Joseph J. Tabacco, Jr. (75284)
Christopher T. Heffelfinger (118058)
Nicole Lavallee (16576)
Michael Stocker (179083)
BERMAN DEVALERIO PEASE TABACCO BURT & PUCILLO
425 California Street, Suite 2100
San Francisco, CA 94104
Telephone: (415) 433-3200
Facsimile: (415) 433-6382

Norman Berman
Michael G. Lange
Leslie R. Stern
Julie A. Richmond
BERMAN DEVALERIO PEASE TABACCO BURT & PUCILLO
One Liberty Square
Boston, MA 02109
Telephone: (617) 542-8300
Facsimile: (617) 542-1194

Lead Counsel for Lead Plaintiff
Massachusetts Laborers' Pension Fund

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

In re MICROMUSE INC. SECURITIES LITIGATION This Document Relates To: ALL ACTIONS	Master File No. C-04-0136 SBA CLASS ACTION **LEAD PLAINTIFF'S MEMORANDUM OF POINTS AND AUTHORITIES IN OPPOSITION TO DEFENDANTS' MOTIONS TO DISMISS** DATE: MARCH 8, 2005 TIME: 1:00 PM DEPT: COURTROOM 3

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Federal Cases

Federal Statutes

Other Authority (SEC Decision)

Lead Plaintiff Massachusetts Laborers' Pension Fund ("Lead Plaintiff") respectfully submits this memorandum of points and authorities in opposition to the motions to dismiss by individual defendants Lloyd Carney ("Carney") and Stephen A. Allott ("Allott"), and to the motion to dismiss brought by Micromuse Inc. ("Micromuse" or the "Company"), Gregory Q. Brown ("Brown"), Carney, Allott, Michael L. Luetkemeyer ("Luetkemeyer"), David A. Wise ("Wise"), and Brendan Kelly ("Kelly") (collectively "Defendants").[1] Because Defendants' arguments are both unfounded and premature, the Court should deny these motions to dismiss in their entirety.

I. PRELIMINARY STATEMENT

Defendants' motions to dismiss the Class Action Consolidated Complaint (the "Complaint") underscore their fundamental misunderstanding of Lead Plaintiff's claims. As detailed in the Complaint, Lead Plaintiff alleges that Defendants artificially inflated the value of Micromuse stock throughout the class period by misstating earnings in order to meet Wall Street expectations. By means of this fraud, Defendants were able to ensure that, for all but one of the fifteen reporting periods during the class period, Micromuse's reported earnings per share fell within *one cent* of analysts' expectations, thereby painting a picture of apparent steady growth and financial stability while betraying investors' faith in the credibility of Company management. As fiduciary to the members of the Massachusetts Laborers' District Council of the Laborers International Union of North America, AFL-CIO, and as the designated Lead Plaintiff in this case, Massachusetts Laborers' Pension Fund brings this action to recover its losses and those of similarly situated class members in Micromuse common stock caused by Defendants' financial

---

[1] Brown was Chairman and Chief Executive Officer ("CEO") of Micromuse from February 1999 until December 31, 2002, and served on the Company's Board of Directors throughout the class period. Consolidated Class Action Complaint ("Complaint") at ¶ 20. Carney joined Micromuse as Chairman and CEO effective July 29, 2003. ¶ 21. Allott was Micromuse's President and a director from October 1998 until April 18, 2001. ¶ 22. Luetkemeyer joined Micromuse in October 2001 as the Company's Senior Vice President, and served as interim CEO between Brown's resignation and July, 2003. ¶ 23. Wise was Micromuse's Senior Vice President, Finance and investor relations and CFO from April 2001 until October 2001. ¶ 24. Kelly was Micromuse's Vice President of Finance from January 2001 and reported directly to Luetkemeyer. ¶ 25. Brown, Carney, Allott, Luetkemeyer, Wise and Kelly are collectively referred to herein as the "Individual Defendants."

reporting legerdemain.

There is nothing novel about Lead Plaintiff's claims in this case. Manipulating earnings in order to present an image of steady growth is a well-recognized and increasingly pervasive species of securities fraud. As former SEC Chairman Arthur Levitt has observed, "[i]n the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."[2] Indeed, Levitt fears "that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; integrity may be losing out to illusion." *Id.* The pervasive and widespread manipulation of revenues and expenses described in the Complaint illustrates Levitt's concerns.

In their motions to dismiss Lead Plaintiffs' detailed allegations of fraud, Defendants repeatedly assume, without basis in law or fact, that the Company's fraudulent manipulation of revenues downward to coincide with analysts' expectations cannot give rise to artificial inflation of its stock prices. This basic mistake fatally undermines the principal arguments raised in their briefs. While Defendants urge that Lead Plaintiff lacks standing to prosecute this action, their contention is premised on the notion that Lead Plaintiff could suffer no cognizable injury when it bought Company stock during periods that earnings were being managed downward to hit analysts' targets. This assertion is unfounded. Lead Plaintiff alleges stock inflation throughout the class period arising from Micromuse's failure to disclose its fraudulent scheme to track Wall Street estimates. Whether the Company overstated or understated revenues in any given quarter to accomplish this feat is irrelevant to Lead Plaintiff's injury.

Identically flawed is Defendants' argument that, prior to the commencement of any discovery, Lead Plaintiff is obliged to explain the magnitude of any earnings misstatements "in relation to Micromuse's total financial picture." Def. Mem. at 9. Courts in this Circuit have

---

[2] Remarks by Chairman Arthur Levitt, Securities and Exchange Commission, "The 'Numbers Game,'" Sept. 28, 1998, http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt, attached as Exhibit A to the Declaration of Christopher T. Heffelfinger ("Heffelfinger Decl.") in support of this memorandum.

repeatedly held that such fact-intensive determinations should not be made in the absence of a fully developed factual record. The court should also swiftly reject Defendants' assertion that the Company's understatement of revenue is inherently inconsistent with a strong inference of scienter. This is so because Lead Plaintiff alleges that Micromuse fraudulently met analysts' estimates by both overstating and understating revenues. Finally, Micromuse's argument that Lead Plaintiff cannot demonstrate loss causation for stock purchases made during periods when earnings were being underreported suffers from the same logical defect as the Company's other assertions. Because Lead Plaintiff contends that Micromuse artificially inflated its stock by adjusting its earnings to meet Wall Street expectations, it is irrelevant that the Company was sometimes obliged to underreport, rather than overreport, its revenues to accomplish its overall fraudulent scheme to track Wall Street estimates.

II. STATEMENT OF FACTS

A. Defendants Fraudulently Manipulated Micromuse Stock Prices During the Class Period

During the class period, Defendants embarked on a scheme to fraudulently manage earnings in order to ensure that the Company would meet Wall Street's earnings expectations. ¶ 2.[3] By "plugging," or exaggerating, certain accrued expenses during prosperous quarters, Defendants smoothed precipitous revenue increases, while simultaneously creating "cookie jar" reserves to minimize losses during lean periods. ¶ 3. The scheme permitted the Company to ensure that its earnings per share ("EPS") were neither too far above nor too far below analysts' predictions, simulating the kind of steady growth that investors find most attractive.

Micromuse's high revenues in fiscal year 2000 presented the Company with a dilemma. According to a former employee in the finance department, Micromuse was making "tons of money" and "needed expenses" because "Wall Street analysts liked to see incremental growth from one quarter to the next." ¶ 51. Defendants began "scrambling to come up with expenses" and were "killing themselves" trying to hide all the earnings. ¶ 51. Their solution was to create

[3] All paragraph references refer to the Consolidated Amended Class Action Complaint.

plugs. ¶ 51.

Plugging was a complex process that Defendants initiated well before the close of each quarter. ¶ 49. According to the former employee, the director of accounting Mark Damstetter ("Damstetter") produced and distributed weekly "flash reports" to Defendants, senior officers, key accounting, legal and operations staff. ¶ 49. The flash reports contained Company sales, revenues and key "controllable" items such as travel, entertainment, and headcount. ¶ 50. At the end of each quarter, the Company would also produce "variance reports" that compared the Company's actual results to its forecasts. ¶ 50.

Before each quarterly earnings call, and for each of the quarters that they were at the Company, Defendants Brown, Carney, Allott, Wise, Luetkemeyer and Kelly, as applicable, would direct Damstetter to look for ways to inflate or "plug," Company expenses, to understate earnings and create a "rainy day fund" to dip into later. ¶¶ 51, 89. Damstetter and Defendant Wise would examine how much money Micromuse made relative to Wall Street's expectations. ¶ 52. Defendants were careful to manipulate multiple categories of expenses, in that the Company had to "get the expense in the right category," that is, those large and "mushy" enough to hide plugs from investors. ¶ 52.

Throughout 2000 and in all but the last quarter of 2001, the Company plugged $500,000 to $1.5 million in categories including travel and entertainment, commissions, audit fees, bonuses, marketing, bad debts and taxes. ¶ 53. According to the former employee, Defendants Wise, Kelly, and Luetkemeyer would "go back and forth on where they wanted the numbers to end up." ¶ 52. So significant were the plugs to management that the books were not to be closed until verification from Damstetter that he made his "journal entries." ¶ 56.

Beginning on or around the third quarter of 2001, Micromuse began releasing the plugs into revenue, disguised as "aggressive cost-cutting" initiatives. ¶ 59. For example, in its July 18, 2001 press release, Defendant Brown stated: "[T]he economic climate is more challenging than ever and as a result we have reset our revenue target. We plan to take advantage of this discontinuity by creating an even more efficient cost base, realigning our resources, and reinforcing and solidifying our market-leading position." ¶ 59.

Analysts praised the Company's apparent success in curbing expenses in 2002 and 2003 as bucking the trend of declining industry results. *See* ¶¶ 60-64. However, unbeknownst to investors, Micromuse's "aggressive cost-cutting" plan amounted to nothing more than the release of plugs back into Company income. ¶ 59. As a direct result of Defendants' improper accounting, for all but one of the fifteen reporting periods during the class period, Micromuse's reported earnings per share fell within *one cent* of analysts' expectations. ¶ 58.[4]

In addition to plugs, Micromuse manipulated its financial statements by improperly accounting for long-term property lease expenses. ¶ 65. Under SFAS 13, the Company's London office was required to expense the total rent for its new lease in 2002 over the lease term. ¶ 66. According to the former employee, the Company discovered it had improperly accounted for the lease. ¶ 67. Instead of correcting the error, Defendant Kelly expressly told the former employee, "we're not booking" the adjustment. ¶ 67. To avoid "taking a huge hit" of millions of dollars, Defendants Kelly and Luetkemeyer decided not to book a correction. ¶ 67. Moreover, the same former employee confirmed that the Company materially understated lease expenses for its New York and California properties. ¶ 68.

B. Restated Earnings Confirm The Creation and Release of "Plugs"

On December 30, 2003, Micromuse announced it would delay filing its 10-K for fiscal year 2003. ¶ 69. Citing the pending internal inquiry of accounting for accrued expenses and expense recognition, the Company also disclosed the SEC was conducting a related, informal inquiry. ¶ 69. That day, Defendant Luetkemeyer explained the impetus for an internal investigation. While "addressing a *human resource issue* in the finance department" in mid-September 2003, "he was made aware" of questions about the past accounting treatment of specific entries. ¶ 71. According to the former employee, the *human resource issue* was a conversation between Defendant Luetkemeyer and Damstetter in September 2003, in which Damstetter said he no longer wanted to implement the plugs. ¶ 72. The Company responded by

[4] Table of quarterly results, as alleged in paragraph 58 of the Complaint, attached as exhibit B to the Heffelfinger Decl.

dismissing Damstetter. ¶ 72.

On May 17, 2004, the Company filed its 2003 10-K and restated earnings financial results for fiscal year 2000, 2001, and 2002 (the "Restatement"). ¶ 73. The net effect of the Restatement was to: decrease net losses by $2.3 million in 2003; to decrease net losses by $964,000 in 2002; and toincrease net income by $438,000 in 2001. ¶ 74. The 10-K further disclosed several accrued expense items for which the amount, the timing of recognition, or the timing of the release "could not be substantiated or was in error and should be adjusted." ¶ 74.

The Restatement also identified the Company's flawed lease accounting, and increased its lease expense and related deferred lease liability by $427,000 in 2001; $217,000 in 2002; and decreased lease expenses by $123,000 in 2003. ¶ 75.

Finally, the Company announced significant changes to its internal controls, including revised procedures for preparing and reviewing quarterly financial statements; "re-emphasiz[ing] to finance employees their responsibility for appropriate journal entries that are properly documented, in particular relating to non-system generated journal entries." ¶ 76.

The Restatement reveals that Micromuse consistently overstated expenses for sales and marketing, and research and development, resulting in an understatement of net income during the first three quarters of 2001. ¶¶ 77-79. These overstatements formed the plugs the Company would later release into income. ¶ 77. In the fourth quarter of 2001, the Company reversed its course and began releasing plugs to overstate net income ($1.9 million) and understate expenses ($3.277 million). ¶¶ 80-81. It would repeat this practice in 2Q 2002, 3Q 2002, 4Q 2002, 1Q 2003, and 2Q2003. ¶¶ 82-87. Releasing the plugs to smooth out losses allowed the Company to report EPS exactly in-line with Wall Streets' expectations. ¶¶ 80-86.

C. Insider Trading

Defendants Brown, Allott, and Luetkemeyer each sold large amounts of their personal holdings of Micromuse common stock for total proceeds of $33,464,569 during the Class Period. ¶ 103. Defendants Brown and Allott disposed of nearly 100% of all common stock holdings and more than half of their vested securities (94.74% for Defendant Allott), in sales that occurred shortly after Company released false quarterly financial results. *See* ¶¶ 104-08. Similarly,

Defendant Luetkemeyer's suspicious trades of 79,167 shares in 2003 occurred over just three days, following the Company's release of false quarterly financial results ¶¶ 108-09.

III. ARGUMENT

A. Standard

In evaluating the sufficiency of a securities fraud complaint under Federal Rule of Civil Procedure 12(b)(6), the Court must "accept plaintiff's allegations as true and construe them in the light most favorable to plaintiffs." *Gomper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir. 2002) (citing *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 983 (9th Cir. 1999)). The Court should review the complaint in its entirety to determine whether the totality of the facts and all reasonable inferences show a strong inference of scienter. *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1038 (9th Cir. 2002). "[I]ndividual pieces of evidence, insufficient in themselves to prove a point, may in cumulation prove it. The sum of an evidentiary presentation may well be greater than its constituent parts." *Bourjaily v. United States*, 483 U.S. 171, 179-80 (1987). Finally, a securities fraud complaint need not be dismissed for relying on circumstantial evidence, as long as that evidence meets the "strong inference" standard. *Silicon Graphics*, 183 F.3d at 996; *In re NorthPoint Communications Group, Inc. Sec. Litig.*, 184 F. Supp. 2d 991, 997 (N.D. Cal. 2001).

B. Lead Plaintiff Has Adequately Alleged Injury and Standing

Defendants err in arguing that Lead Plaintiff lacks standing to prosecute this action because it has failed to adequately allege injury. Def. Mem. at 7-8. The Supreme Court has held that, in order to demonstrate standing at the pleading stage, "general factual allegations of injury resulting from the defendant's conduct may suffice, for on a motion to dismiss one presumes that general allegations embrace those specific facts that are necessary to support the claim." *Nat'l Org. for Women, Inc. v. Scheidler*, 510 U.S. 249, 256 (1994) (quoting *Lujan v. Defenders of Wildlife*, 504 U.S. 555, 561 (1992)); *see also Lujan v. Nat'l Wildlife Fed'n*, 497 U.S. 871, 889 (1990) (noting the difference between the standards to maintain standing under a 12(b) motion and a summary judgment motion); *Warth v. Seldin*, 422 U.S. 490, 501 (1975) ("On a motion to dismiss for want of standing…courts must accept as true all material allegations of the complaint, and must construe the complaint in favor of the complaining party."); *Desert Citizens Against*

Pollution v. Bisson, 231 F.3d 1172, 1178 (9th Cir. 2000) ("[I]it is significant that [the court is] reviewing a motion to dismiss, and not a summary judgment on the issue of standing."). Indeed, courts are exhorted to avoid "wad[ing] into territory that need not be entered at this stage of the proceeding." *See In re Managed Care Litig.*, 298 F. Supp. 2d 1259, 1306 (S.D. Fla. 2003)(citing *Havens Realty Corp. v. Coleman*, 455 U.S. 363, 378-79 (1982)).[5]

Lead Plaintiff's allegations easily meet the standard for pleading standing. The Complaint states that during the Class Period, Defendants engaged in a fraudulent scheme to artificially inflate the price of Micromuse common stock by "smoothing earnings" in order to meet Wall Street's expectations. ¶¶ 2, 4, 45, 47, 48, 57. The Complaint explains that Defendants executed this fraudulent scheme by exaggerating certain accrued expenses and underreporting revenues because "Wall Street analysts liked to see incremental growth from one quarter to the next' rather than sudden increases and decreases." ¶ 51. The Complaint further alleges that as a result of Defendants' wrongful conduct, Lead Plaintiff and members of the Class purchased Micromuse stock at artificially inflated prices and were damaged thereby. ¶¶ 18, 200, 201, 205. By alleging that it was a purchaser of the Company's stock at inflated prices during the perpetration of this scheme, Lead Plaintiff has adequately alleged injury for purposes of standing under *Lujan* and *Warth*.[6] Lead Plaintiff's allegations, if proven, will constitute injuries in fact and are sufficient to confer standing.

---

[5] Defendants' citation to *Armstrong v. Davis*, 275 F.3d 849 (9th Cir. 2001), only underscores the prematurity of their argument. In *Armstrong*, the court considered on appeal and *after a 10-day bench trial* whether the named plaintiffs had standing. *See id.* at 860. Here, Lead Plaintiff has not had an opportunity to present evidence to demonstrate its damages, and the Court is not in a position to make specific factual findings as to whether Lead Plaintiff has incurred damages.

[6] Additionally, the fact that Lead Plaintiff purchased early in the Class Period does not preclude it from having standing to represent later purchases since it, like all Micromuse investors during the Class Period, were defrauded by the very same scheme. *See Endo v. Albertine,* 147 F.R.D. 164, 167 (N.D. Ill. 1993) (finding that where a proposed class representative's claims arise from same event or practice or course of conduct giving rise to other class members' claims, are based on same legal theory, and arise from issuance of prospectuses equally applicable to different types of securities purchased by different class members, proposed class representative may represent all such purchasers); s*ee also In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1461 (D. Ariz. 1992).

C. Lead Plaintiff Has Adequately Alleged Materiality

Defendants' assertion that there are "no facts showing that the alleged misrepresentations are material," is unsupported legally and factually. Def. Mem. at 8. Lead Plaintiff has adequately alleged material misrepresentations and omissions, and Defendants' attempt to have the Court engage in a premature weighing of the facts must be rejected.

A statement or omission is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994) (quoting *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988)). It well settled that the issue of materiality is one that ought to be resolved by the trier of fact. The Supreme Court in *TSC Ind., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), observed that the determination of materiality requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact." *Id.* at 450; *see also Abromson v. Amer. Pacific Corp.*, 114 F.3d 898, 904 (9th Cir. 1997) ("It is difficult to imagine a more fact intensive issue than materiality. Indeed, our prior cases teach us that it is an issue which should ordinarily be left to the trier of fact."); *Fecht v. Price Co.*, 70 F.3d 1078, 1080-81 (9th Cir. 1995). "[A] complaint may not be properly dismissed pursuant to Rule 12(b)(6) on the grounds that the alleged misstatements or omissions are not material unless they are 'so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.'" *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1306 (C.D. Cal. 1996) (quoting *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985).

Here, the Complaint alleges that Defendants engaged in a fraudulent scheme to manipulate and smooth earnings, and that the purpose of this fraudulent scheme was to present smooth, incremental growth to Wall Street rather than volatile earnings decreases and increases, as well as to permit the Company to meet Wall Street earnings expectations. ¶¶ 2,4, 45, 47, 48, 51, 57. The Complaint further alleges that as a result of this scheme, Micromuse was required to restate "its previously reported financial results during the Class Period" and that such restatement,

"constitutes an admission that each of those statements, as included in the press releases and Forms 10-K and 10-Q issued during the Class Period were materially false and misleading." ¶ 183. The Complaint also alleges that Generally Accepted Accounting Principles ("GAAP") "requires restatements only for *material* accounting errors or misstatements."[7] ¶ 183 (emphasis in original). Lead Plaintiff alleges that Micromuse "would have fallen short of consensus EPS forecasts in *seven* of the fifteen periods it previously reported meeting expectations.[8] ¶ 58 (emphasis in original). Lead Plaintiff has alleged that Micromuse's stock price dropped when the December 30, 2004 partial corrective disclosure was made. ¶¶ 10-11. Finally, Lead Plaintiff alleges massive and suspicious insider trading during the class period.[9] ¶¶ 101-109.

Defendants strain credulity in urging that, as a matter of law, a reasonable investor would not have considered important the fact that Micromuse omitted to disclose in any of its press releases and financial statements during the class period the fact that its apparent ability to meet Wall Street expectations was in fact the result of pervasive accounting fraud. Indeed, the Securities Exchange Commission has concluded that a company's intent to meet market expectations by manipulating earnings is information that the reasonable investor "would have considered important in deciding whether or not to invest." *In the Matter of Robert W. Armstrong, III*, Initial Decision Release No. 248, File No. 3-9793, at p. 13, attached as Exhibit C to the Heffelfinger Declaration.[10]

---

[7] *See Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1306 (C.D. Cal. 1996) ("Overstatement of revenues in violation of GAAP can constitute a material misrepresentation that gives rise to an action for securities fraud."). *See Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 935 (9th Cir. 2003) (determining that when disclosure of information actually leads to a reduction in share value, it is likely that a reasonable investor would find that information material).

[8] *See S.E.C. v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y. 1987) (concluding that false disclosures regarding company's yearly income were material because a reasonable investor would attach importance to the information in determining his or her choice of action).

[9] *See Basic*, 485 U.S. at 240 n.18 ("We recognize that trading (and profit making) by insiders can serve as an indication of materiality").

[10] Defendants' citation at page 10 of their memorandum to *In re NVIDIA Corp. Sec. Litig.*, No. 02-0853 CW, slip op. at 15, is unavailing. In *NVIDIA*, the Court concluded that fraud was not demonstrated where the misrepresentation did not inflate stock prices. *Id.* Such is not the case

(continued ...)

Similarly specious is Defendants' suggestion that investors could not have found material the fact that Micromuse's statements to the public about its quarterly EPS were premised on fraudulent earnings manipulation.[11] Defendants fail to cite to any Ninth Circuit authority for the proposition that a misstatement or omission that concerns only a fraction of the Company's revenues or assets is immaterial as a matter of law. *See In re Envoy Corp. Sec. Litig.*, 133 F. Supp. 2d 647, 662 (M.D. Tenn. 2001). In fact, the Ninth Circuit has rejected the application of a per se or bright-line rule to the determination of materiality and instead engages in the fact-specific inquiry of *Basic*. *See Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.* ("*America West*"), 320 F.3d 920, 934 (9th Cir. 2003). The *Basic* court held that "[a]s we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." 485 U.S. at 240.

Given the foregoing allegations, Defendants have failed to demonstrate, as a matter of law, that no reasonable investor would have viewed the Company's misstatements and false EPS reports as "obviously unimportant." *Marksman*, 927 F. Supp. at 1306. Accordingly, Lead Plaintiff has adequately alleged materiality.[12]

D. Lead Plaintiff's Allegations Support a Strong Inference of Scienter

1. The "Strong Inference Standard" Under the PSLRA

The PSLRA requires a plaintiff to plead facts "giving rise to a strong inference that the

---

(... continued)

here, where Lead Plaintiff alleges that the Company's fraud inflated stock prices throughout the class period.

[11] Micromuse's alleged false statements are set out at paragraphs 122 to 175 of the Complaint.

[12] In footnote 8 of their memorandum, Defendants urge that the purported "absence of any market impact also negates the presumption of reliance under the fraud on the market doctrine." Def. Mem. at 11, n.8. Defendants' argument is inapposite. In *America West* the Ninth Circuit expressly rejected the argument that a market's failure to react immediately after a corrective disclosure demonstrates that such disclosure is immaterial as a matter of law. *See id.* at 934. In any event, however, Lead Plaintiff alleges that on December 30, 2003, Defendants revealed that Micromuse was conducting an internal inquiry related to its accounting for accrued expenses and expense recognition, and that the inquiry would likely lead to a restatement. ¶¶ 69-70. As a result of this *partial* disclosure, Micromuse's stock price dropped from $6.90 to $6.83, on heavy volume. ¶ 10.

defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). To determine whether a plaintiff has met that burden, the Ninth Circuit has held that a court must determine "whether [the] complaint *considered in its entirety* states facts which give rise to a strong inference" of scienter. *In re Silicon Graphics*, 183 F.3d at 985. Scienter or "knowledge may be inferred from a combination of circumstances." *In re Autodesk, Inc. Sec.. Litig.*, 132 F. Supp. 2d 833, 843 (N.D. Cal. 2000). Moreover, "[s]cienter may be proven and pled by reference to circumstantial evidence, for it is rare that perpetrators of a fraud would confess outright." *In re PeopleSoft, Inc., Sec. Litig.*, No. C 99-00472 WHA, 2000 U.S. Dist. LEXIS 10953, at *9 (N.D. Cal. May 26, 2000). Here Lead Plaintiff alleges detailed circumstantial evidence demonstrating intentional fraudulent conduct, thereby permitting "the drawing of a strong inference of scienter." *Bielski v. Cabletron*, 311 F.3d 11, 39 ("*Cabletron*") (1st Cir. 2002).

2. The Allegations Regarding Defendants' Illegal Earnings Management Practices Support a Strong Inference That Defendants Acted Intentionally or With Deliberate Recklessness.

Lead Plaintiff bases its factual allegations upon analyses of the public statements made by Defendants, as well as internal statements that Defendants never intended for the public to hear. Lead Plaintiff learned of the private statements from a confidential informant (the "Informant") who worked in the finance department during the class period. Having worked in the finance department, the specific department at the center of inquiry according to Defendant Luetkemeyer's December 30, 2003 revelation to the investing public, the Informant was in position to have acquired information about the fraud.[13] Indeed, the Informant's statements dovetail with and corroborate the story of fraud revealed by the public filings, announcements, and press releases made by Defendants.

[13] In order to support Lead Plaintiff's belief of Defendants' intentional or deliberately reckless conduct, this Circuit has adopted the Second Circuit standard regarding confidential informants as set forth in *Novak v. Kasaks*, 216 F. 3d 300, 314 (2d Cir. 2000). Namely, it is sufficient to support allegations upon information and belief with information by a confidential source provided the confidential source is "described in the complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged." *Id. Accord Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1233 (9th Cir. 2004)

Those allegations of the Complaint which support a strong inference of scienter include (a) specific allegations that senior management directed the fraud; (b) the Informant's detailed corroborating account of intentional fraud; (c) strong circumstantial evidence that defendants were preoccupied with meeting Wall Street Expectations; (d) the duration of the fraud as revealed by the Restatement; (e) the specificity of the GAAP violations and accounting machinations; and (f) the direct personal benefits to the Individual Defendants. Taken together, these allegations paint a compelling portrait of fraud and provide the strong inference of scienter required under the PSLRA.

a. The Allegations that Senior Management Directed the Fraud are Sufficient to Satisfy The "Strong Inference" Standard of the PSLRA.

The role of senior Company management in the fraud supports a strong inference of scienter. According to the Informant, Defendants received weekly "flash reports" from Damstetter, the former director of accounting who managed the day-to-day accounting operations of the San Francisco office and reported variously to Defendant Wise and Kelly. ¶ 49. The flash reports contained the Company's sales, revenues and key "controllable" expense items, such as travel and entertainment and headcount. ¶ 50. Defendants also received "variance reports" at the end of each quarter. ¶ 50 The variance reports compared the Company's actual results to forecasts.[14] Based upon the contents of the flash and variance reports, at the end of each quarter, Defendants Brown, Allott, and Luetkemeyer directed Defendant Wise, and later Defendant Kelly, to manipulate the Company's expenses. ¶¶ 49-50.

The market responded favorably and, in April 2003, Defendant Kelly stated on a

---

[14] In a case where plaintiff alleged that senior officers "received and understood internal reports that document[ed] the fraud," specifically the Risk and Opportunity schedules, the court upheld plaintiff's complaint. *See In re Homestore, Inc. Sec. Litig.*, 252 F. Supp. 2d at 1032. Here, Lead Plaintiff's details regarding the author, recipients, and contents of the flash and variance reports satisfy the PSLRA's requirement that a plaintiff allege facts supporting a strong inference of scienter. *See also In re Silicon Graphics, Inc.*, 183 F.3d 970, 985 (9th Cir. 1999). (concluding that if a report is the alleged source of defendants' knowledge, plaintiff must provide "adequate corroborating details" regarding the report); *In re Splash Technology Holdings, Inc. Sec. Litig.*, No. C 99-00109 SBA, 2000 Dist. LEXIS 15369, No. C 99-00109 SBA, 2000 WL 1727377, *21 (N.D. Cal. Sept. 29, 2000) (with regard to internal reports, plaintiff must allege who drafted them, who received them, their contents, and how they became aware of them).

conference call that the second quarter of fiscal year 2003 represented the Company's "seventh quarter on quarter decline in pro forma operating expenses." ¶ 64. Defendant Kelly was the person at Micromuse who, along with Defendant Luetkemeyer, made the decision not to take a charge to earnings to correctly account for the London lease once that error was brought to his attention. ¶ 67. In fact, Defendant Kelly never made any decisions without first speaking with Defendant Luetkemeyer. ¶ 90. Further, it was Defendant Kelly who expressly told the Informant that Micromuse would not be booking the adjustment because it would have meant "taking a huge hit." ¶ 90 Thereafter, the Informant notes, the Company began to utilize the same incorrect accounting for its properties in New York and California, thus understating lease expenses for those properties as well, in order to meet Wall Street expectations. ¶ 68.[15]

Even when the Company had determined to restate its financial statements in an effort to cover up the fraud, senior management was integrally involved in each step of the process. On December 30, 2003, Defendant Luetkemeyer informed the investing public that he was only made aware of accounting issues with respect to "seemingly unrelated accounting entries" mid-September. Further, he stated, it was only in late October that the Company learned of errors with respect to accrued expenses and expense recognition; and not until December that management had concluded that a restatement was necessary." ¶ 71. To the contrary, we know from the Informant, that Luetkemeyer was intimately involved in the "seemingly unrelated accounting entries" and that, in fact, the impetus to undertake a Restatement was the conversation in September between Luetkemeyer and Damstetter in which Damstetter stated that he did not want to book any more fabricated entries on the Company's journals. ¶ 72.

Even after the PSLRA, there exists a strong inference that a company's senior officials are assumed to be aware of facts significant to a company's core operations. *In re Northpoint Communications Group*, 2002 U.S. Dist. LEXIS 13242 (N.D. Cal. May 28, 2002); *Epstein v.*

---

[15] Where complaints have alleged defendants were approached by employees about improprieties, courts elsewhere have denied defendants' motion to dismiss. *See, e.g., In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1338 (S.D. Fla. 1999); *Hamilton*, 194 F. Supp. 2d at 1358.

Itron, Inc., 993 F. Supp. 1314, 1326 (E.D. Wash. 1998); *Adams v. Amplidyne, Inc.*, 2002 U.S. Dist. LEXIS 21383, at *23 (D.N.J. Oct. 24, 2000); *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 599 (D.N.J. 2001); *In re Providian Financial Corp. Sec. Litig.*, 152 F. Supp. 2d 814, 825 (E.D. Pa. 2001); *Angres v. Smallworldwide PLC*, 94 F. Supp. 2d 1167, 1175 (D. Colo. 2000). *See also Cosmas v. Hassett*, 886 F.2d 8, 12-13 (2d Cir. 1989) (determining that top officials were presumed to know about elimination of a "potentially significant source of income for the company. *In re Read-Rite Sec. Litig.*, No. C 98-20434 JF, 2000 WL 1641275, *5-6 (N.D. Cal. Oct. 13, 2000) (finding that while a presumption of knowledge on the part of defendants, without more, cannot save a pleading, if otherwise adequate, specific, particularized facts are alleged, the PSLRA's strong inference requirement is met).[16]

b. The Informant's Detailed Account of the Intentional Fraud at Micromuse Provides Strong Circumstantial Evidence of Intentional or Deliberately Reckless Conduct.

In order to use statements of confidential sources to support a strong inference of scienter, confidential sources must be identified "with sufficient particularity to support the probability that a person in the position occupied by the source as described would possess the information pleaded." *ABC Arbitrage*, 291 F.3d 336, 353 (5th Cir. 2002). *See also Cabletron*, 311. F.3d at 29. This requires an "evaluation, inter alia, of the level of detail provided by the confidential source, the corroborative nature of the other facts alleged . . . . the coherence and plausibility of the allegations, . . . the reliability of the sources and similar indicia." *Id*. at 29-30. Ultimately, the level of detail required to be revealed will vary case by case. *In re Secure Computing Corp. Sec.*

---

[16] Defendants continue to emphasize that they underreported Micromuse's income and therefore, they claim, they "portrayed [the Company] in an artificially negative light" and couldn't have artificially inflated the Company's stock price. Def. Mem. at 12-13. This emphasis is a deliberate refusal to admit that by managing earnings and purportedly meeting or exceeding analysts' expectations throughout the Class Period, Defendants gave the unforgiving market what they wanted and thereby artificially inflated the price of Micromuse stock, just as Chairman Levitt described in his 1998 speech. Indeed, as Defendants knew, the important factor is meeting or exceeding analyst expectations, not the absolute amount of earned income taken in isolation. Where the market is unforgiving on a company that fails to meet expectations, but does not proportionally reward a company for exceeding expectations, Defendants' illegal conduct clearly inflated the market for Micromuse shares to artificial levels. *See* Chairman Levitt's statement at ¶ 96.

Litig., 120 F. Supp. 2d 810, 988 (N.D. Cal. 2000).

The level of detail provided by the Informant is significant. The details corroborate the nature of the other facts alleged, i.e, the Restatement, the GAAP violations, who was involved in the fraud and how it was perpetrated. For instance, the Informant knew that the accounting machinations were referred to as "plugs." ¶ 47. Further, the Informant knew that the "plugs" were adjustments made to expenses to allow the company to overstate expenses in prosperous years in order to create a "cookie jar" from which to pull monies during less prosperous years. ¶ 48. The Informant knew that Damstetter booked the entries on the financial statements and reported first to Defendant Wise and then Defendant Kelly. ¶ 48-49.

The Informant knew and specifically identified the internal reports that Defendants reviewed (flash and variance reports), and what those reports contained, in order to determine the amount of the plugs. ¶ 50. The Informant knew that the Individual Defendants received the reports (¶ 49) and that it was based upon these that Defendants Brown, Allott and Luetkemeyer would direct Defendant Wise and later Defendant Kelly to have Damstetter alter the books of the Company. ¶ 50.

The Informant knew that prior to each quarterly earnings call the Individual Defendants would direct Damstetter to "plug" the Company's expenses to create a "rainy day fund." ¶ 51. The Informant knew that, as part of that process, Damstetter and Defendant Wise would examine earnings to see how closely analysts' estimates were met. Regarding 2000 and earlier quarters of the Class Period, the Informant stated "What was happening was that we were making tons of money – too much money. We needed expenses." Defendants were "scrambling" and "killing themselves" trying to hide earnings. ¶ 51. Only a person in the center of the finance department would be privy to these details.

The Informant also noted that determining the amount of the plug and which line items to "plug" was complex. The best categories to plug were those large and "mushy" enough to hide the plugs from investors. ¶ 52. The Informant noted that the plugged entries appeared as the last dozen entries in the Company's general ledger each quarter and that these numbers were "nice round numbers." ¶ 54.

Moreover, the Informant knew which software – the Great Plains software – Damstetter used in order to make the fraudulent bookings. ¶ 55. The Informant noted that the entries were so important to the Company that the books and records were not allowed to be closed until Damstetter made his entries and that another employee, Jennifer Wall, would ask him if he "booked his journal entries." Only upon receiving confirmation were the books closed. ¶ 55.

The Informant also knew when the Company, in response to the economic climate, began to release the plugs and that the releasing of the plugs was referred to as "releasing the gold into revenues." ¶ 57. The Informant also knew how it came about that Micromuse began to manipulate its lease. ¶ 65-68. Finally, the Informant knew that Damstetter had spoken to Luetkemeyer and told him that he no longer wished to make the fraudulent bookings, and that the Company had dismissed Damstetter in response. ¶ 72.

Only an employee with daily involvement in the finance department during the Class Period would be able to make such allegations with such specific details. Defendants in their public statements admitted that the accounting issues occurred in the finance department. The Informant's statements are all borne out by Micromuse's publicly filed documents. The Informant's information is detailed and credible sufficient enough to support the requisite strong inference of intentional conduct under the PSLRA and the applicable caselaw.

c. Plaintiff Has Alleged Strong Circumstantial Evidence that Defendants Were Preoccupied With Meeting Analyst Expectations and Therefore Engaged in Earnings Management To Do So.

The allegations in Lead Plaintiff's complaint detail with specificity how Micromuse's preoccupation with meeting Wall Street estimates led Defendants in this case to manage earnings at Micromuse.[17] Notably in line with Levitt's theory that management manages earnings in order to meet analysts' expectations and thereby increase stock price, the Informant specifically

[17] Where plaintiffs alleged that the CEO, Chairman and co-founder of another company was "obsessed" with revenue growth rates, the district court held that those allegations supported a strong inference when viewed in connection with other allegations. Further, they "provide important background information by which to assess the other alleged facts." *See In re Homestore, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1032 (C.D. Cal. 2003). Lead Plaintiff's Informant here likewise presents particularized background facts which aid in assessing other facts and thus, together with those facts, create a strong inference of culpable conduct.

attributes Defendants' wrongful conduct to their desire to track the benchmarks and expectations of analysts, especially Credit Suisse First Boston. ¶ 54.

Defendants were successful at making the earnings of Micromuse appear to match analyst expectations. In **every** quarter between the first quarter of 2001 and the fourth quarter of 2003, the Company announced that it had met or exceeded Wall Street estimates. ¶ 45. In reality, but for the accounting machinations engaged in by Defendants, the Company would have fallen short of Wall Street estimates **for nearly half** the earnings periods at issue. ¶¶ 45-46.[18]

It is undisputed that the announcements of having met or exceeded analysts' expectations were false. The subsequent Restatement, filed on May 17, 2004, revealed the $3.6 "cookie jar" that Defendants had stashed away for a rainy day, and their later release of those funds during less prosperous periods.[19] Net losses for fiscal year 2003 were decreased by $2.3 million; net losses for fiscal year 2002 were decreased by $964,000; and net income for fiscal year 2001 was increased by $438,000. ¶ 74. In addition, the Restatement decreased lease expenses by $123,000 for fiscal year 2003; and increased lease expense and related deferred lease liability by $217,000 and $427,000 for fiscal years 2002 and 2001, respectively. ¶ 75.

d. The Restatement Reveals that Defendants Engaged in Illegal Earnings Management for Fifteen Fiscal Quarters, Supporting a Strong Inference of Intentional or Deliberately Reckless Conduct.

The duration and the nature of the accounting machinations support a strong inference that

---

[18] The allegation that defendants were motivated to falsify financial statements in order to meet analyst expectations was held to be sufficient to plead scienter in *Zuckerman v. Smartchoice Auto Group, Inc.*, 2000 U.S. Dist LEXIS 14676, *16-17 (M.D. Fla. 2000). *See also In re Lucent Techs., Inc. Sec. Litig.,* 217 F. Supp. 2d 529, 555 (D.N.J. 2002) (complaint upheld where plaintiffs gave a "meticulous" account of defendants allegedly unlawful practices in order to meet analyst expectations); *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 598 (D.N.J. 2001) (motion to dismiss denied where plaintiffs provided a "detailed picture" of defendants' wrongful practices aimed at "meet[ing] analyst estimates").

[19] In his September 1998 speech, Chairman Levitt labels the type of earnings management engaged in by Defendants as creating "Cookie Jar Reserves." Remarks by Chairman Arthur Levitt, Securities and Exchange Commission, "The 'Numbers Game'", Sept. 28, 1998, <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>. He states that "some companies [use] unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in cookie jars during the good times and reach into them when needed in the bad times." *Id.* This is exactly what defendants did here.

Defendants acted with the requisite scienter. The Company restated financial results for the fiscal years ended September 30, 2001 and 2002 and for the quarters ended December 31, 2000 through June 30, 2003. This lengthy period supports the strong inference that Defendants either knew or were deliberately or consciously reckless in disregarding the prevalence of improper accounting practices. ¶ 91.[20] In fact, from the Informant's statements, we know that Defendants participated in the accounting improprieties.

The Restatement also affected every item on the Company's Profit and Loss Statement and included a violation of one of the most basic accounting principles, SFAS No. 13, "Accounting for Leases." ¶ 92. Moreover, it is inconceivable that the precision required for creating and releasing the plugs necessary to appear to meet (or exceed) analysts' expectations for every quarter during the class period would have occurred by happenstance. Where the number of restatements a company makes has been great, courts have considered that fact in denying a motion to dismiss. *See, e.g.*, *In re Hamilton Bankcorp., Inc. Sec. Litig.*, 194 F. Supp. 2d 1353, 1359 (S.D. Fla. 2002).

e. The Detailed GAAP Violations Support the Strong Inference That Defendants Acted Intentionally or with Deliberate Recklessness.

Plaintiff's detailed allegations of the GAAP violations support the strong inference that defendants knew, or were deliberately reckless in not knowing, of the "plugs" at Micromuse and the earnings management to meet analysts' expectations. Specifically, the Restatement proves that defendants violated the GAAP matching concept through the improper recording of accrued expenses. Indeed, for the Form 10-K filed for fiscal year 2003, Micromuse admitted that it had "identified several accrued expense items for which it concluded that the amount of the liability, the timing of the liability recognition, or the timing of the release of the liability *could not be substantiated* or was in error and should be adjusted." ¶ 94-95. (Emphasis added.) This is not an instance where plaintiff "attempts to bootstrap conclusory allegations of GAAP violations" into

[20] Where the company was forced to restate fewer quarters (only 7) in *Homestore*, the complaint was upheld as to all insiders. *See In re Homestore, Inc. Sec. Litig.*, 252 F. Supp. 2d at 1019. *See also In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, (N.D. Cal. 2000) (denying dismissal where there were restatements of financial results).

proof of scienter. *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d at 1273.

Plaintiff's allegations concerning the fraud are detailed and specific. For instance, Lead Plaintiff compares each quarter of earnings results with consensus analyst expectations, to show that in each instance, Micromuse either met or slightly exceeded expectations in their originally reported results. ¶ 45. In addition, Lead Plaintiff sets forth a chart showing in which quarters and by how much Defendants actually missed or overstated results, after taking into effect the Restatements. ¶ 58.

With information learned from the Informant, Lead Plaintiff is able to describe in detail the manner in which the Company utilized "plugs" to manage the earnings result. Lead Plaintiff alleges which officers directed the fraudulent entries on the Company's financial statements and who booked them. ¶¶ 47-64. Lead Plaintiff also identifies specific line items that were fraudulently reported, including lease expenses for rental property in London, New York, and California. ¶¶ 65-68. Finally, Plaintiff analyzes in detail, quarter by quarter, the effect of the May 17, 2004 Restatement on Micromuse's financial performance for the previous fifteen quarters. ¶¶ 73-87. The specificity of these details alone is sufficient to support a strong inference of scienter. In *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, the Ninth Circuit specifically references the fact that plaintiffs had "hard numbers" and made specific allegations regarding specific transactions in upholding that complaint. 380 F.3d 1226, 1231 (9th Cir. 2004). Likewise, in *McKesson*, where plaintiff did "[m]ore than simply providing 'approximate amounts' for the alleged revenue inflation" and, in fact, "compare[d] the pre- and post-disclosure accountings" this Court held that "[i]t would be impossible to require anything more specific." 126 F. Supp. 2d at 1273. Moreover, in *McKesson*, the plaintiff detailed "numerous individual transactions during the class period" involving line items which were subsequently reversed. *Id*. Lead Plaintiff here has done no less.

When considered in connection with the detailed allegations of Lead Plaintiff's Informant and the precise manipulation of numbers required to meet or exceed analysts' expectations for twelve consecutive quarters, there can be little doubt that these violations of GAAP and other varied accounting principles support a strong inference of scienter. *See McKesson*, 126 F. Supp.

2d at 1272-73 (concluding that while allegations of GAAP, standing alone, do not create a strong inference of scienter, detailed allegations of GAAP violations may provide "powerful indirect evidence of scienter" because "[a]fter all, books do not cook themselves."); *Marksman*, 927 F. Supp. at 1313-14 (finding that while violations of accounting principles alone generally will not establish scienter, improper accounting in conjunction with other circumstances may support an inference of fraudulent intent); *Cabletron*, 311 F.3d at 29 ("Significant GAAP violations 'could also provide evidence of scienter'")(citation omitted).

f. The Individual Defendants Personally Benefited by The Improper Earnings Management

"Unusual or suspicious stock sales by corporate insiders may constitute circumstantial evidence of scienter." *Employer-Teamster Joint Council Pension Trust Fund*, 320 F.3d 9 at 938 (citing *Silicon Graphics*, 183 F.3d at 986). Factors to be considered when determining whether sales are suspicious include the amount and percentage of shares and the timing of the sales.[21]

As set forth in the Complaint, Defendant Brown sold shares of Micromuse stock during the Class Period for a total of $21,709,112. ¶ 103. This represented nearly 100% of his common stock holdings and 30.35% and 28.40% of his vested securities in 2001 and 2003, respectively. ¶ 104. In these amounts and percentages, and in light of Brown's complicity in the fraud, these stock sales are sufficiently suspicious to support a strong inference of scienter. *See Employer-Teamster Joint Council Pension Trust Fund*, 320 F. 3d at 939 (concluding that sales of 100% of insiders' shares were suspicious). *See also In re PetSmart, Inc. Sec. Litig.*, 61 F. Supp. 2d 982, 1000 (D. Ariz. 1999)(citing *Alfus v. Pyramid Technology Corp.*, 764 F. Supp. 598, 605 n. 1 (N.D. Cal. 1991))(finding that where an insider sells even 20%, *especially where the dollar amounts involved are high,* the sales support an inference of scienter). Lead Plaintiff alleges further that, if compared to public statements made by the Company, these sales are suspicious in timing. ¶ 105.

Defendant Allott sold shares worth $11,323,953. ¶ 103. Allott's sales represented nearly

---

[21] Courts also consider whether sales are consistent with the insider's prior trading history. *Silicon Graphics*, 183 F.3d at 986. The Complaint, however, does not address Defendants' prior trading practices.

100% of his common stock holdings and approximately 94.7% of his vested securities. ¶ 106. In these amounts and percentages, Allott's sales are suspicious and support a strong inference of scienter. Moreover, Lead Plaintiff alleges that, if compared to public statements made by the Company, these sales are also suspicious in timing. ¶ 107.

Finally, Defendant Luetkemeyer sold shares for a total of $431,503. ¶ 103. Plaintiff alleges that these sales were suspicious in timing if compared to statements made by Micromuse to the public. ¶ 108-09.

Defendants' bonus compensation was tied to "stockholder value" along with individual achievement. ¶ 111. Lead Plaintiff alleges that this bonus compensation highly motivated Defendants to increase the stock price of Micromuse by managing earnings. ¶ 110. Indeed, in 2001, Defendant Brown received more bonus than base, with a salary of $400,000 and a bonus of $431,250. ¶ 115 In fiscal year 2002, he again received a base of $400,000 and a bonus of "between $225,000 and $400,000. ¶ 115. He also received 400,000 options in fiscal year 2002 with a realizable value of $3,455,233. ¶ 116. Furthermore, during the class period, Brown beneficially owned between 2% and 2.7% of the shares in Micromuse. ¶ 117. Accordingly, he had a strong incentive to maintain the price of Micromuse's shares.

For serving as an officer for only a partial year in fiscal year 2001, Defendant Allott earned $321,047 in base salary and $185,300 in bonus. ¶ 118. His long-term compensation included 110,000 options with a realizable value of $6,765,680. ¶ 118. These amounts gave Allott a strong incentive to commit fraud.

Defendant Luetkemeyer earned $250,000 for fiscal year 2002 in salary and a bonus of $131,250. ¶ 119. His long-term compensation included 400,000 options with a realizable value of $3,455,233. ¶ 119 In fiscal year 2003, his base salary was $289,583 and his bonus was $237,500. ¶ 119 His long-term compensation for fiscal year 2003 was 450,000 options with a realizable value of $2,353,363. ¶ 119. Accordingly, Luetkemeyer had a strong incentive to commit fraud.

Finally, Defendant Carney, as interim CEO between January 2003 and July 2003 earned a base salary of $300,000. ¶ 120. In July, he was appointed CEO and earned a base salary of $400,000. ¶ 120. For fiscal year 2003, his long-term compensation consisted of 1,500,000

options with a realizable value of $17,379,761. ¶ 120. Based upon this compensation package, he had a strong incentive to commit fraud.

3. Defendants' Remaining Arguments to the Contrary are Without Merit

The briefs of Carney, Allott, and the Defendants collectively do not counsel any different result. The Court should reject Defendants' assertions that the alleged insider trading is impervious to suspicion given some of the Defendants' allegedly large number of retained shares. Courts in this Circuit have repeatedly rejected the suggestion that the retention of a large position in a company defeats any inference that can be drawn from insider trading. *See In re Secure Computing Corp. Sec. Litig.*, 184 F. Supp. 2d 980, 989-90 (N.D. Cal. 2001 (holding that, although defendants had only sold 6%, 7%, 13%, 28% and 56%, respectively of their available shares, the sales were suspicious because defendants all sold unusual amounts of stock within a three-week period and they coincided with alleged misstatements made by company officials). *See also Provenz v. Miller*, 102 F.3d 1478, 1491 (9th Cir. 1996) (concluding that insider sales by individual defendant of 20% of his holdings raised an inference of scienter), *cert. denied*, 522 U.S. 808 (1997); *In re HI/FN, Inc. Sec. Litig.*, No. C99-4531 SI, 2000 U.S. Dist. LEXIS 11631, at *31-32 (N.D. Cal. Aug. 9, 2000) (same); *Marksman*, 927 F. Supp. at 1313 (C.D. Cal. 1996) (same).[22]

Similarly misguided is defendants' assertion that the Complaint impermissibly relies on group pleading doctrine in order to implicate the individual defendants. In fact, the Complaint specifically alleges that "Defendants Brown, Allott, Wise, Luetkemeyer and Kelly directed Damstetter, the former Director of Accounting, to plug the Company's expense figures to ensure that the Company's earnings met analyst expectations." ¶¶ 51 and 89. In any event, despite the enactment of the PSLRA, many courts have continued to recognize the continued viability of the

---

[22] *See also In re Seagate Tech. II, Inc. Sec. Litig.*, 843 F. Supp. 1341, 1371 (N.D. Cal. 1994) (finding scienter properly alleged based on sale of 30% of total holdings for $2.5 million by one insider); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 51 (D. Mass. 1997) (denying motion to dismiss on scienter grounds where plaintiffs alleged that several insiders sold 12%, one sold 33%, and another sold 50% of his holdings). As explained in *In re MicroStrategy, Inc. Securities Litigation*, "an insider may not always trade all his shares in the company for which he possesses the inside information; the trader may hold on to a portion of his shares to hedge against the unforeseen or to obscure the insider trading from the SEC." 115 F. Supp. 2d 620, 646 (E.D. Va. 2000)(citation omitted).

group published doctrine. *See, e.g.*, *In re Homestore, Inc. Sec. Litig.*, 252 F. Supp. 2d at 1031 (citing *In re Secure Computing Corp. Sec. Litig.*, 120 F. Supp. 2d 810, 821-22 (N.D. Cal. 2000)).

E. Lead Plaintiff Has Adequately Alleged Loss Causation

Defendants erroneously claim that Lead Plaintiff did not suffer losses because the Company's previously published financial statements understated Micromuse's financial performance in certain quarters, purportedly depressing the price of Micromuse stock at the time of Lead Plaintiff's stock purchases and sales. Def. Mem. at 22. As an initial matter, Lead Plaintiff does not concede that Micromuse's stock price was depressed during the earlier part of the Class Period, when Lead Plaintiff purchased and sold its Micromuse stock. To the contrary, the Complaint alleges a scheme by Defendants to manipulate expenses by "smoothing" earnings, which was rewarded by the market *in the form of an inflated stock price*. ¶¶ 42-47, 122-26. Indeed, the Complaint alleges the importance of smooth earnings, noting that had the scheme been disclosed to the market, the Company would have fallen short of Wall Street forecasts in all but five of the twelve succeeding quarters during the Class Period and would not have enjoyed the quarter-over-quarter reduction in operating margins it touted to investors. ¶¶ 61, 77-87.

Under the leading Ninth Circuit case, *Broudo v. Dura Pharm. Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), loss causation "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause."[23] As discussed above, Lead Plaintiff has alleged both that Micromuse's stock price was inflated at the time of its purchases (¶¶ 2, 18, 47, 48, 51, 96, 200, 201, 205) and identified the reason for the inflation, namely Defendants' smoothing of earnings to meet market expectations. ¶¶ 47-64, 61, 77-87. Under *Broudo*, Lead Plaintiff has met its pleading burden.

Further inquiry as to whether or not Lead Plaintiff has proven loss causation is inappropriate at this stage in the litigation. It is well established that "the causation issue

[23] Defendants call the viability of *Broudo* into doubt, as it is currently pending review by the United States Supreme Court. *Broudo*, however, is the leading case in the Ninth Circuit on the issue of loss causation and remains the authority on the Ninth Circuit's pleading standard for loss causation while review by the Supreme Court is pending.

'becomes most critical at the proof stage,' and the question of 'whether the plaintiff has proven causation is usually reserved for the trier of fact.'" *In re DaimlerChrysler AG Sec. Litig*, 197 F. Supp. 2d 42, 66 (D. Del. 2002) (citations omitted); *see also Miller v. NTN Communications, Inc.*, No. 97-CV-1116, 1999 WL 817217, at *11 (S.D. Cal. May 21, 1999) (finding the trier of fact determines whether defendant's misrepresentations satisfy elements of loss causation); *Kaplan v. Kahn*, No. C-93-20015, 1994 WL 618473, at *5 (N.D. Cal. Oct. 25, 1994) (determining that plaintiffs are required to plead loss causation at motion to dismiss phase, but prove allegations later); *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997) (concluding that loss causation requirement ought not place unrealistic burdens on a plaintiff at initial pleading stage); *Miller v. Apropos Tech., Inc.*, No. 01C 8406, 2003 WL 1733558 at *8 (N.D. Ill. Mar. 31, 2003) (alleging the element of loss causation in complaint is sufficient for plaintiffs to survive motion to dismiss stage of litigation). Whether or not Lead Plaintiff has *proven* loss causation must be left for another day. However, at this point in the litigation there is no question that Lead Plaintiff has met its pleading burden.

IV. LEAD PLAINTIFF HAS ADEQUATELY PLEADED ITS SECTION 20(a) CLAIM

The Individual Defendants argue summarily that because no primary claim has been stated against them under the Exchange Act, the claims against them under section 20(a) of the Exchange Act must also be dismissed. As shown above, the Complaint sufficiently states Section 10(b) claims against these defendants. Because no other arguments against the secondary liability claims have been advanced by the Individual Defendants, these claims also survive their motions to dismiss.

V. CONCLUSION

For all of the foregoing reasons, the Complaint adequately states claims under Sections Sections 10(b) and 20(a) of the Exchange Act. Accordingly, Defendants' motion to dismiss the Complaint should be denied. [24]

---

[24] Lead Plaintiff respectfully requests leave to amend if the Court is inclined to grant any portion of Defendants' motions. *Cook, Perkiss & Liehe, Inc. v. Northern Cal. Collection Serv. Inc.,* 911 F.2d 242, 247 (9th Cir. 1990).

Dated: January 6, 2005

Respectfully submitted,

BERMAN DeVALERIO PEASE
TABACCO BURT & PUCILLO

By:/s/_____
Christopher T. Heffelfinger
Joseph J. Tabacco, Jr.
Nicole Lavallee
Michael W. Stocker
425 California Street, Suite 2025
San Francisco, California 94104-2205
Telephone: (415) 433-3200
Facsimile: (415) 433-6382

Lead Counsel for Lead Plaintiff Massachusetts Laborers Pension Fund