



UNITED STATES DISTRICT COURT  
DISTRICT OF MINNESOTA

Civil No. 97-5 (DWF/RLE)

In re Digi International Inc.  
Securities Litigation

MEMORANDUM  
OPINION AND ORDER

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**Introduction**

This action arises under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Plaintiff Louisiana State Employees Retirement System ("LSERS") and the putative class plaintiffs (collectively, "Plaintiffs") allege that Defendants Digi International, Inc. ("Digi") and former corporate officers Ervin F. Kamm, Jr., and Gerald A. Wall artificially inflated Digi's earnings during the class period by using improper accounting methods to misrepresent Digi's investment in AetherWorks Corporation ("AetherWorks").

FILED                      **AUG 17 2000**  
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JUDGMENT ENTD                      **AUG 17 2000**  
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The Plaintiffs' Rule 10b-5 and Section 20(a) claims survived an earlier motion to dismiss pursuant to Rule 12(b)(6), as the district court found that the allegations of the complaint set forth cognizable claims for relief.<sup>1</sup> In re Digi Intern., Inc. Securities Litigation, 6 F. Supp.2d 1089 (D. Minn. 1998).

As the discovery period has now closed, the matter is currently before the Court on the Defendants' Motions for Summary Judgment against the putative class plaintiffs and LSERS, for sanctions against LSERS, and to strike certain of LSERS' affidavits.

Although the Plaintiffs' claims survived the earlier motion to dismiss, the record now establishes that the evidence does not support the Plaintiffs' allegations. Because no reasonable jury could conclude, based upon the record before the Court, that the Defendants acted with scienter, the Plaintiffs' securities claims fail and the Defendants' motions for summary judgment must be granted.

#### **Background**

Digi is a producer of data communications hardware and software. Defendant Kamm was Digi's Chief Executive Officer ("CEO") during the relevant time period. Defendant Wall was Digi's Chief Financial Officer ("CFO") until approximately August 22, 1996.

Digi's common stock trades upon NASDAQ. The Plaintiffs were purchasers of Digi's stock during the purported class period.

During the relevant time period, AetherWorks was a development stage company involved in developing data packet modems and telephone software. Jonathan Sachs was AetherWorks' president and CEO. During 1995 and 1996, AetherWorks was developing a

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<sup>1</sup> Several other statutory and common law claims were dismissed at that time, however.

product called "Jeeves," which was a "unified messaging application," and a series of modems called "ARM." (Sachs Dep. at pp. 8-9, 14-18.)

Digi became interested in AetherWorks' technology and wanted to invest in the company. (Kamm Dep. at pp. 32-33.) Digi's first preference was an acquisition of AetherWorks, but Mr. Sachs was not interested in selling AetherWorks in whole or in part. (Kamm Dep. at pp. 29-30, 226-27.)

Instead, on October 9, 1995, Digi entered into a Note Purchase Agreement with AetherWorks, whereby Digi purchased approximately \$3.35 million in convertible secured notes. Pursuant to the agreement, Digi would also be obligated to purchase approximately \$1.43 million in additional notes if AetherWorks met certain stated milestones for development of its products.

Also according to the agreement, Digi had the ability to convert the notes into 51% or more of AetherWorks' common stock once AetherWorks essentially completed development and marketing of its products, or in the event that AetherWorks missed certain interim milestones. The notes were also convertible if AetherWorks made an initial public offering ("IPO") of its stock, and Digi had the right to request an IPO under certain conditions. Digi also bargained for the right to elect two members to AetherWorks' five-member Board of Directors and to have a right of approval over the fifth member.

No payment on the notes or interest was due for over three years. Although the notes were secured by AetherWorks' tangible and intangible property, the Defendants have revealed during discovery that Digi never really expected or intended that the notes would be repaid. Instead, Digi intended to convert the notes into AetherWorks' common stock and call for an IPO.

Defendant Wall was responsible for determining the correct accounting treatment of the AetherWorks transaction. (Wall Dep. at p. 28.) Wall testified that he reviewed the relevant

accounting literature, including Accounting Principles Board Opinion No. 18 ("APB 18"), regarding the equity method of accounting. (Wall Dep. at pp. 28-32.) Wall testified that he determined that APB 18, the equity method, did not apply because the AetherWorks transaction involved a convertible note rather than common stock, because Digi did not have 20 percent of AetherWorks' voting stock, and because Digi was not controlling AetherWorks operations. (Wall Dep. at pp. 198-201.) Wall reported to the Digi Board of Directors that he had determined, after consulting with Digi's outside auditors at Coopers & Lybrand,<sup>2</sup> that the notes receivable method was the appropriate accounting method for reporting the AetherWorks transaction. (Kamm Dep. at pp. 77-79, 219; Schinas Dep. at p. 175.)

Digi reported the AetherWorks transaction as notes receivable in the financial statements contained in Digi's Form 10-Q for the first quarter of Digi's 1996 fiscal year. (Def. Ex. 23, Form 10-Q.) Digi had engaged the services of Coopers & Lybrand to perform quarterly reviews of Digi's financial statements prior to the issuance of the Form 10-Q's. (Wall Dep. at p. 34; Killmer Dep. at pp. 11, 267-70; Stanley Dep. at pp. 80-81.) Ken Wise of Coopers & Lybrand reviewed the Form 10-Q and conferred with Digi regarding the AetherWorks transaction; Mr. Wise testified that "the majority of the comments were related to the proper classification of the notes receivable disclosure in the cash flow . . . ." (Wise Dep. at pp. 26-27.) Coopers & Lybrand recommended that the AetherWorks note be reclassified from current to non-current "to be in conformity with accounting principles." (Scholtes Dep. at p. 26; Wise Dep. at p. 27.)

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<sup>2</sup> Wall testified that he discussed the terms of the AetherWorks transaction with Ken Wise of Coopers & Lybrand, who concurred that the transaction was properly recorded as a note receivable. (Wall Dep. at p. 32.) Wall told others that he had conferred with Wise regarding the proper accounting method to use. (Kamm Dep. at pp. 78-79; Schinas Dep. at pp. 135-37, 174-75; Wise Dep. at pp. 43-44.) Wise, however, has no recollection of any such conversation. (Wise Dep. at pp. 20-22, 43-44.)

Digi also had its outside legal counsel review its SEC filings, including the Form 10-Q's. (Nicholson Dep. at p. 15.) In discussing the disclosure regarding the AetherWorks transaction, outside counsel determined that Digi was not required to make detailed disclosures regarding the AetherWorks transaction because less than 5% of Digi's total assets were involved and because the transaction did not involve Digi's core operations. (Nicholson Dep. at pp. 49-52.) Counsel determined that the transaction represented "a side venture capital type investment of an amount that was very insubstantial in relation to the company's total assets." (Nicholson Dep. at p. 52.)

After consulting with outside counsel and with Coopers & Lybrand, as set forth above, Digi's first quarter Form 10-Q, dated February 14, 1996,<sup>3</sup> and filed with the SEC, included the following disclosure:

The increase in note receivable arose from the Company's purchase of a secured convertible note from a company engaged in the development of remote access technology. If the company developing such technology attains certain development and financial performance milestones, the Company will be obligated to purchase one additional secured convertible note in the principal amount of approximately \$1.4 million in the second quarter.

(Def. Ex. 23, Form 10-Q at p. 9.)

In early 1996, AetherWorks gained control of another type of technology, the V. Mach. (Schinas Dep. at pp. 68-69.) Digi became interested in investing in the V. Mach technology. (Schinas Dep. at pp. 117-18.)

On June 19, 1996, Digi and AetherWorks entered into additional agreements, which revised certain terms of the previous agreement and under which Digi agreed to purchase up to \$9 million in additional notes. The notes were convertible into up to 62.7% of AetherWorks common stock at Digi's election. The notes were also convertible in the event of an

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<sup>3</sup> During the week of February 14, 1996, Digi's stock fluctuated between \$25 and \$27 per share. (Def. Ex. 66.)

AetherWorks IPO. In addition, Digi was granted a worldwide license to manufacture and sell the V. Mach technology. Again, no payment on the notes or interest was due until December 31, 1998.

At Digi's July 2, 1996, board meeting, Digi's directors discussed the development of a plan regarding a gradual disclosure of Digi's investment in AetherWorks and AetherWorks' technology, in light of the substantial increase in Digi's investment. (Def. Ex. 34, Board Minutes; Kamm Dep. at p. 179; Stanley Dep. at pp. 63-64; Schinas Dep. at pp. 142-44, 151.) The Board of Directors charged Defendant Wall to work with outside counsel "to develop a proposal for orderly disclosure regarding AetherWorks Corporation." (Def. Ex. 36, Memorandum at p. 1; Nicholson Dep. at p. 102.)

Defendant Wall and outside counsel drafted a Memorandum to Digi's board recommending a disclosure plan regarding AetherWorks:

It is recommended that the Company develop a plan for gradual disclosure relative to AetherWorks so that the successful Jeeves system demonstration, expected in the first half of 1997, is not a complete surprise to the investment community. On the other hand, because of the uncertainty and speculative nature of the technology and its prospects, disclosure relative to AetherWorks should be carefully qualified to avoid creating expectations that may not be realized.

(Def. Ex. 36, Memorandum at p. 1; Nicholson Dep. at p. 103; Kamm Dep. at p. 185.)

The Memorandum, primarily authored by outside counsel, included a draft of the proposed text regarding the AetherWorks transaction to be included in the third quarter Form 10-Q.<sup>4</sup> (Def. Ex. 36, Memorandum at p. 3; Nicholson Dep. at p. 103.)

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<sup>4</sup> Digi's Form 10-Q for the second quarter of fiscal 1996, dated May 10, 1996, and filed with the SEC, was not markedly different from the Form 10-Q of the first quarter in regards to the AetherWorks transaction, as the nature of the investment had remained substantially unchanged during that time. (Def. Ex. 24, Form 10-Q.)

The board approved the proposed language for the Form 10-Q. (Kamm Dep. at pp. 193-94.) Digi's Form 10-Q for the third quarter, dated August 12, 1996,<sup>5</sup> and filed with the SEC, thus included the following disclosure:

The increase in notes receivable arose from the sale of the Company's former corporate headquarters facility and from the Company's purchase of secured convertible notes from AetherWorks Corporation, a development stage company engaged in the development of wireless and dial-up remote access technology. The Company is obligated to purchase additional secured convertible notes aggregating \$9 million from time to time at the request of AetherWorks, based on certain conditions. Secured convertible notes held by the Company are presently convertible into 51% of AetherWorks' common stock, and the purchase of \$9 million additional principal amount of secured convertible notes would increase the Company's ownership position upon conversion to 62.7%, based on AetherWorks' present capitalization.

(Def. Ex. 25, Form 10-Q at p. 11.)

Unrelated to the AetherWorks situation, on July 2, 1996, Digi issued a news release, announcing that, although Digi expected to announce record revenues for the third fiscal quarter of 1996, "softness in international sales and higher than anticipated returns will cause earnings to be below analysts estimates." (Def. Ex. 18, News Release.) The following day, Digi's stock fell from \$26 to \$16 3/4 per share. (Def. Ex. 66.) On July 24, 1996, Digi issued another press release, announcing that "[d]espite achieving record sales levels, as previously announced, we fell short of our revenue goals due primarily to softness in international markets." (Def. Ex. 19, News Release.) The following day, Digi's stock fell again, from \$15 1/8 to \$12 per share. (Def. Ex. 66.)

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<sup>5</sup> During the week of August 12, 1996, Digi's stock remained at approximately \$14 per share. (Def. Ex. 66.)

The circumstances regarding the releases of the third quarter earnings caused a "falling out" between CFO Wall and CEO Kamm. (Wall Dep. at p. 6.) Defendant Wall resigned as CFO and left Digi on or about August 22, 1996.

Digi hired Jonathon Killmer, formerly of Coopers & Lybrand, as its new CFO. (Killmer Dep. at pp. 5-6.) Upon assuming his new duties as CFO, Mr. Killmer conducted his own investigation of the accounting for the AetherWorks transaction. (Killmer Dep. at pp. 59-60.) After Killmer looked at the note agreements and supporting documents, researched various accounting materials, and attempted to find examples as to how similar transactions had been accounted for, Killmer concluded that the accounting was appropriate as a note receivable, as it then appeared on the books. (Killmer Dep. at pp. 60, 63.)

Digi's 1996 fiscal year ended on September 30, 1996, shortly after which Coopers & Lybrand began its year-end audit. (Wise Dep. at p. 96.) The night before Digi was to issue its year-end earnings, Mr. Wise of Coopers & Lybrand informed Killmer that Coopers & Lybrand needed more time to determine whether the AetherWorks transaction had been properly accounted for:

They [Coopers & Lybrand] were concerned that they felt there were some fact patterns within the agreement that would lend one to come to a conclusion that consideration should be given to record this transaction on an equity basis rather than on a straight loan basis.

(Killmer Dep. at pp. 56-57.)

Killmer called Defendant Kamm "in a panic" and informed Kamm that Coopers & Lybrand believed that the accounting might have to be changed. (Kamm Dep. at p. 209.) Within three hours, Kamm contacted Wall, who was no longer CFO by that time, and arranged a conference call between Kamm, Wall, Coopers & Lybrand, outside counsel, and Killmer.

(Kamm Dep. at p. 210.)

Killmer was agitated that, according to his interpretation of events, Coopers & Lybrand was changing its position as to the accounting issue and had waited until the night before the year-end earnings were to be released to raise the issue:<sup>6</sup>

A: [T]he discussion was more of why were they changing their position at this point in time, trying to get an understanding of why they would have already passed on this transaction and, all of a sudden, changed their mind.

....

Q: Did they agree with your statement just now that they had previously passed on the transaction?

A: They certainly couldn't deny it, because they had done quarterly reviews, and part of the responsibility of a quarterly review is to inform management of any significant deviation from what they considered to be appropriate to the generally accepted accounting practices at that point in time.

(Killmer Dep. at pp. 113-14.)

On November 14, 1996, Digi issued a press release, which was drafted by Killmer and reviewed by Coopers & Lybrand and outside counsel. (Killmer Dep. at pp. 124-25.) The document included the following disclosure:

The Company is releasing only preliminary, unaudited results, as Digi has not, at this time, resolved the appropriate accounting treatment of its investment in AetherWorks Corporation, a development stage company engaged in the development of wireless and remote access technology. Through November, 1996, Digi has purchased secured convertible notes for approximately \$6.3 million from AetherWorks, and is obligated to purchase up to an additional \$7.5 million of secured convertible notes from time to time at the request of AetherWorks, based on certain conditions. Secured convertible notes held by Digi are presently convertible into approximately 54 percent of AetherWorks' common stock and the purchase of \$7.5 million additional principal amount of secured convertible notes would increase the Company's ownership position upon conversion to 62.7 percent, based on AetherWorks' present capitalization.

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<sup>6</sup> David Stanley, another member of Digi's board, also expressed his displeasure to Mr. Wise of Coopers & Lybrand, in a private telephone conversation between the two. (Stanley Dep. at pp. 78-79.) Stanley "expressed a high degree of disappointment at the fact that this matter was raised at what I would call the 11<sup>th</sup> hour and 59<sup>th</sup> minute." (Stanley Dep. at p. 78.) Wise responded that he had never actually reviewed the AetherWorks contract and, upon reviewing the contract, issues were raised. (Stanley Dep. at p. 79.)

In view of the fact that generally accepted accounting principles and SEC rules in accounting for this type of investment, either as an investor or through equity accounting or consolidation, are subject to differing interpretations and judgments, the company is carefully assessing its position to determine the appropriate accounting treatment.

The preliminary, unaudited results for the fourth quarter and year presently reflect the investment as a long-term receivable and has not recorded any results relating to AetherWorks. If Digi should consolidate such results or utilize the equity method of accounting, Digi presently estimates that its share of the operating losses of AetherWorks for the year ended September 30, 1996, would be in the range of \$.15 to \$.20 per Digi share.

(Def. Ex. 20, News Release at p. 3.)

The estimated loss per share, as disclosed in the press release, had been calculated by Killmer, who was of the opinion that, even if equity accounting was adopted, Digi was required to report only a proportionate share of AetherWorks' losses, based upon Digi's maximum ownership position in AetherWorks upon conversion of the notes. (Killmer Dep. at pp. 157-60; Kamm Dep. at pp. 220-22; Stanley Dep. at pp. 73-74.)

The following day, Digi's stock fell from \$13 to \$11 7/8 per share. (Def. Ex. 66.)

Additional consultants from Coopers & Lybrand's national consulting office were brought in to determine the appropriate accounting method for the AetherWorks transaction. (Kerans Dep. at pp. 27-29, 76, 107; Wise Dep. at pp. 31-36.) Accountants from Coopers & Lybrand met with AetherWorks to gather factual information about the business relationship and the specific nature of the transaction. (Kerans Dep. at pp. 69-70; Killmer Dep. at pp. 100-02.)

Eventually, Coopers & Lybrand decided to recommend that Digi adopt equity accounting for the AetherWorks transaction. Coopers & Lybrand issued its report, dated December 7, 1996, as follows:

The ultimate conclusion reached in connection with this transaction was that the equity method of accounting was appropriate and that the proportionate share of the AetherWorks losses that Digi should record is 100%. The equity method treatment stems from Digi's clear ability to exhibit significant influence over

Digi. This is evidenced by Digi's board representation and AetherWorks clear economic dependence on Digi, at least during fiscal 1996 as evidenced by Digi funding 100% of AetherWorks operating losses . . . . It should be noted that at this time, AetherWorks has no resources which it can utilize to pay either the principal or interest on the notes. With significant influence clearly established the equity method at a minimum is appropriate.

(Pl. Ex. 42, Digi Audit at CL 0028.)

Coopers & Lybrand's reasoning and conclusion were discussed at Digi's Audit Committee meeting of December 2, 1996. (Pl. Ex. 44, Minutes.) Killmer remained unconvinced that the equity method was appropriate and specifically disagreed that Digi's statements should reflect 100% of AetherWorks' losses. (Killmer Dep. at pp. 175-84.) Specifically, Killmer disagreed that Digi exercised "significant influence" over AetherWorks. (Killmer Dep. at pp. 177-78.) Nevertheless, Digi decided to accept Coopers & Lybrand's recommendation on the matter, which also meant that Digi was required to issue restatements of Digi's first three quarters of the 1996 fiscal year, in which the notes receivable method had been used. (Pl. Ex. 44, Audit Committee Minutes; Killmer Dep. at pp. 175-84.)

On December 23, 1996, Digi issued a press release to report that it had "adjusted previously reported earnings for its fiscal year ended September 30, 1996 to \$9,300,220, or \$.69 per share from preliminary, unaudited earnings of \$14.8 million or \$1.10 per share for the 1996 fiscal year." (Def. Ex. 21, News Release at DIGI 7730.) The disclosure continued as follows:

After research and consultation with its independent accountants and legal counsel, the Company has determined that it should be reporting the investment in AetherWorks on the equity method and has recorded a \$3.6 million loss which represents 100 percent of the AetherWorks' net loss for the year ended September 30, 1996.

.....  
Digi has restated each of its Form 10-Q quarterly filings to reflect the recording of the AetherWorks losses.  
.....

The Company anticipates that AetherWorks losses will be greater in fiscal 1997 than those reported in fiscal 1996, and that all, or a major portion, of these losses will be included in the Company's results of operations for 1997.

(Def. Ex. 21, News Release at DIGI 7731-32.)

Digi's stock fell from \$12 3/4 to \$8 7/8 per share the following day. (Def. Ex. 66.)

Defendant Kamm resignation as Digi's president and CEO was announced on January 6, 1997.

(Def. Ex. 22, News Release.)

## Discussion

### A. Standard of Review

Summary judgment is proper if there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). Enterprise Bank v. Magna Bank of Missouri, 92 F.3d 743, 747 (8<sup>th</sup> Cir. 1996). The court must view the evidence and the inferences which may be reasonably drawn from the evidence in the light most favorable to the nonmoving party. Enterprise Bank, 92 F.3d at 747. However, as the Supreme Court has stated, "summary judgment procedure is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed to 'secure the just, speedy, and inexpensive determination of every action.'" Fed. R. Civ. P. 1. Celotex Corp. v. Catrett, 477 U.S. 317, 327, 106 S. Ct. 2548, 2555, 91 L. Ed. 2d 265 (1986).

The moving party bears the burden of showing that there is no genuine issue of material fact and that it is entitled to judgment as a matter of law. Enterprise Bank, 92 F.3d at 747. The nonmoving party must then demonstrate the existence of specific facts in the record which create a genuine issue for trial. Krenik v. County of Le Sueur, 47 F.3d 953, 957 (8<sup>th</sup> Cir. 1995). A party opposing a properly supported motion for summary judgment may not rest upon mere allegations or denials, but must set forth specific facts showing that there is a genuine issue for

trial. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 256, 106 S. Ct. 2505, 2514, 91 L. Ed. 2d 202 (1986); Krenik, 47 F.3d at 957.

#### **B. Securities Fraud**

Private causes of action brought pursuant to Rule 10b-5 are of judicial creation, as the text of § 10(b) of the Securities Exchange Act of 1934 does not provide for private claims. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 358, 111 S. Ct. 2773, 2779, 115 L. Ed. 2d 321 (1991). Rule 10b-5, promulgated by the SEC, prohibits fraudulent conduct in the sale and purchase of securities. In re NationsMart Corp. Securities Litigation, 130 F.3d 309, 320 (8<sup>th</sup> Cir. 1997). The essential components of a Rule 10b-5 claim are scienter, causation, and damages. Arthur Young & Co. v. Reves, 937 F.2d 1310, 1327 (8<sup>th</sup> Cir. 1991).

Section 20(a) of the Securities Exchange Act extends liability under Rule 10b-5 to any “controlling person.” 15 U.S.C. 78t(a). In re NationsMart, 130 F.3d at 320. In order to state a claim for controlling person liability under Section 20(a), the Plaintiffs must show: (1) a primary violation by Digi; and (2) the alleged control persons exercised control over the general operations of Digi and had the power to determine the acts or omissions upon which the primary violation was predicated. In re Digi, 6 F. Supp.2d at 1101. Therefore, if the Plaintiffs cannot show a primary violation under Rule 10b-5, then the claims under Section 20(a) must also fail.

In the present matter, the Defendants argue that the Plaintiffs’ claims of securities fraud under Rule 10b-5 and Section 20(a) must fail because the Plaintiffs cannot show the necessary elements of scienter and causation. Because the issue of scienter is fatal to the Plaintiffs’ claims, the Court does not reach the issue of causation.

Proof of scienter, or the “intent to deceive, manipulate, or defraud,” is necessary to prevail in a Rule 10b-5 action. In re NationsMart, 130 F.3d at 320, quoting Ernst & Ernst v.

Hochfelder, 425 U.S. 185, 193, 96 S. Ct. 1375, 1381, 47 L. Ed. 2d 668 (1976). Scienter requires that the Defendants knew or recklessly disregarded that their statements were false. In re Green Tree Financial Corp. Stock Litigation, 61 F. Supp.2d 860, 870 (D. Minn. 1999). Recklessness under Rule 10b-5 requires more than inexcusable or gross negligence. In re Green Tree, 61 F. Supp.2d at 870. Recklessness encompasses behavior that is an extreme departure from ordinary care, which presents a danger of misleading the public that is either known to the defendants or so obvious that the defendants must have been aware of it. In re Green Tree, 61 F. Supp.2d at 870-71.

In the present matter, the Plaintiffs' allegations of scienter were sufficient to survive a motion to dismiss under Rule 12(b)(6):

[A]t this stage of the litigation, the Court must reject defendants' contention that their accounting treatment cannot support an inference of fraud because (1) accounting principles are complex and subject to differing interpretations and (2) AP[B] 18 does not refer to convertible notes. Plaintiffs allege that defendants' use of the note receivable method was not only mistaken, but also clearly inappropriate with regard to the AetherWorks investment; defendants respond that the appropriate method of accounting for the AetherWorks investment was open to interpretation during the class period. The evidence, in the form of expert testimony or otherwise, ultimately may prove defendants to be correct, but the Court cannot resolve this issue on a motion to dismiss.

In re Digi, 6 F. Supp.2d at 1098.

Now that discovery is closed, the facts do not support the Plaintiffs' allegations. No reasonable jury could find, based upon the record before the Court, that the Defendants' statements regarding the AetherWorks transaction were either known to be false or so obviously wrong that the Defendants must have been aware of it. To the contrary, the evidence establishes

that the issues were hotly contested and subject to differing interpretations among accountants, both when the relevant decisions were being made<sup>7</sup> and also in hindsight.

Mr. Killmer, Defendant Wall's successor as CFO and formerly of Coopers & Lybrand, performed his own research of the AetherWorks transaction and concurred with the previous accounting as a note receivable. Killmer, who is not an individual defendant, testified that, although he ultimately determined that the notes receivable method was appropriate, the issue was open to interpretation:

It was a very unusual transaction. There is no authoritative literature that specifically addresses this kind of transaction. Therefore, it's very difficult to find a transaction that's even similar in nature to it.

....

I'm just relying on over 30 years of experience of a professional accountant. I can tell you I never saw a transaction similar to this.

....

I mean, the whole transaction was unusual in its whole nature. The fact that you had a note agreement that was coupled with a marketing agreement, a licensing agreement; with board membership, yet no voting rights with the board; all sorts of constraints upon the lender as to how they could exercise their equity position; very restrictive requirements on the board members on how they could cast their votes.

(Killmer Dep. at pp. 64-65.)

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<sup>7</sup> The undisputable fact that the Defendants were in consultations with their outside accountants and legal counsel during the period in question is in itself evidence which tends to negate a finding of scienter. See S.E.C. v. Caserta, 75 F. Supp.2d 79, 94-95 (E.D.N.Y. 1999) ("Good faith reliance on the advice of an accountant or an attorney has been recognized as a viable defense to scienter in securities fraud cases" where the defendant can show that it "made a complete disclosure, sought the advice as to the appropriateness of the challenged conduct, received advice that the conduct was appropriate, and relied on that advice in good faith"). The Plaintiffs respond that the Defendants, particularly Defendant Wall, may not have revealed enough to Coopers & Lybrand regarding the transactions to make the consultations meaningful. The Plaintiffs' position is not supported by the record, however, as set forth in the Factual Background, *supra*. The record conclusively shows that, at a minimum, outside legal counsel and Coopers & Lybrand reviewed Digi's SEC filings, including the quarterly Form 10-Q's. Ken Wise of Coopers & Lybrand testified that he reviewed the first quarter Form 10-Q and conferred with Digi regarding the AetherWorks transaction, specifically regarding the proper classification of the notes receivable. (Wise Dep. at pp. 26-27.)

Similarly, Edward Kerans, who was involved in the consultations between Digi and Coopers & Lybrand when the decision to change to the equity accounting method was made,<sup>8</sup> testified that “we were looking at all the possible alternatives because there’s no clear guidance—there was no clear guidance in the literature at that time, and there really isn’t today in terms of how to account for these arrangements.” (Kerans Dep. at p. 49.) Kerans testified that he was not certain that APB 18 applied to the AetherWorks transaction because, for example, APB 18 referred to 20 percent of common stock and testified that “I don’t believe APB 18 is constructed to refer to financing.” (Kerans Dep. at p. 72.)

Even when reviewing the transaction in hindsight, the experts are in disagreement as to which method of accounting was appropriate. The Plaintiffs’ expert, Arthur Cobb, testified that the equity accounting method was required in light of the fact that Digi had “substantial influence over AetherWorks, and that the influence was established the date of the agreement, as were the conversions the day of the agreement, as was the board representation the day of the agreement.” (Cobb Dep. at p. 116.) Indeed, these are the same factors of “significant influence” that caused Coopers & Lybrand to ultimately conclude that the equity accounting method was appropriate. (Pl. Ex. 42, Digi Audit at CL 0028.)

The Defendants’ expert, Donald Nicholson of Arthur Anderson LLP, on the other hand, concluded that the equity method would not have been appropriate for the first and second

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<sup>8</sup> In their memorandum, the Plaintiffs stated that Coopers & Lybrand found that the necessity of using the equity accounting method was “obvious.” (Pl. Mem. at pp. 2, 20.) This is not an accurate representation of the record. In fact, as set forth in detail in the Factual Background, *supra*, and above, the record shows exactly the opposite. The evidence in the record from Coopers & Lybrand, including the testimony of the accountants involved and the work papers submitted, consistently states that the issue was complex and open to interpretation, and that technical consultants from Coopers & Lybrand’s national office had to be brought in on the matter. (Kerans Dep. at pp. 27-29; Wise Dep. at pp. 33-35.)

quarter of fiscal 1996, before Digi's second investment with AetherWorks. (Def. Ex. 68, Report at pp. 7-9.) Nicholson based his conclusion on his findings that, prior to the restructuring of the first investment, Digi did not have the ability to immediately convert its debt into a majority of AetherWorks equity and did not control the Board of Directors. (Def. Ex. 68, Report at pp. 7-9.)

The issue is not which of the experts is correct, and the Court will not weigh one opinion against another. Rather, the issue is whether the Defendants were so obviously wrong that a reasonable jury could conclude that the Defendants were either intentionally or recklessly erroneous in their position. No reasonable jury could find that that requirement has been met here.

Indeed, when the Plaintiffs' expert was asked whether the appropriate accounting treatment should have been "obvious," Mr. Cobb answered as follows:

I think *a reasonable reading* of those two items within the document [the note purchase agreement], taking them out, would have indicated the economic substance of the transaction to have required equity accounting.

(Cobb Dep. at pp. 210-11) (emphasis added).

The entirety of the Plaintiffs' evidence, at best, stands for the proposition that the equity method of accounting was appropriate and that the Defendants' use of the notes receivable method was negligent. Even that position would be open to debate were the issue relevant.

In fact, on September 28, 1998, the SEC issued a letter to Digi questioning the application of the equity method to the AetherWorks transaction, referencing the very issues that had been discussed between Digi and Coopers & Lybrand:

Tell us why you believe it is appropriate to apply the equity method of accounting to your transactions with AetherWorks, given that you did not hold any common stock in AetherWorks.

....

Also, tell us why it was appropriate for you to recognize 100% of the loss of AetherWorks. Using the percentage of financing provided as a basis for allocation does not appear contemplated by GAAP.

(Def. Ex. 48 at DIGI 7142-43.)

Digi wrote back, setting forth its position in detail, including an explanation of the transactions in question and the decision-making process. (Def. Ex. 49 at DIGI 7152-59.)

The SEC responded as follows:

We have reviewed your responses, however, we do not believe it is appropriate for you to apply the accounting guidance under APB 18 to your investment in the AetherWorks Convertible Note since you do not have an investment in any voting stock in AetherWorks.

(Def. Ex. 50 at DIGI 7364.)

In addition to the fact that the record could not support a reasonable conclusion that the Defendants intentionally or recklessly misrepresented the nature of the AetherWorks transaction, the record is also devoid of any evidence establishing any plausible reason why the Defendants would have done so.

Strictly speaking, motive is not required to sustain a claim of securities fraud. Brogren v. Pohlad, 960 F. Supp. 1401, 1404 (D. Minn. 1997). Nevertheless, courts have looked to the existence of a motive to commit fraud in order to support the inference that fraud occurred. Brogren, 960 F. Supp. at 1404. Where no motive appears, the quantum of proof of a defendant's fraudulent activity required to justify the inference that it was undertaken with scienter is correspondingly greater. Brogren, 960 F. Supp. at 1404. Here, the Plaintiffs' allegations of motive are unsupported by the facts.

When addressing the Plaintiffs' allegations pursuant to the motion to dismiss, the district court noted that "performance-based compensation alone, or combined with only poor economic

results or conclusory allegations, is insufficient to support a claim for fraud.” In re Digi, 6

F. Supp.2d at 1098. The Court nevertheless found as follows:

In the circumstances presented here, in which the individual defendants’ performance-based compensation could be enhanced significantly by inflated financial results caused by particularized material omissions of fact and misleading accounting practices, such compensation constitutes evidence of conscious misbehavior.

In re Digi, 6 F. Supp.2d at 1098.

The evidence has not supported the Plaintiffs’ theory, however. The Defendants have set forth evidence in the record establishing that compensation, including bonuses, for Defendants Wall and Kamm was not affected by the AetherWorks transaction, and instead that the individual Defendants’ compensation was based upon a plan prepared by Digi’s board at the beginning of the fiscal year. (Def. Ex. 27, Shareholder Statement at pp. 8-10; Def. Ex. 65, Employment Agreement at DIGI 6837.) John Schinas, Digi’s Chairman of the Board during the relevant time period, testified in his affidavit as follows:

Digi’s Board offered bonuses to Digi’s management based upon the performance of the Company in relation to the Company’s business plan, or budget, for the fiscal year. The business plan for each fiscal year was reviewed and approved by Digi’s Board before the start of the fiscal year that the plan related to. The business plan related solely to Digi’s core businesses, because those were the businesses that Digi’s management had the ability to control.

Digi’s business plan for fiscal year 1996 was established before Digi made any investment in [AetherWorks] and did not include any component relating to the AetherWorks investment or its performance. . . .

Digi’s Board would not have considered anything relating to AetherWorks as relevant to whether or not Digi’s management had earned bonuses.

(Schinas Aff. at ¶¶ 3-5.)

The Plaintiffs have not submitted any evidence in the record to create an issue of fact as to whether the individual Defendants’ compensation was affected by the AetherWorks transaction. The evidence also does not show that Defendants Kamm or Wall sold their Digi

stock at any relevant time period relating to the Plaintiffs' claims. Instead, the Plaintiffs propounded a new theory that Digi "succumbed to intense pressure to meet analyst's expectations by the use of improper accounting." (Pl. Mem. at p. 1.)

For example, the Plaintiffs point to Defendant Kamm's testimony that, on January 23, 1996, he provided earnings guidance for Digi's 1996 fiscal year and for 1996's second quarter. (Kamm Dep. at p. 116.) The Plaintiffs then allege that "Kamm thus essentially committed Digi to reporting a level of earnings that he surely knew Digi could not meet if it properly accounted for the [AetherWorks] investment using the equity method." (Pl. Mem. at p. 5.) However, the evidence establishes that the decision to record the AetherWorks transaction as a note receivable had already been made before Defendant Kamm made the statements in question. (See Factual Background, *supra*; Wall Dep. at pp. 30-31.) The Plaintiffs theorize that pressure to meet projected earnings caused the improper accounting decision; yet the evidence shows that the accounting decision was made first, before the earnings projections.

In addition, Digi revealed that it had failed to meet analyst's expectations for the third quarter of fiscal 1996 even before Digi converted its accounting of the AetherWorks transaction to the equity method. Digi issued press releases on July 2 and July 24, 1996, announcing that earnings were below analysts' estimates and revenue goals were not met. (Def., Exs. 18, 19.) Digi's stock fell from \$26 to \$16 3/4 per share and then from \$15 1/8 to \$12 per share following these announcements. (Def. Ex. 66.)

The breakdown of the Plaintiffs' theories regarding the Defendants' alleged motives further emphasizes the overall failure of the record to create a triable issue as to scienter. In short, although the Plaintiffs' theory for relief was plausible, the facts did not turn out to support the theory, and summary judgment must now be granted.

### C. Defendants' Motions Against Plaintiff LSERS

The Defendants also move for sanctions against Plaintiff LSERS and to strike certain of LSERS' submissions.

15 U.S.C. § 78u-4(c)(1) provides in relevant part that, upon final adjudication of any private action arising under the Exchange Act, "the court shall include in the record specific findings regarding compliance by each party and each attorney representing any party with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure as to any complaint, responsive pleading, or dispositive motion"; if the court finds such a violation, "the court shall impose sanctions," although only after giving the party or attorney involved notice and an opportunity to respond, pursuant to 15 U.S.C. § 78(c)(2). Gurary v. Winehouse, 190 F.3d 37, 47 (2<sup>nd</sup> Cir. 1999).

The Defendants move for sanctions against LSERS based upon, *inter alia*, allegedly inadequate pre-filing investigation of its claims, alleged failure to prosecute its case, and overall bad faith in bringing the suit. The Defendants also claim that LSERS obstructed the Defendants' discovery requests "at every turn" and violated numerous orders of the magistrate judge. Due to the extensive pretrial history and discovery issues that were before the magistrate in this matter, the Court will refer the issue of sanctions against LSERS to Magistrate Judge Raymond Erickson, in light of his history with this file.

The Defendants also moved to strike the affidavits of I. Walton Bader and Henry F. Otto, submitted in opposition to the Defendants' Motion for Summary Judgment.<sup>9</sup> The Court finds that the majority of Mr. Bader's affidavit was patently improper. Most of the affidavit is

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<sup>9</sup> Mr. Bader submitted a separate affidavit in opposition to the Defendants' Motion for Sanctions, which affidavit is not at issue here.

comprised of recitations of the allegations of the complaint, unsupported by facts and unaccompanied by any basis for Mr. Bader's personal knowledge. The remainder of the affidavit, to the extent it is not improper, would not affect the outcome of the case. The motion to strike the affidavit will therefore be granted.

Mr. Otto's affidavit relates to the issue of causation and, as the subject was not part of the Court's consideration of this matter, the motion to strike Mr. Otto's affidavit is denied as moot.

### **Conclusion**

Although the Plaintiffs' allegations were sufficiently set forth in their complaints so as to survive the earlier motion to dismiss, the Plaintiffs now lack the necessary evidence in support of their allegations to withstand summary judgment. Due to the fact that the evidentiary record would not enable a reasonable jury to conclude that the Defendants acted with scienter, the Plaintiffs' claims of security fraud must be dismissed as a matter of law.

For the reasons stated, **IT IS HEREBY ORDERED:**

1. The Motion by the Defendants for Summary Judgment against the Class Plaintiffs (Doc. No. 110) is **GRANTED**.

2. The Class Plaintiffs' Complaint is **DISMISSED WITH PREJUDICE**.

3. The Motion of the Defendants for Summary Judgment against Plaintiff Louisiana State Employees Retirement System (Doc. No. 116) is **GRANTED**.

4. Louisiana State Employees Retirement System's Complaint is **DISMISSED WITH PREJUDICE**.

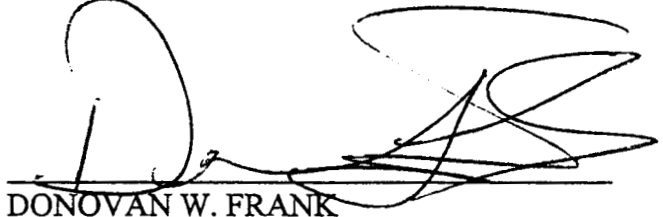
5. The Motion by the Defendants to Strike the Affidavits of I. Walton Bader and Henry F. Otto (Doc. No. 121) is **GRANTED IN PART** and **DENIED IN PART**. The Motion is

**GRANTED** as to the Bader affidavit, submitted in opposition to the summary judgment motion, and **DENIED** as to the Otto affidavit.

6. The Defendants' Motion for Sanctions Against Plaintiff Louisiana State Employees Retirement System is hereby referred to Magistrate Judge Raymond Erickson.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: August 17<sup>th</sup>, 2000

  
DONOVAN W. FRANK  
Judge of United States District Court