

MAR 31 2008

JAMES N. HATTEN, Clerk
By: *[Signature]*
Deputy Clerk

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

IN RE WITNESS SYSTEMS, INC.
SECURITIES LITIGATION

Civil Action No. 1:06-CV-1894

ORDER

This matter is presently before the Court on the Witness Defendants' Motion to Dismiss Lead Plaintiff's Consolidated Amended Complaint [Doc. No. 53] and Defendant Thomas Crotty's Motion to Dismiss Plaintiff's Consolidated Amended Complaint [Doc. No. 54].¹ Having considered the briefs submitted by the parties and the oral arguments of counsel, the Court **GRANTS** the above motions.²

¹ The "Witness Defendants" are Witness Systems, Inc. and Individual Defendants David Gould, William Evans, Loren Wimpfheimer, Joel Katz, Peter Sinisgalli, Dan Lautenbach, Terry Osborne, Nicholas Discombe, and Thomas Bishop. Thomas Crotty is separately represented.

² At the conclusion of the March 26, 2008 hearing on these motions, the Court instructed counsel for Defendants to prepare and submit this Order. Counsel filed the Order electronically on March 29, 2008 at 4:42 pm. As of 1:00 pm on March 31, 2008, the Court has received no objections to the proposed Order, and the Court finds that it fairly and accurately reflects the Court's reasons for granting the motions to dismiss.

I. BACKGROUND

Lead Plaintiff, Witness Systems Investor Group (“Plaintiff”), brings this securities fraud action under Sections 10(b) and 20(a) of the Securities and Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. §§ 78j, 78t, and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The action is brought on behalf of a putative class of individuals who purchased common stock of Witness Systems, Inc. (“Witness” or the “Company”) between April 23, 2004 and August 11, 2006 (the “Class Period”).

Witness is a Roswell, Georgia based software and services company that helps businesses use customer information to improve efficiency. (Consolidated Amended Complaint (“CAC”) ¶ 2.) The Individual Defendants consist of certain officers and directors of Witness:

- David Gould served as Chief Executive Officer (“CEO”) from February 1999 and Chairman of the Board from November 1999; he resigned from those positions on December 1, 2006. (*Id.* ¶ 41.) He is not alleged to have exercised any backdated stock options. (*Id.* ¶ 28 & Ex. A.)
- William Evans has served as Chief Financial Officer (“CFO”) and Executive Vice President since May 2002 and Chief Administrative Officer (“CAO”) since April 2003. (*Id.* ¶ 43.) He is not alleged to have received or exercised any backdated stock options. (*Id.* ¶ 28 & Ex. A.)
- Loren Wimpfheimer served as General Counsel and Secretary from September 2000 to December 2006, and as Senior Vice

President of Corporate Development starting January 2001. (*Id.* ¶ 46; Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 12.) He is alleged to have exercised some options starting March 2002. (CAC Ex. A.) He did not sign the relevant financial statements during the Class Period. (2004 Witness Form 10-K, filed Mar. 16, 2005 [Doc. No. 53-7] at 87; 2005 Witness Form 10-K, filed Mar. 17, 2006 [Doc. No. 74-2] at 82.)

- Joel Katz joined Witness as a director in July 1999. (Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 11.) He is alleged to have served as Chair of the Audit Committee during 1999-2005 and Member of the Compensation Committee during 1999-2001. (CAC ¶ 44.) He is not alleged to have had any specific day-to-day role in the management or operations of the Company. (*Id.* ¶¶ 44, 231-26 [pp. 161-64].)³ He is alleged to have exercised 27,000 options that he received upon joining the Company. (*Id.* Ex. A; Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 13.)
- Peter Sinisgalli joined Witness as a director in July 2000. (Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 11.) He is alleged to have served as Member of the Compensation Committee from July 2000 to July 2003 (Chair during certain years) and the Audit Committee from July 2000 to 2005. (CAC ¶ 47.) He is not alleged to have had any specific day-to-day role in the management or operations of the Company. (*Id.* ¶¶ 47, 231-26 [pp. 161-64].) He is alleged to have exercised 27,000 options that he received upon joining the Company. (*Id.* Ex. A; Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 13.)
- Dan Lautenbach joined Witness as a director in March 2002. (Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 11.) He is alleged to have served as Member of the Compensation

³ Due to an apparent typographical error, the paragraph numbers in the CAC jump from ¶ 233 (p. 162) back to ¶¶ 224-33 (p. 163-68). To avoid confusion, the Court has noted in brackets the relevant page cites where appropriate.

Committee during 2002-05. (CAC ¶ 48.) He is not alleged to have had any specific day-to-day role in the management or operations of the Company. (*Id.* ¶¶ 48, 231-26 [pp. 161-64].) He is not alleged to have received or exercised any backdated options. (*Id.* ¶ 28 & Ex. A.)

- Terry Osborne joined Witness as a director in June 2003 when Witness acquired Eyretel plc, a U.K. company with which Mr. Osborne was affiliated prior to April 2003. (Witness Form DEF 14A, filed Apr. 26, 2005 [Doc. No. 53-15] at 10.) He is alleged to have served as Member of the Compensation Committee from July 2003 to 2005. (CAC ¶ 49.) Mr. Osborne is not alleged to have had any specific day-to-day role in the management or operations of the Company. (*Id.* ¶¶ 49, 231-26 [pp. 161-64].) He is not alleged to have received or exercised backdated options. (*Id.* ¶ 28 & Ex. A.)
- Nicholas Discombe served as Chief Operating Officer (“COO”) from April 2003 to January 3, 2007; he joined Witness when it acquired Eyretel plc, a U.K. company with which he was affiliated prior to March 2003. (Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 11.) Mr. Discombe is not alleged to have received or exercised any backdated options. (CAC ¶¶ 28, 42 & Ex. A.) He did not sign the relevant financial statements during the Class Period. (2004 Witness Form 10-K, filed Mar. 16, 2005 [Doc. No. 53-7] at 87; 2005 Witness Form 10-K, filed Mar. 17, 2006 [Doc. No. 74-2] at 82.)
- Thomas Bishop joined Witness as a director in October 2004. (Witness Form DEF 14A, filed Apr. 30, 2007 [Doc. No. 53-8] at 11.) He is not alleged to have had involvement in options or accounting. (*Id.* ¶¶ 50.) He is not alleged to have had any specific day-to-day role in the management or operations of the Company,

(*id.* ¶¶ 50, 231-26 [pp. 161-64]), or to have received or exercised backdated options, (*id.* ¶ 28 & Ex. A).⁴

The case centers on allegations relating to the practice of stock option “backdating.” While the specific mechanics of employee stock options are governed by various tax and accounting rules and considerations, in substance, a stock option gives an employee a right to buy company stock in the future at the price of the stock on the date of the grant. This price is referred to as the “exercise price” or the “strike price.” As a general matter, the date of the grant is referred to as the “measurement date.” If, over time, the stock price rises, the options gain value. As described by U.S. District Judge William Alsup:

Once exercisable, the options are worth the difference between the exercise price and the current market price. If the stock price falls, the options are worthless. Options with an exercise price equal to the stock’s price as of the grant date are referred to as ‘at-the-money’ options. Those with an exercise price lower than the stock’s market price are referred to as ‘in-the-money’ options. For financial reporting purposes, companies granting in-the-money options have to recognize compensation expenses equal to the difference between the market price and the exercise price. No compensation costs need be recognized for at-the-money options, for the company does not forego any revenue by granting them.

⁴ Thomas Crotty has submitted a separate motion to dismiss. The Court addresses the factual allegations relating to Mr. Crotty in Part III.C., *infra*.

Middlesex Ret. Sys. v. Quest Software, Inc., 527 F. Supp. 2d 1164, 1170 (C.D. Cal. 2007) (quoting *In re Zoran Corp. Deriv. Litig.*, 511 F. Supp. 2d 986, 996-97 (N.D. Cal. 2007)).

In this case, the CAC specifically identifies seven option grants in 2000 and 2001 for which the grant dates were “selected in hindsight” to coincide with low share prices for Witness. (CAC ¶ 28.) The CAC does not identify any backdated options granted after 2001. After 2002, Plaintiff alleges that Witness engaged in “springloading” stock options by granting options in advance of positive news that led to increases in Witness’s stock price. The CAC alleges that the Company granted springloaded options on four dates in 2004. (*Id.* ¶ 30.)

Plaintiff’s core allegation is that Witness’s financial results and financial statements issued during the Class Period of April 23, 2004 to August 11, 2006 were false and misleading because they improperly accounted for stock options that were backdated in 2000 and 2001. The CAC states that the improper accounting for backdated stock options (as reflected in the Company’s later restatement) caused Witness’s compensation expenses to be understated and earnings per share to be overstated. (*Id.* ¶ 78.) It alleges that such material misstatements began prior to the Class Period and continued into the 2004 to 2006 Class Period. (*Id.* ¶¶ 77-157.)

The specific Class Period statements alleged to be false and misleading are:

(i) the Company's press releases and conference calls announcing quarterly results (CAC ¶¶ 95-157, items 1, 3, 5, 8, 10, 11, 13, 15, 18, 20); (ii) quarterly 10-Q filings for each quarter from Q1 2004 to Q1 2006 (*id.*, items 2, 4, 6, 12, 14, 16, 21); (iii) annual 10-K filings for 2004 and 2005 (*id.*, items 9, 19); (iv) a December 17, 2004 press release regarding an anticipated acquisition of Blue Pumpkin Software (*id.*, item 7); and (v) a Form 424B5 prospectus supplement filed in connection with a secondary stock offering in December 2005 (*id.*, item 17).⁵

The CAC further alleges that on March 18, 2006, the Wall Street Journal published an article entitled "The Perfect Payday," which first brought attention to the practice of options backdating at public companies. (CAC ¶ 10.) On May 17, 2006, Deutsche Bank also published a study of option grant practices at several companies, including Witness. (*Id.* ¶ 12.) The stock of Witness fell \$1.14 a share over the two days of May 17 and May 18, 2006. (*Id.*)

On July 27, 2006, the Company announced during an analyst call that it had initiated an internal review of stock options granted in 2000, 2001, and 2002. (*Id.*

⁵ The CAC also alleges that the 10-Qs and 10-Ks attested to the effectiveness of Witness's internal controls and procedures and contained signed certifications pursuant to the Sarbanes-Oxley Act of 2002 ("SOX certifications") attesting to the accuracy of the company's financial reporting. (CAC ¶¶ 100-01, 105-06, 113-14, 123-24, 129-30, 134-35, 138-39, 146, 148, 155-56.)

¶ 15.) Mr. Evans, the Company's CFO, stated that "[d]epending on the results of the review, there may or may not be adjustments to prior periods." (*Id.*) Plaintiff alleges that, as a result of this information, the stock of Witness fell from \$18.19 a share to \$15.75 a share on July 28, 2006. (*Id.* ¶ 16.)

On August 9, 2006, Witness further announced that its Board of Directors had formed a Special Committee of independent directors to review certain option grants between February 2000 and August 2002. (*Id.* ¶¶ 17, 161.) The Company stated that based on its "preliminary internal review," it expected to record additional charges for stock-based compensation expenses in prior periods, but stated that it did "not anticipate any material adjustment to the previously disclosed 2005 or 2006 financial results of operations." (*Id.* ¶ 161.) Plaintiff alleges that, as a result of the August 9, 2006 announcement, the price of Witness stock dropped from \$14.93 to \$13.48 a share. (*Id.* ¶ 19.) On August 11, 2006, Witness filed a Form 8-K with the SEC attaching the August 9 press release. (*Id.* ¶¶ 22, 163.) Plaintiff alleges that, as a result of this announcement, the stock dropped again, closing at \$12.91 per share. (*Id.* ¶ 23.)

On February 8, 2007, Witness filed an amended 10-K for fiscal year 2005, which reported the Special Committee's findings and presented restated financial statements for six years, from 2000 to 2005. (*Id.* ¶ 26.) The Company concluded

that for the aggregate six year period, additional stock based compensation expense of \$9.7 million should be recorded. (*Id.* ¶ 165.) Of the total restated expense increase of \$9.7 million, the restated amounts for the years in the Class Period were \$0.8 million for 2004 and \$0.2 million in 2005. (*Id.*)

II. LEGAL STANDARDS

In order for a complaint to survive a motion to dismiss, it “must include ‘[f]actual allegations [adequate] to raise a right to relief above the speculative level,’” with “‘enough heft’ to set forth ‘a plausible entitlement to relief.’” *Financial Sec. Assur., Inc. v. Stephens, Inc.*, 500 F.3d 1276, 1282 (11th Cir. 2007) (quoting *Bell Atlantic Corp. v. Twombly*, -- U.S. --, 127 S.Ct. 1955, 1964-67 (2007)) (alterations in original). “At the motion to dismiss stage, all well-pleaded facts are accepted as true, and the reasonable inferences therefrom are construed in the light most favorable to the plaintiff.” *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1261 (11th Cir. 2006) (quoting *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1273 n. 1 (11th Cir. 1999)). “Regardless of the alleged facts, however, a court may dismiss a complaint on a dispositive issue of law.” *In re Sportsline.com Sec. Litig.*, 366 F. Supp. 2d 1159, 1162 (S.D. Fla. 2004) (citing *Marshall County Bd. of Educ. v. Marshall County Gas Dist.*, 992 F.2d 1171, 1174 (11th Cir. 1993)). A court may consider publicly filed documents on a motion to dismiss. *Garfield*, 466 F.3d at

1260 n.2 (11th Cir. 2006); *La Grasta v. First Union Sec. Inc.*, 358 F.3d 840, 847 n.4 (11th Cir. 2004).

A. Section 10(b) Claim

Section 10(b) and Rule 10b-5 of the Exchange Act make it unlawful for any individual to employ a manipulative or deceptive device in connection with the purchase or sale of any security. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5. To allege a claim of securities fraud under these provisions, a plaintiff must show: “1) a misstatement or omission, 2) of a material fact, 3) made with scienter, 4) on which plaintiff relied, 5) that proximately caused his injury.” *Garfield*, 466 F.3d at 1261 (quoting *Bryant*, 187 F.3d at 1281).

The Private Securities Litigation Reform Act of 1995 (“PSLRA”) heightened the pleading requirements in securities class actions. The PSLRA requires that a plaintiff asserting a securities fraud claim “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 defendants acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2) (emphasis added). The requisite state of mind for a Section 10(b) claim is the “intent to deceive, manipulate or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Rule 9(b) of the Federal Rules of Civil Procedure further requires that “[i]n alleging fraud . . . a party must

state with particularity the circumstances constituting fraud[.]” Fed. R. Civ. P. 9(b) (2007).

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, -- U.S. --, 127 S. Ct. 2499, 2504 (2007), the Supreme Court recently clarified the “[e]xacting pleading requirements” of the PSLRA. The Court stated that such requirements are not met merely where a “reasonable person could infer that the defendant acted with the required intent.” 127 S. Ct. at 2509. Instead, the inference of scienter “must be more than merely ‘reasonable’ or ‘permissible’—it must be *cogent and compelling*, thus strong in light of other explanations.” *Id.* at 2510 (emphasis added).

B. Section 20(a) Claim

Section 20(a) of the Exchange Act provides that “[e]very person who, directly or indirectly, controls any person liable under any provision of this chapter” shall be held jointly and severally liable to the same extent as the controlled person. 15 U.S.C. § 78t(a). In order to state a claim under Section 20(a) based on a violation of Section 10(b), a plaintiff must allege that: (1) a primary liability under Section 10(b) exists; (2) defendant had the “power to control the general business affairs” of the corporation; and (3) defendant had the requisite power to “control or influence the specific corporate policy which resulted in

primary liability.” *Theoharous v. Fong*, 256 F.3d 1219, 1227 (11th Cir. 2001) (quotation marks and citation omitted).

III. DISCUSSION

Defendants argue that Plaintiff’s Section 10(b) claim should be dismissed on two separate grounds: first, failure adequately to plead scienter, and second, failure to allege facts that would support a finding of loss causation. Defendants also argue that Plaintiff’s Section 20(a) fails in the absence of primary liability under Section 10(b). The Court addresses each of these grounds below.

A. Section 10(b) Claim

1. Scienter

Consistent with the Supreme Court’s *Tellabs* decision, the Eleventh Circuit requires that a “securities fraud plaintiff must plead scienter with particular facts that give rise to a strong inference that the defendant acted in a severely reckless manner.” *Garfield*, 466 F.3d at 1264 (quoting *Bryant*, 187 F.3d at 1287). “Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care.” *Id.* (quoting *Bryant*, 187 F.3d at 1282 n.18). Where a lawsuit involves multiple defendants, “scienter must be found with respect to each defendant and with respect to each

alleged violation of the statute.” *In re Coca-Cola Enters. Inc. Sec. Litig.*, 510 F. Supp. 2d 1187, 1199 (N.D. Ga. 2007) (quoting *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1017-18 (11th Cir. 2004)).

Plaintiff has failed to allege sufficient, particularized facts to support a “cogent and compelling” inference of scienter as to Witness or as to each Individual Defendant. *Tellabs*, 127 S. Ct. at 2510. Although the CAC is lengthy, the details contained therein are simply insufficient to support a strong inference of scienter. Specifically, the allegations are in the nature of a theory that Defendants must have known that the 2004 and 2005 financial statements were misstated due to backdating that occurred in 2000 and 2001. The CAC never explains when, or how, any or all Defendants learned about the details or circumstances pertaining to any backdated option grants. While this is the case as to all Defendants, it is particularly so as to the five Individual Defendants (Discombe, Evans, Lautenbach, Osborne, Bishop) who were not even employed at the Company in 2000-01. The CAC does not allege particularized facts supporting any inference that these defendants would have any basis even to know of the allegedly backdated options (or any subsequent accounting pertaining to such options) for the period pre-dating their arrival at the Company.

Moreover, there are no allegations that the Individual Defendants are or were familiar with the accounting principles applicable to stock options, or that they knew that the proper accounting of the 2000 and 2001 options would necessitate a restatement of the 2004 and 2005 financial statements. For example, with respect to the Individual Defendants who were employed at the Company in 2000 and 2001, nothing is alleged that would demonstrate that those individuals had any knowledge that disclosures during the Class Period might require future adjustments based on option grants made in 2000 and 2001. Specifically:

- Gould served as CEO in 2000-01, but is not alleged to have any accounting expertise; he also did not serve on any Board committees that dealt with the relevant stock options or accounting issues. (CAC ¶ 41.)⁶
- Wimpfheimer was the Company's General Counsel in 2000-01, but is not alleged to have been a member of any Board committees relating to option granting or accounting. (*Id.* ¶ 46.) While he appears to have exercised some options starting March 2002, (*id.* Ex. A), the CAC does not allege that he was involved in the accounting for those options. He also did not sign the relevant financial statements during the Class Period. (2004 Witness Form 10-K, filed Mar. 16, 2005 [Doc. No. 53-7] at 87; 2005 Witness Form 10-K, filed Mar. 17, 2006 [Doc. No. 74-2] at 82.)

⁶ While the CAC states that Gould served on the Options Committee, this committee was only authorized to grant options to employees below the rank of Senior Vice President. (*See* Witness Form DEF 14A, filed Apr. 23, 2002 (Doc. No. 53-16) at 14.) The options granted by the Options Committee are not at issue here. (*See* CAC ¶¶ 28-29, 41-58.)

- Crotty, Katz, and Sinisgalli were Outside Directors who served on the Compensation and Audit Committees in 2000-01. (*Id.* ¶¶ 44-45, 47.) While they approved the option grants at issue, there are no facts to suggest that these directors were involved in the accounting for those options, or had the accounting expertise to understand the impact of the options on future financial statements.

See also Weiss v. Amkor Tech., Inc., 527 F. Supp. 2d 938, 949 (D. Ariz. 2007)

(dismissing options backdating case and stating that the “accounting rules at issue, specifically [Accounting Principles Board (“APB”)] No. 25, are complex and require accounting expertise and judgment”); *Sportsline.com*, 366 F. Supp. 2d at 1168-69 (dismissing restatement case involving stock options and stating that the principles of APB No. 25 are “far from obvious”).⁷

Plaintiff contends that the application of relevant accounting principles, referred to as APB Opinion No. 25, is relatively straightforward with respect to calculating the proper compensation expense for stock options. (Pl. Opp. at 24.) It asserts that this is a simple process of subtracting the exercise price from the fair market value of Witness’s stock on the measurement date. However, Plaintiff’s

⁷ The amounts of the misstatements alleged in 2004 and 2005 are also not of such a magnitude that scienter can reasonably be inferred. Here, the amounts of the restated expense adjustments for the Class Period equaled 0.5% of revenues in 2004 and 0.17% of revenues in 2005. *Compare In re CP Ships Ltd., Sec. Litig.*, 506 F. Supp. 2d 1161, 1168-69 (M.D. Fla. 2007) (dismissing restatement case involving less than 1% of revenues); *In re AFC Enters. Inc. Sec. Litig.*, 348 F. Supp. 2d 1363, 1372 n.3 (N.D. Ga. 2004) (dismissing restatement case involving 0.3% and 0.8% adjustments to revenue).

assertion oversimplifies the application and substance of APB No. 25. While some of the necessary calculations may be straightforward once the proper measurement date has been determined, the initial determination of the measurement date is not so straightforward. *See, e.g.*, APB 25.10 (acknowledging that “the measurement date may be later than the date of grant or award” in certain circumstances); APB 25.11 (setting forth eight different measurement dates).

But more fundamentally, Plaintiff glosses over the fact that here the analysis of scienter is not limited to whether APB No. 25 was properly applied to the determination of compensation expenses at the time the options in question were granted in 2000 and 2001. Those option grants, and the financial statements reflecting their accounting treatment, predated by several years the beginning of the Class Period. Statements made in those pre-Class Period financial disclosures do not form the basis of Plaintiff’s claims of liability in this case. (CAC ¶ 94 (alleging that pre-Class Period disclosures merely “set the stage for the materialization of the fraud that *began* with the commencement of the Class Period on April 23, 2004”) (emphasis added).) Whether or not determinations in 2000 and 2001 with respect to the proper accounting for options granted in those years were as simple as Plaintiff claims, the issue in this case is a different and more complex one. Here, the restatements in question pertained to the Class Period of

2004 to 2006, during which period there is no allegation that Witness or any of the Individual Defendants issued or received backdated option grants. The more relevant question here is what facts are alleged to show that any of the Defendants had the requisite knowledge of the impact, under appropriate accounting principles, on the financial statements for 2004 and 2005 of corrections made with respect to options granted in 2000 and 2001. The CAC, however, does not set forth particularized allegations that would show how Defendants, at the time the financial results for 2004 and 2005 were being disseminated during the Class Period, knew that the application of Generally Accepted Accounting Principles would have mandated a restatement of those financial results due to problems in the granting of options three to four years earlier.

Ultimately, Plaintiff's claim rests on the mere job titles and committee memberships of the Individual Defendants and the appearance of their signatures on various SEC filings. Such allegations fall well short of meeting the strict pleading requirements of the PSLRA. *See, e.g., Weiss*, 527 F. Supp. 2d at 949 (dismissing options backdating case and stating that plaintiffs "have done little more than allege[] the Individual Defendants' respective board or executive positions"); *In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1159 (C.D. Cal. 2007) (dismissing options backdating claim and finding insufficient

allegations that individual defendants “held positions on various committees, such as the executive, audit, and compensation committees”); *see also In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1330 (M.D. Fla. 2002) (dismissing claims against officers and directors because “mere status as outside directors and committee members . . . do[es] not raise a strong inference of scienter”).

Plaintiff also argues that a review of other factors supports a strong inference of scienter. However, as discussed below, a review of these factors as a whole, as well as the CAC as a whole, do not give rise to a strong inference of scienter.

a) *Stock Sales*

Plaintiff places heavy reliance on alleged insider sales to advocate for a finding of scienter. However, a review of the alleged insider stock sales shows that they do not support a strong inference of scienter. During the Class Period, six of the eight defendants sold reasonable percentages of their holdings: for instance, Lautenbach sold 14% of his holdings; Evans 19%, Gould 39%, Katz 40%, Sinisgalli 56%, and Wimpfheimer 59%. (CAC ¶ 169.) These amounts are within the range of percentages held not to give rise to an inference of scienter. *E.g.*, *AFC Enters.*, 348 F. Supp. 2d at 1373 & n.4 (finding that sales of 19-46% and 100% of holdings were insufficient to support a strong inference of scienter); *In re Spectrum Brands, Inc. Sec. Litig.*, 461 F. Supp. 2d 1297, 1316-18 (N.D. Ga. 2006) (finding

sales of 25% and 15% of holdings insufficient); *see also* *Teacher's Ret. Sys. of La. v. Hunter*, 477 F.3d 162, 185 (4th Cir. 2007) (sales of 92%, 100%, and 82% insufficient).

Moreover, the stock sales reflect a pattern of regular dispositions that persisted throughout the Class Period or pre-dated the Class Period. *See Coca-Cola*, 510 F. Supp. 2d at 1202 (plaintiff “bear[s] the burden of showing that sales by insiders were in fact unusual or suspicious in amount and in timing”) (citation omitted). For instance, Gould sold stock, both before and during the Class Period, in regular, small amounts (mostly less than 4,000 shares), making approximately 300 sales over a nearly six-year period. (*See* CAC Ex. A.) He also sold shares pursuant to Rule 10b5-1 plans filed with the SEC in 2002, 2004, 2005 and 2006.⁸ *See Spectrum*, 461 F. Supp. 2d at 1317 (stating that if a sale is made pursuant to a 10b-5 plan, the plan serves as an affirmative defense to allegations of insider trading). Similarly, Wimpfheimer made regular sales, selling on more than 50 separate dates between June 2004 and July 2006. (*See* CAC Ex. A.) Comparable patterns are reflected for Discombe (sales on 20 separate days over the span of 26

⁸ (*See* Witness Forms 8-K, filed September 11, 2002; February 4, 2004; March 3, 2005; and March 21, 2006 (Doc. Nos. 53-10 to 53-13).) These SEC filings contradict Plaintiff's suggestion that Mr. Gould filed a 10b5-1 plan only after the March 18, 2006 Wall Street Journal article on options backdating (CAC ¶ 171).

months), Osborne (sales in 2004, 2005 and 2006), and Evans (sales in 2004 and 2005). (*Id.*)⁹

Finally, no scienter can be inferred from the stock sales of Discombe and Osborne, who did sell a significant portion of their holdings (99% and 92% respectively) during the Class Period. Both individuals joined Witness following its acquisition of Eyretel plc, a U.K.-based company, in March 2003; this was long after the alleged backdating practices had occurred in 2000 and 2001. (*See* Witness Form DEF 14A, filed Apr. 26, 2005 [Doc. No. 53-15] at 10, 14.) Plaintiff fails to allege with particularity how either individual sold shares with knowledge or with reckless disregard in failing to know about technical U.S. accounting practices in 2000 and 2001, when both were with a British company. In any event, the trading history of these individuals (*see* CAC Ex. A) exhibits a consistent pattern of regular exercises and sales throughout their tenure at Witness, and cannot support an inference of scienter, particularly in light of the absence of suspicious trading by other defendants. *See, e.g., In re Humphrey Hospitality Trust, Inc. Sec. Litig.*, 219 F. Supp. 2d 675, 686 (D. Md. 2002) (finding no

⁹ Sinisgalli's and Katz's disposition of 27,000 shares each, which they appear to have received upon joining the Board of Directors, also do not carry any indicia of fraud. (*See* Witness Form DEF 14A, filed Apr. 30, 2007 (Doc. No. 53-8) at 13 (describing policy of granting 27,000 options to new directors).)

inference of scienter as to defendant who sold stock during the class period where other defendants did not, and citing cases); *see also Ronconi v. Larkin*, 253 F.3d 423, 435-36 (9th Cir. 2001) (stating that executive's sale of 98% of her shares "supports only a weak inference [of scienter], not a strong one, in light of what the other, equally knowledgeable, insiders were doing").

b) *Motive and Opportunity*

Plaintiff also alleges that the 2004 Blue Pumpkin acquisition and 2005 secondary stock offering provided a motive to inflate the price of Witness stock. (Pl. Opp. at 35-36.) However, general "allegations of a motive to maintain stock price or enhance a Company's business prospects cannot support a strong inference of scienter." *SportsLine.com*, 366 F. Supp. 2d at 1171 (rejecting claim of motive based on business acquisition); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 420 (5th Cir. 2001) (rejecting claim of potential benefit from higher public offering price). There is also no allegation that any defendant secured a "personal gain" from these business ventures. *Rombach v. Chang*, 355 F.3d 164, 177 (2d Cir. 2004).

c) *Executive Resignations*

Plaintiff further alleges that Gould and Wimpfheimer left the Company through "high-level terminations." (Pl. Opp. at 29.) Contrary to Plaintiff's characterization, however, the CAC does not indicate that these resignations were

anything but voluntary. It merely states that Gould “resigned” his position as CEO (¶ 41), and that Wimpfheimer was “removed” as General Counsel but remains at the Company as Senior Vice President of Corporate Development (¶ 46). These allegations fail to support an inference of fraud. *See, e.g., In re Cyberonics Inc. Sec. Litig.*, 523 F. Supp. 2d 547, 553 (S.D. Tex. 2007) (holding that allegedly “forced resignations” of CEO and CFO in options case were not a proper basis for inferring fraud where there was “no evidence in the record that the resignations were indeed forced”); *In re Openwave Sys. Sec. Litig.*, 528 F. Supp. 2d 236, 251 (S.D.N.Y. 2007) (stating that executive’s resignation is insufficient to infer scienter in options case in absence of “a single fact linking [executive’s] resignation to the alleged fraud or his knowledge thereof”); *Middlesex*, 527 F. Supp. 2d at 1183 (stating that mere reassignment of executive is insufficient to infer scienter in options case).

d) *Internal Controls and SOX Certifications*

Plaintiff alleges that fraud can be inferred from the statements in Witness’s 10Qs and 10Ks, including SOX certifications, that attested to the effectiveness of internal controls and the accuracy of financial reporting. (Pl. Opp. at 30-32.) However, the alleged falsity of a SOX certification is only probative of scienter if the person signing the certification was “severely reckless” by ignoring “red flags”

or “glaring accounting irregularities” in the *underlying* financial statements. *Garfield*, 466 F.3d at 1266; *see also Hansen*, 527 F. Supp. 2d at 1159-60; *Cyberonics*, 523 F. Supp. 2d at 554; *Weiss*, 527 F. Supp. 2d at 950. As discussed, Plaintiff has not adequately alleged that Defendants were reckless in misstating the Company’s financial statements in the Class Period. And even if Witness’s internal controls were deficient in this period, this only “amount[s] to negligence,” and does not “raise an inference of severe recklessness.” *Sunterra*, 199 F. Supp. 2d at 1326; *see also Hansen*, 527 F. Supp. 2d at 1158.

For the foregoing reasons, Plaintiff has failed to allege sufficient facts to support a “cogent and compelling” inference of scienter as required by the PSLRA and the Supreme Court in *Tellabs*.

2. Loss Causation

Plaintiff also has not adequately pleaded loss causation. Under the PSLRA, Plaintiff is required to prove that the “act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-4(b)(4). In *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court held that it is insufficient for a plaintiff to allege that “the price *on the date of purchase* was inflated because of the misrepresentation.” 544 U.S. 336, 342 (2005) (emphasis in original). Rather, a plaintiff must show a “logical link between the inflated share

purchase price and any later economic loss.” *Id.*; see also *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) (“loss causation describes the link between the defendant’s misconduct and the plaintiff’s economic loss,” and can be proved only if plaintiff shows that “the untruth was in some reasonably direct, or proximate, way responsible for his loss”) (quotation marks and citation omitted).

Plaintiff contends that it would be inappropriate to rule on the issue of loss causation at the pleading stage, and that the question of whether Plaintiff can meet the requisite loss causation element of their claim should be deferred to the time of trial. However, where the pleadings do not set forth a basis to establish loss causation, dismissal on that basis is mandated. Courts in this Circuit have granted motions to dismiss claims due to a failure to adequately allege loss causation. See, e.g., *In re Paincare Holdings Sec. Litig.*, No. 6:06-cv-362, 2007 WL 1229703, at *8 (M.D. Fla. Apr. 25, 2007); *Coca-Cola*, 510 F. Supp. 2d at 1204; *In re Faro Tech. Sec. Litig.*, No. 6:05-cv-1810, 2007 WL 430731, at *12 (M.D. Fla. Feb. 3, 2007); *In re Teco Energy, Inc. Sec. Litig.*, No. 8:04-cv-1948, 2006 WL 2884960, at *8-*9 (M.D. Fla. Oct. 10, 2006); *Davidco Investors, LLC v. Anchor Glass Container Corp.*, No. 8:04CV2561T, 2006 WL 547989, at *22 (M.D. Fla. Mar. 6, 2006) (same); *In re Recoton Corp. Sec. Litig.*, 358 F. Supp. 2d 1130, 1152-53

(M.D. Fla. 2005); *Barr v. Matria Healthcare, Inc.*, 324 F. Supp. 2d 1369, 1380 (N.D. Ga. 2004).

In this case, dismissal is required because the CAC fails to adequately plead loss causation. First, Plaintiff has not alleged any corrective disclosures for its “springloading” claim.¹⁰ The CAC itself states that “[t]he Company’s restatement did not admit to [] spring-loading. In fact, the Special Committee investigating the Company’s option practices concluded that it was not necessary to expand the investigation to cover periods after August 31, 2002.” (CAC ¶ 31.) Absent a corrective disclosure, Plaintiff’s allegations of loss causation cannot survive. *See Teco*, 2006 WL 2884960, at *8-*9 (dismissing claims for which no corrective disclosure existed); *Premiere*, 2000 WL 33231639, at *14 (same); *see also Barr*,

¹⁰ Even if Plaintiff’s “springloading” allegations (comprising a mere three of 254 paragraphs (¶¶ 29-31) in the CAC) are only considered in connection with the issue of scienter, they are inadequate as they are too general, conclusory, and insubstantial to support the required strong inference of scienter. For example, as Defendants point out, there were numerous option grants that were not followed by positive news. (*See* Def. Br. (Doc. No. 53-2) at 34-35.) In addition, while the CAC does not specify clearly the timing of the alleged releases of good news, the price movements that followed the allegedly “springloaded” option grants appear, based on the allegations that are made, to be modest. (*See* CAC ¶¶ 29-30; Bloomberg price chart (Doc. No. 74-3) (showing modest price moves between the alleged option grant dates and the dates of the alleged positive news).) In any event, the CAC presents no factual allegations suggesting that the increases in price were anomalous or not otherwise attributable to normal volatility or general movements in the stock market.

324 F. Supp. 2d at 1380 (dismissing claim where investor sold stock in response to unrelated announcement by company).

Second, Plaintiff has not alleged a corrective disclosure for any misstatements relating to Witness's 2005 and 2006 financial results (CAC ¶¶ 117-57.) The Company's August 9, 2006 press release, which is alleged to be a corrective disclosure (*id.* ¶ 220), *affirmed* the Company's prior statements. Specifically, while indicating that the Company may need to restate its financials at the conclusion of the Special Committee investigation, Witness stated that it "*does not anticipate any material adjustment* to the previously disclosed 2005 or 2006 financial results of operations." (*Id.* ¶ 161 (emphasis added).) Thus, to the extent Plaintiff's claims rest on misstatements in 2005 and 2006, they are insufficient and subject to dismissal.

Third, Plaintiff's allegations are equally insufficient as to the alleged misstatements relating to the 2004 financial results (*id.* ¶¶ 95-116). None of the corrective disclosures made any modifications or corrections to the 2004 financial statements. Rather, the July 27, 2006 statement merely indicated that "[d]epending on the results of the [Company's internal] review, there *may or may not be adjustments* to prior periods." (*Id.* ¶ 15 (emphasis added).) The August 9 announcement presented new information—the formation of the Special

Committee—to the market and cautioned that, until the investigation was concluded, prior statements “should not be relied upon”; however, the prior financials were not corrected. (*Id.* ¶¶ 18, 161); *see also Weiss*, 527 F. Supp. 2d at 947 (dismissing options backdating claim because press release announcing the formation of a Special Committee did not correct prior financial statements); *Hansen*, 527 F. Supp. 2d at 1162 (same; stating that the “mere existence of [an] investigation cannot support any inferences of wrongdoing”) (quotation marks and citation omitted).

Moreover, the August 9 announcement cited in the CAC contained several distinct and separate disclosures, and did not distinguish between anticipated problems with the financial statements for the period before the Class Period and the 2004 financial statement. Given the dates of the options at issue that had been identified (2000 and 2001) it is more likely that the effect of any restatement would be larger with respect to financial statements that pre-date the Class Period and which are not at issue in this case. In fact, the August 9 announcement expressly stated that the subject of the Special Committee’s investigation was the stock options issued from February 2000 to August 2002. And, as confirmed by the Company’s later restatement, the bulk of the restated compensation expenses (approaching 90%) pertained to the financial statements for periods *before* 2004.

(*See id.* ¶ 165 (listing adjustments for each year from 2000 to 2005).) Because the August 9 announcement thus related primarily to periods prior to the Class Period, it cannot serve as a corrective disclosure as to the 2004 financial statement. *See Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 158 (2d Cir. 2007) (dismissing complaint and holding that certain alleged misstatements could not be deemed the “proximate cause of plaintiffs’ loss” where other “more consequential and numerous” misstatements were made); *Barr*, 324 F. Supp 2d at 1380 (dismissing complaint where plaintiff sold stock in response to news about a different quarter).

B. Section 20(a) Claims

As shown above, Plaintiff has not adequately alleged a claim of primary liability under Section 10(b) against any defendant. Accordingly, its 20(a) claim is dismissed. *See Theoharous*, 256 F.3d at 1227 (dismissing § 20(a) claim for failure to allege primary liability); *Mizzaro v. Home Depot, Inc.*, No. 1:06-CV-1151, 2007 WL 2254693, at *9 (N.D. Ga. July 18, 2007) (same).

C. Claims Against Thomas Crotty

Thomas Crotty, an Outside Director of Witness, filed a separate motion to dismiss. While the reasoning in Parts I-III.B. above applies equally to Mr. Crotty, the Court also addresses his motion separately. According to the CAC, Mr. Crotty served on the Witness Board’s Compensation Committee between 1999 and 2005,


and was its Chairman in 1999, 2000, 2004 and 2005, and the second half of 2003. (CAC ¶ 45.) Mr. Crotty is also alleged to have served on the Audit Committee between 1999 and 2005 (except for the last six months of 2000). (*Id.*) Plaintiff alleges that Mr. Crotty signed Witness's Forms 10-K for the years 2004 and 2005. *Id.* Plaintiff alleges that Mr. Crotty, as Member of the Compensation Committee, "had full knowledge" of the alleged backdating of options in 2000-01. (*Id.* ¶ 72.)

The allegations against Mr. Crotty are based entirely on the conclusory assertion that, because of his service on Board committees, Mr. Crotty participated in or knew about alleged fraudulent acts. Status allegations of this kind do not give rise to a strong inference of scienter. *See Cheney v. Cyberguard Corp.*, No. 98-6879-CIV, 2000 WL 1140306, at *7 (S.D. Fla. July 31, 2000). There are no particularized allegations tending to show that Mr. Crotty knew that any statement at issue was false or misleading when made. *See, e.g., In re Theragenics Corp. Sec. Litig.*, 105 F. Supp. 2d 1342, 1360 (N.D. Ga. 2000). Plaintiff's scienter allegations are further undermined by the absence of allegations that Mr. Crotty sold any shares of Witness during the Class Period or that he received any of the options grants cited in the CAC. (*See* CAC ¶ 28 & Ex. A); *see also In re iXL Enters., Inc. Sec. Litig.*, No. 00-cv-2347, slip op. at 3 (N.D. Ga. Feb. 27, 2002).

IV. CONCLUSION

For the reasons stated above, the Court hereby **GRANTS** the Witness Defendants' Motions to Dismiss Lead Plaintiff's Consolidated Amended Complaint [Doc. No. 53] and Defendant Thomas Crotty's Motion to Dismiss Plaintiff's Consolidated Amended Complaint [Doc. No. 54] with prejudice.

SO ORDERED this 31st day of March, 2008.



THE HONORABLE CLARENCE COOPER
UNITED STATES DISTRICT JUDGE