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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

In re GUESS?, INC.)
SECURITIES LITIGATION)
CV 01-00871 LGB (RNBx)
ORDER GRANTING DEFENDANTS'
MOTION TO DISMISS FOR FAILURE
TO STATE A CLAIM
This Document Relates To:)
ALL ACTIONS)

I. INTRODUCTION

Guess?, Inc. ("Guess"), a maker of fashion apparel, experienced financial difficulties during the 2000 calendar year. As a result, its stock value dropped and the current securities litigation was instituted against defendants Guess, Maurice Marciano, Paul Marciano, Armand Marciano and Brian Fleming. The class action complaint alleges violations of the Exchange Act, section 10(b), Securities Exchange Commission ("SEC") Rule 10b-5, and the Exchange Act, section 20(a). Defendants' bring the present motion to dismiss all claim for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6) ("Rule 12(b)(6)").

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1 II. FACTUAL AND PROCEDURAL BACKGROUND

2 The following facts are derived from the complaint, records
3 referenced in the complaint, or from public records properly
4 before the Court¹:

5 Guess is primarily engaged in the business of designing,
6 marketing and distributing casual clothing, accessories, and
7 related consumer products. Compl. ¶ 1. It markets its clothing
8 lines through two primary distribution channels: (1) wholesale
9 distribution, through which Guess sells its product to large
10 upscale department stores; and (2) retail distribution, which
11 consists of sales directly to the public through full-price
12 retail and discount factory outlet stores owned and operated by
13 Guess. Id. For the fiscal year that ended on December 31, 1999
14 ("fiscal 1999"), Guess recorded roughly equal revenues from its
15 wholesale and retail distribution channels. Id.

16 Maurice Marciano is one of the founders of Guess. Id. ¶ 14a.
17 He served as Co-Chairman of the Board of Directors and Co-Chief
18 Executive Officer of Guess through the time covered by this
19 action. Id. He is also one of the largest shareholders of Guess.
20 Id. Paul Marciano shared Maurice Marciano's duties as Co-Chairman
21 of the Board of Directors and Co-Chief Executive Officer of
22 Guess. Id. ¶ 15a during this time period. Paul Marciano further
23 served as Guess's President and Chief Operating Officer from
24

25 ¹See, e.g., Fed. R. Evid. 201; Plevy v. Haggerty, 38 F.
26 Supp. 2d 816, 821, 835 (C.D. Cal. 1998) (SEC filings, stock
27 prices and news articles may be considered under a motion to
28 dismiss).

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1 September 1992 to December 2000. Id. He also enjoyed sizable
2 holdings of Guess stock. Id.

3 Another defendant, Armand Marciano, served as Guess's
4 Executive Vice President and Assistant Secretary during the time
5 period covered by this complaint. Id. ¶ 16a. He was also one of
6 the company's largest shareholders and served on the Guess Board
7 of Directors during this time. Id. The last individual defendant,
8 Brian Fleming, served as Guess's Executive Vice President and
9 Chief Financial Officer from July 20, 1998 to November 16, 2000.
10 Id. ¶ 17a.

11 On February 14, 2000, Guess announced that it had net
12 earnings for fiscal 1999 of \$51.5 million on revenues of \$599.7
13 million. It also announced that its inventories as of December
14 31, 1999 were valued at \$106.6 million. Id. ¶ 54. At the same
15 time, Guess admitted that "certain inventory costs and related
16 costs of goods should have been recognized in the third quarter
17 [of fiscal 1999] rather than the fourth quarter." Id. As a result
18 of this accounting issue, Guess restated its 1999 third quarter
19 results and announced that adjustments in the fourth quarter
20 "have produced unusually high gross margin rates for the fourth
21 quarter, which should not be expected in future results." Id.
22 Guess also announced that it was "strengthening controls and
23 procedures surrounding its inventory cost accounting to assure
24 the accuracy of future quarterly inventory and gross margin
25 results, and the company has engaged outside consultants to
26 assist it in doing so." Id. ¶ 55.

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1 In its SEC 10-K annual report, filed March 30, 2000, Guess
2 discussed its current business situation and made projections for
3 the future. At the end of fiscal 1999, Guess operated 92 full-
4 price and 54 factory outlet stores in the United States. Defs.'
5 Ex. 1 at 11. These factory outlet stores were used primarily to
6 sell outdated fashion items and other slow-moving merchandise at
7 severely discounted prices. Compl. ¶ 28. In its 10-K report,
8 Guess stated: "We plan that our retail division will be our
9 primary growth initiative over the next three to five years."
10 Defs.' Ex. 1 at 12. Supporting this growth was Guess's plan to
11 open a number of new stores, increase the average size of the new
12 stores, and increase sales productivity of all stores. Id.

13 At the same time, Guess discussed its opening of a "new,
14 automated distribution center in Louisville, Kentucky" to replace
15 its distribution center in Los Angeles, California. Id. at 14.
16 Its "new, 500,000 square-foot facility . . . is expected to . . .
17 allow [Guess] to reduce distribution operating costs per unit,
18 reduce [its] shipping costs and provide better service to [its]
19 customers." Id. This new center was expected to be fully
20 operational in the second quarter of fiscal year 2000. Id. Guess
21 stated that it uses "fully integrated and automated distribution
22 systems" in its distribution centers, providing "timely,
23 controlled, accurate and instantaneous updates to the
24 distribution. Id. at 19. During the fourth quarter of 1999,
25 enhanced ability to estimate reserves through improved processes
26 and more current and accurate data led Guess to revise its

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1 estimate of certain reserves. Id. at 27. This resulted in a
2 reduction of cost of sales of \$2.3 million and an increase of
3 gross margin of \$2.3 million, or 2.4%. Id. Guess also represented
4 that it valued its inventory at the lower of cost or market.
5 Compl. ¶ 61.

6 In cautioning against its forward-looking statements, Guess
7 stated that "Certain statements . . . including those relating to
8 . . . our cost containment efforts . . . are forward-looking
9 statements. Such statements involve risks and uncertainties,
10 which may cause results to differ materially from those set forth
11 in these statements." Defs.' Ex. 1 at 29. The 10-K went on to
12 identify "[i]mportant factors that could cause actual results in
13 future periods to differ materially from our forward-looking
14 statements," such as:

- 15 1) Possible cancellation of wholesale orders, which could
16 have a material adverse effect on Guess's financial
17 condition and results of operations;
- 18 2) The success of Guess's programs to strengthen its
19 inventory cost accounting controls and procedures,
20 which could have a material adverse effect on its
21 financial condition and results of operation; and
- 22 3) The success of technology to be used in Guess's new
23 distribution center, which could have a material effect
24 on its financial condition and results of operation.

25 Id. Nevertheless, Guess represented that the results were in
26 accordance with GAAP. Compl. ¶ 56.

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1 At some point in March 2000, an inventory control committee
2 allegedly reported the existence of approximately \$30 million in
3 inventory that was 1 ½ to 2 ½ seasons old. Id. ¶ 46. A month
4 later, on April 27, 2000, Guess filed an S-3 Registration
5 Statement. Defs.' Ex. 3 at 128. In the S-3, Guess related:

6
7 The efficient operation of our business is very
8 dependent on our information and accounting systems. .
9 . . Due to our recent rapid growth and increased
10 international sourcing, we have experienced some
11 difficulties with our current management information
12 and accounting systems. In addition, segments of our
13 current information and accounting systems are manually
14 intensive. We have in the past and may in the future
15 experience errors in entering and processing
16 information. While we are taking additional action to
17 reduce the risks associated with these situations,
18 including to purchase a new enterprise-wide information
19 system that could integrate all of our business
20 functions, we can give no assurances that these risk
21 will not have a material adverse effect on our results
22 of operations and financial condition.

23
24 Id. at 140. The S-3 then refers the reader to the "Management's
25 Discussion and Analysis of Financial Condition and Result of
26 Operations." Id. at 141.

1 There, Guess reports that, on February 16, 2000, it filed an
2 amendment to its quarterly report on Form 10-Q for the three and
3 nine month periods ended September 25, 1999. Id. at 151. It did
4 so in order to restate Financial Statement and revise the
5 Management's Discussion because it had learned that certain
6 inventory costs and related cost of sales should have been
7 recognized in the third quarter. Id. Later, Guess reiterated its
8 belief that "during the fourth quarter of 1999, we enhanced our
9 ability to estimate reserves through improved processes and more
10 current and accurate data. As a result, we revised our estimate
11 of certain reserves. This resulted in a reduction of cost of
12 sales of \$2.3 million and an increase of gross profit or [sic]
13 2.4%." Id. at 153.

14 In Guess's May 1, 2000 Press Release, the company discussed
15 its rising inventory levels. Compl. ¶ 58. "Inventories were
16 \$135.5 million [for the first quarter of 2000] . . . versus
17 \$106.6 million at year-end and \$70.9 million a year ago. . . .
18 [I]nventories were up 25.1% from year-end and 71.7% from a year
19 ago. The majority of these higher inventory levels are the result
20 of significantly increased product sales, substantially higher
21 wholesale backlog and our retail expansion program. . . . Our
22 wholesale backlog continues at high levels reflecting the
23 popularity of our brand and product." Id. The Form 10-Q, filed on
24 May 16, 2000 for the first quarter, confirmed the results
25 announced in the press release and stated the results were in
26 accordance with GAAP. Id. ¶ 59.

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1 On May 4, 2000, an analyst, David P. Campbell of Merrill
2 Lynch, issued a report rating Guess stock "Long Term Accumulate."
3 Id. ¶ 62. Campbell noted that Guess inventories included only
4 "\$10m of excess merchandise . . . The company plans to liquidate
5 the excess inventories through their outlet stores and off price
6 channels over the next two quarters." Id.

7 In June, however, Bloomberg News Service reported that the
8 stock dropped 2 3/8 or 15% after a Salomon Smith Barney broker
9 stated that the company inflated its backlog numbers by including
10 orders from its retail stores in its wholesale backlog. Id. ¶ 63.
11 On June 23, 2000, Maurice Marciano said the email was "completely
12 false because we do not include sales to our own stores in
13 wholesale backlog." Id. During the same time period, in June
14 2000, the inventory control committee allegedly reported that \$20
15 million in inventory could only be sold, if at all, at severely
16 discounted prices. Id. ¶ 46. A few days after Marciano's
17 statement, on July 6, 2000, Guess announced that the "Company had
18 unfilled wholesale orders from department and specialty stores
19 customers of \$162.4 million, a 62% increase from a year ago." Id.
20 ¶ 64. Paul Marciano commented, "[d]emand for our brand and
21 product remains strong." Id.

22 In its July 31, 2000 Press Release announcing its second
23 quarter earnings, Guess reported that its earnings increased
24 72.3% to 12.1 million from earnings the year before of \$7.0
25 million. Id. ¶ 67. Paul Marciano commented: "We are very pleased
26 with our seventh consecutive quarter of strong revenue and
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1 earnings growth." Id.

2 Maurice Marciano commented, in a concurrent statement with
3 the Press Release:

4
5 While we are still working through some excess
6 inventory by primarily utilizing wholesale off-price
7 and factory store channels, the amount of inventory
8 overage at the end of the second quarter is less than
9 \$15 million. The year-over-year comparison for
10 inventory at the end of the second quarter is
11 exaggerated by several factors: inventories at July 1,
12 2000 include \$14.2 million for Guess Canada, the
13 abnormally low inventory in the year-ago period, the
14 inventory necessary for new stores, and inventory
15 necessary to support our retail comparable sales gains.
16 The remaining increases in inventory is in line with
17 sales trends and is necessary to support our
18 substantially higher wholesale backlog. We expect to
19 have the inventory overage substantially cleared by
20 early in the fourth quarter.

21
22 Id. ¶ 68. Guess's August 14, 2000 SEC Form 10-Q contained the
23 quarterly financial statements and reported inventories of
24 \$173,711,000, costs of goods sold of \$100,080,000 and accounts
25 payable of \$65,559,000. Id. ¶ 69. Again, inventory was
26 represented at the lower of cost or market. Id. Unfilled

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1 wholesale backlog orders increased 61.4% to \$162.4 million. Id.

2 Following these reports, several analysts, including Lee F.
3 Backus of the Buckingham Research Group rated Guess positively.

4 Id. ¶ 73. During this time, from August 31 to September 15, 2000,
5 Armand Marciano and Maurice Marciano sold 101,600 shares of Guess
6 common stock for over \$2.1 million in proceeds. Id. ¶ 74. These
7 sales consisted of Armand Marciano's selling of 81,600 common
8 shares and Maurice Marciano's selling of 20,000 common shares.

9 Id. These amounts represented 1.3% of Armand's holdings and .12%
10 of Maurice Marciano's holdings. See Defs. Exs. 8-11. The average
11 selling price of these shares was slightly under \$18.00, \$15.00
12 off the high price during the relevant time period.

13 On September 25, 2000, Guess announced that it was lowering
14 its third-quarter earnings forecast, expecting \$.35 to .38 per
15 share. Compl. ¶ 75. Securities analysts had projected earnings of
16 \$.44 per share. Id. One security analyst, John P. Rouleau,
17 diagnosed the problem this way: "They were overly aggressive in
18 planning their sales and inventory levels for the spring, summer,
19 and fall seasons. . . . They've got too much stuff." Id. ¶ 76.

20 The November 9, 2000 Press Release acknowledged that third-
21 quarter profits fell 60% and that third-quarter net-income fell
22 to \$5.64 million, or \$.13 a share. Id. ¶ 77. Its Form 10-Q, filed
23 November 14, 2000, reported that the results were in accordance
24 with GAAP and that the inventories were valued at the lower of
25 cost or market, with an inventory of \$164,214,000. Id. ¶ 78. the
26 Form 10-Q also reported that Guess's order backlog stood at

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1 | \$133.3 million. Id.

2 | In November 2000, Guess announced that Paul Marciano would
3 | no longer be President of the Company and Fleming resigned as the
4 | company's Chief Financial Officer. Id. ¶ 81. These personnel
5 | moves were followed on January 26, 2001 with a Press Release. Id.
6 | ¶ 82.

7 | The January release announced Guess's expectation of a
8 | diluted loss per share for the quarter ended December 31, 2000 in
9 | the range of \$.27 to \$.31. Id. This would include the recording
10 | of non-recurring charges of approximately \$14 million, consisting
11 | of inventory write-down charges to address the valuation of aged
12 | or impaired inventory, asset impairment charges, store closing
13 | costs and other non-recurring expenses. Defs.' Ex. 5. Guess also
14 | determined that it was necessary to restate its earnings over the
15 | first three quarters of 2000. Id. These planned restatements
16 | suggested that earnings were overstated by \$.02 in the first
17 | quarter, \$.13 in the second quarter, and understated by \$.06 in
18 | the fourth quarter. Id. This was needed because certain costs
19 | that should have been expensed were capitalized and the existence
20 | of unrecorded inventory accruals, triggered by the relocation
21 | from the Los Angeles distribution facility to Louisville. Id.
22 | This resulted in an overstatement of certain assets and
23 | understatements of vendor obligations for inventory purchases.
24 | Id. Carlos Alberini, President and Chief Operating Officer said,
25 | "We have been working diligently to improve controls in our
26 | financial and operational planning processes." Id.

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1 On March 8, 2001, Guess acknowledge a net loss for the
2 fourth quarter of 2000, including a \$15.6 million pre-tax special
3 charge. Defs.' Ex. 7 at 238. This charge consisted of \$5.7
4 million in inventory write-downs to address the valuation of aged
5 or impaired inventory; \$4.5 million in restructuring charges,
6 including store closing costs, \$4.1 million to write-down
7 impaired assets, including certain fixed assets and an investment
8 in an internet company; and \$1.3 million in other charges. Id.
9 Evaluating the overall picture for the year, Maurice Marciano
10 commented, "The challenging retail environment in the Fall
11 contributed to lower sales and margin pressures. This, combined
12 with our excess inventory situation, had a significant negative
13 impact on our profitability for the period." Id. The reported
14 remarks assumed the restatement of the company's previously
15 reported results for the first three quarters of fiscal year
16 2000. Id.

17 In Guess's Form 10K for fiscal year 2000, it reported that
18 it recorded special charges of approximately \$10.3 million to
19 reduce inventories to the lower of cost or market. Defs. Ex. 2 at
20 78. In the auditors' section of the report, it was reported that
21 \$12.9 million in inventory reductions were taken to reduce
22 inventories to the lower of cost or market.

23 Following some preliminary stages of the litigation, the
24 current Consolidated Amended Class Action Complaint was filed in
25 this Court on July 9, 2001. The complaint alleges two causes of
26 action: 1) violation of section 10(b) of the Exchange Act, and
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1 SEC Rule 10b-5, and 2) violation of section 20(a) of the Exchange
2 Act for actions taken between February 14, 2000 and January 26,
3 2001.

4 **III. LEGAL STANDARDS**

5 **A. Federal Rule of Civil Procedure 12(b)(6)**

6 Federal Rule of Civil Procedure 12(b)(6) provides for
7 dismissal when a complaint fails to state a claim upon which
8 relief can be granted. See Fed.R.Civ.P. 12(b)(6). A complaint
9 fails to state a claim if it does not allege facts necessary to
10 support a cognizable legal claim. See Balistreri v. Pacifica
11 Police Dept., 901 F.2d 696, 699 (9th Cir. 1990); Robertson v.
12 Dean Witter Reynolds, Inc., 749 F.2d 530, 533-34 (9th Cir. 1984).

13 In reviewing a Rule 12(b)(6) motion, the court must presume
14 the truth of the factual allegations in the complaint, and draw
15 all reasonable inferences in favor of the non-moving party. See
16 Parks Sch. of Bus., Inc. v. Symington, 51 F.3d 1480, 1484 (9th
17 Cir. 1995); see also Usher v. City of Los Angeles, 828 F.2d 556,
18 561 (9th Cir. 1987). Dismissal under Rule 12(b)(6) is
19 appropriate "only if it is clear that no relief could be granted
20 under any set of facts that could be proved consistent with the
21 allegations." Hishon v. King & Spalding, 467 U.S. 69, 73 (1984)
22 (citing Conley v. Gibson, 355 U.S. 41, 45-46 (1957)) (dismissal
23 appropriate only where "plaintiff can prove no set of facts in
24 support of his claim which would entitle him to relief")); see
25 also Ascon Properties, Inc. v. Mobil Oil Co., 866 F.2d 1149, 1152
26 (9th Cir. 1989). The issue is not whether the plaintiff will
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ultimately prevail, but whether the plaintiff is entitled to offer evidence to support the plaintiff's claim. See Usher, 828 F.2d at 561.

B. The Private Securities Litigation Reform Act

Federal Rule of Civil Procedure 8(a) requires only that a defendant be given fair notice of the factual allegations supporting the complaint. See Fed. R. Civ. P. 8(a); Leatherman v. Tarrant Cty. Narcotics & Intelligence Unit, 507 U.S. 163, 168 (1993). In 1995, Congress enacted the Private Securities Litigation Reform Act. In re Silicon Graphics Inc. Sec. Litig., 183 F.3d. 970, 973 (9th Cir. 1999). Its purpose was to deter opportunistic private plaintiffs from filing abusive securities fraud claims, in part, by raising the pleading standards for private securities fraud plaintiffs. Id. Congress raised the pleading bar in three principal ways.

First, it requires that "[i]n 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 . . . 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). This requires a plaintiff plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct. Silicon Graphics, 183 F.3d at 974.

1 Second, a complaint must "specify each statement alleged to
2 have been false or misleading, [and] the reason or reasons why
3 the statement is misleading." Finally, "if an allegation
4 regarding [a] statement or omission is made on information and
5 belief, the complaint shall state with particularity all facts on
6 which that belief is formed." 15 U.S.C. § 78u-4(b)(1)(B). If a
7 complaint does not meet the pleading requirements of the PSLRA,
8 the court, upon motion of the defendant, shall dismiss the
9 complaint. See 15 U.S.C. § 78u-4(b)(3)(A).

10 **IV. ANALYSIS**

11 Neither party disputes that the PSLRA applies to this case.
12 Plaintiffs attack a variety of statements attributed to the
13 defendants in this case. Defendants advance several arguments in
14 response, but the Court focuses its attention on the factual
15 sufficiency of the allegations directed at establishing the
16 falsehood and at establishing scienter. In particular six core
17 assertions form the backbone of the allegations in the complaint,
18 arranged for ease of reference:

19
20 1) Various defendants were aware no later than February 2000 that
21 the Company's internal computer systems were inadequate to track
22 Guess's inventory. See Compl. ¶ 6.

23 **Basis (1):** "top members of Guess' financial reporting
24 organization participated in a 'financial
25 roundtable group' which met on a weekly basis for
26 the purpose of discussing and resolving financial
27

reporting issues within the company." Id. ¶ 14d.
Fleming attended these meetings and "regularly
reported the results . . . to each of the other
Individual Defendants." Id.

Basis (2): During the financial roundtable meetings Guess's
Director of Internal Audit reported that Guess's
internal computer systems were not accurately
tracking the company's inventory as it was
transported between the Los Angeles and Louisville
distribution centers. Id. ¶ 14e. As a result,
defendants knew that Guess was unable to reconcile
the inventory reports prepared by its distribution
centers, leading to overvaluation of the inventory
on the company's financial statements. Id.

2) Various defendants were aware that the company was not
recording expenses associated with its inventory purchases.
See id. ¶ 14(f).

Basis: In March 2000, the Director of Internal Audit reported
that the company's computer system failed to record
expenses when Guess personnel failed to enter certain
corresponding entries. Id. This failure was reportedly
wide-spread. Id.

3) Various defendants knew that Guess's inventory was
overvalued because as much as \$30 million consisted of

1 inventory that was 1 1/2 to 2 1/2 seasons old-a lifetime in the
2 fashion world-and therefore had to be sold at severe
3 discounts. See id. ¶ 14g.

4 **Basis:** In March 2000, various defendants formed an "inventory
5 control committee" to track the company's inventory.
6 This group met on a weekly basis. Id. During these
7 meetings, defendants were informed about excess
8 inventory. Id.

9
10 4) Guess fired its entire internal audit staff in June 2000 and
11 this was never disclosed to the public in order to conceal
12 the alleged financial skullduggery at Guess. See id. ¶ 14b.

13
14 5) Guess inflated its wholesale backlog by including orders
15 from its retail stores, even as management denied the
16 practice. See id. ¶ 14i.

17 **Basis:** Guess's backlog increased as demand was significantly
18 declining and large wholesale customers, including
19 Macy's, were demanding to return substantial amounts of
20 product that could not be sold. See id. ¶¶ 45, 48.
21 Combined with a "weekly inventory report" defendants
22 knew that sales were slowing and that inventory needed
23 to be marked down. Id. ¶ 45. Maurice Marciano visited
24 the Louisville distribution center several times early
25 in 2000 and spoke with the company's vice-president of
26 operations almost every day throughout the year. Id. ¶

1 16c. Despite this the backlog numbers grew much larger
2 than any sales consummated 90 to 120 days later. See
3 id. ¶¶ 51, 52.

4
5 6) The defendants concealed the negative information.

6 **Basis:** Knowing all the information found above, none of it was
7 revealed, some public statements are alleged
8 inconsistent with this information, and some of the
9 defendants sold stock. See, e.g., id. ¶ 17h
10 (concealment); ¶ 74 (stock sales).

11
12 The defendants' primary attack on these pleadings is two-
13 fold. First, they maintain that the plaintiffs fail to allege the
14 underlying facts with the requisite specificity. Def. Mem. of P &
15 A ("Def. Mem.") at 17-20. Second, they argue that the pleadings
16 fail to create the "strong inference" of recklessness necessary
17 under the PSLRA and Silicon Graphics. Def. Mem. at 7-14; see also
18 id. at 14-22 (arguing statements not false).

19 **A. Specificity of the Pleadings**

20 A quick scan of the supporting reasons for the allegations
21 shows that many rest on the existence of "weekly inventory
22 reports," "financial roundtable meetings," and the "inventory
23 control committee." These sources presumably supplied the
24 individual defendants and the company with information that did
25 more than just put them on notice there might be a problem, it
26 provided such detailed information that their conduct crossed the
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1 line into deliberately reckless or conscious misconduct. See,
2 e.g., Compl. ¶ 6 ("From these weekly reports and discussions . . .
3 . defendants knew that the Company's inventory was materially
4 overstated")

5 The similarity between these sources of information and
6 those in Silicon Graphics is striking. In Silicon Graphics, the
7 plaintiff's allegations pointed to three types of internal status
8 reports that alerted officers to "serious production and sales
9 problems." 183 F.3d at 984. The complaint then alleged that "the
10 officers conducted several meetings during which they entered
11 into a 'conspiracy of silence.'" Id. at 985. As the basis of
12 these allegations, the Silicon Graphics plaintiffs' based them
13 "upon the investigation of their counsel, which included a review
14 of SGI's filings, securities analysts reports and advisories
15 about the company, press releases issued by the company, media
16 reports about the company and discussions with consultants, and
17 believe that substantial evidentiary support will exist for the
18 allegations [] after a reasonable period of discovery." Id. at
19 985.

20 The Ninth Circuit rejected these allegations as insufficient
21 under the PSLRA. Id. at 985. The Silicon Graphics court stated
22 that "a plaintiff must provide, in great detail all the relevant
23 facts forming the basis of her belief." Id. (emphasis added). The
24 complaint in Silicon Graphics failed to include adequate
25 corroborating details to support a "strong inference" of
26 deliberate recklessness. Id. The Ninth Circuit pointed to the
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1 plaintiff's failure to identify:

- 2
- 3 1) the source of information with respect to the reports;
- 4 2) how the plaintiff learned of the reports;
- 5 3) who drafted them;
- 6 4) which officers received them; and
- 7 5) an adequate description of the contents, "which would
- 8 include some specifics from those reports as well as such
- 9 facts as may indicate their reliability."

10 Id. To quote the Silicon Graphics court, "[Plaintiff] would have
11 us speculate as to the basis for the allegations about the
12 reports, the severity of the problems, and the knowledge of the
13 officers. We decline to do so." Id. These same shortcomings apply
14 to the current complaint.

15 Plaintiffs argue that they adequately identify the
16 speaker-the Director of Internal Audit-who reported the
17 information to the other individual defendants. Pls.' Opp'n at
18 19. It is unclear whether this argument is meant to encompass
19 both the information relayed at the financial roundtable
20 meetings, at the inventory control meetings, or in the various
21 reports. For the present purposes the Court will assume it to
22 apply to all the information alleged. Nevertheless, this alone
23 fails to satisfy the pleading requirements of the PSLRA.

24 The Court is provided no information as to who drafted these
25 reports, what date the key reports or statements were made, what
26 specifically the reports contained, or any other corroborating
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1 details. See Silicon Graphics, 183 F.3d at 985. This is
2 insufficient pleading. See id. Plaintiffs' reliance on In Re USA
3 Talks.com Sec. Litig., 2000 U.S. Dist. LEXIS 14823 *1, *8 (S.D.
4 Cal. 2000), is misplaced. There, the allegations generally
5 discussed the availability of daily red and yellow flag reports,
6 alerting management of severe technical problems with a fledgling
7 company that asserted its technology was working well. Id. at
8 *10. The district court found these allegations sufficient under
9 the PSLRA. Id. The significant differences between that case and
10 this one is found in the size of the companies and the relative
11 nature of the claims.

12 In USA Talks.com, the company only had four employees. Id.
13 at *11. The inferences of knowledge were thus much stronger than
14 they are in the present case, where the defendants were in charge
15 of a large corporation bringing in over \$500 million dollars in
16 annual revenue. Additionally, the relevant information in the
17 cases was different. In USA Talks.com, knowledge of the
18 mechanical difficulties was enough to create scienter. Id. at *8.
19 Here, even granting the reports identified problems, there is no
20 indication that the reports had sufficient grasp of the scale
21 posed by these problems to create a "strong inference" of
22 "deliberate recklessness". The "facts" alleged in the complaint
23 only suggest the possible worst case scenario. See Compl. ¶ 15f
24 ("Guess had as much as \$30 million") (emphasis added); ¶ 46
25 (three months after ¶ 15f, the number is \$20 million). They give
26 no indication of how this number was calculated, what the range
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1 of possible values was, or anything else. In evaluating the
2 adequacy of the pleadings and scienter, these details matter. See
3 Silicon Graphics, 185 F.3d at 985. As Guess had notified the
4 public of potential problems in its accounting systems, see
5 Defs.' Ex. 3 at 140, plaintiffs must plead specific facts showing
6 that the failure to actually reduce its financial projections
7 based on the ongoing investigation of a contingent problem, with
8 unknown potential ramifications-small or large-was so faulty that
9 it amounts to deliberate recklessness. The few "facts" in this
10 complaint fail to show, with adequate specification, when, where
11 or how the company identified \$30 million in aged inventory; how,
12 when or where the company realized its wholesale sales were
13 slowing and why this was so obvious that it constituted
14 deliberate recklessness to still forecast strong sales; or how,
15 how much, when or where the company and executives lodged retail
16 sales on the wholesale backlog.

17 Nor does In re McKesson HBOC Inc. Sec. Litig., 126 F. Supp.
18 2d 1248 (N.D. Cal. 2000), support plaintiffs. Although the
19 district court in McKesson held that the failure to identify the
20 name of sources was not always a pleading failure, the facts
21 pled, including specific conversations corroborated by reports of
22 widespread fraudulent practices were sufficient to state a claim.
23 Id. at 1254-56, 1272, 1276 (describing fraud as "breathing" and
24 "so well substantiated"). Here, there is no indication that Guess
25 adopted any policy as egregious as the booking of entirely
26 contingent contracts as sales, followed by hiding the side

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1 letters that established the contingencies. See id. at 1255. Nor
 2 is there sufficient corroboration for the Court to credit these
 3 vague allegations. This case presents the situation, recognized
 4 by the McKesson court, where "Congress meant to prohibit general
 5 allegations that corporate officers' statements were contradicted
 6 by unspecified 'negative internal reports' seen by completely
 7 unidentified sources." Id. at 1271. Alleging the involvement of
 8 the Director of Internal Audits in communications, without
 9 supplying an adequate basis for the allegations, is insufficient
 10 to rise above this prohibition.

11 At the hearing, plaintiffs placed great stress on a recent
 12 case from the Northern District of California, In re Cylink
 13 Securities Litigation, 2001 U.S. Dist. Lexis 15734 (N.D. Cal.
 14 2001). The Court finds the limited analogy between the cases is
 15 insufficient to alter its analysis. In Cylink, the allegations
 16 that survived the motion to dismiss identified five specific
 17 transactions where GAAP was violated through premature revenue
 18 recognition. Id. at *14-15. The "exchange provision [in one of
 19 the deals] made it clear that the customer did not have a fixed
 20 purchase commitment" and that deal alone overstated quarterly
 21 revenue by 12.5%. Id. at *15. Combined with other evidence
 22 provided in an SEC complaint alleging fraudulent revenue
 23 recognition practices and the size of the overstatements
 24 (overstating revenues from 46% to 97%), the Court concluded the
 25 facts alleged gave rise to a strong inference of scienter. Id. at
 26 *4, *15-16.

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1 In contrast, the Cylink court had previously dismissed the
2 complaint because its earlier allegations were insufficient to
3 satisfy the PSLRA's pleading requirements. Id. at *6-7. In the
4 earlier complaint, the plaintiffs "first pointed to the existence
5 of internal controls . . . to imply that the magnitude of the
6 premature revenue recognized was beyond the capability of a few
7 "rogue" sales representatives and thus must have been known by
8 defendants." Id. at *7. Plaintiffs then alleged that the
9 magnitude of the problem indicated that defendants either knew or
10 disregarded the problem with deliberate recklessness. Id.
11 Although the current complaint is slightly more detailed than the
12 original complaint in Cylink, it fails to rise to the level of
13 specificity or to create the strong inferences of scienter, based
14 on the character and amount of the specific transactions at
15 issue, that the Cylink court found satisfied the PSLRA's
16 requirements.

17 Nor do the other cases cited by plaintiffs help their cause.
18 In each, more specific information was alleged that allowed the
19 court in each case to adequately evaluate the ultimate
20 allegations of fraud and to find corroboration in the specific
21 details related. See, e.g., In re 2theMart.com Sec. Litig., 114
22 F. Supp. 2d 955, 960 (finding a "clear disparity" between
23 statements and the known business reality, and "much more
24 precise" pleadings than Silicon Graphics). Defendants are correct
25 to compare the pleading in this case to the allegations in a
26 Northern District of California case, In re Autodesk, Inc. Sec.

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1 Lit., 132 F. Supp. 2d 833, 839 (N.D. Cal. 2000) (granting motion
2 to dismiss for similar reasons).

3 Additionally, based on the current allegations, taken as a
4 whole, Plaintiffs have failed to plead facts sufficient to
5 support a strong inference of scienter. See, e.g., Autodesk, 132
6 F. Supp. 2d at 843-44 ("Defendants are correct in their argument
7 that plaintiffs must do more than allege that these key officers
8 had the requisite knowledge by virtue of their 'hands on'
9 position"). The insider stock sales provide no support for a
10 conclusion of scienter. See Silicon Graphics, 183 F.3d at 987.
11 Between the significant drop-off from the stock's high during the
12 class period (high: \$33.00, apx. average at sale: \$22) and the
13 minuscule percentages involved by only two of the four
14 defendants, the Court finds this information is not probative of
15 scienter. See Ronconi v. Larkin, 253 F.3d 432, 435 (9th Cir.
16 2001) ("when insiders miss the boat this dramatically, their
17 sales do not support an inference that they are preying on ribbon
18 clerks who do not know what the insiders know"); Silicon
19 Graphics, 185 F.3d at 987 (7.7% and 6.9% stock sales provide no
20 indication of scienter). The violations of GAAP are just as
21 consistent with the existence of an accounting problem of unknown
22 scope as they are with intentions to hide the performance of the
23 company.² Plaintiffs have provided insufficient factual

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25 ²The Court reads the defendants' acknowledgment of
26 accounting problems, Defs.' Ex. 3, recognition of an inventory
27 overage of \$15 million, and plaintiffs' allegation of a \$20
28 million overage in June as consistent with a technology and
operating upgrade gone awry in the midst of rapid expansion.

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1 | allegations to support the inference that the failure to
2 | recognize the eventual costs of these problems was attributable
3 | to fraud, rather than a lack of caution, a lack of solid
4 | information, a belief that it was part of the company's grand
5 | expansion plans, or a momentary surplus of hubris. And, finally,
6 | the layoffs of the internal audit department may be attributable
7 | to the creation of the inventory and accounting problems, as well
8 | as a failure to provide sufficient answers to management.
9 | Frankly, on the allegations in the complaint, the Court cannot
10 | find sufficient factual support to believe fraud is any more
11 | likely than mismanagement or growing pains as the cause of any
12 | misrepresentations—and thus the motion to dismiss will be
13 | granted, with leave to amend within twenty (20) days of this
14 | order.

15 | **B. Amending the Pleadings**

16 | In approaching the amended complaint, the Court agrees with
17 | the Autodesk court in its conclusion that the pleading for a
18 | securities claim such as this should be more straightforward. See
19 | Autodesk, 132 F. Supp. 2d at 842. The Autodesk court adopted a
20 | sensible requirement to provide a framework for complaints such
21 | as the present one. The Court finds that court's solution to the
22 | requirements of the PSLRA persuasive.

23 | Accordingly, if plaintiffs choose to amend the complaint,
24 | the Court requires the following:

25 | _____
26 | Allegations concerning the scope of the problem and how they were
27 | reported may overcome this problem created by the current status
28 | of the complaint.

EXHIBIT

1 Separately, for each alleged false or misleading statement,
2 plaintiffs shall

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4 1. State the false or misleading statement;

5 2. State whether the statement was written or oral;

6 a. If the statement was written, identify the document in
7 which it appeared -- that is, provide the title and author of the
8 document, the date it was prepared, and, if not a
9 publicly-available document, name of the person or persons who
10 reviewed it;

11 b. If the statement was oral, state when and under what
12 circumstances the statement was made, and by whom; if an
13 allegation regarding an oral statement is not made on personal
14 knowledge, state with particularity all facts upon which
15 plaintiffs formed the belief that one or more of the defendants
16 made the statement at the time and place at which it is alleged
17 to have been made.

18 3. State why the statement was false or misleading at the time
19 it was made, and state with particularity all facts upon which
20 plaintiffs formed the belief that the statement was false or
21 misleading;

22 a. If plaintiffs allege that the falsity of the statement is
23 shown by conflicting information in internal reports, identify
24 the report (title, author, date prepared, recipient(s)) and
25 indicate the portion of the report that contradicts the false or
26 misleading statement;

1 b. If plaintiffs allege that the falsity of the statement is
2 shown by contemporaneous information inconsistent with a
3 particular statement, state with particularity what the
4 contemporaneous information was, what the source of the
5 information was, who had the information, and how plaintiffs
6 learned of the information.

7 4. State particular facts giving rise to a strong inference of
8 a degree of recklessness that strongly suggests actual intent to
9 deceive;

10 a. If plaintiffs allege that defendants received or possessed
11 documents or information that was at odds with the alleged false
12 or misleading statement, state all the relevant facts supporting
13 this belief;

14 b. If plaintiffs allege that the information was contained in
15 documents, state the title, date, and contents of such documents
16 (with particularity), the identity of the person or persons who
17 drafted such documents, the identity of the person or persons who
18 reviewed such documents, how plaintiffs learned of the existence
19 of the documents, and how plaintiffs know that defendants
20 received these documents;

21 c. If plaintiffs allege that the information was in a form
22 other than written, state the source or sources of their
23 information (how they learned of this information allegedly
24 possessed by defendants) and how they know that the defendants
25 possessed this information; and

26 5. With regard to allegations concerning the liability of the
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1 individual defendants for "group-published" information,
2 plaintiffs must indicate the statements that they contend fall
3 under the doctrine.

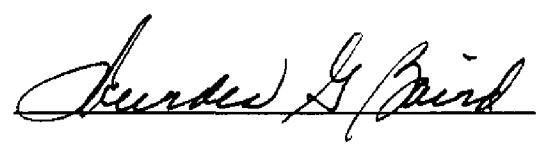
4 Autodesk, 132 F. Supp. 2d at 846; see also In re Secure Computing
5 Corp. Sec. Litig., 2001 U.S. Dist. LEXIS 13563 *1, *11
6 (commenting on a well-drawn pleading where facts were repeated
7 for various statements).

8 **IV. CONCLUSION**

9 Because the complaint in this case fails to meet the
10 specificity and scienter pleading requirements under the PSLRA,
11 the Court GRANTS the defendants' motion to dismiss with leave to
12 amend within twenty (20) days of this order.

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14 IT IS SO ORDERED.

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16 Dated: Nov. 22, 2001



18 LOURDES G. BAIRD
19 United States District Judge

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