DECLARATION OF JOHN C. KAIRIS IN SUPPORT OF PLAINTIFF’S OMNIBUS BRIEF IN OPPOSITION TO DEFENDANTS’ MOTIONS TO DISMISS THE FIRST AMENDED CONSOLIDATED COMPLAINT

CLASS ACTION

Date: August 10, 2005

Time: 9:00 a.m.

Ctm: 3

Judge: Hon. Jeremy Fogel
I, John C. Kairis, declare as follows:

I am an attorney at the law firm of Grant & Eisenhofer P.A., lead counsel in this action. I am admitted Pro Hac Vice to practice law before this Court. I have personal knowledge of the facts set forth herein and, if called as a witness, I would testify competently thereto.

1. Attached hereto as Exhibit A is a true and correct copy of the Common Stock Warrant of Siara Systems, Inc., dated November 27, 1999.


3. Attached hereto as Exhibit C is a true and correct copy of the Comparative Returns of Redback stock and to related indices from December 3, 1999 through October 10, 2003.


6. Attached hereto as Exhibit F is a true and correct copy of Stuart M. Grant & Megan D. McIntyre, Class Certification and Section 18 of the Exchange Act, The Rev. of Sec. and Commodities Reg.: An Analysis of Current Laws and Reg. Affecting the Sec. and Futures Indus. (2002).
I declare under penalty of perjury under the laws of the State of California and the laws of the United States of America that the foregoing is true and correct.

Executed at Wilmington, Delaware on this 19th day of July 2004.

/s/ John C. Kairis
John C. Kairis
GRANT & EISENHOFER P.A.
Chase Manhattan Centre
1201 North Market Street
Wilmington, DE 19801
Telephone: (302) 622-7000
Facsimile: (302) 622-7100

Attorneys for Lead Plaintiff
The Connecticut Retirement Plan and Trust Funds
EXHIBIT A

TO DECLARATION OF JOHN C. KAIRIS
NEITHER THE SECURITY EVIDENCED BY THIS WARRANT NOR THE SECURITIES ISSUABLE UPON EXERCISE OF THIS WARRANT HAVE BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. SUCH SECURITIES MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF SUCH REGISTRATION UNLESS THE COMPANY RECEIVES AN OPINION OF LEGAL COUNSEL FOR THE HOLDER OF SAID SECURITIES THAT IS REASONABLY ACCEPTABLE TO THE COMPANY, STATING THAT SUCH SALE OR TRANSFER IS EXEMPT FROM THE REGISTRATION REQUIREMENTS OF THE SAID ACT OR THE COMPANY OTHERWISE SATISFIES ITSELF THAT SUCH TRANSACTION IS EXEMPT FROM REGISTRATION.

COMMON STOCK WARRANT
OF SIARA SYSTEMS, INC.

THIS CERTIFIES THAT, subject to the terms and conditions of this Warrant, for the consideration of $1.00, the receipt and sufficiency of which are hereby acknowledged, U.S. Telesource, Inc., a Delaware corporation, or its successors and assigns (the "Holder"), is entitled to purchase from Siara Systems, Inc., a Delaware corporation (the "Company"), at any time and from time to time on or after the date hereof, of shares of Common Stock, par value $0.001 per share (the "Common Stock"), of the Company in such number and at such price as determined in accordance with this Warrant.

Upon delivery of this Warrant (with the Notice of Exercise in the form attached hereto as Exhibit A), together with payment of the Warrant Price (as defined below) for the shares of Common Stock to be issued, which payment may be made by converting this Warrant, or any portion thereof, pursuant to Section 5 below ("Warrant Conversion"), at the principal office of the Company or at such other office or agency as the Company may designate by notice in writing to the Holder hereof, the Holder shall be entitled to receive a certificate or certificates for the shares of Common Stock so purchased. All shares of Common Stock that may be issued upon the exercise of this Warrant will, upon issuance in accordance with the terms hereof, be fully paid and nonassessable and free from all taxes, liens and charges with respect to the issuance and delivery thereof.

This Warrant is subject to the following terms and conditions:

1. **Term of Warrant.** This Warrant may be exercised in whole or in part, at any time and from time to time on or after the date hereof; provided, however, that this Warrant shall expire to the extent then unexercised as of 5:00 p.m., eastern time on December 31, 2004.

2. **Number of Warrant Shares.** Subject to adjustment from time to time pursuant to Section 4 hereof and subject to all the other terms and conditions of this Warrant, the Holder may exercise this Warrant with respect to 100,000 shares (the "Shares") of Common Stock (or other securities issuable in the event of a reclassification, change, merger or consolidation as set forth in Section 4 hereof).

FOIA Confidential Treatment
Requested by Qwest Communications Intl Inc.
QDSEC S14420
Common Stock Warrant
11/27/01

CCI:418051.5

[Signature]

[Date: 11/27/01]
Qwest Communications Corporation, a Delaware corporation and the parent corporation of Holder ("Qwest"), hereby agrees to purchase (on its own behalf or through its affiliates) from the Company or its successors upon reasonable and customary terms at least $40 million worth of equipment, that is currently under development by the Company, on or prior to December 31, 2001; provided that the Company shall have made available to Qwest equipment that meets in all material respects the specifications and product pricing and service level agreements (commensurate with pricing and service levels offered to third parties for similar quantities) which shall be reasonably agreed to by Qwest and the Company. If Qwest does not purchase at least $40 million worth of such equipment from the Company on or prior to December 31, 2001, then the Company may pursue all remedies available to it at law or in equity to recover all damages (including reasonable attorneys' fees) arising in connection with Qwest's breach of Qwest's agreement in the immediately preceding sentence.

3. **Warrant Price.** The exercise price of this Warrant (the "Warrant Price") shall equal $2.00 per Share, subject to adjustment from time to time pursuant to Section 4 hereof.

4. **Adjustment of Number of Shares and Warrant Price.** The number and kind of Shares purchasable upon the exercise of the Warrant and the Warrant Price shall be subject to adjustment from time to time in accordance with the following provisions:

   (a) **Adjustment for Stock Splits and Combinations.** If at any time or from time to time while this Warrant remains outstanding and unexpired, the Company shall effect a subdivision of the outstanding Common Stock, the Warrant Price then in effect immediately before that subdivision shall be proportionately decreased. If at any time or from time to time while this Warrant remains outstanding and unexpired, the Company shall combine the outstanding shares of Common Stock, the Warrant Price then in effect immediately before the combination shall be proportionately increased. Any adjustment under this subsection (a) shall become effective at the close of business on the date that the subdivision or combination becomes effective.

   (b) **Adjustment for Certain Dividends and Distributions.** In the event that, while this Warrant remains outstanding and unexpired, the Company at any time or from time to time shall make or issue (1) a dividend or other distribution on its Common Stock payable in Common Stock, then in each such event the Warrant Price shall be decreased as of the time of issue of such dividend or other distribution on its Common Stock, and then in each such event the Warrant Price shall be decreased as of the time that the Holder shall receive upon the exercise of the Warrant in addition to the number of Shares receivable thereupon, the amount of securities of the Company that the Holder would have received had the Warrant been exercised with respect to the Shares.
on the date of such event and had thereafter, during the period from the date of such event to and including the date on which the Warrant was exercised, retained such securities receivable by the Holder as aforesaid during such period given application to all adjustments called for during such period.

(d) **Reclassification, Consolidation or Merger.** In case of any capital reorganization, reclassification or change of outstanding securities of the class issuable upon exercise of the Warrant (other than as a result of a subdivision, split, combination or stock dividend), or in case of any consolidation or merger of the Company with or into another entity, the Company, or such successor entity, as the case may be, shall execute a new Warrant, with substantially the same terms as this Warrant, or amend this Warrant, to provide that the Holder shall have the right to exercise such new Warrant or amended Warrant and procure upon such exercise in lieu of the Common Stock theretofore issuable upon exercise of this Warrant the kind and amount of shares of stock, other securities, money and/or property receivable upon such reorganization, reclassification, change, consolidation or merger by the Holder as if this Warrant had been fully exercised immediately prior to such event. Any such new Warrant shall provide for adjustments which shall be as nearly equivalent as may be practicable to the adjustments provided for in this Section 4. The provisions of this subsection (d) shall similarly apply to successive reorganizations, reclassifications, changes, consolidations and mergers.

(e) **Certificate as to Adjustments.** Upon the occurrence of each adjustment or readjustment of the Warrant Price pursuant to this Section 4, the Company at its expense shall promptly compute such adjustment or readjustment in accordance with the terms hereof and furnish to the Holder a certificate setting forth such adjustment or readjustment and showing in detail the facts upon which such adjustment or readjustment is based and shall file a copy of such certificate with its corporate records. The Company shall, upon the reasonable written request of the Holder, furnish or cause to be furnished to the Holder a similar certificate setting forth (i) such adjustments and readjustments, (ii) the Warrant Price then in effect, and (iii) the number of Shares and the amount, if any, of other property which then would be received upon the exercise of the Warrant.

5. **Payment by Warrant Conversion.** The Holder may exercise the purchase right represented by this Warrant with respect to a particular number of Shares subject to this Warrant ("Converted Warrant Shares") and elect to pay for a number of such Converted Warrant Shares through Warrant Conversion by specifying such election in the Notice of Exercise attached hereto as Exhibit A. In such event, the Company shall deliver to the Holder (without payment by the Holder of any Warrant Price or any cash or other consideration) that number of Shares equal to the quotient obtained by dividing (x) the value of this Warrant (or the specified portion hereof) on the date of exercise, which value shall be determined by subtracting (A) the aggregate Warrant Price of the Converted Warrant Shares immediately prior to the exercise of the Warrant from (B) the aggregate fair market value of the Converted Warrant Shares issuable upon exercise of this Warrant (or the specified portion hereof) on the date of exercise, by (y) the fair market value of one Share on the date of exercise. For purposes of this Section 5, fair market value of a Share as of a particular date shall be (i) the average closing price of the Company’s Common Stock for the twenty (20) trading days immediately prior to the exercise of the applicable Warrant if the Company’s Common Stock is then publicly traded; or (ii) the value determined by
the Company's Board of Directors in good faith, if no public market exists for the Company's
Common Stock.

6. **Notices.** Upon any adjustment of the Warrant Price and any increase or decrease
in the number of Shares purchasable upon the exercise of this Warrant, then, and in each such
case, the Company, within 30 days thereafter, shall give written notice thereof to the registered
holder of this Warrant (the "Notice"). The Notice shall be mailed to the address of such holder
as shown on the books of the Company; and shall state the Warrant Price as adjusted and the
increased or decreased number of shares purchasable upon the exercise of this Warrant, setting
forth in reasonable detail the method of calculation of each.

7. **Transfer and Exchange of the Warrant and Shares.** When this Warrant or Shares
are presented to the Company with a request to register their transfer or to exchange such
Warrant for an equal number of warrants of other authorized denominations, the Company shall
register the transfer or make the exchange as requested if the following requirements are met:

(a) The Warrant shall be duly endorsed or accompanied by a written
instruction of transfer in form satisfactory to the Company, duly executed by the Holder thereof
or by its attorney-in-fact, duly authorized in writing; and

(b) In the case of Shares, such request shall be accompanied by the following
additional information and documents (all of which may be submitted by facsimile), as
applicable:

(i) If such Shares are being transferred (A) to a "qualified institutional
buyer" (as defined in Rule 144A) in accordance with Rule 144A, or (B) pursuant to an
exemption from registration in accordance with Rule 144 (and based on an opinion of
counsel if the Company so requests), or (C) pursuant to an effective registration statement
under the Securities Act, a certification to that effect;

(ii) If such Shares are being transferred pursuant to an exemption from
registration in accordance with Rule 504 under the Securities Act (and based on an
opinion of counsel if the Company so requests), a certification to that effect; or

(iii) If such Shares are being transferred in reliance on another
exemption from the registration requirements of the Securities Act (and based on an
opinion of counsel if the Company so requests), a certification to that effect.

8. **Representations and Warranties.** The Company represents and warrants to the
Holder as follows:

(a) **Organization and Powers.** The Company (i) is a corporation duly
organized, validly existing and in good standing under the laws of the jurisdiction of its
incorporation; and (ii) has all the requisite power and authority to carry on its business and to
execute, deliver and perform its obligations under this Warrant.

(b) **Authorization; No Conflict.** The offer and sale of the Warrant and the
Common Stock underlying the Warrant, and the execution, delivery and performance by the
Company of the Warrant and the Common Stocks in accordance with the terms hereof, do not
violate (i) any charter, bylaws or other organizational documents of the Company, or (ii) any
applicable law or regulation or any valid mortgage, deed of trust, agreement, indenture, or
instrument to which the Company is subject.

Common Stock Warrant

QDSEC S14423
Company of the Warrant have been duly authorized by all necessary corporate action of the Company and do not and will not (i) contravene the Company's articles of incorporation or bylaws; (ii) result in a breach or default under any material instrument, contract or other agreement to which the Company is a party; or (iii) to the Company's knowledge, violate any provision of any law, rule, regulation, order, judgment, decree or the like binding on or affecting the Company.

(c) **Binding Obligations.** The Warrant constitutes, or will constitute, a legal, valid and binding obligation of the Company, enforceable against the Company in accordance with its terms, except as may be limited by bankruptcy, insolvency, reorganization, moratorium or other similar laws relating to or affecting creditors' rights generally and general principles of equity, including, without limitation, concepts of materiality, reasonableness, good faith and fair dealing and the possible unavailability of specific performance or injunctive relief, regardless of whether considered in a proceeding of equity or at law.

(d) **Capitalization.** As of the date of this Warrant, the authorized capital stock of the Company consists of 35,000,000 shares of the Common Stock and 13,500,000 shares of preferred stock, par value $0.001 per share of the Company (the "Preferred Stock"), of which (i) 14,226,153 shares of the Common Stock were issued and outstanding, (ii) no shares of the Common Stock were held in the treasury of the Company, (iii) 7,055,905 shares of the Preferred Stock were issued and outstanding, (iv) 3,657,370 shares of the Common Stock reserved for issuance upon exercise of outstanding stock options issued by the Company to current or former employees and directors of the Company, and (v) 16,477 shares of the Common Stock reserved for issuance upon exercise of authorized but unissued stock options. In addition, warrants to purchase approximately 16,000 shares of Common Stock and 135,000 shares of Series B Preferred Stock are currently outstanding.

(e) **Shares Duly Issued.** The Shares, when issued upon the exercise of this Warrant pursuant to the terms hereof, shall be duly issued, fully paid and non-assessable.

(f) **No Registration.** Based upon the representation of the Holder in Section 11, and in reliance thereon, and based upon the applicable provisions of the Securities Act of 1933, as amended (the "Securities Act"), and the rules and regulations promulgated thereunder, the offer and sale of the Warrant and the underlying Shares of Common Stock are exempt from the registration and prospectus delivery requirements of the Securities Act.

9. **Registration Rights.** The Holder shall have such registration rights with respect to the Shares as are applicable to shares of Common Stock as specified in that certain Amended and Restated Investors' Rights Agreement dated as of December 21, 1998.

10. **Press Releases.** The Holder shall have the right to approve the form and content of all press releases or public announcements that shall be made concerning this Warrant and the transactions contemplated hereby, and the Company shall not make any press release or public announcement without the Holder's prior written consent, which shall not be unreasonably withheld.
11. Representation and Warranties and Agreements of Holder. The Holder hereby represents and warrants to, and agrees with, the Company as follows:

(a) **Investment Purpose.** The right to acquire the Common Stock issuable upon exercise of the Holder's rights contained herein will be acquired for investment and not with a view to the sale or distribution of any part thereof, and the Holder has no present intention of selling or engaging in any public distribution of the same except pursuant to a registration or exemption.

(b) **Private Issue.** The Holder understands (i) that the Common Stock issuable upon exercise of this Warrant is not registered under the Securities Act, and (ii) that the Company's reliance on exemption from the Securities Act is predicated on the representations and warranties of the Holder.

(c) **Financial Risk.** The Holder has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of its investment, and has the ability to bear the economic risks of its investment.

(d) **Accredited Investor.** The Holder is an "accredited investor" within the meaning of Rule 501 under the Securities and Exchange Act of 1934, as amended, as presently in effect.

(e) **State of Residence.** The Holder resides in the state of Colorado.

(f) **Market Standoff Agreement.** In connection with the Company's initial underwritten public offering of the Company's securities, neither the Holder nor any transferee of the Holder may sell, make short sale of, loan, gift any options for the purchase of, or otherwise dispose of any Shares (other than any Shares included in the registration) without the prior written consent of the Company or the underwriters managing such initial underwritten public offering of the Company's securities for one hundred eighty (180) days from the effective date of such registration. The Holder agrees to execute any form of lock-up agreement substantially similar to the preceding sentence prepared by the Company or the managing underwriters that is also required of the Company's officers, directors and employees generally.

12. **Miscellaneous.**

(a) **Assignment.** The terms of this Warrant shall be binding upon and shall inure to the benefit of any successors or assigns of the Company and of the holder or holders hereof and of the Common Stock issued or issuable upon the exercise hereof.

(b) **Rights and Obligations.** No Holder, as such, shall be entitled to vote or receive dividends or be deemed to be a stockholder of the Company for any purpose, nor shall anything contained in this Warrant be construed (i) to confer upon the Holder, as such, any rights of a stockholder of the Company, or any right to vote, give or withhold consent to any corporate action, receive notice of meetings, receive dividends or subscription rights, or otherwise, or (ii) as imposing any obligation on the Holder to purchase any securities or any liability as a stockholder of the Company, whether such obligations or liabilities are asserted by the Company or its creditors.

Common Stock Warrant

WEST - FEBRUARY 18, 1993

QDSEC S14425
(e) **Acceptance.** Receipt of this Warrant by the Holder hereof shall constitute acceptance of and agreement to the foregoing terms and conditions.

(d) **Further Assurances.** The Company will not, by amendment of its certificate of incorporation or bylaws or through any other action, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, but will at all times in good faith assist in the carrying out of all such terms and in the taking of all actions as may be necessary or appropriate in order to protect the rights of the Holder against impairment.

(e) **Replacement.** Upon receipt of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of this Warrant and, in the case of any such loss, theft or distribution, upon delivery of an indemnity agreement reasonably satisfactory in form and amount to the Company or, in the case of any such mutilation, upon surrender and cancellation of such Warrants, the Company at its expense will execute and deliver, in lieu thereof, a new Warrant of like date and tenor.

(f) **Amendment and Waiver.** Any provision of this Warrant may be amended, waived or modified upon the written consent of the Company and the Holder.

(g) **Reservation of Shares.** The Company hereby agrees that at all times there shall be reserved for issuance and/or delivery upon exercise of this Warrant, free from preemptive rights, such number of authorized but unissued shares of Common Stock as from time to time shall be required for issuance or delivery upon exercise of this Warrant. The Company further agrees that it will promptly to take all action as may from time to time be required in order to permit the holder hereof to exercise this Warrant and the Company duly and effectively to issue shares of Common Stock hereunder.

(h) **Governing Law.** This Warrant shall be governed by and construed in accordance with the laws of the State of Delaware without regard to the conflicts of laws provisions thereof.

[Remainder of Page Intentionally Left Blank]
IN WITNESS WHEREOF, the Company, the Holder and Qwest have caused this Warrant to be signed by their respective duly authorized officers.

Dated: November 27, 1999

SIARA SYSTEMS, INC.

By: Vivek Ragavan
Name: Vivek Ragavan
Title: President & CEO

U.S. TELSOURCE, INC.

By: ______________________
Name: ____________________
Title: ____________________

QWEST COMMUNICATIONS CORPORATION

By: ______________________
Name: ____________________
Title: ____________________

FCC-08904.5

S.1

COMMON STOCK WARRANT

To: FENWICK & WEST LLP
Page 02

FENWICK & WEST

S.14427
IN WITNESS WHEREOF, the Company, the Holder and Qwest have caused this
Warrant to be signed by their respective duly authorized officers.

Dated: November 1, 1999

SIARA SYSTEMS, INC.

By: __________________________
Name: _______________________ Title: __________________________

U.S. TELESOURCE, INC.

By: __________________________
Name: Marc B. ___________ Title: ___________

QWEST COMMUNICATIONS CORPORATION

By: __________________________
Name: Marc B. ___________ Title: ___________

TO PENNIECK & WEST LLP - Page 02

QDSEC S14428
EXHIBIT A

NOTICE OF EXERCISE

TO: Siara Systems, Inc.

1. The undersigned hereby elects to purchase ____________ shares of the Common Stock of Siara Systems, Inc. pursuant to the terms of the attached Warrant, and tenders herewith payment of the purchase price of such shares in full, together with all applicable transfer taxes, if any.

2. The undersigned hereby elects to exercise the purchase right with respect to shares of such Common Stock through Warrant Conversion, as set forth in Section 5 of the attached Warrant.

3. Please issue a certificate or certificates representing said shares of Common Stock in the name of the undersigned or in such other names as is specified below:

   (Name)

   (Address)

Signature of Holder:

By: ____________________________

Name: __________________________

Title: __________________________

Date: __________________________
Attached is an executed copy of the Common Stock Warrant dated November 27, 1999. Should you have any questions, please call me at (650) 858-7635.
EXHIBIT B

TO DECLARATION OF JOHN C. KAIRIS
IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
Judge Robert E. Blackburn

Civil Case No. 04-RB-0238 (CBS)

STICHTING PENSIOENFONDS, ABP,

Plaintiff,

v.

QWEST COMMUNICATIONS INTERNATIONAL, INC., a Delaware corporation, et. al.,

Defendants.

ORDER CONCERNING DEFENDANTS’ MOTIONS TO DISMISS

Blackburn, J

This matter is before me on the following motions: 1) defendant Qwest Communications’ motion to dismiss [#84], filed August 9, 2004; 2) defendants Anschutz and Slater’s motion to dismiss [#86], filed August 9, 2004; 3) defendant Arthur Andersen LLP’s motion to dismiss [#90], filed August 9, 2004; 4) defendant Mark Iwan’s motion to dismiss [#92], filed August 9, 2004; 5) defendants Peter Hellman, Linda Alvarado, Jordan Haines, and Thomas Stephens’ motion to dismiss [#95], filed August 9, 2004; and 6) defendants Citigroup Global Markets, Inc., Jack B. Grubman, Citigroup Global Capital Market Holdings, Inc., and Citigroup, Inc.’s motion to dismiss [#97], filed August 1, 2004. The motions are fully briefed. For the reasons discussed below, some of the motions are denied, and some are granted in part and denied in part.

I. JURISDICTION

The plaintiff, alleges various claims under the Securities Exchange Act of 1934 (the 1934 Act), 15 U.S.C. § 78j(b), and related rules. I have federal question jurisdiction over
these claims under 28 U.S.C. § 1331. The plaintiff also asserts claims under Colorado law. I have supplemental jurisdiction over these claims under 28 U.S.C. § 1367.

II. FACTS

The complaint addressed in the motions to dismiss is the plaintiff’s First Amended Complaint, filed July 7, 2004. I will refer to this document as the Complaint, and I will refer to specific paragraphs by their number (¶ 1). Qwest is a publically traded communications company which provides telephone service and a wide variety of other communications services in the United States and internationally. The plaintiff alleges that Qwest engaged in accounting fraud “designed to create the false perception that Qwest was a dynamic, growing company that constantly met or exceeded Wall Street expectations.” ¶ 4. The plaintiff, Stichting Pensioenfonds, ABP, (ABP) outlines nine different accounting manipulations which it alleges Qwest used to factitiously inflate Qwest’s financial performance, and therefore Qwest’s stock price. By mid-2002, according to the plaintiff, the defendants’ scheme began to unravel as Qwest’s accounting came under increasing public scrutiny. In October and December, 2003, this public scrutiny culminated in Qwest restating its financial results for fiscal years 2000 and 2001 and for the fiscal quarter ending March 31, 2002. Qwest restated its GAAP revenues for this period from $40.674 billion to 37.8 billion, an overstatement of $2,874 billion, and its losses from $4.802 billion to $30.290 billion, an understatement of $25,488 billion.

¶ 5 (emphasis in original).

ABP alleges that between July 5, 2000, and March 11, 2002, it purchased over 5.6 million shares of Qwest’s common stock in reliance on the defendants’ misstatements and misrepresentations concerning Qwest’s financial performance. ¶ 10. ABP alleges that it suffered more than 100 million dollars in losses when the value of Qwest stock fell
substantially “following the disclosure of the Company’s fraudulent accounting practices.” ¶ ¶ 9 - 10.

In analyzing the sufficiency of the Complaint, the parties frequently refer to my order concerning motions to dismiss in another case that includes many claims similar to the plaintiff’s claims in this case, *In re Qwest Communications International, Inc.* Securities Litigation, 01-RB-1451 (CBS). *In re Qwest* involves claims under sections 10(b) and 20 A of the 1934 Act, and sections 11 and 15 of the Securities Act of 1933. When appropriate, I will follow my analysis in *In re Qwest* in this case.

ABP alleges that Qwest engaged in nine different accounting manipulations which form the basis of the plaintiff’s claims. The plaintiff’s allegations concerning six of the alleged manipulations are essentially the same as the allegations in the complaint in *In re Qwest*. These six alleged manipulations, and the relevant paragraphs in the Complaint, are 1) IRU swap deals (¶¶ 151-232); 2) reciprocal transactions with KMC Telecom (¶¶ 303-312); 3) manipulation of directory revenues (¶¶ 315-319); 4) revenue recognition on the Genuity contract (¶¶ 234-260); 5) accounting for Qwest’s interest in KPNQwest (¶¶ 320-330); and 6) accounting for the declining value of network capacity booked as property, plant, and equipment (¶¶ 331-338). The plaintiff says it has alleged three additional accounting manipulations that are not at issue in the *In re Qwest* complaint. *Response to Qwest’s motion to dismiss*, p. 5-6. These alleged manipulations are 7) improper recognition of revenue on IRU sales (¶¶ 128-150); 8) ASFB transaction (¶¶ 261-289); and 9) manipulation of pro forma indicators (¶¶ 339-359).

ABP has grouped the defendants into four groups: 1) Qwest; 2) the individual defendants, who were members of the Qwest board of directors, or members of Qwest senior management during the relevant times (¶¶ 16-35); 3) the Andersen defendants,
which include the accounting firm Arthur Andersen, LLP, and Mark Iwan, an audit partner at Arthur Andersen who worked closely with Qwest; and 4) the Citigroup defendants, which include Citigroup Global Markets, Inc. (CGMI), formerly known as SolomonSmithBarney, Inc. (SSB), Citigroup Global Market Holdings, Inc. (CGMHI), formerly known as SolomonSmithBarney Holding, Inc. (SSB Holdings), which is a wholly owned subsidiary of Citigroup, Inc. (Citigroup), and an individual named Jack Grubman, who was the primary telecommunications analyst at SSB.

The plaintiff claims that the alleged accounting manipulations at Qwest violated Generally Accepted Accounting Principles (GAAP). GAAP is a widely recognized set of accounting principles, standards, and procedures. However, GAAP is not “a canonical set of rules that will ensure identical accounting treatment of identical transactions by all accountants.” Thor Power Tool Co. v. C. I. R., 439 U.S. 522, 544 (1979). Rather, GAAP generally tolerates a range of reasonable treatments, leaving the choice among reasonable treatments to management. Id. ABP claims that Qwest's accounting manipulations were undertaken in an effort to falsely inflate Qwest's financial statements to make the company appear more profitable than it was in reality. These manipulations were, according to ABP, reflected in financial statements made to the investing public, including filings with the SEC. ABP says many of these financial statements contained material misrepresentations of Qwest's financial position. ABP alleges that it relied on these misrepresentations when it purchased Qwest stock between July 5, 2000, and March 11, 2002.

ABP alleges that defendant Jack Grubman was the primary telecommunications analyst for SSB. SSB had an ongoing investment banking relationship with Qwest. ABP says Grubman's frequent reports to the market about Qwest often were materially false
because Grubman sought to be a cheerleader for Qwest in an effort to retain Qwest's investment banking business for SSB. Grubman's compensation was tied, to some extent, to the investment banking business he brought to SSB. "Grubman's positive analyst reports about Qwest were based not on his or SSB's belief in the fundamentals of the company, but upon Grubman's desire to win and retain investment banking business for SSB." ¶ 104. ABP also claims that Grubman was aware of the "adverse facts" known to Qwest insiders, as alleged in the Complaint, and was aware that Qwest was concealing these facts from the market. ¶ 103. Grubman had this knowledge, ABP claims, because Grubman had ready access to Qwest insiders, and to detailed information maintained by Qwest.

Based on the factual allegations in the Complaint, 'ABP asserts the seventeen claims listed below:

1) A claim against Qwest and individual defendants Woodruff, Anschutz, Nacchio, Haines, Slater, Stephens, Szeliß, Alvarado, and Hellman under § 18 of the 1934 Act, 15 U.S.C. § 78r;

2) A claim against the Andersen defendants under § 18 of the 1934 Act, 15 U.S.C. § 78r;

3) A claim against Qwest and the individual defendants under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10(b)(5) of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5;

4) A claim against the Andersen defendants under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10(b)(5) of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5;

5) A claim against Citigroup Global Markets, Inc. (CGMI) and Jack Grubman under Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10(b)(5) of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5;

6) A claim against the individual defendants under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a);
7) A claim against Citigroup and Citigroup Global Market Holdings, Inc. (CGMHI) under Section 20(a) of the 1934 Act;


9) A claim against all defendants under the Colorado Securities Act, §§ 11-51-501 & 604, C.R.S.;

10) A claim against the Andersen defendants and the Citigroup defendants for aiding and abetting Qwest’s violation of the Colorado Securities Act, §§ 11-51-501 & 604, C.R.S.;

11) A claim against all defendants for common law fraud;

12) A claim against all defendants for civil conspiracy;

13) A claim against Citigroup Global Markets, Inc. (CGMI), and Jack Grubman for aiding and abetting common law fraud;

14) A claim against the Andersen defendants for aiding and abetting common law fraud;

15) A claim against all defendants for negligent misrepresentation

16) A claim against the Andersen defendants for fraudulent concealment;

17) A claim against Qwest, Arthur Andersen, and SolomonSmithBarney, Inc.(SSB) that they are responsible for the alleged harm caused by the actions of their individual agents, which actions were taken in the scope of the agents’ employment.

III. STANDARD OF REVIEW

In their motions to dismiss, the defendants argue that the plaintiff’s claims against them must be dismissed because the plaintiff’s factual allegations are not sufficient to support the claims asserted. For the purpose of ruling on a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), the complaint is construed in the light most favorable to plaintiffs, and its allegations are taken as true. See, e.g., Daigle v. Shell Oil Co., 972 F.2d 1527, 1533 (10th Cir.1992). In appraising the sufficiency of plaintiff’s allegations, “the complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the
plaintiff can prove no set of facts in support of his claim that would entitle him to relief."

_Conley v. Gibson_, 355 U.S. 41, 45-46 (1957). With regard to some of the plaintiff's claims, the defendants argue that the plaintiff's allegations do not satisfy the particular pleading requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), as stated in 15 U.S.C. § 78u-4(b)(1) and (2).

**IV. TIMELINESS - § 10(b) AND § 18 CLAIMS**

ABP filed this suit on February 9, 2004. Several of the defendants argue that ABP's claims under § 10(b) and § 18 are time barred.

**A. Applicable Period of Limitations**

Prior to July 28, 2002, a one year statute of limitations was applicable to claims under § 10(b) and § 18. Section 804 of the Sarbanes-Oxley Act extended the applicable statute of limitations for any "private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws" to the earlier of two years following notice or five years after the occurrence of the facts giving rise to the claim. 28 U.S.C. § 1658 (2004). The plaintiff's § 10(b) claims are subject to this two year statute of limitations because the Complaint was filed after July 28, 2002.

The defendants argue that ABP's § 18 claims are not covered by the two year statute of limitations in § 1658. Rather, the defendants argue that § 18(c) of the 1934 Act, which provides for a one year period of limitations for § 18 claims, controls ABP's § 18 claims. 15 U.S.C. § 78(c). I conclude that the two year period of limitations of § 1658 is applicable to ABP's § 18 claims. The United States Supreme Court has noted that § 18 targets "the precise dangers that are the focus of § 10(b), and the intent motivating (both) sections is the same - to deter fraud and manipulative practices in the
securities markets, and to ensure full disclosure of information material to investment
decisions.” *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 296
(1993)(quotation and citations omitted). Section 1658 applies to private rights of action
involving claims of fraud, deceit, manipulation, or contrivance. Section 18 easily falls
within these parameters. The defendants arguments to the contrary are unavailing.

B. Events Triggering the Statute of Limitations

In the context of securities fraud, the Tenth Circuit has held that the statute of
limitations begins to run “once the investor, in the exercise of reasonable diligence, should
have discovered the facts underlying the alleged fraud.” *Sterlin v. Biomune Systems*,
154 F.3d 1191, 1201 (10th Cir. 1998). The standard outlined in *Sterlin* and similar cases
often is viewed as a two step process: 1) the date when the plaintiff was on “inquiry notice”
of the possibility of fraud; when there existed “sufficient storm warnings” to alert a
reasonable person to the possibility that misleading statements or significant omissions
had been made; and 2) the period thereafter during which a diligent investor should have
discovered the facts underlying the alleged fraud. *Id.* at 1202 - 05. Qwest argues that
reports issued by Morgan Stanley in June, July, and August of 2001, reports which were
critical of Qwest’s accounting on various issues, put the plaintiff on inquiry notice of the
possibility of fraud at Qwest. The plaintiffs allege also that in the few days after Morgan
Stanley’s June, 2001, report, “Morgan Stanley was blasted by other analysts that covered
Qwest, such as SSB, who published reports contradicting Morgan Stanley.” ¶ 71. Qwest
and the other defendants also note that putative class action complaints were filed in *In re
Qwest* on July 27 and November 30, 2001. They argue that ABP had notice of these
complaints, and that these complaints put ABP on notice of the possibility of fraud. Given
these warnings, Qwest and the other defendants argue that ABP should have discovered
the alleged fraud before February 9, 2002, the date two years prior to the filing of the original Complaint in this case.

The allegations in the Complaint indicate that two improprieties alleged in the Complaint were addressed also in the Morgan Stanley reports: 1) Qwest’s the valuation of its investment in KPNQwest; and 2) Qwest’s accounting for swaps and IRU sales. ¶¶ 730-738. Nothing in the record indicates that the Morgan Stanley reports described potentially fraudulent practices on a broad range of fronts, as alleged in the Complaint. If the Morgan Stanley reports constitute storm warnings, they are warnings only of the controversy concerning the valuation of Qwest’s investment in KPNQwest, and Qwest’s swap and IRU transactions, not of the broader scheme alleged in the Complaint.

It is important to note that ABP alleges also that Qwest undertook a concerted effort to counter the effect of the Morgan Stanley report among investors and analysts, and thus to conceal and deny the existence of accounting improprieties. ¶¶ 730-745. As alleged, this effort was more than comforting statements to Qwest investors, this was a campaign to make Qwest’s practices appear proper to analysts and the investing public.

The complaints filed in In re Qwest in late 2001 likely constitute storm warnings under Sterlin, although such complaints are not necessarily sufficient to alert a reasonable investor to the possibility of fraud. Given the complexity of the fraudulent scheme alleged by ABP, and Qwest’s efforts to quell the controversy, rapid discovery of the alleged scheme following such storm warnings cannot reasonably be expected. Under these circumstances, the passage of six months following the storm warnings is not unreasonable. Assuming that the Morgan Stanley reports and the complaints in In re Qwest did not constitute storm warnings on the issues addressed in those reports, those events triggered a duty on the part of the plaintiff to investigate the reported improprieties.
However, under the circumstances of this case, I conclude that the period after these warnings during which a diligent investor should have discovered the basis for the plaintiff's fraud allegations extends to February 9, 2002. I conclude that the plaintiff's § 10(b) and § 18 claims were filed within the applicable two year statute of limitations.

The Citigroup defendants argue that the conflict of interest that underlay their analysts' reports was well known to the market long before ABP filed this suit. They cite press coverage reaching back into the 1990s that indicates Grubman and other analysts were not presenting objective opinions to the market. This coverage culminated in two articles published in December, 2000. *Citigroup defendants' motion to dismiss*, filed August 16, 2004, pp. 10-11. The Citigroup defendants outline how these articles described the conflicts of interest that existed between investment banking operations and the analysts connected to those operations. Based on this publicity, the Citigroup defendants argue that ABP was on inquiry notice of its claims against the Citigroup defendants by the end of 2000, yet ABP did not file its Complaint until February, 2004.

Again, the statute of limitations does not begin to run until after 1) the date when the plaintiff was on "inquiry notice" of the possibility of fraud, when there existed "sufficient storm warnings" to alert a reasonable person to the possibility that misleading statements or significant omissions had been made; and 2) the period thereafter during which a diligent investor should have discovered the facts underlying the alleged fraud. The articles cited by the Citigroup defendants indicate that analysts like Grubman may have been coloring their analysis to suit their investment banking clients. However, these articles do not constitute inquiry notice concerning the particular fraud undertaken by Qwest, and Grubman's participation in the fraud, as alleged in the Complaint.
ABP's claims against the Citigroup defendants are based on 1) the alleged fraud at Qwest; and 2) Grubman's reports to the market about Qwest which allegedly failed to reveal adverse material facts about Qwest that were known to Grubman. The "storm warnings" cited by the Citigroup defendants did not cover this second element. Only when ABP should have discovered both the alleged fraud at Qwest, and Grubman's alleged role in the fraud did the statute of limitations begin to run on the claims against the Citigroup defendants. As discussed above, I conclude that this threshold was not crossed until early 2002, less than two years before ABP filed its Complaint in this case. ABP's § 10(b) and § 18 claims against the Citigroup defendants are not barred by the statute of limitations.

V. § 10(b) CLAIMS

Section 10(b) makes it unlawful for any person to employ any manipulative or deceptive device, in contravention of the rules and regulations of the Securities and Exchange Commission (SEC), in connection with the purchase or sale of a security. 15 U.S.C. § 78j(b). SEC rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. s 240.10b-5 (1994). Liability under Rule 10b-5(b) is predicated on an untrue statement of material fact, or omission to state a material fact. To state a claim under § 10(b) and rule 10b-5(b), a plaintiff must allege that the defendant: a) made an untrue
statement of material fact or failed to state a material fact; b) in connection with the purchase or sale of a security; c) with scienter; and d) the plaintiff relied on the misrepresentation and sustained damages as a proximate result of the misrepresentation. See, e.g., Anixter v. Home-Stake Products, 77 F.3d 1215, 1225 (10th Cir. 1996). ABP's § 10(b) claims are, in large part, based on allegations that the defendants made materially false statements.

To some extent, ABP also argues that it has stated § 10(b) claims against certain defendants for "scheme liability" under Rule 10b-5(a) or (c). To state a claim under Rule 10b-5(a) or (c), a plaintiff must allege that the defendant: a) committed a manipulative or deceptive act; b) in furtherance of the alleged scheme to defraud; c) scienter; and d) reliance. See, e.g., In re Global Crossing, Ltd. Securities Litigation, 322 F.Supp.2d 319, 336 (S.D.N.Y. 2004).

The level of scienter required to support a § 10(b) claim is intent to deceive, manipulate, or defraud. City of Philadelphia v. Fleming Companies, Inc., 264 F.3d 1245, 1259 (10th Cir. 2001). Proof of recklessness is sufficient to establish a § 10(b) claim. In this context, a defendant acts recklessly when his or her conduct amounts to an extreme departure from the standards of ordinary care, and presents a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of the danger. Id. at 1260. In the context of a claim based on non-disclosure of material facts, a plaintiff must show that the defendant 1) knew of the material fact; and 2) knew that failure to reveal the fact likely would mislead investors. Fleming, 264 F.3d at 1261.

The plaintiff alleges that the defendants engaged in a broad scheme to materially overstate Qwest's profitability, and to otherwise falsely enhance Qwest's balance sheet.
According to the plaintiff, the defendants arranged for Qwest to improperly recognize large amounts of revenue on various transactions, to improperly account for costs on various transactions, and otherwise to cause Qwest's accounting to substantially deviate from accepted standards. Again, the plaintiff alleges that the defendants engaged in nine different accounting manipulations in their effort to falsely enhance Qwest's balance sheet.

A. PSLRA Requirements

A section 10(b) claim is a type of fraud claim. Under Fed. R. Civ. P. 9(b), a plaintiff must plead with particularity the facts supporting a fraud claim. In addition, the Private Securities Litigation Reform Act of 1995 (PSLRA) imposes particular pleading requirements on complaints alleging securities fraud under § 10(b). 15 U.S.C. § 78u-4(b)(1) and (2). The PSLRA provides:

(1) Misleading statements and omissions

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

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

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading; the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.
15 U.S.C. § 78u-4(b)(1) and (2). Generally, the PSLRA is seen as imposing a standard of pleading which is more strict than that of Rule 9(b). *Fleming*, 264 F.3d at 1258.

In sum, the PSLRA requires the plaintiffs 1) to specify each statement alleged to have been misleading, and the reason or reasons the statement is misleading; and 2) with regard to each act or omission alleged to violate § 10(b), to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind, i.e. scienter. *See, e.g., Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1186 (10th Cir. 2003). Courts must look to the totality of the pleadings to determine whether the plaintiff’s allegations support a strong inference of fraudulent intent, or scienter, as required by the PSLRA. *Fleming*, 264 F.3d at 1262. In this context, a strong inference of scienter is “a conclusion logically based upon particular facts that would convince a reasonable person that the defendant knew a statement was false or misleading.” *Adams v. Kinder Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003). I have considered the totality of the plaintiff’s allegations in determining whether those allegations meet the requirements of the PSLRA.

When considering the adequacy of an inference of scienter under the PSLRA, a court must consider negative inferences which may be drawn against the plaintiff. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1187 - 88 (10th Cir. 2003). In other words, a court must evaluate a plaintiff’s suggested inference in the context of other reasonable inferences that may be drawn from the facts alleged. *Id.* The inference of scienter suggested by the plaintiff must be strong in light of the overall context of the allegations, including reasonable inferences against the plaintiff’s position. *Id.*
B. Andersen Defendants

Andersen argues that the plaintiff's fraud allegations in support of its claims under § 10(b) do not satisfy the particular pleading requirements of the PSLRA. ABP alleges that three audit letters issued by Andersen, and filed with the SEC, were false because they represented that Qwest's financial statements fairly presented Qwest's financial position, and that those statements were prepared in conformity with accounting principles generally accepted in the United States. The first audit letter was dated January 31, 2000, and concerned Qwest's 1999 financial results (1999 statement). ¶ 545. The second audit letter was dated January 24, 2001, and concerned Qwest's 2000 financial results (2000 statement). Id. ¶ 546. The third audit letter was dated January 29, 2002, and concerned Qwest's 2001 financial results (2001 statement). Id. ¶ 547. For the sake of clarity, I consider these statements in reverse order.

1. Andersen's 2001 Statement - Andersen argues that ABP cannot assert any claim based on Andersen's January 29, 2002, audit letter concerning Qwest's 2001 financial results. This statement was not filed with the SEC, and was not otherwise publically available, until April 1, 2002. ¶ 547. The plaintiff alleges that its last purchase of Qwest stock took place on March 11, 2002. Id. ¶ 10. ABP could not have relied on Andersen's letter made public on April 1, 2002, in purchasing stock prior to that date. Thus, ABP cannot establish reliance on Andersen's 2001 statement for any claim in which reliance is an essential element. ABP concedes this point. Further discussion will address only Andersen's 1999 and 2000 statements.
2. **Andersen's 2000 statement** - Andersen argues that ABP has not alleged with adequate particularity the basis for its § 10(b) claims on issues other than accounting for IRU transactions in 2000. Andersen argues that ABP's allegations do not indicate that Andersen made knowing misrepresentations about non-IRU related accounting manipulations in its 2000 statement. In response, ABP cites its allegations concerning side-letter deals (¶¶ 111, 214-223), booking of revenue related to QwestDex (¶¶ 561-565), and equipment sales to the Arizona School Facilities Board (¶¶ 293-301, 543). I conclude that ABP's allegations concerning these transactions do not support its claim that Andersen made knowing misrepresentations on these issues in its 2000 statement.

ABP's allegations about side letter deals largely concern events in 2001. ¶¶ 214-232. ABP does mention one side letter deal in 2000. ¶ 221. However, there is no allegation that Andersen was aware of this alleged impropriety, but still approved Qwest's accounting for that year. Further, ABP's side-letter allegations note Andersen's requirement that side letters not be used to evade proper accounting. ¶¶ 215, 222. The side-letter deals do not provide a basis for claims of misrepresentation in Andersen's 2000 statement.

ABP alleges that Qwest manipulated directory publication dates to improperly advance the recognition of revenue. ¶¶ 315-319. ABP cites an e-mail sent from Mark Iwan, Andersen's audit partner at Qwest, to the chairman of Qwest's audit committee (Stephens) as evidence that Andersen knew of this manipulation. Iwan sent the e-mail on April 18, 2001. Stephens made notes on a printed copy of the e-mail during a conversation with Iwan, and those notes refer to Qwest Dex. ¶¶ 561-565. Andersen's 2000 statement was dated January 24, 2001. ABP's allegations about an e-mail
written on April 18, 2001, do not demonstrate that Andersen knew of the alleged
directory publication manipulation when Andersen made its 2000 statement. Absent
some indication of such knowledge, this alleged manipulation cannot properly be
included as a basis for ABP’s claim that Andersen’s 2000 statement was misleading.

Finally, ABP notes its allegations concerning equipment sales to the Arizona
School Facilities Board (ASFB). The allegations in the Complaint indicate that the
ASFB transaction took place in 2001. ¶ 302. The ASFB transaction cannot properly be
included as a basis for ABP’s claim that Andersen’s 2000 statement was misleading.

3. Andersen’s 1999 Statement - Andersen argues that ABP has not alleged
any fraudulent transactions in 1999 that made Andersen’s 1999 statement false and
misleading. ABP alleges that Qwest engaged in IRU transactions in 1999, that revenue
from these transactions was recognized improperly, and that Andersen participated in
developing an improper accounting scheme for these transactions.

¶¶ 135-40. In addition, ABP alleges that Andersen counseled Qwest to improperly
recognize revenue from “capacity swaps” beginning in 1999, and to misapply the
generally accepted term EBITDA in its financial statements for 1999. ¶¶ 155-60; 340-
55. The EBITDA manipulation “was designed specifically to emphasize the revenue
derived from IRU sales, capacity swaps, and equipment sales,” according to ABP.
¶ 355. These allegations describe sufficiently the allegedly improper accounting
manipulations, Andersen’s knowledge of the manipulations, and thus describe how
Andersen’s 1999 statement allegedly was false and misleading.

4. Andersen’s Non-Statement Conduct or Scheme Liability - Andersen
argues that cannot be held liable under § 10(b) for statements made by others, which
statements Andersen allegedly prepared or directed. Rather, Andersen argues that it
can be liable only for statements attributed to Andersen. ABP argues that it has stated a claim against the Andersen defendants under Rule 10b-5(a) and (c) because Andersen participated in a course of business or a scheme or artifice that operated as a fraud because they structured and approved fraudulent accounting practices at Qwest, they certified financial statements knowing that they were false, and they made other false and misleading statements. I disagree.

In Anixter v. Home-Stake Production Co., 77 F.3d 1215 (10th Cir. 1996), the Tenth Circuit held that "in order for accountants to use or employ a deception actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."

Id. at 1226 (applying § 10(b); internal quotation omitted).

Reading the language of § 10(b) and 10b-5 through the lens of Central Bank of Denver, we conclude that in order for accountants to "use or employ" a "deception" actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule allowing liability to attach to an accountant or other outside professional who provided "significant" or "substantial" assistance to the representations of others. See Central Bank of Denver, 511 U.S. at ----, 114 S.Ct. at 1454 (certainty and predictability are crucial to securities markets).


The Anixter court disavowed "a rule allowing liability to attach to an accountant or other outside professional who provided significant or substantial assistance to the representations of others." Id. at 1227. To the extent other cases "allow liability to attach without requiring a representation to be made by defendant, and reformulate the substantial assistance element of aiding and abetting liability into primary liability, they
do not comport with *Central Bank of Denver.*” *Id.* at 1226 n. 10 (citing *Central Bank of Denver*, 511 U.S. 164 (1994)). Applying the rules stated in *Anixter*, Andersen is entitled to dismissal of ABP’s § 10(b) claim to the extent that claim is based on allegations that Andersen participated in a scheme or artifice to defraud by providing substantial assistance to the representations of others.

5. **Iwan** - Iwan, Andersen’s audit partner at Qwest, argues that the plaintiff has not alleged that he made any statement that can form the basis of § 10(b) liability. ABP argues that Iwan essentially acted as Andersen’s representative in conducting Andersen’s auditing responsibilities, and in developing Andersen’s statements concerning Qwest’s finances. Iwan’s actions as Andersen’s alter ego, ABP argues, subject him to liability under § 10(b) for Andersen’s fraudulent statements. Again, the *Anixter* court disavowed “a rule allowing liability to attach to an accountant or other outside professional who provided significant or substantial assistance to the representations of others.” *Id.* at 1227. Andersen made representations, but Iwan did not directly make representations. Iwan is not subject to § 10(b) liability based on Andersen’s representations. Like Andersen, Iwan also is not liable under § 10(b) for other non-statement conduct that ABP describes as participation in a scheme or artifice to defraud. ABP’s § 10(b) claim against Iwan is dismissed.

6. **Andersen’s Sciente**r - Andersen argues that ABP’s allegations are not sufficient to indicate that Andersen acted with the requisite scienter when it made its allegedly fraudulent statements. I conclude that ABP’s allegations concerning Andersen’s scienter are sufficient to support ABP’s § 10(b) claim. ABP has made non-conclusory allegations that Andersen had detailed knowledge of facts material to the alleged misrepresentations, that the scope and magnitude of Andersen’s
misrepresentations was substantial, and that Andersen was motivated to accept and adopt Qwest's fraud to retain Qwest's substantial audit and non-audit related work. For essentially the same reasons discussed in my January 13, 2004, order in In re Qwest, 01-RB-1451, I conclude that ABP's allegations concerning Andersen are sufficient to support a strong inference of scienter.

C. Anschutz & Slater

Defendants Philip Anschutz and Craig Slater argue that ABP has not alleged facts showing a strong inference of scienter, as required by the PSLRA, and that the group publication doctrine is not applicable to the plaintiff's § 10(b) claim. On these fronts, ABP's allegations against these defendants are, in large part, similar to the plaintiffs' allegations against these defendants in In re Qwest. For the reasons stated in my January 13, 2004, order in In re Qwest, I conclude that ABP has alleged facts supporting a strong inference of scienter as to Anschutz and Slater. Further, to the extent ABP's § 10(b) claim relies on the group publication doctrine, I conclude that the doctrine supports ABP's claim as to Anschutz and Slater, for the reasons stated in my January 13, 2004, order in In re Qwest.

Finally, I disagree with Anshutz' and Slater's argument that ABP has not pled loss causation sufficiently. ABP has pled sufficient facts to indicate that the defendants' alleged fraud was a significant cause of the losses it allegedly suffered from its investment in Qwest stock. Anschutz and Slater propose that the court "take judicial notice of the burst of the notorious internet bubble" as the cause of ABP's losses. Anschutz & Slater's Motion to Dismiss, p. 19 (citing In re Merrill Lynch & Co. Research Reports Securities Litigation, 289 F. Supp. 2d 416, 419 (S.D.N.Y 2003). While it is readily conceivable that the burst of the so-called internet bubble played a
role in causing ABP’s losses, that possibility does not preclude ABP from alleging that the defendants’ false statements concerning Qwest’s financial status was a significant cause, or even the primary cause, of its losses. The plaintiff sufficiently has alleged such a causal connection.

D. Audit Committee Defendants

Defendants Linda Alvarado, Jordan Haines, S. Thomas Stephens, and Peter Hellman were outside directors of Qwest, and members of the Qwest Audit Committee (the audit committee defendants). ¶¶ 20-23. The audit committee defendants each signed Qwest Form 10-Ks that were filed with the SEC. ¶¶ 382, 406. ABP alleges that these Form 10-Ks contained material misrepresentations.

The PSLRA requires that ABP make allegations sufficient to support a strong inference of scienter as to these defendants. Again, to establish a strong inference of scienter, the plaintiff must allege that the defendant 1) knew of the material fact; and 2) knew that failure to reveal the fact likely would mislead investors. Fleming, 264 F.3d at 1261. The audit committee defendants argue that ABP’s allegations are not sufficient to support a strong inference of scienter. I agree.

The audit committee defendants were outside directors of Qwest who served on the audit committee during the relevant period. Their level of involvement with Qwest’s operations is reflected in ABP’s allegation that the audit committee met 35 times between June, 2000, and September, 2002. In this context, it is important to distinguish between directors who are involved in the day-to-day operations of a company, or who exercise detailed control over certain operations, from directors whose involvement is more limited.

This Court distinguishes between a corporation’s inside directors, who normally participate in its operations and create its policies, and outside
directors, who are supposedly independent and disinterested and who, without a showing that the situation is otherwise, rely on the insiders' disclosure of material information about the corporation's business.

In re Enron Corp. Securities, Derivative & ERISA Litigation, 258 F.Supp.2d 576, 626 (S.D.Tex. 2003). This limited involvement, and reliance on insiders' disclosure of material information, must be considered in determining if the plaintiff's allegations support a strong inference of scienter.

ABP alleges that IRU transactions were discussed at each of the 35 meetings of the audit committee that took place between June, 2000 and September, 2002.

¶ 516. In October, 2000, Mark Iwan allegedly warned the committee that Qwest's accounting for these transactions was being "vigorously challenged" by the SEC.

¶ 517. In early 2001, ABP alleges, Qwest managers "repeatedly raised concerns about Qwest's accounting for capacity swap transactions and IRU sales with the Audit Committee. . . ." ¶ 518. The nature of these concerns is not described. Qwest's auditor, Arthur Andersen, "periodically presented its findings, views and opinions on accounting issues to the committee." ¶ 519. In October 2001, Iwan told the audit committee that the accounting positions Qwest had taken on IRU swaps and equipment sales were "not only 'aggressive but very close to outright 'unacceptable.'" ¶ 521 (internal quotation not attributed).

Qwest's CFO, Zeliga, investigated the use of side agreements by Qwest officials, and presented her findings to the audit committee on an unstated date.

¶ 523. One of Zeliga's conclusions was that Qwest improperly had recognized 109 million dollars in revenue on a transaction with Cable & Wireless. Id. Iwan, Zeliga, Qwest's legal counsel, Tempest, and the audit committee decided that this revenue recognition was not material, and did not need to be restated. Id. In February, 2002,
after receiving information about Qwest's involvement in improper swap transactions with Global Crossing, the audit committee hired a law firm to help it to investigate more than 200 network deals dating back to 1999. ¶ 524. The committee concluded that the problems were not quantitatively or qualitatively material to Qwest's financial statements. Id.

ABP also notes an April, 2001, e-mail from Iwan to audit committee defendant Hellman, which discusses Qwest's accounting for the first quarter of 2001. ¶ 520. Hellman's handwritten notes concerning one swap transaction say "this one stinks." The notes refer to QwestDex by saying "13 month book . . . spending more to get revenue." Id. Hellman also wrote "the sky is falling." Id.

1. Statements by Audit Committee Defendants - The plaintiff's allegations indicate that the audit committee defendants were presented with information indicating that Qwest managers and its auditor, Iwan, had some concerns about accounting for IRAU transactions. The strongest expression of concern is Iwan's alleged statement in October, 2001, that the accounting for IRAU transactions was "very close to outright 'unacceptable.'" ¶ 521. However, none of the alleged expressions of concern indicated that the accounting was false, a violation of generally accepted accounting procedures (GAAP), or fraudulent. In light of the fact that the audit committee defendants were outsiders relying on information from insiders, these expressions of concern are not sufficient to indicate that the audit committee defendants knew or should have known that Qwest's IRAU accounting would necessarily lead to materially false statements in Qwest's financial reporting. The facts allegedly known to the audit committee defendants do not support the conclusion that the audit committee defendants knew of the material facts that allegedly were not disclosed. Absent this
knowledge, they could not have known that failure to reveal these facts was likely to mislead investors. In this context, I cannot conclude that the plaintiff's allegations support a strong inference of scienter as to statements by these defendants.

ABP argues that the group publication doctrine supports its claim against the audit committee defendants. "Identifying the individual sources of statements is unnecessary when the fraud allegations arise from misstatements or omissions in group-published documents such as annual reports, which presumably involve collective actions of corporate directors or officers." *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1254 (10th Cir. 1997). The group publication doctrine is based on the presumption that corporate officers engaged in collective action when making such statements. This presumption is based on the officers' direct involvement with the day-to-day affairs of the company, and with its finances. See, e.g., *In re GlenFed, Inc. Securities Litigation*, 60 F.3d 591, 593 (9th Cir.1995). The *GlenFed* court concluded that outside directors should not be subject to this presumption absent allegations that they "participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times." *Id.* I conclude that the audit committee defendants' involvement with Qwest, as alleged in the Complaint, does not indicate that these defendants had such close involvement with Qwest that the group publication doctrine should be applied. In short, it is not reasonable to presume that these defendants knew of the alleged inaccuracy of all of the fraudulent statements alleged by ABP because these defendants had such a close involvement with Qwest's operations.

Finally, I note that the application of the group publication doctrine establishes
only the scope of statements which potentially are the subject of § 10(b) liability. The application of the doctrine, by itself, does not demonstrate a strong inference of scienter.

2. **Scope and Magnitude of Misrepresentations** - Allegations of pervasive and long-standing accounting machinations, and resulting misstatements, may support a strong inference of scienter under the PSLRA. *See, e.g., Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003). Here, ABP has concentrated on the audit committee defendants' alleged knowledge of improper accounting for IRU transactions, but its allegations do not support an inference that these defendants knew this accounting was materially misleading. In this context, the scope of the alleged misrepresentations does not add weight to a strong inference of scienter.

3. **Motive and Opportunity** - Allegations concerning a defendant's motive and opportunity to commit securities fraud may be considered in determining whether the "plaintiffs' allegations, taken as a whole, give rise to a strong inference of scienter." *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1263 (10th Cir. 2001). To establish scienter by pleading motive and opportunity, the plaintiff must allege that the defendant benefitted from the alleged fraud in some concrete and personal way, "as when the defendants made material misrepresentations to maintain a high stock price and then sold their own shares at a profit." *Id.* at 1261, *citing Novak v. Kaskas*, 216 F.3d 300, 307 - 08 (2nd Cir. 2000) (pre PSLRA). Here, ABP makes no such allegations against the audit committee defendants.

4. **Scheme Liability** - Again, the facts allegedly known to the audit committee defendants do not support the conclusion that the audit committee defendants knew of the material facts that allegedly were not disclosed by Qwest. Absent this knowledge,
they could not have known that failure to reveal these facts was likely to mislead investors. Under these circumstances, I cannot conclude that the facts alleged by ABP demonstrate that the audit committee defendants, acting with scienter, committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud. To the extent ABP asserts a claim against these defendants under Rule 10b-5(a) or (c), this claim must be dismissed.

5. Conclusion - In short, ABP’s allegations concerning the audit committee defendants’ knowledge of the accounting issues surrounding Qwest’s IRU transactions are not, by themselves, sufficient to support a strong inference of scienter as to these defendants. The group publication presumption is not applicable to these defendants. In this context, the scope and magnitude of the alleged misrepresentations does not support a strong inference of scienter. Finally, there are no motive and opportunity allegations concerning these defendants. The audit committee defendants’ motion to dismiss ABP’s § 10(b) claims is granted.

E. Citigroup Defendants

The Citigroup defendants argue that ABP’s allegations do not indicate: 1) that Grubman or the Citigroup defendants knew Qwest’s financial statements were fraudulent; and 2) that the opinions expressed by Grubman in his reports had no reasonable basis, or were made in bad faith.

The statements that are the basis of ABP’s § 10(b) claim against the Citigroup defendants are specified in the Complaint at paragraphs 635 through 717. These statements were made in Grubman’s analyst reports issued between April 25, 2000, and March 6, 2002. In each of these statements, Grubman discusses Qwest’s recent financial reporting, and expresses his opinion about Qwest’s current status and future
prospects. Many of the statements in these reports are prefaced with phrases like "we believe" or "we think." Following its description of Grubman's statements in each report, ABP lists the reasons Grubman's statements were false and misleading.

Again, to establish the scienter necessary to prove a § 10(b) claim, the plaintiff must allege and prove that the defendant acted with intent to deceive, manipulate, or defraud. *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1259 (10th Cir. 2001). Proof of recklessness is sufficient to establish scienter. A statement of opinion is actionable if it is worded as a guarantee, is supported by specific statements of fact, or the speaker does not genuinely or reasonably believe the opinion. *Int'l Bus. Mach Corp. Sec. Litig.*, 163 F.3d 102, 107 (2nd Cir. 1998). Under the bespeaks caution doctrine, forward-looking representations are considered to be immaterial when the defendant has provided the investing public "with sufficiently specific risk disclosures or other cautionary statements concerning the subject matter of the statements at issue to nullify any potentially misleading effect." *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1120 (10th Cir. 1997) (quotation and citation omitted). The PSLRA added a "safe harbor" for forward-looking statements. This safe-harbor applies only to statements accompanied by meaningful cautionary language, or which are not proven to have been made with actual knowledge that they were false or misleading. *In re Worldcom Securities Litigation*, 294 F. Supp. 2d 392, 411 (S.D.N.Y. 2003).

1. Facts Known to Grubman - When a person makes a statement with knowledge of facts that are contrary to the statement, the contrast between the statement and the known facts tends to indicate that the person knew the statement was false, or that the person made the statement with reckless disregard of its truth or falsity. Again, in the context of a claim based on non-disclosure of material facts, a
plaintiff must show that the defendant 1) knew of the material fact; and 2) knew that failure to reveal the fact likely would mislead investors. **Fleming**, 264 F.3d at 1261. In describing Grubman's allegedly false statements, ABP repeatedly contrasts his statements with facts allegedly known to him. That Grubman's statements turned out to be false or inaccurate is not enough. ABP must allege facts that indicate that Grubman knew his statements were false, or that he recklessly disregarded their truth or falsity.

ABP alleges that Grubman knew as much about the details of Qwest's alleged false financial reporting as any Qwest insider would have known. ABP's allegations that Grubman's knew his statements were false are based, in part, on its claim that Grubman was aware of the same information that Qwest insiders knew. ABP alleges that Grubman was personal friends with Anschutz, co-chairman of the Qwest board of directors, and Nacchio, Qwest's president and CEO. ABP further alleges that Grubman attended at least two of Qwest's board of director meetings between 1998 and 2000, and that Anschutz met with Grubman at least ten times since 1996. ¶ 103. Further, ABP alleges that Qwest was an investment banking customer of SSB, and that SSB had access to Qwest's books and records.

Grubman's alleged relationships with Anschutz and Nacchio do not support a presumption that Grubman was a Qwest insider, or that Grubman knew the internal details of Qwest's financial reporting decisions. The nature of the relationship Grubman had with Anshutz and Nacchio, as described in the Complaint, does not indicate that Grubman maintained a detailed knowledge of Qwest's accounting practices. The fact that SSB had access to Qwest's books and records does not demonstrate that SSB or Grubman had examined those books and records, and, thus,
had become aware of all of the alleged financial reporting improprieties known to Qwest insiders. To the extent ABP's § 10(b) claims against the Citicorp defendants are based on the claim that Grubman knew certain facts because he was a Qwest insider, those claims must be dismissed. The allegations that the Citigroup defendants possessed this knowledge are far too general to support such claims under the PSLRA.

In listing the various items Grubman allegedly knew about Qwest's financial picture, ABP has listed several items that Grubman could have known only if he were a Qwest insider, assuming the allegations in the Complaint to be true. As to these items, the plaintiffs have not alleged any facts that indicate that Grubman would have known these facts from any other source of knowledge. These facts are:

A) That Qwest's reported EBITDA excluded operating costs deemed non-recurring, and thus did not reflect true EBITDA, as that term commonly is used and understood.

B) That Qwest's reported revenue and EBITDA were artificially inflated because of Qwest's improper recognition of revenue and EBITDA from sales of equipment to KMC, despite the fact that these sales actually were reciprocal transactions with no net cash gain to Qwest.

C) That Qwest's EBITDA and revenues were artificially boosted as a result of Qwest's fraudulent recognition of revenue from equipment sales to Genuity.

D) That Qwest's EBITDA and revenues were artificially boosted because Qwest moved the publication date of its QwestDex directories from January 2001, to December 2000.

E) That Qwest improperly included equipment sales to the Arizona School Facilities Board in reported revenue.

The allegations in the Complaint do not indicate how Grubman would have known these details of Qwest's accounting if he was not a Qwest insider. Again, the
allegations in the Complaint do not support the presumption that Grubman knew these details because he was a Qwest insider.

On the other hand, the allegations in the Complaint do indicate that Grubman was aware of some information that arguably was contrary to his statements in his analyst reports. The Complaint indicates that Grubman was aware of these facts based on his expertise in the telecommunications industry, his constant monitoring of Qwest and other telecommunications companies, his contact with Qwest and other telecommunications companies, and public reports about issues related to Qwest’s accounting and performance. ABP alleges that Grubman was aware of the following facts:

A) Qwest’s reported revenue and EBITDA were artificially inflated because they included improperly recognized revenue from IRU sales and capacity swaps.

B) Qwest could not maintain various projected growth rates, as high as 20%, because falling broadband prices and falling demand for bandwidth undermined Qwest’s primary growth area.

C) Qwest’s carrying value of its investment in KPNQwest and of Qwest’s network assets were overstated because Qwest failed accurately to write down the fair value of those assets.

D) Qwest’s accounting for the Calpoint transaction and similar sales artificially inflated Qwest’s EBITDA, EPS, and reported rates of growth, and GAAP did not allow for the type of accounting Qwest used on these transactions. ¶ 696.

It is important to determine when Grubman became aware of the information that allegedly contradicts his statements. This point in time indicates when he knew, or recklessly disregarded, the falsity of his statements.

**IRU & Capacity Swap** - ABP describes the issue of accounting for IRU transactions and capacity swaps as a pervasive controversy in the telecommunications industry. Grubman was aware of the issue generally because he was the preeminent
analyst in this area, and he knew that many of the companies he covered accounted for these transactions in a way that was, at minimum, controversial. ¶ 629. However, the specific allegation in the Complaint that indicates that Grubman became aware of questions and controversy about Qwest’s accounting for IRU transactions and capacity swaps is the allegation that Morgan Stanley raised this issue about Qwest specifically in July, 2001. ¶¶ 72-73. Morgan Stanley indicated that Qwest’s revenue growth was dependent on revenue from capacity swaps. *Id.* At this point, ABP’s specific allegations indicate that Grubman was aware of the controversy surrounding accounting for these transactions in the telecommunications industry generally, that Qwest was using this controversial accounting practice, and that the validity of Qwest’s revenue reporting and growth projections was being brought into question on this basis.

Grubman’s reaction to this Morgan Stanley report indicates that he was aware of this issue generally, and with regard to Qwest specifically, for at least 12 quarters. ¶ 684. In this report, he discussed the effect capacity swaps was having on Qwest’s revenue. *Id.*

Obviously, investors could choose to value or not value any part of any company’s revenue stream and this particular activity has been going on for 12 quarters at Q (Qwest) and probably represents about 30% or so of Qwest’s revenue growth . . . . This means 2Q revenue growth of roughly 12% would probably have been in the 9.5-10% range excluding capacity swaps.

*Id.*

It is important to note, however, that Morgan Stanley did not claim that Qwest’s accounting was not in compliance with GAAP. There are no specific allegations in the Complaint that Grubman knew Qwest’s accounting on these transactions was not in compliance with GAAP, or otherwise was clearly improper. Absent some indication that Grubman knew this accounting was not just debatable, but was improper, it cannot
be said that Grubman was on notice of accounting fraud at Qwest on this basis. Grubman acknowledged the controversy surrounding this accounting issue, and argued that recognition of revenue from IRU sales and capacity swaps was acceptable. ABP alleges that Grubman knew that “recognizing revenue from these transactions was an anomaly and not consistent with past practice.” ¶ 686. However, ABP makes no allegation that indicates how or when Grubman knew this.

Bandwith Prices and Demand - Falling bandwidth prices, and falling demand for bandwidth, is the second factor of which Grubman was aware which ABP claims is contrary to his statements about Qwest. “Grubman was uniquely aware of the extent of the declining demand for internet bandwidth, a problem endemic to all the telecom companies he covered . . . .” ¶ 629. In essence, ABP claims Grubman’s predictions of high growth rates for Qwest were false because Grubman knew these rates could not be maintained when demand for a key Qwest product was falling. In one report, Grubman said “the whole notion of worrying about pricing and capacity - we continue to believe and Nacchio agrees - is an unfounded worry. Again, this is an industry with declining costs which then allows unit pricing to decline with expansion of supply to creating demand.” ¶ 645.

Grubman’s predictions for Qwest may have been panglossian, in view of the falling demand for bandwidth. However, Grubman’s statements that demand for bandwidth would be strong, fueling Qwest’s growth, are predictions, not statements about facts that existed at Qwest. Such predictions often are wrong, as Grubman’s predictions were. However, I conclude that Grubman’s predictions of continued strong growth for Qwest, despite falling bandwidth prices and demand for bandwidth, are expressions of optimism or puffing that are not actionable as securities fraud. See,
e.g., *Grossman v. Novell, Inc.*, 120 F.3d 1112, 119-20 (10th Cir. 1997).

**Carrying Value of KPNQwest and Network Assets** - The allegation that indicates that Grubman was aware of questions surrounding Qwest's valuation of its interest in KPNQwest is ABP's allegation that this issue was discussed in Morgan Stanley's June, 2001, report. ¶ 666. The Morgan Stanley report noted that Qwest valued its interest in KPNQwest at 7.4 billion dollars, while current market prices for KPNQwest indicated that it should be valued at around two billion dollars. ¶ 320. The report noted that "the market clearly is cognizant of this possibility." *Id.* ABP alleges that this factor in Qwest's balance sheet helped to make Grubman's rosy statements about Qwest false. However, ABP does not cite any statement by Grubman in which he made specific statements about the valuation of KPNQwest, or indicated that the valuation of KPNQwest was a significant factor in his analysis.

Similarly, ABP alleges that Qwest over-estimated the value of its fiber optic and broadband network assets during the relevant time period. "Throughout 2000 and 2001, the entire telecommunications industry was depressed because of a glut in the supply of bandwidth capacity and economic slowdown." Under these circumstances, ABP alleges, Qwest was required to reduce the valuation of its network assets under applicable accounting rules. ¶¶ 332-335. "The Individual Defendants knew, however, that any asset impairment change at that time would have revealed to its investors that Qwest was unable to sell its network capacity at its carrying value." ¶ 337. As a result, ABP claims, the individual defendants failed to reduce the valuation of Qwest's network assets.

While the Complaint indicates that Grubman may have been aware of this issue in the telecommunications industry generally, none of the allegations in the Complaint
indicates that Grubman was aware of how this issue affected Qwest's accounting, or that Qwest's accounting violated applicable accounting rules, as ABP alleges. Absent such knowledge on Grubman's part, this issue does not tend to show that Grubman made statements that were contrary to his knowledge of this accounting issue at Qwest.

Calpoint - ABP alleges that Grubman made a false statement when he rationalized Qwest's accounting for an equipment sale known as the Calpoint transaction. ¶¶ 69 -696. ABP alleges that Grubman knew his statements were false because he knew that such sales were "more than just 2-3% of Qwest's revenue." ¶ 696(a) (emphasis in original). ABP further alleges that Grubman knew Qwest's accounting for this transaction violated GAAP. The source of Grubman's knowledge of this aspect of GAAP is not stated. ABP alleges also that Grubman knew there was no basis for his claim that "(w)e estimate that Q already has pending demand that could equate into as much as $100 million per quarter in recurring monthly revenues from corporate customers who will purchase the managed wavelength service from Q beginning in 2002." ¶ 696(c). However, ABP does not state the nature and source of the specific, contrary knowledge possessed by Grubman when he made this statement.

The four issues discussed above concern debates about accounting issues at Qwest, and predictions of Qwest's future performance, that were addressed in Grubman's statements. To the extent Grubman addressed debates about how to account for various transactions, those debates do not involve statements that Grubman knew to be materially false, assuming the allegations in the Complaint to be true. ABP alleges that Qwest's accounting violated applicable accounting rules in some instances. However, ABP has not alleged that Grubman was aware of the rules
allegedly violated. In this context, Grubman cannot be said to have known, or recklessly disregarded, violations of accounting rules of which he was not aware. In short, as to these four issues, the specific allegations in the Complaint do not indicate that Grubman had knowledge of facts that were contrary to the statements he made. Thus, the specific factual allegations in the Complaint do not support the conclusion that Grubman knowingly or recklessly made false statements.

2. Scope and Magnitude of Misrepresentations & Motive and Opportunity -
If the Complaint sufficiently alleged that Grubman knowingly or recklessly made false statements in most or all of the areas alleged in the Complaint, the scope and magnitude of those misrepresentations likely would be sufficient to support a strong inference of scienter. Similarly, ABP’s allegations concerning the Citigroup defendants’ motive and opportunity to commit the fraud alleged also would tend to support a strong inference of scienter. Absent an underlying knowing or reckless material misrepresentation, however, these considerations are not relevant.

3. Scheme Liability - With regard to several of Grubman’s statements, the allegations in the Complaint do not indicate how Grubman would have known that his statements were materially false because the Complaint does not indicate how Grubman would have known the details of Qwest’s accounting that allegedly would indicate that his statements were materially inaccurate. As to other statements, the allegations of the Complaint do not indicate that Grubman knew Qwest was violating certain accounting rules because there is no indication that Grubman was aware of those rules. Under these circumstances, I cannot conclude that the facts alleged by ABP demonstrate that the Citigroup defendants, acting with scienter, committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud. To the
extent ABP asserts a claim against the Citigroup defendants under Rule 10b-5(a) or (c), this claim must be dismissed.

4. **Conclusion** - For the reasons discussed above, I conclude that ABP's § 10(b) claims against the Citigroup defendants must be dismissed. The facts alleged by ABP are not sufficient to satisfy the pleading requirements of the PSLRA.

**VI. § 18 CLAIM**

Liability under § 18 can be established by showing: 1) a false or misleading statement or omission; 2) made or caused to be made by a defendant; 3) that is material; 4) contained in an SEC filing; and 5) on which the plaintiff relied in the purchase or sale of a security. See, e.g., Magna Inv. Corp. v. John Does One through Two Hundred, 931 F.2d 38, 40 (11th Cir. 1991). ABP alleges that Qwest reported favorable financial data in each form 10-Q and 10-K filed with the SEC from the last quarter of 1999 through the first quarter of 2002. ¶ 365. The plaintiff alleges that "this materially false information inflated the value of (Qwest's) stock." Id. Qwest argues, without response from ABP, that Qwest's form 10-Qs cannot support § 18 claims because those documents are exempt from § 18 liability under a Securities and Exchange Commission regulation. "(T)he financial information required by Part I of Form 10-Q and 10-QSB, shall not be deemed to be 'filed' for the purpose of Section 18 of the Act." 17 C.F.R. § 240.13a-13(d). Qwest asks that ABP's § 18 claim be dismissed as to statements made in Qwest's 10-Qs. Qwest also notes that ABP alleges reliance on form 10-Ks filed by Qwest in 1999 and 2000, but not 10-Ks filed at other times. ¶ 754. Qwest asks that ABP's § 18 claim be limited to Qwest's for the fiscal years 1999 and 2000.

Qwest is correct that a § 18 claim may not be based on statements made in 10-
Qs. ABP does not mention 10-Qs in its allegations describing its § 18 claim against Qwest. ABP has not asserted a § 18 claim based on 10-Qs. I also conclude that ABP has not alleged reliance on 10-Ks other than those relating to fiscal years 1999 and 2000. On its own terms, ABP’s § 18 claim does not extend beyond the 10-Ks specified in Count I of the Complaint ¶¶ 752-763.

Defendants Anschutz and Slater argue that ABP has not pled actual reliance with particularity, and has not alleged proximate cause, and that its § 18 claim therefore fails. I disagree. ABP has specified the statements in Qwest’s 10-Ks which it claims were materially inaccurate. ABP has alleged also that it read these documents and relied on them in purchasing Qwest securities. ¶¶ 9-10, 754-760. As discussed in Section IV-C, above, I also disagree with Anschutz and Slater’s argument that ABP has not sufficiently alleged a causal connection between the defendants’ alleged materially false statements and its losses. The motions to dismiss ABP’s § 18 claim are denied.

VII. § 20(a) CLAIM

Anschutz, Slater, the audit committee defendants, and the Citigroup defendants argue that ABP has not alleged facts sufficient to state a claim under § 20(a) of the 1934 Act, 15 U.S.C. § 78t. Under § 20(a), “a person who controls a party that commits a violation of the securities laws may be held jointly and severally liable with the primary violator.” *Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1305 (10th Cir. 1998). To the extent ABP has alleged § 10(b) claims against Qwest, Andersen, and individual defendants employed by Qwest, a control person may be subject to § 20(a) liability, if the control element of this claim adequately has been alleged. The plaintiff need not “show the defendant actually or culpably participated in the primary violation.” *Id.* (quotation and citation omitted). Anschutz, Slater, and the audit
committee defendants argue that ABP has not alleged facts indicating that they had sufficient control over primary violators.

Section 20(a) "has been interpreted as requiring only some indirect means of discipline or influence short of actual direction to hold a controlling person liable." Id. at 1305 (internal quotations omitted).

The SEC's definition of "control" reflects this remedial purpose: "control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405.

Id.

An outside director and audit committee member who is in a position to approve a corporation's financial statements can be presumed to have "the power to direct or cause the direction of the management and policies of" the corporation, at least insofar as the "management and policies" referred to relate to ensuring a measure of accuracy in the contents of company reports and SEC registrations that they actually sign. 17 C.F.R. § 240.12b-2. For, by placing liability on directors and other controlling persons the statute contemplates not only giving plaintiffs an additional source of redress to recover losses caused by corporate misrepresentations. It also seeks indirectly to foster accountability by imposing a penalty on those who are in a position to monitor the truthfulness of corporate public representations and establish standards to that end, but fail to do so, to the detriment of the corporation's investors.


Anschutz was chairman of Qwest's board of directors, and a significant stockholder. ABP alleges that he was consulted on many of the significant decisions made by Qwest management. Slater represented Qwest's's largest shareholder on the board of directors, and was part of the executive committee which oversaw supervision of management. The four audit committee defendants each attended regular meetings concerning the state of Qwest's finances, and they each signed Qwest Form 10-Ks.
filed with the SEC. Haines and Stephens signed Qwest's 1999 Form 10-K. ¶ 366.

Alvarado, Haines, Hellman, and Stephens signed Qwest's 2000 and 2001 Form 10-Ks.

¶¶ 382, 406.

These allegations are sufficient to demonstrate control for the purpose of a § 20(a) claim.

[An] outside director and audit committee member who is in a position to approve a corporation's financial statements can be presumed to have "the power to direct or cause the direction of the management and policies of" the corporation, at least insofar as the "management and policies" referred to relate to ensuring a measure of accuracy in the contents of company reports and SEC registrations that they actually sign.

Sprint Corp., 314 F.Supp.2d at 1144 (quoting 17 C.F.R. § 240.12b-2. F). Anschutz, Slater, and the four audit committee defendants' motions to dismiss the § 20(a) claim are denied.

On the other hand, I conclude that ABP's allegations are not sufficient to state a § 20(a) claim against the Citigroup defendants. Absent an underlying § 10(b) claim against a Citigroup defendant, the other Citigroup defendants cannot be held liable as controlling persons. The Citigroup defendants' motion to dismiss the § 20(a) claim is granted.

VIII. STATE LAW CLAIMS
STATUTE OF LIMITATIONS

Several defendants argue that ABP's state law claims for civil conspiracy, negligent misrepresentation, and respondeat superior are barred by the applicable statute of limitations. For example, Qwest and the Andersen defendants argue that the two year statute of limitations stated in §13-80-102(1)(a), C.R.S., applies to these state law claims. Section 102(1)(a) applies to "(t)ort actions, including but not limited to actions for negligence, trespass, malicious abuse of process, malicious prosecution,
ABP argues that the three year statute of limitations of §13-80-101(c), C.R.S., is applicable. Section 101(c) applies to civil actions “for fraud, misrepresentation, concealment, or deceit . . .”

The plaintiff’s claims under §11-51-604, C.R.S. are, in essence, claims based on alleged misrepresentations or fraud. The plaintiff’s claims for common law fraud, for negligent misrepresentation, and for fraudulent concealment are, of course, claims based on allegations of fraud or misrepresentation. The plaintiff’s civil conspiracy claim alleges a conspiracy to “misrepresent Qwest’s true financial condition.” ¶ 842. All of these claims are claims “for fraud, misrepresentation, concealment, or deceit . . .” §13-80-101(c), C.R.S. Thus, the three year statute of limitations of §13-80-101(c) controls.

In essence, the defendants argue that ABP reasonably should have discovered the factual basis for these claims by the end of 2001, more than two years before the Complaint was filed in this case. For the reasons discussed in Section IV of this order, I conclude that ABP should not reasonably have discovered the factual basis for these claims prior to February 9, 2002, the date two years before this case was filed. Thus, ABP’s Complaint was filed within the applicable three year statute of limitations.

IX. STATE LAW CLAIMS
FAILURE TO STATE A CLAIM

A. Negligent Misrepresentation

Some of the defendants argue that ABP’s allegations are not sufficient to state a claim for negligent misrepresentation under Colorado law. Qwest argues that it owed no duty to the plaintiff, and that the economic loss rule bars such a claim. Andersen also argues that ABP is not within the group of persons who can seek relief for the alleged misrepresentations.
The Colorado courts have adopted the Restatement (Second) of Torts § 552(1) (1976), and its definition of a claim of negligent misrepresentation.

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

Fluid Technology, Inc. v. CVJ Axles, Inc., 984 P.2d 614, 616 (Colo.App., 1998) (citing Restatement (Second) of Torts § 552(1) (1976)). The plaintiff has alleged that the defendants, in the course of their business, profession, or employment, supplied false information to the market concerning Qwest's business, which information was known to be used as a guide by those investing in Qwest stock, and which information was known to have an affect on the price of Qwest stock. The plaintiffs claim to have relied justifiably on the false information provided by the defendants, and to have suffered a financial loss as a result of their reliance on this information. The facts alleged by the plaintiff are sufficient to state a claim for negligent misrepresentation.

Qwest argues that it cannot be liable on such a claim because a corporation has no duty to its shareholders. In supplying information for the guidance of others in business transactions, one often will face the foreseeable risk that inaccurate information may cause harm to those relying on the information. In this context, one undertakes a duty to exercise reasonable care in providing information. The information in question in this case is information on which investors routinely, foreseeably, and justifiably rely. In this context, the defendants had a duty to exercise reasonable care. Further, Qwest is liable for the actions of its employees and agents. Many of the defendants are employees and agents of Qwest who allegedly supplied false information to investors.
Qwest argues also that the economic loss rule prohibits the plaintiff from pursuing a negligent misrepresentation claim. The Colorado Supreme Court has said that “a party suffering only economic loss from the breach of an express or implied contractual duty may not assert a tort claim for such a breach absent an independent duty of care under tort law.” *Grynberg v. Agri Tech, Inc.*, 10 P.3d 1267, 1269 (2000).

The court described the rule in similar terms in *Town of Alma v. Azco Construction, Inc.*, 10 P.3d 1256, 1264 (2000). The rule “serves to maintain a distinction between contract and tort law.” *Id.* at 1262.

In the present case, there is no need to preserve this distinction. ABP does not assert any claims that sound in contract. Its negligent misrepresentation claim is based on the duty, established in Colorado law, to exercise reasonable care when supplying information for the guidance of others in their business transactions. Assuming the allegations of the Complaint to be true, the plaintiff may be able to establish that Qwest and the other defendants tortiously breached this duty.

In *Mehaffy, Rider, Windholz & Wilson v. Central Bank Denver, N.A.*, the Colorado Supreme Court said a “theory of negligent misrepresentation is proper where a professional knows that its representation will be relied upon by a non-client for business purposes.” 892 P.2d 230, 236 (Colo.1995). Given the misrepresentations alleged in the Complaint, ABP is within the group of plaintiffs who can seek recovery for negligent misrepresentation from defendants such as Andersen and Iwan. Further, I do not agree with Andersen and Iwan that the plaintiff is obligated to file a certificate of review, as required by §13-20-602, C.R.S., in professional malpractice case. ABP’s negligent misrepresentation claim is not a professional malpractice claim.
In short, applying the notice pleading standard of Fed. R. Civ. P. 8, I conclude that ABP has stated a state law claim for negligent misrepresentation against the defendants.

B. Colorado Securities Act

ABP asserts a claim under §11-51-604(3), C.R.S., part of the Colorado Securities Act. Section 604(3) provides, in relevant part:

(3) Any person who recklessly, knowingly, or with an intent to defraud sells or buys a security in violation of section 11-51-501(1) . . . is liable to the person buying or selling such security . . . In connection with the violation for such legal or equitable relief that the court deems appropriate, including rescission, actual damages, interest at the statutory rate, costs, and reasonable attorney fees.

Section 11-51-501(1) provides:

(1) It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly:

(a) To employ any device, scheme, or artifice to defraud;

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Qwest argues that the language of §604(3) indicates that a claim for violation of that section, based on an underlying violation of §501(1), can be brought only when there is privity between the plaintiff and the defendant; only when the plaintiff alleges that the plaintiff purchased or sold a security from or to the defendant.

Although §604(3) can be read to include a privity requirement, as Qwest and the Andersen defendants suggest, I find that the holding of the Colorado Supreme Court in Rosenthal v. Dean Whitter Reynolds, Inc., precludes such a reading. 908 P.2d 1095 (Colo. 1995). The Rosenthal court applied §11-51-125(2), the predecessor of
§604(3). Section 125(2) read,

Any person who recklessly, knowingly, or with an intent to defraud sells or buys a security in violation of section 11-51-123 [the predecessor of § 501(1)] is liable to the person buying or selling a security in connection with the violation for such legal or equitable relief which the court deems appropriate, including rescission, actual damages, interest at the statutory rate, costs, and reasonable attorney fees.

The language of §125(2) is nearly identical to that of §604. The Rosenthal court held, to state a claim pursuant to section 11-51-125(2), a plaintiff must allege the following: (1) that the plaintiff is a purchaser or seller of a security; (2) that the security is a "security"; (3) that the defendant acted with the requisite scienter; (4) that the defendant's conduct was in connection with the purchase or sale of a security; (5) that the defendant's conduct was in violation of section 11-51-123 [the predecessor of § 501(1)]; and (6) that plaintiff relied upon defendant's conduct to his or her detriment, or that defendant's conduct caused plaintiff's injury.

Rosenthal, 908 P.2d at 1102. These elements, adopted by the Colorado Supreme Court, do not include a privity requirement. ABP's claim under §604(3) is not subject to dismissal for failure to allege privity between ABP and the defendants.

To the extent ABP has pled a § 10(b) claim against Andersen, Section 11-51-604(c), C.R.S., provides a basis for ABP's claim against Andersen for aiding and abetting Qwest's violation of §11-51-604(a)(3), C.R.S. ABP's allegations are sufficient to state a claim for aiding and abetting Qwest's §604(a)(3) violation against Andersen. On the other hand, for the reasons discussed in Section V-B-5, above, I conclude that ABP has not alleged facts sufficient to state a claim under the Colorado Securities Act against Iwan. Similarly, for the reasons discussed in Section V-E, above, I conclude that ABP has not alleged facts sufficient to state a claim under the Colorado Securities Act as to the Citigroup defendants. Again, the specific factual allegations in the Complaint do not support the conclusion that Grubman knowingly or recklessly made false statements.
C. Common Law Fraud

The Andersen defendants argue that ABP’s allegations do not support a common law fraud claim because they do not satisfy the specificity requirement of Fed. R. Civ. P. 9(b), and because ABP has not pled that Andersen had a duty to disclose truthful information to ABP. I conclude that, to the extent ABP adequately has pled § 10(b) claims, it also has adequately pled common law fraud. ABP’s allegation that Andersen had a duty to disclose truthful information based on its role as an independent auditor is sufficient to sustain this claim. The same rationale applies to Iwan, Andersen’s audit partner at Qwest.

Further, I conclude that aiding and abetting common law fraud is a claim that has been recognized under Colorado law.

Liability for aiding or abetting a tortious act will be found if the party whom the defendant aids performs a wrongful act that causes an injury, the defendant is generally aware of his role as part of an overall illegal or tortious activity at the time that he provides the assistance, and the defendant knowingly and substantially assists the principal violation.

Holmes v. Young, 885 P.2d 305, 308 (Colo.App.1994). ABP’s allegations are sufficient to state an aiding and abetting claim.

For the reasons discussed in Section V-E, above, I conclude that ABP has not alleged facts sufficient to state a common law fraud claim or an aiding and abetting common law fraud claim against the Citigroup defendants. Again, the specific factual allegations in the Complaint do not support the conclusion that Grubman knowingly or recklessly made false statements. Absent such allegations, the Complaint does not state a claim for common law fraud.
D. Fraudulent Concealment

As ABP notes, the Colorado Supreme Court has recognized a claim for fraudulent concealment. *Mallon Oil Co. v. Bowen/Edwards Associates, Inc.*, 965 P.2d 105, 111 (Colo. 1998). ABP provides a fair statement of the elements of this claim: 1) non-disclosure of material information; 2) a duty to disclose material information; 3) the non-disclosure ought to have been disclosed in "equity and good conscience;" and 4) justifiable reliance on the non-disclosure. *Id.* adopting Restatement (Second) of Torts §551.

The Andersen defendants argue that they had no duty to disclose information to ABP concerning Qwest's financial status. I agree with ABP that Andersen's role as an independent auditor created a duty to disclose information material to Qwest's financial performance, and, thus, to the valuation of Qwest's stock, to the public market, including ABP. ABP's allegations are sufficient to state a claim for fraudulent concealment, as that claim is defined in *Mallon Oil*.

E. Civil Conspiracy

There are five elements required to establish a civil conspiracy in Colorado. [T]here must be: (1) two or more persons, and for this purpose a corporation is a person; (2) an object to be accomplished; (3) a meeting of the minds on the object or course of action; (4) one or more unlawful overt acts; and (5) damages as the proximate result thereof.

*Jet Courier Service, Inc. v. Mulei*, 771 P.2d 486, 502 (Colo.1989). ABP alleges that "Qwest and the Individual Defendants on the one hand, and Andersen Defendants and/or the Citigroup Defendants, on the other hand, engaged in a conspiracy the object of which was to misrepresent Qwest's true financial condition." ¶ 843. The Andersen defendants argue that the complaint lacks any factual details of the purported conspiracy, such as when it started, who was involved, when the agreement was
reached, or what specific unlawful acts were committed. Further, Andersen argues that ABP must satisfy the fraud pleading requirements of Fed. R. Civ. P. 9(b) to state a claim for civil conspiracy.

I conclude that ABP sufficiently has alleged a civil conspiracy claim against the Andersen defendants. The Complaint makes clear how Qwest and Andersen, including Iwan, allegedly worked together to present an inaccurate picture of Qwest's financial condition to the investing public from 1999 through 2001. The plaintiff adequately has alleged a variety of unlawful acts taken by various defendants in the course of this effort, and it has alleged that the misrepresentation of Qwest's finances to the public caused it harm. This is sufficient to state a claim for civil conspiracy under Colorado law.

To the extent the civil conspiracy claim is based on acts that are unlawful because they constitute fraud, I conclude that the fraudulent acts must be pled under the standard of Rule 9(b). With some exceptions discussed in Section V, above, ABP adequately has pleaded fraud concerning several alleged misrepresentations. These misrepresentations also can form a basis for ABP's civil conspiracy claim. Further, the negligent misrepresentations alleged by ABP also are unlawful, and also can form a basis for the civil conspiracy claim. The defendants' motions to dismiss ABP's civil conspiracy claim are denied.

E. Respondeat Superior

To the extent ABP properly has stated state law claims against individual defendants, Qwest, Andersen, and Solomon Smith Barney (SSB), they may be liable for actions taken by individuals who were their agents or employees. To this extent, ABP has stated claims for respondeat superior liability against Qwest, Andersen, and SSB.
X. ORDERS

THEREFORE, IT IS ORDERED as follows:

1) That defendant Qwest Communications’ motion to dismiss [# 84], filed August 9, 2004, is DENIED;

2) That defendants Anschutz and Slater’s motion to dismiss [# 86], filed August 9, 2004, is DENIED;

3) That defendant Arthur Andersen LLP’s motion to dismiss [# 90], filed August 9, 2004, is GRANTED to the extent any of ABP’s claims are based on Andersen’s January 29, 1992, audit letter;

4) That defendant Arthur Andersen LLP’s motion to dismiss [# 90], filed August 9, 2004, is GRANTED to the extent ABP’s § 10(b) claim and other fraud claims are based on statements in Andersen’s January 24, 2001, audit letter that do not concern accounting for IRU transactions, and any alleged non-statement conduct or scheme liability under § 10(b);

5) That defendant Arthur Andersen LLP’s motion to dismiss [# 90], filed August 9, 2004, is DENIED otherwise;

6) That defendant Mark Iwan’s motion to dismiss [# 92], filed August 9, 2004, is GRANTED as to ABP’s § 10(b) claim and ABP’s claim under the Colorado Securities Act;

7) That defendant Mark Iwan’s motion to dismiss [# 92], filed August 9, 2004, is DENIED otherwise;

8) That the audit committee defendants’ (defendants Peter Hellman, Linda Alvarado, Jordan Haines, and Thomas Stephens) motion to dismiss [# 95], filed August
9, 2004, is **GRANTED** as to ABP's § 10(b) claim, ABP's claim under the Colorado Securities Act; and ABP's common law fraud claim;

9) That the audit committee defendants' (defendants Peter Hellman, Linda Alvarado, Jordan Haines, and Thomas Stephens) motion to dismiss [#95], filed August 9, 2004, is **DENIED** otherwise;

10) That defendants Citigroup Global Markets, Inc., Jack B. Grubman, Citigroup Global Capital Market Hodkings, Inc., and Citigroup, Inc.'s motion to dismiss [#97], filed August 1, 2004, is **GRANTED** as to ABP's § 10(b) claim and § 20(a) claim, ABP's claim under the Colorado Securities Act; ABP's common law fraud claim, and ABP's aiding and abetting common law fraud claim; and


BY THE COURT:

[Signature]
Robert E. Blackburn
United States District Judge
IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

CERTIFICATE OF SERVICE

Civil Case No. 04-RB-0238 (CBS)

The undersigned certifies that a copy of the foregoing was
served on March 29, 2005, by:

(X) delivery to:

Magistrate Judge Craig B. Shaffer

Terence C. Gill, Esq.
Marcy M. Heronimus, Esq.
Sherman & Howard, LLC
DC Box 12

Holly Stein Sollod, Esq.
Nicholas Billings, Esq.
Holland & Hart, LLP
DC Box 6

James M. Lyons, Esq.
Frederick J. Baumann, Esq.
Jesus M. Vazquez, Esq.
Rothgerber Johnson & Lyons, LLP
DC Box 11

() by electronic mail to the addressed to:

(X) depositing the same in the United States Mail, postage prepaid, addressed to:

J. W. Eisenhofer, Esq.
Geoffrey C. Jarvis, Esq.
Sharan Nirmul, Esq.
Grant & Eisenhofer, PA
1201 North Market Street, Ste. 2100
Wilmington, DE 19801

Kenneth F. Rossman, IV, Esq.
Alfred P. Levitt, Esq.
David R. Boyd, Esq.
Boies, Schiller & Flexner, LLP
5301 Wisconsin Ave., NW, Ste. 800
Washington, DC 20015
Roberta A. Kaplan, Esq.
Marguerite S. Dougherty, Esq.
Paul, Weiss, Rifkind, Wharton
& Garrison, LLP
1285 Avenue of the Americas
New York, NY 10019-8064

Clyde A. Faatz, Jr., Esq.
Christopher J.W. Forrest, Esq.
Hamilton and Faatz, PC
1600 Broadway, Ste. 500
Denver, CO 80202-4905

Tim Atkeson, Esq.
Joshua D. Franklin, Esq.
Arnold & Porter, LLP
370 Seventeenth Street, Ste. 4500
Denver, CO 80202

Scott B. Schreiber, Esq.
John A. Freedman, Esq.
Elissa Preheim, Esq.
Kwame Clement, Esq.
Shelby H. Hunt, Esq.
Arnold & Porter, LLP
555 12th Street, NW
Washington, DC 20004

Terry W. Bird, Esq.
Vincent J. Marella, Esq.
Mark T. Drooks, Esq.
Thomas V. Reichert, Esq.
Bird, Marella, Boxer, Wolpert, Nessim,
Drooks & Linenberg, PC
1875 Century Park East, 23rd Floor
Los Angeles, CA 90067-2561

Deputy Clerk
EXHIBIT D
TO DECLARATION OF JOHN C. KAIRIS
No. 04-55665

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

T. JEFFREY SIMPSON, on behalf of himself and
all others similarly situated,

Plaintiff,

and,

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM,

Plaintiff - Appellant,

v.

HOMESTORE.COM, INC.; et al.,

Defendants - Appellees.

On Appeal from the United States District Court
for the Central District of California

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE, IN SUPPORT OF POSITIONS THAT FAVOR APPELLANT

GIOVANNI P. PREZIOSO
General Counsel
JACOB H. STILLMAN
Solicitor
KATHARINE B. GRESHAM
Assistant General Counsel
MICHAEL L. POST
Senior Counsel

Of Counsel
MEYER EISENBERG
Deputy General Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 942-0921 (Post)
TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>TABLE OF AUTHORITIES</td>
<td>iii</td>
</tr>
<tr>
<td>INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION</td>
<td>1</td>
</tr>
<tr>
<td>STATEMENT OF THE CASE</td>
<td>3</td>
</tr>
<tr>
<td>A. Facts</td>
<td>3</td>
</tr>
<tr>
<td>B. District Court Decision</td>
<td>3</td>
</tr>
<tr>
<td>ARGUMENT</td>
<td>6</td>
</tr>
<tr>
<td>I. THE DISTRICT COURT'S HOLDINGS, BASED ON UNWARRANTED DISTINCTIONS, WOULD UNDERMINE THE PURPOSE OF THE ANTIFRAUD PROVISIONS.</td>
<td>6</td>
</tr>
<tr>
<td>II. THE DISTRICT COURT MADE SEVERAL LEGAL ERRORS IN ITS RESOLUTION OF THE CLAIMS AGAINST THE BUSINESS PARTNER DEFENDANTS</td>
<td>9</td>
</tr>
<tr>
<td>A. A defendant is not required to have a special relationship with the corporation of which the plaintiffs are shareholders to be primarily liable to them for securities fraud.</td>
<td>9</td>
</tr>
<tr>
<td>B. Designing the fraudulent scheme is not required for a defendant to be primarily liable for employing a scheme to defraud</td>
<td>11</td>
</tr>
<tr>
<td>C. The district court erroneously analyzed the element of reliance</td>
<td>12</td>
</tr>
</tbody>
</table>
TABLE OF CONTENTS (cont'd):

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>III. THE APPROPRIATE TEST FOR PRIMARY LIABILITY</td>
<td></td>
</tr>
<tr>
<td>FOR A SCHEME TO DEFRAUD</td>
<td>12</td>
</tr>
<tr>
<td>A. Scope of the statute and rule</td>
<td>12</td>
</tr>
<tr>
<td>B. The appropriate test for conduct</td>
<td>15</td>
</tr>
<tr>
<td>1. Any person can be primarily liable under Section 10(b) and Rule 10b-5(a) for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme</td>
<td>15</td>
</tr>
<tr>
<td>2. Engaging in a transaction whose principal purpose and effect is to create a false appearance of corporate revenues constitutes a deceptive act that can support primary liability</td>
<td>18</td>
</tr>
<tr>
<td>C. The reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant's deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction</td>
<td>21</td>
</tr>
</tbody>
</table>

CONCLUSION ........................................................................................................ 24

ADDENDUM

CERTIFICATE OF SERVICE

CERTIFICATE OF COMPLIANCE
**TABLE OF AUTHORITIES**

**CASES:**

<table>
<thead>
<tr>
<th>CASES</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)</td>
<td>9,14</td>
</tr>
<tr>
<td>Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)</td>
<td>2</td>
</tr>
<tr>
<td>Chemical Bank v. Arthur Andersen &amp; Co., 726 F.2d 930 (2d Cir. 1984)</td>
<td>21</td>
</tr>
<tr>
<td>Cooper v. Pickett, 137 F.3d 616 (9th Cir.1998)</td>
<td>4,10,16,18,22, passim</td>
</tr>
<tr>
<td>In re Enron, 235 F. Supp.2d 549 (S.D. Tex. 2002)</td>
<td>18</td>
</tr>
<tr>
<td>In re Enron, 310 F. Supp.2d 819 (S.D. Tex. 2004)</td>
<td>18</td>
</tr>
<tr>
<td>Ernst &amp; Ernst v. Hochfelder, 425 U.S. 185 (1976)</td>
<td>13,15</td>
</tr>
<tr>
<td>GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189 (3d Cir. 2001)</td>
<td>19</td>
</tr>
<tr>
<td>Harris v. Union Elec. Co., 787 F.2d 355 (8th Cir. 1986)</td>
<td>21</td>
</tr>
<tr>
<td>Herman &amp; MacLean v. Huddleston, 459 U.S. 375 (1983)</td>
<td>9</td>
</tr>
<tr>
<td>Howard v. Everex Systems, Inc., 228 F.3d 1057 (9th Cir. 2000)</td>
<td>16</td>
</tr>
<tr>
<td>In re Homestore.com, Inc., 252 F. Supp.2.d 1018 (C.D. Cal. 2003)</td>
<td>4,5,6,10, passim</td>
</tr>
<tr>
<td>J.I. Case Co. v. Borak, 377 U.S. 426 (1964)</td>
<td>2</td>
</tr>
</tbody>
</table>
CASIES (cont'd):

Santa Fe Indus., Inc. v. Green, 430 U.S. 475 (1977) ...................... 14
SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90 (2d Cir. 1978) ....... 19
SEC v. Rana Research Inc., 8 F.3d 1358 (9th Cir. 1993) .................... 21
SEC v. U.S. Environmental, 155 F.3d 107 (2d Cir. 1998) ................. 11
United States v. Charnay, 537 F.2d 341 (9th Cir. 1976) .................... 9,14
U.S. v. Russo, 74 F.3d 1383 (2d Cir. 1996) ............................. 19
Warshaw v. Xoma Corp., 137 F.3d 955 (9th Cir. 1996) ................... 22
In re ZZZZ Best Sec. Litig., 864 F. Supp. 960 (Cal. 1994) .............. 18,22
<table>
<thead>
<tr>
<th>STATUTES AND RULES:</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Securities Act of 1933, 15 U.S.C. 77a, et seq.:</strong></td>
<td></td>
</tr>
<tr>
<td>Section 17(a), 15 U.S.C. 77q(a)</td>
<td>13,16</td>
</tr>
<tr>
<td>Section 9, 15 U.S.C. 78i</td>
<td>19</td>
</tr>
<tr>
<td>Section 10(b), 15 U.S.C. 78j(b)</td>
<td>9,12,13,16, passim</td>
</tr>
<tr>
<td>Section 20(e), 15 U.S.C. U.S.C. 78t(e)</td>
<td>2</td>
</tr>
<tr>
<td><strong>Rule under the Securities Exchange Act of 1934, 17 C.F.R. 240.01, et seq.:</strong></td>
<td></td>
</tr>
<tr>
<td>Rule 10b-5, 17 C.F.R. 240.10b-5</td>
<td>9,13, passim</td>
</tr>
<tr>
<td>Rule 10b-5(a), 15 C.F.R. 240.10b-5(a)</td>
<td>13, passim</td>
</tr>
<tr>
<td>Rule 10b-5(c), 15 C.F.R. 240.10b-5(c)</td>
<td>13,16</td>
</tr>
</tbody>
</table>
**MISCELLANEOUS:**  

<table>
<thead>
<tr>
<th>Source</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Black's Law Dictionary (3d ed. 1933)</td>
<td>19</td>
</tr>
<tr>
<td>Funk &amp; Wagnalls, New Standard Dictionary of the English Language (1937)</td>
<td>15</td>
</tr>
<tr>
<td>The Random House Unabridged Dictionary of the English Language (2d ed. 1987)</td>
<td>19</td>
</tr>
<tr>
<td>Webster's New International Dictionary (2d ed. 1934)</td>
<td>15</td>
</tr>
</tbody>
</table>
INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief, amicus curiae, to address an important question concerning liability in private lawsuits, and possibly certain Commission actions, brought under the antifraud provisions of the federal securities laws:

What is the appropriate test for finding a defendant to be a primary violator rather than an aider and abettor in a scheme to defraud under Rule 10b-5(a)?

The question arises because the Supreme Court, in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), held that private actions under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, can only be brought against persons who are primary violators and not against those who aid and abet a primary violator.

This case involves allegations that a corporation and several of its business partners engaged in a scheme to defraud investors by entering into transactions that were deceptive because their purpose and effect was to falsely inflate the corporation’s revenues. These allegations raise the question whether the business partners’ alleged conduct—engaging in such transactions—can make them primary violators. This situation has arisen in several recent cases involving schemes to inflate the revenues of internet companies, as well as other types of schemes to misrepresent the financial condition of publicly traded companies.
Meritorious private actions under the federal securities laws serve an important role, both because they provide compensation for investors who have been harmed by violations of the securities laws and because, as the Supreme Court has repeatedly recognized, they “provide ‘a most effective weapon in the enforcement’ of the securities laws and are ‘a necessary supplement to Commission action.’” *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)). *See also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).


The Commission has a further interest in this case, beyond its implications for private actions. Because *Central Bank* was a private action under the Exchange Act, the Supreme Court did not explicitly address either the Commission’s authority to bring actions against aiders and abettors or the availability of aiding and abetting liability under the Securities Act of 1933, 15 U.S.C. 77a et seq. After *Central Bank*, Congress, in the Litigation Reform Act, reaffirmed the Commission’s authority to bring aiding and abetting actions under the Exchange Act. *See* Exchange Act Section 20(e), 15 U.S.C. 78t(e).
Litigation Reform Act, however, does not give the Commission authority to proceed against aiders and abettors of violations of the Securities Act. Thus, assuming the Central Bank holding applies to the Commission, this Court’s resolution of the present case could have a bearing upon the Commission’s authority to proceed against violators of the antifraud provisions of the Securities Act.

STATEMENT OF THE CASE

A. Facts

Homestore.com, Inc. was a leading internet provider of real estate listings and home purchasing and moving services whose stock plummeted when the company was forced to restate its revenues for 2000 and 2001 by approximately $190 million. The restatement was necessary because Homestore had inflated its revenues through a series of transactions whose purpose and effect was to create the false appearance of legitimate revenues, thus enabling Homestore to meet or exceed targets set by Wall Street analysts and maintain the high price of the company’s stock. The defendants include three companies – AOL Time Warner Inc., Cendant Corporation, and L90, Inc. – that were Homestore’s business partners in the transactions; two executives at AOL; and one at Cendant, collectively referred to by the district court as the business partner defendants.

B. District Court Decision

The district court dismissed the complaint against the business partner defendants for three reasons: (1) there was no precedent for holding an outside business partner to a corporation liable to that corporation’s shareholders for
securities fraud; (2) the primary architects of the scheme were the officers of Homestore, not the other companies that entered into the transactions with Homestore; and (3) Homestore’s shareholders were injured by their reliance on material misstatements and omissions made by Homestore about the revenues, not the transactions that created the revenues. See In re Homestore.com, Inc. Sec. Litig., 252 F. Supp. 2d 1018, 1037-42 (C.D. Cal. 2003).

The district court, citing this Court’s decision in Cooper v. Pickett, 137 F.3d 616 (1998), acknowledged that a defendant may be held primarily liable for participating in a scheme to defraud after Central Bank. See id. at 1038. The court stated, however, that it was “unaware of any case since Central Bank that has ever held that outside business partners, no matter how involved they were in fraudulent transactions with a corporation, can be held liable in a private action brought by the shareholders of that company.” Id. “[I]n every post-Central Bank case cited to the Court where an ‘outsider’ has been held liable as a primary violator, that outsider had some type of special relationship with the corporation, i.e. accountant, auditor, etc.” Id. at 1039. The court noted that “these are exactly the types of ‘secondary actors’ the Supreme Court envisioned as potential ‘primary violators’ in Central Bank.” Id. 1/

1/ The Supreme Court stated in Central Bank:

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all (continued...)
partner with no special relationship to the corporation” liable would “broaden the scope of the securities acts so as to haul into court anyone doing business with a publicly traded company.” Id. Thus, the court held that the plaintiffs’ claims against the business partner defendants were precluded as a matter of law, and that the court therefore did not need to address the sufficiency of the complaint as to them. Id. at 1042; id. at 1038 ("Central Bank precludes liability for ordinary business partners and third party corporations doing business with the primary violator as a matter of law."). As to scheme liability in particular, the court stated that “[t]here is no indication that liability for participation in a scheme can extend beyond the corporate officers and those with a special relationship with the corporation.” Id. at 1040.

With respect to a test for liability of participants in a scheme to defraud, the district court stated that although Cooper did not define the kind of scheme in which a group of defendants could be liable, “Central Bank requires a plaintiff to allege that each and every defendant committed its own independent primary violation.” 252 F. Supp.2d at 1040. In order to implement this “independent primary violation” requirement, the court held that “[t]hose who actually ‘employ’ the scheme to defraud investors are primary violators, while those who merely participate in or facilitate the scheme are secondary violators.” Id. In this case, the court found that the officers of Homestore, who were the “primary architects of

\[\text{(continued)}\]

of the requirements for primary liability under Rule 10b-5 are met.

511 U.S. at 191.
the scheme” and “designed and carried [it] out,” had employed the scheme. Id. The court found that “other actors, such as AOL and its employees who actively participated in the *** scheme, did not ‘employ’ the scheme to defraud investors, and are therefore secondary violators.” Id.

Finally, with respect to the reliance element in private actions, the district court found that the plaintiff “suffered damage through its reliance on false or misleading statements” about Homestore’s revenues, not on the “scheme itself.” Id. at 1041. Thus, the court viewed the scheme to generate false revenues as “one step removed from the injured party.” Id. Because the false statements were “the principal ‘wrong’ alleged,” the court reasoned, “it is appropriate to require defendants in this case to be connected in some material way to the drafting of the statements made to the investing public.” Id. This means that the plaintiffs could not state a claim against the business partner defendants, who the district court held were not involved in the making of the false statements concerning Homestore’s revenues, no matter how involved they were in the scheme to create those revenues. Id.

ARGUMENT
I. THE DISTRICT COURT’S HOLDINGS, BASED ON UNWARRANTED DISTINCTIONS, WOULD UNDERMINE THE PURPOSE OF THE ANTIFRAUD PROVISIONS.

Not only are the district court’s holdings inconsistent with the language of Section 10(b) and Rule 10b-5 and the relevant case law (as explained below), but it bears emphasizing at the outset that the district court’s holdings would undermine the statutory intent to protect investors against fraud and to ensure
honest markets. These holdings, and the positions taken by the business partner defendants below, would permit wrongdoers to evade liability on the basis of meaningless distinctions.

First, to require a special relationship with the corporation of which the plaintiffs are shareholders would allow a person who is not in such a relationship to accomplish the same fraud, with the same state of mind, and the same effect on investors as a person in such a relationship, and nonetheless escape liability. Wrongdoers could deliberately avoid having any such relationship arise, and effectively immunize their fraudulent conduct. Liability under Section 10(b) should be imposed on any person whose conduct comes within the proscriptions of the statute, regardless of the person's relationship with the subject corporation.

Second, to require a defendant to have designed the fraudulent scheme would have a similarly unwarranted impact. Where a wrongdoer, intending to deceive investors, engages in a deceptive act as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the markets, regardless of whether he designed the scheme. Wrongdoers could studiously avoid engaging in any design activity, and effectively immunize their conduct. An unlimited number of persons could join in a scheme where one schemer does all of the designing, and only that single schemer would be potentially liable. The district court's test would also suggest that an unlimited number of schemers could simply mimic some prior, well-publicized scheme and escape liability — none having designed it. Liability should be available against any person who engages
in a deceptive act within the meaning of Section 10(b) as part of a scheme to defraud, regardless of who designed the scheme.

Third, deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as words. For example, if an investment bank falsely states that a client company has sound credit, there is no dispute that it can be primarily liable. If the bank creates an off-balance-sheet sham entity that has the purpose and effect of hiding company debt, it has achieved the same deception, and liability should be equally available.

Finally, the district court's holding with respect to the reliance element in private actions would invite similar gamesmanship. The deception created by fraudulent activity frequently will be disseminated into the marketplace through some person's making a false statement. If prior fraudulent activity, from which the making of that false statement flowed as a natural consequence, is not covered, large swaths of fraudulent activity could go unremedied. Groups of many schemers could deliberately arrange for one schemer to make the false statement on which the completion of their scheme depends. Under the district court's rule, all of the other schemers could be insulated from liability as a matter of law. The reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff's securities transaction.
II. THE DISTRICT COURT MADE SEVERAL LEGAL ERRORS IN ITS RESOLUTION OF THE CLAIMS AGAINST THE BUSINESS PARTNER DEFENDANTS.

A. A defendant is not required to have a special relationship with the corporation of which the plaintiffs are shareholders to be primarily liable to them for securities fraud.

The district court ruled that a business partner with no special relationship to a company whose security is the subject of a securities fraud action cannot be liable as a primary violator. A proper analysis, however, should not focus upon whether there is such a relationship, but rather upon the conduct of the party alleged to have played a part in a fraudulent scheme.

Nothing in the language of Section 10(b) or Rule 10b-5 suggests a requirement of any special relationship among alleged co-schemers. Section 10(b) makes it unlawful for "any person" to use or employ any manipulative or deceptive device. Rule 10b-5, likewise, makes it unlawful for "any person" to engage in fraudulent conduct. The Supreme Court has observed that the "repeated use of the word 'any'" in the statute and rule is "obviously meant to be inclusive." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). The Court has expressly recognized that while "[s]ome of the express causes of action [in the securities Acts] specify categories of defendants who may be liable; others (like § 10(b)) state only that 'any person' who commits one of the prohibited acts may be held liable." Central Bank, 511 U.S. at 179.

2/ See Herman & MacLean v. Huddleston, 459 U.S. 375, 382, 387 n.22 (1983); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971) (finding the "fact that the fraud was perpetrated by an officer of [the victim corporation] and his outside collaborators" to be "irrelevant" "[f]or § 10(b) bans the use of any deceptive device *** by 'any person.'"). See also United States v. Charnay, 537 (continued...)
Moreover, the district court’s holding automatically excluding all business partners from primary liability is inconsistent with the Supreme Court’s directive that Section 10(b) be construed “not technically and restrictively, but flexibly to effectuate its remedial purposes.” United States v. Zandford, 535 U.S. 813, 819 (2002). Pronouncements like the district court’s may appear to have the virtue of “bright-line” certainty and predictability, but may also have the unfortunate consequence of encouraging fraudulent schemes deliberately designed to evade liability through compliance with such mechanical distinctions.

The district court supported its conclusion by misreading a passage in Central Bank in which the Court stressed that “[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission)” may be primarily liable under Rule 10b-5. The district court focused on the Supreme Court’s reference to lawyers, accountants, and banks, and gleaned a “special relationship” requirement. See 252 F. Supp.2d at 1039. But the words “[a]ny person or entity,” and the introduction of the reference to those professional categories by the word “including,” show that the categories were given by way of illustration, not limitation. This Court stated in Cooper v. Pickett that a group of defendants can be liable for acting together to violate the securities laws, “as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme.” 137 F.3d at 624.

2/(...continued)
F.2d 341, 349 (9th Cir. 1976) (“[T]he language of the Rule provides no basis for concluding that only ‘insiders’ are subject to its requirements.”).
That language did not in any way suggest a requirement that there be a special relationship among alleged co-schemers.

Indeed, the district court’s standard further conflicts with Cooper v. Pickett by precluding liability even for a defendant who meets the requirement of committing a manipulative or deceptive act in furtherance of a scheme to defraud. This conflict is apparent in the district court’s statement that outside business partners cannot be held liable in a private action for securities fraud “no matter how involved they were in fraudulent transactions with a corporation.” In re Homestore, 252 F. Supp. 2d at 1038.

B. Designing the fraudulent scheme is not required for a defendant to be primarily liable for employing a scheme to defraud.

The district court held that the primary violators in a scheme to defraud are the “primary architects” of the scheme who “designed and carried [it] out.” The “use or employ” language of Section 10(b), however, suggests no such requirement. The Second Circuit, in holding a defendant primarily liable for securities fraud, found it “of no relevance” that another individual “masterminded” the stock manipulation scheme at issue. SEC v. U.S. Environmental, 155 F.3d 107, 112 (2d Cir. 1998). The district court’s requirement would lead to absurd results. As noted, a group of defendants could join in a scheme with a mastermind who designed it and then the group could implement the scheme without any further involvement of the mastermind. Under the district court’s test, no member of the group that implemented the scheme would be primarily liable because they had no part in designing it.
C. The district court erroneously analyzed the element of reliance.

The district court concluded that the plaintiffs could not show reliance on the business partners’ conduct because they relied on Homestore’s misrepresentations about its revenue, not on the scheme to create the revenue. The court appears to have assumed that the scheme to defraud did not include the actual making of the false statements about Homestore. The court viewed the transactions to generate false revenues as the scheme in which the business partner defendants were involved (for which liability did not attach because there was no reliance), and the making of false statements as a separate wrong in which the business partner defendants were not involved (for which liability could attach because there was reliance). The type of scheme in which the business partners were allegedly involved — to artificially inflate the price at which a security is traded by disseminating false information into the marketplace — does not end before the false statements are made. Indeed, at one point in its opinion, the court recognized that “the scheme was not complete until the statement was made,” 252 F. Supp. 2d at 1041, but then failed to take this fact into account in its analysis.

III. THE APPROPRIATE TEST FOR PRIMARY LIABILITY FOR A SCHEME TO DEFRAUD

A. Scope of the statute and rule

A principal purpose of Congress in enacting the Securities Exchange Act of 1934 was to “insure honest securities markets and thereby promote investor confidence.” United States v. O’Hagan, 521 U.S. 642, 658 (1997). Section 10(b) of the Act explicitly delegated authority to the Commission to prescribe rules, “as necessary or appropriate in the public interest or for the protection of investors,”
making it “unlawful for any person, directly or indirectly,” to “use or employ, in connection with the purchase or sale of any security *** any manipulative or deceptive device or contrivance.” Section 10(b) (emphasis added). In 1942, consistently with the Act’s broad remedial purposes, the Commission implemented Section 10(b) through the promulgation of Rule 10b-5. See Zandford, 535 U.S. at 819-20 (holding that Commission’s interpretation of Section 10(b) is entitled to deference if reasonable).

Rule 10b-5 tracks the language of Section 10(b) in many respects, see Central Bank, 511 U.S. at 172 (“Rule 10b-5 *** casts the proscription in similar terms”), and closely tracks Congress’s own language in Section 17(a), the general antifraud provision of the Securities Act of 1933. As pertinent here, Rule 10b-5(a) makes it unlawful for “any person,” “directly or indirectly,” to “employ any device, scheme, or artifice to defraud.” The Supreme Court has stated that “any manipulative or deceptive device or contrivance” in Section 10(b) includes a “scheme,” Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976), and that Section 10(b) applies to “complex securities frauds” in which “there are likely to be multiple violators” Central Bank, 511 U.S. at 191. Rule 10b-5(c) makes it unlawful for “any person,” “directly or indirectly,” to “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person ***.”

It has long been accepted that Section 10(b), and Rule 10b-5(a) and (c) thereunder, cover conduct beyond the making of false statements and misleading omissions, which are covered by Rule 10b-5(b). The Supreme Court has stated
that Section 10(b) encompasses deceptive “practices,” Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475-76 (1977), deceptive “conduct,” id. at 475 n.15; O’Hagan, 521 U.S. 659, and deceptive “acts,” Central Bank, 511 U.S. at 173; see Bankers Life, 404 U.S. at 9. In the recent Zandford decision, where the Court considered a fraudulent scheme under Rule 10b-5(a) and a course of business that operated as a fraud under Rule 10b-5(c), the Court concluded: “Indeed, each time respondent ‘exercised his power of disposition [of his customers’ securities] for his own benefit,’ that conduct, ‘without more,’ was a fraud.” Zandford, 535 U.S. at 815 (emphasis added); see Affiliated Ute, 406 U.S. at 152 (noting that while Rule 10b-5(b) targets false statements or omissions, paragraphs (a) and (c) “are not so restricted”); Charnay, 537 F.2d at 350 (clauses (a) and (c) prohibit deceptive “practices”). As a whole, Rule 10b-5 implements all of the authority granted to the Commission in Section 10(b). See Zandford, 535 U.S. at 816 n.1 (“The scope of Rule 10b-5 is coextensive with the coverage of § 10(b).”). Thus, if conduct is covered by Section 10(b), it is necessarily covered by Rule 10b-5.

The Supreme Court has stated repeatedly that Section 10(b) should be construed “‘not technically and restrictively, but flexibly to effectuate its remedial purposes.’” Zandford, 535 U.S. at 819 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)). See also Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (“No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.”); Affiliated Ute, 406 U.S. at 151 (stating Section 10(b) and Rule 10b-5 “are broad and, by repeated use
of the word ‘any,’ are obviously meant to be inclusive”). The Supreme Court has explained:

[We do not think] it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is “usually associated with the sale or purchase of securities.” We believe that § 10 (b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

Bankers Life, 404 U.S. at 11 n.7 (citation omitted); see Hochfelder, 425 U.S. at 203 (Section 10(b) is “a ‘catchall’ clause to enable the Commission ‘to deal with new manipulative (or cunning) devices.’”).

Consideration of contemporaneous dictionary definitions of the plain language of Section 10(b) confirms its breadth. “Employ” is essentially a synonym for the verb “use,” derived from the Latin word for “engage.” Webster’s New International Dictionary 839 (2d ed. 1934). “Use” means “to engage in,” or “to put into operation.” Id. at 2806; see Funk & Wagnalls, New Standard Dictionary of the English Language 2622 (1937) (defining “use” as “[t]he act of using; employment, as of means or material for a purpose”). “Scheme” means “a plan or program of something to be done.” Webster’s New International Dictionary 2234. “Directly” means “without anything intervening; personally.” Webster’s New International Dictionary 738. The definitions for “indirectly” include “not directly,” and “in [a] roundabout or subtle manner.” Id. at 1267.
B. The appropriate test for conduct

1. Any person can be primarily liable under Section 10(b) and Rule 10b-5(a) for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme.

The Commission urges the following test for determining when a person's conduct as part of a scheme to defraud constitutes a primary violation:

Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

This test is consistent with this Court's observation in Cooper v. Fickett that "Central Bank does not preclude liability based on allegations that a group of defendants acted together to violate the securities laws, as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." 137 F.3d at 624. 3/

3/ Instead of the verb "commit" used in Cooper, the Commission's test uses the verb "engage" because it is more naturally applicable to acts carried out in concert by multiple actors. Using the verb "engage" is consistent with the words of Section 10(b), the statutory structure, see Securities Act Section 17(a)(3), 15 U.S.C. 77q(a)(3), the Commission's Rule adopted in 1942, 17 C.F.R. 240.10b-5(c), and the definitions given above: to "use or employ" a manipulative or deceptive device means to put the device into operation, and to engage in a manipulative or deceptive act has the same meaning. The test uses "as part of a scheme" instead of "in furtherance of a scheme," which connotes assistance and thus suggests aiding and abetting.

We do not believe that a test requiring that a defendant have "substantial participation" in a scheme would be appropriate in the context of a scheme to defraud under Rule 10b-5(a). This Court uses such a test for primary liability in false statement cases. Howard v. Everex Systems, Inc., 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (primary liability found when secondary party had "substantial participation or intricate involvement" in preparation of fraudulent statements). (continued...)
It is essential that the test for primary liability provide a meaningful distinction between a primary violator and an aider and abettor; otherwise, there is a risk that primary liability would be extended to cover activity that should properly be viewed as only aiding and abetting. The Commission's test, which requires that a particular defendant engage in a manipulative or deceptive act as part of the scheme, provides such a meaningful distinction, and is consistent with Section 10(b) and **Central Bank**. The Central Bank Court defined an aider and abettor as one whose conduct does not come within the proscriptions of Section 10(b), but who assists another whose conduct is covered by Section 10(b). See 511 U.S. at 184. The Court found aiding and abetting liability, so defined, to be precluded by the plain language of Section 10(b). See id. at 177. The Court stated: "We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." Id. The test the Commission urges, by requiring that each defendant engage in a manipulative or deceptive act for primary liability to attach, ensures — by language taken from Section 10(b) itself — that only conduct covered by Section 10(b) is

3/(...continued)
That test, however, derives from the Rule 10b-5(b) context, which presents the special problem of interpreting the verb "make" in paragraph (b) of the Rule. This Court requires "significant participation" in the scenario where the defendant was not publicly identified with a false statement, and thus can only be considered as having "made" the statement if the defendant substantially participated in its drafting or editing. Rule 10b-5(a), however, uses the verb "employ," which, as noted above, does not suggest a requirement that a person be involved in designing, planning, or otherwise creating a scheme.
sufficient for primary liability. 4/ Several district courts construing Section 10(b) and Rule 10b-5(a) are in accord with this approach and Cooper. 5/

2. Engaging in a transaction whose principal purpose and effect is to create a false appearance of corporate revenues constitutes a deceptive act that can support primary liability.

It is reasonable to construe Section 10(b) as encompassing, within the rubric of engaging in a deceptive act, engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues. This rule follows from the well-established principle that facts can be misrepresented by conduct as well as

4/ This Court made reference in Cooper v. Pickett to “direct[] particip[ation]” in a scheme. 137 F.3d at 624. We do not believe that direct conduct should be a requirement for primary scheme liability. Section 10(b) and Rule 10b-5 expressly cover “indirect” conduct. Thus, a defendant should be primarily liable where he either directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud. See In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d 161, 173 (D. Mass. 2003) (holding that any person can be primarily liable who participates in a scheme to defraud “by directly or indirectly employing a manipulative or deceptive device”).

5/ See, e.g., In re Enron, 310 F. Supp.2d 819, 827-30 (S.D. Tex. 2004) (“reject[ing] the narrow construction of the statute [in] Homestore.com”); In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d at 173 (holding that any person can be primarily liable “who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (like the creation or financing of a sham entity) intended to mislead investors ***”); In re Enron, 235 F. Supp.2d 549, 592 (S.D. Texas 2002) (“If a plaintiff meets the requirements of pleading primary liability as to each defendant, i.e., alleges with factual specificity (1) that each defendant made a material misstatement (or omission) or committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud, (2) scienter, and (3) reliance, that plaintiff can plead a scheme to defraud and still satisfy Central Bank.”) (emphasis added); In re ZZZZZ Best Sec. Litig., 864 F. Supp. 960, 969 (C.D. Cal. 1994) (Central Bank “makes clear that more than simply knowing assistance with the underlying fraudulent scheme is required;” “Plaintiffs must prove that [defendants] engaged in some form of deception that is prohibited by Rule 10b-5.”).
words. 6/ If two companies together make a false statement about the revenues of one of them, both companies could be primarily liable for securities fraud. If they together achieve the same deception through conduct rather than words, the same result should obtain. See supra pp. 13-14 (explaining that Section 10(b) and Rule 10b-5 cover conduct beyond the making of false statements and misleading omissions).

This rule is also consistent with Section 10(b)'s coverage of market manipulation, which typically involves conduct that creates a false appearance of trading activity. See United States v. Russo, 74 F.3d 1383, 1391 (2d Cir. 1996) (holding trading scheme which "created[d] a false impression" of demand for the subject stock constituted market manipulation under Section 10(b) and Rule 10b-5). 7/

* * * *

6/ A legal dictionary in use at the time of Section 10(b)'s enactment defined "deception" as follows: "The act of deceiving; intentional misleading by falsehood spoken or acted." See Black's Law Dictionary 529 (3d ed. 1933) (emphasis added). See also The Random House Unabridged Dictionary of the English Language 516 (2d ed. 1987) ("deceive *** 1. to mislead by a false appearance or statement") (emphasis added); 37 Am. Jur. 2d Fraud and Deceit § 38 (2004) ("[F]raud may consist of *** the creation of a false impression by words or acts ***."). "I can see no substantial distinction between false rumours and false and fictitious acts." Scott v. Brown, Doering, McNab & Co., [1892] 2 Q.B. 724, 730 (C.A.) (recognizing that manipulation can occur without the dissemination of false statements) (quoted approvingly in Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 7 n.4 (1985)).

7/ See also GFL Advantage Fund, Ltd. v. Colkitt, 272 F.3d 189, 204 (3d Cir. 2001) (holding trading activity that "created a false impression of market activity" can violate Section 10(b)); SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, (2d Cir. 1978) (Friendly, J.) (finding violation in case of "large-scale manipulation" where defendant created phony nominee accounts to "create a false appearance" that a large number of securities had been sold); cf. Section 9 of the Exchange Act, 15 U.S.C. 78i.
Consideration of hypothetical scenarios confirms that the above approach would appropriately distinguish between conduct to which primary liability should attach and mere aiding and abetting. For example, a bank that makes a loan, even knowing that the borrower will use the proceeds to commit securities fraud, is at most an aider and abettor. The bank itself has not engaged in any manipulative or deceptive act because there is nothing manipulative or deceptive about the bank’s making of the loan. Likewise, if an investment bank provides services to arrange financing for a client, knowing the client will use the proceeds to commit securities fraud, then it is at most an aider and abettor. If, however, the investment bank engages in the creation of a sham entity as part of the services to arrange the financing, the investment bank may be a primary violator if it acted with scienter. The investment bank itself engaged in a deceptive act.

In the context of the overstatement of revenues, if a third party enters into a legitimate transaction with a corporation, knowing that the corporation will overstate the revenue generated by the transaction, the third party is at most an aider and abettor. There is nothing deceptive about the third party entering into the legitimate transaction. If, however, the third party engages with the corporation in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation’s stock, it may be a primary violator.

Similarly, if a third party enters into a sale-of-goods transaction with a corporation where the terms include a legitimate option on the part of the third party (the buyer) to return the goods for a full refund, knowing that the corporation
will misrepresent the transaction as a final sale, the third party is at most an aider and abettor. If, however, the parties to the transaction have a side oral agreement that no goods will be delivered and no money will be paid, and the corporation falsely reflects revenue from the transaction, the third party could be a primary violator.

C. The reliance requirement is satisfied where a plaintiff relies on a material deception flowing from a defendant’s deceptive act, even though the conduct of other participants in the fraudulent scheme may have been a subsequent link in the causal chain leading to the plaintiff’s securities transaction.

The Supreme Court in Central Bank stressed the importance of the reliance requirement in distinguishing primary liability from aiding and abetting liability. 8/ 511 U.S. at 180 (“Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor’s statements or actions.”). The Court, however, had no occasion in that case to address the reliance requirement in the context of a scheme to defraud under Rule 10b-5(a).

Reliance in securities fraud cases is a form of transaction causation, which is established where the plaintiff’s reliance on the defendant’s fraudulent conduct caused the plaintiff to engage in his securities transaction. See Harris v. Union Elec. Co., 787 F.2d 355, 366 (8th Cir. 1986); Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 n.23 (2d Cir. 1984). Nothing in the rules of causation suggests that only the final act in a scheme to defraud meets the causation requirement. Indeed, in Cooper v. Pickett, this Court held a maker of false

8/ Reliance is an element in private actions, but is not required in Commission actions. See SEC v. Rana Research Inc., 8 F.3d 1358, 1363-64 (9th Cir. 1993).
statements primarily liable, although the deceptive information flowed into the marketplace through the intervening conduct of subsequent speakers. 137 F.3d 624-25; see In re Lernout & Hauspie Sec. Litig., 236 F. Supp.2d at 173 (holding a person who employs a deceptive device as part of a fraudulent scheme may be primarily liable “even if a material misstatement by another person creates the nexus between the scheme and the securities market”). Cooper's holding implicitly recognized that subsequent conduct that does not break the causal chain can include another party’s making of false statements. See also In re ZZZZ Best, 864 F. Supp. at 973. Although reliance on the acts of defendants who do not themselves disseminate information to the securities market may be indirect, liability in these circumstances is fully consistent with Section 10(b) and Rule 10b-5's explicit coverage of deceptions accomplished “directly or indirectly.” See supra pp. 12, 13.

Thus, a prior deceptive act, from which the making of the false statements follows as a natural consequence, can constitute a sufficient step in the causal chain to support a finding of reliance. Certainly where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation. See Warshaw v. Xoma Corp., 137 F.3d 955, 959 (9th Cir. 1996) (If "Xoma intentionally used these third parties to disseminate false information to the investing public," it "cannot escape liability simply because it carried out its alleged fraud through the public statements of third parties."). Another example of subsequent conduct that should not break the causal chain would be an outside

-22-
auditor's failure to detect another person's deceptive act — or even the auditor's fraudulent certification of financial statements as part of the scheme. A person should not be able to escape liability simply because his deceptive act also deceived the outside auditor — or because the outside auditor also engaged in the fraudulent scheme.
CONCLUSION

For the foregoing reasons, the Court should hold that any person who has the requisite scienter can be liable as a primary violator of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5(a) thereunder when he, directly or indirectly, engages in a manipulative or deceptive act as part of a scheme to defraud; that engaging in a transaction whose principal purpose and effect is to create a false appearance of revenues constitutes such a deceptive act; and that the reliance requirement in private actions is satisfied where a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiff’s securities transaction.

Respectfully submitted,

GIOVANNI P. PREZIOSO
General Counsel

JACOB H. STILLMAN
Solicitor

KATHARINE B. GRESHAM
Assistant General Counsel

MICHAEL L. POST
Senior Counsel

Of Counsel
MEYER EISENBERG
Deputy General Counsel

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0606
(202) 942-0921 (Post)

October 2004
ADDENDUM
**TABLE OF CONTENTS**

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a)</td>
<td>A1</td>
</tr>
<tr>
<td>Section 10(b) of the Exchange Act of 1934, 15 U.S.C. 78j(b)</td>
<td>A1</td>
</tr>
<tr>
<td>Rule 10b-5, 17 C.F.R. 240.10b-5</td>
<td>A1</td>
</tr>
</tbody>
</table>
FRAUDULENT INTERSTATE TRANSACTIONS

Section 17. [77q] (a) Use of interstate commerce for purpose of fraud or deceit—It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. * * * *

MANIPULATIVE AND DECEPTIVE DEVICES

Section 10. [78]] It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. * * * *

EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES

17 C.F.R. 240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
CERTIFICATE OF SERVICE

I hereby certify that, on this day, I caused an original and four copies of the
Motion of the Securities and Exchange Commission for Leave to File Amicus
Curiæ Brief Out of Time, and the original and fifteen copies of the foregoing brief
to be sent by overnight delivery to

Cathy Catterson
Clerk of Court
U.S. Court of Appeals for the Ninth Circuit
95 Seventh Street
San Francisco, CA 94103-1526

and a copy of the Commission’s motion and two copies of the foregoing brief to
be sent by overnight delivery to

John B. Quinn, Esq.
Quinn Emanuel Urquhart
Oliver & Hedges
865 South Figueroa Street
Los Angeles, CA 90017

F. Whitten Peters, Esq.
Williams & Connolly
725 - 12th Street, NW
Washington, DC 20005

Michael C. Tu, Esq.
Orrick Herrington & Sutcliffe
777 S. Figueroa Street
Los Angeles, CA 90017

Roger C. Spaeder, Esq.
Zuckerman Spaeder Goldstein
Taylor & Kolker
1201 Connecticut Ave., NW
Suite 1200
Washington, D.C. 20036

Everett C. (Kip) Johnson, Jr., Esq.
Latham & Watkins
555 Eleventh Street, N.W.
Suite 1000
Washington, DC 200004-1304

Samuel Kadet, Esq.
Skadden, Arps, Slate, Meagher
& Flom
Four Times Square
New York, NY 10036

Edward S. Nathan, Esq.
Stern Greenberg & Kilcullen
75 Livingston Avenue
Roseland, NJ 07068

Belinda Lee
Latham & Watkins
633 W. Fifth Street, Suite 4000
Los Angeles, CA 90071-2007

Paul D. Murphy, Esq.
Murphy Rosen & Cohen
100 Wilshire Boulevard
Suite 700
Santa Monica, CA 90401

Eric A. Isaacson
Lersch Coughlin Stoia Geller
Rudman & Robbins
401 'B' Street
San Diego, CA 92101
October 21, 2004
CERTIFICATE OF SERVICE

I hereby certify that on the 16th day of May 2005 a true and correct copy of the foregoing
Moving Defendants' Motion for Certification for Appeal Pursuant to 28 U.S.C. §1292(b) together
with its Supporting Memorandum of Law were served via first class mail upon the following
counsel:

Stuart M. Grant
John A. Curseaden
Lauren A. Wagner
GRANT & EISENHOFER, P.A.
Chase Manhattan Centre
1201 North Market Street, Suite 2100
Wilmington, DE 19801

Richard L. Scheff
MONTGOMERY, MCCRAKEN, WALKER & RHOADS, LLP
123 South Broad Street, 28th Floor
Philadelphia, PA 19109

William J. Taylor
COZEN O'CONNOR
1900 Market Street
Philadelphia, PA 19103

Kelly D. Eckel
Robert E. Kelly
Matthew A. Taylor
Patrick Loftus
DUANE MORRIS, LLP
One Liberty Place, Suite 4200
Philadelphia, PA 19103

Edward F. Mannino
David L. Comerford
Jeffery A. Dailey
Suzanne Marie Sweeney
AKINGUMP STRAUSS HAUER & FELD LLP
One Commerce Square
2005 Market Street, Suite 2200
Philadelphia, PA 19103
Maura E. Fay
Dawn Zubrick
DILWORTH PAXSON LLP
3200 Mellon Bank Center
1735 Market Street
Philadelphia, PA 19103
David S. Hoffner
DECHERT LLP
30 Rockefeller Plaza
New York, NY 10112

Alessandro Martuscelli
DECHERT LLP
4000 Bell Atlantic Tower
1717 Arch Street
Philadelphia, PA 19103

David M. Laigaie
Gregory P. Miller
Michael A. Morse
Stephen G. Stroup
MILLER ALFANO & RASPANTI, P.C.
1818 Market Street, Suite 3402
Philadelphia, PA 19103

Patricia M. Hamill
Paul J. Greco
CONRAD O'BRIEN, GELLMAN & ROHN, P.C.
1515 Market Street, 16th Floor
Philadelphia, PA 19102

William P. Quinn
Karen Pleslak Pohlmann
David W. Marston, Jr.
MORGAN, LEWIS & BOCKIUS, LLP
1701 Market Street
Philadelphia, PA 19103

Stuart J. Chanen
Leah J. Domitrovic
KATTEN, MUCHIN, ZAVIS, ROSENMAN
525 West Monroe Street, Suite 1600
Chicago, IL 60661-3693

Jeffrey Saltz
LAW OFFICES OF JEFFREY SALTZ, PC
1515 Market Street, Suite 1000
Philadelphia, PA 19101
IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

STATE OF WISCONSIN )
INVESTMENT BOARD, KENNETH )
D. BUSH, EDWARD E. EUBANK, )
and JOHN MICHAEL, suing on )
behalf of themselves and all others )
similarly situated, )

Plaintiffs,

vs.

HAROLD RUTTENBERG, et al., )

Defendants.

CIVIL ACTION
NOS.
CV-99-BU-3097-S
and
CV-99-BU-3129-S

ENTRERED
JUL 03 2001

MEMORANDUM OF OPINION

This cause comes to be heard on a motion for class certification
filed by the Lead Plaintiff Committee ("Committee") on February 1, 2001.
This Committee, consisting of the State of Wisconsin Investment Board,
Kenneth D. Bush, Edward E. Eubank, Jr., and John Michael, contends
that class treatment under Federal Rule of Civil Procedure 23(b)(3) is
appropriate for the putative class members' claims for various violations

Page 1 of 20
of securities laws by Harold Ruttenberg, Eric L. Tyra, Peter Berman, Cooper Evans, Patrick Lloyd, Don-Allen Ruttenberg, Michael P. Lazarus, Helen Rockey, Scott C. Wynne, Randall Haines, and Adam Gilburne, as high-level officers and insiders of Just for Feet, Inc. ("Feet Defendants"); and by Deloitte & Touche LLP, Steven H. Barry, and Karen Baker, as independent auditors and audit managers ("audit Defendants"). Only one argument against certification of the class as a whole has been presented to the Court by any of the Defendants. This argument is that internal conflicts among the claims of the putative class members make a class action an inadequate means of resolving the claims of the putative class members. The Defendants concentrate instead on issues of class definition, disputing which claims would come within the compass of the class action; what the appropriate class period is; and whether a single class or multiple subclasses should be certified against the Defendants.

Class certification is appropriate if and only if all of the requirements of Federal Rule of Civil Procedure 23(a) are satisfied and “at least one of the alternative requirements of Rule 23(b) are satisfied. . . .,” so long as that alternative requirement is appropriate to the relief sought in the action. Turner v. Beneficial Corp., 242 F.3d 1023, 1025 (11th Cir. 2001).
To begin with, plaintiffs desiring class certification "must satisfy the
prequisites of numerosity, commonality, typicality, and adequacy of
representation specified in Rule 23(a)." Murray v. Auslander, 244 F.3d
807, 810 (11th Cir. 2001). The class must be so numerous that any
tempt to bring such claims of its members in a single action pursuant to
standard joinder rules would be impracticable. See Kilgo v. Bowman
Transport, Inc., 789 F.2d 859, 878 (11th Cir. 1986); Pederson v. Louisiana
State University, 213 F.3d 858, 868 (5th Cir. 2000); and Andrews v.
Bechtel Power Corp., 780 F.2d 124, 132 (1st Cir. 1985). Next, issues of
law or fact common to all members of the putative class must exist. This
requirement is a minimal one, requiring a mere identity of some factual or
legal matter among members of the putative class. See Hudson v. Delta
Air Lines, Inc., 90 F.3d 451, 456 (11th Cir. 1996); James v. City of Dallas,
Texas, — F.3d —, 2001 WL 682089 at *12 (5th Cir. June 18, 2001);
Hanlon v. Chrysler Corp., 150 F.3d 1011, 1019-20 (9th Cir. 1998); and
Baby Neal for and by Kanter v. Casey, 43 F.3d 48, 56 (3rd Cir. 1994).
Third, the claims and defenses of the class representatives must be
typical of those of the class members. This requirement tends to merge
with those of commonality and adequacy: both representative plaintiffs
and putative class members must be able to bring their claims to court on board the same truck. See Hudson, 90 F.3d at 456; In re Milk Products Antitrust Litigation, 195 F.3d 430, 436-37 (8th Cir. 1999); Marisol A. v. Giuliani, 126 F.3d 372, 376 (2d Cir. 1997) ("Typicality Search Term End . . . requires that the claims of the class representatives be typical of those of the class, and 'is satisfied when each class member's claim arises from the same course of events, and each class member makes similar legal arguments to prove the defendant's liability."); and Georgine v. Amchem Products, Inc., 83 F.3d 610, 631 (3d Cir. 1996) ("The typicality requirement is intended to preclude certification of those cases where the legal theories of the named plaintiffs potentially conflict with those of the absentees.").

Fourth, it must be the case that the class representatives will fairly and adequately protect the interests of the class. "Resolution of two questions determines legal adequacy: (1) do the named plaintiffs and their counsel have any conflicts of interest with other class members and (2) will the named plaintiffs and their counsel prosecute the action vigorously on behalf of the class?" Hanlon v. Chrysler Corp., 150 F.3d at 1020. See also Baffa v. Donaldson, Lufkin & Jenrette Securities Corp.,
222 F.3d 52, 60 (2d Cir. 2000). First, there can exist no conflicts between
the class representatives and the putative class members that would
impair those representatives' ability to effectively litigate their class
claims. See Andrews v. American Telephone and Telegraph Co., 95 F.3d
1014, 1022-23 (11th Cir. 1996); and Georgine v. Amchem Products, Inc.,
83 F.3d at 630-31. Second, representative plaintiffs and their counsel
must be of sufficient quality, determination, and demeanor that they can
celerously and skillfully litigate all relevant matters. See Local Joint
Executive Board of Culinary/Bartender Trust Fund v. Las Vegas Sands,
Inc., 244 F.3d 1152, 1162 (9th Cir. 2001); Rand v. Monsanto Corp., 926
F.2d 596, 599 (7th Cir. 1991) ("Rule 23 contemplates, and the district court
should insist on, a conscientious representative plaintiff . . .," as "[a]ll
class suits create some conflict between the representative and the class;
the representative and counsel may be tempted to sell out the class for
benefits to themselves."); and Dujanovic v. MortgageAmerica, Inc., 185
F.R.D. 660, 667-68 (N.D. Ala. 1999).¹

¹ At points in this litigation, this Court has been given reason to doubt that lead counsel for the
Committee has the appropriate demeanor with which to litigate this action on behalf of the class
as opposed to themselves or their principal clients. These concerns need not prevent
certification, however, as this Court has authority under the Private Securities Litigation Reform
Act to remedy the inadequacies of counsel by substitution of lead counsel that the Court deems to
be adequate for the remainder of the prosecution of this case.
Beyond showing that all requisites of Rule 23(a) are satisfied, representative plaintiffs must show that an appropriate requisite condition of Rule 23(b) is met. In the instant action, the Committee, seeking damages relief on their putative class-wide securities claims, contends that the putative class satisfies not only the requirements of Rule 23(a), but those of Rule 23(b)(3), which requires that individual issues or the claims of the individual class members not predominate over those of the class as a whole. See Culpepper v. Irwin Mortgage Corp., — F.3d —, 2001 WL 672825 at * 3 (11th Cir. June 15, 2001). Rule 23(b)(3) requires "a functional similarity amongst the class members, that is, while each individual class member may have some different particulars to his or her claim, for purposes of resolving the core matters of the suit, any class member [is] functionally as good as another." Culpepper v. Inland Mortgage Co., 189 F.R.D. 668, 672 n.1 (N.D. Ala. 1999), aff'd sub. nom., Culpepper v. Irwin Mortgage Corp., — F.3d —, 2001 WL 672825 at * 3 (11th Cir. June 15, 2001). As this Court stated in Culpepper v. Inland Mortgage Co.,

"[t]he Rule 23(b)(3) predominance inquiry tests whether proposed classes are sufficiently cohesive to warrant adjudication by representation." Amchem Products, Inc. v.
Windsor, 521 U.S. at 594, 117 S.Ct. at 2249. Therefore, the examination of predominance "focuses on the legal or factual questions that qualify each class member's case as a genuine controversy," and is "far more demanding" than Rule 23(a)'s commonality requirement." Jackson v. Motel 6 Multipurpose, Inc., 130 F.3d 999 (11th Cir.1997) (citing Amchem Products, Inc. v. Windsor, 521 U.S. at 594, 117 S.Ct. at 2249-50). The locus of the predominance inquiry is whether those common issues of law and fact presented by the case are overwhelmed by the particular factual and legal inquires that the case might present. See Andrews v. American Telephone & Telegraph Company, 95 F.3d 1014 (11th Cir.1996). If resolution of the central inquiry of the class claim "breaks down into an unmanageable variety of individual legal and factual issues," class certification is inappropriate. Id.

Id. at 673 n.3. "The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action." Fed. R. Civ. Pro. 23(b)(3).
BACKGROUND

Many of the facts related to this motion are stated in this Court's opinion of April 7, 2000. Burke v. Ruttenberg, 102 F. Supp. 2d 1280, 1286-89 (N.D. Ala. 2000). The Court only states the most pertinent facts here. The claims of the putative class members in this case stem from alleged attempts by the various Feet Defendants to manipulate the price of Just for Feet common stock for personal or corporate gain.² In May of 1997, at the opening of the proposed class period, Feet ran thirty company-owned and forty-eight franchised specialty stores in eighteen states and Puerto Rico. These stores, in contrast to others owned by different companies in the market, had been unaffected by recent flagging sales of athletic footwear, and had, in fact, shown growth during the period of lackluster sales, at least on paper. This stellar performance, as reported by Feet, allegedly persuaded numerous individuals and entities, including the members of the Committee and putative class members, to invest in Feet common stock. However, the Committee alleges, the

² Throughout the alleged class period, Just for Feet, although incorporated in Delaware, was principally an Alabama corporation, headquartered in Pelham, Alabama, and running its operations from there. Until trading was halted on November 2, 1999, shares of Feet common stock were publicly traded on the NASDAQ National Market System.
stellar performance of Feet was an illusion, maintained through the
deliberate efforts of the company’s officers and directors. This illusion
was first maintained by inadvisable efforts to expand Feet’s share of the
athletic shoe market at a period when sales were low. These expansion
efforts tended to require the masking of losses through the alleged use of
fraudulent accounting practices, in order that expansion occur with a
minimum of dissent from shareholders.

Also, the Feet Defendants, the Committee alleges, attempted to
directly mislead investors in the market by filing fraudulent documents
with the Securities and Exchange Commission supported by less-than-
austere accounting methods. Averedly, in each Form 10-Q or 10-K filed
with the SEC and in each public release touting Feet’s performance
contemporaneously issued, the Defendants made or participated in the
making of several fraudulent misrepresentations by overstating the total
sales of Feet, its gross and net income, and income per share. This
continued without abatement from May of 1997, until January 21, 1999,
when Feet slowly began to disseminate statements indicating the financial
weakness of the company and presaging later, stronger disclosures of
financial instability in September, October, and November of 1999. According to the complaints, to keep up the illusion of profitability and continued cash flow into and through 1999, the directors and officers of Feet engaged in a number of improper accounting practices.

Feet's third alleged fraudulent act was an attempt to maintain the appearance that the company would remain intact, even after buffeted by harsh financial winds in 1999 and even though up to six weeks prior to the announcement by Just for Feet that it would file a petition of bankruptcy under Chapter 11, the officers and directors of Feet knew of such an intention. According to the Committee, Feet did not disclose this intention to the public, for the purpose of arranging a secret repayment plan with certain of Feet's creditors that would be unfavorable to its shareholders. The Committee attributes this wrongdoing to a host of officers and directors of Just for Feet, averring that each either participated in the wrongdoing or permitted it to happen, with his or her knowledge and blessing, despite the presence of duty to intervene in and correct the wrongdoing.

With regard to Deloitte & Touche ("Deloitte"), the Committee avers

---

3 According to the Committee, these later disclosures were not entirely forthcoming, either.
that it was derelict in its duty to expose the improper accounting practices of Just for Feet. In particular, it asserts that Deloitte, while issuing audit reports on the company's financial statements for the fiscal year ending January 1998 through the end of the class period, failed to insure that the underlying audit tests conformed to generally accepted auditing standards ("GAAS"). Among other things, the complaint alleges that Deloitte violated GAAS in that its senior personnel did not adequately supervise junior personnel; that it did not develop an audit plan that would screen for management irregularities; that Deloitte's auditors had an inadequate understanding of Feet's operations; that the auditors insufficiently examined collected evidence to make informed opinions about the financial statements audited by it; and that it failed to report problems to the audit committee of Feet's board of directors. Claims based on the same facts are also aimed against Steven H. Barry ("Barry"), who was, during the class period, the Birmingham office managing partner of Deloitte and the audit partner on Deloitte's audit of Just for Feet, and against Karen Baker ("Baker"), who was, during the class period, the senior manager in the audit of Just for Feet.
CONTENTIONS & ANALYSIS

The Committee, in its motion, seeks to have certified the following defined class:

A class of all persons and entities who purchased common stock of Just for Feet, Inc., between May 5, 1997, and November 1, 1999, excluding (1) the Defendants in this action; (2) members of the families of the Defendants in this action; (3) the subsidiaries or affiliates of any Defendants; (4) any person or entity who is a shareholder, partner, officer, director, employee, or controlling person of any Defendant; (5) any entity in which any Defendant has a controlling interest; (6) sitting magistrates, judges, justices, and their representative spouses and children; (7) counsel for Plaintiffs and their respective spouses and children; and (8) the legal representatives, heirs, successors or assigns of any such excluded person.

The Defendants have made only one challenge to certification of a class, focusing their efforts on narrowing the class definition. In arguing against class certification, the Defendants claim that the Committee is unable to satisfy the adequacy requirement of Rule 23(a) because conflicts within the class structure prevent the representative Committee from serving the interests of all class members. The Defendants next assert that if, however, class certification is appropriate, the class definition should be narrowed by the exclusion of certain claims from its
compass; by the shrinking of the class period; and by the certification of multiple subclasses against the different Defendants.

A. ADEQUACY CHALLENGE TO CLASS CERTIFICATION.

Various defendants have presented a challenge to class certification on the grounds that the class representatives are incapable of fairly and adequately representing the interests of the class due to intra-class conflicts. This conflict, the Defendants aver, are over the nature of the securities claims between those individuals who purchased Just for Feet, Inc., securities before any disclosure of alleged misrepresentations — principally on May 21, 1999 — and those individuals who purchased those securities after the disclosure. The Defendants spell out the conflict as follows: Individuals who sold after disclosure of alleged misrepresentations will have an incentive to maximize the amount to which that disclosure corrected the price of Feet securities from their prior inflated values. This is so because their recovery for purchasing at an inflated price will be offset by the amount in excess of the "true" market value at which they sold their shares. By contrast, argue the Defendants, post-disclosure purchasers will argue that the value of their shares
remained inflated even after the disclosure because it was only a partial confession of Feet’s mismanagement. These post-disclosure purchasers have an interest in arguing such because if the purchase price was not inflated after disclosure, post-disclosure purchasers are entitled to no remedy.

The Defendants thus portend to raise an allocation dilemma, as discussed in Amchem Products, Inc. v. Windsor, 521 U.S. 591 (1997). Although involving a settlement class, the proposed class in Windsor contained an irreconcilable conflict of interests among its members, who were suing asbestos manufacturers for present and future compensation: the interests of one group of claimants for immediate disbursement of medical benefits would conflict with the interests of another group in the establishment of a long-term fund for care. Id. at 625-26. As has been described by the Third Circuit Court of Appeals; in Hanlon v. Chrysler Corp., “the clashing interests of present and future claimants presented insurmountable conflicts for class counsel who could not possibly provide adequate representation to both groups as required by Rule 23(a)(4).” Hanlon, 150 F.3d at 1020.
Here, however, the Defendant's allocation dilemma argument fails, for three reasons. First, the argument presented by the Defendants is, in fact, a red herring. No conflict between various pre- and post-disclosure purchasers exists, as the pre-disclosure purchasers are economically neutral on whether the disclosure deflated the price to market levels. As an example, assume that the stock was inflated by $10 per share prior to disclosure and that disclosure fully deflated the price to market levels. The pre-disclosure purchaser would then be entitled to the entire amount of the over-valuing: $10 per share. By contrast, assume that the stock price is inflated $20 per share, but the disclosure is only partial, deflating the stock value $10 per share. The purchaser then sells. He still has the benefit of $10 inflation when he sells, and thus, that $10 per share being offset from the inflation value, he is only entitled to a $10 per share recovery. Thus, it does not matter how much the deflation of the stock price at the time of sale: the recovery to the post-disclosure purchaser will be the same with or without offset.

Second, even were the Defendants correct in their argument, it still would not imply an irreconcilable conflict between pre-disclosure purchasers and post-disclosure purchasers sufficient to merit denial of
certification. This is so, because the conflicts argued by the Defendants between groups of pre-disclosure and post-disclosure purchasers would also apply to the common series of pre-disclosure purchasers, each of whom sells his or her stock at a different price after disclosure. Each of these pre-disclosure purchasers, on the Defendants' argument will have an interest in arguing that on the day of his or her sale, the stock price had declined to market values, precluding any sellers who received a greater loss after that date from claiming more damages. This Court has not found a case in which such a difficulty defeated the prospect of class certification. Finally, the Committee contains members that represent the whole range of interests capable of maximizing recovery for the class in a manner not possible were the class divided. The challenge to the adequacy of representation in the class therefore fails.

B. CHALLENGES TO CLASS DEFINITION.

The remaining challenges of the Defendants relate to the appropriate definition of the class. First, the Defendants argue that the representative Plaintiffs' claims pursuant to section 18 of the Securities Act should not be made class-wide, as a demonstration of liability on
those claims would require individualized proof of reliance by each Plaintiff on the misrepresentations of Feet. This would violate the predominance requirement of Rule 23(b)(3), the Defendants argue, by making individual issues of reliance the overwhelming issue of the various claims. This Court will follow *Simpson v. Specialty Retail Concepts*, 149 F.R.D. 94, 102 (M.D.N.C. 1993) and *In re MDC Holdings Securities Litigation*, 754 F.Supp. 785, 792 (S.D. Cal. 1990). Because the *Simpson* court's argument is persuasive, the Court quotes it in full:

    In the remaining federal and state law claims, Simpson must prove individual reliance on behalf of himself and the class. DH & S argues that class certification should be denied as to these claims because such proof would be unwieldy and unnecessary. While individualized reliance will have to be proven, this Court agrees with those courts which have found that the common issues predominate and that considerations of judicial efficiency and economy will be furthered by permitting certification of the pendent state law claims. See e.g. *Kirschner*, 139 F.R.D. at 83 (and cases cited therein); *Keyser v. Commonwealth Nat. Fin. Corp.*, 121 F.R.D. 642 (M.D.Pa. 1988). As noted in *Kirschner*, "[i]n the event that individual issues of reliance pose difficulties as to case management at a later stage, there are mechanisms available to effectively litigate the reliance questions, without destroying the efficiency of class proceedings on other issues." 139 F.R.D. at 83 (citing *In re ORFA Sec. Litig.*, 654 F.Supp. 1449, 1462 (D.N.J. 1987) (citing cases that approve of the use of hearings, questionnaires, or other procedures to manage the reliance element)). As a result, the Court finds individual
questions of reliance do not predominate over issues common
to the claims.

Simpson, 149 F.R.D. at 102. This Court, after the principal common
practice issues are resolved, can hold mini-trials on the issue of individual
reliance with respect to each shareholder. In re MDC Holdings Securities
Litigation, 754 F.Supp. at 792. As such, this Court will not cleave this
claim from the class definition on grounds that individual issues will
therefore preponderate.

The Defendants next argue for the Court to shrink the class period
for the same reasons it requests the Court to deny class certification.
This Court is of the opinion that the periods for which liability can be
ascribed to the various Defendants is one best left to the jury at trial and
not made by the Court on a motion for class certification.

Finally, the Defendants argue that multiple subclasses must be
certified to deal with each of the Defendants in this action and the various
limited periods of their liability. For the most part, this argument lacks
merit. The Feet Defendants were allegedly engaged in a common
scheme and it would be redundant to have to retry much of those issues
with regard to separate classes. At the same time, the putative class
members’ bases for liability against the Feet Defendants and the audit Defendants are substantially varied. Combining trials against these two sets of defendants would be potentially confusing for a jury. However, the certification of two subclasses is not likely to remedy the issue; the two subclasses would be identical and could still try the issue in a common (and still more confusing) proceeding.

The appropriate course, rather, is to sever the action by the class against the Feet Defendants from their action against the audit Defendants pursuant to Federal Rule of Civil Procedure 21. The severance of issues for subsequent proceedings and trial is committed to the district court’s broad discretion. See Brunet v. United Gas Pipeline Co., 15 F.3d 500, 505 (5th Cir. 1994). Several factors are to be considered in determining the appropriateness of severance: the convenience of the parties, the risk of prejudice to any party, and the promotion of judicial expedition and economy. See Rojas v. National Accident Insurance Underwriters, 2001 WL 682231 (W.D. Tex. 2001), and Old Colony Ventures I v. SMWNPF Holdings; Inc., 918 F.Supp. 343, 350 (D.Kan. 1996). All of these factors militate in favor of severing the
action against the Feet Defendants from that against the audit Defendants.

CONCLUSION

For the foregoing reasons, the motion for class certification will be GRANTED. Further, the case will heretofore be SEVERED into one action against Harold Ruttenberg, Eric L. Tyra, Peter Berman, Cooper Evans, Patrick Lloyd, Don-Allen Ruttenberg, Michael P. Lazarus, Helen Rockey, Scott C. Wynne, Randall Haines, and Adam Gilburne and a second action against Deloitte & Touche LLP, Steven H. Barry, and Karen Baker.

IT IS SO ORDERED this 21st day of July, 2001.

H. DEAN BUTTRAM, JR.
UNITED STATES DISTRICT JUDGE
EXHIBIT F

TO DECLARATION OF JOHN C. KAIRIS
CLASS CERTIFICATION AND
SECTION 18 OF THE EXCHANGE ACT

In a Recent Split of Authority, Several Courts Have Certified Classes of
Investors in Section 18 Cases After Finding That Individual Issues of Reliance
Did Not Predominate Over Common Issues Such as Falsity, Materiality, and
Defendants' Good Faith. The Authors Approve These Holdings, Arguing that to
Refuse Certification in Such Cases Would Effectively Deprive Individual
Investors of the Express Remedy Provided by Congress.

By Stuart M. Grant and Megan D. McIntyre

In recent years, there has been a split of authority as to
whether actions pursuant to Section 18 of the Securities
Exchange Act of 1934, 15 U.S.C. § 78r, may be certified
as class actions. Some courts have been reluctant to per-
mit class certification, reasoning that individualized issues
of reliance preclude class-wide treatment of such claims.
Other courts have certified classes in actions involving
Section 18 claims, concluding that the legal and factual
issues that are common to all class members predominate
over any individual issues of reliance, thus making class
treatment appropriate.

In 2000, we published an article discussing the virtues
of Section 18 as a remedy for institutional investors who
suffer damages as a result of their reliance on false state-
ments in SEC filings.1 That article indicated that class
actions were unavailable for Section 18 claims, which
has historically been the general rule. However, several
cases — including a recent 2001 decision — have
reached the opposite result and certified plaintiff classes
for the pursuit of Section 18 claims. This article is
intended to update and modify the prior Section 18 arti-
cle with respect to the issue of class certification, and to
discuss why class-wide treatment of Section 18 claims is
critical to preserving the remedy of Section 18 for indi-
vidual investors. Indeed, to deny investors the ability to
pursue Section 18 claims in class actions is to effectively
deny any remedy for Section 18 violations to the majority
of investors who are injured by them.

1. See Jay W. Eisenhofer and Stuart M. Grant, "Institutional
Investors and Section 18 of the Exchange Act," The Review of
Securities & Commodities Regulation (March 14, 2000).

IN THIS ISSUE
• Class Certification and Section 18 of the Exchange Act
• Indemnification of Directors and Officers Under Delaware Law
SECTION 18 AND RELIANCE

Section 18 of the Exchange Act provides for liability for the making of material false or misleading statements in documents filed with the SEC. It affords a remedy to investors who purchase securities in reliance on such false or misleading statements, making it one of the few provisions of the Securities Exchange Act of 1934 that provides an express private right of action to investors.

2. Section 18 reads, in pertinent part: "Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r(a).

3. The only other section that provides an express private right of action is Section 9(e), 15 U.S.C. § 78j(e) (relating to manipulation of security prices). Section 16(b), 15 U.S.C. § 78p(b) (relating to insider short-swing profits) provides for a derivative action if the issuer fails to bring an action for short swing profits.

In order to prevail on a claim under Section 18, an investor must establish: (1) a false or misleading statement; (2) contained in an SEC filing; (3) that is material; (4) on which the investor relied; (5) in connection with the purchase or sale of securities. Section 18 is an important remedy for investors because, unlike Rule 10b-5, it does not require a showing of scienter. Instead, Section 18 places the burden on defendants to establish as an affirmative defense that they acted in "good faith and had no knowledge that [the] statement was false or misleading." In order to avoid liability.

Reliance is a crucial element in the establishment of a Section 18 claim. Indeed, most courts have held that, unlike Rule 10b-5 which permits reliance to be presumed through a fraud-on-the-market theory, Section 18 requires proof of a plaintiff's "actual knowledge of and reliance upon" the false statements or misrepresentations.


Published 22 times a year by Standard & Poor's, a division of The McGraw-Hill Companies. Exec. Office 55 Water Street, New York, New York 10041. Editorial Office, 259 Park Avenue 16th fl New York, New York 10171. Subscription rates: $898 per year in U.S., Canada and Mexico; $960 where air mail delivered. Subscribers to both The Review of Securities & Commodities Regulation and The Review of Banking and Financial Services who receive both publications at the same address are entitled to a $250 discount. In addition, a 15% discount is available for qualified academic libraries and universities. General Editor: Michael O. Finkelshein. Associate Editor: Sarah Strauss Himmelfarb. Copyright © 2002 by Standard & Poor's. ISSN: 0884-2426. Reproduction in whole or in part prohibited except by permission. All rights reserved. Officers of The McGraw-Hill Companies: Harold W. McGraw III, Chairman, President and Chief Executive Officer; Kenneth M. Vinitz, Executive Vice President and General Counsel; Robert J. Balshe, Executive Vice President and Chief Financial Officer; Frank D. Pangrle, Senior Vice President, Treasury Operations. Information has been obtained by The Review of Securities & Commodities Regulation from sources believed to be reliable. However, because of the possibility of human mechanical error by our sources, The Review of Securities & Commodities Regulation does not guarantee the accuracy, adequacy, or completeness of any information.

The Review of Securities & Commodities Regulation is not responsible for any errors or omissions or for the results obtained from the use of such information.

General Editor
Michael O. Finkelshein
Associate Editor
Sarah Strauss Himmelfarb
Board Members
Jay Baris
Kramer Levin Naftalis & Frankel LLP
New York, N.Y.
Kenneth J. Bialkin
Skadden, Arps, Slate, Meagher & Flom
New York, N.Y.
Arthur M. Borden
Rosenman & Colin
New York, N.Y.
Alan R. Bromberg
Jenkins & Gilchrist
Dallas, TX
Roberto Carmona
Kelley Drye & Warren
New York, N.Y.
Richard M. Phillips
Kirkpatrick & Lockhart
San Francisco, CA
A. Robert Pietszak
Sidley Austin Brown & Wood, LLP
New York, N.Y.
Irving M. Pollock
Dillowth Paxson PLLC
Washington, D.C.
Norman S. Posner
Brooklyn Law School
Brooklyn, N.Y.
Thomas A. Russo
Lehman Brothers
New York, N.Y.
Carl W. Schneider
Ellings Park, PA
Edmund B. Schroeder
Cadwaladers, Wickersham & Taft
New York, N.Y.
Stephen J. Selig
Brown, Raysman, Miller, Felder, & Steiner
New York, N.Y.
In other words, “constructive” rather than “actual” or “eyeball” reliance generally will not satisfy the requirements of Section 18.8

**Class Certification**

The costs of litigation and the stamina of corporate defendants make class actions appealing to plaintiffs in federal securities law cases, because it allows them to pursue claims that would be economically impractical to pursue on an individual basis. It is the rare investor — typically only institutions and the wealthiest of individual investors — whose potential recoveries would justify the substantial costs of bringing an individual securities lawsuit.

Rule 23 of the Federal Rules of Civil Procedure permits plaintiffs to pursue federal claims on a class action basis, provided that certain requirements are met. Of particular importance in the Section 18 context is the requirement that there exist issues of law and fact that are common to the class, and that such common issues predominate over any individual issues.9 Generally, the existence of a “common nucleus of operative fact” is enough to establish commonality.10 There is a “common nucleus of operative fact” where “defendants have engaged in standardized conduct towards members of the proposed class.”11

Because Section 18 claims involve false and/or misleading statements in SEC filings — which are widely disseminated to investors in an identical form — such claims typically involve several common legal and factual issues. These include: the false or misleading nature of the statement; the materiality of the statement; whether the statement was made in connection with the purchase or sale of securities; and the rebuttal of any affirmative defenses regarding the defendant’s state of mind. These questions can generally be determined on a class-wide basis, eliminating the need for individual trials.

Not all issues inherent in a Section 18 claim may be established on a class-wide basis, however. In particular, the requirement of actual reliance necessitates individual determinations of each class member’s reliance. The question is whether the existence of this individualized issue is sufficient to preclude class certification of Section 18 claims — i.e., whether it predominates over the questions of law and fact that are common to all class members. As discussed below, the courts are divided on that question.

**THE SPLIT OF AUTHORITY**

Some courts have rejected class certification in Section 18 actions due to the strict requirement of individual reliance.12 These courts have held that the common questions do not predominate over the individual questions of reliance. For example, in *Beebe v. Pacific Realty Trust*, the District Court for the District of Oregon acknowledged that “the [Section 18] claim embodies common questions of law and fact as to the materiality of any omissions or misrepresentations,” but denied class certification because “as to proof of individual reliance, plaintiff does not meet the commonality requirement.”13 Likewise, in *Elster v. Alexander*, the District Court for the Northern District of Georgia held that Section 18 claims “are inappropriate for treatment as class actions because they present substantial and predominant individual questions.”14 The court also expressed reluctance to undertake the perceived “judicial nightmare” of resolving the individual issues separately from the class issues.15

Conversely, other courts have held that individual issues of reliance do not predominate over common issues, and thus do not preclude class certification in Section 18 actions. In *Simpson v. Specialty Retail Concepts*,16 for example, the court certified a class for purposes of the plaintiffs’ Section 18 and state law fraud claims, holding that “the question of whether Defendants ... made material misrepresentations, and if so, whether they were made intentionally or recklessly or negligently are common to the entire class and predominate over individual issues of reliance.”17 Similarly, in the case of *In re MDC Holdings*

---

8. *See Ross, 607 F.2d at 552; Heit, 402 F.2d at 916; In re Digi International Inc., Sec. Litig., 6 F. Supp. 2d 1089, 1103 (D. Minn. 1998) (following “the majority of courts which have held that mere ‘constructive reliance’ is insufficient under Section 18(a)”)* (citations omitted). "Eyeball reliance" is generally used to describe a reading, by the investor, of the document containing the false statement or misrepresentation. *Gross v. Diversified Mortg. Investors, 438 F. Supp. 190, 195 (S.D.N.Y. 1977).*


11. Id. (citation omitted).


15. *See id.* at 443.


17. *Id.* at 102 (citation omitted).
Securities Litigation, the court stated that “individual issues of actual reliance do exist [with respect to the plaintiffs’ Section 18 claim]... however, this does not mean that individual issues predominate over common ones.”

The court certified a class, concluding that there were “numerous common questions of fact” and a “common course of wrongdoing based on the same misrepresentations,” such that common issues predominated over the individual issue of reliance. Further, the court recognized that “[t]he alternative would be to unleash thousands of individual suits into the judicial system, and risk that many plaintiffs would be unable to seek redress because of economics.”

More recently, in a July 2001 decision in State of Wisconsin Investment Board v. Rutenber, the court followed the holdings in Simpson and In re MDC Holdings and certified a class for purposes of the plaintiffs’ Section 18 claims. The court concluded that the individual issue of reliance did not predominate over the common issues, and also that considerations of judicial economy would be furthered by allowing the plaintiffs to pursue their Section 18 claims as a class action. As the court noted, the reliance issue could be determined by way of “mini-trials” with respect to each shareholder after the common issues had been resolved.

THE BETTER APPROACH:
PERMITTING CLASS CERTIFICATION

Because of the plethora of common legal and factual issues that will exist in most putative Section 18 class actions, the class action is by far the superior means of adjudicating those issues. There is ample precedent, both in the federal securities context and elsewhere, for the bifurcation of issues so that common issues may be determined in a class action, followed by separate, individual proceedings to determine individualized issues. In fact, as discussed in this section, permitting class certification on the common issues of Section 18 claims may be the only way to ensure that Congress’s intent when enacting Section 18 — to provide an express remedy to investors injured by violations of that statute — is not frustrated.

Application of Rule 23(b)

While Rule 23(b) requires commonality of legal and factual issues, it does not require that all questions of fact and law be common to all class members in order for a class to be certified. Instead, it “just requires common issues to predominate, thereby logically implying that the existence of some individual issues will not destroy common issue predominance.”

The predominance inquiry under Rule 23(b)(3) “involves an analysis of the substantive elements of plaintiffs’ claims and the requisite proof on these issues and an inquiry into the form the trial on these issues would take.” The central issue with respect to the typical Section 18 claim is the existence of fraudulent conduct by the defendants which resulted in the dissemination of materially false and misleading statements in the company’s SEC filings. The proof on these issues will be the same for all class members, because the defendants will have engaged in the same course of conduct, and disseminated the same statements (by way of SEC filings), to all of them. Reliance is usually the only element of the plaintiffs’ liability case that is not common to all class members. As one commentator has stated:

The need to show individual reliance has not precluded class treatment in cases where standardized written misrepresentations have been made to class members ... In such cases, the courts have uniformly found it appropriate to certify a securities class on the common liability issues and to defer consideration of individual reliance by class members until after disposing of the common class questions.

As discussed above, several courts have certified classes in Section 18 cases, in recognition that the single individu-

19. Id. at 806.
20. Id.
21. Id. at 807.
23. Id.
24. Id. at 18.
al issue of reliance does not predominate over the numerous common issues. The same result has been reached outside the Section 18 context as well.

For example, there are numerous cases in which class certification was granted on Section 10(b) claims despite the existence of individual issues of reliance (either because those cases were decided prior to the Supreme Court’s recognition that reliance may be presumed for such claims, or because the presumption was found not to apply). As the Third Circuit held in one such case:

The presence of individual questions as to the reliance of each investor does not mean that the common questions of law and fact do not predominate over questions affecting individual members as required by Rule 23(b)(3) ... In rejecting such a contention, the Second Circuit stated, “Carried to its logical end [this argument] would negate any attempted class action under Rule 10b-5, since ... reliance is an issue lurking in every 10b-5 action.” Green v. Wolf Corp., 406 F.2d [291] 301 [2d Cir. 1968]). Rather than eliminate securities class actions, it would be more efficient to order separate trials, if necessary, limited to the issue of reliance.

This reasoning is equally applicable to Section 18 claims, and perhaps even more so in light of the fact that Congress provided an express private right of action for violations of Section 18, whereas the right of action under Rule 10b-5 is only an implied right of action.

Many courts have also certified classes for the pursuit of pendent state law fraud claims, even though they may require individualized proof of reliance, when the remaining factual and legal elements are common to all class members.

**Legislative Intent**

The objective of Section 18 is to “encourage[e] use of and reliance upon records filed with the S.E.C.” In furtherance of that objective, Section 18 provides an express private right of action to persons who purchase or sell securities in reliance upon a false or misleading statement filed with the SEC. This is one of only two sections of the Exchange Act that provide an express private right of action for investors. Thus, Congress obviously found it important to provide a means for investors to recoup losses they sustain through reliance on a company’s SEC filings. By providing for such a cause of action, Congress not only gave investors an express remedy, but sent a message to issuers that full and honest disclosure in their SEC filings is critical.

A substantial number of the investors who suffer losses in reliance on false or misleading SEC filings are individuals for whom the pursuit of an individual Section 18 claim would be impractical and cost-prohibitive given the relative amounts of their losses compared to the cost of bringing such an action. Thus, if courts were to conclude that individual reliance issues bar class certification of Section 18 claims as a matter of law, only the institutional investor (and perhaps in rare cases the exceedingly wealthy individual investor) would have the resources, and the economic incentive, to pursue Section 18 claims. Congress cannot have intended to legislate an express remedy which is nearly worthless to the average individual investor.

28. See supra pages 3-4. See also Helfand v. Cenco, Inc., 80 F.R.D. 1, 8-9 (N.D. Ill. 1977) (certifying class action that included Section 18 claims).


30. Eisenberg, 766 F.2d at 786. See also Lubin, 688 F. Supp. at 1460 (where plaintiff “has alleged that each investor relied [sic] upon precisely the same misrepresentations and omissions ... it would defy common sense that class certification is defeated by the possibility of individual questions appertaining to one of the elements of one of the case’s causes of action”).


Prior to the Supreme Court’s decision that reliance can be presumed on a class-wide basis for Rule 10b-5 claims under the fraud-on-the-market theory, the courts recognized that “[t]he policies served by the securities laws would be in part eviscerated if the reliance requirement precluded class certification.”34 The importance of allowing class certification is even greater for Section 18 claims, because Section 18 provides an express right of action whereas Section 10(b) provides only an implied right of action.

Moreover, if class certification were not permitted for Section 18 claims, then most investors would be forced to seek remedies through a Rule 10b-5 claim, for which there is no individual reliance requirement and for which class certification is universally permitted. Because Rule 10b-5 requires proof of a defendant’s scienter whereas Section 18 does not, this places an unfair burden on plaintiffs. Essentially, denial of class certification on Section 18 claims sets up a system whereby different investors must satisfy different burdens of proof in order to recover for the same wrongdoing: institutions and wealthy individuals can bring individual Section 18 actions and need not establish the defendant’s state of mind, while the rest of the investor community is relegated to the pursuit of class action claims under Rule 10b-5, which requires proof of scienter.

Dealing with Individual Issues of Reliance

It is indisputable that “a district court has broad discretion in separating issues and claims for trial as part of its wide discretion in trial management.”35 Many courts, both in the Section 18 context and elsewhere, have exercised this discretion to certify classes for purposes of determining common issues, and to hold separate individual trials or create subclasses to deal with individual issues.36 While individual proceedings regarding reliance may be time-consuming, they are far less burdensome to the court and the parties than the alternative of individual proceedings as to all elements of each class member’s Section 18 claim. This is particularly true when one considers that the individualized proceedings do not even become necessary unless and until all of the common issues are resolved in favor of the plaintiffs. As one court explained in the Rule 10b-5 context:

If separate hearings are ultimately required on the issues of reliance and/or damages, some additional time and effort will be required ... but it should not be overwhelming. In any case, with the presence of a common core which predominates, considerations of judicial efficiency and economy, overall expense and uniformity will be furthered by permitting this case to proceed as a class action.... If plaintiff’s case is as weak as defendant insists, then this case provides it an economical vehicle for establishing its innocence as to all members of the class. For it is only if plaintiff prevails on all of the common issues that the need will arise for split trials on whatever individual issues remain.37

CONCLUSION

In summary, there is relatively little case law on the issue of class certification for Section 18 claims, and the case law that exists is severely divided. Some courts hold that the need to prove reliance on an individual basis necessarily precludes class certification, while others permit class certification because the single individual issue of reliance does not predominate over the many issues common to all class members. In light of Congress’s express provision of a private remedy for Section 18 violations, and the fact that most investors will be without such a remedy if class

(footnote continued...)

omitted); Ridings v. Canadian Imperial Bank of Commerce Trust Co. (Bahamas) Ltd., 94 F.R.D. 147, 151 (N.D. Ill. 1982) (“[i]f necessary, the Court may order separate hearings on the individual questions of reliance after determination of the common questions of law and fact.”) (citation omitted); Sharp, 70 F.R.D. at 547 (“[i]f at trial it is determined that individual proof of reliance is required ... then separate hearings can be held to determine which members of the class in fact relied on defendant’s letter. This is the approach which the vast majority of courts faced with this problem have advocated.”) (citing cases).

37. Sharp, 70 F.R.D. at 548 (citations and footnote omitted).
actions are unavailable, the certification of classes in Section 18 cases appears to be consistent with Congressional intent and the purposes behind the statute. Moreover, even assuming that every investor would have the economic wherewithal and incentive to bring individual Section 18 actions, judicial economy and efficiency are far better served by the use of a class action to determine the questions that will be common to all investors — such as the falsity and materiality of the defendants' statements, and the viability of an affirmative "good faith" defense — than individual actions would be. By permitting Section 18 claims to proceed as class actions on all issues except reliance, and then holding individual mini-trials to determine reliance if the common issues are resolved in the plaintiffs' favor, the courts can promote judicial economy as well as preserve the important remedies provided by Section 18.