

E-Filed 7/30/07

NOT FOR CITATION
IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

IN RE MERCURY INTERACTIVE CORP.
SECURITIES LITIGATION

Case Number C 05-3395 JF (PVT)

ORDER¹ GRANTING MOTIONS TO
DISMISS WITH LEAVE TO AMEND

[re: doc. nos. 130, 133, 134, 137, 139,
147, 152]

I. BACKGROUND

1. Procedural Background

The initial complaint in this action was filed on August 19, 2005. On December 8, 2005, in light of the filing of several related cases, the Court issued an order setting a briefing schedule for competing motions for appointment as lead plaintiff. On May 5, 2006, the Court appointed Mercury Pension Fund Group (“Lead Plaintiff”) to lead the litigation and approved its choice of lead counsel. On June 7, 2006, the Court established a schedule for the filing of a consolidated complaint and the briefing of any subsequent motions to dismiss. On September 8, 2006, the instant consolidated class action complaint (“the Complaint”) was filed. The class is defined as

¹ This disposition is not designated for publication and may not be cited.

1 “all persons and entities who purchased or otherwise acquired Mercury securities between
2 October 17, 2000, and November 1, 2005, inclusive, and who were damaged thereby.”
3 Complaint ¶ 352.

4 The Complaint names nine defendants: Mercury Interactive Corporation (“Mercury” or
5 “the Company”), Amnon Landan, Douglas Smith, Sharlene Abrams, Susan Skaer, Igal Kohavi,
6 Yair Shamir, Giora Yaron, and PricewaterhouseCoopers (“PWC”). The Complaint refers to
7 Landan, Smith, Abrams, and Skaer as the “Officer Defendants,” and to Kohavi, Shamir, and
8 Yaron as the “Compensation Committee Defendants.” It refers to the Officer Defendants and the
9 Compensation Committee Defendants as the Individual Defendants, and to the Individual
10 Defendants and Mercury as the Mercury Defendants. The Complaint asserts three claims: (1)
11 violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated
12 thereunder, against the Mercury Defendants; (2) violation of Section 20(a) of the Securities
13 Exchange Act, against the Officer Defendants and the Compensation Committee Defendants; and
14 (3) violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated
15 thereunder, against PWC.

16 On November 17, 2006, seven separate motions to dismiss² were filed by: (1) PWC; (2)
17 Abrams; (3) Skaer; (4) Smith; (5) Mercury; (6) Landan; and (7) the Compensation Committee
18 Defendants. Lead Plaintiff has filed two oppositions, the first to the motions filed by Mercury
19 and the Individual Defendants, and the second to the motion filed by PWC. The Court heard oral
20 argument on March 30, 2007.³

21 **2. Factual Allegations**

22 This action arises from the alleged backdating of stock options at Mercury Interactive
23 Corporation (“Mercury”). The Complaint contains the following allegations, which the Court
24 assumes to be true for the purposes of this motion.

25
26 ² Defendants also have joined in various portions of each other’s motions.

27 ³ During the briefing of the instant motions, a dispute arose as to the unsealing of the
28 derivative complaint in a factually-related state court action. That dispute is not the subject of
the instant order.

1 Mercury provides software and services to the business technology optimization
2 marketplace. Complaint ¶ 13. It is incorporated under Delaware law and is headquartered in
3 California. *Id.* Landan was Chairman of the Board of Mercury (“the Board”) from July 1999
4 until he resigned on November 2, 2005. *Id.* at ¶ 14. He was Chief Executive Officer from
5 February 1997 until his resignation, and a director from February 1996 until his resignation. *Id.*
6 Smith was Chief Financial Officer and Executive Vice President from November 2001 until
7 November 2, 2005, when he resigned. *Id.* at ¶ 15. Previously, Smith was Executive Vice
8 President of Corporate Development. *Id.* Abrams was Chief Financial Officer and Vice
9 President of Finance and Administration from November 1993 until November 2001, when she
10 resigned. *Id.* at ¶ 16. Skaer was Vice President, General Counsel, and Secretary of Mercury
11 from November 2000 until November 2, 2005, when she resigned. *Id.* at ¶ 17. The
12 Compensation Committee Defendants were the only outside directors on the Board and the only
13 members of the Compensation and Audit Committees from October 1996 to July 2002. *Id.* at ¶
14 22. Kohavi and Shamir have been directors since 1994. *Id.* at ¶¶ 19-20. Each was a member of
15 the Compensation and Audit Committees from 1996 through June 2006. *Id.* Yaron has been a
16 director since 1996 and Chairman of the Board since November 2, 2005. *Id.* at ¶ 21. He was
17 chair of the Compensation Committee from 2002 through June 2006. *Id.* He was a member of
18 the Audit Committee from 1996 to 2002. *Id.* PWC was Mercury’s outside public auditor during
19 the class period. *Id.* at ¶ 24.

20 Mercury has had at least four options plans: the 1989 Stock Option Plan and its
21 replacement, the 1999 Stock Option Plan; the 1994 Directors’ Plan; and the 1998 Employee
22 Stock Purchase Plan. *Id.* at ¶¶ 37-41. The 1989 Stock Option Plan, under which options no
23 longer are granted, permitted purchase at less than one hundred percent of the fair market value
24 for statutory stock option grants. *Id.* at ¶ 37. The 1998 Employee Stock Purchase Plan allows
25 purchase at less than one hundred percent of the fair market value. *Id.* at ¶ 41. The 1999 Stock
26 Option Plan and the 1994 Directors’ Plan require that the exercise price of options granted
27 thereunder be one hundred percent of fair market value on the date of the grant. *Id.* at ¶¶ 39, 41.

28 In November 2004, the SEC launched an informal investigation into Mercury’s past stock

1 option grants. *Id.* at ¶ 45. In July 2005, the Company revealed that there were potential
2 problems with the dating and pricing of stock option grants and with the accounting for these
3 option grants. *Id.* The Board formed a Special Committee to investigate the Company's stock
4 option practices. *Id.* at ¶ 46. In August 2005, the Special Committee concluded that the actual
5 grant dates of certain past stock option grants differed from the dates on which they should have
6 been granted. *Id.* The Special Committee found that on fifty-four separate occasions between
7 1994 and 2005, stock options reflected a grant date that differed from the date on which the
8 option actually had been granted. *Id.* at ¶ 48. In almost every such instance, the price on the
9 actual grant date was higher than the price on the originally stated date. *Id.* Of those fifty-four
10 grants, twenty-four were approved by the Compensation Committee. *Id.* The Special Committee
11 also found that option exercise dates were incorrectly reported, that some option documentation
12 was missing, and that a loan was made by Mercury to Landan without proper documentation. *Id.*
13 at ¶¶ 50, 52, 56. As a result, the Board concluded that Mercury's financial statements from 2000
14 through the first quarter of 2005 no longer should be relied upon because they contained
15 misstatements of material facts and would need to be restated. *Id.* at ¶ 47. On August 29, 2005,
16 Mercury issued a press release stating that it had undertaken a restatement. *Id.* at ¶ 204.⁴

17 On October 4, 2005, Mercury issued a press release that described the pending
18 restatement but that did not disclose the full impact of the backdating on Mercury's financial
19 position. *Id.* at ¶ 204. It also reported that the SEC inquiry had been converted into a formal
20 investigation. *Id.* Mercury's stock price fell from \$36.90 to a closing price of \$31.61 on October
21 4, 2005. *Id.* at ¶ 351. On November 2, 2005, Mercury issued a press release stating that it had
22 identified forty-nine instances of improper backdating and that it had concluded that internal
23 controls had been inadequate. *Id.* at ¶ 206. Mercury also announced that it had accepted the
24 resignations of Landan, Smith, and Skaer, and stated:

25 Chief Executive Officer Amnon Landan, Chief Financial Officer Douglas Smith,
26 and General Counsel Susan Skaer were each aware of and, to varying degrees,
participated in the practices discussed above. Each of them also benefited [sic]

27 _____
28 ⁴ Unlike the other press releases discussed herein, the August 29, 2005 press release is
not described in detail in the Complaint.

1 personally from the practices. While each of these officers asserts that he or she
2 did not focus on the fact that the practices and their related accounting were
3 improper, the Special Committee has concluded that each of them knew or should
4 have known that the practices were contrary to the options plan and proper
5 accounting. While the Special Committee is appreciative of and sympathetic to
6 the far-reaching demands of these executives' positions during this critical period,
7 missing or overlooking a practice as basic and important as the proper granting of
8 options is not acceptable.

9 *Id.* Upon this full disclosure of the improper stock options practices, Mercury stock fell from its
10 November 1, 2005 closing price of \$35.00 to \$25.66 on November 2, 2005. *Id.* at ¶ 207.
11 Mercury subsequently admitted that each of the financial statements issued from fiscal year 1992
12 through the end of the first month of fiscal year 2005 was materially false and misleading. *Id.* at
13 ¶ 208. On July 3, 2006, Mercury filed a Form 10-K/A restating its consolidated financial
14 statements for 2002, 2003, and 2004. *Id.* at ¶ 59.

15 II. LEGAL STANDARD

16 1. Motion to Dismiss

17 For purposes of a motion to dismiss, the plaintiff's allegations are taken as true, and the
18 Court must construe the complaint in the light most favorable to the plaintiff. *Jenkins v.*
19 *McKeithen*, 395 U.S. 411, 421 (1969). Leave to amend must be granted unless it is clear that the
20 complaint's deficiencies cannot be cured by amendment. *Lucas v. Department of Corrections*,
21 66 F.3d 245, 248 (9th Cir. 1995). When amendment would be futile, however, dismissal may be
22 ordered with prejudice. *Dumas v. Kipp*, 90 F.3d 386, 393 (9th Cir. 1996). On a motion to
23 dismiss, the Court's review is limited to the face of the complaint and matters judicially
24 noticeable. *North Star International v. Arizona Corporation Commission*, 720 F.2d 578, 581
25 (9th Cir. 1983); *MGIC Indemnity Corp. v. Weisman*, 803 F.2d 500, 504 (9th Cir. 1986); *Beliveau*
26 *v. Caras*, 873 F.Supp. 1393, 1395 (C.D. Cal. 1995). However, under the "incorporation by
27 reference" doctrine, the Court also may consider documents which are referenced extensively in
28 the complaint and which are accepted by all parties as authentic, which are not physically
attached to the complaint. *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970 (9th
Cir. 1999).

2. Heightened Pleading Standard Under Rule 9(b) and the PSLRA

1 Fed. R. Civ. P. 9(b) requires that “the circumstances constituting fraud . . . be stated with
2 particularity.” The Ninth Circuit has explained that a “plaintiff must include statements
3 regarding the time, place, and nature of the alleged fraudulent activities, and that mere conclusory
4 allegations of fraud are insufficient.” *In re GlenFed, Inc. Securities Litigation*, 42 F.3d 1541,
5 1548 (9th Cir. 1994). A plaintiff asserting fraud “must set forth an explanation as to why the
6 statement or omission complained of was false or misleading.” *Id.* (internal quotation marks
7 omitted); *see also Yourish v. California Amplifier*, 191 F.3d 983, 992-93 (9th Cir. 1999). The
8 Private Securities Litigation Reform Act (“PSLRA”) raises the pleading standard even further:

9 (1) Misleading statements and omissions

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

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

12 (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;
13 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
14 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 (2) Required state of mind

16 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
17 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.

18 15 U.S.C. § 78u-4b(1)-(2).

19 **III. DISCUSSION**

20 **1. Claim One: Violation of Section 10(b) and Rule 10b-5 Against the Mercury**

21 **Defendants**

22 a. Elements of the Claim

23 Lead Plaintiff alleges that the Mercury Defendants violated Section 10(b) of the
24 Securities Exchange Act and Rule 10b-5 promulgated thereunder. Section 10(b) makes it
25 unlawful

26 [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 . . .
27 any manipulative or deceptive device or contrivance in contravention of such rules
and regulations as the Commission may prescribe as necessary or appropriate in
28 the public interest or for the protection of investors.

1 15 U.S.C. § 78j(b). Rule 10b-5 makes it unlawful for any person to use interstate commerce

- 2 (a) To employ any device, scheme, or artifice to defraud,
3 (b) To make any untrue statement of a material fact or to omit to state a material
4 fact necessary in order to make the statements made, in the light of the
5 circumstances under which they were made, not misleading, or
6 (c) To engage in any act, practice, or course of business which operates or would
7 operate as a fraud or deceit upon any person, in connection with the purchase or
8 sale of any security.

9 17 C.F.R. § 240.10b-5. In cases involving publicly-traded securities and purchases or sales in
10 public securities markets, the elements of an action under Section 10(b) and Rule 10b-5 are: (1)
11 a material misrepresentation or omission, (2) scienter, (3) a connection with the purchase or sale
12 of a security, (4) reliance, (5) economic loss, and (6) loss causation. *Dura Pharmaceuticals, Inc.*
13 *v. Broudo*, 544 U.S. 336, 341-42 (2005).

14 b. The Class Period and the Statute of Limitations

15 i. The Beginning of the Asserted Class Period

16 Mercury argues that the statute of limitations bars claims by investors who purchased
17 Mercury stock before September 8, 2001, five years prior to the filing of the Complaint. This
18 would exclude a portion of the asserted class because the class period asserted in the Complaint
19 includes purchasers of Mercury stock between October 17, 2000 and November 1, 2005.
20 Complaint ¶ 352. In contrast, the initial complaint in this action asserted a class period that
21 includes purchasers of Mercury stock between December 1, 2004 and July 5, 2005. Initial
22 Complaint ¶ 119.⁵ The relevant statute of limitations provides:

- 23 [A] private right of action that involves a claim of fraud, deceit, manipulation, or
24 contrivance in contravention of a regulatory requirement concerning the securities
25 laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15
26 U.S.C. § 78c(a)(47)), may be brought not later than the earlier of –
27 (1) 2 years after the discovery of the facts constituting the
28 violation; or
(2) 5 years after such violation.

28 28 U.S.C. § 1658(b). The five-year period of repose is not subject to tolling. *See Durning v.*
Citibank, In'l, 990 F.2d 1133, 1136-37 (9th Cir. 1993).

⁵ Because the initial complaint was filed on August 15, 2005, the class period asserted in the Complaint would have begun within five years of that date.

1 The class period asserted in the Complaint includes individuals who purchased Mercury
2 stock more than five years before the filing of the Complaint. However, Lead Plaintiff argues
3 that the Complaint relates back to the initial complaint in this action and that, accordingly, no
4 portion of the class period is time-barred. The Ninth Circuit has held that:

5 An amendment adding a party plaintiff relates back to the date of the original
6 pleading only when: 1) the original complaint gave the defendant adequate notice
7 of the claims of the newly proposed plaintiff; 2) the relation back does not unfairly
8 prejudice the defendant; and 3) there is an identity of interests between the
9 original and newly proposed plaintiff.

10 *In re Syntex Corp. Securities Litigation*, 95 F.3d 922, 935 (9th Cir. 1996). The court found
11 identity of interests absent in *Syntex* because “[t]he claims of the proposed plaintiffs are different
12 because the newly proposed class members bought stock at different values and after different
13 disclosures and statements were made by Defendants and analysts.” *Id.* The court also cited its
14 earlier decision in *Besig v. Dolphin Boating & Swimming Club*, 683 F.2d 1271, 1278-79 (9th Cir.
15 1982), in which it had focused on the “central issue of th[e] litigation,” the “goals” of the
16 litigants, and the relief sought, in determining whether an identify of interests existed. *Id.*

17 Applying *Syntex* to the facts now before it, this Court concludes that an identity of
18 interests does not exist between the class members who purchased Mercury stock before
19 September 8, 2001 and those who purchased Mercury stock after that date. Class members who
20 purchased Mercury stock between October 17, 2000 and September 8, 2001 bought their stock at
21 a much higher price than did purchasers of Mercury stock after September 8, 2001: the
22 Complaint alleges that the share price averaged between \$80/share and \$100/share in the fourth
23 quarter of 2000 and between \$20/share and \$40/share during the fourth quarter of 2001.
24 Complaint ¶¶ 222, 259. Accordingly, while the relief sought may be similar in kind, and may
25 have been triggered by the same disclosures of improper accounting, the quantum of relief sought
26 is vastly different in scale. Moreover, while they may have been similar in kind and effect,
27 different statements also were made as to the state of Mercury’s financials prior to the purchases
28 at issue. The Court does not hold that a difference in stock price by itself is enough to avoid
application of the relation-back doctrine, but *Syntex* does not allow the Court to ignore the
significant difference in stock price that is present here. Because the class should not include

1 individuals or entities that purchased Mercury stock prior to September 8, 2001,⁶ the Complaint
2 will be dismissed with leave to amend.

3 ii. The Statute of Limitations as to Claims Against Abrams

4 Abrams argues that the Complaint alleges no wrongful conduct by her after September 8,
5 2001. Lead Plaintiff responds that the Complaint alleges in fact wrongful conduct by Abrams in
6 the form of an earnings release dated October 16, 2001. However, the Complaint does not name
7 Abrams as a person responsible for that release. If Lead Plaintiff can assert that Abrams
8 committed a wrongful act during the class period, it should do so in an amended complaint.

9 c. Loss Causation

10 Mercury and Landan argue that the Complaint does not allege loss causation sufficiently.
11 Mercury notes that the Complaint identifies five disclosures occurring on: July 5, 2005; July 28,
12 2005; August 8, 2005; October 4, 2005; and November 2, 2005. The analysis of each of the
13 disclosures is governed by the decisions of the Supreme Court in *Dura Pharmaceuticals* and of
14 the Ninth Circuit in *In re Daou Systems, Inc. Securities Litigation*, 411 F.3d 1006 (9th Cir.
15 2005). In *Dura Pharmaceuticals*, the Supreme Court held that the fact that a purchase price was
16 inflated, by itself, does not establish causation of economic loss. Instead, the Supreme Court
17 reaffirmed the principle that a securities plaintiff must allege both cause and loss. In *Daou*
18 *Systems*, the Ninth Circuit described the loss causation inquiry as considering whether “the
19

20 ⁶ Lead Plaintiff cites *In re Network Associates, Inc. II Securities Litigation*, 2003 WL
21 24051280 (N.D.Cal., Mar. 25, 2003) (unpublished). The court in that case emphasized that the
22 claims of the new class members were “based on the same underlying allegations as the original
23 class members” and “[m]ore importantly, all of the claims are based on the same . . . disclosure
24 and subsequent stock drop.” *Id.* at *7. The court read the reference to “disclosures and
25 statements” in *Syntex* as pertaining to the disclosures that caused the stock price drop, not to the
26 statements causing stock purchase and supporting the higher stock price. This reading avoids the
27 conclusion, decried by Lead Plaintiff, that the relation-back doctrine cannot apply in securities
28 class actions because the new plaintiffs always will have purchased the stock at a different price.
While the Court might have reached a different conclusion in the instant case were the stock
prices roughly similar, the stock price difference in this action is sufficiently large to bar
application of the relation-back doctrine. The Court notes that at least one other court in this
district has reached a similar conclusion on similar facts. See *In re Commtouch Software Ltd.*
Securities Litigation, 2002 WL 31417998 (N.D.Cal. July 24, 2002) (unpublished) (finding lack
of identity of interests).

1 misrepresentations or omissions caused the harm.” *Daou Sytems*, 411 F.3d at 1025. In that case,
2 the court found a lack of loss causation: “if the improper accounting did not lead to the decrease
3 in Daou’s stock price, plaintiffs’ reliance on the improper accounting in acquiring the stock
4 would not be sufficiently linked to their damages.” *Id.* at 1026. The court concluded that a loss
5 suffered in an earlier period could not be considered causally related to the alleged fraudulent
6 conduct because that stock drop occurred when “the true nature of Daou’s financial condition
7 had not yet been disclosed.” *Id.* at 1027.

8 The theory of Lead Plaintiff’s case appears to be that multiple, individual disclosures
9 caused multiple, individual economic losses. Such a theory fits within the constraints articulated
10 by *Dura Pharmaceuticals* and *Daou* to the extent that it does not attempt to capture losses
11 attributable to other causes. By way of example, if a stock fell from \$110/share to \$10/share over
12 the course of a year, the total loss attributable to the full universe of causes would be \$100/share.
13 If, however, after three disclosures of wrongdoing during that overall descent, the stock price fell
14 from \$80/share to \$70/share, from \$60/share to \$50/share, and from \$40/share to \$30/share, and
15 those losses were attributable to the disclosed wrongdoing, a plaintiff would be able to plead loss
16 caused by the wrongdoing in the amount of \$30/share, not \$100/share. Any attempt to recover an
17 amount of loss including loss unattributable to the wrongdoing at issue would be barred under
18 *Dura Pharmaceuticals* and *Daou*. No Defendant has cited authority indicating that a plaintiff
19 only may recover for damages stemming from a single disclosure. While an earlier disclosure
20 may be relevant to reasonable reliance, an earlier disclosure does not necessarily strip a later
21 disclosure of its ability to cause loss. Accordingly, while it is not entirely clear that the claims in
22 the Complaint are limited to losses caused by the individual disclosures, Lead Plaintiff may
23 proceed on such a theory in an amended complaint.

24 i. The July 5, 2005 Disclosure

25 Lead Plaintiff alleges that “[o]n July 5, 2005, Mercury disclosed that it had initiated an
26 internal investigation to determine whether it had been improperly accounting for stock option
27 grants, that the SEC had initiated an informal investigation into the matter, and that Mercury
28 would potentially need to restate its past financial statements.” Complaint ¶ 348. Lead Plaintiff

1 does not allege any specific drop in share price as a result of this disclosure. Accordingly, Lead
2 Plaintiff fails to plead loss causation with respect to the July 5, 2005 disclosure.

3 ii. The July 28, 2005 Disclosure

4 Lead Plaintiff alleges that “[o]n July 28, 2005, Mercury disclosed a ‘preliminary’
5 conclusion that the resulting restatement of earnings would likely be material and impact prior
6 year’s earnings. The price of Mercury stock dropped more than a dollar on this news, closing at
7 \$39.15 or \$1.11 lower than the previous day’s close.” *Id.* Mercury asserts that this alleged drop
8 is not what it appears to be, in that the disclosure came after the market already had closed for the
9 day and that when the market had the opportunity to digest the information the next day, the
10 stock price actually went up twenty-two cents. Lead Plaintiff argues that it is not appropriate to
11 consider such assertions at the pleading stage. While this argument is correct generally,
12 considering that leave to amend is required on other bases, Lead Plaintiff either should omit this
13 disclosure from an amended complaint or plead it with more contextual facts. It is not in the
14 interest of judicial economy to encourage artful pleading of claims that will be subject to
15 summary adjudication.

16 iii. The August 8, 2005 Disclosure

17 Lead Plaintiff alleges that “[o]n August 8, 2005, the Company announced it would miss
18 the deadline for filing its second quarter 2005 Form 10-Q 2005 report with the SEC as a result of
19 the restatement. Mercury’s stock price dropped again to close \$0.65 lower at \$37.62.” *Id.* The
20 implication of these allegations is that the reported need to restate financials, which was caused
21 by the improper backdating, caused the decline in the price of Mercury’s stock. However, this
22 drop in share price does not appear to be statistically significant, and Lead Plaintiff seemed to
23 concede at oral argument that this disclosure did not form the basis of any economic loss.
24 Accordingly, while Lead Plaintiff may include this disclosure in an amended complaint, the
25 Court notes its skepticism that such an allegation would survive a future motion to dismiss.

26 iv. The October 4, 2005 Disclosure

27 Lead Plaintiff alleges that “[o]n October 4, 2005, in its press release reporting preliminary
28 3Q05 results, Mercury revealed that the SEC’s informal investigation had been converted to a

1 formal investigation. On this news, Mercury's stock price dropped \$5.29, or 14.3%, from \$36.90
2 to \$31.61, although the full extent of the problems at Mercury still had yet to be revealed." *Id.* at
3 ¶ 351. However, the press release also included the disclosure that Mercury would record third
4 quarter 2005 revenue of \$198-205 million, rather than the \$205-215 million that previously had
5 been predicted. *Id.* at ¶ 204. The Complaint does not allege what portion of the loss is
6 attributable to the news regarding the SEC investigation as distinguished from the portion that is
7 attributable to the Company's failure to hit revenue targets. As the Fifth Circuit observed in
8 *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657 (5th Cir. 2004), failure to establish that the
9 disclosure of the relevant wrongdoing played a significant role in a loss merits entry of summary
10 judgment for failure to show loss causation. This action remains at the pleading stage, however,
11 raising the question as to how specifically a securities plaintiff must plead loss caused by the
12 relevant disclosure, as opposed to loss caused by other simultaneous events. Because the
13 Complaint will be dismissed with leave to amend on other grounds, the Court need not answer
14 that question at this time. The Court notes that further specificity as to the loss caused by the
15 October 4, 2005 disclosure would increase the likelihood that an amended version of this aspect
16 of the Complaint will survive a future motion to dismiss.

17 v. The November 2, 2005 Disclosure

18 Lead Plaintiff alleges that "[w]hen the full extent of the options backdating scandal was
19 revealed on November 2, 2005, the market reacted swiftly and decisively with the price of
20 Mercury's common stock plummeting 27% from its November 1 closing price of \$35.00 to close
21 down \$9.44 at \$25.66 on November 2." Complaint at ¶ 351. Mercury does not appear to contest
22 the pleading of loss causation as to this disclosure. Landan argues that the loss could have been
23 the result of other causes, but it reasonably may be inferred that these other causes (officer
24 resignations, delisting, delayed financial statements, and a poor outlook) all stem from the
25 underlying wrong. Accordingly, Landan's challenge to the allegation that the November 2, 2005
26 disclosure of the scope of the backdating problem caused a share price drop of \$9.44/share is
27 unpersuasive.

28 However, Mercury also argues that Lead Plaintiff may not graft onto the November 2,

1 2005 disclosure the effects of other disclosures made after the end of the class period. Mercury
2 argues that the Company's improper accounting for options exercisable with promissory notes
3 was not revealed until July 2006, nine months after the close of the class period. Lead Plaintiff
4 appears to concede that this is correct, but states that events occurring after the close of the class
5 period remain relevant to scienter. Opposition to Mercury Motion 30 n.29. Lead Plaintiff should
6 ensure that any amended complaint is clear as to the relevance of such allegations and that it does
7 not attempt to support loss causation in an inappropriate manner.⁷

8 d. Reliance

9 Abrams⁸ and Landan argue that the Complaint contains insufficient allegations regarding
10 reliance. Lead Plaintiff argues that it has pled reliance adequately under both the fraud on the
11 market theory allowed under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Supreme Court
12 described the fraud on the market theory as follows:

13 The fraud on the market theory is based on the hypothesis that, in an open and
14 developed securities market, the price of a company's stock is determined by the
15 available material information regarding the company and its business....
16 Misleading statements will therefore defraud purchasers of stock even if the
17 purchasers do not directly rely on the misstatements The causal connection
18 between the defendants' fraud and the plaintiffs' purchase of stock in such a case
19 is no less significant than in a case of direct reliance on misrepresentations.

20 *Basic Inc.*, 485 U.S. at 241-42 (citing *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

21 ⁷ Mercury argues that because the November 2, 2005 disclosure announced that
22 *intentional* misconduct ended in April 2, 2002, Plaintiff cannot establish loss causation for any
23 intentional misconduct occurring after April 2, 2002. This argument is unpersuasive. While a
24 wrong must be disclosed and that disclosure must cause a loss for it to be actionable, Mercury
25 cites no authority indicating that such disclosure must be made in the terms of the relevant claims
26 for relief under federal securities law. Such a rule would create perverse incentives for
27 companies to frame their releases to investors in the most legally insulating manner. The
28 ultimate responsibility for determining whether an action was intentional or negligent does not lie
with the Company, but with the Court. Here, Mercury disclosed that a series of wrongful acts
had occurred and the market responded to that disclosure. The use of terms of art does not
foreclose potential liability.

⁸ Abrams's argument regarding reliance depends in part on the assertion that the
Complaint alleges no actions in which she participated. Because leave to amend will be granted
in order that Lead Plaintiff may attempt to make such allegations, the Court does not consider
Abrams's reliance arguments to the extent that they may be rendered moot by amendment.

1 The Supreme Court adopted a rebuttable presumption of reliance based on fraud on the
2 market theory and identified situations in which it might be rebutted:

3 Any showing that severs the link between the alleged misrepresentation and either
4 the price received (or paid) by the plaintiff, or his decision to trade at a fair market
5 price, will be sufficient to rebut the presumption of reliance. For example, if
6 petitioners could show that the “market makers” were privy to the truth about the
7 merger discussions here with Combustion, and thus that the market price would
8 not have been affected by their misrepresentations, the causal connection could be
9 broken: the basis for finding that the fraud had been transmitted through market
10 price would be gone. Similarly, if, despite petitioners’ allegedly fraudulent
11 attempt to manipulate market price, news of the merger discussions credibly
12 entered the market and dissipated the effects of the misstatements, those who
13 traded Basic shares after the corrective statements would have no direct or indirect
14 connection with the fraud. Petitioners also could rebut the presumption of reliance
15 as to plaintiffs who would have divested themselves of their Basic shares without
16 relying on the integrity of the market. For example, a plaintiff who believed that
17 Basic’s statements were false and that Basic was indeed engaged in merger
18 discussions, and who consequently believed that Basic stock was artificially
19 underpriced, but sold his shares nevertheless because of other unrelated concerns,
20 e.g., potential antitrust problems, or political pressures to divest from shares of
21 certain businesses, could not be said to have relied on the integrity of a price he
22 knew had been manipulated.

23 *Basic*, 485 U.S. at 248-49.

24 The Court concludes that Lead Plaintiff is entitled at the pleading stage to a presumption
25 of reliance under the fraud on the market theory. The Court does not read *Dura Pharmaceuticals*
26 as limiting *Basic Inc.* The presumption of reliance created in *Basic Inc.* is based upon the
27 efficiency of markets, whereas the language highlighted by Landan in *Dura Pharmaceuticals*
28 refers to the severing of loss causation.⁹ While reliance, or transaction causation, and loss
causation are related, an extended period of time between purchase and sale does not necessarily
affect the underlying efficiency of the market.

Because the Court concludes that Lead Plaintiff is entitled to a presumption of reliance
under *Basic Inc.*, it need not consider Lead Plaintiff’s alternative argument that it can invoke a
reliance presumption under *Affiliated Ute Citizens v. United States*, 485 U.S. 224 (1988). The
Court notes that the filing of the initial complaint and its implicit suggestion that the market price

⁹ See *Dura*, 524 U.S. at 342-43 (“Other things being equal, the longer the time between
purchase and sale, the more likely that this is so, *i.e.*, the more likely that other factors caused the
loss.”).

1 no longer could be trusted may be relevant to the reliance analysis if this action passes the
2 pleading stage and defendants seek to rebut the presumption.

3 e. Economic Loss

4 Landan argues that the Complaint fails to plead economic loss.¹⁰ Landan argues that the
5 Lead Plaintiff and other named plaintiffs sold their stock too early to be affected by the drop in
6 the stock price allegedly caused by the disclosure of the options backdating. Lead Plaintiff
7 disputes this assertion. In light of the dismissal of the Complaint with leave to amend, the Court
8 need not address the dates of the sales at issue. Lead Plaintiff should ensure that any amended
9 complaint alleges that sales of Mercury stock by the named plaintiffs occurred during the
10 appropriate period.

11 Landan argues that no economic loss can be established on the basis of sales occurring
12 after the commencement of this lawsuit. In *Dura Pharmaceuticals*, the Supreme Court cited a
13 series of sources discussing the common law requirement that a plaintiff in an action based upon
14 fraudulent misrepresentation suffer economic loss before bringing suit. *See Dura*
15 *Pharmaceuticals*, 544 U.S. at 344 (citing *e.g.* M. Bigelow, *Law of Torts* 101 (8th ed. 1907)
16 (damage “must already have been suffered before the beginning of the suit”). However, the
17 Supreme Court did not address the question, presented by the facts alleged in the Complaint, as
18 to whether the filing of an initial complaint based upon an initial and incomplete disclosure of
19 wrongdoing precludes the filing of an amended complaint after a fuller disclosure has been made.
20 Landan cites no authority prohibiting such an amendment. Instead, while *Dura Pharmaceuticals*
21 prohibits the filing of a complaint without *any* allegation of loss and loss causation, the Court
22 concludes that it does not bar the filing of an amended complaint alleging a greater loss for which
23 loss causation also can be pled.¹¹

24 _____
25 ¹⁰ This argument is made jointly with the argument, discussed above, that the Complaint
26 fails to plead loss causation. It is discussed here to the extent that it is separate from the loss
causation argument.

27 ¹¹ Landan’s argument is stronger in the contexts of loss causation and reliance. It
28 suggests that the class cannot have relied upon the stock price after the filing of the initial
complaint. It also implies that, since an earlier complaint was filed on the basis of a cause that

1 f. Scienter

2 The Ninth Circuit has explained:

3 [A] private securities plaintiff proceeding under the PSLRA must plead, in great
4 detail, facts that constitute strong circumstantial evidence of deliberately reckless
5 or conscious misconduct. . . . [A]lthough facts showing mere recklessness or a
6 motive to commit fraud and opportunity to do so may provide some reasonable
7 inference of intent, they are not sufficient to establish a strong inference of
8 deliberate recklessness. In order to show a strong inference of deliberate
recklessness, plaintiffs must state facts that come closer to demonstrating intent,
as opposed to mere motive and opportunity. Accordingly, . . . particular facts
giving rise to a strong inference of deliberate recklessness, at a minimum, is
required to satisfy the heightened pleading standard under the PSLRA.

9 *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 974 (9th Cir. 1999). Each
10 defendant argues that the Complaint alleges its scienter inadequately.

11 i. The Compensation Committee Defendants

12 The Compensation Committee Defendants, each of whom served as an outside director
13 during the relevant period, argue that the Complaint fails to allege sufficient facts regarding
14 scienter as to those financial statements signed by them.¹² This argument is well taken. The
15 Complaint contains insufficient allegations of fact giving rise to the inference that the
16 Compensation Committee Defendants acted knowingly or with deliberate recklessness in
17 approving backdated options. Instead, the Complaint alleges that those defendants signed
18 incorrect financial statements and that the “Special Committee found that questions should have
19 been raised in the minds of the Compensation Committee members from 1998 to 2002 –
20 including Kohavi, Shamir and Yaron – as to whether grants they approved were properly dated.”

21 _____
22 occurred prior to such filing, any injury after that time must have been the result of other causes.
23 In other words, if the initial complaint captured the loss caused by the misrepresentations at issue
24 in this action, the losses that occurred after the filing of the initial complaint must not have
25 caused by those misrepresentations. However, while these are interesting arguments that are
potentially compelling in other contexts, the Court concludes that they are premature at the
pleading stage.

26 ¹² The Compensation Committee Defendants also argue that the Complaint fails to allege
27 that they signed the large bulk of the financial statements at issue in this action. Lead Plaintiff
28 appears to concede that liability does not attach to those defendants for the bulk of the
misstatements, as it focuses upon five Form 10-K’s filed during the asserted class period that
were signed by the Compensation Committee Defendants.

1 Complaint ¶ 247. While their alleged conduct throughout this period, and particularly their
2 alleged failure to recognize or pursue warning signs, may have been negligent, the allegations of
3 the Complaint are insufficient to create a strong inference of knowledge or deliberate
4 recklessness as required by *Silicon Graphics*.

5 ii. The Officer Defendants

6 The Complaint alleges that the Company lacked effective internal controls during the
7 period of the backdating, and that the Special Committee concluded that Landan, Smith, and
8 Skaer knew or should have known that the Company's accounting practices violated GAAP and
9 that those defendants knew or should have known about the backdating practices. One court in
10 this district has concluded that similar allegations are sufficient to establish scienter. *See In re*
11 *McKesson HBOC, Inc. Sec. Litig.*, 126 F.Supp.2d 1248 (N.D.Cal. 2000). In light of its decision
12 to dismiss the Complaint with leave to amend on other grounds, and considering that the
13 question of scienter appears close, particularly as to Landan and Skaer, the Court concludes that
14 it should not attempt to resolve this question without the benefit of the anticipated amendment.
15 Accordingly, in addition to the amendments discussed elsewhere in this order, an amended
16 complaint should include all specific allegations relevant to the scienter of Landan, Smith,
17 Abrams, and Skaer.

18 iii. Mercury

19 As Mercury argues, to the extent that the Complaint fails to plead scienter with respect to
20 any of the individual defendants, it also fails to plead scienter with respect to Mercury. *See In re*
21 *Apple Computer, Inc., Securities Litigation*, 243 F.Supp.2d 1012, 1023 (N.D.Cal. 2002) (“A
22 defendant corporation is deemed to have the requisite scienter for fraud only if the individual
23 corporate officer making the statement has the requisite level of scienter, i.e., knows that the
24 statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she
25 makes the statement.”). Accordingly, a claim against Mercury in an amended complaint will be
26 subject to dismissal if Lead Plaintiff fails to allege scienter by one of the individual defendants.

27 g. Scheme Liability

28 Rule 10b-5(b) pertains to “untrue statement[s] of a material fact” or the omission of such

1 a fact. The bulk of the Complaint focuses on such untrue statements, with approximately one
2 hundred and fifty paragraphs dedicated to that purpose. *See* Complaint ¶¶ 59-205. However,
3 Lead Plaintiff also alleges that the Mercury Defendants “carried out a plan, scheme and course of
4 conduct” that caused violations of Rule 10b-5(a) & (c). *See Id.* at ¶¶ 362-63. Lead Plaintiff
5 alleges that the scheme was carried out by:

6 (1) intentionally selecting a more favorable price for option grants that had
7 previously been granted at a higher price; (2) failing to adhere to the legal terms of
8 promissory notes used by employees to exercise stock options, evidenced by
9 interest and principal forgiveness, subsequent modifications to the length and
10 collateral of the notes, and additional principal added to the note without
11 additional collateral; (3) failing to properly account for stock-based compensation
to certain individuals who held consulting, transition or advisory roles with the
Company either preceding or following their full-time employment with the
Company; and (4) reporting false exercise dates for options whereon the price of
Mercury stock was substantially lower on the reported exercise date than on the
date the option was actually exercised.

12 *Id.* at ¶ 34.

13 The Ninth Circuit has explained that:

14 Participation in a fraudulent transaction by itself, however, is insufficient to
15 qualify the defendant as a “primary violator” if the deceptive nature of the
16 transaction or scheme was not an intended result, at least in part, of the
17 defendant’s own conduct. We hold that to be liable as a primary violator of §
18 10(b) for participation in a “scheme to defraud,” the defendant must have engaged
19 in conduct that had the principal purpose and effect of creating a false appearance
of fact in furtherance of the scheme. It is not enough that a *transaction* in which a
defendant was involved had a deceptive purpose and effect; the defendant’s *own*
conduct contributing to the transaction or overall scheme must have had a
deceptive purpose and effect.

20 *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006). Because the Complaint
21 contains insufficient allegations that the various defendants’ contributions to the overall scheme
22 had a deceptive purpose and effect, the scheme allegations will be dismissed. Lead Plaintiff
23 stated at oral argument that the scheme allegations were part of a “belts and suspenders”
24 approach in the Complaint. While Lead Plaintiff is not precluded by this order from including
25 scheme allegations in an amended complaint, the Court notes its skepticism that Lead Plaintiff
26 will be able to state a separate claim for scheme liability and directs Lead Plaintiff not to include
27 redundant allegations in any amended complaint.

28 h. Challenges to the Class Definition

1 Landan challenges the class definition asserted in the Complaint, arguing that there must
2 be individualized determinations as to who should be included in the class. Landan Motion 10-
3 11. The Court concludes that this challenge is premature. In light of its conclusion that the
4 Complaint should be dismissed with leave to amend, the Court notes that an amended complaint
5 may address any deficiencies in the class definition.

6 **2. Claim Two: Violation of Rule 20(a) Against the Mercury Defendants**

7 Section 20(a) provides:

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

12 15 U.S.C. § 78t(a). “To establish ‘controlling person’ liability, the plaintiff must show that a
13 primary violation was committed and that the defendant ‘directly or indirectly’ controlled the
14 violator.” *Paracor Finance, Inc. v. General Elec. Capital Corp.*, 96 F.3d 1151, 1161 (9th Cir.
15 1996). As discussed above, Lead Plaintiff has failed to state a claim for a primary violation of
16 the securities laws. However, it is possible that it will do so in an amended pleading.
17 Accordingly, the Section 20(A) claim will be dismissed with leave to amend.

18 **3. Claim Three: Violation of Section 10(b) and Rule 10b-5 Against PWC**

19 PWC moves to dismiss the claim against it on the basis that the Complaint does not plead
20 scienter adequately. This Court has explained in a previous action that when asserting a claim
21 under Section 10(b) against a public auditor, “a plaintiff must demonstrate that ‘the accounting
22 practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to
23 see the obvious, or to investigate the doubtful, or that the accounting judgments which were
24 made were such that no reasonable accountant would have made the same decisions if confronted
25 with the same facts.’” *In re Redback Networks, Inc.*, 2006 WL 1805579, *6 (N.D.Cal. Mar. 20,
26 2006) (citing *In re Software Toolworks, Inc.*, 50 F.3d 615, 627 (9th Cir. 1994)). Accordingly,
27 this motion turns on the question as to whether PWC was deceived by the individuals who
28 backdated options or whether PWC knew about the backdating or allowed it to occur by acting

1 recklessly. As discussed below, the Court concludes that while it may be able to do so in an
2 amended complaint, Lead Plaintiff has not pled facts supporting a strong inference of knowledge
3 or recklessness. Accordingly, this claim will be dismissed with leave to amend.¹³

4 Lead Plaintiff argues that PWC's alleged failure to heed six "red flags" is powerful
5 evidence of scienter. However, the failure to heed these purported "red flags," even taken
6 together, does not amount to deliberate recklessness or the failure to provide any audit at all.
7 First, while Mercury discovered upon investigation that what appeared to be recourse notes in
8 fact were not treated as such, Lead Plaintiff alleges no facts indicating that PWC knew or should
9 have known of Mercury's alleged misconduct at the time it occurred. Second, the fact that
10 options were granted on a broad range of dates within the year may have represented a deviation
11 from past practice, but it does not suggest by itself that PWC was deliberately reckless in its
12 audit. Third, Lead Plaintiff alleges no facts indicating that PWC knew of long delays between
13 'grant dates' and the approval of the grants, and, at least as currently alleged, PWC's failure to
14 check a sufficient number of option grants amounts to negligence rather than deliberate
15 recklessness. Fourth, it is unreasonable to describe PWC as reckless for failing to connect a
16 decline in option grants after the passage of the Sarbanes-Oxley Act with the backdating of
17 options, particularly in light of the possibility of other explanations for such a decline. Fifth,
18 even if PWC had discovered an improper loan to Landan, it is not clear that such a discovery
19 would have led it to discover the improper backdating of stock options. Finally, the fact that
20 PWC inherited a client that previously had taken a charge due to a mistake in backdating did not
21 by itself put PWC on notice that illegal backdating might be occurring at Mercury.

22 If proved, PWC's alleged failure to exercise due care and exhibit a proper degree of
23 professional skepticism, to evaluate Mercury's internal controls properly, and to gather sufficient
24 evidence to support its unqualified endorsements of Mercury's financial statements all reflect
25 poorly on the quality of work performed by PWC. However, while such actions may amount to

26
27 ¹³ PWC argues that the asserted fact that the investigation into the backdating at Mercury
28 cost over seventy million dollars means that it could not have been expected to discover the
backdating. This argument ignores the obvious possibility that PWC's wrongdoing contributed
to the expense of discovering the fraudulent activities.

1 negligence, they do not rise to the level of deliberate recklessness. Nor does the scope of the
2 restatement rendered necessary by the backdating alter the insufficient character of the other
3 allegations. Instead, the allegations against PWC amount to a series of allegations about
4 improprieties at Mercury and a conjecture that PWC must have known about it. As currently
5 pled, this is the type of “fraud by hindsight” theory barred by the PSLRA. *See Silicon Graphics,*
6 *183 F.3d at 488.*

7 **IV. ORDER**

8 Good cause therefor appearing, IT IS HEREBY ORDERED that the motions to dismiss
9 are GRANTED with leave to amend. Any amended complaint shall be filed within thirty days of
10 the issuance of this order.

11
12 DATED: 7/30/07

13 
14 JEREMY FOGEL
United States District Judge

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