipeline had "collapsed;" (3) Oracle's 3Q01 forecast had no reasonable basis because of economic changes, Ellison's directive to add risk, the overstatement of 2Q01 financial returns due to the debit memo fraud, the higher mix of applications in the pipeline, and Minton's mechanical application of the historical conversion ratio to the 3Q01 pipeline; and (4) problems with Suite 11i were affecting applications sales.

***34** The foregoing discussion has established that plaintiffs have failed to establish the existence of a genuine factual dispute on the first three categories of information. Assuming for the sake of argument that there are disputed facts about whether Henley and Ellison had material insider information about Suite 11i at the time of their trades, plaintiffs would have to prove that the revelation of the concealed information about Suite 11i was a substantial cause of plaintiffs' loss. *See Johnson,* 490 F.3d at 782 (citing *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv.,* 189 F.3d 1017, 1025 (9th Cir.1999) ("To prove violation of either Section 10(b) or Rule 10b-5, the private plaintiff must demonstrate that the alleged fraud occurred 'in connection with the purchase or sale of a security'. Once this foundational requirement has been met, the plaintiff must prove five elements: (1) misrepresentation (or omission, where there exists some duty to disclose); (2) materiality; (3) scienter (intent to defraud or deceive); (4) reliance; and (5) causation. The plaintiff must prove both actual cause ('transaction causation') and proximate cause ('loss causation')."). As discussed above, defendants have demonstrated that there is no triable issue as to loss causation for the purportedly concealed information about Suite 11i.

Accordingly, the Court GRANTS defendants' motion for summary judgment on plaintiffs' § 20A claim against Henley and Ellison.

4. Adverse Inference

The Court rejects plaintiffs' argument that the Court should apply the adverse inference broadly. If plaintiffs had been able to establish the existence of a factual dispute on the issue of whether the 3Q01 forecast had a reasonable basis, for example, the adverse inference would have helped plaintiffs prove that Oracle officials were aware of those problems. The inference cannot help plaintiffs with the absence of evidentiary support for plaintiffs' allegations.

CONCLUSION

For the foregoing reasons and for good cause shown, the Court hereby GRANTS defendants' motion for summary judgment on plaintiffs' § 10(b), § 20(a), and § 20A claims and DENIES plaintiffs' motion for partial summary judgment. The Court also GRANTS defendants' motion to exclude the expert report and testimony of Alan Goedde. All other evidentiary objections are DENIED as moot unless discussed in this order.

IT IS SO ORDERED.

N.D.Cal.,2009.
In re oracle Corp. Securities Litigation
Slip Copy, 2009 WL 1709050 (N.D.Cal.)

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