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No. 68130-3-I

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

FUTURESELECT PORTFOLIO MANAGEMENT, INC.,
FUTURESELECT PRIME ADVISOR II LLC, THE MERRIWELL
FUND, L.P. and TELESIS IIW, LLC

Plaintiffs/Appellants,

v.

TREMONT GROUP HOLDING, INC., TREMONT PARTNERS, INC.,
OPPENHEIMER ACQUISITION CORPORATION,
MASSACHUSETTS MUTUAL LIFE INSURANCE CO., and ERNST &
YOUNG LLP

Defendants/Respondents.

BRIEF OF RESPONDENT OPPENHEIMER
ACQUISITION CORP.

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ORIGINAL

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OTHER AUTHORITIES

Respondent Oppenheimer Acquisition Corp. ("OAC") respectfully requests that this Court affirm the Superior Court's order granting OAC's motion to dismiss for lack of personal jurisdiction and for failure to state a claim, and thereby dismissing the Complaint as against OAC with prejudice.

I. INTRODUCTION

OAC is a non-resident holding company that became the parent of respondent Tremont Group Holdings, Inc. ("Tremont Group") in 2001 after purchasing Tremont Group's stock for $145 million. Tremont Group is itself the parent holding company of Respondent Tremont Partners, Inc. ("Tremont Partners," together with Tremont Group, "Tremont"), i.e., the investment advisor that Appellants FutureSelect Portfolio Management, Inc., FutureSelect Prime Advisor II, LLC, The Merriwell Fund, L.P., and Telesis IIW, LLC (collectively, "FutureSelect") utilized so that it could invest in Tremont-sponsored hedge funds.[1] Those hedge funds, in turn, invested with Bernard L. Madoff Investment Securities, LLC ("BMIS" or "Madoff").

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1 FutureSelect alleges that it invested in three hedge funds managed by Tremont Partners: Rye Select Broad Market Fund, L.P., Rye Select Broad Market Prime Fund, L.P., and Rye Select Broad Market XL Fund, L.P. (collectively, the "Rye Funds").

FutureSelect's Opening Brief ("App. Br.") concedes that OAC did not have any contact with the state of Washington or with FutureSelect. Similarly, FutureSelect has not alleged that OAC played any direct role in FutureSelect's investment with Tremont Partners, or with Tremont Partners' selection, retention, or monitoring of Madoff. Nonetheless, FutureSelect sought to establish jurisdiction over, and to pursue claims against, OAC based on nothing more than the alleged actions of others.

However, after careful consideration, extensive briefing, and three days of hearings, the Superior Court correctly granted OAC's motion to dismiss with prejudice because (i) OAC is not subject to personal jurisdiction in Washington, and/or (ii) each of FutureSelect's claims against OAC failed as a matter of law. This Court should affirm.

II. ISSUES ON APPEAL

1. Whether the Superior Court correctly could have determined that it lacked personal jurisdiction over non-resident defendant OAC where (a) OAC concededly never has had any contacts with the state of Washington, and (b) the exercise of personal jurisdiction over OAC on the basis of the in-forum contacts of its indirect subsidiary, Tremont Partners, would be inconsistent both with the Washington long-arm statute and constitutional due process?

2. Whether the Superior Court correctly could have determined that FutureSelect failed to state an agency claim against OAC where FutureSelect did not and cannot allege either that (a) OAC and Tremont mutually consented to an agency relationship, or (b) OAC controlled Tremont?

3. Whether the Superior Court correctly could have determined that FutureSelect failed to state an apparent agency claim against OAC where FutureSelect did not and cannot allege that (a) OAC "objectively manifested" to FutureSelect that Tremont was its agent, or (b) FutureSelect's belief as to an agency relationship was objectively reasonable?

4. Whether the Superior Court correctly could have determined that FutureSelect failed to state a control person claim against OAC under Section 21.20.430(3) of the Washington State Securities Act where FutureSelect did not and cannot allege that OAC (a) controlled Tremont, or (b) had the ability to control Tremont's marketing and sale of Rye Fund limited partnerships to FutureSelect?

III. STATEMENT OF THE CASE

FutureSelect, a professional investor that exercised discretionary investment authority on behalf of its clients, hand-picked the Rye Funds and Tremont so that FutureSelect allegedly could place "more than $195 million" with Madoff. CP 2, 5-6 ¶¶ 4, 15-18. Following the revelation of the Madoff Ponzi scheme in December 2008, FutureSelect commenced the present lawsuit.

In its Complaint, FutureSelect asserts an assortment of claims against a variety of defendants, including several Tremont entities, the Rye Funds' auditors, OAC, and OAC's corporate parent, Massachusetts Mutual Life Insurance Co. ("MassMutual"). CP 6-7 ¶¶ 19-20, 24-25. FutureSelect avers that Tremont Partners, as the investment adviser to the Rye Funds: (a) failed to conduct sufficient due diligence in selecting Madoff's investment firm to manage the Rye Funds' assets, (b) failed to engage in proper oversight of BMIS' management of the Rye Funds' assets, and (c) misrepresented its due diligence procedures. *See, e.g.,* CP 2-4, 13-15 ¶¶ 1, 2, 8, 9, 46, 49, 51-53.

Because OAC had no connection to FutureSelect, FutureSelect's investments with Tremont, or Madoff, FutureSelect attempts to hold OAC liable for the alleged wrongs of Tremont solely through theories of vicarious liability, e.g., agency, apparent agency, and control person liability under Section 21.20.430(3) of the Washington State Securities Act. CP 32-34, 39-40.

A. OAC HAS NO CONTACTS WITH THE STATE OF WASHINGTON OR FUTURESELECT

OAC is a Delaware corporation with its principal place of business in New York. CP 890 ¶ 4. OAC is a parent company to two entities: Tremont Group and OppenheimerFunds, Inc. ("OFI").[2] CP 890-91 ¶¶ 13, 16.

Tremont Partners is the investment advisor and the general partner of the Rye Funds and is headquartered in New York. CP 6 ¶ 20; CP 891 ¶ 14. Tremont Partners is a wholly-owned subsidiary of Tremont Group, which also is located in New York. CP 6 ¶ 19; CP 891 ¶ 14. OAC acquired Tremont Group in 2001 for $145 million. OAC does no business in Washington and never has promoted, marketed, advertised, or sold any products in Washington (or, for that matter, anywhere else), or directed either of its subsidiaries to promote, market, advertise, or sell any products in Washington (or anywhere else). CP 890-91 ¶¶ 7, 10, 17.

As a holding company, OAC never interacted with investors or potential investors in any fund or investment product, including FutureSelect. CP 892 ¶ 21. OAC has no products or services that it even could theoretically sell. Hence, OAC never has sold any hedge fund

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2 OFI has no relationship with FutureSelect or Madoff and is not named as a defendant in this action.

products, such as the Rye Funds, nor has it ever offered any investment advisory services. CP 890-92 ¶¶ 10, 17, 21.

Tremont invested with Madoff and began marketing and selling Rye Fund limited partnerships long before OAC acquired Tremont's stock in 2001. FutureSelect first invested in the Rye Funds in 1998, three years before OAC acquired Tremont. CP 10 ¶ 38. Nothing changed after the acquisition -- OAC never became the "seller" of Rye Fund limited partnerships and Tremont continued to sell Rye Fund limited partnerships in its own name to its own customers. CP 891 ¶ 20. FutureSelect does not allege that it was aware, relied upon or was in any way affected by OAC's acquisition of Tremont Group in 2001.

B. FUTURESELECT'S LIMITED AND CONCLUSORY ALLEGATIONS AGAINST OAC

Because FutureSelect never interacted with OAC in any manner, its substantive allegations against OAC are confined to a generic description of OAC's acquisition and ownership of Tremont. Specifically, FutureSelect alleges that: (i) OAC acquired Tremont Advisors, Inc. (n/k/a Tremont Group) in October 2001 (CP 7 ¶ 24); (ii) prior to the closing of that transaction, OAC conducted due diligence into Tremont's operations, learning that Tremont utilized Madoff as an investment manager (CP 16-17 ¶¶ 60-62); (iii) since the acquisition, non-party OFI (but not OAC) employed certain Tremont executives to perform unspecified tasks, two OFI employees took positions at Tremont, and two executives of OAC have served on Tremont Group's board of directors (CP 18-19 ¶¶ 66-70); and (iv) OAC interacted with Tremont in routine "operational" functions—compliance, audit, finance and employee hiring (CP 18 ¶ 64).

As noted, FutureSelect does not (and cannot) allege that OAC played any role in investment-related activities carried out by Tremont Partners with respect to investments in the Rye Funds, including as to those funds' investment strategy, the selection of Madoff as manager, the due diligence performed with respect to that selection, the monitoring of Madoff's performance as manager, the preparation or review of any offering materials for the Rye Funds, or communications with FutureSelect (or any other investor in the Rye Funds) on any topic.

IV. STANDARD OF REVIEW

The Superior Court's dismissal with prejudice of the claims asserted against OAC pursuant to a Rule 12(b)(2) motion to dismiss for lack of personal jurisdiction, or pursuant to a Rule 12(b)(6) motion for failure to state a claim, is reviewed *de novo*. *Dana v. Boren*, 133 Wn. App. 307, 310, 135 P.3d 963 (2006); *Harbison v. Garden Valley Outfitters, Inc.*, 69 Wn. App. 590, 595, 849 P.2d 669 (1993). Although FutureSelect's allegations are taken as true for present purposes, the

Superior Court properly dismissed FutureSelect's Complaint as against OAC with prejudice because the Superior Court lacked personal jurisdiction over OAC and/or because it was "clear from the complaint that the allegations set forth do not support a claim." *Berge v. Gorton*, 88 Wn.2d 756, 759, 849 P.2d 669 (1977).

V. SUMMARY OF ARGUMENT

This Court should affirm the Superior Court's dismissal of the claims asserted against OAC with prejudice for either or both of two independent reasons: (i) OAC is not subject to jurisdiction in Washington under any cognizable theory; and (ii) FutureSelect's attempts to hold OAC liable for Tremont's alleged wrongdoing under theories of agency or apparent agency, or for violation of the Washington control person statute, each fail as a matter of law.

FutureSelect concedes that OAC never had any contacts with either the state of Washington or even with FutureSelect. Nonetheless, FutureSelect argues that because it alleged a substantive agency claim against OAC, it automatically established jurisdiction over OAC in Washington because Tremont Partners' in-forum contacts necessarily are "imputed" to OAC. FutureSelect is wrong as a matter of law. There is no legal basis to "impute" Tremont Partners' contacts to OAC, nor does FutureSelect cite any authority supporting its pioneering theory that OAC is subject to jurisdiction solely by virtue of its indirect corporate parent status to Tremont Partners. Even more fundamentally, FutureSelect does not even attempt to argue that such "agency" jurisdiction over OAC meets the requisite constitutional due process standards, presumably because the case law makes clear that its theory would be entirely unconstitutional.

Even if FutureSelect could establish personal jurisdiction over OAC (which it cannot), each of its claims still failed as a matter of law, notwithstanding FutureSelect's indiscriminate bundling of Defendants together, and even its pejorative and unfounded reference to all Defendants as the "Madoff Defendants."

FutureSelect's agency claim failed because FutureSelect did not and cannot allege how Tremont acted as OAC's agent in selling Rye Fund limited partnerships to FutureSelect given the conceded fact that FutureSelect's Rye Fund investments pre-dated OAC's ownership by years. OAC is—and was—a parent holding company that conducts only one business: buying and holding assets of its investments. FutureSelect conclusorily reclassified OAC's parent company status as that of a "principal" in attempting to plead an agency claim, but it did not and cannot allege that: (1) OAC and Tremont "mutually consented" to Tremont selling Rye Fund limited partnerships as OAC's agent, or (2) that OAC "controlled" Tremont's conduct, particularly with regard to

Tremont's solicitation and sale of Rye Fund limited partnerships to FutureSelect.

FutureSelect's apparent agency claim was similarly deficient. FutureSelect was unable to allege—let alone plausibly argue—that OAC "objectively manifested" to FutureSelect that Tremont was its agent. Tellingly, FutureSelect did not allege ever to have known that OAC was Tremont's parent holding company or to have communicated with OAC on any topic, let alone that OAC ever represented to FutureSelect that Tremont was its agent. Instead, FutureSelect relied on allegations of purported statements and conduct by entities other than OAC, which is legally insufficient to plead an apparent agency claim against OAC. FutureSelect, itself a sophisticated investment advisor investing hundreds of millions of dollars of its clients' money, also cannot allege it was objectively reasonable for it blindly to assume that Tremont's subsidiary status made it OAC's agent in selling Rye Fund limited partnerships.

FutureSelect's control person claim failed for the fundamental reason that FutureSelect did not and cannot allege that OAC (a) "actually participated" in Tremont Partners' operations, (b) possessed the power to control Tremont's solicitation and sale of Rye Fund limited partnerships to FutureSelect, or (c) actually controlled the Tremont Partners/Madoff relationship at issue.

At bottom, FutureSelect's claims are ultimately nothing more than a conclusory attempt to circumvent the well-established "general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation . . . is not liable for the acts of its subsidiaries." *United States v. Bestfoods*, 524 U.S. 51, 61, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (1998). As such, the Superior Court's dismissal of the claims against OAC was entirely consistent with other courts' dismissals of similar claims against OAC in similar Madoff-related litigation.[3] *See Askenazy v. Tremont Group Holdings, Inc.*, No. Civ. A. 201004801BLS2, 2012 WL 440675 (Mass. Super. Jan. 26, 2012) (dismissing OAC for lack of personal jurisdiction); *Zutty v. Rye Select Broad Mkt. Fund, L.P.*, No. 113209/09, 2011 WL 5962804 (N.Y. Sup. Ct. Apr. 20, 2011) (dismissing claims against OAC with prejudice for failure to state a claim).[4]

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3 FutureSelect erroneously suggests the Superior Court's dismissal of OAC was a "departure from decisions involving investors' claims against the Madoff Defendants." App. Br. at 13 n.3. As correctly cited above, two courts have decided motions to dismiss filed by OAC—and both have dismissed similar claims against OAC with prejudice. Notably, FutureSelect fails to identify even a single Tremont-related decision that is inconsistent with the Superior Court's dismissal of OAC with prejudice, because there is none.

4 Pursuant to General Rule 14.1, a party may cite an unpublished decision issued by a court outside Washington state where citation to the decision is permitted under the law of the jurisdiction of the issuing court. GR 14.1(b). There is no rule prohibiting citation to unpublished cases in Massachusetts, New York, the Southern District of New York, the Northern District of California, or the Western District of Washington.

VI. ARGUMENT

A. OAC IS NOT SUBJECT TO PERSONAL JURISDICTION IN WASHINGTON

FutureSelect properly concedes that OAC never has had any contacts with Washington, much less the requisite "minimum contacts" necessary to satisfy constitutional due process requirements. Despite OAC's complete lack of contact with Washington, FutureSelect seeks to proceed against OAC in a Washington court on the legally untenable premise that the in-forum contacts of OAC's indirect subsidiary, Tremont Partners, must be imputed to OAC solely by virtue of FutureSelect's assertion of a substantive agency claim against OAC. App. Br. at 49. FutureSelect neither offers any case law support for its novel theory, nor does it make any mention of the constitutional due process requirements that would be trampled if OAC could be subject to jurisdiction in Washington based on nothing more than the mere assertion of a substantive agency claim.

Regardless of whether a plaintiff has asserted a substantive agency claim against a non-resident parent company, constitutional due process requires that jurisdiction over a parent company based on a subsidiary's in-forum conduct can be found only where the plaintiff can demonstrate that the subsidiary performs services in the forum that are sufficiently important to the parent such that in the absence of a representative to perform them, the parent would undertake to perform such services itself. Here, FutureSelect no longer even attempts to argue, let alone demonstrates, that OAC—a parent holding company with no investment advisory or hedge fund business itself—would have undertaken to market or sell the Rye Funds in Washington in the absence of Tremont's performance of these same activities. This failure is fatal to any effort to establish personal jurisdiction over OAC on the basis of Tremont Partners' contacts with this state.

1. FutureSelect Cannot Demonstrate That the Exercise of Jurisdiction Over OAC Comports With Constitutional Due Process

FutureSelect argues that it need only allege an agency claim against OAC to establish personal jurisdiction in Washington over OAC. *See* App. Br. at 49. However, FutureSelect ignores—but could not possibly dispute[5]—that the exercise of personal jurisdiction—particularly with regard to a nonresident holding company with no Washington contacts—not only must satisfy the Washington long-arm statute, but also must comport with constitutional due process. *SeaHAVN, Ltd. v. Glitnir*

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[5] Even the cases FutureSelect relies on recognize that "the exercise of jurisdiction must comport with the state's long arm statute, *and* with the constitutional requirement of due process." *Kreidler v. Pixler*, No. C06-0697, 2006 WL 3539005, at *3 (W.D. Wash. Dec. 7, 2006) (emphasis added); *see CTVC of Hawaii, Co. v. Shinawatra*, 82 Wn. App. 699, 709, 919 P.2d 1243 (1996) (same), *review denied,* 131 Wn.2d 1020 (1997).

Bank, 154 Wn. App. 550, 563, 226 P.3d 141 (2010). *Accord Harbison*, 69 Wn. App. at 597.

To satisfy constitutional due process, FutureSelect must meet a three-prong test:

> (1) [t]he nonresident defendant or foreign corporation must purposefully do some act or consummate some transaction in the forum state; (2) the cause of action must arise from, or be connected with, such act or transaction; and (3) the assumption of jurisdiction by the forum state must not offend traditional notions of fair play and substantial justice, consideration being given to the quality, nature, and extent of the activity in the forum state, the relative convenience of the parties, the benefits and protection of the laws of the forum state afforded the respective parties, and the basic equities of the situation.

Shute v. Carnival Cruise Lines, 113 Wn.2d 763, 767 (1989), *rev'd other grounds*, 499 U.S. 585 (1991). FutureSelect's personal jurisdiction argument does not begin to meet any of these basic and constitutional requirements.

A plaintiff "may not use liability as a substitute for personal jurisdiction." *American Tel. & Tel. Co. v. Compagnie Bruxelles Lambert*, 94 F.3d 586, 590-91 (9th Cir. 1996). FutureSelect fails to cite even a single case premising jurisdiction over a parent company on nothing more than the assertion of an agency claim based on the in-forum contacts of a subsidiary—because there is none. The pertinent question for jurisdiction purposes is not whether FutureSelect has asserted an agency claim, but whether FutureSelect has met its burden of demonstrating that OAC has "purposefully avail[ed] itself of the privilege of conducting activities within the forum state, thereby invoking the benefits and protections of its laws." *Walker v. Bonney-Watson Co.*, 64 Wn. App. 27, 34, 823 P.2d 518 (1992) (finding a plaintiff bears burden of establishing purposeful availment). Indeed, as another court recently recognized in dismissing Madoff/Tremont-related claims against OAC on personal jurisdiction grounds, the "constitutional dimensions" of personal jurisdiction prohibit a plaintiff from conflating allegations of "substantive liability . . . with 'amenability to suit in a particular forum.'" *Askenazy*, 2012 WL 440675, at *9.[6]

FutureSelect's failure to satisfy constitutional due process is alone grounds to affirm the Superior Court's order as to OAC. *See SeaHAVN*, 154 Wn. App. at 569 (affirming dismissal where plaintiff failed to satisfy the "purposeful availment" prong of constitutional due process test); *Grange Ins. Ass'n v. State of Washington*, 110 Wn.2d 752, 762, 757 P.2d 933 (1988) (reinstating trial court order dismissing defendant for lack of constitutionally sufficient contacts with Washington).

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6 FutureSelect's speculation that the *Askenazy* court would have found jurisdiction over OAC had the plaintiffs merely added an agency claim (App. Br. at 50 n.12) is directly contrary to the court's proper finding that substantive liability cannot satisfy the constitutional requirements of due process.

2. FutureSelect Cannot Rely Upon Tremont Partners' Washington Contacts for Purposes of Establishing Personal Jurisdiction Over OAC

FutureSelect's attempt to impute Tremont Partners' contacts to OAC also is directly contrary to the "well established" principle that a parent-subsidiary relationship by itself is "insufficient to attribute the minimum contacts of the subsidiary to the parent." *Bingham v. Blair LLC*, No. C10-5005, 2010 WL 2196106, at *4 (W.D. Wash. May 27, 2010). The U.S. Supreme Court has established that due process mandates that "[e]ach defendant's contacts with the forum State must be assessed individually." *Calder v. Jones*, 465 U.S. 783, 790, 104 S. Ct. 1482, 79 L. Ed. 2d 804 (1984). Thus, courts applying Washington law correctly have refused to exercise jurisdiction over a foreign parent company based on its subsidiary's in-forum contacts. *See, e.g., Bingham*, 2010 WL 2196106, at *4 (declining to impute subsidiary's in-forum contacts to foreign parent company).

FutureSelect is unable to cite a single Washington state court decision finding jurisdiction over a parent company based on its subsidiary's in-forum contacts—because there are no such cases. The few Washington federal courts to consider the issue have imposed an appropriately stiff burden on plaintiffs, by requiring well-pled factual allegations that the subsidiary performs "services sufficiently important to [the parent] that if it did not have a representative to perform them, [the parent] . . . would undertake to perform" such services. *Beltappo, Inc. v. Rich Xiberta, S.A.*, No. C05-1343Z, 2006 WL 314338, at *5 (W.D. Wash. Feb. 7, 2006). And, where the parent is purely a holding company (such as OAC), the burden on plaintiffs is even higher because the subsidiary of a parent holding company "conduct[s] business not as [the parent's] agent but as its investment. The business of the parent is the business of the investment, and that business is carried out entirely at the parent level." *Doe v. Unocal Corp.*, 248 F.3d 915, 929 (9th Cir. 2001).

FutureSelect itself advanced this standard in its brief below (CP at 1725-28), but deserted it at oral argument below and again deserts it on appeal—presumably because FutureSelect cannot even allege, let alone demonstrate, that Tremont sold Rye Fund limited partnerships "on behalf" of OAC. Specifically, FutureSelect alleged only that:

- OAC owns Tremont's stock (CP 7 ¶ 24);
- OAC purportedly "directed and influenced the management of [Tremont]" (CP 18 ¶ 64);
- shared board members with Tremont (*id.* ¶ 66); and
- "provided extensive support services to Tremont" (*id.* ¶ 64).

None of these tangential facts regarding OAC's ownership of Tremont bears any relation to the pertinent question of whether Tremont

Partners' presence substituted for OAC's in Washington. Nearly every parent/subsidiary relationship includes stock ownership and overlapping directors and officers; thus, courts consistently have held that allegations of these normal incidences of a parent/subsidiary relationship fail to provide a legally sufficient basis to impute Tremont's contacts to OAC under any jurisdictional theory. *See Williams v. Canadian Fishing Co.*, 8 Wn. App. 765, 768, 509 P.2d 64 (1973) (mutuality of corporate officers and directors insufficient to impute contacts because "there is no showing in the record that the officers of the subsidiary do not act independently of the parent corporation"); *Glud & Marstrand A/S v. Microsoft Corp.*, No. C05-1563, 2006 WL 2380717, at **9-10 (W.D. Wash. Aug. 15, 2006) (allegation of "extremely close relationship" insufficient to impute subsidiary's contacts).

Tellingly, FutureSelect does not even attempt to argue that Tremont performed services "on behalf of" OAC that, if not for Tremont, OAC would have itself performed in Washington. *See, e.g., Beltappo*, 2006 WL 314338, at *5. Even if it did try to make this argument, the bottom line is that OAC did (and does) nothing more than own the stock of the parent company (Tremont Group) to the general partner (Tremont Partners) of the limited partnership hedge funds in which FutureSelect invested (the Rye Funds). Thus, OAC would not, and never did, step into the shoes of Tremont to perform activities related to the sale of Rye Fund limited partnerships in Washington or elsewhere—and FutureSelect cannot allege or demonstrate otherwise.

In sum, given the incontestable facts that (a) OAC is a parent holding company that itself had no contact with FutureSelect or played any role in FutureSelect's or Tremont's investment decisions, and (b) OAC never did, could or would step into Tremont's shoes to perform any activities related to the sale of the Rye Funds, FutureSelect cannot establish jurisdiction over OAC consistent with constitutional due process.

B. FUTURESELECT FAILED TO STATE ANY CLAIM AGAINST OAC

FutureSelect's bare allegations against OAC do not support any of the three claims it asserted against OAC:

First, FutureSelect's agency claim failed because FutureSelect did not (and cannot) allege that (a) OAC and Tremont "mutually consented" to an agency relationship, or (b) Tremont sold Rye Fund limited partnerships "on behalf" and under "control" of OAC.

Second, FutureSelect's apparent agency claim was equally deficient because FutureSelect did not (and cannot) allege either that (a) OAC "objectively manifested" to FutureSelect that Tremont sold Rye Fund limited partnerships as OAC's agent, or (b) FutureSelect subjectively believed Tremont was OAC's agent or that such a belief was objectively reasonable.

Third, FutureSelect's RCW 21.20.430 control person claim against OAC failed because FutureSelect did not (and cannot) allege that (a) OAC actually controlled Tremont's operations, or (b) OAC possessed the power to control Tremont's Madoff-related disclosures.[7]

1. FutureSelect Failed to State a Claim Against OAC for Agency

FutureSelect's agency claim failed because FutureSelect did not and cannot make the requisite showing that: (1) both OAC and Tremont mutually consented to an agency relationship, and (2) OAC, as principal, controlled Tremont as its agent. *Moss v. Vadman*, 77 Wn.2d 396, 402-03, 463 P.2d 159 (1969).[8]

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[7] Additionally, OAC cannot be liable to FutureSelect under any theory for any alleged wrongdoing or losses that occurred prior to OAC's acquisition of Tremont in late 2001. *See, e.g.*, *In re Petco Animal Supplies Inc. Sec. Litig.*, No. 05-823, 2005 WL 5957816, at *33 (S.D. Cal. Aug. 1, 2005) (dismissing control person claim against defendants who were not "*at the time of the alleged securities violations,* able to exercise control over the corporation") (emphasis in original); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 949 (7th Cir. 1989) (finding facts insufficient to support control person claim because "section 20(a) requires control at the time of the alleged violation").

[8] The dismissal of FutureSelect's agency claim also should be affirmed because FutureSelect's underlying claims failed as to the Tremont Defendants. *See Estep v. Hamilton*, 148 Wn. App. 246, 258, 201 P.2d 331 (2008) ("Essential to a principal's vicarious liability is some negligence by the alleged agent."), *review denied*, 166 Wn.2d 1027 (2009).

a. FutureSelect Failed Adequately to Allege That OAC and Tremont Mutually Consented to an Agency Relationship

FutureSelect's Complaint failed to satisfy the mutual consent requirement for an agency claim because its factual allegations did not demonstrate that OAC and Tremont mutually consented to Tremont acting as OAC's agent in the marketing and sale of Rye Fund limited partnerships to FutureSelect. *Hewson Const., Inc. v. Reintree Corp.*, 101 Wn.2d 819, 823, 685 P.2d 1062 (1984) (agency relationship requires well-pled facts demonstrating that "[b]oth the principal and agent . . . consent[ed] to the relationship"). FutureSelect conclusorily argues that "[t]he Complaint contains numerous other specific factual allegations that explain . . . each element of agency" (App. Br. at 47), but it fails to indicate what these allegations are or explain how they satisfy the mutual consent requirement.

In actuality, Tremont is an "investment service provider" (CP 42 ¶ 186), while OAC always has acted as a holding company and never has offered investment advisory services or any hedge fund products. Because OAC never had any products or services, Tremont could not even theoretically market or sell "on behalf of" OAC. Consequently, FutureSelect's allegations have nothing to do with OAC and Tremont mutually consenting to Tremont selling Rye Fund limited partnerships on behalf of OAC. Instead, they reveal only that Tremont was OAC's subsidiary, i.e.:

- OAC wholly owned Tremont Group;
- OAC, Tremont and OFI had some overlapping board members and employees;
- OAC "provided extensive support services to Tremont, including compliance, audit, finance, and human resources;"
- Tremont's auditor changed post-acquisition.

CP 7, 11, 18 ¶¶ 24, 39, 64, 66.

FutureSelect's allegations are entirely consistent with a parent/subsidiary relationship, and they belie any suggestion that Tremont was OAC's agent. For example, FutureSelect's allegation that OAC received seats on Tremont's board is expected in the parent/subsidiary context, but is unusual in a principal/agent relationship. It would be equally unusual for an agent to change its auditor at a principal's request or for the companies to share support services, while such synergies are customary within a corporate family.

Additionally, FutureSelect broadly alleged that OAC's "control included the manner in which Tremont solicited its investment business" (CP 17-19), but tellingly it did not allege that OAC controlled Tremont's solicitation of ***FutureSelect's*** investment business—undoubtedly because FutureSelect's "investment business" was solicited more than three years before OAC even owned Tremont's stock. CP 10 ¶ 38. Similarly, FutureSelect's marketing allegations are irrelevant because they did not relate to the marketing of any Rye Fund limited partnerships, let alone marketing of such limited partnerships to FutureSelect. Indeed, the marketing to which FutureSelect alludes was not even conducted by OAC, but rather OFI, which is not a defendant in this case and had no relationship with FutureSelect or Madoff.

FutureSelect's allegations were thus insufficient as a matter of law because they did not reveal OAC and Tremont's mutual consent to Tremont acting as OAC's agent in relation to the conduct at issue. *Matsumura v. Eilert*, 74 Wn.2d 362, 369-70, 444 P.2d 806 (1968) (reversing finding of agency where there was no evidence that defendant "manifested any consent that [the alleged agent] acted on their behalf and subject to their control nor any corresponding consent").

b. FutureSelect Failed Adequately to Allege That OAC Controlled Tremont

FutureSelect recycled its general description of OAC's and Tremont's parent/subsidiary relationship in hopes of satisfying the control element of its agency claim. However, FutureSelect fails to cite a single case finding an agency relationship between a parent and subsidiary, let alone doing so solely on that basis. In fact, courts consistently have rejected similar attempts to shoehorn a parent/subsidiary relationship into an agency claim. For example, in *Campagnolo S.R.L. v. Full Speed Ahead, Inc.*, No. C08-1372, 2010 WL 2079694, at *7 (W.D. Wash. May 20, 2010), the court questioned whether agency law even applies to a parent/subsidiary relationship, finding that "[i]t is not clear, however, that [Washington state] agency analysis applies where the asserted principal and the asserted agent are separately incorporated entities," *aff'd*, 447 F. App'x 814 (9th Cir. 2011). Because the plaintiff there fell far short of alleging domination and control equal to that necessary to pierce the corporate veil, the court dismissed the agency claim. *Id.* Similarly, in *Uni-Com Nw., Ltd. v. Argus Publ'g Co.*, 47 Wn. App. 787, 797, 737 P.2d 304, the court rejected an agency claim against a sole shareholder because holding a shareholder liable on an agency theory would be a "disguised way of finding corporate disregard," *review denied*, 108 Wn.2d 1032 (1987).

Consequently, where a plaintiff—such as FutureSelect here—attempts to circumvent the strict veil piercing requirements through an agency claim, courts require both parental domination and control equal to that necessary to pierce the corporate veil, and that corporate formalities were ignored. FutureSelect does not (and cannot) make the necessary showing that OAC and Tremont disregarded corporate formalities or that

OAC "exercise[d] total control over [Tremont], well beyond the normal control exercised" in a parent-subsidiary relationship. *Campagnolo*, 2010 WL 2079694, at *8; *accord In re Washington Mut., Inc.*, No. 09-50039, 2010 WL 3238903, at *15 (Bankr. D. Del. Aug. 13, 2010) (plaintiff "failed to allege the complete control necessary to hold [parent] liable for [subsidiary]'s acts under Washington agency law" where allegations "establish that a lawful parent-subsidiary relationship existed but fail to establish that [parent] exercised complete control by directing and managing the manner in which [subsidiary] conducted business").

Even if FutureSelect somehow could premise an agency claim on a parent/subsidiary relationship, it still failed to allege that OAC "controlled" Tremont's "manner of performance," i.e., Tremont's marketing and sale of the Rye Funds. *Neil v. NWCC Invs. V, LLC*, 155 Wn. App. 119, 132, 229 P.3d 837 ("control establishes agency only if the principal controls the manner of performance"), *review denied,* 169 Wn.2d 1018 (2010). FutureSelect's failure to allege or explain how ordinary indicia of corporate ownership adequately demonstrate that OAC controlled Tremont's marketing and sale of Rye Fund limited partnerships to FutureSelect is fatal to FutureSelect's agency claim against OAC. *See, e.g., Uni-Com*, 47 Wn. App. at 796-97 (dismissing agency claim where plaintiff failed to allege principal controlled purported agent's "manner of performance"); *Progressive N. Ins. Co. v. Fleetwood Enters., Inc.*, No. C04-1308, 2006 WL 1009334, at *8 (W.D. Wash. Apr. 14, 2006) (parent corporation may be directly involved in subsidiary's activities without incurring liability so long as that involvement is "consistent with the parent's investor status" which includes monitoring performance, financial supervision, and "articulation of general policies and procedures").

2. FutureSelect Failed to State a Claim Against OAC for Apparent Agency

FutureSelect also failed to allege (or even argue) that OAC made any "objective manifestations" to FutureSelect causing it to believe that Tremont was OAC's agent, as is required to plead a cognizable apparent agency claim against OAC. *King v. Riveland,* 125 Wn.2d 500, 507, 886 P.2d 160 (1994). Nor did (or could) FutureSelect make the required allegations that: (1) OAC's conduct "caused FutureSelect "to actually, or subjectively, believe that [Tremont had] authority to act for" OAC; and (2) FutureSelect's actual, subjective belief that Tremont was OAC's agent in selling Rye Fund limited partnerships was objectively reasonable. *Id.*; *see Bill McCurley Chevrolet, Inc. v. Rutz,* 61 Wn. App. 53, 56-57, 808 P.2d 1167, *review denied,* 117 Wn.2d 1015 (1991).

a. FutureSelect Is Unable to Allege OAC "Objectively Manifested" That Tremont Was Its Agent

FutureSelect is unable to meet the objective manifestation element because none of the alleged statements upon which FutureSelect relies was made by OAC, as is required to state an apparent agency claim against OAC. For example, FutureSelect alleged that ***Tremont*** informed FutureSelect representatives "that Oppenheimer, now Tremont's parent, was so impressed with Tremont and its operations, including the Rye Funds, that it wanted Tremont to develop hedge funds to be publicly traded," and that ***Tremont*** told FutureSelect "that Oppenheimer was making Tremont change auditors from E&Y to KPMG." (CP 11 ¶ 39). However, an apparent agency claim fails where, as here, the "objective manifestations" of the agency relationship are not made by the alleged principal.

Similarly, FutureSelect's additional allegations that (i) "***Tremont*** put 'An OppenheimerFunds Company' on Tremont's stationary and marketing materials," and (ii) "***Tremont*** also began offering funds with the Oppenheimer name," are also actions purportedly undertaken by Tremont. CP 19 ¶ 72 (emphasis added).[9] Likewise, FutureSelect's

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[9] Moreover, the fact that Tremont identified its affiliation with a subsidiary of its corporate parent on its stationary in no way indicated that OAC was the

(factually incorrect) allegation that Tremont sold funds "with the Oppenheimer name" and which FutureSelect is not alleged to have invested in, bears no relation to whether or not Tremont acted as OAC's agent in selling Rye Fund limited partnerships.

Furthermore, FutureSelect's allegation that unidentified "statements and conduct" made by OAC to unnamed people somehow "conveyed to FutureSelect that Tremont had the authority to offer and sell the Rye Fund investments on [OAC's] behalf" (CP 40 ¶ 168) merely restates the first element of an apparent agency claim, and is entirely inconsistent with FutureSelect's correct concession that it never had any contact with OAC.

While it is not surprising that FutureSelect relied on Tremont's conduct in support of its apparent agency claim, given that FutureSelect never met with a single OAC representative, received any documents from OAC, or communicated with OAC in any manner, FutureSelect's failure to allege any "objective manifestation" by OAC of the purported Tremont-OAC agency relationship necessarily precludes FutureSelect from pursuing an apparent agency claim against OAC. *See, e.g.*, *Douglass v. Stanger*, 101 Wn. App. 243, 251, 2 P.3d 998 (2000) (stating "[a]pparent

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party offering the Rye Funds and that Tremont was merely operating as an agent selling the Rye Funds on behalf of OAC.

authority may be inferred from the acts of the principal only" and affirming dismissal of apparent agency claim where plaintiff failed to allege any "objective manifestations by the principal . . . that reasonably led [plaintiff] to believe that [defendant] was [principal]'s agent"); *Mauch v. Kissling*, 56 Wn. App. 312, 316, 783 P.2d 601 (1989) ("Apparent authority can only be inferred from the acts of the principal and not from the acts of the agent").

b. FutureSelect Failed to Allege That It Actually Believed Tremont Was OAC's Agent, Let Alone That Such a Belief Was Objectively Reasonable

FutureSelect failed to allege facts sufficient to show that "a person exercising ordinary prudence, acting in good faith and conversant with business practices and customs, would be misled thereby, and such person has given due regard to such other circumstances as would cause a person of ordinary prudence to make further inquiry." *J&J Food Ctrs., Inc. v. Selig*, 76 Wn.2d 304, 309, 456 P.2d 691 (1969).

Instead, FutureSelect provided only legal conclusions as to its belief that an agency relationship existed. For example, FutureSelect alleged that OAC's "statements and conduct would have led a reasonably careful person under the circumstances to believe that Tremont had the authority to so act." CP 40 ¶ 170. But FutureSelect made no attempt to identify what OAC's purported "statements and conduct" were. And, FutureSelect could not plausibly plead that it was "objectively reasonable" for a sophisticated investment firm such as FutureSelect, "conversant with business practices and customs," and that was investing over $195 million of its clients' money, to believe that Tremont Partners was cloaked with apparent authority merely because OAC indirectly owned its stock. *See Lamb v. Gen. Assocs. Inc.*, 60 Wn.2d 623, 680-81, 374 P.2d 677 (1962); *Estep*, 148 Wn. App. at 258 (affirming dismissal of apparent agency claim because Plaintiff's "subjective beliefs [as to apparent agency] must be objectively reasonable" and "[plaintiff] points to no acts . . . that would lead a reasonable person to believe [purported agent] was acting with the apparent authority of his former partners").

Moreover, FutureSelect invested in the Rye Funds long before OAC even acquired Tremont Group, thereby destroying any suggestion that FutureSelect's perception of Tremont as an agent of OAC was a factor in FutureSelect's investment decision. Nor can FutureSelect credibly suggest that it later perceived some agency relationship, since FutureSelect did not identify when Tremont purportedly ceased offering the Rye Funds on its own accord and instead began selling those investment vehicles "on behalf of" OAC.

Moreover, FutureSelect failed to plead—as it must to state an apparent agency claim—that OAC "had knowledge of the act which was being committed by its agent." *Mauch*, 56 Wn. App. at 316. FutureSelect made only the most conclusory of allegations that OAC "knew or should have known that Tremont's representations to its investors about Madoff were false." *See* CP 4 ¶ 10. However, FutureSelect's reliance on unsupported assumptions as to what due diligence OAC performed and what that due diligence must have uncovered with regard to Madoff's fraud is legally insufficient to show that OAC "had knowledge of the act which was being committed by its agent." *Mauch*, 56 Wn. App. at 316; *see Taylor v. Smith*, 13 Wn. App. 171, 177, 534 P.2d 39 (1975) (apparent authority exists where "the principal knowingly permits the agent to perform certain acts").

3. FutureSelect Failed to State a Control Person Claim Against OAC Under the Washington State Blue Sky Law

To state a Section 21.20.430(3) control person claim against OAC, FutureSelect had to adequately plead: (1) a predicate violation of RCW Section 21.20.010;[10] (2) that OAC "actually participated in (*i.e. exercised* control over) the operations of the corporation in general;" and (3) that OAC "possessed the power to control the specific transaction or activity upon which the primary violation is predicated." *Herrington v. David D.*

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10 As detailed in the Opening Brief of the Tremont Respondents, FutureSelect failed to plead a primary violation of Section 21.20.010.

Hawthorne, CPA, P.S., 111 Wn. App. 824, 836, 47 P.3d 567 (2002) (emphasis in original), *review denied,* 148 Wn.2d 1025 (2003). Complaints—such as FutureSelect's—premised on "bare legal conclusions [that are] devoid of any factual underpinnings" of "defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions" are insufficient to state a control person claim as a matter of law. *City of Westland Police & Fire Ret. Sys. v. Sonic Solutions*, No. C 07-05111, 2009 WL 942182, at *10 (N.D. Cal. Apr. 6, 2009).[11] Under these settled standards, FutureSelect failed to adequately plead any of the essential elements of its Section 21.20.430(3) claim against OAC.

a. FutureSelect Failed Adequately to Allege That OAC "Actually Participated" in Tremont's Operations

To properly plead "control" for purposes of its Section 21.20.430(3) claim, FutureSelect had to allege OAC's "power to direct or cause the direction of the management and policies of [Tremont], whether through the ownership of voting securities, by contract, or otherwise." *Fouad v. Isilon Sys., Inc.*, No. C07-1764, 2008 WL 5412397, at *11 (W.D.

[11] Washington courts look to Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a), and Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o, as "analogous federal law" when analyzing Section 21.20.430(3) control person claims. *Hines v. Data Line Sys., Inc.*, 114 Wn.2d 127, 135, 787 P.2d 8 (1990).

Wash. Dec. 29, 2008). FutureSelect's factual allegations again were cabined to a description of OAC's ownership of Tremont:

- OAC owned Tremont Group's stock and "provided extensive support services to Tremont, including compliance, audit, finance and human resources" (CP 17-18 ¶¶ 63-64);
- OAC and Tremont had some overlapping directors and some Tremont and non-party OFI (not OAC) employees overlapped (CP 18 ¶¶ 66-67, 70); and
- Tremont listed OAC as a "control person" on forms filed with the SEC (CP 19 ¶ 69).

As recently held by a court dismissing similar control person claims arising out of the Madoff fraud, none of these allegations—alone, or in combination—is sufficient to support a control person claim. In *Askenazy,* 2012 WL 440675, at *17, plaintiffs asserted control person claims against OAC[12] and MassMutual based on the same allegations as here, *i.e.*, on MassMutual's "status as a parent corporation, the listing of MassMutual as a 'control person' on Tremont Partners' SEC form, and some overlap of directors between MassMutual, Oppenheimer Acquisition, OppenheimerFunds, and Tremont." The court ruled that such allegations "[a]t most . . . show some potential to control Tremont and the Funds, but the potential to control is not sufficient." *Id.* FutureSelect's

[12] The *Askenazy* court dismissed OAC on jurisdictional grounds, but its reasoning in dismissing the control person claims against MassMutual is equally applicable to OAC here.

control person allegations, which substantively mirror those in *Askenazy*, likewise fail to adequately allege control by OAC.[13]

The *Askenazy* decision is well reasoned and consistent with numerous other decisions finding the same allegations FutureSelect relies on insufficient to state a control person claim. First, the mere fact that OAC "wholly owned" Tremont (CP 6 ¶ 19) and provided certain "support services" to its subsidiary (CP 18 ¶ 64) alleges only that OAC was Tremont Group's parent and does not suffice to plead actual control. *Fouad*, 2008 WL 5412397, at *11 ("conclusory allegations" of defendants' shareholder status insufficient to allege "participation in day-to-day affairs of the corporation and defendants' power to control corporate actions"); *Reese v. Malone*, No. C08-1008, 2009 WL 506820, at **10-11 (W.D. Wash. Feb. 27, 2009) (granting motion to dismiss because "conclusory allegation" that defendant was parent company and acted as "a controlling person" of subsidiary insufficient to establish control person claim).

Second, FutureSelect does not and cannot sufficiently allege control based on the allegations of certain board and employee overlap

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13 FutureSelect's attempt to distinguish *Askenazy* by arguing that OAC "directed and influenced the management of Tremont" (App. Br. at 33), fails due to FutureSelect's failure to allege any "*facts* from which it might reasonably be inferred that [OAC] 'actively participated in the decisionmaking processes' of Tremont." *Askenazy,* 2012 WL 440675, at *17 (emphasis added).

between OAC, OFI, and Tremont. CP 18-19 ¶¶ 66, 67, 70. "[I]t is entirely appropriate for directors of a parent corporation to serve as directors of its subsidiary, and that fact alone may not serve to expose the parent corporation to liability for its subsidiary's acts." *Bestfoods*, 524 U.S. at 69; *see also Fouad*, 2008 WL5412397, at *11 (allegations that defendants selected members of primary violator's board of directors insufficient to establish control person liability).

Third, FutureSelect's suggestion that "Tremont admitted MassMutual and Oppenheimer were control persons of Tremont in a public document" (App. Br. at 32) is a red herring. Pursuant to SEC disclosure rules, Tremont is required to file a Form ADV with the SEC identifying all direct owners of 5% or more of a class of voting securities and any indirect owners that own 25% or more of a class of voting securities of a direct owner, regardless of whether such entities exercised any control.[14] Tremont Partners' proper disclosure of OAC on its Form ADV as an indirect owner based solely on OAC's ownership interest in Tremont Group thus in no way reveals, or even suggests, that OAC exercised actual control for purposes of a control person claim. *See, e.g., Sedona Corp. v. Ladenburg Thalmann & Co.*, No. 03-3120, 2005 WL

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[14] *See* 15 U.S.C. §§ 80b-3, 80b-4; Form ADV, Uniform Application for Investment Adviser Registration, Item 10, Schedules A and B, *available at* http://www.sec.gov/about/forms/formadv.pdf.

1902780, at *16 (S.D.N.Y. Aug. 9, 2005) (allegation that "publicly-filed documents with the SEC indicate that [primary violators] are wholly-owned subsidiaries of defendant" insufficient to sustain a federal control person claim).

Were a Form ADV designation alone sufficient to state a control person claim, every parent company would be exposed to control person claims based on nothing more than its ownership of a subsidiary. No court has adopted such an absolute theory of liability, nor could such a rule be reconciled with the long-established principles of corporate separateness. Indeed, to allow a control person claim to survive merely on the basis of a parent/subsidiary relationship would violate the well established "general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation . . . is not liable for the acts of its subsidiaries." *Bestfoods*, 524 U.S. at 61.[15]

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[15] Even if OAC's ownership of Tremont Group somehow was adequate to demonstrate control, FutureSelect did not and cannot make the requisite allegation that OAC controlled Tremont Partners, i.e. the entity alleged to have made the misrepresentations at issue. CP 6 ¶¶ 19-20; *see Boilermakers Nat'l Annuity Trust Fund v. Wamu Mortg. Pass Through Certificates, Series AR1*, 748 F. Supp. 2d 1246, 1257 (W.D. Wash. 2010) (control person claim dismissed because plaintiff's allegations based on "virtue of [defendants'] control, ownership, offices, [or] directorship" were "circular and couched as conclusions of law").

b. FutureSelect Failed Adequately to Allege That OAC Had the Power to Control Tremont's Purported Misrepresentations and Due Diligence

Neither FutureSelect's Complaint nor its Opening Brief offers any support for FutureSelect's conclusory allegation that OAC "had the right to control Tremont such that they could have prevented Tremont from offering investments with Madoff." CP 18 ¶ 63; App. Br. at 33.

FutureSelect alleged that Tremont misrepresented that: (1) Tremont had conducted due diligence on Madoff; (2) Tremont was familiar with Madoff's operations, and was monitoring Madoff's transactions, internal controls, and operational risk; (3) the assets purportedly managed by Madoff on behalf of the Rye Funds existed and were appreciating; and (4) the trades Madoff purported to be making on behalf of the Rye Funds occurred. *See* CP 30 ¶ 124. However, FutureSelect's inability to allege a single fact suggesting that OAC had the power to control any of these alleged misrepresentations is fatal to FutureSelect's control person claim against OAC. *See Swartz v. Deutsche Bank*, No. C03-1252, 2008 WL 1968948, at *20 (W.D. Wash. May 2) (dismissing control person claim premised on "general (and factually unsupported) conclusion that [defendant] controlled primary violator" because primary violators were "merely shell companies, owned, operated and controlled by [defendant]"), *subsequent determination sub nom.*, *Swartz v. Presidio Advisory Grp.*, C03-1252, 2008 WL 2545054 (W.D. Wash. June 24, 2008).

Nor did (or could) FutureSelect allege that OAC controlled Tremont's alleged misrepresentations because—as FutureSelect now concedes—the alleged misrepresentations that FutureSelect relied upon in electing to purchase its interests in the Rye Funds occurred more than three years <u>before</u> OAC acquired Tremont. CP 9-10 ¶¶ 34-37; *Richard v. NW Pipe Co.*, No. 09-5724, 2011 WL 3813073 (W.D. Wash. Aug. 26, 2011) (alleged control person not liable for events prior to employment by primary violator). FutureSelect cannot explain how OAC controlled misrepresentations pre-dating its ownership of Tremont, and it therefore is patently implausible for OAC to have had "control over the very solicitation of FutureSelect to invest in Madoff," as FutureSelect asserts. App. Br. at 33; *see Tumelson Family Ltd. P'ship v. World Fin. News Network*, No. 05-35813, 2007 WL 650329, at *1 (9th Cir. Feb. 28, 2007) (determining defendant not a control person under Washington state securities law where "there was no evidence that Defendant [] played any role whatsoever in the day-to-day operations . . . when Plaintiffs made their investment decisions"); *see* Ninth Circuit Rule 36-3.

VII. CONCLUSION

For the foregoing reasons, the Superior Court properly dismissed the Complaint as against OAC with prejudice because (1) OAC is not subject to personal jurisdiction in Washington and (2) as a matter of law, FutureSelect did not state any cognizable claim against OAC.

RESPECTFULLY SUBMITTED this 16th day of May, 2012.

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Superior Court of Massachusetts,
Suffolk County.
Dorothy ASKENAZY & others,[FN1] Plaintiffs,

FN1. Philip Askenazy; Richard Askenazy; Samuel Askenazy Revocable Trust; Beggs & Cobb Corporation; Kenneth Conway; William Gallagher III; Nanci Gelb; Margaret Griner; John Keane; Maureen Meister; Chet Opalka; Karen Opalka; Monomoy Investments Limited Partnership; the Chester J. Opalka, Jr. Trusts; John Palmer; Karen Anderson Palmer; Peter Roberts; Patrick Roche; Diana Rockefeller; Bedford Clay LLC; Todd Ruderman; James Schamus; Ivy Street Investment Co., LLC; Rachel Seelig; Eileen Silvers; and Kenneth Weiss.

v.
TREMONT GROUP HOLDINGS, INC., & others,[FN2] Defendants.

FN2. Tremont Group Holdings, Inc.; Tremont Partners, Inc.; Rye Select Broad Market Prime Fund, L.P.; Rye Select Broad Market XL Fund, L.P.; KPMG LLP; Oppenheimer Acquisition Corporation; Massachusetts Mutual Life Insurance Company; and MassMutual Holding LLC.

Civil Action No. 2010–04801–BLS2.
Jan. 26, 2012.

MEMORANDUM OF DECISION AND ORDER ON MOTIONS TO DISMISS

JANET L. SANDERS, Justice.

***1** This action arises in the aftermath of the criminal conduct of Bernard Madoff, who in December 2008 admitted to operating the largest Ponzi scheme in United States history. The plaintiffs allege the loss of millions of dollars they invested in two Madoff "feeder funds," hedge funds whose assets were invested almost exclusively with Madoff and his investment advisory firm. The plaintiffs' Second Amended Complaint (the Complaint) asserts twenty-three counts variously against the two hedge funds; the corporate general partner of both funds; the corporate parent, grandparent, great-grandparent, and great-great-grandparent of the general partner; and the independent auditor of the funds. The Complaint alleges claims for fraudulent securities transactions under the laws of several states, fraud in the inducement, negligent misrepresentation, breach of fiduciary duty, violation of G.L.c. 93A, §§ 9 and 11, aiding and abetting breach of fiduciary duty, aiding and abetting fraud, and professional malpractice. The plaintiffs seek unspecified damages, costs, fees, and other relief.

The action comes before this Court on four separate motions to dismiss; the funds' auditor also moves in the alternative to compel arbitration of the claims against it. After careful review of all the materials submitted by the parties, this Court (1) ***Allows*** the motion filed by Oppenheimer Acquisition Corporation, (2) ***Allows*** the motion filed by Massachusetts Mutual Life Insurance Company and MassMutual Holding LLC, and (3) ***Allows*** in part and ***Denies*** in part each of the other three motions. The reasons for these rulings follow.

BACKGROUND

This Court begins by summarizing the allegations in the Complaint, reserving certain details for later discussion in connection with the issues raised. [FN3]

FN3. The Complaint itself is extraordinary in its length, totaling 944 pages. Although this Court is tempted to take defendants up on their suggestion to dismiss this case outright because the Complaint does not comply with Rule 8, requiring a "short and plain statement," this will only delay the case more.

On December 11, 2008, the United States Department of Justice announced that Bernard L. Madoff, founder of investment advisory firm Bernard L. Madoff Investment Securities LLC (BLMIS) and former chairman of the NASDAQ stock market, had been arrested and charged with securities fraud. According to the Justice Department announcement, Madoff admitted that it was "all just one big lie" and that his investment advisory business was basically "a giant Ponzi scheme." Rather than investing clients' money in shares of common stock, options, and other securities as he had represented, Madoff used funds from new investors to pay the prior investors. In later pleading guilty to securities fraud violations and other federal crimes, Madoff acknowledged that since at least the early 1990s, he had not actually purchased any securities with his clients' investments but instead had simply deposited the money into an account at Chase Manhattan Bank which he used to pay redemptions. To sustain his scheme, Madoff generated fraudulent client statements and other documents and maintained his operations in secrecy, providing very little access to investors. Sources revealed that Madoff and his firm had more than $17 billion in assets under management as of the beginning of 2008. Madoff himself estimated that his fraud caused losses of approximately $50 billion.

***2** The plaintiffs are twenty-seven individuals and entities that invested in one of two hedge funds: defendant Rye Select Broad Market Prime Fund, L.P., (Rye Prime Fund) and defendant Rye Select Broad Market XL Fund, L.P., (Rye XL Fund) (collectively with the Rye Select Broad Market Fund, L.P., the Rye Funds or the Funds). The Rye Funds served as Madoff "feeder funds"; nearly all the assets of each fund were invested with Madoff and BLMIS. One month after Madoff's arrest and the disclosure of his fraudulent scheme, the plaintiffs and other investors were informed that the Rye Funds had lost substantially all their value and that there appeared "no prospect for meaningful recovery of those assets."

Each of the Rye Funds was formed as a Delaware limited partnership in which defendant Tremont Partners, Inc. (Tremont Partners) was the general partner. Tremont Partners as general partner had the sole authority over the investments made by the Rye Funds and the selection of any investment advisor used by the Funds. Tremont Partners selected Madoff and BLMIS, using them as the Funds' investment advisor, custodian, and broker/dealer.

Tremont Partners is an investment management firm with offices in Rye, New York. Its corporate parent, also located in Rye, is defendant Tremont Group Holdings, Inc., (Tremont Group Holdings) (collectively with Tremont Partners, Tremont). Tremont Partners is operated by Tremont Group Holdings through a division called Rye Investment Management. Although Tremont Partners as the general partner was responsible for the day-to-day administration and operation of each partnership, Tremont Group Holdings also used Rye Investment Management to manage the Rye Funds. In certain respects, Tremont Group Holdings treated Rye Investment Management and Tremont Partners as interchangeable. The plaintiffs allege that Tremont Partners and Tremont Group Holdings were collectively responsible for the solicitation, sale, operation, and management of the Rye Funds.

The plaintiffs began investing in the Rye Funds in 2006, almost all of them in consultation with their investment advisor, LongVue Advisors, LLC, (LongVue). Many of the plaintiffs are residents of the Commonwealth of Massachusetts, and LongVue is a Massachusetts-based investment advisory firm. LongVue had been approached years before to discuss possible investments by the plaintiffs with Tremont. In 2006, Tremont solicited a meeting with LongVue at which Tremont specifically suggested to LongVue that its clients (including the plaintiffs), consider investing with Madoff and BLMIS via the Rye Funds.

To make this investment, each of LongVue's clients was offered a limited partnership interest in the Rye Funds through a Confidential Private Placement Memorandum (PPM). The Rye Fund PPMs contained specific representations that led the plaintiffs to believe that: a) Tremont Partners, as general partner, carefully selected the investment advisor for each partnership using designated criteria; b) Tremont and the Rye Funds actively monitored the selected advisor, the advisor's trading activity, and the securities in which the Funds invested; c) Tremont and the Funds regularly monitored fund assets through, among other means, producing audited financial statements for the limited partners; and d) the Rye XL Fund engaged in a diversified investment strategy. None of the PPMs for the Rye Funds disclosed that the majority of the Funds' assets were invested with Madoff. Nor did the PPMs disclose that Madoff and BLMIS were fulfilling three roles generally filled by three separate companies: Madoff was the investment advisor, and BLMIS was both the custodian for the Rye Funds' account and the broker/dealer for the trades that were purportedly made on the Funds' behalf. Tremont and the Rye Funds knew that having related parties perform all three functions was a substantial material risk, but did not disclose that risk to the plaintiffs.

***3** In making their initial investments, the plaintiffs also relied upon the most recent annual fact sheet for the fund in which they invested. Among other things, each fund's fact sheet explained the "split-strike conversion" (or "split-strike synthetic conversion") investment strategy which Madoff claimed to follow, and illustrated the particular fund's purported historic performance. The fact sheets stated that the respective fund had experienced "years of consistent positive returns" and adhered to "defined risk and return parameters." They further stated that Tremont Partners allocated the Funds' investment portfolios to advisors with "conservative investment styles" who demonstrated over time and under all economic and market conditions the ability to achieve consistent returns. In addition to the fact sheets, each plaintiff received monthly capital account reports, relying on Tremont to provide accurate information. Those reports purported to show a significant and steady return on investment with low volatility.

Before LongVue recommended investing in the Rye Funds in 2006, representatives from LongVue met with representatives from Tremont, and LongVue conducted due diligence on Tremont and the Rye Funds. During those meetings, Tremont offered specific assurances about Madoff and BLMIS. For instance, when LongVue expressed skepticism regarding Madoff's consistently low volatility, Tremont stated that it "had access to [Madoff and BLMIS] that no one else had" and that Tremont received paper trade confirmations from Madoff by which it could confirm that his trades were real.[FN4] In responding to LongVue's concern that Madoff "self-custodied" the Rye Funds' assets, Tremont represented that Madoff did not use an independent custodian because doing so would make the details of his proprietary investment strategy more widely known. When LongVue inquired why Madoff appeared to engage in the unusual practice of selling off his investments in order to report only a cash balance at the end of each quarter, Tremont represented that Madoff did so to protect his investments from quarter and year-end volatility.

> FN4. Throughout the years the plaintiffs invested in the Rye Funds, LongVue's Chief Investment Officer had numerous conversations with a Tremont representative who stated that Tremont "verified" the trades which Madoff reported against independent market data. At certain times, in response to LongVue's requests, Tremont provided what it purported to be confirmations of some of Madoff's trades.

In addition to these assurances, Tremont furnished to LongVue documents and other materials, including a completed due diligence questionnaire. This questionnaire represented that Tremont had invested tens of millions of dollars in the Rye Funds, described Madoff's purported investment strategy, and stated that, although Madoff had full discretion over the trading of the Rye Prime Fund, Tremont Partners had reviewed each of the trades to ensure that Madoff did not deviate from the Fund's stated investment strategy. Moreover, both before recommending that the plaintiffs invest in the Rye Funds and roughly every month thereafter, Tremont provided LongVue with detailed information regarding the Funds' purported holdings and performance. Through multiple PowerPoint representations, marketing materials for the Rye Funds and on its own website, Tremont represented that it reviewed investment managers' analytical processes and financial models, carefully scrutinized investments for risk allocation, and closely monitored individual managers by making quarterly calls and onsite visits.

***4** The Rye Fund PPMs stated that the annual reports for the Funds were audited by an independent certified public accountant. Since 2004, defendant KPMG LLP (KPMG) served as the Funds' auditor and performed annual audits of the plaintiffs' investments. Specifically, KPMG audited the Rye Funds' financial statements, schedules of investments, statements of operations, year-end cash flows, and changes in the limited partners' capital accounts. Each annual report for the Rye Funds was addressed to "The Partners" of the respective fund, which included the plaintiffs. The reports stated that KPMG had performed its audits in accordance with generally accepted auditing principles, which required that KPMG be reasonably assured that financial statements were free of any material misstatement. The reports also stated that KPMG's audits "include [d] examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by the General Partner, as well as evaluating the overall financial statement presentation." KPMG expressed an unqualified opinion that each fund's financial statements fairly presented the financial position of the fund at year's end, the results of its operations, and its cash flows.

In addition to its audits, KPMG annually prepared individual Form K–1 tax statements for each plaintiff using information from its audits. Because the Rye Funds were "pass through" tax entities with no independently taxable income, the profits and losses of the Funds were allocated to the partners in accordance with the distributive share of each partner. The Rye Funds did not pay taxes on profits nor offset against losses allocated to the capital accounts. Rather, each individual partner paid taxes on the profits allocated to the partner's particular capital account and could offset other taxable income with losses allocated to such capital account. The Form K–1 statements reported yearly individual profits or losses to each partner, and the plaintiffs relied upon representations made by KPMG in the Form K–1 statements in paying taxes on their capital accounts and in managing their investments. The Form K–1 statements identified taxable income associated with each plaintiff's capital account, certifying to each plaintiff that real investment income was earned for each account. The plaintiffs allege that KPMG knew and intended that its audits and K–1 tax statements would be provided to the plaintiffs, who subsequently relied upon them in making investment decisions and calculating individual tax liabilities.

In the days following Madoff's arrest in December 2008, the United States Securities and Exchange Commission (SEC or the Commission) initiated an investigation regarding Madoff going back to at least 1999. In a 457 page report released August 31, 2009 (the SEC Report), the SEC Office of Investigations catalogued the numerous "red flags" that could have led investment professionals and their auditors to uncover Madoff's fraud—and in fact did lead other feeder funds to decide not to invest with Madoff.[FN5] Those "red flags" included the implausibility of Madoff's years of consistently positive, low volatility returns that others in the industry could not replicate, as well as the atypical structure and operation of Madoff's business. As to the latter, the SEC and others in the financial world noted: (a) the lack of segregation among service providers, (b) the use of an obscure, unqualified auditor, (c) the use of an unusual fee structure that resulted in Madoff foregoing millions of dollars of fees, (d) the employment of numerous family members for key control positions, (e) Madoff's insistence on secrecy about his operations, (f) the insufficient staff he used given the reported amount of assets under management, (g) his failure to register with the SEC, (h) the use of outdated, unsophisticated customer account information; and (i) the location of BLMIS's comptroller. The SEC Report noted that the Madoff's investment results were particularly difficult to analyze or explain through quantitative analysis.

FN5. For example, in 2000, Credit Suisse warned its clients to pull their investments from Madoff due to their suspicions concerning his operations. In 2003, Société Générale similarly discouraged their clients from investing with Madoff. In 2007, hedge fund investment adviser Aksia LLC gave its clients the same advice.

***5** Well before Madoff's revelations in 2008, several press articles raised questions about the legitimacy of his activities. These included the May 2001 article appearing in *MAR/Hedge,* a semi-monthly newsletter that reported on the hedge fund industry and was widely read by hedge fund managers. In that article, author Michael Ocrant wrote that Madoff had reported consistently positive results for the last eleven years and that a number of industry experts had questioned the consistency of the results. Ocrant reported that Madoff refused to provide details on how the firm managed risk, saying, "I'm not interested in educating the world on our strategy.... The strategy is the strategy and the returns are the returns."

The instant action was commenced on December 10, 2010. The complaint named as defendants the Rye Funds, Tremont Partners, Tremont Group Holdings, and KPMG, in addition to three upstream parent corporations of Tremont Group Holdings: defendants Oppenheimer Acquisition Corporation (Oppenheimer Acquisition), MassMutual Holding LLC (MassMutual Holding), and Massachusetts Mutual Life Insurance Company (MassMutual Life Insurance, or collectively with MassMutual Holding, MassMutual). Tremont Group Holdings is a wholly-owned subsidiary of Oppenheimer Acquisition, which itself is a subsidiary MassMutual Holding, which in turn is a subsidiary of MassMutual Life Insurance. The plaintiffs allege in conclusory fashion that, through Tremont, Oppenheimer Acquisition and MassMutual were involved in and had oversight of the solicitation, sale, operation and management of the Rye Funds.

Oppenheimer Acquisition—the parent of OppenheimerFunds, Inc., (OppenheimerFunds), acquired Tremont Group Holdings (then known as Tremont Advisers, Inc.) in 2001. At the time, Oppenheimer Acquisition and its parent corporations were interested in allowing their investors greater access to alternative investments, including hedge funds and funds of multiple hedge funds. As one of the early pioneers in the "fund of funds" sector, Tremont was an attractive target, and, according to the Complaint, Tremont's access to Madoff was one of its most critical selling points. Tremont was also an attractive acquisition because of the revenue stream it generated through fees assessed on the investments made by investors in the Rye Funds. At the time it was approached, Tremont claimed to have been growing at a rate of thirty percent annually for three consecutive years—growth that Tremont attributed to investor fees. Tremont also stood to benefit from the proposed acquisition. Among other things, the deal promised to give Tremont the opportunity to market its products and services through MassMutual Financial Group's extensive global distribution network and would allow Tremont to operate with the imprimatur of the familiar and well-established OppenheimerFunds and MassMutual names.

Oppenheimer Acquisition conducted months of extensive due diligence into Tremont during the parties' negotiations. This due diligence included review of materials maintained in Tremont's data room and focused in large part on Tremont's business with Madoff and BLMIS, as well as Madoff's investment strategy and the overall nature of BLMIS's operations. The data room housed an extensive group of materials including legal contracts, corporate documents, regulatory filings, audited and unaudited financial statements, and tax returns. On October 1, 2001, the acquisition deal closed, making Tremont a wholly-owned, direct subsidiary of Oppenheimer Acquisition and bringing Tremont's operations, including the Rye Funds, under the MassMutual corporate umbrella. Since that point, MassMutual, Oppenheimer Aquisition, and OppenheimerFunds have been listed as "control persons" of Tremont on Tremont Partners' Uniform Application for Investment Advisors Registration filed with the SEC.

***6** At and after the time of the acquisition, the companies and/or their affiliates shared a number of senior executives and directors. For example, each member of the restructured board of directors of Tremont Advisers, Inc., had direct ties to MassMutual and/or to an entity affiliated with Oppenheimer Acquisition. In addition, executives at MassMutual Life Insurance and OppenheimerFunds served on Oppenheimer Acquisition's board of directors, executives of Oppenheimer Acquisition held executive positions with MassMutual Life Insurance and OppenheimerFunds, and certain executives at MassMutual Life Insurance served as board members and/or executives at MassMutual Holding. Further, there were individuals employed by OppenheimerFunds who also served in management positions within Tremont Partners.

According to the Complaint, Tremont and the Rye Funds have been held out as being a part of the MassMutual network of subsidiaries and affiliates since 2001. For example, in MassMutual Life Insurance's 2002 and 2003 Annual Reports, Tremont's funds are specifically referenced in connection with OppenheimerFunds' performance. In its 2005 report, MassMutual Life Insurance listed Tremont Capital Management Ltd. (formerly Tremont Advisers, Inc.) as one of its "General Agencies and Other Offices" and named Tremont Group itself as one of its "General Agencies and Other Offices" in Annual Reports for 2006, 2007, and 2008.

When Tremont's acquisition was announced, senior executives at both Tremont and OppenheimerFunds publically underscored the benefits the companies anticipated from their future relationship. Since then, Oppenheimer entities have been involved with the marketing of Tremont's capabilities. For instance, there have been jointly-launched new funds with names that reflect the ownership of and connection to Tremont, including the "Oppenheimer Tremont Market Neutral Fund LLC" and the "Oppenheimer Tremont Opportunity Fund LLC." Tremont Partners served as investment adviser and OppenheimerFunds handled fund distribution. Over the years, that family of joint funds has continued to grow such that, in its Uniform Application for Investment Adviser Registration dated March 31, 2006, Tremont Partners stated that it was the sub-advisor or investment manager for several funds which OppenheimerFunds advised. In addition, the plaintiffs allege, Tremont, with the knowledge and approval of its parent companies, marketed itself as being related to those established companies in order to attract investors to the Rye Funds. For example, following the acquisition, the phrase, "An OppenheimerFunds Company," began to appear on Tremont's stationery, publications and marketing materials.

DISCUSSION

Defendants Tremont, the Rye Funds, and Oppenheimer Acquisition each have moved to dismiss the Complaint against them pursuant to Rule 12(b)(2) on the grounds that this Court lacks personal jurisdiction over them.FN6 They—together with defendant MassMutual—have also moved to dismiss the Complaint under Rule 12(b)(6) for several different reasons, each of which will be discussed separately below. Finally, defendant KPMG has moved to dismiss or in the alternative to compel arbitration. This Court deals with the 12(b)(2) motions first, since resolution of those motions may render any other issues moot.

FN6. The Complaint asserts the same counts against Tremont as against the Rye Funds. At least for purposes of the current motions, the Rye Funds have adopted the arguments made by Tremont, and the plaintiffs have submitted identical opposition memoranda, so this Court will not attempt to distinguish between these defendants in this decision.

1. *Personal Jurisdiction* (Tremont and Oppenheimer Acquisition)

*7 Because the Tremont defendants are foreign corporations, personal jurisdiction over them is only permissible where (i) the assertion of jurisdiction is authorized by statute, and (ii) exercise of jurisdiction under state law is consistent with basic due process requirements. See *Good Hope Indus., Inc. v. Ryder Scott Co.,* 378 Mass. 1, 5–6 (1979); *Caplan v. Donovan,* 450 Mass. 463, 465 (2008). Tremont concedes that this Court has jurisdiction as to those claims made by the plaintiffs who are Massachusetts residents. It argues, however, that those plaintiffs who do not reside in this state cannot show a sufficient nexus between their claims and Tremont's Massachusetts contacts. In determining whether these plaintiffs have made a sufficient showing, this Court takes as true the allegations of the Complaint, construing them in the light most favorable to the plaintiffs' jurisdictional claim and adding to the mix facts put forward by the defendants to the extent that they are uncontradicted. *Massachusetts Sch. of Law at Andover, Inc. v. American Bar Assn.,* 142 F.3d 26, 34 (1st Cir.1998). Applying this standard, the Court concludes that it has personal jurisdiction over the claims asserted against Tremont by the nonresident plaintiffs.

The plaintiffs rely on the Massachusetts long-arm statute, G.L.c. 223A, § 3(a), which permits a court to exercise jurisdiction over any person who transacts business in this Commonwealth, *provided that* the plaintiff's claim arose from those forum-based contacts. *Connecticut Nat'l Bank v. Hoover Treated Wood Prods., Inc.,* 37 Mass.App.Ct. 231, 233 n. 6 (1994). Here, the Complaint adequately alleges that Tremont transacted business in the Commonwealth. Specifically, it states that Tremont approached LongVue, a Massachusetts-based investment advisor, to obtain business from it, solicited meetings with and sent marketing materials to LongVue in repeated efforts to pitch investment opportunities, and sent LongVue frequent reports about the Rye Funds' performance. The "transacting any business" clause has been construed broadly, *Heins v. Wilhelm Loh Wetzlar Optical Mach. GmbH & Co. KG.,* 26 Mass.App.Ct. 14, 17 (1988), and may be satisfied by purposeful solicitation of business in Massachusetts by a nonresident defendant, e.g., *Gunner v. Elmwood Dodge, Inc.,* 24 Mass.App.Ct. 96, 99–101 (1987). See *Tatro v. Manor Care, Inc.,* 416 Mass. 763, 767–768 (1994). The Complaint alleges facts sufficient to show precisely that.

This Court also concludes that the allegations in the Complaint are sufficient to show that the nonresident plaintiffs' claims *arose from* Tremont's transaction of business in Massachusetts. The Supreme Judicial Court has construed the "arising from" language in subsection 3(a) of the long-arm statute to create a "but for" test, which is satisfied if the plaintiff's claim "was made possible by, or lies in the wake of, the transaction of business in the forum State." *Tatro v. Manor Care, Inc.,* 416 Mass. at 770–771. Here, where apparently all the nonresident plaintiffs invested in the Rye Funds in consultation with LongVue, their claims lie "in the wake of" Tremont's transaction of business here: but for the alleged misrepresentations by Tremont and the Rye Funds in their communications with LongVue and in the marketing, due diligence, and fund performance materials that the Tremont defendants sent to LongVue, the nonresident plaintiffs would not have invested in those Funds. FN7

FN7. This Court notes that the plaintiffs did not specifically allege in the Complaint but have only represented in their memorandum that all the nonresident plaintiffs invested through LongVue. Should that representation not be borne out by discovery, the personal jurisdiction question could be ripe for summary adjudication.

***8** Finally, this Court concludes that the exercise of jurisdiction over Tremont is consistent with due process. Here, the touchstone of the determination is whether the defendant "purposefully established 'minimum contacts' in the forum state." *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 474 (1985), quoting *International Shoe Co. v. Washington,* 326 U.S. 310, 316 (1945); *Tatro v. Manor Care, Inc.,* 416 Mass. at 772. If the plaintiff's claim arises out of the defendant's contacts within the forum and those contacts consist of acts which suggest that the defendant has purposefully availed itself of the privilege of conducting business in the forum state so as to invoke the benefits and protections of its laws, then the assertion of jurisdiction is constitutional. See *Bulldog Investors Gen. Partnership v. Secretary of the Commonwealth,* 457 Mass. 210, 217–218 (2010). Here, the Complaint alleges that Tremont sought to expand the market for the Funds by soliciting clients in Massachusetts, either directly or through a Massachusetts-based investment advisory firm. Moreover, these marketing efforts were not isolated or transitory: Tremont reached out from New York to create continuing relationships with clients in Massachusetts through LongVue. In this Court's view, this level of solicitation satisfies due process concerns.

This Court reaches the opposite conclusion, however, with respect to Oppenheimer Acquisition, also a foreign corporation: the plaintiffs have failed to allege facts sufficient to show jurisdiction is either statutorily authorized or constitutionally appropriate, particularly in the face of submissions by the defendant, which reveal the following.[FN8] Oppenheimer Acquisition is a Delaware corporation with a principal place of business in New York. It is a parent company to two entities: Tremont Group Holdings and OppenheimerFunds. Oppenheimer Acquisition has no offices or employees in Massachusetts, and it holds no licenses here or elsewhere. It does no business in Massachusetts and is not qualified as a foreign corporation in this state. Oppenheimer Acquisition does not rent or own real property in Massachusetts or elsewhere, nor does it have any bank accounts here. It has never promoted, marketed, advertised, or sold any products in this state or elsewhere, nor has it ever directed either of its subsidiaries to do so. Oppenheimer Acquisition has no registered agent in Massachusetts and was not served with the summons or complaint for this action within the Commonwealth. Given this factual constellation, there is no basis to conclude that Oppenheimer Acquisition transacts business in Massachusetts, much less that the plaintiffs' claims must have arisen from those forum-based contacts.

FN8. In support of its motion to dismiss under Rule 12(b)(2), Oppenheimer Acquisition has submitted the Affidavit of Robert G. Zack, the Vice President, Secretary, and General Counsel of Oppenheimer Acquisition.

The plaintiffs offer two theories in support of an assertion of personal jurisdiction over Oppenheimer Acquisition, each of them based on the in-state activities of Tremont.[FN9] First, the plaintiffs contend that, because Tremont is the wholly owned subsidiary of Oppenheimer Acquisition and the Complaint alleges generally that the latter exercised some control over Tremont, Tremont's in-state activities should be imputed to Oppenheimer Acquisition for purposes of personal jurisdiction. Under Massachusetts law, however, that is permissible only upon a showing tantamount to what is necessary to pierce the corporate veil: the subsidiary's activities would be enough to establish jurisdiction over the out of state parent only where there was "*significant* exercise of control" by the parent over the subsidiary, or where there is a "*significant* intermingling of officers and directors ." See *Kleinerman v. Morse,* 26 Mass.App.Ct. 819, 823 (1989) (italics added). Ownership of all the controlling stock is not enough nor is the fact that the two entities have common officers and directors. In the instant case, the plaintiffs have failed to show anything more than a relatively meager involvement by Oppenheimer Acquisition in Tremont's affairs.

FN9. In addition to these two theories, the plaintiffs make two other unpersuasive arguments on pages 8–9 of their memorandum. First, they argue that Oppenheimer Acquisition assisted Tremont in marketing the Rye Funds and soliciting investments in Massachusetts, but they fail to cite non-conclusory factual allegations specific to Oppenheimer Aquisition to support that argument. The plaintiffs similarly fail to support their argument that Oppenheimer Acquisition aided and abetted the misrepresentations alleged to have induced the plaintiffs to invest in the Rye Funds.

***9** Second, the plaintiffs contend that Tremont's jurisdictional contacts should be imputed to Oppenheimer Acquisition because of its "controlling person" status over Tremont, including the fact that since 2001, Tremont Partners listed Oppenheimer Acquisition as a "control person" in its SEC filings. Even assuming that a viable claim of "control person" liability has been alleged against Oppenheimer Acquisition, this Court is not persuaded that statutory liability can itself be enough to establish personal jurisdiction. As the majority of state and federal courts have recognized when presented with essentially the same argument as the plaintiffs make here, substantive liability for purposes of the securities law "is not to be conflated with amenability to suit in a particular forum," *AT & T Co. v. Compagnie Bruxelles Lambert,* 94 F.3d 586, 591 (9th Cir.1996); see, e.g., *MFS Series Trust III v. Grainger,* 96 P.3d 927, 933–934 (Utah 2004). That is because personal jurisdiction has constitutional dimensions, protecting nonresident defendants from being haled into distant courts even where the legislature has made a determination that they should be held substantively responsible for the activities of their in-state subsidiary. The two inquiries are distinct, such that "control persons" liability under the securities law is simply "not germane to the issue of personal jurisdiction." See *City of Monroe Employees Retirement Sys. v. Bridgestone Corp.,* 399 F.3d 651, 667–668 (6th Cir.2005), quoting *FDIC v. Milken,* 781 F.Supp. 226, 234 (S.D.N.Y.1991).

2. *Standing* (Tremont, MassMutual, and KPMG)

In support of their motions under Rule 12(b)(6), Tremont, MassMutual, and KPMG each argues that the plaintiffs lack standing to make certain claims because they are derivative: that is, they are actually claims that belong to the entities of which the plaintiffs are limited partners (the Rye Funds) and cannot be asserted without a demand upon the partnership to bring suit or a showing by the plaintiffs that such demand is excused. In opposition, the plaintiffs maintain that their claims are not derivative. This Court concludes that some of the claims to which the defendant' motions are addressed are in fact derivative in nature and must be dismissed.

The parties agree that, because the Rye Funds were organized as Delaware partnerships, this Court should apply Delaware law to this issue. The parties further agree that this Court may determine whether the claims here are derivative or direct by answering two questions: 1) who suffered the alleged harm; and 2) who would receive the benefit of any recovery or other remedy? *Tooley v. Donaldson, Lufkin & Jenrette, Inc.,* 845 A.2d 1031, 1033, 1035 (Del.2004) (*Tooley*). If the partnership alone suffered the harm for which the plaintiffs seek compensation, then it is the partnership (i.e. the Rye Funds) which is entitled to recover, and the claim is derivative. Conversely, if the plaintiffs suffered some harm independent of any injury to the Rye Funds, then individualized recovery is warranted so the cause of action is direct. Tremont and MassMutual argue that, under the *Tooley* analysis, the plaintiffs' claims alleging breach of fiduciary duty and aiding and abetting breach of fiduciary duty must be dismissed as derivative; KPMG contends that all claims alleged against it should be dismissed as derivative in nature or in the alternative, must be arbitrated.

***10** With respect to the counts asserting claims for breach of fiduciary duty (Count XII) and aiding and abetting breach of fiduciary duty (Counts XVIII–XX), this Court agrees with the defendants that these claims are derivative in nature. As alleged in the Complaint, the plaintiffs' fiduciary duty claims arise from Tremont's alleged mismanagement of the Rye Fund partnerships through inadequate due diligence, imprudent investing, and otherwise improper day-to-day partnership operation. As other courts presented with similar Madoff-related allegations have held, a claim for deficient management or administration of a fund is "a paradigmatic derivative claim" under Delaware law. *Saltz v. First Frontier, LP,* 782 F.Supp.2d 61, 79 (S.D.N.Y.2010), quoting *Albert v. Alex. Brown Mgt. Servs., Inc.,* Nos. 762–N, 763–N, 2005 WL 2130607, at *12–13 (Del. Ch. Aug. 16, 2005), and citing *Litman v. Prudential–Bache Props., Inc.,* 611 A.2d 12, 15–16 (Del. Ch.1992) (holding claim to be derivative where the "gist of plaintiffs' complaint is that the general partners breached their fiduciary duties by inadequately investigating and monitoring investments and by placing their interests in fees above the interests of the limited partners"); see also Newman v. Family Mgt. Corp., 748 F.Supp.2d 299, 315 (S.D.N.Y.2010); Stephenson v. Citco Group Ltd.; 700 F.Supp.2d 599, 610 (S.D.N .Y.2010). The harm alleged by these claims was suffered directly by the Rye Fund partnerships and only indirectly experienced by the limited partners, whose interests declined in value as a result of the damages inflicted on the partnership itself. The Rye Fund partnerships would thus properly receive the benefit of any recovery or other remedy. Without a demand on the partnerships to brings these claims (or a showing that such demand was excused), they must be dismissed.

The plaintiffs argue that these claims may nonetheless be pleaded as direct under the reasoning of Anglo American Securities Fund, L .P. v. S.R. Global International Fund, L.P., 829 A.2d 143, 151 (Del. Ch.2003) (*Anglo American*). That case is distinguishable, however. In the *Anglo American* case, the plaintiffs were former partners, so that treating their claims as derivative would mean that any recovery by the partnership would benefit only those partners who joined the fund *after* the harm occurred. It would provide no relief to those who were actually harmed by the misconduct. Here, none of the plaintiffs is alleged to be a former partner who would be deprived of any recovery, and there is no possibility of a windfall to partners that join after the harm occurred.

Turning to the other counts asserted in the Complaint against KPMG (which does not limit its argument to the fiduciary duty claims) this Court concludes that they are claims that may be directly prosecuted by the individual plaintiffs. Certain of those claims are for negligence and misrepresentation: specifically, the plaintiffs allege that, as a result of KPMG's misstatements and professional incompetence, they were induced to invest in the Rye Funds, to stay invested, and in some cases to make additional investments in the Funds. As such, these claims describe individualized harm independent of harm to the partnership, and rest on a duty to each plaintiff that is not merely derivative of KPMG's fiduciary duties as the Rye Funds' auditor. This was precisely the conclusion the court reached in *Stephenson v. Citco Group Ltd., supra,* where the plaintiffs were limited partners in a fund called Greenwood Sentry that invested most of its assets with Madoff. Contrasting the claims of negligence and fraud with those alleging breach of fiduciary duty, the court noted that the former would turn on proof that individual plaintiffs were actually induced at a particular point in time into investing in the fund (or increasing their investment) as a direct result of the auditor's misrepresentations. It therefore involved a particular subset of the limited partnership and did not involved a harm to the partnership which would affect all of its limited partners in proportion to their ownership interest.

***11** Those claims made against KPMG that seek recover of losses sustained by the plaintiffs as a result of paying taxes on "phantom income" are also direct and not derivative. These claims rest on the fact that the Rye Funds were pass-through tax entities, so the profits and losses of the Funds were allocated to the individual partners. The plaintiffs allege that, as a result of false information provided to them by KPMG in their Form K–1 tax statements, they each paid taxes on income which did not exist. Because the Rye Funds themselves did not pay taxes, these tax related losses are necessarily individual. See, e.g., Little v.. Cook, 274 Va. 697, 708–712 (2007) (reversing a lower court's award on "tax damages" claim improperly asserted as a derivative action, since the partnership did not sustain the injury, only the limited partners).

This Court's conclusion that some of the plaintiffs' claims against KPMG are direct and not derivative also compels the conclusion that KPMG's motion to compel arbitration of these claims must be denied. That motion is based on an arbitration clause in the Engagement Agreement between KPMG and the Rye Funds. It is undisputed that this clause applies only to those claims by the Funds' limited partners which are derivative in nature. In a footnote of its memorandum, KPMG argues that even the plaintiffs' direct claims fall within the scope of the arbitration clause because they somehow arise from the Engagement Agreement. This Court finds this argument entirely unpersuasive. Nothing suggests that the plaintiffs expressly assented to the Engagement Agreement or its arbitration provision, and none of the claims alleged in the Complaint against KPMG depends on a third-party beneficiary status.

3. *Exculpation Clauses* (Tremont)

Tremont contends that those claims alleging negligent misrepresentation (Count X) and violation of chapter 93A (Counts XIII and XV) as asserted against Tremont Partners and Tremont Holdings must be dismissed because those entities are protected against liability under the exculpation clause contained in the Limited Partnership Agreement (LPA) for each of the Rye Funds. Section 2.7 of the Rye Prime Fund LPA and section 2.6 of the Rye XL Fund LPA in relevant part each states:

> The General Partner and any member, director, officer, employee or agent of the General Partner shall not be liable to any Limited Partner or the Partnership for mistakes of judgment or for action or inaction which said party reasonably believed to be in the best interests of the Partnership.... Notwithstanding the foregoing, the provisions of this [Section] shall not be construed so as to relieve (or attempt to relieve) the General Partner or any member, director, officer, employee or agent of the General Partner of any liability, to the extent (but only to the extent) that such liability may not be waived, modified or limited under applicable law, but shall be construed so as to effectuate the provisions of this [Section] to the fullest extent permitted by law. Notwithstanding the foregoing[,] no person shall be exculpated or exonerated from liability, or indemnified against loss for violation of federal or state securities laws, or for any other intentional or criminal wrongdoing.

***12** According to Tremont, construing these provisions "to fullest extent permitted" by Delaware law requires the plaintiffs to plead particularized facts that demonstrate that the defendants acted with scienter, *Wood v. Baum,* 953 A.2d 136, 141 (Del.2008).[FN10] This Court disagrees.

> FN10. Tremont contends that each LPA, in accordance with its choice of law section, should be construed under Delaware law. The plaintiffs do not argue otherwise.

The degree to which a partnership agreement limits liability depends upon the language used in the agreement's provisions. See 6 Del. C.1953, § 17–1101; see generally M.I. Lubaroff & P.M. Altman, *Delaware Limited Partnerships* § 11.2.6.2 (2011 supp.). Here, the language in the exculpation provisions does not offer the breadth of protection Tremont claims.

Wood v. Baum, supra, the decision upon which Tremont's argument relies, involved a materially different exculpation provision. At issue in that case was a broadly-worded operating agreement that exempted the company's directors from *all* liability *except* in case of "fraudulent or illegal conduct." 953 A.2d. at 139 & n. 1. In such circumstances—where a defendant is exculpated from all liability except for claims that involve demonstrating the defendant's knowledge of wrongdoing—the court held that a plaintiff must allege scienter. See *id.* at 141.

In contrast, each LPA exculpates the General Partner (and other parties) from liability for mistakes of judgment or for action or inaction reasonably believed to be in the best interests of the Partnership, to the fullest extent permitted by Delaware law, except in case of intentional or criminal wrongdoing. That language does not offer protection from all liability save that which involves establishing knowledge of wrongdoing; a non-exculpated claim thus need not require proof of scienter.

That this is not a basis to dismiss certain counts at this early stage in the case is underscored by the fact that an exculpatory provision in a limited partnership agreement is treated by Delaware courts as an affirmative defense. See, e.g., *In re Nantucket Island Assocs. Ltd. Partnership Unitholders Litig.,* No. 17379 NC, 2002 WL 31926614, at *2 & n. 3 (Del. Ch., Dec. 16, 2002), citing *Emerald Partners v. Berlin,* 787 A.2d 85, 91–92 (Del.2001); *Paige Capital Mgt., LLC v. Lerner Master Fund, LLC,* No. 5502–CS, 2011 WL 3505355, at *33 (Del. Ch., Aug. 8, 2011). That does not mean that a defendant must ultimately disprove the plaintiffs' claims. On a motion to dismiss brought under Rule 12(b)(6), however, the court must be convinced that the complaint contains no facts that cast any doubt on the defendant's entitlement to this affirmative defense. This Court cannot say at this point that there is no doubt but that the exculpation clauses apply.

4. *Fraud in the Inducement.* (Tremont and KPMG)

Count VIII of the Complaint alleges fraud in the inducement against Tremont and the Rye Funds, and Count IX of the Complaint alleges fraud in the inducement against KPMG. Each of those defendants argues that, as a matter of New York substantive law, the facts as alleged in the Complaint do not support a plausible claim for relief.[FN11] In particular, Tremont and the Funds argue that the Complaint does not identify material misstatements on which the plaintiffs reasonably relied and that it fails to allege sufficiently the element of scienter. KPMG argues that the plaintiffs fail to allege facts showing that the accounting firm knew that its representations were false or that it intended to deceive the plaintiffs. None of these arguments is persuasive.

> FN11. Although the plaintiffs claim that Massachusetts law applies, not New York law, I do not need not to resolve the parties' choice of law dispute since there is no difference between them that is relevant to the issue before me.

***13** Tremont first argues that the plaintiffs' reliance upon the various misrepresentations identified in the Complaint was unreasonable as a matter of law. It notes that each plaintiff executed a Subscription Agreement before purchasing a limited partnership interest in the one of the Rye Funds and in so doing, agreed that the "Subscriber has relied solely upon the [PPM], the [LPA], and independent investigations made by the Subscriber...." In addition, Tremont points out that each Rye Fund PPM stated: "NO PERSON HAS BEEN AUTHORIZED TO MAKE ANY REPRESENTATIONS OR PROVIDE ANY INFORMATION WITH RESPECT TO THE INTERESTS EXCEPT SUCH INFORMATION AS IS CONTAINED IN THIS MEMORANDUM" (capitalization in original). But the Subscription Agreement expressly permitted reliance upon the fruits of "independent investigations" and upon representations made in the PPMs, which (according to the Complaint) the plaintiffs relied upon to their detriment. Whether this reliance was reasonable or justified are fact specific questions in any event, and not appropriately determined on a motion to dismiss.[FN12]

> FN12. Tremont and the Rye Funds rely on a similar argument in moving to dismiss claims for negligent misrepresentation (Count X), violation of G.L.c. 93A, §§ 9 and 11, (Counts XIII and XV), and violation of the securities laws of Florida and Illinois (Counts IV and VII). For the same reason that this Court declines to dismiss Count VIII, I decline to dismiss these counts as well.

Tremont also argues that, as a matter of fact, none of the representations made in the Rye Funds' PPMs was false or misleading, much less made with knowledge of their falsity. Although this argument has some appeal when the statements in the PPMs are viewed in isolation, it falters under the indulgent standard governing a Rule 12(b)(6) motion. For example, it could permissibly be inferred from all the facts alleged in the Complaint that Tremont did *not* "review the confirmations of the Partnership's trading activity for purposes of tracking the current status of the Partnership's accounts," and did *not* "review the Partnership's holdings with the Investment Advisor" on a regular basis, as the PPMs stated. As to the element of scienter, intent under New York law can be demonstrated by "recklessness of sufficient degree to create an inference of intent." *Stephenson v. Citco Group Ltd.,* 700 F.Supp.2d at 619, citing *State St. Trust Co. v. Ernst,* 278 N.Y. 104, 111 (1938); see also *South Cherry St., LLC v. Hennessee Group LLC,* 573 F.3d 98, 109 (2d Cir.2009) (scienter element under similar federal standard). In this case, the plaintiffs allege facts that, assumed true, demonstrate reckless disregard by Tremont for the truth. For example, the Complaint alleges that Tremont disregarded obvious warning signs (as described in the *Background* Section, *supra*) that Madoff was perpetrating a fraud so as not to jeopardize Tremont's critical revenue stream.[FN13] Allegations of similar "red flags" in another Madoff-related case were found sufficient at the pleading stage to establish scienter. See *Anwar v. Fairfield Greenwich Ltd.,* 728 F.Supp.2d at 411.[FN14]

> FN13. While a generalized profit motive does not support a strong inference of fraudulent intent, e.g., *Chill v. General Elec. Co.,* 101 F.3d 263, 268 (2d Cir.1996), the Complaint alleges that the defendants took tens of millions of dollars in management and other fees from the Rye Funds for essentially funneling money into Madoff's operations. Furthermore, the fee structure Madoff used—a "red flag" in itself according to the SEC and others—resulted in his foregoing millions of dollars of fees that he could have received and allowing Tremont Partners to charge those fees instead.

> FN14. Tremont and the Rye Funds rely on a similar argument in moving to dismiss counts alleging violation of the securities laws of Massachusetts and Colorado (Counts I and II). For the same reasons as outlined above, this Court rejects these arguments, at least at this early stage in the case.

KPMG makes a similar scienter argument as to the fraud claim against it. Like Tremont's argument, this argument fails when this Court applies the standard it must under Rule 12(b)(6). The Complaint alleges facts from which it may permissibly be inferred that KPMG represented to the plaintiffs that its audits complied with professional standards knowing that they did not. Specifically, KPMG failed to verify the valuation of the Funds' assets, failed to note that the Funds essentially had no internal controls to verify the accuracy of the information Madoff and BLMIS reported, and did not obtain the required audit evidence by examining more closely the books and records of BLMIS. Such failings may indeed support a claim for fraud. See, e.g., *Houbigant, Inc. v. Deloitte & Touche LLP,* 303 A.D.2d 92, 100 (N.Y.2003); *Fidelity & Deposit Co. of Md. v. Arthur Andersen & Co.,* 131 A.D.2d 308 (N.Y.1987).

5. *Negligent Misrepresentation and Professional Malpractice* (KPMG)

***14** Count XI of the Complaint alleges negligent misrepresentation against KPMG. Count XXIII alleges the related claim of professional malpractice. As to both, KPMG maintains that the Complaint fails to allege a plausible claim for relief under the applicable law.[FN15] This Court disagrees.

FN15. The parties disagree as to whether New York law or Massachusetts law applies to these claims. Any differences between the two jurisdictions are not important to resolution of the issues before me at this point, however.

According to Section 552 of the Second Restatement of Torts, a claim for negligent misrepresentation requires proof (among other things) that the defendant, in the course of its business, supplied false information "for the guidance of others in their business transactions" and that those others relied on that information so as to suffer pecuniary loss. See *Cumis Ins. Soc'y, Inc. v. BJ's Wholesale Club, Inc.,* 455 Mass. 458, 471–472 (2009). Section 552 limits liability to losses suffered by persons for whose benefit and guidance the information is supplied. See *Nycal Corp. v. KPMG Peat Marwick LLP,* 426 Mass. 491, 496 (1998). In moving to dismiss this claim, KPMG argues that the Complaint does not allege facts showing that the plaintiffs were part of this limited group. It also contends that the allegations are insufficient to show a causal connection between the losses suffered by the plaintiffs and any misrepresentations by KPMG. Neither argument has merit.

According to the Complaint, each plaintiff as a limited partner in the Rye Funds received an annual report, audited by KPMG, that was specifically addressed to "The Partners" of the respective fund. KPMG knew the identities of those "Partners" because the firm also prepared a Form K–1 tax statement for each limited partner's capital account. Whether New York or Massachusetts law is applied, these allegations provide a basis from which one could infer that the plaintiffs were indeed part of a group for whose benefit and guidance KPMG intended to supply its audit information. See *White v. Guarente,* 43 N.Y.2d 356, 361–363 (1977) (accountants retained by limited partnership hedge fund may be liable to identifiable group of limited partners); see also, e.g., *Ackerman v. Price Waterhouse,* 252 A.D.2d 179, 198–199 (N.Y.1998) (discussing liability of accountants for allegedly negligent tax advice rendered to individual limited partners).

As to the argument on causation, KPMG contends that the plaintiffs' losses were occasioned by Madoff and BLMIS, not KPMG. This argument misses the mark, however. All of the Rye Funds' assets were invested with Madoff; KPMG took on the task of auditing the Funds, and allegedly misrepresented to the plaintiffs that the audits complied with generally accepted auditing standards when they did not. The plaintiffs invested in the Funds in reliance upon KPMG's unqualified audit opinions, to their detriment. Morever, KPMG misrepresented in each annual Form K–1 statement that taxable investment income was earned for each plaintiff's capital account when in fact the income was illusory. In short, these allegations show a sufficient causal connection between wrongdoing by KPMG and some harm to the plaintiffs for purposes of Rule 12(b)(6).

***15** KPMG also moves to dismiss Count XXIII alleging the related claim of professional malpractice. Specifically, it argues that such a claim requires a showing that the plaintiffs were in privity with the firm. That position finds no support in either New York law, see, e.g., *Caprer v. Nussbaum,* 36 A.D.3d 176, 195 (N.Y.2006), or Massachusetts law, see *Nycal Corp. v. KPMG Peat Marwick LLP,* 426 Mass. at 498.

KPMG cites no authority to the contrary.

6. *Aiding and Abetting Fraud* (KPMG and MassMutual)

Count XXII of the Complaint alleges aiding and abetting fraud against KPMG, and Count XXI alleges aiding and abetting fraud against MassMutual. The gist of the allegations contained in both counts is that these defendants had actual or constructive knowledge of the fraudulent representations made by Tremont and the Rye Funds and provided substantial assistance to that fraud. This Court concludes that the allegations are insufficient as to MassMutual. Having already concluded that the Complaint states a claim against KPMG for fraud as well as for other claims, this Court sees no reason to dismiss a claim for aiding and abetting fraud at this early stage in the case.

Under Massachusetts law,[FN16] a defendant may be held liable for aiding and abetting a tort committed by another upon proof (among other things) that the defendant provided "substantial assistance or encouragement to the other party." *Go–Best Assets Ltd. v. Citizens Bank of Mass.,* 79 Mass.App.Ct. 473, 486 (2011), quoting from *Payton v. Abbott Labs,* 512 F.Supp. 1031, 1036 (D.Mass.1981). Here, there is no allegation in the Complaint that MassMutual directly assisted either Tremont or the Rye Funds in the commission of fraud. Rather, the plaintiffs contend that MassMutual is liable because it "controlled and dominated" Oppenheimer Acquisition, which itself aided and abetted the fraud perpetrated against the plaintiffs. There is little in the Complaint to suggest that Oppenheimer Acquisition provided any substantial assistance or encouragement to Tremont or the Rye Funds: indeed, the plaintiffs rely on the same anemic allegations of control and involvement in the affairs of Tremont that they did in making their argument that this Court had personal jurisdiction over Oppenheimer Acquisition. The connection from that corporation to MassMutual Holding and MassMutual Life Insurance is even more remote. Shorn of conclusory statements about control, involvement, and oversight, the factual allegations show only common stock ownership and a modest overlap of senior executives and company directors. That is simply not enough.

> FN16. Although the parties dispute whether the substantive law of New York, Delaware, or Massachusetts applies, the result would be the same regardless.

7. *State Securities Law Violations* (Tremont, Rye Funds, and MassMutual)

The plaintiffs, residents of the Commonwealth and six other states, assert counts for securities fraud against Tremont, the Rye Funds, and MassMutual under the laws of Massachusetts, Colorado, Connecticut, Florida, New Mexico, Virginia, and Illinois (Counts I–VII). For each such count, liability for the primary violation is alleged against Tremont and the Funds, and "controlling person" liability is alleged against MassMutual. As to Count V, the plaintiffs do not oppose defendants' motion to dismiss, since that Count relies on a New Mexico statute that was not in effect until after the time of the alleged transactions. The plaintiffs also concede that Florida law does not permit "controlling person" liability, see, e.g., *Dillon v. AXXSYS Int'l,* 385 F.Supp.2d 1307, 1311 (M.D.Fla.2005), so that Count (IV) as asserted against MassMutual should also be dismissed. As to the remaining counts, the defendants make three principal arguments, which this Court addresses in turn.[FN17]

> FN17. Tremont and the Rye Funds also recycle their contentions that the plaintiffs have failed adequately to allege reasonable reliance and scienter. Even assuming these are necessary elements of state securities law violations, this Court has already concluded that the Complaint alleges sufficient facts to satisfy Rule 12(b)(6) in the context of discussing other claims against these defendants.

***16** First, Tremont and the Rye Funds and MassMutual each argues that claims alleged by plaintiff Rachel Seelig for violation of the Illinois securities laws must be dismissed because she failed to provide timely notice to rescind her securities purchases. Under Section 13(B) of Illinois Securities Act, 815 Ill. Comp. Stat. 5/13(B), a plaintiff must give such notice within six months after she has knowledge that the purchase or sale is voidable. *766347 Ontario Ltd. v. Zurich Capital Markets, Inc.,* 249 F.Supp.2d 974, 988 (N.D.Ill.2003). This rule is not a statute of limitations but an equitable rule intended to protect defendants against stale claims. *Martin v. Orvis Bros. & Co.,* 25 Ill.App.3d 238, 246 (1974), citing *Gowdy v. Richter,* 20 Ill.App.3d 514 (1974) see also *Norville v. Alton Bigtop Restaurant, Inc.,* 22 Ill.App.3d 273

(1974). Here, the Complaint fails to allege Seelig's compliance with this statutory notice. The failure to plead this is enough in and of itself to justify dismissal. See, e.g., *Denten v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 887 F.Supp. 176, 180–181 (N.D.Ill.1995); *Kleban v. S.Y.S. Rest. Mgmt., Inc.*, 912 F.Supp. 361, 369 n. 3 (N.D.Ill.1995); *Endo v. Albertine*, 812 F.Supp. 1479, 1496 (N.D.Ill.1993); *Wislow v. Wong*, 713 F.Supp. 1103, 1107 (N.D.Ill.1989); cf. *Norville v. Alton Bigtop Restaurant, Inc.*, 22 Ill.App.3d 273, 284 (1974). The plaintiffs make no argument to the contrary.

This Court also agrees with the defendants that the claims alleged by plaintiff Richard Askenazy for violation of the Virginia Securities Act are time-barred. The applicable provision of the Virginia Code, section 13.1–522D, sets out a two year limitations period, construed to be "an absolute cutoff" of any claims asserted two years after the securities transaction at issue. *Caviness v. Derand Resources Corp.*, 983 F.2d 1295, 1305–1306 (4th Cir.1993); *Goldstein v. Malcolm G. Fries & Assocs., Inc.*, 72 F.Supp.2d 620, 627 (E.D.Va.1999). The limitations period cannot be tolled by an absence of knowledge. *Caviness v. Derand Resources Corp.*, 983 F.2d at 1306; *Goldstein v. Malcolm G. Fries & Assocs., Inc.*, 72 F.Supp.2d at 627–628. In this case, there is no dispute that the actions giving rise to Richard Askenazy's state securities law claim occurred more than two years before the original complaint was filed. That claim is therefore time-barred.

More generally, MassMutual contends that neither MassMutual Holding nor MassMutual Life Insurance can be held liable for any state securities law violation to the extent it is based strictly on controlling person liability. This Court agrees. Each state's "control person" provision as pleaded in the Complaint is modeled after section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78t(a); hence, federal decisional law interpreting section 20(a) offer persuasive guidance as to what is required. The plaintiffs apparently agree with MassMutual that the standard for liability is correctly stated by the United States Court of Appeals for the First Circuit, which requires a showing by plaintiff that the defendant in fact controlled the violator. *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 (1st Cir.2002). "To meet the control element, the alleged controlling person must not only have the general power to control the company, but must also *actually exercise control* over the company. *Ibid.* (italics added). I conclude that the Complaint fails to allege enough facts to satisfy this standard.

***17** Although the question of control is not ordinarily resolved summarily at the pleading stage, see, e.g., *In re Cabletron Systems, Inc.*, 311 F.3d 11, 40 (1st Cir.2002), the plaintiffs' allegations fall well short of showing that either MassMutual Holding or MassMutual Life Insurance exerted actual control over Tremont or the Rye Funds. Here again, the plaintiffs rely on MassMutual's status as a parent corporation, the listing of MassMutual as a "control person" on Tremont Partners' SEC form, and some overlap of directors between MassMutual, Oppenheimer Acquisition, OppenheimerFunds, and Tremont. At most, these facts show some potential to control Tremont and the Funds, but the potential ability to control is not sufficient: what is required are facts from which it might reasonably be inferred that MassMutual "actively participated in the decision-making processes" of Tremont and the Rye Funds. See *Aldridge v. A.T. Cross Corp.*, 284 F.3d at 85. These facts are notably absent from the Complaint, even construing the allegations in favor of the plaintiffs.

8. *General Laws c. 93A* (Tremont, KPMG and MassMutual)

The Complaint alleges variously in Counts XIII–XVII that each defendant engaged in unfair or deceptive acts or practices in violation of both G.L.c. 93A, § 9, and § 11.[FN18] Most of those claims have sufficient factual support in the Complaint plausibly to suggest entitlement to relief, the numerous arguments made collectively by the defendants notwithstanding. However, two sets of chapter 93A claims may be dismissed as a matter of law at the pleading stage.

FN18. Each plaintiff except for Beggs & Cobb Corporation alleges violations of chapter 93A, § 9; Beggs & Cobb Corporation alleges violations of section 11.

The first concerns the chapter 93A counts asserted against MassMutual. The substance of the claims alleged to support of those counts is that MassMutual directly or indirectly controlled, and gave substantial assistance to, the misrepresentations made by Tremont and the Rye Funds. As previously explained, such claims are not borne out by the allegations in the Complaint. The plaintiffs have not alleged specific facts from which it may permissibly be inferred that MassMutual meaningfully controlled Tremont and the Rye Funds or assisted the fraud and other underlying conduct alleged against those entities. Where chapter 93A claims are derived solely from the same operative facts as other failed common law and statutory claims, courts refuse to impose c. 93A liability. See, e.g., *Macoviak v. Chase Home Mortg. Corp.,* 40 Mass.App.Ct. 755, 760 (1996); see also *Professional Servs. Group, Inc. v. Rockland,* 515 F.Supp.2d 179, 194 (D.Mass.2007), citing cases; *Lily Transp. Corp. v. Royal Inst. Servs., Inc.,* 64 Mass.App.Ct. 179, 204–205 & n. 14 (2005) (Laurence & Green, JJ., concurring in part and dissenting in part), collecting cases. So too here.

The second set encompasses the claims brought under section 9 by the six plaintiffs who, the Complaint fails to allege sent the statutorily-required demand letter.[FN19] The plaintiffs do not dispute that no demand letter was sent. That pleading omission is "fatal" to their claims. *Boston v. Aetna Life Ins. Co.,* 399 Mass. 569, 574 (1987), citing *Spring v. Geriatric Auth. of Holyoke,* 394 Mass. 274, 287 (1985), and *Slaney v. Westwood Auto, Inc.,* 366 Mass. 688, 704 (1975).

> FN19. Those plaintiffs are Kenneth Conway, Chet Opalka, Karen Opalka, Patrick Roche, Bedford Clay LLC, and Ivy Street Investment Co., LLC.

ORDER

18** It is therefore ***ORDERED that Defendant Oppenheimer Acquisition Corp.'s Motion to Dismiss the Second Amended Complaint be ***ALLOWED;*** that Defendants Massachusetts Mutual Life Insurance Company and MassMutual Holding LLC's Motion to Dismiss the Second Amended Complaint be ***ALLOWED;*** that The Tremont Defendants' Motion to Dismiss be ***ALLOWED IN PART*** and ***DENIED IN PART;*** that the Motion of Defendants Rye Select Broad Market Prime Fund, L.P. and Rye Select Broad Market XL Fund, L .P. to Dismiss Complaint be ***ALLOWED IN PART*** and ***DENIED IN PART;*** and that KPMG LLP's Motion to Compel Arbitration and Stay the Action Against It, or, in the Alternative, to Dismiss Counts IX, XI, XVI, XIX, XXII and XXIII of the Second Amended Complaint be ***ALLOWED IN PART*** and ***DENIED IN PART.***

It is therefore further ***ORDERED*** that judgment enter dismissing all counts of the Second Amended Complaint asserted against Oppenheimer Acquisition Corporation, Massachusetts Mutual Life Insurance Company, and MassMutual Holding LLC; that judgment enter dismissing Counts V–VII, XII, XVIII, and XIX of the Second Amended Complaint; and that judgment enter dismissing so much of Counts XIII and XVI of the Second Amended Complaint as allege claims by plaintiffs Kenneth Conway, Chet Opalka, Karen Opalka, Patrick Roche, Bedford Clay LLC, and Ivy Street Investment Co., LLC.

Mass.Super.,2012.
Askenazy v. Tremont Group Holdings, Inc.
Not Reported in N.E.2d, 29 Mass.L.Rptr. 340, 2012 WL 440675 (Mass.Super.)

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Only the Westlaw citation is currently available.

United States District Court,
W.D. Washington.
BELTAPPO INC., a Washington corporation, Plaintiff,
v.
RICH XIBERTA, S.A., a Spanish corporation, Defendant.

No. C05-1343Z.
Feb. 7, 2006.

Mark S. Carlson, Peter Scott Ehrlichman, Shannon Marie McMinimee, Dorsey & Whitney LLP, Seattle, WA, for Plaintiff.

Hugh N. Helm, III, Law Offices of Hugh N. Helm, III, Santa Rosa, CA, Ann Marie Bender, James Alexander Smith, Jr., Smith & Hennessey, Seattle, WA, for Defendant.

ORDER

ZILLY, J.

*1 Plaintiff Beltappo, Inc. ("Beltappo") brings this claim against Defendant Rich Xiberta S.A. ("Rich Xiberta") for breach of contract. Complaint, docket no. 1. Before the Court is Rich Xiberta's motion to dismiss for lack of personal jurisdiction pursuant to FED. R. CIV. P. 12(b)(2) or, in the alternative, to dismiss under the doctrine of *forum non conveniens.* Docket no. 21. Rich Xiberta also requests costs and attorneys' fees pursuant to RCW 4.28.185(5). Having reviewed Rich Xiberta's motion to dismiss, Beltappo's brief in opposition, and Rich Xiberta's reply, the Court enters the following Order.

BACKGROUND

Rich Xiberta

Rich Xiberta is a Spanish corporation with its principal place of business in Caldes de Malavella, Spain. Dalmau Decl., docket no. 21, at ¶ 3. Rich Xiberta produces and sells wine corks. Carlson Decl., docket no. 24, Ex. A and B (Rich Xiberta web site). Rich Xiberta has no offices, property, bank accounts, or employees located in the State of Washington. Dalmau Decl. at ¶¶ 14, 16. Nor does Rich Xiberta advertise, solicit customers, or sell its products in the State of Washington. *Id.* at 17. Rich Xiberta is the parent company of a wholly owned subsidiary known as Rich Xiberta U.S.A. ("RXUSA"). Second Dalmau Decl., docket no. 29, at ¶ 2.

Beltappo

Beltappo is a Washington Corporation with its principal place of business in the State of Washington. Complaint, docket no. 1, ¶ 1. Beltappo markets and sells synthetic cork that is manufactured by Zamar, S.N.C., an Italian corporation located in Porto Ricanti, Italy. Belforte Decl., docket no. 26, ¶ 2; Dalmau Decl. at ¶ 6. John Belforte II is Beltappo's President and CEO. Belforte Decl. at ¶ 1.

The Distribution Agreement

Rich Xiberta and Beltappo began contract discussions for the sale of Beltappo's synthetic corks to Rich Xiberta through agents in Chile in 2002. Kinsella Decl., docket no. 30, ¶ 4. In Chile, Beltappo's agent, Brian Kinsella, began contact with Rich Xiberta's agent, Josep Vila, by email. *Id.* Eventually, Vila requested specific information relating to a possible distribution agreement between Beltappo and Rich Xiberta, which was forwarded to Belforte in Washington State. *Id.* In January 2004, Kinsella and Belforte traveled to Spain to further negotiate the terms of a possible distribution contract. *Id.* at ¶ 5. After additional exchanges by email, telephone, and fax, the parties reached an agreement, which was signed in California on June 27, 2004 ("Distribution Agreement"). Belforte Decl. at ¶ 5, Ex. B; Delmau Decl. at ¶¶ 7-8; Helm Decl., docket no. 21, Ex. C (copy of Distribution Agreement).

The Distribution Agreement provides that Rich Xiberta is the exclusive distributor of Beltappo's products world wide, excluding Italy and North America, for a period of five years. *Id.* at §§ 2.01(a), 2.03. The Distribution Agreement also permitted Beltappo to represent Rich Xiberta's natural cork products in North America, although it appears Beltappo never sold any of Rich Xiberta's products. *Id.* at § 3.12; Botifoll Decl., docket no. 28, ¶ 10. Finally, the

Distribution Agreement contains a "Controlling Law" provision, which states in relevant part as follows:

***2** The validity, interpretation, and performance of this Agreement shall be controlled by and construed under the laws of the State of Washington, U.S.A, the state in which this Agreement is [sic] be *performed by [Beltappo]*. It is understood, however, that this is a general form of agreement, designed for use in the United States wherever [Beltappo] may desire to sell its products and that any provision herein which in any way contravenes the laws of any state or jurisdiction shall be deemed not to be a part of this Agreement therein.

Id. at 5.05 (emphasis added).

Pursuant to the Distribution Agreement, Rich Xiberta sent purchase requests from Spain to Beltappo's Washington State offices, which in turn transmitted the order to the manufacturer, Zamar. Belforte Decl. at 9, Ex. F. After an order was placed, Zamar invoiced Beltappo, which then invoiced Rich Xiberta, and Rich Xiberta deposited payment into Beltappo's bank account at the Bainbridge Island branch of Bank of America. *Id.* at Ex. G. The synthetic corks manufactured by Zamar were shipped to Rich Xiberta's customers in Europe or, as appears on the purchase orders, picked up by Rich Xiberta at Zamar's factory. *Id.* at Ex. F; Dalmau Decl. at ¶ 10. At no time did corks purchased by Rich Xiberta under the Distribution Agreement originate in, pass through, or end up in Washington State. Dalmau Decl. at ¶ 10.

On other occasions, Rich Xiberta requested samples from Beltappo, which were shipped from Beltappo's Washington State warehouse to Spain, Argentina, and Chile. Belforte Decl. at ¶ 14. Rich Xiberta states that it did not request that Beltappo ship the samples from Washington State, nor did it have knowledge that the corks were in fact shipped from Washington State. Second Dalmau Decl., docket no. 29, ¶ 15.

RXUSA

Rich Xiberta is the parent company of several wholly owned subsidiary companies, including RXUSA, a California corporation. Botifoll Decl., docket no. 28, ¶¶ 1-2. According to RXUSA's General Manager, RXUSA has independent management that determines its own goals, activities, and strategy apart from Rich Xiberta. *Id.* at ¶ 2. RXUSA has a contract with Rich Xiberta to purchase and market Rich Xiberta's corks in the United States, but Rich Xiberta does not control or supervise the manner in which RXUSA performs under this contract. *Id.* at ¶ 3. RXUSA also sells wine products such as barrels, bungs, barrel washers, and barrel racks through distribution agreements with other manufacturers. *Id.* at ¶ 4. RXUSA markets its products throughout the United States, including Washington State. For example, RXUSA has one sales representative whose territory includes Washington State, attends annual trade shows in Washington State, and advertises its products in national wine magazines that are sold in Washington State. Botifoll Decl. at ¶¶ 11-12. RXUSA is not a party to this litigation.

Litigation in Spain

***3** Beltappo filed its Complaint in this case on August 2, 2005. Docket no. 1. On October 12, 2005, Beltappo received permission from the Court to serve Rich Xiberta by mail. Docket no. 4. Beltappo transmitted the summons and complaint to Rich Xiberta by certified mail, facsimile, and email on October 13, 2005. Carlson Decl. at ¶ 5. On October 14, 2005, Rich Xiberta filed suit against Beltappo in Santa Coloma de Farners, Spain. Dalmau Decl. at ¶ 12. In the Spanish litigation, Rich Xiberta argues that the applicable law is the United Nations Convention on Contracts for the International Sale of Goods ("CISG").

Beltappo's Request to Supplement the Record

After the briefing for the personal jurisdiction motion was complete, Beltappo filed a separate motion requesting leave to supplement the record. Docket no. 34. Beltappo seeks to submit evidence that Beltappo was authorized to sell Rich Xiberta's natural corks in the United States and, specifically, in Washington State via an agreement with RXUSA. For the reasons that follow, the Court does not consider this evidence in addressing Rich Xiberta's motion to dismiss. Accordingly, the Court STRIKES AS MOOT Beltappo's motion to supplement the record.

DISCUSSION

I. *Personal Jurisdiction*

In Washington State, the long-arm statute and constitutional due process requirements for personal jurisdiction merge into a single test. McGowan v.

Pillsbury Co., 723 F.Supp. 530, 534 (W.D.Wa.1989). The constitutional test is satisfied if a foreign corporation has sufficient contacts with the forum state to establish either specific or general jurisdiction. *Id.* The plaintiff bears the burden of establishing that personal jurisdiction exists but, where the court relies only on affidavits and discovery materials without an evidentiary hearing, uncontroverted allegations in the complaint must be taken as true and conflicts between the affidavits must be resolved in the plaintiff's favor. *Ochoa v. J.B. Martin and Sons Farms, Inc.*, 287 F.3d 1182, 1187 (9th Cir.2002). However, the plaintiff may not rest on the bare allegations in its complaint. *Schwarzenegger v. Fred Martin Motor Co.*, 374 F.3d 797, 800 (9th Cir.2004).

A. *Specific Jurisdiction*

In *Schwarzenegger,* the Ninth Circuit described the traditional three-prong test for specific personal jurisdiction as follows:

(1) The non-resident defendant must purposefully direct his activities or consummate some transaction with the forum or resident thereof; or perform some act by which he purposefully avails himself of the privilege of conducting activities in the forum, thereby invoking the benefits and protections of its laws;

(2) the claim must be one which arises out of or relates to the defendant's forum-related activities; and

(3) the exercise of jurisdiction must comport with fair play and substantial justice, i.e. it must be reasonable.

374 F.3d at 802 (quoting *Lake v. Lake,* 817 F.2d 1416, 1421 (9th Cir.1987)). The plaintiff bears the burden of establishing the first two prongs of the test and, if the plaintiff fails as to either prong, there is no personal jurisdiction in the forum state. *Id.* If the plaintiff succeeds in establishing the first and second prong, the burden shifts to the defendant to present a compelling case that the exercise of jurisdiction would not comport with fair play and substantial justice. *Id.* (citing *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 476-78, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985)).

1. Purposeful Availment

***4** The "purposeful availment" prong is present where "the defendant has deliberately engaged in significant activities within a State, or has created continuing obligations between himself and residents of the forum." *Burger King,* 471 U.S. at 476 (citations and internal quotations omitted). The Supreme Court has "consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction [in another State]." *Id.* However, the existence of a contract alone cannot automatically establish sufficient minimum contacts in another forum to create personal jurisdiction. *Id.* at 478. Rather, in determining whether minimum contacts exist, courts must evaluate other factors surrounding the contract, such as prior negotiations, contemplated future consequences, the terms of the contract, and the parties' actual course of dealing. *Id.*

The parties' rely principally on two analogous cases, *Burger King* and *Roth v. Garcia Marquez,* 942 F.2d 617 (9th Cir.1991), both of which held that personal jurisdiction existed. In *Burger King,* the defendant, Rudzewicz, entered a franchise agreement to operate a Burger King restaurant in Michigan for a period of twenty years. 471 U.S. at 467. Plaintiff Burger King Corporation, incorporated in Florida and principally based in Miami, entered into the contract but was not primarily responsible for ensuring day-to-day compliance with its terms because Burger King maintained a regional office that supervised Rudzewicz's restaurant. *Id.* at 465-67. Rudzewicz never traveled to Miami to negotiate the contract or perform under the terms of the contract, but he did interact with Burger King employees based in Miami during the negotiation process. *Id.* at 466-67. When Rudzewicz's franchise did not succeed and he began missing scheduled franchise payments, Burger King officials in Miami began unsuccessful negotiations with Rudzewicz and ultimately brought suit in United States District Court for the Southern District of Florida. *Id.* at 468. The district court denied Rudzewicz's motion to dismiss for lack of personal jurisdiction but was reversed on appeal by the Eleventh Circuit. The United States Supreme Court accepted review and reversed the Eleventh Circuit. *Id.* at 469.

Examining the contract factors listed above, the *Burger King* Court concluded that the franchise contract had a "substantial connection" to the State of Florida. *Id.* at 479. The *Burger King* Court cited the following facts: (1) Rudzewicz deliberately reached out beyond Michigan and negotiated with a Florida corporation; (2) the contract was long term; (3) the contract "envisioned continuing and wide-reaching contacts with Burger King in Florida"; (4) the relationship was in no sense "random, fortuitous, or attenuated"; (5) Rudzewicz's failure to make scheduled payments and continued use of Burger King's trademarks "caused foreseeable injuries to the Florida Corporation"; (6) Rudzewicz knew that major disputes could be resolved only by the Miami office; (7) Rudzewicz carried on a continuous course of direct communications by mail and telephone with Miami headquarters; and (8) the contract contained a Florida choice-of-law provision that "reinforced [Rudzewicz's] deliberate affiliation with the forum State and the reasonable foreseeablity of possible litigation there." *Id.* at 479-82. Based on this "substantial record evidence," the *Burger King* Court concluded that Rudzewicz had purposefully availed himself of the Southern District of Florida forum. *Id.* at 478.

***5** Similarly, in *Roth,* the Ninth Circuit concluded that the foreign defendants Marquez (Mexico) and Balcells (Spain) were subject to personal jurisdiction in California. 942 F.2d at 625. Roth produced films and sought to purchase the rights to *Love in the Time of Cholera,* which was written by Marquez, who was represented by Balcells. *Id.* at 618. Roth sought out Marquez and traveled abroad several times in an effort to negotiate the terms of a contract to purchase the film rights. *Id.* at 619. The only negotiations in the United States were the result of meetings that occurred when Marquez and Balcells happened to be in California for other reasons. *Id.* As a term of the contract negotiations, the movie was to be filmed in Brazil, although all of the editing, production work, and advertising would have occurred in California. *Id.* at 622. Additionally, Marquez was to receive a percentage of the net profits from the film once it was completed. *Id.* at 619.

Finding the question "a very close call," the Ninth Circuit nonetheless held that Roth satisfied the "purposeful availment" prong. *Id.* at 622. The *Roth* Court concluded that two facts, the defendants' minimal physical presence in California and Roth's initiation of the negotiations, suggested there was no personal jurisdiction. *Id.* However, the Court reasoned that these facts were outweighed by the fact that "most" of the work on the film would be completed in California and Roth would be sending payment to the defendants, the amounts of which depended on California activities. *Id.* Thus, the "economic reality" indicated that 'the contract's subject would have continuing and extensive involvement with the forum." *Id.*

In this case, the parties dispute both the scope of the contacts the Court should consider under the "purposeful availment" prong and whether those contacts are enough to satisfy Beltappo's burden. The first question is whether the Court should consider the activities of both Rich Xiberta and RXUSA, or Rich Xiberta alone. Beltappo suggests that the Court should consider the economic activities of both Rich Xiberta and RXUSA, while Rich Xiberta contends that RXUSA is irrelevant to the analysis. Generally, a foreign corporation's contacts with the forum state do not include the activities of a wholly-owned subsidiary. *See* Keeton v. Hustler Magazine, Inc., 465 U.S. 770, 781 n. 13, 104 S.Ct. 1473, 79 L.Ed.2d 790 (1984); *Dean v. Motel 6 Operating L.P.,* 134 F.3d 1269, 1273 (6th Cir.1998) ("a company does not purposefully avail itself merely by owning all or some of a corporation subject to jurisdiction"). There is an exception to this general rule where the subsidiary acts as the parent's general agent. *Harris Rutsky & Co. Ins. Services, Inc. v. Bell & Clements Ltd.,* 328 F.3d 1122, 1134-35 (9th Cir.2003). Under the general agent exception, the "plaintiff must make a prima facie showing that the subsidiary represents the parent corporation by performing services 'sufficiently important to the [parent] corporation that if it did not have a representative to perform them, the [parent] corporation ... would undertake to perform substantially similar services." ' *Id.* at 1135.

***6** Beltappo makes a conclusory assertion that "[i]t cannot be reasonably disputed that but for the existence of Rich Xiberta USA, Rich Xiberta could not market and sell its products in the United States without performing itself the functions it delegates to Rich Xiberta USA." Pl.'s Resp., docket no. 23, at 15. Based on the declaration of RXUSA's General Manager, Beltappo's assertion is incorrect. RXUSA operates independently from Rich Xiberta and has a separate contract with Rich Xiberta to sell Rich Xiberta's products in the United States. Presumably, if RXUSA did not exist, Rich Xiberta could simply enter into distribution or licensing agreements with other distributors in the United States and would not, as Beltappo suggests, be required to perform RXUSA's functions itself. RXUSA also sells products other than Rich Xiberta's wine corks. These products are purchased from separate manufacturers, indicating that RXUSA is more than simply a sales agent of Rich

Xiberta. Accordingly, the prohibition against considering the activities of a foreign corporation's wholly-owned subsidiary applies in this case. RXUSA's activities are irrelevant.

The next question is whether Rich Xiberta's activities in connection with this forum are sufficient for Beltappo to satisfy the purposeful availment prong. Apart from RXUSA, Beltappo relies on (1) the pre-contract negotiations in which the parties exchanged emails, phone calls, and faxes to and from Washington State; (2) the fact that the contract provided for continuing obligations over a five-year period, including the purchase of several million Beltappo synthetic corks; (3) Rich Xiberta sent several purchase requests to Beltappo in Washington State, received invoices from Beltappo in response, and paid on the invoices to Beltappo's Washington State bank account; and (4) the Distribution Agreement includes a choice of law clause providing for the application of Washington State law.

In response, Rich Xiberta contends that minimum contacts do not exist because Beltappo initiated and conducted the negotiations "entirely outside the State of Washington" and the Distribution Agreement "was to be performed entirely outside of the State of Washington." Def.'s Reply, docket no. 27, at 10-11. First, Rich Xiberta relies on the declaration of Brian Kinsella, Beltappo's agent. However, the Kinsella Declaration states only he "exchanged email starting in 2002" with Rich Xiberta's agent and received an email from Rich Xiberta's agent on November 11, 2003, requesting specific information regarding a distribution agreement. Docket no. 30 at ¶ 4. The evidence suggests that interest in negotiations was mutual and does not demonstrate which party "initiated" negotiations. Moreover, negotiations did not occur "entirely" outside Washington State. The negotiations included email and telephone communications exchanged between Beltappo in Washington State and Rich Xiberta in Spain. Belforte Decl. at ¶ 5, Ex. B; Dalmau Decl. at ¶¶ 7-8. Second, Rich Xiberta's assertion that the contract was to be performed "entirely" outside the State of Washington is incorrect. While Rich Xiberta is correct that the actual shipment and receipt of Beltappo's synthetic corks occurred in Europe, the Distribution Agreement provides that Beltappo's performance is to occur in Washington State. Helm Decl., Ex. C at § 5.05. The parties' course of dealings was consistent with this provision in that Beltappo received orders, passed the orders on to Zamar, and received payment in Washington State.

*7 Under *Burger King* and *Roth,* Beltappo has demonstrated sufficient activity by Rich Xiberta to satisfy the purposeful availment prong of the personal jurisdiction analysis. Rich Xiberta negotiated directly with a Washington State corporation over a period of several months, sending and receiving communications to and from this State. As in *Burger King,* the contract was long term (five years) and envisioned continuing contacts between the parties whereby Rich Xiberta would submit orders and payment to Beltappo in Washington State. Also, Rich Xiberta's alleged breach, if it occurred, caused foreseeable injury to Beltappo, a Washington corporation. Rich Xiberta knew that any disputes would have to be resolved through communication with Beltappo in Washington State and, if a dispute went into litigation, such a dispute would be presumptively subject to the laws of Washington State under the choice-of-law clause, just as in *Burger King.* And, as in *Roth,* Rich Xiberta's lack of physical presence in Washington State and the extra-forum negotiations do not outweigh the many other factors supporting jurisdiction. Therefore, on balance, Rich Xiberta's contacts establish that Rich Xiberta purposefully availed itself of this forum.

2. Whether Claim Arises Out of Forum Activities

The Ninth Circuit applies a "but for" test to assess whether a plaintiff's claims "arise out of" the defendant's contacts with the forum State. *Glencore Grain Totterdam B.V. v. Shivnath Rai Harnarain Co.,* 284 F.3d 1114, 1123 (9th Cir.2002) (finding claims did not arise out of contacts where both parties were foreign corporations, the contract was negotiated, executed, and performed entirely abroad, and the defendant's contacts were unrelated to the contract). Rich Xiberta briefly contends that Beltappo's breach of contract claim does not arise out of its contacts with Washington State. Rich Xiberta states only that it "never set foot in Washington to negotiate, execute, or perform the Distribution Agreement" and "[n]o part of Rich Xiberta's performance of the Distribution Agreement" occurred in Washington State. Def.'s Br. at 15. In response, Beltappo relies on the contacts discussed above (negotiations to and from Washington State, the orders to and invoices from Washington State, and the choice of law provision). Rich Xiberta does not discuss this prong of the analysis in its reply brief.

Beltappo's claim is limited to a breach of the Distribution Agreement. FN1 Rich Xiberta has no other contacts with Washington State other than those relating to the negotiation and performance of the Distribution Agreement. Beltappo's breach of contract claim clearly arises out of the contacts described above under the Ninth Circuit's "but for" test.

> FN1. Beltappo alleges that Rich Xiberta breached the Distribution Agreement by (1) failing to make the guaranteed minimum purchases in 2004 and 2005, (2) failing to put forth its best efforts to promote demand for Beltappo's corks, and (3) failing to pay for the products it has purchased from Beltappo. Complaint, docket no. 1, at ¶¶ 11-13.

3. Fair Play and Substantial Justice

If the plaintiff establishes the first two prongs of the specific jurisdiction analysis, the burden shifts to the defendant to "present a compelling case" that maintaining jurisdiction would not comport with fair play and substantial justice. Schwarzenegger, 374 F.3d at 802. This is a test of "reasonableness," in which courts should consider the following factors: (1) extent of defendant's purposeful interjection; (2) burden on the defendant in defending in the forum; (3) extent of conflict with the sovereignty of defendant's state; (4) forum state's interest in adjudicating the dispute; (5) most efficient judicial resolution of the controversy; (6) importance of the forum to plaintiff's interest in convenient and effective relief; and (7) existence of an alternative forum. *Core-Vent Corp. v. Nobel Industries, A.B.,* 11 F.3d 1482, 1487-88 (9th Cir.1993). "None of the factors is dispositive in itself; [courts] must balance all seven." *Id.* at 1488.

***8** In this case, the factors conflict and lead to no clear result. First, while Rich Xiberta maintained significant and ongoing contacts with Beltappo in Washington State, those contacts did not include the sale or purchase of products in Washington State; the contacts were limited to contract formation, purchase and payment communications, and the choice of law clause. The "purposeful injection" factor favors Rich Xiberta. Second, while the burden of a Spanish corporation litigating in Washington State is apt to be heavy, the Ninth Circuit has noted that "[m]odern advances in communications and transportation have significantly reduced the burden of litigating in another country." *Core-Vent,* 11 F.3d at 1489. This factor weighs slightly in favor of Rich Xiberta. Third, Rich Xiberta concedes that there will be no conflict with a sovereign state because of the choice-of-law provision and the fact that both Spain and the United States are signatories to the CISG. This factor is neutral. Fourth, a State maintains a strong interest in providing an effective means of redress for its residents. *Id.* Beltappo is a Washington State corporation with its principal place of business in Washington State and, therefore, this factor favors Beltappo. Fifth, both parties contend that their own forum is the most efficient location to resolve this dispute. Rich Xiberta contends that most of the individuals and documents are located in Europe and that Spain's legal system will provide a less-complicated means of obtaining testimony from foreign witnesses. In response, Beltappo suggests that Washington State is more efficient because the application of Washington State's law in Spain would require the translation of cases into Spanish and the application of Washington State's common law in Spain's civil judicial system. This factor does not clearly favor either party. Sixth, just as Rich Xiberta is burdened by litigating in the United States, Beltappo will be burdened by litigating in Spain. While more of the parties' witnesses may reside in Europe, it will surely be inconvenient for Beltappo and its witnesses to travel to Spain. This factor weighs slightly in Beltappo's favor. Finally, the availability of Spain as an alternative forum and Rich Xiberta's pending law suit in that forum weighs in Rich Xiberta's favor.

Rich Xiberta bears the burden of presenting a "compelling case" that the maintenance of jurisdiction in this forum would be unreasonable. Only factors one, two, and seven favor Rich Xiberta in the "fair play and substantial justice" analysis. The remaining factors either favor Beltappo or are neutral. Accordingly, the Court finds that Rich Xiberta has failed to satisfy its burden of presenting a compelling case that jurisdiction in this case would be unreasonable. The Court has specific personal jurisdiction over Rich Xiberta.

B. *General Jurisdiction*

If a defendant's activities are substantial, continuous and systematic, a federal court can exercise jurisdiction as to any cause of action, whether or not the cause of action is related to the defendant's activities within the state. *Perkins v. Benguet Consol. Mining Co.,* 342 U.S. 437, 445, 72 S.Ct. 413, 96 L.Ed. 485 (1952). For general jurisdiction to attach, the defendant must have a higher level of contacts with the forum state to support local jurisdiction. *See* Data Disc, Inc. v. Sys. Tech. Assocs., Inc., 557 F.2d 1280, 1287 (9th Cir.1977). Under this heightened standard, and excluding the contacts of RXUSA, Rich Xiberta's contacts with Washington State fall short of establishing general jurisdiction.

II. *Forum Non Conveniens*

***9** As an alternative to dismissal for lack of personal jurisdiction, Rich Xiberta argues that the Court should exercise its discretion to dismiss under the *forum non conveniens* doctrine. The party moving to dismiss based on *forum non conveniens* bears the burden of showing (1) the existence of an alternative adequate forum and (2) that the balance of private and public interest factors favor dismissal. *Dole Food Co., Inc. v. Watts,* 303 F.3d 1104, 1117 (9th Cir.2002). The private interest factors include the residence of the parties and witnesses, availability of compulsory processes for attendance of witnesses, costs of bringing willing witnesses and parties to the place of trial, access to physical evidence, enforceability of judgments, and all other practical problems. *Gulf Oil Corp. v. Gilbert,* 330 U.S. 501, 508, 67 S.Ct. 839, 91 L.Ed. 1055 (1947). Public interest factors include the burden on local courts, the local interest in having the matter decided locally, familiarity with governing law and avoidance of unnecessary problems in conflicts of law or application of foreign law. *Id.* at 508-09. A plaintiff's choice of forum is ordinarily entitled to deference unless the private and public interest factors strongly favor trial in the foreign country. *Id.* at 509.[FN2]

> FN2. Notably, Beltappo offers no substantial opposition to the *forum non conveniens* argument. Pl.'s Response, docket no. 23, at 21.

Rich Xiberta first contends that Spain is an adequate alternative forum for the resolution of this contract dispute. Other than potentially having to apply Washington State case law in a Spanish court, Rich Xiberta is correct. However, the balance of private and public interests do not strongly favor dismissal under the *forum non conveniens* doctrine. Parties and witnesses are present in both Washington State and Spain, and there will be costs in bringing witnesses to court in either forum. The documentary evidence largely consists of the contract and purchase orders/invoices that may be obtained in both forums, and a judgment may be enforced in either forum. As for the public interest, this Court will be far more familiar with Washington State law than the Spanish courts, and this State has a strong interest in providing a forum for its residents. Finally, the Court must weigh heavily the deference ordinarily given to the plaintiff's choice of forum. For all of these reasons, the Court DENIES Rich Xiberta's alternative motion for dismissal under the *forum non conveniens* doctrine.

III. *Costs and Attorneys' Fees*

Rich Xiberta's request for costs and attorneys' fees was based on the assumption that it would be successful in its motion to dismiss for lack of personal jurisdiction. *See* RCW 4.28.185(5) (reasonable attorneys' fees and costs for a party who prevails on a jurisdictional defense under the long-arm statute). This request is DENIED because the Court has personal jurisdiction over Rich Xiberta.

CONCLUSION

The Court DENIES Defendant's motion to dismiss for lack of personal jurisdiction or, in the alternative, for *forum non conveniens,* and for costs and attorneys' fees. Docket no. 21. The Court STRIKES AS MOOT Beltappo's motion to supplement the record. Docket no. 34.

***10** IT IS SO ORDERED.

W.D.Wash.,2006.
Beltappo, Inc. v. Rich Xiberta, S.A.
Not Reported in F.Supp.2d, 2006 WL 314338 (W.D.Wash.)

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Only the Westlaw citation is currently available.

United States District Court, W.D. Washington, at Tacoma.
Patti BINGHAM, Cody Bingham, Plaintiffs,
v.
BLAIR LLC, Blair Corporation; Appleseeds Topco, Inc.; Orchard Brands Corporation; Orchard Brands Topco, LLC; Catalog Holdings, LLC, Susan D. Carlson, Defendants.

No. C10-5005 RBL.
May 27, 2010.

West KeySummary**Federal Courts 170B** 79

170B Federal Courts
170BII Venue
170BII(A) In General
170Bk77 Corporations, Actions by or Against
170Bk79 k. Corporate Activities and Contacts Within District; Doing Business in General. Most Cited Cases

District Court in Washington lacked specific jurisdiction over companies named as defendants in consumers' action against them seeking damages for injuries sustained when an alleged defective bathrobe caught fire. The companies lacked the minimum contacts to sustain jurisdiction. They were not residents of Washington, and were organized under the laws of Delaware with offices in either Massachusetts or California. Further, they did not maintain offices or employees in Washington, nor did they sell or distribute goods in Washington. Fed.Rules Civ.Proc.Rule 12(b)(2), 28 U.S.C.A.

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ORDER GRANTING MOTION TO DISMISS ON BEHALF OF ORCHARD BRANDS CORP., ORCHARD BRANDS TOPCO, LLC, and CATALOG HOLDINGS, LLC.
RONALD B. LEIGHTON, District Judge.

***1** This matter comes before the Court on the motion of Defendants Orchard Brands Corporation, Orchard Brands Topco LLC, and Catalog Holdings LLC., to Dismiss Plaintiffs' complaint pursuant to Fed.R.Civ.P. 12(b)(2). Plaintiff has not filed a timely response.[FN1] The Court, having reviewed the motion and the record herein, is fully informed and **GRANTS** the motion for the reasons stated herein.

FN1. Plaintiffs have filed a document entitled "Plaintiffs Dismiss Parties Without Prejudice." Dkt. # 50. This pleading is considered an untimely response to the motion to dismiss and provides no basis for dismissal without prejudice.

Introduction and Background

Plaintiffs filed the instant lawsuit seeking damages arising from an incident where an allegedly defective bathrobe caught fire resulting in injuries to Plaintiffs, Patti and Cody Bingham. Plaintiffs' complaint alleges that the Defendants collectively advertised, sold and delivered, without adequate testing, the robe that is basis of their lawsuit. Other than Defendant Blair LLC,[FN2] Plaintiffs provide no jurisdictional basis for their claims against the moving Defendants. Plaintiffs simply allege that they will "ascertain the exact relationship of the entities" with "investigation and discovery."

FN2. Defendant designated as "Blair Corporation" is not a legal entity and accordingly is not an appropriate defendant in this case. Blair Corporation filed a Certificate of Conversion with the Delaware Secretary of State on April 30, 2007, changing its name from "Blair Corporation" to "Blair LLC."

On April 23, 2010, Defendants Orchard Brands, Orchard Brands Topco, and Catalog Holdings (collectively, the Moving Defendants) [FN3] moved to dismiss Plaintiffs' complaint for lack of jurisdiction pursuant to Fed.R.Civ.P. 12(b)(2). Plaintiffs have not responded to the motion.

> FN3. Plaintiffs' Complaint also names Appleseed's Topco, Inc. as a defendant in this matter. However, Appleseed's Topco is a wrongly-named defendant that does not exist. Prior to suit, Appleseed's Topco changed its name and is now doing business as Orchard Brands Corporation, a named Defendant.

On April 19, 2010, this Court entered an order denying a motion to dismiss filed by Codefendant Blair LLC, but ordering Plaintiffs to file a First Amended Complaint no later than May 7, 2010 to address certain deficiencies in the original complaint. Plaintiffs filed their First Amended Complaint on May 5, 2010, addressing the issues raised by the Court order. The First Amended Complaint failed to address any of the jurisdictional issues raised by the Moving Defendants in their pending motion to dismiss.

The Moving Defendants are privately held companies that do not manufacture, distribute or sell clothing products. The Moving Defendants played no role in the design, testing, sale, or manufacture of the robe in question as alleged by Plaintiffs.

Orchard Brands is a privately held company incorporated under the laws of the state of Delaware. Orchard Brands maintains its principal place of business in Beverly, Massachusetts. Orchard Brands is not incorporated or domiciled in the state of Washington. Orchard Brands is not licensed to do business in the state of Washington. Orchard Brands does not own, use or possess real or personal property in Washington, nor does it pay taxes in the state. Orchard Brands does not sell or distribute goods or services in Washington. Orchard Brands does not maintain a place of business, mailing address, bank account, employees or phone listing in the state of Washington, nor does it have a registered agent for service of process.

Appleseed's Intermediate Holdings LLC is a wholly owned subsidiary of Orchard Brands and the sole member of Blair LLC, therefore Blair is an indirect subsidiary of Orchard Brands. Blair is not a department or division of Orchard Brands. Orchard Brands and Blair have separate boards of directors/managers and officers. Orchard Brands and Blair maintain separate budgets and financial records. Orchard Brands and Blair maintain separate bank accounts and do not commingle funds.

***2** Orchard Brands Topco is a privately held holding company formed under the laws of the state of Delaware. Orchard Brands Topco maintains its principal place of business in Beverly, Massachusetts. Orchard Topco is not incorporated or domiciled in the state of Washington. Orchard Topco is not licensed to do business in the state of Washington. Orchard Topco does not own, use or possess real or personal property in Washington, nor does it pay taxes in the state. Orchard Topco does not sell or distribute goods or services in Washington. Orchard Topco does not maintain a place of business, mailing address, bank account, employees or phone listing in the state of Washington, nor does it have a registered agent for service of process.

Orchard Brands is a wholly owned subsidiary of Orchard Brands Topco, making Blair an indirect subsidiary of Orchard Brands Topco. Blair is not a department or division of Orchard Brands Topco. Orchard Brands Topco and Blair have separate boards of managers and officers.

Catalog Holdings, LLC is a privately held holding company formed under the laws of the state of Delaware. Catalog Holdings maintains its principal place of business in San Francisco, California. Catalog Holdings is not incorporated or domiciled in the state of Washington. Catalog Holdings is not licensed to do business in the state of Washington. Catalog Holdings does not own, use or possess real or personal property in Washington. Catalog Holdings does not sell or distribute goods or services in Washington. Catalog Holdings does not maintain a place of business, mailing address, bank account, employees or phone listings in the state of Washington. Catalog Holdings does not have a registered agent for service of process in Washington.

Orchard Brands Topco is majority owned by Catalog Holdings, as such Blair is an indirect subsidiary of Catalog Holdings. Blair is not a department or division of Catalog Holdings. Catalog Holdings and Blair file separate tax returns. Catalog Holdings and Blair maintain separate budgets and financial records. Catalog Holdings and Blair maintain separate bank accounts and do not commingle funds.

The non-moving Defendant, Blair LLC, is a retailer and distributer of clothing products. Blair's corporate headquarters are located in Warren, Pennsylvania. Blair sells clothing products directly in the domestic market through its own sales organization, as well as through its own website, catalogues and retail stores. Blair is a named defendant in this lawsuit and does not contest the jurisdiction of this Court.

The Moving Defendants contend that this Court lacks personal jurisdiction over these Defendants and thus are subject to dismissal.

Rule 12(b) (2) Standards

Fed.R.Civ.P. 12(b)(2) governs the dismissal of an action based on lack of personal jurisdiction. Where a defendant moves to dismiss a complaint for lack of personal jurisdiction, the plaintiff bears the burden of demonstrating that jurisdiction is appropriate. *Schwarzenegger v. Fred Martin Motor Co.,* 374 F.3d 797, 800 (9th Cir.2004). Plaintiff cannot simply rest on the bare allegations of its complaint, but rather is obligated to come forward with facts, by affidavit or otherwise, supporting personal jurisdiction. *Amba Marketing Systems, Inc. v. Jobar International, Inc.,* 551 F.2d 784, 787 (9th Cir.1977). Where, as here, the motion is based on written materials rather than an evidentiary hearing, the plaintiff need only make a prima facie showing of jurisdictional facts. *Schwarzenegger,* at 800. Uncontroverted factual allegations must be taken as true. Conflicts between parties over statements contained in affidavits must be resolved in the plaintiff's favor. *Id.* A prima facie showing means that the plaintiff has produced admissible evidence, which if believed, is sufficient to establish the existence of personal jurisdiction. *Ballard v. Savage,* 65 F.3d 1495,1498 (9th Cir.1995).

***3** Where no applicable federal statute addresses the issue, a court's personal jurisdiction analysis begins with the "long-arm" statute of the state in which the court sits. *Glencore Grain Rotterdam B.V. v. Shivnath Rai Harnarain Co.,* 284 F.3d 1114, 1123 (9th Cir.2002). Washington's long-arm statute extends the court's personal jurisdiction to the broadest reach that the United States Constitution permits. *Byron Nelson Co. v. Orchard Management Corp.* . 95 Wash.App. 462, 465, 975 P.2d 555 (1999). Because Washington's long-arm jurisdictional statute is coextensive with federal due process requirements, the jurisdictional analysis under state law and federal due process are the same. *Schwarzenegger,* at 800-01.

The Due Process Clause protects a defendant's liberty interest in not being subject to the binding judgments of a forum with which she has established no meaningful contacts, ties or relations. *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 471-72, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985). In determining whether a defendant had minimum contacts with the forum state such that the exercise of jurisdiction over the defendant would not offend the Due Process Clause, courts focus on the relationship among the defendant, the forum, and the litigation. *Shaffer v. Heitner,* 433 U.S. 186, 204, 97 S.Ct. 2569, 53 L.Ed.2d 683 (1977).

Personal jurisdiction exists in two forms, general and specific. *Dole Food Co. v. Watts,* 303 F.3d 1104, 1111 (9th Cir.2002). General jurisdiction exists over a non-resident defendant when there is "continuous and systematic general business contacts that approximate physical presence in the forum state." *Schwarzenegger,* at 801. In the absence of general jurisdiction, the court may still exercise specific jurisdiction over a non-resident defendant. To establish specific jurisdiction, the plaintiff must show that: (1) defendant purposefully availed itself of the privilege of conducting activities in Washington, thereby invoking the benefits and protections of its laws; (2) plaintiff's claims arise out of defendant's Washington-related activities; and (3) the exercise of jurisdiction would be reasonable. *Easter v. American West Financial,* 381 F.3d 948, 960-61 (9th Cir.2004); *Bancroft & Masters, Inc. v. Augusta Nat'l Inc.,* 223 F.3d 1082, 1086 (9th Cir.2000).

General Jurisdiction

A defendant is subject to general jurisdiction only where the defendant's contacts with a forum are "substantial" or "continuous and systematic." *Bancroft & Masters, Inc. v. Augusta Nat'l, Inc.,* 223 F.3d 1082, 1086 (9th Cir.2000). The threshold for satisfying the requirements for general jurisdiction is substantially greater than that for specific jurisdiction. The contacts with the forum state must be of a sort that "approximate physical presence." *Id.,* at 1086. "Factors to be taken into consideration are whether the defendant makes sales, solicits or engages in business in the state, serves the state's markets, designates an agent for service of process, holds a license, or is incorporated there." *Id.* In applying the "substantial" or "continuous and systematic" contacts test, the focus is primarily on two areas. First, there must be some kind of deliberate "presence" in the forum state, including physical facilities, bank accounts, agents, registration, or incorporation. An additional consideration is whether the defendant has engaged in active solicitation toward and participation in the state's markets, i.e., the economic reality of the defendant's activities in the state. *Helicopteros Nacionales de Colombia, S.A. v. Hall,* 466 U.S. 408, 417, 104 S.Ct. 1868, 80 L.Ed.2d 404 (1984); *Gates Learjet Corp. v. Jensen,* 743 F.2d 1325, 1331 (9th Cir.1984).

***4** The Plaintiff has not shown that any of the Moving Defendants engaged in such continuous and systematic contacts with the forum state as to amount to her maintaining a physical presence in Washington State. See *Easter v. American West Financial,* 381 F.3d 948, 960 (9th Cir.2004); *Bancroft & Masters, Inc. v. Augusta Nat'l, Inc.,* 223 F.3d 1082, 1086 (9th Cir.2000).

Specific Jurisdiction

Specific jurisdiction applies if (1) the defendant has performed some act or consummated some transaction within the forum state or otherwise purposefully availed himself of the privileges of conducting activities in the forum, (2) the claim arises out of or results from the defendant's forum-related activities, and (3) the exercise of jurisdiction is reasonable.

Under the first prong of our three-part specific jurisdiction test, Plaintiffs must establish that a Moving Defendant either "purposefully availed" itself of the privilege of conducting activities in Washington, or "purposefully directed" its activities toward Washington. See *Schwarzenegger* at 802. In order to establish purposeful availment in a tort action, the plaintiff must demonstrate the existence of (1) intentional actions (2) expressly aimed at the forum state (3) causing harm, the brunt of which is suffered, and which the defendant knows is likely to be suffered, in the forum state. *Panavision Int'l, L.P. v. Toeppen,* 141 F.3d 1316, 1321 (9th Cir.1998); *Core-Vent Corp. v. Nobel Indus. AB,* 11 F.3d 1482, 1486 (9th Cir.1993). A showing that a defendant purposefully directed his conduct toward a forum state usually consists of evidence of the defendant's actions outside the forum state that are directed at the forum, such as the distribution in the forum state of goods originating elsewhere. *Schwarzenegger,* at 803.

The Moving Defendants lack even the minimum contacts required to sustain jurisdiction in this case. All these companies are non-residents, organized under the laws of Delaware with offices in either Massachusetts or California. These companies do not maintain offices in Washington nor do they sell or distribute goods to the citizens of this state. The Moving Defendants maintain no offices, employees, agents or property in the state of Washington. Furthermore, these defendants have not purposefully directed their activities to the forum state. They lack sufficient minimum contacts to allow for specific jurisdiction under the effects test in that they were not involved in the manufacture, distribution, testing or sale of the product in question.

ParentSubsidiary Relationship

Plaintiff appears to be asserting a connection to the forum state through a parentsubsidiary relationship. However, it is well established that a parent-subsidiary relationship by itself is insufficient to attribute the minimum contacts of the subsidiary to the parent. *Wells Fargo & Co. v. Wells Fargo Express Co.,* 556 F.2d 406, 420 (9th Cir.1977).

***5** In *Kramer Motors, Inc., v. British Leyland, LTD.,* 628 F.2d 1175 (9th Cir.1980), the Ninth Circuit found that although the parent corporation was generally responsible for the sale of company products, active in approving the subsidiary's major policy decisions, and involved in the general executive operation of the subsidiary, the facts were insufficient to subject the parent to personal jurisdiction based solely on the subsidiary's contacts with the forum. *Id.* at 1177. The court noted that the parent corporation failed to control the internal affairs of the subsidiary as well as its daily operations. *Id.*

However, "if the parent and subsidiary are not really separate entities, or one acts as an agent of the other, the local subsidiary's contacts with the forum may be imputed to the foreign parent corporation." *Doe v. Unocal Corp.* 248 F.3d 915, 926 (9th Cir.2001). An alter ego or agency relationship is typified by parental control of the subsidiary's internal affairs or daily operations. *Kramer Motors, Inc. v. British Leyland, Ltd.,* 628 F.2d 1175, 1177 (9th Cir.1980). To demonstrate that a subsidiary is an "alter ego" such that its contacts with a forum should be imputed to a parent, the plaintiff must show (1) that there is such unity of interest and ownership that the separate per-

H

United States District Court, W.D. Washington,
at Seattle.
CAMPAGNOLO S.R.L., Plaintiff,
v.
FULL SPEED AHEAD, INC., a Washington Corporation, and Tien Hsin Industries, Co., Ltd., Defendants.

No. C08-1372 RSM.
May 20, 2010.

West KeySummary**Corporations and Business Organizations 101 ⚷1074**

101 Corporations and Business Organizations
101II Disregarding Corporate Entity; Piercing Corporate Veil
101k1057 Particular Occasions for Determining Corporate Entity
101k1074 k. Fraud. Most Cited Cases
(Formerly 101k1.6(13))

Parent company did not exercise total domination over subsidiary sufficient to be vicariously liable in a false advertising action. While parent company was able to exercise some control over subsidiary and is nearly the sole-supplier to subsidiary, parent company did not exercise any control of the day-to-day operations of subsidiary. There was no overlap between parent and subsidiary employees, and no subsidiary employees reported to any employees of the parent company. Further, no evidence existed that parent company had any oversight over the content of subsidiary company's advertising.

ORDER GRANTING DEFENDANT TIEN HSIN'S MOTION FOR SUMMARY JUDGMENT

RICARDO S. MARTINEZ, District Judge.

*1 This matter comes before the Court on the motion for summary judgment brought by Tien Hsin Industries, Co., Ltd. ("Tien Hsin") (Dkt.# 205). Campagnolo S.r.l. ("Campagnolo"), an Italian corporation, brought this false advertising action against Full Speed Ahead, Inc. ("FSA"), a Washington corporation, alleging that advertisements published by FSA misrepresented product characteristics of FSA's and Campagnolo's bicycle cranksets. Tien Hsin is a Taiwan corporation that manufactures the bicycle components that FSA sells to retailers and distributors in North America. Tien Hsin moves for summary judgment on the basis that it had no knowledge of or involvement with the allegedly false advertisements published by FSA, is a separate corporate entity from FSA, and is not vicariously liable for FSA's torts.

I. FACTS

In its May 11, 2010 order, this Court denied FSA's motion for summary judgment on the merits of the underlying false advertising claim because there are genuine disputes of material fact regarding the elements of Campagnolo's claims (Dkt.# 327). The facts of the underlying false advertising dispute are discussed in detail in that order and will not be recounted here. Only the facts regarding Tien Hsin's relationship with FSA and its involvement in the advertising campaign are relevant to the present disposition. As this is a motion for summary judgment, the facts are stated in the light most favorable to Campagnolo, the non-moving party.

Tien Hsin manufactures bicycle components which it sells to over one hundred distributors worldwide. These products are sold under a variety of different brand names, one of which is Full Speed Ahead or FSA. Full Speed Ahead branded products are sold to FSA in the United States, or Full Speed Ahead, S.r.l. ("FSA-Europe") in Italy. Those companies in turn sell the products to distributors and retailers in North America and Europe respectively. FSA primarily sells products that it purchases from Tien Hsin, although on at least one occasion it has purchased and resold a product from one of Tien Hsin's competitors.

Tien Hsin is owned by four shareholders: Yudi Chiang, her husband Douglas Chiang, Douglas Chiang's mother, and Douglas Chiang's sister. Yudi Chiang is FSA's sole shareholder. FSA and Tien Hsin do not share any employees. FSA is managed by Matt Van Enkenvort. In the late 1990s, Ms. Chiang formed a distributorship in California to sell bicycle parts in North America. At some point this distributorship was incorporated as a California corporation, and in 2001 that corporation was moved to Washington and reincorporated as a Washington corporation, FSA. Van Enkevort testified that prior to 2001 when FSA was reincorporated in Washington, Tien Hsin marketed its products in North America directly and placed advertisements in magazines and sold goods themselves. Later, however, he admitted that he was not with the company at that time and only knew this information because he, as a product manager for a different company, saw Tien Hsin's products being marketed.

*2 Tien Hsin owns the trademark "FSA." It has no written agreements with FSA regarding the licensing of the trademark; however, Yudi Chiang testified in her declaration that Tien Hsin and FSA have an oral license agreement. Although there are no written agreements of any kind formalizing the relationship between Tien Hsin and FSA, when Tien Hsin sends products to FSA, it invoices FSA in writing.

Van Enkevort makes the day-to-day operating decisions for FSA. He reports to FSA's chairman and sole shareholder, Yudi Chiang, at least once every quarter, providing her with FSA's sales reports and financial data. These reports are sent to Chiang's Tien Hsin e-mail address. Because Van Enkevort manages FSA, neither Yudi Chiang nor Tien Hsin is typically involved in FSA's operations, including advertising. Neither Yudi Chiang nor any Tien Hsin employee directs FSA's advertising campaigns, controls the content of advertisements, directs when advertisements should be published, advises or comments on the advertisements. In fact, Yudi Chiang testified that she had not seen the FSA advertisements at issue in this case until her deposition. Tien Hsin runs its own Taiwanese web site and does not control FSA's web site. Tien Hsin does not advertise FSA branded products on its web site.

Even though Tien Hsin did not directly prescribe the content of FSA's advertisements, Tien Hsin did take some actions that indirectly influenced the ad campaign at issue in this case. First, Tien Hsin publishes a yearly Bike Solutions Manual that contains product information for all of Tien Hsin's products including FSA branded products. FSA often gets technical information regarding FSA branded products from that manual. In this case, the product information on which FSA's ad campaign was based derived from independent testing, not solely from information in the Bike Solutions Manual, although the record is unclear whether the same product information in the advertisements in this case was also contained in the Bike Solutions Manual. Secondly, Tien Hsin provided FSA-Europe with the prototype crankset that was independently tested, data from which was the basis of the ad campaign. FSA-Europe, not Tien Hsin, however, decided to have the prototype tested. Third, Tien Hsin sells the crankset that is the subject of the advertisements to FSA, which then advertises and resells the crankset.

Although Tien Hsin does not directly pay FSA to conduct advertising, Tien Hsin indirectly compensates FSA to conduct some advertising on its own behalf and for the benefit of Tien Hsin. FSA purchases products from Tien Hsin at prices determined by a formula. According to Van Enkevort, that formula sets "a very aggressive price," lower than the price other distributors would receive, that allows FSA to be profitable reselling goods to other distributors "and also to engage in marketing." Any marketing conducted by FSA for its FSA products benefits Tien Hsin as well as FSA because the products originate from Tien Hsin and Tien Hsin owns the FSA trademark. When FSA meets with its customers, distributors and original equipment manufacturers, it meets on behalf of itself. However, as many of these customers do significant business in Asia, they often buy products directly from Tien Hsin. Van Enkevort testified that "it is understood between [Tien Hsin and FSA]" that the low price FSA receives on Tien Hsin's products compensates FSA for its sales efforts that do not directly bring in compensation for FSA.

*3 The licensing agreement and pricing formula create a close business relationship between FSA and Tien Hsin in which Tien Hsin benefits from FSA's activities. This relationship is close enough that Van Enkevort referred to FSA as "our [Tien Hsin's] U.S. company" or "the U.S. office." Additionally, on some special occasions, Yudi Chiang will ask Van Enkevort to negotiate business deals on behalf of Tien Hsin because Yudi Chiang and her husband do not speak fluent English. On these special occasions, Tien Hsin makes the substantive decisions regarding what to accept, but Van Enkevort communicates Tien Hsin's position. For example, in 2007, Van Enkevort helped negotiate a license agreement between Cane Creek Cycling Components, Inc. ("Cane Creek") and Tien Hsin as a means of settling a royalty claim. Prior to that negotiation, Douglas Chiang sent an e-mail to Cane Creek's president explaining that Van Enkevort would represent Tien Hsin as to the license and royalty matters.

II. DISCUSSION

Campagnolo bases its claims against Tien Hsin both on a theory of "direct" liability and vicarious liability for FSA's actions. First, Campagnolo argues that Tien Hsin and FSA were joint actors in the advertising campaign, Tien Hsin participated directly, and Tien Hsin contributed to the false advertising. Second, Campagnolo argues that Tien Hsin is vicariously liable for FSA's torts first because Tien Hsin and FSA are alter egos of one another-in other words a single entity-or second, because FSA acts as Tien Hsin's agent.

The Court applies the familiar summary judgment standard. Summary judgment may only be granted where there is no genuine dispute of material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. Proc. 56(c). If a jury believing the nonmoving party's evidence and making reasonable inferences in its favor could return a verdict for the non-moving party, summary judgment must be denied. *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

A. Liability for Tien Hsin's Own Actions

Plaintiff first claims that Tien Hsin is "directly liable for false advertising" (Dkt. # 258 at 11). This claim lacks merit. Uncontroverted evidence establishes that no Tien Hsin employees contributed to FSA's advertisements, commissioned the advertisements, reviewed the advertisements, or participated in their creation or dissemination in any way. Plaintiff points to Tien Hsin's dissemination of its Bike Solutions Guide to FSA as a basis for liability. However, there is no evidence that FSA's advertisements were based off the Bike Solutions Guide or that Tien Hsin intended the information in the Bike Solutions Guide to be the basis for an FSA advertising campaign. Indeed uncontradicted testimony from FSA witnesses, and the text of the advertisements themselves, indicate that the numbers in FSA's advertisements were derived from independent testing by a German laboratory, not from any Tien Hsin publication. It is not clear that the Bike Solutions Guide contained information or language similar to the FSA advertisements since it is not part of the record. Campagnolo does not allege that the Bike Solutions Guide is itself a false advertisement. These facts do not establish any liability.

***4** It is also of no help to Campagnolo that Tien Hsin provided FSA-Europe with the crankset that was eventually tested by a German laboratory, providing the data that became the basis of FSA's advertisements. There is no evidence that Tien Hsin provided that crankset to FSA-Europe in 2006 for the purposes of creating advertisements. Even if such a fact were established, there is no evidence that Tien Hsin had a hand in misusing that 2006 testing data to create false or misleading advertisements in 2008.

Plaintiff contends that Tien Hsin may be contributorily liable for false advertising by intentionally inducing FSA to create false advertisements. Inducement is a cognizable theory of liability for false advertising. In *Societe Des Hotels Meridien v. LaSalle Hotel Operating P'ship, L.P.,* the Second Circuit held that a defendant could be contributorily liable for false advertising for "intentionally directing, approving, authorizing, drafting and/or editing" the advertisements in question. 380 F.3d 126, 133 (2d Cir.2004). In this case, however, there is no evidence of any inducement as no Tien Hsin employees were involved with the advertisements. The evidence suggests that Tien Hsin may have contemplated through its pricing arrangement that FSA would advertise and Tien Hsin would benefit as the owner of the FSA trademark, but Tien Hsin did not direct or control the advertisements nor induce FSA to make its advertisements false.

Lastly, Campagnolo points to trademark infringement cases stating that one may be contributorily liable for infringing a trademark if one continues to supply a product knowing that the recipient is using the product to engage in trademark infringement. *See Fonovisa, Inc. v. Cherry Auction, Inc.* 76 F.3d 259, 264 (9th Cir.1996) (citing *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.,* 456 U.S. 844, 854-55, 102 S.Ct. 2182, 72 L.Ed.2d 606 (1982)). Campagnolo cites no cases, however, and the Court has found none, holding that a defendant may be subject to liability for false advertising by selling a product which is falsely advertised by the buyer. Campagnolo fails to provide any argument as to why the doctrines applicable to contributory trademark infringement should apply to false advertising. In any case, on these facts where there is no evidence that Tien Hsin had knowledge of the advertisements, or more importantly the their falsity, the Court holds that it is not liable as a matter of law.

B. Vicarious Liability

Campagnolo's vicarious liability theory is based on Tien Hsin's relationship with FSA, not any particular action Tien Hsin took in connection with FSA's advertisements. First, Campagnolo argues that Tien Hsin and FSA are "intertwined" such that they act as a single entity. Since FSA is merely Tien Hsin's alter ego, Campagnolo argues, the corporate form should be disregarded and Tien Hsin should be held liable for FSA's acts. Secondly, but relatedly, Campagnolo contends that Tien Hsin is responsible for torts committed by FSA because FSA is Tien Hsin's agent.

***5** Analyzing the facts in the light most favorable to Plaintiff, it is clear that FSA and Tien Hsin are closely related. FSA exists almost solely to distribute Tien Hsin's products in North America. It rarely sells any other product. Tien Hsin owns the FSA trademark, which it licenses to FSA without any written contract. When Tien Hsin sells its product to FSA, it does so at an aggressively low price with the understanding that FSA will use the profit to advertise. The more FSA advertises, the more the value of the FSA brand, which Tien Hsin owns, increases, and the more product Tien Hsin can sell through FSA. Additionally, FSA, at least on occasion, conducts negotiations on behalf of Tien Hsin.

These facts demonstrate a relationship between FSA and Tien Hsin that is akin to a subsidiary-parent relationship. At least at a high level, Tien Hsin has the power to control FSA because it supplies substantially all the products FSA sells and owns the FSA trademark. FSA is wholly owned by one of Tien Hsin's four shareholders who is related through marriage to the other three shareholders. That relationship is crucial to FSA. It is not an ordinary business practice for an independent company to have the trademark to its own name owned by a completely unrelated company, especially when there is no written agreement guaranteeing a continued license to that mark. FSA cannot function independently; it needs Tien Hsin to provide its products and its trademark. The current arrangement only works for FSA because Yudi Chiang and her immediate family own both Tien Hsin and FSA. In this sense, then, FSA operates as Tien Hsin's subsidiary even though Tien Hsin does not own any of FSA's stock directly.

That FSA's relationship with Tien Hsin is similar to a subsidiary-parent relationship is further supported by Van Enkevort's reference to FSA as Tien Hsin's Washington office and "our U.S. company." It also explains why FSA occasionally does business on behalf of Tien Hsin or is willing to meet with customers who ultimately buy from Tien Hsin directly.

That FSA acts like Tien Hsin's subsidiary is only the beginning of the vicarious liability inquiry, however. The Court next analyzes Campagnolo's alter ego and agency theories with the background understanding that, while Tien Hsin technically does not own FSA, it in fact acts as its parent.

1. *Alter Ego*

Although FSA and Tien Hsin are clearly related entities with aligned interests, there is no question that they are separately incorporated companies. "It is a general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries." *United States v. Bestfoods,* 524 U.S. 51, 61, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998). This general principle is only violated in "exceptional cases." *Culinary Workers & Bartenders Union v. Gateway Cafe, Inc.* ., 91 Wash.2d 353, 366, 588 P.2d 1334 (1979). "To pierce the corporate veil and find a parent corporation liable, the party seeking relief must show that there is an overt intention by the corporation to disregard the corporate entity in order to avoid a duty owed to the party seeking to invoke the doctrine." *Minton v. Ralston Purina Co.,* 146 Wash.2d 385, 397, 47 P.3d 556 (2002).[FN1] "The alter ego theory ... is applied when the corporate entity has been disregarded by the principals themselves so that there is such a unity of ownership and interest that the separateness of the corporation has ceased to exist." *Grayson v. Nordic Construction Co., Inc.,* 92 Wash.2d 548, 552, 599 P.2d 1271 (1979). On the other hand, "[w]hen the shareholders of a corporation ... conscientiously keep the affairs of the corporation separate from their personal affairs, and no fraud or manifest injustice is perpetrated upon third persons who deal with the corporation, the corporation's separate entity should be respected." *Id.*

FN1. Tien Hsin notes that there is much uncertainty regarding whether state or federal veil-piercing law should be applied. Campagnolo does not discuss the issue, but cites to both federal and state cases in support of its alter ego argument. The Court need not decide which law applies because the law is similar, if phrased differently, and the outcome in this case is the same regardless of which law applies.

***6** Under Washington law, a plaintiff seeking to pierce the corporate veil must show (1) that the corporate form was intentionally used to violate or evade a duty, and (2) disregard of the corporate form is necessary to prevent unjustified loss to the injured party. *Meisel v. M & N Modern Hydraulic Press Co.,* 97 Wash.2d 403, 410, 645 P.2d 689 (1982). The first element requires an abuse of the corporate form, which typically involves "fraud, misrepresentation, or some form of manipulation of the corporation to the stockholder's benefit and creditor's detriment." *Id.* (quoting *Truckeweld Equip. Co. v. Olson,* 26 Wash.App. 638, 645, 618 P.2d 1017 (1980)). The second element requires that the wrongful corporate activities cause the harm suffered by the party seeking relief. *Id.* "The absence of an adequate remedy alone does not establish corporate misconduct. The purpose of a corporation is to limit liability." *Id.* at 411, 645 P.2d 689.

Federal veil-piercing law in the Ninth Circuit is similar. First, the court must find (1) that there is "such a unity of interest and ownership between the corporation and the shareholder that the two no longer exist as separate entities," and (2) that failure to disregard the corporate form would result in fraud or injustice. *Seymour v. Hull & Moreland Engineering,* 605 F.2d 1105, 111 (9th Cir.1979); *see also Igen Int'l, Inc. v. Roche Diagnostics GmbH,* 335 F.3d 303, 309 n. 5 (4th Cir.2003) (noting that under Delaware law "to pierce the corporate veil based on an agency or 'alter ego' theory, "the corporation must be a sham and exist for no other purpose than as a vehicle for fraud"). The court should consider the degree to which the separate identity of the parent and subsidiary were maintained, the degree of injustice visited on the litigants by recognizing separate entities, and fraudulent intent. *Id.* That a creditor may be unsatisfied is not an injustice warranting piercing the corporate veil. *United States v. Standard Beauty Supply Stores, Inc.,* 561 F.2d 774, 777 (9th Cir.1977).

The facts of this case, interpreted in the light most favorable to Campagnolo, do not support an alter ego finding. There is no evidence that any corporate formalities were disregarded.[FN2] FSA and Tien Hsin have separate offices, assets, and employees. FSA pays its own employees. Tien Hsin does not supervise any FSA employees. Tien Hsin does not finance FSA. There is no evidence that FSA is inadequately capitalized. *See Commodity Futures Trading Commission v. Topworth Int'l, Ltd.,* 205 F.3d 1107, 1112-13 (9th Cir.2000) (noting that undercapitalization is a significant factor in veil-piercing analysis). [FN3]

FN2. Contrary to Campagnolo's contention, that Yudi Chiang receives financial reports at her Tien Hsin e-mail address is not evidence of corporate disregard.

FN3. *See also Yoder v. Honeywell, Inc.,* 104 F.3d 1215, 1221 (10th Cir.1997) (listing ten factors to consider in determining whether the corporate veil should be pierced).

There is also no indication that Tien Hsin abused the corporate form to avoid a duty, and no evidence of fraud. The evidence shows only that FSA and Tien Hsin have a close relationship and nearly perfectly aligned business interests. That is true in the case of most parent-subsidiary relationships, but it is not grounds for piercing the corporate veil. In *J.I. Case Credit Corp. v. Stark,* 64 Wash.2d 470, 475, 392 P.2d 215 (1964), the Supreme Court of Washington held that the corporate veil should not be pierced even where the facts indicated: (1) one corporation was a wholly owned subsidiary of the other; (2) the secretary-treasurer of one was the president of the other; (3) all employees of the subsidiary were paid by the parent; (4) both companies had the same address, credit managers, lawyers, nonresident agents and auditors; and (5) the subsidiary was in business only to handle retail financing for the parent. Accordingly, the corporate form in the present case, which has none of those factors, must not be disregarded.

2. *Agency*

***7** Campagnolo argues that Tien Hsin is liable for torts committed by FSA because FSA is an agent of Tien Hsin. A principal may be liable for the acts of his agent if those acts are on the principal's behalf and within the scope of the agency. *See Scott v. Ross,* 140 F.3d 1275, 1281 (9th Cir.1998) (applying Washington law). An agency relationship requires (1) consent and (2) control. *Moss v. Vadman,* 77 Wash.2d 396, 403, 463 P.2d 159 (1970). An agency may arise without an express agreement, but "it does not exist unless the facts, either expressly or by inference, establish that one person is acting at the instance of and in some material degree under the direction and control of the other." *Matsumura v. Eilert,* 74 Wash.2d 362, 368, 444 P.2d 806 (1968). "It arises from manifestations that one party consents that another shall act on his behalf and subject to his control, and corresponding manifestations of consent by another party to act on behalf of and subject to the control of another." *Id.* Control is often the crucial factor. "Control is not established if the asserted principal retains the right to supervise the asserted agent merely to determine if the agent performs in conformity with the contract. Instead, control establishes agency only if the principal controls the manner of performance." *Uni-Com Northwest, Ltd. v. Argus Publishing Co.,* 47 Wash.App. 787, 796-97, 737 P.2d 304 (1987).

It is not clear, however, that this agency analysis applies where the asserted principal and the asserted agent are separately incorporated entities. None of the cases cited by Campagnolo, nor any of the cases cited above by the Court, involve corporations acting as agents for parent corporations.[FN4] A corporation's managers always act as agents for its shareholders-the principals. Yet even where a subsidiary is wholly owned, the parent corporation-the shareholder or principal-is generally not liable for the subsidiary's torts. *See, e.g., Bestfoods,* 524 U.S. at 61. The purpose of incorporation is to override the common law principal-agent relationship to limit liability.

> FN4. Campagnolo does cite to *Chan v. Society Expeditions,* 39 F.3d 1398 (9th Cir.1994), and *Gallagher v. Mazda Motor of Am., Inc.,* 781 F.Supp. 1079 (E.D.Pa.1992). These cases analyze the circumstances necessary for finding a subsidiary to be a general agent of the parent for purposes of personal jurisdiction. That inquiry is separate from a vicarious liability inquiry, and thus, these cases are inapposite.

Thus the Court doubts whether alter ego and agency theories for parent liability are in fact separate. *See Igen,* 335 F.3d at 309 n. 5 (discussing test "to pierce the corporate veil based on an agency or 'alter ego' theory"); *A.G. Nelson v. Int'l Paint Co., Inc.,* 734 F.2d 1084, 1092 (5th Cir.1984) (equating alter ego inquiry with inquiry into whether corporation is a "mere agent" or "conduit" of another). To the extent the theories are separate, agency liability in the corporate context must require more than the agency affiliation present in all parentsubsidiary relationships. *See Uni-Com,* 47 Wash.App. at 798, 737 P.2d 304 (noting that to hold shareholder liable for corporation's wrongs "would seem to be a disguised way of finding corporate disregard").

To hold a parent liable on an agency theory requires that the parent exercise total control over the subsidiary, well beyond the normal control exercised by parents over subsidiaries. *See Igen,* 335 F.3d at 309 n. 5 ("[M]ere control and even total ownership of one corporation by another is not sufficient to warrant the disregard of a separate corporate entity") (internal quotation omitted). Courts look to see if the parent exercises "complete domination" over the subsidiary or whether the subsidiary is a shell corporation, *Japan Petroleum v. Ashland Oil, Inc.,* 456 F.Supp. 831, 845 (D.Del.1978), or whether "the parent specifically directs the actions of its subsidiary, using its ownership interest to command rather than merely cajole," *Esmark, Inc. v. Nat'l Labor Relations Bd.,* 887 F.2d 739, 757 (7th Cir.1989). A parent has no liability on an agency theory where it does not "direct[ ] and authorize[ ] the *manner* in which the subsidiary conduct[s] its business." *Forsythe v. Clark USA, Inc.,* 224 Ill.2d 274, 289, 309 Ill.Dec. 361, 864 N.E.2d 227 (2007) (emphasis in original) (considering veil-piercing law of numerous jurisdictions). Whether the parent and subsidiary respected corporate formalities is relevant to the question of whether the parent so dominated the subsidiary that the subsidiary is a mere agent of the parent. *See Esmark,* 887 F.2d at 758-59.

***8** Turning to the case before the Court, Tien Hsin is able to exercise some control over FSA owing to its ownership of the FSA trademark, Yudi Chiang's stock ownership, and Tien Hsin being nearly the sole-supplier of FSA's goods. But Tien Hsin does not exercise total domination over FSA sufficient to be vicariously liable. FSA is not a sham nor a shell corporation. Tien Hsin does not exercise any control over the day-to-day operations of FSA. There is no overlap between Tien Hsin employees and FSA employees, and the latter do not report to the former. Specifically, there is no evidence that Tien Hsin exercises any oversight over the content of FSA's advertising campaigns. Although, Tien Hsin's pricing arrangement with FSA contemplates that FSA will advertise and Tien Hsin will benefit from that advertisement as the trademark owner and goods supplier, Tien Hsin does not control the manner of that advertisement. As far as the record shows, on the rare occasions when Van Enkevort would negotiate on behalf of Tien Hsin, Tien Hsin's directors explicitly authorized it in writing.[FN5] In short, there are no exceptional circumstances present that would justify holding Tien Hsin liable for torts committed by a separately incorporated entity. *See* Japan Petroleum, 456 F.Supp. 831 (cited in Uni-Com, 47 Wash.App. at 798, 737 P.2d 304) (no agency liability where parent held voting shares of the subsidiary; parent and subsidiary had common officers and directors; parent loaned money to subsidiary; parent benefited from subsidiary's operation; parent and subsidiary had joint management and joint operations). Accordingly, summary judgment is GRANTED in favor of Tien Hsin.

FN5. *See* Dkt. # 105.

C. Attorneys' Fees

Tien Hsin moves for attorneys' fees on the grounds that Campagnolo's claims are "groundless, unreasonable, vexatious, or pursued in bad faith." (Dkt. # 205 at 14); *see* Gracie v. Gracie, 217 F.3d 1060, 1071 (9th Cir.2000). The motion is DENIED.

III. CONCLUSION

Having reviewed the relevant pleadings, the declarations and exhibits attached thereto, and the remainder of the record, the Court hereby finds and ORDERS:

(1) Tien Hsin's Motion for Summary Judgment (Dkt.# 205) is GRANTED.

(2) Tien Hsin's request for attorneys fees is DENIED.

(3) The Clerk is directed to forward a copy of this Order to all counsel of record.

W.D.Wash.,2010.
Campagnolo S.R.L. v. Full Speed Ahead, Inc.
Not Reported in F.Supp.2d, 2010 WL 2079694 (W.D.Wash.), 2010-1 Trade Cases P 77,072

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United States District Court,
N.D. California.
CITY OF WESTLAND POLICE AND FIRE RETIREMENT SYSTEM and Plymouth County Retirement System, On Behalf of Themselves and All Others Similarly Situated, Plaintiffs,
v.
SONIC SOLUTIONS et al., Defendants.

No. C 07–05111 CW.
April 6, 2009.

West KeySummary**Securities Regulation 349B 60.51(2)**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.50 Pleading
349Bk60.51 In General
349Bk60.51(2) k. Scienter. Most Cited Cases

Stockholders' allegations were insufficient to give rise to a strong inference of scienter, as required to state a 10b-5 claim arising out of alleged false statements about a corporation's earnings and the alleged concealment of backdated stock option grants. Several factors lent support for the requisite mental state. These included the defendants' admissions, the magnitude of defendants' accounting violations, the defendants' receipt of backdated options, and the defendants' filing of false documents with the SEC. However, even when viewed cumulatively, these factors did not establish a strong inference that the defendants acted with deliberate recklessness. Private Securities Litigation Reform Act of 1995, § 101(b)(2), 15 U.S.C.A. § 78u–4(b)(2); Fed.Rules Civ.Proc.Rule 9(b), 28 U.S.C.A.; 17 C.F.R. § 240.10b–5.

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Sara B. Brody, Cecilia Y. Chan, Monica Patel, Heller Ehrman LLP, San Francisco, CA, for Defendants.

ORDER GRANTING IN PART AND DENYING IN PART DEFENDANTS' MOTION TO DISMISS
CLAUDIA WILKEN, District Judge.

*1 Defendants Sonic Solutions, David C. Habiger, Robert J. Doris, A. Clay Leighton, Mary C. Sauer, Mark Ely, Robert M. Greber, Peter J. Marguglio and R. Warren Langley move to dismiss the Consolidated Class Action Complaint (CAC). Lead Plaintiffs City of Westland Police and Fire Retirement System (Westland) and Plymouth County Retirement System (Plymouth) oppose the motion. The motion was heard on February 26, 2009. Having considered all of the parties' papers and oral argument on the motion, the Court grants Defendants' motion in part and denies it in part.

BACKGROUND [FN1]

FN1. All facts are taken from Lead Plaintiffs' CAC and are assumed to be true for purposes of this motion.

Defendant Sonic is a California corporation that develops and markets computer software related to digital media, such as data, photographs, audio and video in digital formats. Sonic has been a publicly traded company since February, 1994, and is traded on the Nasdaq Global Select Market. Defendants Robert J. Doris and Mary C. Sauer co-founded Sonic in 1986. Doris has been the Chairman of the Board of Directors since the inception of Sonic and he served as the CEO of Sonic from 1986 until he resigned from the position in September, 2005. Sauer has been a Director and Sonic's Secretary since its founding. She also served as the Senior Vice President of Marketing and Sales from February, 1993 to September, 2005.

Defendants David C. Habiger, A. Clay Leighton, and Mark Ely are executive officers of Sonic. Habiger has worked for Sonic since 1993. In April, 2005, Habiger became President and Chief Operating Officer and, in September, 2005, he succeeded Doris as the CEO. Leighton joined Sonic in 1992 and served as Sonic's Chief Financial Officer from January, 1999 to February, 2008. Ely joined Sonic in 1992 and became an Executive Vice President in September, 2006.

Defendants Robert M. Greber, R. Warren Langley and Peter Marguglio are outside directors and members of various Board Committees. They joined Sonic's Board in August, 1993, August, 1996 and June, 2001, respectively.

Lead Plaintiffs Westland and Plymouth purchased Sonic's publicly traded securities between October 23, 2002 and May 17, 2007 (Class Period).

This case arises out of Defendants' alleged false statements about Sonic's earnings and their concealment of backdated stock option grants. A stock option granted to an employee of a corporation allows the employee to purchase company stock at a specified price (exercise price), typically the fair market value of the stock on the date the option was granted. When the employee exercises an option, he or she purchases the stock from the company at the exercise price, regardless of the stock's price at the time the option is exercised. Backdating occurs when a stock option is reported as having been granted on a certain date, but is actually granted days or months later and is backdated to a date when the company's stock was trading at a lower price. Backdating allows option grantees to realize immediate unearned and undisclosed financial gains. Lead Plaintiffs allege that Defendants altered stock option grants to the Company's officers, directors and employees in order to provide the recipients with a more profitable exercise price. Defendants' statements of Sonic's earnings and expenses were allegedly false because they failed to disclose the backdating of options.

***2** On February 1, 2007, Defendants announced an internal investigation into Sonic's past options practices. At the conclusion of the investigation, on February 26, 2008, Defendants announced a $29 million restatement of Sonic's consolidated financial statements for the fiscal years (FY) from 1998 to 2005 to account for stock option grants which were granted but never documented properly.

In the restatement, Sonic stated that "a substantial number of stock options granted during the review period were not correctly accounted for." The company explained that "option grant agreements were typically dated 'as of' with no separate date for the signature of a Company officer, and Company personnel indicated that these agreements were typically generated as part of the endof-quarter reporting cycle notwithstanding the Record Date appearing on the documents themselves." The restatement also noted,

> Under each of our various options plans, our CEO was delegated the authority to make grants to employees other than executive officers. As described above, except in particular circumstances ... the Company employed a quarterly-focused grant process for non-founder employees and generally lack[ed] contemporaneous grant documents sufficient to support the Record Dates for these option grants.
>
> ...
>
> The Audit Committee noted instances in which personnel actively discussed how to correct mistakes related to the documentation and related accounting treatment, and when to inform auditors of those mistakes.
>
> ...
>
> Prior to September 23, 2005, our CEO [Doris] would typically make grants to our non-founder executive officer(s) who are considered "executive officers" for purposes of Section 16 of the Exchange Act in the same manner as he would for non-executive employees of the Company. Pursuant to the delegation to him under our various option plans, the CEO [Doris] generally did not have express authority to grant options to Section 16 officers, as this power was reserved for the board. Nevertheless, these grants were made in a consistent fashion and it is apparent that our board was aware of these option grants and did not disapprove of them ...

The restatement also concluded, "After reviewing the available documentary evidence and information gathered through interviews of Company personnel, the Audit Committee concluded that the conduct of those who administered our options plans was not intentionally or knowingly wrongful." The restatement reported that the Audit Committee also "found no indication of intent to purposefully circumvent stock option accounting rules or to otherwise inaccurately report the financial results of the Company during the Review Period."

Westland filed the initial complaint in this case on October 4, 2007, eight months after Defendants announced their internal investigation. Following Defendants' restatement in February, 2008, Westland, joined by Plymouth, filed a Consolidated Class Action Complaint. Lead Plaintiffs allege that Defendants violated Sections 10(b), 14(a), 20(a) and 20A of the Exchange Act and Rule 10b–5.

LEGAL STANDARD

***3** A complaint must contain a "short and plain statement of the claim showing that the pleader is entitled to relief." Fed.R.Civ.P. 8(a). On a motion under Rule 12(b)(6) for failure to state a claim, dismissal is appropriate only when the complaint does not give the defendant fair notice of a legally cognizable claim and the grounds on which it rests. *See Bell Atl. Corp. v. Twombly,* 550 U.S. 554, 127 S.Ct. 1955, 1964, 167 L.Ed.2d 929 (2007).

In considering whether the complaint is sufficient to state a claim, the court will take all material allegations as true and construe them in the light most favorable to the plaintiff. NL *Indus., Inc. v. Kaplan,* 792 F.2d 896, 898 (9th Cir.1986). Although the court is generally confined to consideration of the allegations in the pleadings, when the complaint is accompanied by attached documents, such documents are deemed part of the complaint and may be considered in evaluating the merits of a Rule 12(b)(6) motion. *Durning v. First Boston Corp.,* 815 F.2d 1265, 1267 (9th Cir.1987).

When granting a motion to dismiss, the court is generally required to grant the plaintiff leave to amend, even if no request to amend the pleading was made, unless amendment would be futile. *Cook, Perkiss & Liehe, Inc. v. N. Cal. Collection Serv. Inc.,* 911 F.2d 242, 246–47 (9th Cir.1990). In determining whether amendment would be futile, the court examines whether the complaint could be amended to cure the defect requiring dismissal "without contradicting any of the allegations of [the] original complaint." *Reddy v. Litton Indus., Inc.,* 912 F.2d 291, 296 (9th Cir.1990).

REQUESTS FOR JUDICIAL NOTICE

Defendants seek judicial notice of Exhibits A, B and 1–3 to their request. Federal Rule of Evidence 201 allows a court to take judicial notice of a fact "not subject to reasonable dispute in that it is ... capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." Even where judicial notice is not appropriate, courts may also properly consider documents "whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the [plaintiff's] pleadings." *Branch v. Tunnell,* 14 F.3d 449, 454 (9th Cir.1994).

Having reviewed the exhibits, the Court denies Defendants' request as to Exhibits A, B, 1 and 2 because the information contained in these SEC filings is disputed by Lead Plaintiffs. *Lee v. City of Los Angeles,* 250 F.3d 668, 690 (9th Cir.2001) (holding that a court may not take judicial notice of "disputed facts in public records."). The Court will not accept as true the matters asserted in those documents. The Court grants Defendants' request as to Exhibit 3 because historic stock prices are subject to accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.

DISCUSSION

I. Section 10(b) of the Exchange Act and Rule 10b–5

***4** Section 10(b) of the Exchange Act makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b); *see also* 17 C.F.R. § 240.10b–5 (Rule 10b–5). To state a claim under § 10(b), a plaintiff must allege: "(1) a misrepresentation or omission of material fact, (2) reliance, (3) scienter, and (4) resulting damages." *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.,* 96 F.3d 1151, 1157 (9th Cir.1996); *see also McCormick v. Fund Am. Cos.,* 26 F.3d 869, 875 (9th Cir.1994).

Some forms of recklessness are sufficient to satisfy the element of scienter in a § 10(b) action. *See Nelson v. Serwold,* 576 F.2d 1332, 1337 (9th Cir.1978). Within the context of § 10(b) claims, the Ninth Circuit defines "recklessness" as

> a highly unreasonable omission [or misrepresentation], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a

danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir.1990) (en banc) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir.1977)). As explained by the Ninth Circuit in *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir.1999), recklessness, as defined by *Hollinger*, is a form of intentional conduct, not merely an extreme form of negligence. *See Silicon Graphics*, 183 F.3d at 976–77. Thus, although § 10(b) claims can be based on reckless conduct, the recklessness must "reflect [ ] some degree of intentional or conscious misconduct." *See* id. at 977. The *Silicon Graphics* court refers to this subspecies of recklessness as "deliberate recklessness." *See id.* at 977.

Lead Plaintiffs must plead any allegations of fraud with particularity, pursuant to Rule 9(b) of the Federal Rules of Civil Procedure. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1543 (9th Cir.1994) (en banc). Pursuant to the requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), the complaint must "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." 15 U.S.C. § 78u–4 (b) (1).

Further, pursuant to the requirements of the PSLRA, a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2). The PSLRA thus requires that a plaintiff plead with particularity "facts giving rise to a strong inference that the defendant acted with," at a minimum, deliberate recklessness. *See* 15 U.S.C. § 78u–4(b)(2); *Silicon Graphics*, 183 F.3d at 977. Facts that establish a motive and opportunity, or circumstantial evidence of "simple recklessness," are not sufficient to create a strong inference of deliberate recklessness. *See Silicon Graphics*, 183 F.3d at 979. In order to satisfy the heightened pleading requirement of the PSLRA for scienter, plaintiffs "must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent." *Id.*

A. Requisite Mental State

***5** Thus, to state a claim pursuant to § 10(b) of the Exchange Act, Lead Plaintiffs must "plead 'a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.' " *Zucco Partners v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir.2009) quoting *Silicon Graphics*, 183 F.3d at 976. If no individual allegations are sufficient, then the Court will "conduct a 'holistic' review of the same allegations to determine whether the insufficient allegations combine to create a strong inference" of scienter. *Id.*

Defendants argue that Lead Plaintiffs' allegations, when examined alone or considered holistically, are insufficient to give rise to a strong inference of scienter. Lead Plaintiffs counter that nine different sources of evidence support such an inference: (1) Defendants' admissions, (2) the magnitude of the accounting violations, (3) Defendants' receipt of backdated options, (4) the timing of the backdated options, (5) Defendants' filing of false documents with the SEC, (6) the Board of Directors' actions, (7) the importance of the stock options program, (8) Defendants' insider trading and (9) the timing of Defendant Leighton's termination as CFO. The Court addresses these contentions in turn.

1. Defendants' Admissions

Lead Plaintiffs argue that, in the restatement, Defendants admitted to conduct that supports a strong inference of scienter. Specifically, the restatement notes that "option grants were typically dated 'as of' with no separate date for the signature of a Company officer, and Company personnel indicated that these agreements were typically generated as part of the end-of-quarter reporting cycle, notwithstanding the Record Date appearing on the document themselves." Lead Plaintiffs argue that this means that the option was not "granted" on the date that it was approved by the Board or CEO, but instead dated to reflect an effective date "as of" a date that had already passed. Defendants counter that because the Audit Committee concluded that no intentional misconduct occurred, any evidence of backdating should be seen as the result of "innocent but sloppy accounting practices," and that "not each and every single instance where a company has chosen the wrong measurement date is necessarily a case of backdating." *In re Zoran Corp. Deriv. Litig.* 511 F.Supp.2d 986, 1003–04 (N.D.Cal.2007). However, here, Lead Plaintiffs do not assert merely one or two stock options that contain an incorrect measurement date. In other filings submitted to the SEC, Defendants noted that "for a large portion of options issued ... there is little to no contemporaneous grant-specific documentation that satisfies the requirements for 'measurement dates' under APB No. 25." FN2 CAC ¶ 123. Further, Defendants cannot fairly rely on the Audit Committee's statement that no intentional misconduct occurred because the members of the Audit Committee are the same people responsible for overseeing the option backdating process. ¶ 136. In sum, Defendants' statements about their stock options practice provide some insight into their state of mind, but do not give rise to a strong inference of scienter.

FN2. APB No. 25 is the acronym for Accounting Principles Board Opinion No. 25. Issued in 1972, APB No. 25 provides guidelines for the expensing of options granted by a company to its employees. In 1973, APB became the Financial Accounting Standards Board, which is a leading organization in the private sector for establishing standards of financial accounting and reporting in the United States.

2. The Magnitude of Defendants' Accounting Violations

***6** Lead Plaintiffs argue that Defendants' $29 million restatement, which proved that Defendants' earlier SEC filings were inaccurate and in violation of Generally Accepted Accounting Principles (GAAP), supports an inference of scienter. *See In re Daou Sys., Inc. Sec. Litig.,* 411 F.3d 1006, 1016 (9th Cir.2005) ("Violations of GAAP standards can also provide evidence of scienter."); *In re McKesson HBOC, Inc. Sec. Litig.,* 126 F.Supp.2d 1248, 1273 (N.D.Cal.2000) (*In re McKesson*) ("when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."). Defendants do not dispute that throughout the Class Period they failed to comply with APB No. 25 when they backdated stock options. However, Defendants argue that they did so unknowingly. They argue that, until recent years, few companies understood the relevance of or how to apply APB No. 25. Defendants state that it is "an unsubstantiated stretch of the imagination to argue that executives recognized [APB No. 25's] importance in the late 1990s and early 2000s."

In a September, 2006 letter issued by the SEC which describes how APB No. 25 should be applied, the SEC stated:

> The existence of a pattern of past option grants with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms of those grants were determined with hindsight. Further, in some cases, the absence of documentation, in combination with other relevant factors, may provide evidence of fraudulent conduct.

CAC ¶ 44.

Yet, courts have concluded that APB No. 25 is a complex rule, and that a misapplication of APB No. 25 "cannot be construed as a glaring example of scienter because the measurement date criteria embodied in APB No. 25 are far from obvious." *Weiss v. Amkor Tech., Inc.,* 527 F.Supp.2d 938, 949 (D.Ariz.2007); *see In re Sportsline.com Sec. Litig.,* 366 F.Supp.2d 1159, 1168–69 (S.D.Fla.2004) ("interpretations of the measurement date criteria embodied in APB No. 25 are far from obvious"). Also, the $29 million amount in the restatement is not glaringly high given that it applies to a ten-year period. Courts have concluded that restatements of amounts far greater than $29 million do not establish scienter. *See In re Marvell Tech. Group Ltd. Sec. Litig.,* 2008 WL 4544439, at *6 (N.D.Cal. Sept. 29) ("plaintiffs cannot show scienter solely by pointing to the fact that Marvell restated its financial statements [by $327.4 million in stock-based compensation expenses]"); *Weiss,* 527 F.Supp.2d at 942 (dismissing a stock option backdating case where the restatement was $106 million). Though the magnitude of Defendants' accounting violation alone does not demonstrate scienter, together with other allegations, it could amount to the requisite mental state.

3. Defendants' Receipt of Backdated Options

***7** Lead Plaintiffs argue that the receipt of backdated options by Defendants Doris, Sauer and Leighton supports a strong inference of scienter on their part. For instance, Lead Plaintiffs allege that

Defendant Leighton received at least 440,000 backdated options from which he immediately realized earnings when the options were filed. *See* Middlesex Ret. Sys. v. Quest Software, Inc., 527 F.Supp.2d 1164, 1183 (C.D.Cal.2007) ("it is simply incomprehensible that for such large option grants Defendants would not have been keenly aware of the option measurement date and the resulting value of the option grants"); *In re Affymetrix Deriv. Litig.,* 2008 U.S. Dist. LEXIS 97245, at *21 (N.D.Cal. Oct. 24) (concluding that allegations that defendants received backdated options "support an inference that [those defendants] had knowledge of and participated in the backdating of the options because they had a significant financial interest in doing so"). However, Defendants counter that these option grants were only a small subset of the grants that Leighton received while he worked at Sonic and, therefore, do not support any inference of scienter. Further, Defendants argue that if the backdating had been done intentionally, they would have picked even more advantageous dates, dates on which the stock was trading even lower than on the ones recorded. Defendants also argue that the grants to Doris and Sauer are irrelevant because they occurred outside of the class period. This last argument is not well-taken because the class period is defined by the dates of Defendants' alleged false statements, not the option grant dates. *In re Openwave Sys. Sec. Litig.,* 528 F.Supp.2d 236, 250 (S.D.N.Y.2007) ("it is irrelevant that the options were received before the class period. The accounting for the backdated options affected every financial statement until those options vested."). While standing alone, the receipt of backdated options by individual Defendants does not necessarily support a strong inference of those Defendants' scienter, it does provide some support for that conclusion.

4. Timing of the Backdated Options

Lead Plaintiffs argue that the timing of the backdating was "so fortuitous that intentional retroactive selection of such grants is the only reasonable inference that can be drawn." Opposition at 17. Lead Plaintiffs claim that, based on all publicly available documents regarding Sonic's option grants, the Company made fourteen discretionary grants between 1996 and 2004.[FN3] Eight grants were purportedly made on dates when its stock was trading at its lowest point in the relevant month. Lead Plaintiffs assert that, "according to a statistical analysis performed by Professor Eric Lie, the odds of this happening by chance are *1 in 11 million.*" Opposition at 17 (emphasis in original); *see also* CAC ¶ 9. Defendants counter that this statistical claim is spurious because nothing in the complaint describes how the calculation was made nor how Lead Plaintiffs determined which "grants among the thousands made by Sonic during the class period were 'discretionary'." Reply at 7. In the absence of further information as to why these fourteen grants are distinguishable from thousands of other grants made by Sonic, these fourteen grants must be viewed as a small unrepresentative sample of all stock option grants. Further, the claim that many of these grants were made at the lowest point of the month may be misleading because, in some instances, the stock traded at the same price or lower several times in a month. If Defendants were actively selecting grant dates with the intent to maximize their earnings, they would have selected more favorable dates. Absent a clearer showing, the grant dates themselves provide little evidence from which to make an inference scienter.

FN3. Lead Plaintiffs note that, in total, "Sonic made 24 grants between 1996 and 2004, but at least ten of those grants were non-discretionary grants awarded under Sonic's non-employee director plan, under which grant dates could not be manipulated." Opposition at 17 n. 10.

5. Filing of False Documents with the SEC

***8** Lead Plaintiffs argue that each time Defendants signed false SEC filings, Sarbanes–Oxley (SOX) certificates and financial statements they knew or at least were "deliberately reckless in not knowing that stock options were not being issued at fair market value on the date of the grant." *See* Zoran, 511 F.Supp.2d at 1013. However, standing alone, these filings do not give rise to a strong inference of scienter. *Zucco Patners LLC v. Digimarc Corp.,* 2009 WL 311070, at *18 ("Sarbanes–Oxley certifications are not enough to create a strong inference of scienter and do not make [plaintiff's] otherwise insufficient allegations more compelling by their presence in the same complaint."); Brodsky v. Yahoo! Inc., 2008 WL 4531815, at *10 (N.D.Cal. Oct. 7) ("Without any supporting allegations that Defendants made false accounting entries or inflated revenues, Defendants' signatures on the SEC certificates do not create a strong inference of scienter."). However, in conjunction with the fact that many Defendants personally received backdated stock options, their signed false

SEC and SOX documents provide some evidence of scienter.

6. Board of Directors' Actions

With respect to stock option grants to Sonic's non-founding executive officers, the restatement noted that "the CEO generally did not have express authority to grant options to [them], as this power was reserved for the board. Nevertheless, these grants were made in a consistent fashion and it is apparent that our board was aware of these option grants and did not disapprove of them." CAC ¶ 53. Lead Plaintiffs point to this section of the restatement as evidence that the entire Board of Directors participated in a scheme to backdate stock options. However, the restatement refers to actions the CEO took with respect to granting stock options to non-founding executive officers, without first getting the approval of the Board. The restatement does not acknowledge that the Board knowingly participated in illegally backdating stock options.

7. The Importance of the Stock Options Program

Lead Plaintiffs contend that, because the stock options program was "of fundamental importance to the Company's success," there is a strong inference that Defendants knew or were deliberately reckless in not knowing that they acted illegally by not correctly disclosing backdated options to the SEC. In essence, Lead Plaintiffs argue that stock options were critical to Sonic's "core operations." *South Ferry LP v. Killinger,* 542 F.3d 776, 785 (9th Cir.2008) ("Where a complaint relies on allegations that management had an important role in the company but does not contain additional detailed allegations about the defendants' actual exposure to information, it will usually fall short of the PSLRA standard ... However, in some unusual circumstances, the core operations inference, without more, may raise the strong inference required by the PSLRA"). Here, the stock options program was not part of Sonic's core operation, which was the business of manufacturing and selling digital media products. While Defendants no doubt knew that they granted stock options as part of Sonic's benefits packages, not enough facts have been alleged to support a strong inference that, simply because of the importance of the stock option plans and Defendants' position in the company, they knew accounting policies were being violated.

8. Defendants' Insider Trading

***9** Lead Plaintiffs argue that Defendants' sales of $23 million worth of Sonic stock during the Class Period contribute to a strong inference of scienter. However, Lead Plaintiffs have not plead specific facts to show that these sales were unusual or suspicious, including: "(1) the amount and percentage of shares sold by insiders; (2) the timing of the sales; and (3) whether the sales were consistent with the insider's prior trading history." *Zucco,* 2009 WL 311070, at *19. Lead Plaintiffs claim that these three factors are not relevant in the backdating context because of the long duration of the fraud. *Quest,* 527 F.Supp.2d at 1185. Even if these factors are not relevant, Lead Plaintiffs have not plead with particularity any other facts that would show how Defendants' insider trading supports a strong inference of scienter.

9. The Timing of Defendant Leighton's Termination as CFO

On February 25, 2008, shortly after Sonic completed its internal investigation, Defendant Leighton changed positions from CFO to COO. Lead Plaintiffs argue that this move supports a strong inference of scienter because Defendant Leighton was partly responsible for and a direct recipient of backdated stock options. However, Lead Plaintiffs do not plead any facts to show that the Board moved Defendant Leighton from one top management position to another top management position because he engaged in fraud. *See In re U.S. Aggregates, Inc. Sec. Litig.,* 235 F.Supp.2d 1063, 1074 (N.D.Cal.2002) ("after a restatement of earnings and a subsequent loan default, it is unremarkable that the Company would seek to change its management team"); *Zucco,* 2009 WL 311070, at *16 ("Where a resignation occurs slightly before or after the defendant corporation issues a restatement, a plaintiff must plead facts refuting the reasonable assumption that the resignation occurred as a result of restatement's issuance itself.").

In sum, Lead Plaintiffs' allegations do not create a strong inference that Defendants acted with scienter. Several factors do lend support for the requisite mental state, such as Defendants' admissions, the magnitude of Defendants' accounting violations, Defendants' receipt of backdated options and Defendants' filing of false documents with the SEC. However, even when viewed cumulatively, these factors do not establish a strong inference that Defendants acted with deliberate recklessness. Therefore, Lead Plaintiffs have not adequately alleged that Defendants violated § 10(b) of the Exchange Act and Rule 10b–5.

II. Section 14(a) of the Exchange Act

Rule 14a–9, promulgated pursuant to § 14(a) of the Exchange Act, provides that no proxy statement shall contain "any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a–9.

***10** The statute of limitations for claims under § 14(a) is the earlier of one year after the discovery of the violation, or three years after the alleged violation. *See* *In re Asyst Tech, Inc. Deriv. Litig.,* 2008 WL 2169021, at *5 (N.D.Cal.); *Rudolph v. UTStarcom,* 2008 WL 1734763 (N.D.Cal.). Plaintiff Westland filed this complaint on October 4, 2007, making its § 14(a) claim time-barred as to proxy statements issued on July 29, 2003 and July 27, 2004. However, the claim based on Defendants' proxy statement filed on October 24, 2005 is not time-barred.

To plead a § 14(a) violation, a plaintiff must allege that (1) a proxy statement contained a material misrepresentation or omission, (2) the misstatement or omission was made with the requisite level of culpability and (3) the misstatement or omission was an essential link in the accomplishment of the proposed transaction. *Desaigoudar v. Meyercord,* 223 F.3d 1020, 1022 (9th Cir.2000). The requisite level of culpability is negligence. In *re McKesson,* 126 F.Supp.2d at 1265–66.

Here, Lead Plaintiffs have adequately alleged that the 2005 proxy statement omitted the material facts that Defendants had failed properly to account for backdated options. Although Lead Plaintiffs' allegations do not support a strong inference of deliberate recklessness, they do support a strong inference that Defendants were negligent in failing to discover, stop or disclose the alleged backdating scheme. Defendants, as senior executives, Board members and Audit Committee members, had duties associated with administering and accounting the stock option plans, granting the stock options and approving Sonic's financial reports and proxy statements. *See* ¶¶ 24, 53, 61, 63, 65–67, 101, 121, 125, 128, 136. Defendants were also responsible for ensuring that Sonic's public statements describing and accounting for these options were truthful and accurate. Therefore, Lead Plaintiffs' allegations are sufficient to raise an inference that Defendants knew or should have known that Sonic's proxy statement was false.

Lead Plaintiffs have also adequately alleged that the omission in the proxy statement was an essential link in the accomplishment of the proposed transaction. Lead Plaintiffs' complaint alleges that "revelations of the truth [of backdated stock options] would have immediately thwarted a continuation of shareholders' endorsement of the directors' positions, the executive officers' compensation and the Company's compensation policies." CAC ¶ 214. *See also, Belova v. Sharp,* 2008 WL 700961 (D.Or. March 13); *Zoran,* 511 F.Supp.2d at 1016; *In re Maxim Integrated Prods., Inc. Derivative Litig.,* 574 F.Supp.2d 1046, 1066–67 (N.D.Cal.2008). Standing for election as directors based on these proxy statements constitutes a proposed transaction.

III. Section 20(a) of the Exchange Act

Lead Plaintiffs allege control person liability against Defendants based on § 20(a) of the Exchange Act, which states, "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a). To prove a *prima facie* case under § 20(a), a plaintiff must prove: 1) "a primary violation of federal securities law"; and 2) "that the defendant exercised actual power or control over the primary violator." *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1065 (9th Cir.2000). "[I]n order to make out a prima facie case, it is not necessary to show actual participation or the exercise of power; however, a defendant is entitled to a good faith defense if he can show no scienter and an effective lack of participation." *Id.* "Whether [the defendant] is a controlling person is an intensely factual question, involving scrutiny of the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions." *Id.*

***11** The complaint does not allege any specific facts supporting a conclusion that Defendants are controlling persons of Sonic. The entirety of the relevant allegations is contained in the following paragraphs:

> Defendants acted as controlling persons of Sonic within the meaning of § 20(a) of the Exchange Act. By reason of their positions with the Company, and their ownership of Sonic stock, defendants had the power and authority to cause Sonic to engage in the wrongful conduct complained of herein. Sonic controlled defendants and all of its employees. By reason of such conduct, defendants named herein are liable pursuant to § 20(a) of the Exchange Act.

CAC ¶¶ 217. These paragraphs consist of bare legal conclusions and are devoid of any factual underpinnings. Accordingly, the complaint does not state a claim against Defendants.

IV. Section 20A of the Exchange Act

Lead Plaintiffs also allege that Defendants Doris, Sauer, Ely, Greber, Langley, Leighton and Marguglio violated § 20A of the Exchange Act, which states, "Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased ... securities of the same class." 15 U.S.C. § 78t–1.

Defendants argue that Lead Plaintiffs did not trade "contemporaneously" with Defendants. The term "contemporaneous" is inherently vague. Moreover, Congress did not intend precisely to define " 'contemporaneous as used in § 20A', but instead apparently intended to adopt the definition 'which has developed through the case law.' " *Neubronner v. Milken,* 6 F.3d 666, 669 n. 5 (9th Cir.1993) (citing H.R.Rep. No. 910, 100 Cong., 2d Sess. 27 (1988)). The Ninth Circuit has not provided clear guidance on this issue. In *Neubronner,* the Ninth Circuit specifically refrained from determining the "exact contours of 'contemporaneous trading' ..." *Neubronner,* 6 F.3d at 670. The court did, however, explain that "the contemporaneous trading rule ensures that only private parties who have traded with someone who had an unfair advantage will be able to maintain insider trading claims." *Id.*

Defendants assert that, to be contemporaneous, Lead Plaintiffs' trading must have occurred on the same day as Defendants'. *See, e .g., Buban v. O'Brien,* 1994 WL 324093, at *2 (N.D. Cal. June 22); *In re AST Research Sec. Litig.,* 887 F.Supp. 231, 233 (C.D.Cal.1995). Interpreting "contemporaneous" so strictly increases the likelihood that a plaintiff purchased the actual shares sold by the insider. As the time between the insider's sale and the plaintiff's purchase increases, the likelihood that the shares purchased by the plaintiff are the same shares the insider sold decreases substantially.

***12** Here, Lead Plaintiffs have alleged that they purchased Sonic shares on the same day that Defendants Doris and Leighton sold shares, one day after Defendant Langley sold shares, and nine days after Defendant Greber sold shares. Although the purchase of stock nine days after a sale pushes the contours of contemporaneousness, the Court concludes that all of these purchases are contemporaneous with the sales. *See Middlesex,* 527 F.Supp.2d at 1194–96 (holding that the plaintiff's allegation that it traded "on the same day as Smith, within eight days of Garn, and within three days of Brooks" was sufficient to deny the defendants' motion to dismiss the § 20A claims.). The Court notes that Lead Plaintiffs failed to allege that Defendants Sauer, Ely and Marguglio sold stock contemporaneously with Lead Plaintiffs' purchases. Therefore, the § 20A claims against those Defendants are dismissed.

CONCLUSION

For the foregoing reasons, the Court GRANTS in part Defendants' motion to dismiss Lead Plaintiffs' CAC (Docket No. 67). The Court grants Lead Plaintiffs leave to amend their CAC in accordance with this order. Lead Plaintiffs shall serve and file their second consolidated amended complaint by May 8, 2009. Defendants shall respond by June 18, 2009. Any motion to dismiss shall be noticed for August 20, 2009 at 2 p.m. The opposition to Defendants' motion to dismiss shall be filed on July 16, 2009, and any reply brief is due July 30, 2009. A further case management conference will be held on August 20, 2009 at 2 p.m., even if no motion to dismiss is filed.

IT IS SO ORDERED.

N.D.Cal.,2009.

City of Westland Police and Fire Retirement System v. Sonic Solutions
Not Reported in F.Supp.2d, 2009 WL 942182 (N.D.Cal.), Fed. Sec. L. Rep. P 95,206

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Only the Westlaw citation is currently available.

United States District Court, W.D. Washington, at Seattle.
Dr. Magdy FOUAD, individually and on behalf of all others similarly situated, Plaintiff,
v.
ISILON SYSTEMS, INC., et al., Defendants.

No. C07–1764 MJP.
Dec. 29, 2008.

West KeySummary**Securities Regulation 349B 25.61(2)**

349B Securities Regulation
349BI Federal Regulation
349BI(B) Registration and Distribution
349BI(B)5 Prospectuses and Communications
349Bk25.55 False Statements or Omissions; Accuracy
349Bk25.61 Persons Liable
349Bk25.61(2) k. Sellers. Most Cited Cases

A company was not a "seller" of securities where the company participated in "road shows" to promote the sale of stock. Such participation did not constitute active solicitation but rather, was merely common issuer activity. Therefore, stock purchasers' Securities Act claims against the company were dismissed.

Steven J. Toll, Cohen Milstein Sellers & Toll LLC, Washington, DC, Elizabeth Ann Leland, Keller Rohrback, Seattle, WA, for Plaintiff.

Gregory L. Watts, Jerome F. Birn, Jr., Wilson Sonsini Goodrich & Rosati, Palo Alto, CA, Barry M. Kaplan, Christopher F. Nelson, Wilson Sonsini Goodrich & Rosati, David Roy East, Gregory J. Hollon, Mcnaul Ebel Nawrot & Helgren PLLC, Robert M. Sulkin, McNaul, Ebel, Nawrot, Helgren & Vance, Curt Roy Hineline, Peter Scott Ehrlichman, Dorsey & Whitney, Christopher Brian Wells, Larry Steven Gangnes, Lane Powell PC, Bradley T. Meissner, Christopher M. Huck, Stellman Keehnel, DLA Piper US LLP, Louis David Peterson, Michael Ramsey Scott, Hillis Clark Martin & Peterson, John Alan Knox, Mark McLean Myers, Williams Kastner & Gibbs, Seattle, WA, David Hurwitz, Seth Aronson, O'Melveny & Myers, Los Angeles, CA, John H. Ray, III, Peter L. Welsh, Randall W. Bodner, Ropes & Gray, Boston, MA, for Defendants.

ORDER ON MOTIONS TO DISMISS
MARSHA J. PECHMAN, District Judge.

*1 This matter comes before the Court on seven motions to dismiss Plaintiffs' consolidated class action complaint (the "complaint") (Dkt. No. 54). The motions to dismiss have been filed by: (1) Defendants Barry Fidelman, Gregory McAdoo, Matthew McIlwain, James Richardson, Isilon Systems, Inc., William Ruckelshaus, Sujal Patel, and Elliott Jurgensen (the "Isilon Defendants") (Dkt. No. 78); (2) Defendant Steven Goldman (Dkt. No. 83); (3) Defendant Stuart Fuhlendorf (Dkt. No. 86); (4) Defendants Morgan Stanley & Co. Inc., Merrill Lynch Pierce Fenner & Smith Inc., Needham & Co. LLC, and RBC Capital Markets Corp. (the "Underwriter Defendants") (Dkt. No. 77); (5) Defendants Sequoia Capital, Sequoia Capital X, Sequoia Technology Partners X LP, Sequoia Capital X Principals Fund LLC, and SC X Management LLC (collectively "Sequoia") (Dkt. No. 75); (6) Defendants Atlas Venture, Atlas Venture Fund V LP, Atlas Venture Entrepreneurs Fund V LP, and Atlas Venture Associates V LP (collectively "Atlas") (Dkt. No. 81); and (7) Defendant Madrona Venture Group, LLC ("Madrona") (Dkt. No. 88). After reviewing all motions, Plaintiffs' response (Dkt. No. 95), Defendants' replies, and all papers submitted in support thereof, the Court rules as follows: Defendants' requests for dismissal of counts one, three, and six are DENIED; the Court GRANTS in part Defendants' request for dismissal of the remaining counts: the Section 12(a)(2) claims in count two against Isilon, Fuhlendorf, and Goldman are DISMISSED; the claims in count four and count seven against Sequoia, Atlas, and Madrona (the "Venture Capitalist Defendants") are DISMISSED; and the Section 10(b) claims against Ruckelshaus and McIlwain are DISMISSED. The Court's reasoning is set forth below.

Background

This action is brought on behalf of a putative class of individuals who purchased securities of Isilon, Inc. ("Isilon" or "the Company") from December 14, 2006 to November 8, 2007 (the "Class Period"). Isilon's initial public offering ("IPO") was conducted in the fourth quarter of

2006 on December 14. In conjunction with the IPO, Defendants released a Form S–1/A registration statement and a Form 424B4 prospectus (collectively, the "Registration Statement"). (¶ 1.) Isilon completed a successful IPO of 89 million shares at $13 per share, for which Isilon received about $105.7 million in proceeds. (¶ 4.)

In the fall of 2007, Isilon issued three statements that immediately preceded a decreased value in Isilon stock. (¶¶ 9–13 .) On October 3, 2007, Isilon announced that it did not expect to meet its projected revenue for the third quarter of 2007. (¶ 9.) On October 24, 2007, Isilon announced the departure of its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") and postponed announcing financial results for the third quarter of 2007. (¶ 11.) On November 8, 2007, the Company announced that its Audit Committee would conduct an internal investigation regarding Isilon's practice of revenue recognition and that no financial results for the third quarter of 2007 would be released until the investigation was complete. (¶ 12.) After each announcement, the price of Isilon shares fell. (¶¶ 10, 11, 13.)

***2** The Audit Committee concluded its investigation in the spring of 2008. On April 2, 2008, the Audit Committee issued a financial restatement for the fourth quarter of 2006 and the first and second quarters of 2007 (the "Restatement"). (¶ 16.) The Restatement indicates that $7 million of the $68 million in revenue reported during those three quarters had been incorrectly recognized. (*Id.*)

Plaintiffs bring their claims on the theory that Defendants improperly recognized revenue both before the IPO and during the Class Period. Plaintiffs allege that Defendants improperly recognized revenue on accounts: (1) that did not have legally binding terms; (2) where the fee was not fixed or determinable; (3) where collection was not probable; and (4) where the identity of the end-user was unknown. (¶ 137.) Plaintiffs further allege that Defendants falsely assured investors that Isilon "adhered to GAAP-compliant revenue recognition policies" and "recognized revenue only when certain conditions were met," thereby creating "the false impression that the Company was well-managed and its reported financials were true." (¶ 139.) Ultimately, Plaintiffs allege that Defendants' overstatement of financial revenues allowed the Defendants to complete a successful IPO and maintain an artificially inflated stock price throughout the Class Period. (*Id.*)

Plaintiffs bring claims under Sections 11, 12(a)(2) and 15 of the 1933 Securities Act (the "Securities Act claims") and under Sections 10(b) and 20(a) of the 1934 Securities and Exchange Act (the "Exchange Act claims") and Rule 10b–5 promulgated thereunder. Defendants have moved to dismiss all claims.

Analysis

On a 12(b)(6) motion to dismiss, the Court must assess the legal feasibility of the complaint. Accordingly, the Court accepts Plaintiffs' factual allegations as true and draws all reasonable inferences in Plaintiffs' favor. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, ——, 127 S.Ct. 2499, 2509, 168 L.Ed.2d 179 (2007).

The Court may not consider documents outside the pleadings on a 12(b)(6) motion unless they are incorporated by reference into the complaint, form the basis of the plaintiff's claims, or are matters of judicial notice. *U.S. v. Ritchie,* 342 F.3d 903, 908 (9th Cir.2003). Defendants have requested that the Court take judicial notice of various documents, including Isilon's SEC filings. (Dkt. Nos. 76, 79, 82, and 109.) Plaintiffs do not object to these requests. (Dkt. No. 95 at 20.) The Court grants the requests and will draw no inferences in favor of Defendants from judicially-noticeable facts. *See McGuire v. Dendreon Corp.,* No. 07–800MJP, 2008 WL 1791381, at *4 (W.D. Wash. April 18, 2008).

I. *The Securities Act Claims*

As an initial matter, the Court determines that it must apply the stricter pleading standard of Fed.R.Civ.P. 9(b) when reviewing the adequacy of Plaintiffs' Securities Act claims. Rule 9(b) imposes a heightened pleading standard on allegations of fraud, requiring that "the circumstances constituting fraud or mistake shall be stated with particularity."

***3** Plaintiffs' Securities Act claims are alleged under a negligence theory and do not contain an element of fraud. However, a plaintiff will be subject to the particularity requirements of Rule 9(b) if his complaint sounds in fraud, or "allege[s] a unified course of fraudulent conduct and rel[ies] entirely on that course of conduct as the basis of the claim[.]" *In re Daou Systems, Inc.,* 411 F.3d 1006, 1027 (9th Cir.2005) (internal citation omitted). If a plaintiff makes a "wholesale adoption" of his securities fraud allegations for purposes of the Securities Act claim, then the entirety of that claim "must satisfy the heightened pleading standard set out in Rule 9(b)." *Id.* at 1028.

Rule 9(b) was enacted to protect the reputation of a defendant accused of engaging in fraudulent conduct, to minimize strike suits and to provide detailed notice of a fraud claim. *See In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049, 1056 (9th Cir.2008); *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1405 (9th Cir.1996). These goals would be thwarted if the Court were to apply the more liberal pleading standard of Rule 8(a) to negligence allegations that are premised on the same conduct underlying Plaintiffs' fraud allegations. A party is entitled to plead in the alternative and may "set out two or more statements of a claim ..., either in a single count ... or in separate ones." Fed.R.Civ.P. 8(d) (2). Nonetheless, to achieve the goals of Rule 9(b), the Court cannot allow a plaintiff to allege fraud, and alternately, allow the plaintiff to recover "on the simple untruth of the otherwise fraudulent statement" without requiring that both allegations meet the heightened pleading standard. *Wagner v. First Horizon Pharmaceutical Corp.*, 464 F.3d 1273, 1278 (11th Cir.2006).

Plaintiffs purport to bring counts one and two under a negligence theory, alleging that Defendants failed to make a reasonable investigation into whether the statements contained in the Registration Statement were true. Plaintiffs state explicitly that the counts "do[ ] not sound in fraud and [are] not based on any knowing or reckless misconduct by Defendants. Any allegations of fraud or fraudulent conduct and/or motive are specifically excluded from th[ese] Count[s]." (¶¶ 90, 105.) Nonetheless, the Section 11 and Section 12(a)(2) claims against six of the Defendants necessarily allege fraudulent conduct and are subject to the heightened pleading requirement of Rule 9(b).

To support their Exchange Act claims, Plaintiffs allege that Defendants Isilon, Jurgensen, Ruckelshaus, McIlwain, Fuhlendorf and Goldman engaged in fraudulent conduct by knowingly or with deliberate recklessness making misrepresentations about improperly recognized revenue. (¶¶ 298–303.) The alleged misrepresentations and omissions in the Registration Statement concern improper revenue recognition and are part of the same scheme and conduct that support Plaintiffs' allegations of fraud under the Exchange Act. Because Plaintiffs allege "a unified course of fraudulent conduct" against these Defendants and "rely entirely on that course of conduct" as the basis for both the Securities Act and Exchange Act claims, this Court must apply the Rule 9(b) heightened pleading standard to the Securities Act claims. *In re Daou Sys.*, 411 F.3d at 1027 (internal citation omitted); *see also Pestube Sys. v. HomeTeam Pest Def., LLC*, No. CIV–05–2832–PHX–MHM, 2006 U.S. Dist. LEXIS 34337, at *14–15, 2006 WL 1441014 (D.Ariz. May 24, 2006) (applying Rule 9(b) to Lanham Act claim that was "grounded" or "sounding" in fraud because the complaint alleged "knowing" misrepresentations).

***4** Rule 9(b) requires that Plaintiffs plead their claim with "particularized allegations of the circumstances constituting fraud," which may include "[t]he time, place, and content of an alleged misrepresentation" in addition to "the circumstances indicating falseness." *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547–1548 (9th Cir.1994). Ultimately, "[t]he plaintiff must set forth what is false or misleading about a statement, and why it is false." *Id.* at 1548.

1. *Count I: Section 11 of the Securities Act*

In conjunction with the IPO, Defendants Goldman, Patel, Fuhlendorf, Fidelman, Jurgensen, Ruckelshaus, McAdoo, McIlwain and Richardson (the "Individual Defendants") signed the Registration Statement. Defendants Morgan Stanley and Merrill Lynch acted as joint book-running managers for the IPO with Needham and RBC serving as co-manangers (the "Underwriter Defendants"). (¶ 78.) Plaintiffs bring count one against these Defendants on the ground that the Registration Statement contained material misstatements and omissions of fact.

Section 11 creates a private remedy for any purchaser of a security if "any part of the registration statement ... contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading[.]" 15 U.S.C. § 77k(a). The claim "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." *Herman & Maclean v. Huddleston*, 459 U.S. 375, 381–82, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

To succeed on their Section 11 claims, Plaintiffs must demonstrate that: (1) the registration statement contained an omission or misrepresentation; and (2) the omission or misrepresentation would have misled a reasonable investor about the nature of his investment. *In re Daou Sys.*, 411 F.3d 1006, 1028 (9th Cir.2005). To meet the heightened pleading requirement, Plaintiffs must "set forth an explanation as to why the statement or omission complained of was false or misleading." *In re GlenFed, Inc.*, 42 F.3d at 1548.

i. *Revenue Statement*

Plaintiffs allege that the Registration Statement misstated Isilon's total revenue for the nine-month period ending on October 1, 2006 as $41,623,000. Plaintiffs contend that this figure is false because it includes revenue that was improperly recognized. (¶ 80.) For support, Plaintiffs rely primarily on information provided by a confidential witness, CW1, regarding pre-IPO revenue recognition on three of Isilon's accounts. (*See* ¶¶ 68–77.)

As a preliminary matter, the Court finds that Plaintiffs' description of CW1's background and job responsibilities at Isilon "support the probability that a person in the position occupied by the source would possess the information alleged." *In re Daou Sys.*, 411 F.3d at 1015 (internal citation omitted). Plaintiffs describe CW1 as an Isilon employee who worked as a "revenue account manager" from September 2006 until shortly before the IPO. (¶ 58.) A Certified Public Accountant, CW 1 "was responsible for accounts receivable credit" and for "monthly closings of revenue[.]" (*Id.*) CW1 also "provided management with revenue and margin analyses." (*Id.*) CW1's firsthand knowledge of the allegedly improperly recognized revenue came from CW1's assigned duty to collect payment on three of Isilon's largest accounts. (¶¶ 58, 68.) CW1 also "prepared drafts of the IPO Prospectus." (¶ 58.)

***5** CW1 supports Plaintiffs' Section 11 claims with allegations that Isilon improperly recognized revenue before the IPO on three accounts. CW1 alleges that $3 million in revenue on the FM Radio account was improperly recognized in the third quarter of 2006 even though the contract's terms were indeterminable and "allow[ed] FM Radio to return or exchange the Isilon product at any time." (¶ 70.) CW1 also alleges that Isilon improperly recognized approximately $200,000 in revenue prior to the IPO on a contract with Cedars–Sinai when Cedars–Sinai was allowed to "return or exchange its Isilon hardware at any time for any product" and the contract did not contain fixed payment terms. (¶¶ 71–72.) Finally, CW 1 alleges that Isilon improperly recognized revenue in an amount greater than $200,000 on a contract with Comcast whose payment terms were not fixed and had been "extended and extended." (¶ 73.)

Defendants primarily attack these allegations by arguing that the described transactions comply with appropriate revenue recognition policies, thereby discounting the theory that any portion of the $41,623,000 in claimed revenue was improperly recognized. These arguments are more appropriate for a summary judgment motion. Nonetheless, Plaintiffs do not rely on CW1's allegations alone—they offer additional support for their Section 11 claim in the form of Isilon's own "critical accounting policies," also included in the Registration Statement. (*See* ¶ 81.) These policies state:

> We recognize product revenue when we have entered into a legally binding arrangement with a customer, delivery has occurred, the fee is deemed fixed or determinable and free of contingencies and significant uncertainties, and collection is probable.

CW1's descriptions of the FM Radio, Cedars–Sinai and Comcast contracts do not comport with Defendants' own policy of appropriate revenue recognition. According to CW1's allegations, the FM Radio and Cedars–Sinai contracts were subject to "significant uncertainties" because they contained terms that allowed return or exchange at any time, and both the Cedars–Sinai and Comcast contracts were subject to unfixed payment terms that made collection difficult and possibly improbable.

Defendants would have the Court disregard CW1's allegations because the Restatement's adjusted revenue figures were based on transactions that occurred after the IPO and not on any transaction occurring prior to the IPO. (*See* ¶ 172.) The Restatement does not indicate whether the Audit Committee investigated any transactions occurring before the IPO. (*See* Dkt. No. 84–9.) The Restatement says that "[t]he investigation focused on revenue recorded in fiscal 2006 and the first three quarters of fiscal 2007," but explains that only "certain sales" and "specific transactions" were reviewed. (Dkt. No. 84–9 at 3.) Despite Defendants' assurances that the independent investigation was thorough, the Court cannot conclude that the Company's failure to issue a restatement for any pre-IPO transactions means that revenue recognition on all pre-IPO transactions must have been legitimate, especially in light of CW1's sufficiently plead allegations.

***6** Finally, Defendants do not contest that the alleged revenue misstatement is a "material" misrepresentation. Because Plaintiffs successfully state a Section 11 claim on the allegation that the Registration Statement misstated Isilon's total revenue for the nine-month period ending on October 1, 2006, the Court need not address the remaining allegations of misrepresentation and omission. (*See* ¶¶ 82–87.)

ii. *Loss Causation*

Loss causation is the "causal connection between the [defendant's] material misrepresentation and the [plaintiff's] loss." Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 342, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005) (citation omitted). Under Section 11 of the Securities Act, loss causation is an affirmative defense on which Defendants bear the burden of proof.[FN1] *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1422 (9th Cir.1994). Nonetheless, Defendants contend that Plaintiffs' Section 11 claims must be dismissed on this motion. (Dkt. No. 105 at 15, citing *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 682 (9th Cir.1980) (affirmative defenses are appropriate grounds for dismissal where they can be resolved on the face of the complaint).)

> FN1. Loss causation is a required element for a Section 10(b) claim under the Exchange Act. 15 U.S.C. § 78u–4(b)(4). Defendants do not challenge Plaintiffs' 10(b) claims on loss causation grounds.

Rule 12(b) (6) dismissal is inappropriate "so long as the complaint alleges facts that, if taken as true, plausibly establish loss causation." *In re Gilead Sciences Sec. Litig.*, 536 F.3d 1049 at 1057 (9th Cir.2008). Plaintiffs allege that the drop in Isilon's stock price was causally related to the Registration Statement's misstated revenue figure. Isilon's stock price fell after each of three announcements made by the Company in the fall of 2007:(1) an October 3, 2007 announcement that Isilon did not expect to meet its projected revenue for the third quarter of 2007 (¶ 9); (2) an October 24, 2007 announcement postponing the release of third quarter financial results and publicizing the departure of Isilon's CEO and CFO (¶ 11); and (3) a November 8, 2007 announcement that the Company's Audit Committee would conduct an internal investigation regarding Isilon's practice of revenue recognition and that no financial results for the third quarter of 2007 would be released until the investigation was complete (¶ 12). Allegations of improper revenue recognition relate directly to a company's later inability to meet its target earnings. *See* Greebel v. FTP Software, Inc., 194 F.3d 185, 202 (1st Cir.1999) (finding that improper revenue recognition "shift[s] earnings into earlier quarters, quite likely to the detriment of earnings in later quarters").

Critically, the three disclosures do not identify improper revenue recognition practices as occurring in a particular time period, either before or after the IPO. Instead, the fall 2007 announcements informed the market that Isilon had likely engaged in improper revenue recognition at some time previous. Plaintiffs have plausibly alleged that the fall 2007 disclosures are causally connected to pre-IPO revenue that was improperly recognized and reflected in the Registration Statement's revenue figure. *See In re Daou Sys.*, 411 F.3d 1006, 1026 (9th Cir.2005) (finding loss causation allegations sufficient when they "provide[d] [defendant] with some indication that the drop in [defendant's] stock price was causally related to [defendant's] financial misstatements reflecting its practice of prematurely recognizing revenue before it was earned"). At this stage, the Company's April 2008 Restatement does not affect the plausibility of Plaintiffs' loss causation theory.

2. *Count II: Section 12(a)(2) of the Securities Act*

*7 Section 12(a) (2) of the Securities Act allows a person who purchased a security on the basis of a prospectus that included a materially false statement to seek rescission of the transaction. 15 U.S.C. § 77l(a)(2). Plaintiffs bring Section 12(a)(2) claims against Isilon, Goldman, Fuhlendorf and the Underwriter Defendants. As discussed above, Plaintiffs have sufficiently plead with particularity [FN2] that the Prospectus contained a material false statement or omission—that the total revenue for the nine-month period ending on October 1, 2006 was $41,623,000. In addition, Plaintiffs must also plead that Defendants were sellers of the securities, and that Plaintiffs purchased the securities from Defendants. *In re Daou Sys. Inc. Sec. Litig.*, 411 F.3d 1006, 1028–29 (9th Cir.2005).

> FN2. Plaintiffs must plead their Section 12(a)(2) claims with particularity for the same reasons that the Court applied Rule 9(b) to the Section 11 claims.

i. *Seller Status*

A "seller" is someone: (1) who passes title to the securities; or (2) who solicits the sale of securities to serve his own financial interest or the financial interest of the securities' owner. *Pinter v. Dahl*, 486 U.S. 622, 647–50, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988). Plaintiffs' 12(a)(2) claims against the Underwriter Defendants survive because those Defendants actually passed title of the securities pursuant to a firm commitment underwriting. Because Plaintiffs have not sufficiently plead that Isilon, Goldman or Fuhlendorf were "sellers" of the securities, the 12(a)(2) claims against those Defendants must be dismissed.

The complaint alleges that Isilon, Goldman and Fuhlendorf are "sellers" because they issued and participated in the preparation of the Prospectus and paid for and participated in "road shows" to promote the sale of Isilon stock. (¶¶ 28, 106, 108.) The weight of authority indicates that such participation does not constitute active solicitation under *Pinter*.

The *Pinter* Court expressly rejected the contention that Section 12 imposes liability for "mere participation" in unlawful sales transactions, even if that participation constitutes "a substantial factor in causing the transaction to take place." Pinter, 486 U.S. at 649. Courts assessing allegations of sales participation similar to those alleged by Plaintiffs have concluded that such activity is not sufficient to confer liability under Section 12(a)(2). Rosenzweig v. Azurix Corp., 332 F.3d 854, 870 (5th Cir.2003) (dismissing 12(a)(2) claims when defendants did not "directly communicate with the buyer" or otherwise "assume[ ] the 'unusual' role of becoming a 'vendor's agent' ") (internal citation omitted); Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1215 (1st Cir.1996) (finding the defendants' preparation of registration statement and participation in "activities" related to the sale did not confer liability when public offering was made pursuant to a firm commitment underwriting); Central Laborers Pension Fund v. Merix Corp., No. CV04–826–MO, 2005 WL 2244072, at *6–8 (D.Or. Sep.15, 2005) (collecting cases) (same).

"Virtually all issuers routinely promote a new issue, if only in the form of preparing a prospectus and conducting a road show." Lone Star Ladies Inv. Club v. Schlotzsky's Inc., 238 F.3d 363, 370 (5th Cir.2001). Plaintiffs' allegations against Isilon, Goldman and Fuhlendorf consist of common issuer activity, and are not sufficient to establish seller liability under 12(a)(2).

ii. *Standing to Bring 12(a)(2) Claim*

***8** Although Lead Plaintiff Magdy Fouad purchased shares in the secondary market, Plaintiff Southwest Carpenters purchased shares directly from the Underwriter Defendants in the IPO. (¶ 26.) This sufficiently establishes standing for the plaintiff class and Defendants' motion to dismiss on this ground is denied.

II. *Count V: Section 10(b) of the Exchange Act*

To state a claim for securities fraud under Rule 10b–5, Plaintiffs must establish five elements: "(1) a misstatement or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss." In re *Daou Sys., Inc.,* 411 F.3d 1006, 1014 (9th Cir.2005). Because the claim alleges fraud, Plaintiffs must plead "the circumstances constituting the fraud ... with particularity." Fed.R.Civ.P. 9(b). Similarly, under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Plaintiffs' allegations of false or misleading statements must (1) "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading;" and (2) "state with particularity facts giving rise to a strong inference" that the defendant acted with the required scienter. 15 U.S.C. § 78u–4(b) (1)-(2).

Plaintiffs bring count five against Isilon; Goldman and Fuhlendorf (former officers of the Company); and Jurgensen, Ruckelshaus, and McIlwain (outside directors of Isilon who served on the Audit Committee). Defendants move to dismiss the claims on the ground that Plaintiffs failed to allege particularized facts giving rise to a strong inference of scienter.

1. *A Strong Inference of Scienter*

To satisfy the scienter requirement, the complaint must "state with particularity facts giving rise to a strong inference that defendant acted with the required state of mind." 15 U.S.C. § 78u–4(b)(2). In the Ninth Circuit, the required state of mind can be met through either "actual knowledge" that a statement is false or misleading or "deliberate recklessness" as to the truth or falsity of a statement. *In re Silicon Graphics, Inc. Sec. Litg.,* 183 F.3d 970, 977, 995 (9th Cir.1999). Plaintiffs must plead specific allegations as to each defendant's state of mind. *See* Rudolph v. UT Starcom, 560 F.Supp.2d 880, 891 (N.D.Cal.2008) ("plaintiff must plead facts showing that each individual defendant acted with scienter").

The Supreme Court has formulated the following inquiry for determining scienter: "[w]hen the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?" Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, ––––, 127 S.Ct. 2499, 2511, 168 L.Ed.2d 179 (2007). The Ninth Circuit recently stated that "[t]he Supreme Court's reasoning in *Tellabs* permits a series of less precise allegations to be read together to meet the PSLRA requirement[.] .... Vague or ambiguous allegations are now properly considered as a part of a holistic review when considering whether the complaint raises a strong inference of scienter." South Ferry LP, # 2 v. Killinger, 542 F.3d 776, 784 (9th Cir.2008).

***9** As a preliminary matter, the Court finds that Plaintiffs' description of confidential witnesses CW1, CW7, and CW9 are sufficient to support their allegations. When using confidential witnesses, Plaintiffs must describe their sources "with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged" and provide "adequate corroborating details." *In re Daou Sys.,* 411 F.3d 1006, 1015–16 (9th Cir.2005) (finding that description of confidential witnesses including "his or her job description and responsibilities" sufficiently meets the PSLRA's requirements for confidential witnesses).

Plaintiffs describe CW1 as a Certified Public Accountant and former Isilon employee who worked as a "revenue account manager" from September 2006 until shortly before the IPO. (¶ 58.) CW1's firsthand knowledge of the allegedly improperly recognized revenue came from CW1's assigned duty to collect payment on three of Isilon's largest accounts. (¶¶ 58, 68.) The complaint describes CW7 as a former Isilon employee who "worked in different financial positions at Isilon from September 2005 until December 2007" and then was a "financial operations specialist" who reported to Isilon's treasurer until the end of 2006. (¶ 64.) CW7 then "remained in charge of credit and collections until December 2007[.]" (*Id.*) Finally, Plaintiffs describe CW9 as "the executive administrative assistant to CEO Goldman and CFO Fuhlendorf from April 2007 until Goldman and Fuhlendorf left the Company." (¶ 66.)

i. *The Audit Committee Directors*

Plaintiffs allege that CW1 informed Jurgensen of three instances of allegedly improper revenue recognition that occurred before the IPO. (¶¶ 77, 260.) Although Plaintiffs do not allege that Jurgensen played any direct role in improper transactions, CW1's report to Jurgensen of allegedly improper revenue recognition is sufficient to establish that Jurgensen knew or should have known of the alleged falsity of statements concerning Isilon's revenue and revenue recognition policies. The complaint not only states that CW1 spoke with Jurgensen about the allegedly improper transactions, but that Jurgensen then requested additional information, which CW1 provided in an email to Jurgensen detailing the transactions. (¶¶ 77, 149.) This allegation sufficiently establishes a strong inference of scienter and the claim against Jurgensen survives.

However, Plaintiffs fail to plead a single allegation concerning Defendants Ruckelshaus or McIlwain's knowledge of the alleged falsity of any statement concerning Isilon's revenue and revenue recognition practices, and instead assert that they must have had knowledge of these practices because they were members of the Audit Committee. Without specific allegations, this Court cannot simply assume that Jurgensen shared the information from CW1 with all members of the Audit Committee or that the Audit Committee was aware of other information concerning improper transactions. The claims against Ruckelshaus and McIlwain must be dismissed. *See In re GlenFed,* 60 F.3d at 593 (dismissing claims against outsider defendants when scienter allegations described only committee and generic responsibilities).

ii. *Goldman and Fuhlendorf*

***10** Plaintiffs have sufficiently alleged scienter as to Goldman and Fuhlendorf. As discussed above, the Court must evaluate whether all allegations combined create a strong inference of scienter. *South Ferry,* 542 F.3d at 784. Plaintiffs offer four categories of allegations that, when taken together, establish the necessary scienter for both Goldman and Fuhlendorf.

First, Plaintiffs' confidential witnesses provide specific examples of Goldman and Fuhlendorf's direct participation in allegedly improper transactions. In each transaction, Plaintiffs allege that Isilon recognized revenue on indeterminate contracts. CW1 alleges with particularity that Goldman himself allowed flexible and indeterminate payment options on the Cedars–Sinai account even though the revenue on those terms was recognized before the third quarter of 2006. (¶¶ 71–72, 143.) CW7 details two transactions involving Fuhlendorf where revenue was recognized even though no concrete contract existed: (1) the Intelligentias account, where $1 million in revenue was improperly recognized because the transaction involved a reciprocal sales transaction (¶¶ 153, 216–21); and (2) the Talon Data Systems account, where revenue was recognized on $500,000 in the first quarter of 2007 even though the contract's payment terms were flexible and payment had not yet been received by fourth quarter of 2007 (¶¶ 156–57).

Second, the alleged examples of Goldman and Fuhlendorf's participation in transactions involving improper revenue recognition are similar to the improper transactions described in the Audit Committee's Restatement. Further, the Restatement states explicitly that Goldman and Fuhlendorf "participated directly in certain of the transactions for which [revenue] adjustments are being recorded[.]" (¶ 172.) Defendants emphasize that the Audit Committee also "concluded that the evidence about [Goldman and Fuhlendorf's] roles, knowledge and intent is conflicting, disputed, and ultimately inconclusive." (*Id.*) Critically, the Restatement does not absolve either Goldman or Fuhlendorf of wrongdoing. At best, the Audit Committee's unwillingness to make a conclusive determination on Goldman and Fuhlendorf's "knowledge and intent" concerning the improper revenue recognition is a neutral statement that neither adds to or subtracts from the inference of scienter.

Third, alleged violations of generally accepted accounting principles ("GAAP") and a company's internal accounting policies can bolster the inference of scienter. *In re McKesson HBOC, Inc. Sec. Litig.,* 126 F.Supp.2d 1248, 1273 (N.D.Cal.2000) ("[W]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves."). Throughout the class period, the company published its accounting and revenue reporting policies in multiple SEC filings. (¶ 208.) These policies comply with GAAP and specific SEC criteria. (¶¶ 210–214.) The Court can conclude that Fuhlendorf and Goldman, CFO and CEO of the Company, were aware of these policies and were aware that the allegedly improper transactions described by CW1 and CW7 did not comply with them. Further, the Court is unconvinced by Defendants' argument that Goldman and Fuhlendorf might not have known how and when the revenue on these transactions was being recognized.

***11** Finally, the timing of Goldman and Fuhlendorf's departure from Isilon supports an inference of scienter. Goldman and Fuhlendorf left their positions at Isilon on October 24, 2007, three weeks after the Company announced its "disappointing" preliminary revenue results for the Third Quarter of 2007 and two weeks before the Audit Committee announced that it would be conducting an internal investigation. (¶¶ 168–169.) CW9 alleges that Goldman and Fuhlendorf were fired by the Board of Directors. (¶ 167.) Standing alone, Goldman and Fuhlendorf's departure would not support scienter. But because the changes in management occurred while Isilon was preparing its own internal investigation of revenue recognition practices, the departures "add one more piece to the scienter puzzle." *In re Adaptive Broadband Securities Litigation,* No. C 01–1092 SC, 2002 WL 989478, at *14 (N.D.Cal. April 2, 2002) (finding a strong inference of scienter where the timing of the management's departure was "highly suspicious" and the plaintiffs alleged additional scienter facts in the complaint).

Defendants emphasize that neither Fuhlendorf or Goldman sold any stock during the Class Period but instead continued to purchase Isilon stock. This fact is not sufficient to overcome the strong inference of scienter created by the allegations above. The Court finds that Plaintiffs' have sufficiently plead scienter as to Goldman and Fuhlendorf, and the 10(b) claims against them and against Isilon survive this motion.

III. ***Counts III, IV, VI and VII: Control Person Liability***

Under Section 15 of the Securities Act, "[e]very person who ... controls any person liable under [Section 11 or Section 12 of the Securities Act] shall also be liable jointly and severally with and to the same extent as such controlled person[.]" 15 U.S.C. § 77o. Section 20 of the Exchange Act allows for similar control person liability: "[e]very person who ... controls any person liable under [the Exchange Act] shall also be liable jointly and severally with and to the same extent as such controlled person is liable [.]" 15 U.S.C. § 78t(a). The control person analysis is the same for both provisions. To state a claim for control person liability, Plaintiffs must allege: (1) a primary violation of the securities laws; and (2) that the defendant exercised "control" over the primary violator. *Howard v. Everex Sys.,* 228 F.3d 1057, 1065 (9th Cir.2000).

The SEC has defined "control" as follows: "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405. Defendants Isilon, Goldman and Fuhlendorf do not contest their status as control persons. Defendants Fidelman, Jurgensen, Ruckelshaus, McAdoo, and McIlwain move to dismiss the control person claims against them, as do Defendants Sequoia, Atlas, Madrona.

***12** As an initial matter, the Rule 8 notice pleading standard applies to the Court's evaluation of these claims. Plaintiffs are required to plead their primary violations with particularity, but claims based on control person liability do not directly touch on circumstances that constitute fraud. Rule 9(b) requires only that the circumstances of fraud—the falsity of an alleged misrepresentation—be plead with particularity. "Control" over another actor does not constitute a circumstance of fraud. *See* Siemers v. Wells *Fargo & Co.,* No. 05–04518, 2006 WL 2355411, *14 (N.D.Cal. Aug.14, 2006) ("[Control] is not a circumstance that constitutes fraud. Plaintiff is only required to assert fraud with particularity as to the primary violations. At the control-person level, liability exists irrespective of the control person's scienter.") (internal citation omitted).

Defendants' argument to the contrary is in error. In *GlenFed,* the Ninth Circuit affirmed the district court's dismissal of primary liability claims under the Securities

Act and Exchange Act and the related control person liability claims "because the complaint does not satisfy Fed.R.Civ.P. 9(b)." *GlenFed,* 60 F.3d at 592. The Ninth Circuit's language does not indicate that it applied Rule 9(b) to the control person claims; when primary liability claims are dismissed for failing to meet Rule 9(b), the control person claims that depend on those primary claims *must* be dismissed.

1. *The Outside Directors*

Plaintiffs have plead sufficient facts alleging the status of Jurgensen, Ruckelshaus, McIlwain, Fidelman, and McAdoo as control persons. Whether a defendant is a control person is an intensely factual question, and a plaintiff will survive a motion to dismiss on allegations that individual defendants, by virtue of their position, could and did control and influence the company. *See In re Metawave Communs. Corp. Secs. Litig.,* 298 F.Supp.2d 1056, 1091 (W.D.Wash.2003) ("At the motion to dismiss stage, general allegations concerning an individual's title and responsibilities are sufficient to establish control."). While an outside director "is not automatically liable as a controlling person[,]" the director status "is sort of a red light" indicating the potential for day-to-day involvement in a company. *Arthur Children's Trust v. Keim,* 994 F.2d 1390, 1397 (9th Cir.1993).

In addition to their status as outside directors, Plaintiffs have alleged that Defendants Jurgensen, Ruckelshaus, and McIlwain were members of Isilon's Audit Committee, responsible for Isilon's internal controls, independent auditors, and for reviewing financial results, press releases and Isilon's code of ethics. (¶¶ 256–59, 310.) This position relates directly to the subject of Plaintiffs' fraud allegations, and the Court can infer that Jurgensen, Ruckelshaus, and McIlwain had control over the very mechanisms intended to prevent the alleged fraud. Further, Plaintiffs allege that Defendants Fidelman, McAdoo, and Ruckelshaus served on Isilon's Nominating and Governance Committee and were responsible for "overseeing the evaluation of the board of directors and management." (¶¶ 33, 311.) At the least, the Court can infer that this authority required direct engagement in and awareness of management of the company. These allegations are sufficient to establish claims for control person liability against Defendants Fidelman, Ruckelshaus, Jurgensen, McAdoo, and McIlwain. Because Isilon, Goldman, and Fuhlendorf did not challenge the sufficiency of the claims against them, counts three and six should survive these motions to dismiss in their entirety.

2. *The Venture Capital Firms*

***13** In counts four and seven, Plaintiffs allege that Defendants Sequoia, Atlas and Madrona [FN3] (the "Venture Capital Defendants") are liable as control persons for primary violations of the Securities Act and the Exchange Act.[FN4] Because Plaintiffs rely on conclusory allegations, counts four and seven must be dismissed. *In re Gupta Corp. Sec. Litig.,* 900 F.Supp. 1217, 1243 (N.D.Cal.1994) (dismissing conclusory allegations where "plaintiffs allege[d] no facts to support their allegations of control.").

> FN3. It is unclear whether Plaintiffs' have named the correct Madrona entity as a Defendant in this action. The issue need not be resolved on this motion because the Court finds Plaintiffs' control person claims against the Venture Capital Defendants unsustainable.

> FN4. Plaintiffs conceded during oral argument that they do not allege that the Venture Capital Defendants exercised control over their appointed board members.

The control person question is "intensely factual" and involves "scrutiny of the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions." *No. 84 Employer–Teamster Joint Council Pension Trust Fund v. America West Holding Corp.,* 320 F.3d 920, 945 (9th Cir.2003) (internal quotation marks and citation omitted). Plaintiffs allege only two facts to support their theory of control: (1) each Venture Capital Defendant was a large shareholder (¶ 129, 316); and (2) each Venture Capital Defendant appointed a member/members of Isilon's Board of Directors (¶¶ 129, 316).[FN5]

> FN5. Plaintiffs attempt to bolster these allegations with information from the venture capital firms' websites in their opposition brief. (Dkt. No. 95 at 66–68.) These outside sources are not incorporated into the complaint by reference, and the Court must look only to the sufficiency of allegations contained in the complaint when ruling on a motion to dismiss.

Without alleging that the Venture Capital Defendants controlled Isilon by acting in concert, Plaintiffs combine the three venture capital groups to allege that, collectively, these Defendants "beneficially owned 69.8% and 60.2% of the shares of Isilon immediately before and after the IPO, respectively." (¶ 129, 316.) Again grouping the Defendants together, Plaintiffs allege that "[d]irectors and partners of the Venture Capital Firms comprised half of the Isilon Board of Directors[.]" (*Id.*) Without additional allegations that the venture capital firms acted together to control Isilon, these allegations of control by virtue of collective ownership are conclusory and unconvincing. *See America West,* 320 F.3d at 927 (finding plaintiffs had adequately plead control person liability against two large shareholders where the shareholders had "allegedly joined forces to exert undue influence" on the company, "taking advantage of their position as majority owners who controlled the Board of Directors and related committees"); *In re Worlds of Wonder Sec. Litig.,* 721 F.Supp. 1140, 1145 (N.D.Cal.1989) (finding that plaintiffs insufficiently plead securities fraud claims against a group of defendants when plaintiffs grouped them together but "alleged nothing which would at all suggest that these defendants acted 'collectively'[.]"). Plaintiffs make no allegations of collective action in their complaint.

Individually, the three venture capital firms were minority shareholders with one appointed member on Isilon's Board of Directors. Courts in this Circuit have held that a defendant's status as minority shareholder is insufficient to establish control person liability, even when combined with the power to appoint directors. *See In re Gupta,* 900 F.Supp. at 1243 (dismissing a Section 20(a) claim against a minority shareholder with an agent on the board); *O'Sullivan v. Trident Microsystems, Inc.,* No. 93–20621 RMW, 1994 WL 124453, at *18–19 (N.D.Cal. Jan.31, 1994) (same); *In re Splash Technology Holdings, Inc. Securities Litigation,* No. 99–00109–SBA, 2000 WL 1727405, at *16 (N.D.Cal. Sept.29, 2000) (dismissing control person claim against a defendant with "a significant stock position" but where the complaint "fail[ed] to provide some corroborating, particular evidence of control").

Conclusion[FN6]

FN6. The Court has attached a chart reflecting its decision for the convenience of the parties. It would be helpful in future filings if similar charts were produced by the parties.

***14** For the reasons stated above, the Court hereby DENIES Defendants' request for dismissal of counts one, three and six, and GRANTS in part the remaining requests for dismissal as follows: the Section 12(a)(2) claims in count two against Isilon, Fuhlendorf, and Goldman are DISMISSED; the claims in count four and count seven against Sequoia, Atlas, and Madrona are DISMISSED; and the Section 10(b) claims against Ruckelshaus and McIlwain are DISMISSED.

The Clerk is directed to send a copy of this order to all counsel of record.

	Count I: § 11	**Count II: § 12(a)(2)**	**Count III: § 15**	**Count IV: § 15**	**Count V: § 10(b), 10b–5**	**Count VI: § 20(a)**	**Count VII: § 20(a)**
Isilon		dismissed					
Patel							
Fidelman							
Jurgensen							
Ruckelshaus					dismissed		
McAdoo							
McIlwain					dismissed		
Richardson							
Fuhlendorf		dismissed					
Goldman		dismissed					
Sequoia				dismissed			dismissed
Atlas				dismissed			dismissed

Madrona	dismissed	dismissed
Morg Stnly		
Merr Lynch		
Needham		
RBC		

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Not Reported in F.Supp.2d, 2006 WL 2380717 (W.D.Wash.)
(Cite as: 2006 WL 2380717 (W.D.Wash.))

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Only the Westlaw citation is currently available.

United States District Court, W.D. Washington, at Seattle.
GLUD & MARSTRAND A/S, Plaintiff,
v.
MICROSOFT CORP., et al., Defendant.

No. C05-01563RSM.
Aug. 15, 2006.

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ORDER GRANTING DEFENDANT'S MOTION TO DISMISS FOR LACK OF JURISDICTION
RICARDO S. MARTINEZ, District Judge.

*1 This matter is now before the Court for consideration of defendant Viva Magnetics (Europe) N.V.'s ("Viva Europe") motion to dismiss for lack of personal jurisdiction. (Dkt.# 65). The Court has considered the pleadings, the memoranda of the parties, and declarations submitted. For the reasons set forth below, this motion shall be granted.

FACTUAL BACKGROUND

Plaintiff, Glud & Marstrand A/S ("G & M"), brings this action for breach of non-disclosure agreements, misappropriation of trade secrets, and a number of related causes of action. G & M claims it is the owner and developer of confidential proprietary technology relating to a metal container with a plastic insert for Digital Video Discs ("DVDs") and/or Compact Discs ("CDs"). G & M alleges that Viva Europe and other Viva entities worked together to misappropriate G & M's intellectual property and use it to bid on a project for Microsoft, which is headquartered in this District. Further, G & M alleges that Viva Europe and other Viva entities conspired to deprive G & M of a genuine opportunity to bid on the Microsoft proposal request.

G & M is a limited liability entity organized and existing under the laws of Denmark, with a principal place of business in Losning, Denmark. G & M develops and manufactures metal packaging for food and consumer products and decorative tins for a wide variety of other products. While G & M was working with Microsoft on a design for the Halo2 video game case, Microsoft suggested that G & M contact a current plastic supplier to provide a plastic insert for the metal case. Microsoft identified Viva Europe as a supplier and provided G & M with contact information for Lode Vandenbossche. Viva Europe is a limited liability corporation organized and existing under the laws of Belgium, with a principal place of business in Antwerp, Belgium. Thereafter, in early August 2003, G & M contacted Mr. Vandenbossche of Viva Europe.

During the next two months, Jan Bjerregaard of G & M and Lode Vandenbossche of Viva Europe exchanged information regarding the production of a plastic insert for the Halo2 case. On August 8, 2003, G & M emailed Viva Europe a drawing of a plastic insert for the project. In order to obtain a price quotation, Viva Europe forwarded the drawing to Viva Magnetics Ltd. Hong Kong ("Viva HK"). On August 18, 2003, Viva Europe responded to G & M's request with a price quotation for the plastic insert component. Thereafter, G & M received a request for proposal ("RFP") from Microsoft for the Halo2 metal case. The RFP required a response by September 4, 2003. In order to respond to Microsoft's RFP, G & M asked Viva Europe to provide additional technical information on the plastic insert quote. Viva Europe did not provide the information until September 11, 2003.

G & M and Viva Europe continued to work together on the project. At G & M's request, Viva Europe sent G & M a sample of the plastic insert. In addition, the parties scheduled a meeting for October 23, 2003, in Denmark to discuss the project in detail. Viva Europe agreed to sign a non-disclosure agreement ("NDA") prior to the meeting. On October 17, 2003, Viva Europe cancelled the meeting without signing the NDA and advised G & M that, after consulting with Viva HK, Viva Europe would no longer work with G & M on the project. Viva Europe explains that it discontinued work on the project upon learning that Viva Magnetics (Canada) Ltd. ("Viva Canada") was involved in a tin box project with Microsoft. Subsequently, the business relationship between G & M and Viva Europe ceased.

DISCUSSION

***2** Defendant Viva Europe argues that it has done nothing that would confer general jurisdiction by this Court because it has no ties with the State of Washington, no facilities here, and no other presence here, even indirect. Viva Europe also argues there is no specific jurisdiction in Washington because the entire course of contact between Viva Europe and G & M took place in Europe and none of Viva Europe's alleged actions were directed at Washington. Further, Viva Europe asserts that it is a separate entity from defendants Viva HK and Viva Canada and thus contacts with Washington by these Viva entities cannot be attributed to Viva Europe to establish jurisdiction.

In opposition to the motion to dismiss, G & M does not contend that this Court has general jurisdiction over Viva Europe. Instead, G & M argues that this Court has specific jurisdiction over the dispute because Viva Europe's actions were specifically directed at Washington. G & M argues that Viva Europe's conduct was connected with G & M's project with Microsoft and hence, was aimed at Washington and caused harm here. Lastly, G & M argues that this Court has specific jurisdiction over Viva Europe because of Viva Europe's close alignment with other Viva entities that are subject to this Court's jurisdiction.

I. Legal Standard

In response to a motion to dismiss for lack of personal jurisdiction, the plaintiff bears the burden of demonstrating that jurisdiction over the defendant is appropriate. *Dole Food Co. v. Watts,* 303 F.3d 1104, 1108 (9th Cir.2002). Where, as here, the motion to dismiss is based on written materials rather than an evidentiary hearing, the plaintiff need only make a prima facie showing of jurisdictional facts to avoid dismissal. *Id.* While the plaintiff may not simply rely on the bare allegations of its complaint, uncontroverted allegations in the complaint are taken as true. *Schwarzenegger v. Fred Martin Motor Co.,* 374 F.3d 797, 800 (9th Cir.2004). Conflicts between the facts contained in the parties' affidavits must be resolved in plaintiff's favor. *Id.*

II. Specific Jurisdiction

The question of whether personal jurisdiction exists over a nonresident defendant is governed by Washington's long-arm statute, whose reach is coextensive with the outer limits of federal due process. *See Chan v. Society Expeditions, Inc.,* 39 F.3d 1398, 1405 (9th Cir.1994). Thus, this Court need only determine whether jurisdiction comports with constitutional due process requirements. Due process requires that the nonresident defendant have certain "minimum contacts" with the forum state so that exercise of jurisdiction does not offend traditional notions of fair play and substantial justice. *Int'l Shoe Co. v. Washington,* 326 U.S. 310, 316 (1945). Personal jurisdiction can be specific or general. *Helicopteros Nacionales de Colombia v. Hall,* 466 U.S. 408, 414 nn. 8-9 (1984). Specific jurisdiction arises where a cause of action results from a defendant's contacts with the forum state. *Id.* at n. 8.

***3** The Ninth Circuit applies a three-prong test to determine if specific jurisdiction exists:

> (1) The non-resident defendant must purposefully direct his activities or consummate some transaction with the forum or resident thereof; or perform some act by which he purposefully avails himself of the privilege of conducting activities in the forum, thereby invoking the benefits and protections of its laws;
>
> (2) the claim must be one which arises out of or relates to the defendant's forum-related activities; and
>
> (3) the exercise of jurisdiction must comport with fair play and substantial justice, i.e., it must be reasonable.

Schwarzenegger, 374 F.3d at 802. The burden is on the plaintiff to satisfy the first two prongs. *Id.* If the plaintiff meets this burden, then the burden shifts to the defendant to "present a compelling case that the exercise of jurisdiction would not be reasonable." *Id.*

A. Purposeful Availment or Direction

Under the first prong of the test, jurisdictional analysis for contract claims requires "purposeful availment" while analysis for tort claims requires "purposeful direction." *Id.* at 802-03. Personal jurisdiction must exist for each claim asserted against a defendant. *Action Embroidery Corp. v. Atl. Embroidery, Inc.,* 368 F.3d 1174, 1180 (9th Cir.2004). Because G & M's allegations include contract and tort claims, this Court must apply both analyses to determine whether G & M satisfies the first prong.

1. Contract Claims

G & M argues that Viva Europe's contacts satisfy the first prong of the test for specific jurisdiction over its contract claims for two reasons. First, G & M argues that since Microsoft suggested that G & M "partner" with Viva Europe, the subsequent agreement between G & M and Viva Europe was the direct result of conduct by a company located in the forum. Second, G & M argues that "purposeful availment" is satisfied because Viva Europe made an agreement with G & M whose known purpose was to advance a project for Microsoft.

For contract claims, the relevant inquiry focuses on whether a defendant "purposefully availed itself of the privilege of conducting activities within the forum state, thus invoking the benefits and protections of its laws." *Schwarzenegger,* 374 F.3d at 802 (*quoting Hanson v. Denckla,* 357 U.S. 235, 253 (1958)). In return for these benefits and protections, a defendant must submit to the burdens of litigation in that forum. *Id.* Typically, evidence of consummating a transaction in the forum, such as delivering goods or executing a contract, constitutes "purposeful availment." *Id.* at 803. The purposeful availment test is satisfied if the defendant has engaged in deliberate action within the forum or created continuing obligations to forum residents. *Ballard v. Savage,* 65 F.3d 1495, 1498 (9th Cir.1995). Only the defendant's own conduct can establish minimum contacts with the forum, not the actions of a third party or the plaintiff. *World-Wide Volkswagen Corp. v. Woodson,* 444 U.S. 286 (1980) (the plaintiff's act of bringing the defendant's product into the forum state does not confer personal jurisdiction over defendant); *Hanson,* 357 U.S. at 253 ("The unilateral activity of those who claim some relationship with a nonresident defendant cannot satisfy the requirement of contact with the forum State.").

***4** G & M's first argument is unconvincing and does not show that Viva Europe did anything to avail itself of jurisdiction in Washington. The fact that a third party located in the forum suggested that G & M contact Viva Europe provides no evidence that Viva Europe itself engaged in any deliberate action within the forum or created any obligations to forum residents. Viva Europe's only alleged specific contact with Washington arises from G & M's speculation that "[t]here is no doubt that Microsoft communicated with Viva Europe in conjunction with its advice that G & M should contact Viva Europe." Opposition pp. 6-7. However, Viva Europe directly controverts this allegation and states that "Viva Europe and Microsoft never communicated in conjunction with the alleged advice that G & M should contact Viva Europe." Supp. Vandenbossche Declaration ¶ 8. Thus, the uncontroverted allegations only show that G & M's contact with Viva Europe came at the suggestion of a forum-based company and not that Viva Europe itself made any relevant contacts with Washington.

G & M's second argument suggests that the mere contemplation of placing a good into the "stream of commerce" is sufficient to confer jurisdiction. This argument is without support. Viva Europe never consummated the transaction and did not supply the plastic insert to be incorporated into the Halo2 case for Microsoft. Instead, Viva Europe merely provided specifications, samples, and price quotations for the possible production of a plastic insert for G & M, located in Denmark. Negotiations toward a possible future business relationship with a company in Denmark hardly constitute evidence that Viva Europe purposefully availed itself of the privilege of conducting activities within Washington, thereby invoking the benefits and protections of its laws.

Moreover, G & M cites *Byron Nelson Co. v. Orchard Mgmt. Corp.* in support of its proposition that Viva Europe's actions satisfy "purposeful availment" under a contract claim analysis. 975 P.2d 555 (Wash.Ct.App.1999). In *Byron Nelson,* the nonresident defendant initiated contact via telephone, requested brokerage services, and contracted with the plaintiff, a Washington corporation. *Id.* at 557. The court found purposeful availment sufficient for Washington jurisdiction because the defendant "solicit[ed] and engag[ed] a Washington broker." *Id.* at 558. Here, in contrast, there is no evidence that Viva Europe ever contacted, let alone solicited or engaged, anyone in Washington.

Even accepting G & M's uncontroverted allegations as true, G & M has not demonstrated that Viva Europe invoked the benefits and protections of Washington laws such that it must submit to the burdens of litigation in this State. Consequently, G & M has failed to present sufficient evidence to meet its burden of demonstrating that this Court may exercise jurisdiction over Viva Europe based on G & M's contract claims.

Nevertheless, under the doctrine of pendent personal jurisdiction, a court may exercise jurisdiction over a "claim for which there is no independent basis of personal jurisdiction so long as it arises out of a common nucleus of operative facts with a claim in the same suit over which the court does have personal jurisdiction." *Action Embroidery Corp.,* 368 F.3d at 1180; *see also* *CE Distribution, LLC v. New Sensor Corp.,* 380 F.3d 1107, 1113 (9th Cir.2004) (finding a tort claim may serve as a basis for the exercise of pendent personal jurisdiction over a contract claim).

2. Tort Claims

***5** For tort claims, purposeful direction typically consists of the defendant's "actions outside the forum state that are directed at the forum." *Schwarzenegger,* 374 F.3d at 803. The Ninth Circuit applies a three-part "effects" test to determine whether purposeful direction has occurred. *Id.* The "effects" test requires that "the defendant allegedly have (1) committed an intentional act, (2) expressly aimed at the forum state, (3) causing harm that the defendant knows is likely to be suffered in the forum state." *Id.*

(i) Intentional Act

G & M specifically alleges that Viva Europe misused G & M's proprietary information, misled G & M into believing that Viva Europe would partner with G & M on the project, and fraudulently promised to supply information. G & M's Mr. Bjerregaard states that Mr. Vandenbossche told him that Viva Europe understood the confidential nature of the project and would treat G & M's information as confidential. G & M alleges that Viva Europe disregarded this assurance and disclosed G & M's proprietary information to other Viva entities, namely Viva HK.

G & M clears the first hurdle for purposeful direction because its pleadings sufficiently allege that Viva Europe committed an intentional act. Intentional acts giving rise to specific jurisdiction for tort liability need not occur within Washington in order to confer jurisdiction. *See* *Sinatra v. National Enquirer, Inc.,* 854 F.2d 1191, 1198 (9th Cir.1988). For purposes of a motion to dismiss for lack of personal jurisdiction, conflicts between parties over statements contained in affidavits must be resolved in the plaintiff's favor. *Bancroft & Masters, Inc. v. Augusta Nat'l Inc.,* 223 F3d. 1082, 1087 (9th Cir.2000). Thus, accepting G & M's testimony, G & M has specifically alleged that Viva Europe committed an intentional act by disclosing G & M's proprietary information after agreeing to keep it confidential.

(ii) Express Aiming at Forum State

G & M alleges that Viva Europe's conduct satisfies the express aiming requirement because the purpose of Viva Europe's conduct was to cause Microsoft to choose a Viva entity instead of G & M to develop and sell the Halo2 case. G & M further alleges that "Viva entities conspired with Microsoft to misappropriate and misuse G & M's proprietary information" and that "Viva Europe acted in conjunction with agents of Microsoft." Opposition p. 8.

In the Ninth Circuit, the express aiming requirement is satisfied "when the defendant is alleged to have engaged in wrongful conduct targeted at a plaintiff whom the defendant knows to be a resident of the forum state." *Bancroft & Masters,* 223 F3d. at 1087. In *Bancroft & Masters,* the court found "express aiming" at California where the defendant sent a letter to Virginia with the alleged intent and result of disrupting the plaintiff's California business. *See id.* at 1087-1088. G & M relies on *Sinatra v. National Enquirer* in support of its claim that Viva Europe expressly aimed its conduct at Washington. 854 F.2d 1191. In Sinatra, a Swiss clinic made false statements about Frank Sinatra, the famous singer, to National Enquirer reporters during interviews conducted in Switzerland in return for the publicity it would receive by being featured in the resulting article. *Id.* at 1192. The court found it could exercise specific jurisdiction over the Swiss clinic because the false statements were "expressly calculated to cause injury in California." *Id.* at 1198. The court explained that "California is the situs of Sinatra's injury" since Sinatra is a California resident, he conducts his business from California, he licenses his name in California, and the center of his business is in California. *See id.* at 1195-97.

***6** G & M does not clear the second hurdle for purposeful direction because its pleadings do not present evidence supporting its allegation that Viva Europe's acts were "expressly aimed" at Washington. Unlike the plaintiffs in *Bancroft & Masters* and *Sinatra,* G & M is not a forum resident. Instead, G & M is incorporated and has its principal place of business in Denmark. Hence, Viva Europe's alleged interference with G & M's prospective economic relationship with Microsoft is better described as being aimed at and causing injury to G & M in Denmark. In addition, G & M offers no evidence, other than pure conjecture, that Viva Europe conspired with or otherwise had contacts with Microsoft. In fact, Viva Europe directly rebuts any contacts with Microsoft. Mr. Vandenbossche states, "to the best of my knowledge, Viva Europe and Microsoft have had no communications or contacts of any kind." Supp. Vandenbossche Declaration ¶ 8. G & M's evidence, at best, shows that Viva Europe's actions had a collateral aim and impact in Washington where G & M was attempting to secure a contract with Microsoft. Because G & M is not a resident of Washington, this indirect relationship is too attenuated to qualify as "expressly aimed" at Washington. Thus, G & M has failed to present sufficient evidence to satisfy the express aiming requirement and justify the exercise of jurisdiction over Viva Europe.

(iii) Causing Harm in the Forum State

G & M alleges that Viva Europe's tortious acts have caused harm in Washington because Viva Europe injured G & M by interfering with its prospective economic relationship with Microsoft. Further, G & M claims that Viva HK's statement on its website that Viva was first to develop the metal DVD box technology is a disparagement and depreciation of G & M's name that caused harm in Washington.

The third requirement of the "effects" test is that the defendant's alleged actions caused "harm that the defendant knows is likely to be suffered in the forum state." Schwarzenegger, 374 F.3d at 803. Recently, the Ninth Circuit clarified that the " 'brunt' of the harm need not be suffered in the forum state." *Yahoo! Inc. v. La Lique Contre Le Racisme Et L'Antismitisme,* 433 F.3d 1199, 1207 (2006) (en banc). Instead, only a "jurisdictionally sufficient amount of harm" need be suffered in the forum. *Id.* The Ninth Circuit has explained that a corporation suffers economic harm "where the bad acts occurred; where most of (or at least a threshold fraction of) the corporation's shareholders are located; where the corporation has its principal place of business; or where the corporation is incorporated." *Dole Food,* 303 F.3d at 1113.

Here, G & M has failed to present facts to show that Viva Europe's alleged acts caused sufficient harm to G & M in Washington. Viva Europe's alleged bad acts were performed from Belgium where Viva Europe is incorporated and has its principal place of business. Moreover, Vandenbossche states that Viva Europe does not have contacts with anyone in Washington nor does it transact business, sell any product, or advertise within the State. Vandenbossche Declaration ¶¶ 7 & 8. The harm from Viva Europe's alleged interference with G & M's prospective relationship with Microsoft, would likely be suffered in Denmark where G & M is incorporated and has its principal place of business. G & M fails to present any evidence that it conducts business in Washington that could be adversely affected by Viva Europe's actions. The only evidence offered in support of G & M's contention that it has suffered harm in Washington is that the Viva Group's website states Viva was the first to develop the metal DVD box technology. This argument is tenuous at best and fails to show that Viva Europe itself made the statements or that such statements caused the depreciation of G & M's name in Washington. Therefore, in addition to G & M's failure to show "express aiming," G & M has also failed to make a prima facie showing that Viva Europe's conduct caused G & M harm in Washington.

B. Arises Out Of

***7** The Ninth Circuit applies a "but for" test to determine whether a claim arises out of a defendant's forum-related activities. Ballard, 65 F.3d at 1500. A claim will not confer specific jurisdiction if the plaintiff's claim would have arisen regardless of the defendant's contacts with the forum. *Id.* G & M alleges that had Viva Europe disclosed the fact that it was a competitor, G & M would not have supplied its proprietary information to Viva Europe. However, the allegations of misconduct by G & M do not point to any contacts with Washington that would make such claims arise "but for" Viva Europe's forum-related activities. The only evidence of Viva Europe's relationship with Washington arises from Viva Europe's knowledge that its negotiations with G & M over the possible production of a plastic insert would ultimately be incorporated into a DVD case for Microsoft. This knowledge does not demonstrate that Viva

Europe's alleged wrongdoing arises from any contact with Washington. Rather, G & M's claims against Viva Europe arose from the course of dealing between the two companies that occurred entirely in Europe. Consequently, G & M's claims are not sufficiently related to any Viva Europe contacts with Washington to satisfy the "but for" test.

C. Reasonableness

If the plaintiff establishes a prima facie case of jurisdiction under the first two prongs for specific jurisdiction, the burden shifts to the defendant to present a "compelling case" that the exercise of jurisdiction would be unreasonable. *Schwarzenegger,* 374 F.3d at 802. The reasonableness determination requires the consideration of seven factors: (1) the extent of the defendant's purposeful injection into the forum state's affairs, (2) the burden on the defendant in defending in the forum, (3) the extent of conflict with the sovereignty of the defendant's state, (4) the forum state's interest in adjudicating the dispute, (5) the most efficient judicial resolution of the controversy, (6) the importance of the forum to the plaintiff's interest in convenient and effective relief, and (7) the existence of an alternative forum. *Dole Food,* 303 F.3d at 1114.

1. Purposeful Injection

This factor is analogous to the purposeful direction analysis discussed above. Thus, this factor weighs in favor of Viva Europe and against jurisdiction because the extent of Viva Europe's purposeful injection into Washington is tenuous at best.

2. Burden on Viva Europe

"The unique burdens placed upon one who must defend oneself in a foreign legal system should have significant weight in assessing the reasonableness of stretching the long arm of personal jurisdiction over national borders." *Asahi Metal Ind. v. Superior Court,* 480 U.S. 102, 114 (1987). Undoubtedly it would be more burdensome for Viva Europe to litigate in Washington than in Belgium. Nevertheless, with advances in transportation and communication, this burden is substantially lessened. Thus, this factor weighs slightly in favor of Viva Europe.

3. Conflict with the Sovereignty of Viva Europe's State

***8** "Litigation against an alien defendant creates a higher jurisdictional barrier than litigation against a citizen from a sister state because important sovereignty concerns exist." *Sinatra,* 854 F.2d at 1199. Viva Europe is organized under the laws of Belgium and has its principal place of business there. Belgium has at least some interest in regulating Viva Europe's behavior. Therefore, this factor slightly favors Viva Europe and weighs against the exercise of jurisdiction.

4. Washington's Interest

Washington has a strong interest in providing a forum for its residents and citizens who are tortiously injured. *See Sinatra,* 854 F.2d at 1199. However, since G & M is not a Washington resident, Washington's legitimate interests in the dispute have considerably diminished. *See Asahi,* 480 U.S. at 114. Further, any economic injury sustained by G & M was primarily felt in Denmark and the alleged misconduct by Viva Europe occurred entirely in Europe during the course of dealing between the two companies. Thus, this factor weighs in favor of Viva Europe and against the exercise of jurisdiction.

5. Efficient Resolution

The location of the evidence and witnesses is an important consideration in determining which forum can most effectively resolve a dispute. *Caruth v. Int'l Psychoanalytical Ass'n,* 59 F .3d 126, 129 (9th Cir.1995). G & M's alleges that Viva Europe's misconduct included communications with Microsoft and other Viva entities in Canada and Hong Kong. However, evidence of such communications should be accessible through Viva Europe in Belgium. In addition, since the alleged misconduct occurred during the course of dealing between G & M and Viva Europe, the witnesses and evidence are primarily located in Denmark and Belgium. Thus, this factor slightly favors Viva Europe.

6. Convenience to G & M

If Washington is not a proper forum, then G & M would likely have to litigate this suit against Viva Europe in Denmark or Belgium, neither of which is an obvious inconvenience to G & M. However, G & M's claims against Viva Europe involve a common nucleus of operative facts with its claims against Microsoft, Viva HK, and Viva Canada. Without jurisdiction over Viva Europe in Washington, G & M would be forced to litigate separate suits in two different countries. Nevertheless, the Ninth Circuit has noted that this factor is "not of paramount importance." *Harris Rutsky & Co. Ins. Servs. v. Bell & Clements Ltd.,* 328 F.3d 1122, 1133 (2003). Since it would be inconvenient for G & M to litigate separate suits, this factor weighs slightly in favor of G & M and the exercise of jurisdiction over Viva Europe.

7. Alternative Forum

Belgium is an obvious alternative forum. G & M has offered no reasons why Belgian or even Danish courts could not provide effective redress for its dispute with Viva Europe. Since there is clearly an available alterative forum, this factor favors Viva Europe.

8. Balancing the Reasonableness Factors

***9** Six out of the seven reasonableness factors weigh in favor of Viva Europe and against the exercise of jurisdiction. Even if this Court were to find that G & M had minimum contacts with Washington that satisfy the first two prongs for specific jurisdiction, Viva Europe may have a "compelling case" that the exercise of jurisdiction would be unreasonable. While it may be more convenient for G & M to litigate its suit against all defendants together, the balance of the reasonableness factors weighs heavily against the exercise of jurisdiction over Viva Europe.

D. Jurisdiction via Parent-Subsidiary Relationship

G & M argues that even if this Court were to find that Viva Europe does not have minimum contacts with Washington, this Court should nevertheless exercise jurisdiction because of "the extremely close relationship between Viva Europe and Viva Canada and Viva HK." Opposition p. 10. G & M advances a merger theory, discussed in *MGM v. Grockster,* for imputing Viva Canada and Viva HK's forum-related contacts to Viva Europe for jurisdictional purposes. 243 F.Supp.2d 1073 (C.D.Cal.2003). Under this theory, "two entities are so closely aligned that it is reasonable for the parent to anticipate being haled into court in the forum because of its relationship with its subsidiary." *Id.* at 1099 (*quoting* *In re Telectronics Pacing Sys., Inc.,* 953 F.Supp. 909, 919 (S.D.Ohio 1997). Some factors that might indicate a sufficient relationship with the subsidiary to justify jurisdiction include: overlap in board of directors and officers, interchange of personnel between the parent and the corporation, exchange of documents and records between parent and subsidiary, listing subsidiary as a branch, agency, or division of the parent, or indicating that subsidiary and parent are part of the same entity. *Id.* at 1099-1100. G & M argues that these factors are met in this case.

At the outset, G & M's reliance on *MGM* misses an important distinguishing factor: the merger theory involves imputing a *subsidiary's forum-contacts* to the absent parent corporation, not the other way around. The concept behind the merger theory is that "the absent parent and the in-forum subsidiary are in fact a single legal entity." *In re Telectronics,* 909 F.Supp. at 921. Thus, if the parent corporation exercises *de facto* control over the subsidiary, then the subsidiary's contacts are properly attributable to the parent. *See id.* G & M's argument, on the other hand, attempts to impute Viva HK's forum contacts as the parent corporation to Viva Europe as an absent subsidiary because "Viva Europe worked closely with and took its marching orders from Viva HK." Opposition p. 11. G & M's argument essentially attempts to reverse the flow of merger theory so that a parent's forum contacts can be attributable to its subsidiary.

Notwithstanding this difference, the case at bar satisfies many of the merger theory factors that the *MGM* court found indicative of a close relationship sufficient for jurisdiction. In *MGM,* the court reasoned that "extensive overlap of the corporate operation and perception ... shows a tremendous degree of 'merger' between the two companies." 243 F.Supp.2d at 1100. Here, Viva Europe concedes overlap in board directors and shareholders between it and Viva Canada. Viva Europe does not deny G & M's speculation that Viva Europe also has directors and shareholders in common with Viva HK. There is also evidence that Viva Europe and Viva HK frequently exchanged information regarding the production of the plastic insert for G & M. For instance, Viva Europe forwarded G & M's drawing of the DVD case to Viva HK in order to prepare G & M's price quote. Viva Europe also informed G & M that it was discontinuing the project after "consulting" with Viva HK. Moreover, despite Viva Europe's contention that it is nowhere identified as a branch, section, department or division of Viva Canada or Viva HK, the Viva Group website lists Viva Europe as a "regional sales office." Thus, this case meets many of the factors indicative of a "merger" between two companies.

***10** However, the facts that drove the *MGM* court's reasoning and resulting conclusion are distinguishable from the instant case. In *MGM,* the court found jurisdiction over Sharman Network, Ltd. ("Sharman") based on its minimum contacts with the forum. 243 F.Supp.2d at 1088. Jurisdiction was also found over LEF Interactive Pty., Ltd. ("LEF") even though its conduct did not directly satisfy the minimum contacts requirement on the basis that LEF controlled the conduct of Sharman and was established solely for the purpose of doing so. *See id.* at 1100. The court reasoned that Sharman's in-forum activities were "predominantly instigated or maintained by employees of LEF," and concluded that LEF's actions through and with Sharman satisfied the due process requirements for jurisdiction. *Id.* Here, there is no evidence that Viva Europe controlled the activities of either Viva Canada or Viva HK such that forum contacts by these "controlled" entities could be attributed to Viva Europe for jurisdictional purposes. Alternatively, even if Viva HK exercised control over Viva Europe, as G & M alleges, there is no evidence that such control resulted in minimum contacts with Washington. Thus, G & M's evidence does not present a prima facie showing that jurisdiction over Viva Europe is proper because of its relationship with Viva HK and Viva Canada.

E. Jurisdictional Discovery

In the alternative, G & M requests that this Court permit jurisdictional discovery to further explore the relationship between the Viva entities and the contacts between Viva Europe and the forum.

A district court is vested with broad discretion to permit or deny discovery, and a decision "to deny discovery will not be disturbed except upon the clearest showing that the denial of discovery results in actual and substantial prejudice to the complaining litigant." *Hallett v. Morgan,* 287 F.3d 1193, 1212 (9th Cir.2002). Prejudice is established if there is a reasonable probability that the outcome would have been different had discovery been allowed. *Martel v. County of Los Angeles,* 56 F.3d 993, 995 (9th Cir.1995) (en banc). "[D]iscovery should ordinarily be granted where pertinent facts bearing on the question of jurisdiction are controverted or where a more satisfactory showing of the facts is necessary." *Butcher's Union Local No. 498 v. SDC Inv., Inc.,* 788 F.2d 535, 540 (9th Cir.1986) (citation omitted).

The evidence offered by G & M does not present a "reasonable probability" that further discovery would establish jurisdiction over Viva Europe. To satisfy the "express aiming" requirement, G & M would need to discover a relationship between Viva Europe and Microsoft connected with the Halo2 project that shows Viva Europe's conduct was purposefully directed at Washington. Further, G & M would need to discover evidence that Viva Europe's conduct caused some tangible harm to G & M in Washington. Lastly, G & M would have to show that haling Viva Europe into court in Washington would not offend traditional notions of fair play and substantial justice. Given the evidence presented by G & M, it is unlikely that discovery would yield sufficient evidence to establish the above three deficiencies. Perhaps G & M's strongest argument for jurisdictional discovery is its request to explore the relationship among the Viva entities to determine whether Viva HK and Viva Canada's contacts may serve as a basis for jurisdiction over Viva Europe. However, because this argument involves an alteration to the merger theory and because the theory has yet to be adopted by the Ninth Circuit,[FN1] G & M has not demonstrated a likelihood of success on this claim.

FN1. In *Doe v. Unocal Corp.,* the Ninth Circuit stated that "[w]hile the Court follows the alter ego and agency tests as articulated by the Ninth Circuit, the Court notes the useful discussion of alter ego as merger and agency as attribution in *In re Telectronics Pacing Systems, Inc.*" 248 F.3d 915, 926 n. 2 (2001). More recently in *Harris Rutsky & Co. Ins. Servs. v. Bell & Clements Ltd.,* the Ninth Circuit applied the alter ego and agency tests (without discussion of merger theory) to determine if jurisdiction could be established in the parent-subsidiary corporation context. 328 F.3d 1122, 1134-35 (2003). Therefore, unlike the recent district court's decision in *MGM,* the Ninth Circuit has thus far declined the opportunity to adopt the merger theory from *In re Telectronics.*

CONCLUSION

***11** For the reasons set forth above, the Court concludes that it does not have personal jurisdiction over Viva Europe. Accordingly, Viva Europe's Rule 12(b)(2) motion to dismiss is GRANTED. The Clerk shall enter judgment accordingly.

W.D.Wash.,2006.
Glud & Marstrand A/S v. Microsoft Corp.
Not Reported in F.Supp.2d, 2006 WL 2380717 (W.D.Wash.)

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Only the Westlaw citation is currently available.

United States District Court,
W.D. Washington.
PROGRESSIVE NORTHERN INSURANCE COMPANY, as Assignee and Subrogee for George Lassanske, Plaintiff,
v.
FLEETWOOD ENTERPRISES, INC., et al., Defendants.

No. C04-1308-MAT.
April 14, 2006.

James Michael Kristof, Mercer Island, WA, Kathleen M. Boyle, Seattle, WA, for Plaintiff.

Jennifer A. Williams, Martha E. Raymond, David Lawrence Hennings, Wilson, Smith, Cochran & Dickerson, Michael G. Howard, Michael K. Taylor, Murray Dunham & Murray, Earl M. Sutherland, Terry J. Price, Reed McClure, Seattle, WA, John A. Felton, Mara H. Cohara, Lathrop & Gage, Kansas City, MO, for Defendants.

ORDER RE: DISPOSITIVE MOTIONS
THEILER, Magistrate J.

INTRODUCTION AND BACKGROUND

*1 This matter concerns property damage sustained to a motor home owned by George and Arlene Lassanske and insured by plaintiff Progressive Northern Insurance Company. Plaintiff's third amended complaint (Dkt.24) raises negligence, breach of express and implied warranties, strict liability, and breach of contract claims against the following defendants: (1) Fleetwood Enterprises, Inc. and Fleetwood Motor Homes of Indiana, Inc. (collectively "Fleetwood")-manufacturer/seller of the Fleetwood motor home purchased by the Lassanskes; (2) Spartan Motors, Inc. and Spartan Motors Chassis, Inc. (collectively "Spartan")-manufacturer of chassis and component parts of the motor home; (3) Cummins Engine, Co., Inc. ("Cummins")-manufacturer of engine incorporated into the chassis of the motor home; (4) Cummins Great Lakes, Inc. ("Great Lakes")-distributer of Cummins' products in Wisconsin and Upper Michigan which performed repairs on the motor home pursuant to a Cummins' recall relating to an air compressor defect in the motor home; and (5) Cummins NPower, LLC ("NPower")-entity which Cummins maintains purchased the assets of Great Lakes after that entity ceased doing business under that name on March 31, 2002 and that plaintiff asserts is the successor of Great Lakes following a merger of the two entities.

On May 19, 2001, Cummins sent Mr. Lassanske a recall letter urging him to contact his nearest "Cummins Distributor" to arrange for repairs relating to an air compressor defect in the motor home. (Dkt.47, Ex. D.) In response to that letter, Mr. Lassanske took his motor home to Great Lakes, in Wisconsin. Great Lakes performed the necessary repairs to the motor home pursuant to Mr. Lassanske's warranty on June 29, 2001. (Dkt.35, Ex. A.) Additionally, NPower later performed engine work on the motor home in Wisconsin on May 10 and May 16, 2002. *Id.* The motor home caught fire and sustained damage while being driven in Washington State on May 30, 2002.

The Court must now consider four pending dispositive motions in this case: (1) Fleetwood's Motion for Summary Judgment (Dkt.75); (2) Great Lakes/NPower's Motion to Dismiss for Lack of General Personal Jurisdiction (Dkt.88); (3) Cummins' Motion for Summary Judgment (Dkt.89); and (4) Plaintiff's Motion for Summary Judgment (Dkt.82).FN1 Having considered pleadings filed in support of and in opposition to the motions, along with the remainder of the record, and, being fully advised, the Court finds and concludes as follows:

> FN1. As indicated below, Spartan seeks to join the summary judgment motions filed by Fleetwood and Cummins. (Dkts. 94 & 98.)

DISCUSSION

A. *Fleetwood's Motion for Summary Judgment*

Summary judgment is appropriate when "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c); *Celotex Corp.*

v. Catrett, 477 U.S. 317, 322, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). The moving party is entitled to judgment as a matter of law when the nonmoving party fails to make a sufficient showing on an essential element of his case with respect to which he has the burden of proof. *Celotex,* 477 U.S. at 322-23. "[A] party opposing a properly supported motion for summary judgment may not rest upon mere allegation or denials of his pleading, but must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 256, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986) (citing Fed.R.Civ.P. 56(e)).

***2** Fleetwood explains that plaintiff's expert in this case, Michael Schoenecker, determined that the fire in the motor home started because a positive cable coming from the battery shut off switch and the grounding cable from the starter motor were routed too close together. (Dkt.72, Ex. 1.) Fleetwood notes that the Cummins engine installed in the motor home was supplied to it as an integrated part of the chassis manufactured by Spartan. It asserts its only involvement with the chassis is to take the ends of the wires that lead from the chassis and attach the wires and the chassis to the body of the motor home, but that, in so doing, Fleetwood does not move the positive cable coming from the battery shut off switch or the grounding cable from the starter motor, both of which are installed at the Spartan factory. (Dkt.71, ¶¶ 5-9) (stating that such wires are clamped in place by Spartan.)) Fleetwood further notes that, according to Spartan's expert, Allen K. Brethorst, the wires causing the fire in this motor home had to have been rerouted in order to perform the recall repair on the engine compressor. (Dkt.72, Ex. 3.) (*But see* Dkt. 85, Ex. F5 at 26-27 (Cummins' expert, Michael Linscott, disagrees with Spartan's expert, and opines that the relevant wires were located in place during the assembly of the chassis and that the abrasion took place over the life of the unit.))

1. *Product Manufacturer Claim:*

Fleetwood first argues its entitlement to dismissal in that it is not a "manufacturer" of a "relevant product" as those terms are defined in the Washington Products Liability Act ("WPLA"), RCW 7.72 *et seq.* Pursuant to the WPLA:

> "Manufacturer" includes a product seller who designs, produces, makes, fabricates, constructs, or remanufactures the relevant product or component part of a product before its sale to a user or consumer. The term also includes a product seller or entity not otherwise a manufacturer that holds itself out as a manufacturer.
>
> A product seller acting primarily as a wholesaler, distributor, or retailer of a product may be a "manufacturer: but only to the extent that it designs, produces, makes, fabricates, constructs, or remanufactures the product for its sale. A product seller who performs minor assembly of a product in accordance with the instructions of the manufacturer shall not be deemed a manufacturer. A product seller that did not participate in the design of a product and that constructed the product in accordance with the design specifications of the claimant or another product seller shall not be deemed a manufacturer for the purposes of RCW 7.72.030(1)(a).

RCW 7.72.010(2). The relevant product "is that product or its component part or parts, which gave rise to the product liability claim." RCW 7.72.010(3).

Fleetwood asserts that the relevant products in this case are the two wires on the chassis that rubbed together to create the short causing the fire. They further assert that those wires are not modified after leaving Spartan's facility and that there is no evidence the portion of the motor home manufactured by Fleetwood caused or contributed to the fire. They cite *Parkins v. Van Doren Sales, Inc.,* 45 Wash.App. 19, 24-25, 724 P.2d 389 (1986), as supporting that, where a component of a final product can be identified as the cause of the injury, the component, rather than the product as a whole, is the relevant product: "If we consider the entire assembly as a unit and inquire whether there was liability as a component manufacturer or supplier, the 'relevant product' is the component if the component gave rise to the product liability claim." The court in that case held: "Because Ms. Parkins was injured by machinery purchased from Van Doren, as opposed to other equipment which made up the pear processing unit, those parts constitute 'relevant' products for the purposes of the act." *Id.* at 25, 724 P.2d 389. Fleetwood avers that, because it did not manufacture the relevant product, it is entitled to dismissal of all claims against it based on its alleged role as a manufacturer.

***3** Plaintiff responds that Fleetwood was the primary manufacturer of the motor home, including all of its component parts. It asserts that Fleetwood's argument renders the term "relevant product" in the WPLA meaningless because, according to that argument, only component parts of products which malfunction could be deemed relevant products within the ambit of the WPLA. Plaintiff distinguishes *Parkins* as providing a method to determine whether liability exists against any component manufacturer when the product as a whole causes injury; that is, it should be used to determine whether component manufacturers of the Fleetwood motor home should share liability, but is irrelevant as to whether Fleetwood itself is liable.

Plaintiff also argues that Fleetwood held itself out to the public as a manufacturer, noting marketing materials and the "Fleetwood" logo on the back of the motor home. *See* RCW 7.72.01(2) ("The term also includes a product seller or entity not otherwise a manufacturer that holds itself out as a manufacturer.") It asserts that, without the provision pertaining to entities holding themself out to the public as manufacturers, for example, Ford Motor Company could successfully argue that it is not liable as a manufacturer for a fire in a Mustang because it did not actually produce the Delco spark plug that malfunctioned and caused the fire destroying the automobile.

Finally, plaintiff asserts that the question of whether Fleetwood performed only "minor assembly" is a finding properly reserved for resolution by the jury. *See* RCW 7.72.01(s) ("A product seller who performs minor assembly of a product in accordance with the instructions of the manufacturer shall not be deemed a manufacturer.") Plaintiff adds that, given that the engine is a major component of the motor home, its incorporation into the motor home could hardly be called minor. Plaintiff also notes that Fleetwood designed the motor home, meaning it necessarily had to design the motor home to incorporate installation of the chassis and engine.

In its reply, Fleetwood asserts that the Washington Legislature intended the WPLA to place liability only on those entities that actively caused injury; that is, on those manufacturers who had a role in the formation of the defective part. It avers that the WPLA definition of relevant product allows for liability to be placed on either the manufacturer of the whole product, component parts, or both, depending on which of those entities was actively involved in the design or construction of the product that caused the injury. Fleetwood avers that, otherwise, the statute would read: "product *and* its components that give rise to the claim." RCW 7.72.010(2) (emphasis added). It argues that, where a specific component can be identified as the sole cause of the injury and there is no evidence that the manufacturer of the end product altered that component or contributed to the injury in any way, that manufacturer is entitled to dismissal. Fleetwood also notes that the three experts designated by plaintiff in this case opined that they had no opinions or evidence that Fleetwood acted or failed to act in a manner that caused or contributed to the fire.

***4** As noted by plaintiff, *Parkins* did not involve a determination as to whether *either* a component part manufacturer *or* the overall manufacturer of a product was liable; the plaintiff in that case sued only the manufacturer of the component part. However, *Parkins* nonetheless supports the conclusion that where a particular component can be identified as giving rise to the claim, that component, rather than the end product as a whole, may be considered the relevant product. *See* 45 Wash.App. at 19, 24-25, 724 P.2d 389 ("If we consider the entire assembly as a unit and inquire whether there was liability as a component manufacturer or supplier, the 'relevant product' is the component if the component gave rise to the product liability claim."; "Because Ms. Parkins was injured by machinery purchased from Van Doren, as opposed to other equipment which made up the pear processing unit, those parts constitute 'relevant' products for the purposes of the act." 45 Wash.App. 19, 24-25, 724 P.2d 389. *Accord Sepulveda-Esquivel v. Central Machine Works, Inc.*, 120 Wash.App. 12, 18-19, 84 P.3d 895 (2004) (citing *Parkins* for the same principles). Plaintiff's argument, in contrast, reads out the disjunctive aspect of the definition of relevant product: "that product *or* its component part or parts, which gave rise to the product liability claim." RCW 7.72.010(3) (emphasis added). *See also Cadwell Indus's, Inc. v. Chenbro America, Inc.*, 119 F.Supp.2d 1110, 1114 (E.D.Wash.2000) ("The WPLA defines the 'relevant product' as that product or component which gave rise to the product liability claim.") (emphasis removed from original).

Significantly, plaintiff presents no evidence showing that the overall motor home, as opposed to the chassis, engine, and/or the relevant wires, gave rise to any damage. (*See generally* Dkt. 85 (declaration of plaintiff's expert.)) Plaintiff, therefore, fails to establish that Fleetwood is properly considered a manufacturer of the relevant product(s) in this case.

The next question is whether Fleetwood could be deemed "a product seller or entity not otherwise a manufacturer that holds itself out as a manufacturer." RCW 7.72.010(2). Clearly, Fleetwood holds itself out as the manufacturer of the motor home as a whole. However, there is no evidence Fleetwood holds itself out as the manufacturer of the chassis, engine, and/or the relevant wires. Accordingly, plaintiff also fails to establish that Fleetwood held itself out as the manufacturer of the relevant product(s) in this case.

Finally, there remains the question of whether Fleetwood performed only "minor assembly of a product in accordance with the instructions of the manufacturer [,]" and, therefore, should "not be deemed a manufacturer." RCW 7.72.010(2). Fleetwood incorporated the chassis into the motor home. As explained by its expert, Doug Hass:

> These wires to the starter and the surrounding wires (meaning secured to the frame in the same local area) are originally selected, designed, engineered, fabricated per Spartan specifications and installed by Spartan Motors of Charlotte, Michigan ... Fleetwood does not alter the referenced wires at all (meaning re-route, 'tap into", cut, splice, disconnect and reattach or change location) for any purpose. During this time period the motor home was manufactured Fleetwood would have purchased the completed and fully functional chassis directly from Spartan Motors. A completed assembly and fully operational is defined as a chassis that is able to be started and driven as it is received. Fleetwood would have 'tapped into' the electrical system at predetermined locations with specific and dedicated connectors per design requirements while following the 'Spartan Body Builders Handbook.' ... As part of the final assembly Fleetwood builds the 'box' on top of the chassis and it becomes a completed motor home.

***5** (Dkt.33, Ex. A.) Also, plaintiff's expert states: "My investigation in this case revealed that the positive battery cable and the ground cable were installed on the vehicle as part of the chassis manufacture by Spartan Chassis, Inc." (Dkt. 85 at 8.)

Given the above, it is not at all clear, as argued by plaintiff, that this minor assembly issue raises a question of fact. *Cf. Almquist v. Finley School District No. 53,* 114 Wash.App. 395, 404, 57 P.3d 1191 (2002) (rejecting argument that whether a school district which used tainted beef to make tacos was a manufacturer was a question of fact, given that the material facts-that the district stored, thawed, cooked, drained, rinsed, seasoned, and mixed the frozen beef to make tacos-were not disputed, and constituted producing, making, fabricating, and constructing under the definition of a manufacturer of a relevant product). Instead, the facts show that, if anything, Fleetwood's involvement with the relevant product(s) in this case involved nothing more than minor assembly, thereby excluding them from the definition of a manufacturer of the relevant product under the WPLA.

2. *Product Seller Claim:*
Pursuant to the WPLA:

> (1) Except as provided in subsection (2) of this section, a product seller other than a manufacturer is liable to the claimant only if the claimant's harm was proximately caused by:
>
> (a) The negligence of such product seller; or
>
> (b) Breach of an express warranty made by such product seller; or
>
> (c) The intentional misrepresentation of facts about the product by such product seller or the intentional concealment of information about the product by such product seller.
>
> (2) A product seller, other than a manufacturer, shall have the liability of a manufacturer to the claimant if:
>
> (a) No solvent manufacturer who would be liable to the claimant is subject to service of process under the laws of the claimant's domicile or the state of Washington; or
>
> (b) The court determines that it is highly probable that the claimant would be unable to enforce a judgment against any manufacturer; or

(c) The product seller is a controlled subsidiary of a manufacturer, or the manufacturer is a controlled subsidiary of the product seller; or

(d) The product seller provided the plans or specifications for the manufacture or preparation of the product and such plans or specifications were a proximate cause of the defect in the product; or

(e) The product was marketed under a trade name or brand name of the product seller.

RCW 7.72.040.

Fleetwood avers the absence of any of the above-described conditions to create potential liability on its part. It asserts a lack of any evidence of negligence and that none of the expert witnesses have suggested that the cause of the fire was linked to any of its actions.

Plaintiff counters that subsections (2)(a) and (2)(e) of RCW 7.72.040 apply in this case to hold Fleetwood liable as a product seller. With respect to the latter, plaintiff notes that the product was clearly marketed under Fleetwood's brand name, as the "Fleetwood American Eagle." With respect to the former, plaintiff asserts that, because Great Lakes is no longer in business, there are substantial grounds to hold Fleetwood liable as a product seller.

***6** First, plaintiff's solvency argument lacks merit in that there are other solvent manufacturers who could be held accountable, including Spartan and Cummins. Second, because plaintiff's trade/brand name argument is contingent on a determination that the motor home itself is the "relevant product," and because the Court does not find as such, subsection (2)(e) of RCW 7.72.040 also does not apply. Thus, the Court concludes that Fleetwood is not properly considered liable as a product seller under the WPLA.[FN2]

FN2. Fleetwood also argues it is not liable as a manufacturer for damages caused as a result of the recall repair, which occurred after the motor home left Fleetwood's control. *See Padron v. Goodyear Tire & Rubber Co.,* 34 Wash.App. 473, 476, 662 P.2d 67 (1983) (a "plaintiff may be barred from recovery if the product underwent a substantial change in its condition after leaving the manufacturer.") However, given the determination that Fleetwood is not properly characterized as either a manufacturer or seller of the relevant product under the WPLA, the Court need not address this argument. Moreover, as discussed below, causation in this case presents an issue of material fact. For this reason, Spartan's attempt to join in Fleetwood's motion based on the theory of subsequent modification of the wire must also be denied.

3. *Defect at Time of Manufacture:*

Plaintiff additionally argues Fleetwood's liability based on a defect existing at the time of manufacture, quoting the WPLA:

A product manufacturer is subject to strict liability to a claimant if the claimant's harm was proximately caused by the fact that the product was not reasonably safe in construction or not reasonably safe because it did not conform to the manufacturer's express warranty or to the implied warranties under Title 62A RCW.... A product is not reasonably safe in construction if, *when the product left the control of the manufacturer,* the product deviated in some material way from the design specifications or performance standards of the manufacturer, or deviated in some material way from otherwise identical units of the same product line.

RCW 7.72.030(2)(a) (emphasis added). Plaintiff asserts that it is undisputed that the motor home was defective at the time it left Fleetwood, as evidenced by the recall. Plaintiff states that this defect affected the driver's ability to steer, thus rendering the motor home not reasonably safe. Plaintiff argues that, but for the defect, the recall would not have been issued, and the related work would not have been performed.

Fleetwood responds that the defect in the Cummins engine is irrelevant because it did not proximately cause the fire. It asserts that that defect was the potential for the failure of the compressor that could lead to loss of power steering-which was not the proximate cause of damage in this case. RCW 7.72.030(1) ("A product manufacturer is subject to liability to a claimant if the claimant's harm was proximately caused by the negligence of the manufacturer in that the product was not reasonably safe as designed or not reasonably safe because adequate warnings or instructions were not provided.") Fleetwood notes that proximate cause requires both cause in fact and proximity between the negligent act and injury. *Mehrer v. Easterling,* 71 Wash.2d 104, 108, 426 P.2d 843 (1967). Noting expert opinions that it is likely the wires were moved during the recall work, Fleetwood asserts that Cummins' negligence is an independent intervening cause and the proximate cause of the fire.

Plaintiff does not present any evidence that the recall-related defect proximately caused the fire. Also, this argument ultimately rests on the assumption that the wires were re-routed during the repair necessitated by the recall, and that this re-routing caused the fire. However, as discussed below, this issue raises a question of material fact. *See Almquist,* 114 Wash.App. at 406, 57 P.3d 1191 (proximate cause is generally a question of fact for the jury; in particular, "[c]ause in fact requires a direct unbroken sequence between some act and the complained of event[ ]" and is "generally a question for the jury.") Accordingly, the Court rejects plaintiff's argument that Fleetwood is liable based on a defect at the time of the manufacture of the motor home.

B. *Great Lakes/NPower's Motion to Dismiss for Lack of General Personal Jurisdiction*

***7** The Court previously determined that plaintiff failed to establish specific personal jurisdiction over Great Lakes and NPower, but found it appropriate to allow jurisdictional discovery on the issue of general personal jurisdiction based on the existence of an alter ego relationship between Cummins and Great Lakes/NPower. (Dkt.58) Great Lakes/NPower now move to dismiss based on a lack of general personal jurisdiction.[FN3]

> FN3. Plaintiff argues that this motion was untimely, noting that Great Lakes/NPower wrongly noted this dispositive motion for three Fridays, as opposed to the four Fridays required by Local CR 7(d)(3). However, a motion wrongly noted is not, for that reason, untimely. Plaintiff also generally avers prejudice at having to reply a week earlier than required by the local rule. However, plaintiff made no attempt to correct the noting date or to simply respond to the motion within the proper time frame.

Plaintiff bears the burden of establishing personal jurisdiction over defendants. *Doe v. Unocal Corp.,* 248 F.3d 915, 922 (9th Cir.2001). Where, as here, the Court elects to resolve the motion on the parties' briefs, exhibits, and affidavits, rather than hold an evidentiary hearing, plaintiff need only "make a prima facie showing of jurisdictional facts in order to defeat [the] motion to dismiss." *Farmers Ins. Exch. v. Portage La Prairie Mut. Ins. Co.,* 907 F.2d 911, 912 (9th Cir.1990). " 'That is, the plaintiff need only demonstrate facts that if true would support jurisdiction over the defendant." ' *Doe,* 248 F.3d at 922 (quoting *Ballard v. Savage,* 65 F.3d 1495, 1498 (9th Cir.1995)). The Court takes plaintiff's version of the facts as true for purposes of a Rule 12(b)(2) motion to dismiss, and resolves any conflicts in the evidence set forth in the affidavits in plaintiff's favor. *Id.*

The exercise of personal jurisdiction over a nonresident defendant requires both the satisfaction of the requirements of the forum state's long-arm statute, and the requirements of federal due process. *Chan v. Society Expeditions,* 39 F.3d 1398, 1404-05 (9th Cir.1994). Washington's long-arm statute confers personal jurisdiction to the extent due process allows. *Id.* at 1405. "Where the forum's long-arm statute is coextensive with due process, as is Washington's, the focal inquiry becomes whether an exercise of jurisdiction comports with Constitutional due process." *IP Innovation, L.L.C. v. RealNetworks, Inc.,* 310 F.Supp.2d 1209, 1212 (W.D.Wash.2004) (citing, *inter alia, Chan,* 39 F.3d at 1405 and Wash. Rev.Code § 4.28.185).

Satisfaction of due process occurs when a nonresident defendant has " 'certain minimum contacts with [the forum] such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice." " ' *Helicopteros Nacionales de Columbia, S.A. v. Hall,* 466 U.S. 408, 414, 104 S.Ct. 1868, 80 L.Ed.2d 404 (1984) (quoting *International Shoe Co. v. Washington,* 326 U.S. 310, 316, 66 S.Ct. 154, 90 L.Ed. 95 (1945) (quoting *Milliken v. Meyer,* 311 U.S. 457, 463, 61 S.Ct. 339, 85 L.Ed. 278 (1940))). Jurisdiction may be either general or specific. Also, in addition to establishing the requisite contacts, the assertion of jurisdiction must be found reasonable. *Doe,* 248 F.3d at 925 (citing *Amoco Egypt Oil Co. v. Leonis Navigation Co.,* 1 F.3d 848, 851 (9th

Cir.1993)).

General jurisdiction, at issue here, requires that contacts with the forum be "continuous and systematic," and applies whether or not the cause of action arises from those contacts. *Helicopteros Nacionales de Columbia, S.A.,* 466 U.S. at 414-16. While it is undisputed that Cummins is subject to general jurisdiction in this Court, the question remains as to whether Great Lakes/NPower are likewise subject to this Court's jurisdiction based on their relationship with Cummins.

***8** It is well established that the mere existence of a parent-subsidiary relationship is not sufficient to confer personal jurisdiction over the parent based on the subsidiary's forum contacts. *Doe,* 248 F.3d at 925. "[A] parent corporation may be directly involved in the activities of its subsidiaries without incurring liability so long as that involvement is 'consistent with the parent's investor status[.]" ' *Id.* at 926 (quoting *United States v. Bestfoods,* 524 U.S. 51, 72, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998)). "Appropriate parental involvement includes: 'monitoring of the subsidiary's performance, supervision of the subsidiary's finance and capital budget decisions, and articulation of general policies and procedures[.]" ' *Id.* (quoting *Bestfoods,* 524 U.S. at 72).

However, the contacts of a subsidiary may be imputed to the parent under two exceptions-where the subsidiary is the parent's alter ego, or where the subsidiary acts as the parent's general agent. *Harris Rutsky & Co. Ins. Svcs., Inc. v. Bell & Clements Ltd.,* 328 F.3d 1122, 1134 (9th Cir.2003). "An alter ego or agency relationship is typified by parental control of the subsidiary's internal affairs or daily operations." *Doe,* 248 F.3d at 926.

As indicated above, plaintiff previously argued general jurisdiction based on an "alter ego" relationship between Cummins as a parent corporation and Great Lakes and NPower as Cummins' subsidiaries. Great Lakes and NPower dispute the existence of such a relationship in their motion. Also, although allowing jurisdictional discovery, the Court previously stated:

> In this case, plaintiff does not proffer any evidence indicating the involvement of Cummins in the day-to-day activities of Great Lakes or NPower. Moreover, while pointing to their use of a "common marketing image" and the fact that Great Lakes and NPower marketed Cummins' engines as their exclusive distributors (*see* Dkt 47, Exs. B & C), plaintiff fails to show Cummins used these entities as marketing conduits to shield itself from liability. In fact, given that Cummins is itself subject to the general jurisdiction of this Court, its relationship with Great Lakes and NPower cannot be said to shield it from liability. Plaintiff also fails to put forth evidence supporting the conclusion that the entities in any respect failed to observe corporate formalities necessary to maintain corporate separateness.

(Dkt. 58 at 7-8.)

However, in response to defendants' current motion, plaintiff abandons the alter ego argument, arguing instead that the general agency exception applies. Plaintiff further posits that, should Cummins agree that it is legally responsible for the warranty recall repair work performed by Great Lakes/NPower, plaintiff would agree to dismissal of those entities. It further asserts Cummins' apparent intention to argue, upon dismissal of Great Lakes and NPower, that it cannot be held liable for the negligence of entities no longer parties to this lawsuit.[FN4]

> FN4. Plaintiff also notes that all Cummins entities are represented by the same law firm and utilize the same experts, eliminating any economic rationale for Great Lakes and NPower to avoid traveling to Seattle and presenting a defense. While defendants respond that costs are not a component in this Court's due process analysis, the Court notes that costs are relevant to the reasonableness inquiry required in the jurisdictional assessment. *See, e.g., Glencore Grain Rotterdam B.V. v. Shivnath Rai Harnarain Co.,* 284 F.3d 1114, 1125 (9th Cir.2002) (noting, among other factors to be considered in determining whether the exercise of jurisdiction would be reasonable, the burden on the defendant of defending in the forum). However, plaintiff must first establish sufficient minimum contacts.

***9** Cummins declines to agree that is legally responsible for work performed by Great Lakes, arguing plaintiff can always choose to pursue an action against Great Lakes and NPower in Wisconsin or elsewhere.

The issue to be decided, therefore, is whether Great Lakes and NPower can be properly considered the agents of Cummins for the purposes of establishing general personal jurisdiction.

In order to satisfy the agency test for purposes of establishing personal jurisdiction, the plaintiff must show: " 'that the subsidiary functions as the parent corporation's representative in that it performs services that are "sufficiently important to the foreign corporation that if it did not have a representative to perform them, the corporation's own officials would undertake to perform substantially similar services." " ' Doe, 248 F.3d at 928-29 (quoting Chan, 39 F.3d at 1405 (quoting *Wells Fargo & Co. v. Wells Fargo Express Co.,* 556 F.2d 406, 423 (9th Cir.1977))). "Consequently, '[t]he question to ask is ... whether, in the truest sense, the subsidiar[y's] presence substitutes for the presence of the parent." ' *Id.* (quoting *Gallagher v. Mazda Motor of Am., Inc.,* 781 F.Supp. 1079, 1084 (E.D.Pa.1992)).

Plaintiff points out that Cummins performs none of the warranty repair work on the engines it sells, that owners of those engines are required to have warranty work performed at a Cummins-authorized service facility, such as Great Lakes, and that Cummins paid Great Lakes to perform the warranty work on the Lassanske motor home. Plaintiff argues that those repairs are sufficiently important to Cummins such that, if they did not have Great Lakes/NPower to perform them, Cummins would undertake those services themselves. It argues that, without Great Lakes/NPower, Cummins' warranties would be rendered meaningless and void *ab initio.* Plaintiff also notes that Cummins is the 100% shareholder of Great Lakes, and describes Great Lakes and NPower as mere extensions of Cummins in essentially functioning as Cummins' warranty repair department.

Defendants respond that agency based on the warranty work, to the extent it exists, confers jurisdiction on Cummins in Wisconsin, where the repairs were completed. They posit that, were the Court to adopt plaintiff's reasoning, a Firestone in Springfield, Massachusetts, for example, would be subject to personal jurisdiction in this Court simply as a result of performing authorized Cummins' repair work that happened to make its way to Washington State.

As asserted by plaintiff, Cummins is obligated to make repairs pursuant to its warranties, relies on its authorized facilities to make those repairs, and requires the holders of the warranties to utilize those facilities to make the repairs. However, it nonetheless does not follow that Cummins would perform the repairs in the absence of Great Lakes. That is, rather than performing the repair work itself, Cummins could presumably authorize a different entity-including one having no other association with Cummins-to perform repair work.

***10** If anything, plaintiff's argument is more reasonably considered as asserting Cummins' respondeat superior liability for the warranty work performed by Great Lakes/NPower. However, while well taken as a theory of liability, the Court need not address the issue in determining whether this Court has general personal jurisdiction over Great Lakes/NPower.

Morever, even if it could be said that Cummins and Great Lakes/NPower have an agency relationship sufficient to confer general personal jurisdiction over Cummins in Wisconsin for the work performed by Great Lakes/NPower in that state, it also does not follow that the converse application of general personal jurisdiction over Great Lakes/NPower in Washington State would apply in this case. As indicated in the Court's previous decision, "[t]he activities of the parent corporation [in the forum state] are irrelevant absent some indication that 'the formal separation between parent and subsidiary is not scrupulously maintained." ' *Newman v. Comprehensive Care Corp.,* 794 F.Supp. 1513, 1519 (D.Or.1992) (quoting *Uston v. Grand Resorts, Inc.,* 564 F.2d 1217, 1218 (9th Cir.1977)). Here, as before, plaintiff makes no showing that the formal separation of the entities in question is not scrupulously maintained. *See, e.g., Harris Rutsky & Co. Ins. Servs., Inc.,* 328 F.3d at 1135 ("100% control through stock ownership does not by itself make a subsidiary the alter ego of the parent.") (*See also* Dkt. 58 at 7-8 ("Plaintiff also fails to put forth evidence supporting the conclusion that the entities in any respect failed to observe corporate formalities necessary to maintain corporate separateness."))

In sum, the Court finds no basis for the extension of jurisdiction over Great Lakes/NPower in this Court. As such, the Court concludes that plaintiff's claims against Great Lakes/NPower should be dismissed based on a lack of general personal jurisdiction.

C. *Cummins' and Plaintiff's Motions for Summary Judgment*

Cummins and plaintiff raise a variety of arguments in support of their motions for summary judgment. Spartan seeks to join Cummins' motion. However, the Court concludes that these motions cannot be resolved on summary judgment given the existence of at least one issue of material fact.

As indicated above, there is a dispute among the parties and their various experts regarding causation. Spartan's expert, Brethorst, states:

> Personal knowledge of this particular recall and the requirements of space needed in the general area of the compressor to facilitate removal and replacement of the compressor suggest that the wire and cable bundles that were in the area of the compressor were moved and repositioned in order to secure adequate room for repair due to close tolerances of the engine bay.
>
> During the above repair there is no doubt that the cable in question was moved and repositioned to facilitate the recall. Damage resulted to the cable during or after the repair as a result of the means or way that the cable was then routed and secured.

***11** (Dkt.72, Ex. 2.) (*See also* Dkt. 72, Ex. 3 (Brethorst concluded: "I believe that the integrity of the Spartan wiring was compromised during the recall and resulted in the loss. I could find no fault or defect with any Spartan component or part.") Fleetwood's expert, John Powell, concurs, stating: "The conductors in the area described in the Brethorst report were most probably moved, rerouted, or repositioned during the removal and replacement of the air compressor during the repairs that were the subject of the Cummins recall campaign." (Dkt. 85, Ex. F4 at 4.)

However, the expert for Cummins, Michael Linscott, disagrees. Linscott first asserts that Brethorst provided no evidence to validate his purported personal knowledge. (Dkt. 85, Ex. F5 at 26.) He further states:

> Based upon the proximate location of where the wire crossed over the frame on the two units, the evidence indicates that the wire was where it was located during chassis assembly. The exemplar unit [looked at by Linscott] had not been in for service on Warranty Campaign 0111. This evidence contradicts the unsupported allegations that representatives from Cummins-Great Lakes in any way separated any cable bundles that created any conditions, resulting in this fire. Moreover according to Cummins, Inc., distributors, such as Cummins-Great Lakes, would not have been instructed to move wires during Warranty Campaign 0111. However, based on the observations on the exemplar vehicle and the opinions set forth in Mr. Brethorst's report, if the initiating event was at the cable from the master switch where it crossed over the frame, the routing of the wire in an unsecured method over the frame was not the result of Cummins Great Lakes actions. If abrasion took place it was over the life of the unit.

(*Id.* at 27.) Additionally, plaintiff's expert, Schoenecker, declines any independent knowledge as to whether the relevant cable was in fact re-routed during the recall, pointing to either original placement or re-routing during the recall work as the cause of the fire. (Dkt. 85 at 10 and Ex. C2.) FN5

> FN5. Spartan cites a letter from Schoenecker in response to Brethorst's report as agreeing "that the positive cable from the disconnect switch (mechanic's switch) was not routed correctly nor secured properly as a result of the work performed during the recall." (Dkt.94, Ex. 3.) However, Schoenecker disputes the depiction of the letter described by Spartan. (*See* Dkt. 104, Ex. 2 (stating the portion of the letter quoted was merely intended to convey Brethorst's assertion and reiterating statement in previous declaration and his testimony that the fire resulted either as a result of the original positioning of the wiring or the re-routing of the wiring during the recall work.))

This dispute raises a genuine issue of material fact and, therefore, precludes a grant of summary judgment. Moreover, plaintiff's argument that it should be granted summary judgment while the remaining defendants "fight it out" amongst themselves is not well taken. Although the Court declines to delve into plaintiff's various claims and arguments, it notes that the motions and responding documents raise both the possibility of additional issues of material fact and pertinent questions regarding plaintiff's claims. As such, the Court does not find a basis for granting plaintiff's motion for summary judgment.

CONCLUSION

For the reasons described above, Fleetwood's Motion for Summary Judgment (Dkt.75) and Great Lakes/NPower's Motion to Dismiss for Lack of General Personal Jurisdiction (Dkt.88) are hereby GRANTED, while Cummins' Motion for Summary Judgment (Dkt.89), joined by Spartan (Dkt.98), and Plaintiff's Motion for Summary Judgment (Dkt.82) are hereby DENIED based on the existence of at least one genuine issue of material fact.

W.D.Wash.,2006.
Progressive Northern Ins. Co. v. Fleetwood Enterprises, Inc.
Not Reported in F.Supp.2d, 2006 WL 1009334 (W.D.Wash.)

END OF DOCUMENT

C

United States District Court, W.D. Washington,
at Seattle.
REESE, et al., Plaintiff(s),
v.
MALONE, et al., Defendant(s).

No. C08–1008MJP.
Feb. 27, 2009.

West KeySummary**Securities Regulation 349B 60.53**

349B Securities Regulation
349BI Federal Regulation
349BI(C) Trading and Markets
349BI(C)7 Fraud and Manipulation
349Bk60.50 Pleading
349Bk60.53 k. Misrepresentation.
Most Cited Cases

Oil company's quarterly filings with the Securities and Exchange Commission were evidence of false or misleading statements upon which any investor was permitted to rely. Thus, investor stated securities fraud claim in class action lawsuit. Investor alleged that oil company knew pipe line had sediment collecting in the pipes prior to two major spills, was aware of increased corrosion activity in the oil transport lines (OTLs) that leaked, failed to inspect the lines adequately and did not expend sufficient resources to address the corrosion issue in the OTLs. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); 17 C.F.R. § 240.10b–5.

Neal A. Dublinsky, Peter A. Binkow, Glancy Binkow & Goldberg LLP, Los Angeles, CA, for Plaintiffs.

Diane L. McGimsey, Sullivan & Cromwell, Los Angeles, CA, Elizabeth K. Ehrlich, Gerald L. Black, Jr., John L. Warden, Richard C. Pepperman, II, Steven J. Purcell, Sullivan & Cromwell, New York, NY, for Defendants.

ORDER ON MOTION TO DISMISS
MARSHA J. PECHMAN, District Judge.

***1** The above-entitled Court, having received and reviewed:

1. Defendants' Motion to Dismiss Consolidated Amended Class Action Complaint (Dkt. No. 92)

2. Lead Plaintiffs' Opposition to Defendants' Motion to Dismiss Consolidated Amended Class Action Complaint (Dkt. No. 101)

3. Defendants' Reply in Further Support of Their Motion to Dismiss Consolidated Amended Class Action Complaint (Dkt. No. 112)

4. Defendants' Notice of Supplemental Authority (Dkt. No. 115)

and all attached exhibits and declarations, and having heard oral argument, makes the following ruling:

IT IS ORDERED that the motion is PARTIALLY GRANTED: Defendants BP America, Inc. and Walter Massey are DISMISSED from this action, and Plaintiffs' claim for violations of § 18(a) is DISMISSED as time-barred.

IT IS FURTHER ORDERED that the motion is PARTIALLY DENIED: the Court finds that Plaintiffs have adequately pled 10(b)/10b–5 violations by Defendant BPXA, and adequately pled control person liability pursuant to § 20(a) as regards Defendants BP plc, John Browne, Steven Marshall and Maureen Johnson.

Background

The facts as pled in Plaintiffs' Consolidated Amended Class Action Complaint (Dkt. No. 64) include the following allegations:

In 2001, Coffman Engineering ("Coffman") was hired by the Alaska Department of Environmental Conservation to evaluate a report British Petroleum ("BP") had submitted on preventing corrosion in the oil transport lines ("OTLs"). ¶ 67. Coffman's conclusion was that "BP" had "obfuscated" the data and failed to provide sufficient information to ascertain whether they had an effective program for monitoring corrosion in the lines (a process known as "pigging") FN1. ¶¶ 70–71. Plaintiffs allege that, through "BP's" intervention, FN2 the Coffman report was re-written and all the questions about pigging were eliminated. ¶¶ 75–76.

FN1. "Pig" = "Pipeline Integrity Gauge;" there is maintenance "pigging" for cleaning purposes and "smart pigging" for purposes of detecting corrosion and leaks.

FN2. The Complaint routinely refers to "BP" without identifying any specific corporate or individual defendant.

The Complaint goes on to allege a number of facts which it presents as evidence of Defendants' knowledge of the absence of an OTL maintenance program and misrepresentations regarding the corporation's compliance with their own agreements and industry-wide safety practices:

• Defendant Massey received a May 22, 2004 letter from Chuck Hamel (an advocate for BP workers in Alaska) warning of "serious corrosion" and predicting a "major catastrophic event." ¶ 83.

• In September 2005, an internal BP report showed a sevenfold increase in the number of corroded areas and a tenfold increase in the rate of corrosion between 2004 and 2005. ¶ 89. Following a March 2006 spill, Defendant Johnson was quoted by the Associated Press as saying that the September 2005 report revealed a "low manageable corrosion rate." ¶ 147.

• In the wake of the March 2006 spill, it was reported in August 2006 (on MSNBC.com and in the *Financial Times*) that BP had not pigged the OTL in the Eastern Operating Area line ("EOA") since 1992 and had not pigged the Western line ("WOA," the line where the March 2006 spill occurred) since 1998. (Plaintiffs contrast this to the practices of Alyeska, which pigs its trans-Alaska pipeline every two weeks.) ¶¶ 86–87.

***2** • On May 14, 2006, Defendant Johnson had told *Petroleum News:* "You can count on us to not only do the reactive things we've done already: the inspections, the additional inhibitor, maintenance things, the smart pigging ..." ¶ 153.

• Defendant Marshall made statements to *Bloomberg News* that "corrosion caused by a chemical additive [was] involved in the two main theories of why the spill occurred," a statement Plaintiffs label as "false and misleading" for misrepresenting chemical additives as the "unexpected" cause of the corrosion in the OTLs. ¶ 155.

• On April 25, 2006, Defendant Browne reported in a press conference that the March 2006 leak had occurred despite "the fact that we have both world class corrosion monitoring and leak detection systems, both being applied within regulations set by the Alaskan authorities." ¶ 160.

• A Corrective Action Order ("CAO") was issued by Pipeline and Hazardous Materials Safety Administration ("PHMSA") following the March 2006 spill. ¶ 91. One of the requirements was that the EOA be "smart-pigged" by June 15. ¶ 97. BP failed to do that. Only after PHMSA issued a followup warning on July 20 did BP smart-pig the EOA line (on July 22, 2006). ¶ 100.

• Plaintiffs allege that Defendant Johnson's statement (quoted in *Petroleum News* on May 14, 2006) that "[w]e've looked at all of the oil transit lines ... none other has the same combination of factors [as the WOA line]" was false in light of the CAO's language that the pipelines were "similar." ¶ 96, ¶ 91.

• Plaintiffs cite as a "false statement" the 2005 Annual Report (issued on June 30, 2006) which stated that "BP is in discussion with PHMSA on assuring compliance with the corrective actions outline in the [CAO]." ¶ 162. Plaintiffs claims this is a misrepresentation based on BP's failure to pig the OTL until July 22.

The results of the July 22 pigging caused BP to send visual inspectors out to the lines on August 5 and 6, and to shut down the line on August 6. ¶¶ 104–106. The Complaint alleges that, as a result of the announcement of the shutdown of Prudhoe Bay on August 6, 2007, the price of BP's ordinary shares and American Depositary Receipts ("ADRs") fell 13 pence and $2.09, respectively. ¶ 183. On October 24, 2007, BP Exploration (Alaska) Inc. pled guilty to a criminal violation of the Clean Water Act and paid a $20 million fine for the acts leading up to and the damage caused by the 2006 spills. ¶ 124. The plea agreement representing the acknowledgement of guilt contained admissions that the defendant knew of the corrosion which caused the leaks and failed to properly inspect, monitor and maintain the pipelines. ¶ 126.

Plaintiffs filed this proposed shareholder class action against corporate Defendants BP plc, BP Exploration (Alaska) Inc. (BPXA), BP America Inc., and individual Defendants John Browne (former CEO of BP plc), Steve Marshall (former President of BPXA), Maureen Johnson (former Senior Vice–President of BPXA) and Walter Massey (former director and head of the Board of Directors environmental committee for BPXA). The putative class is comprised of "all those who purchased or otherwise acquired ordinary shares and ADRs of BP plc between March 31, 2005 and August 4, 2006, inclusive, and who were damaged thereby." ¶ 170.

Discussion

I. FRCP 12(b) Standard—Failure to State a Claim

***3** The Court is mindful that, in considering the question of whether this complaint states a claim upon which relief may be granted, the Court must (1) accept as true all material allegations in the complaint; (2) make all reasonable inferences to be drawn from those allegations; and (3) construe the allegations in the light most favorable to the plaintiffs. *NL Industries, Inc. v. Kaplan,* 792 F.2d 869, 898 (9th Cir.1986). A complaint will not be dismissed if the plaintiffs can prove any set of facts to support a claim that would merit relief. *Bell Atl. Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 1965–1969, 167 L.Ed.2d 929 (2007); *Cahill v. Liberty Mut. Ins. Co.,* 80 F.3d 336, 337–338 (9th Cir.1996).

II. Heightened Pleading Standards—Fraud and the PSLRA

The federal rules of pleading require that, in any allegation of fraud, the plaintiff must state with particularity the circumstances constituting the fraud. FRCP 9(b). Where the claims concern securities fraud, the claimant must satisfy the even more stringent standards established by the Private Securities Litigation Reform Act ("PSLRA").

The PSLRA mandates that, in any private action in which the plaintiff alleges that a defendant made an untrue statement of material fact or omitted to state a material fact, the complaint must:

> [S]pecify 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.

15 U.S.C. § 78u–4(b)(1). The plaintiff must attribute the misleading statements upon which the claim is based to a particular defendant. Further, the PSLRA states that:

> 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 ... state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u–4(b)(2). Failure to satisfy the PSLRA's heightened pleading standard requires dismissal of the complaint. 15 U.S.C. § 78u–4(b)(3)(A).

III. Liability Under § 10(b)/10b–5

To plead securities fraud under § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)) and Rule 10b–5 of the SEC (17 C.F.R. § 240.10b–5), the plaintiff must allege, in connection with the purchase or sale of securities: (1) a misstatement or omission of fact (2) made with scienter (i.e., intent to defraud) (3) on which plaintiff relied (4) which proximately caused the complained-of damages. *Dura Pharms, Inc. v. Broudo,* 544 U.S. 336, 341–342, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

1. Actionable misrepresentations or omissions

The parties make frequent reference to this Court's prior ruling in an earlier, similar matter: *In re BP Prudhoe Bay Royalty Trust Sec. Litig.,* 2007 WL 3171435 (W.D.Wash. Oct.26, 2007) (*"PBRT"*). The Court rejects any attempt by either side to use this previous opinion as a "shortcut" through sound legal analysis and citation to the record in this matter. While there are some commonalities between these two cases, there are considerable differences as well; sufficiently so that the rationale in this order is beholden only in limited measure to the *PBRT* ruling. The parties' arguments in the instant case (and Plaintiffs' Complaint) must stand or fall on their own merits.

***4** There is, however, at least one "artifact" from *PBRT* which survives to play a role in this matter. The Court finds that the quarterly filings with the Securities and Exchange Commission ("SEC") made in connection with BPXA's obligations under the PBRT contract throughout the purported Class Period (which included documents wherein Defendants represented that they were in compliance with Alaska's Prudent Operator Standard),FN3 may be utilized by Plaintiffs as evidence of false or misleading statements upon which any investor was permitted to rely. A statement is false if it "affirmatively create[s] an impression of a state of affairs that differs in a material way from the one that actually exists," (*Brody v. Transitional Hospitals Corp.*, 250 F.3d 997, 1006 (9th Cir.2002)), and that is not a principle Defendants can evade by arguing that this is simply private contractual language. The Court is likewise cognizant of the "duty to speak" which arises whenever a defendant must "state a material fact necessary in order to make the statements made ... not misleading." *In re Connectics Corp. Sec. Litig.*, 542 F.Supp.2d 996, 1009 (N.D.Cal.2008).

> FN3. "Section 7.1 Prudent Operator Standard. Grantor [BPXA] agrees ... that it will conduct and carry on the development, exploration, production, maintenance and operation of the Subject Interest with reasonable and prudent business judgment, in accordance with the provisions of this Article Seven and good oil and gas field practices, as a reasonable and prudent operator ..." ¶ 134.

Had this commitment to abide by the Prudent Operator Standard simply been a contractual provision between BPXA and the PBRT shareholders, Defendants might have argued convincingly regarding its relevance and/or admissibility, but the filing of the agreement as a public document in compliance with SEC requirements renders it a representation that investors may rightly rely upon; in this case, a representation that, by Defendants' own admission, BPXA knew to be untrue.

The remainder of Plaintiffs' allegations intended to establish Defendants' fraudulent conduct do not fare as well. Challenged by Defendants to meet the heightened specificity standards of the PSLRA, Plaintiffs cite the following statements for their "affirmative falsity" along with the reasons why they are actionably misleading:

1. *Defendant Johnson's statement that the WOA pipeline was "unique;" alleged to be misleading because PHMSA had already determined that other pipelines were "similar."* The Court does not find this to be a false statement, primarily because a review of the Complaint reveals that it does not allege that Johnson said the *pipeline* was "unique"—Defendant Johnson is quoted as saying "the *highly corrosive conditions* were unique to that line" (¶ 149; emphasis added), not that the pipelines were themselves dissimilar.

2. *Defendant Johnson's statement (referring to the OTLs) that "none other has the same combination of factors;" alleged to be misleading based on PHMSA's finding that there was a danger of additional spills because of the similarity between the leaking line and other lines.* The Court finds nothing actionably false about this vague and ambiguous statement. Plaintiffs nowhere allege that Johnson stated there was no danger of spills in any of the other lines. The Court agrees with Defendants that just because the lines were of similar design, construction, composition, etc. does not mean that the combination of factors which produced a leak in one OTL could not be a one-time confluence of events, which is the gist of Johnson's statement here. Plaintiffs' pleadings do not establish that such a statement was false.

***5** 3. *Defendant Johnson's May 14, 2006 statement that "you can count on us to do not only [what] we've already done ... the smart pigging."* The Court finds that, as pled in Plaintiffs' Complaint, there is nothing actionably fraudulent about this statement. (It is presented in both Plaintiff's Complaint and pleadings out of context; i.e., there is no time frame presented for the statement "[what] we've already done.") The *implication* is that the company had been smart pigging all along, which was certainly not true; the pleadings are insufficient to determine if Johnson actually claimed that. Based on the information presented to the Court, since Defendants had smart-pigged at some point (in the

1990s), it is not an inaccurate or false statement to say that they had "already" done so.

4. *Defendant Browne's July 25 statement that BP was "accelerating pigging;" alleged to be false because PHMSA had already had to issue a followup directive based on BP's failure to comply with the original deadlines of the CAO.* It is true that PHMSA had been forced to re-order BP to comply with its original directive; but (as Plaintiffs themselves point out) BP had finally complied on July 22, 2006, making the July 25 statement not inaccurate or false.

5. *Defendant Johnson's statement that the September 2005 inspection had revealed a "low manageable corrosion rate;" alleged to be false because the results of that report showed a "sharp and rapid spike in the corrosion rate."* There is no inherent contradiction in these two statements—a sharp and rapid spike in the corrosion rate could still produce "low, manageable" corrosion, and Plaintiffs' Complaint contains no expert opinions to the contrary.

6. *Defendant Marshall's statement that the spill was the result of "corrosion caused by a chemical additive;" alleged to be false because the plea agreement resulting from the criminal charges against BP contained an admission that "both leaks in substantial part" resulted from Microbial Induced Corrosion ("MIC") with no reference to "chemical additives."* Plaintiffs misstate the allegation as pled in their Complaint, which reads "Marshall said corrosion caused by chemical additive [was] involved in two main *theories* of why the spill occurred." (¶ 155; emphasis supplied) The fact that Defendants later determined that these theories were incorrect and that MIC was the cause of the spill does not make this statement false.

7. *Defendant Browne's statement (at a press conference in April 2006 addressing first quarter 2006 results) that BP had a "world class corrosion monitoring system;" alleged to be false because no pigging had been conducted.* Defendants claim that there are other methods of monitoring corrosion besides pigging, and the Complaint does not plead that pigging was the only means of corrosion monitoring; nor does the statement claim that Defendants had been *using* the system.[FN4]

FN4. Johnson actually goes on to say that BP's "world class corrosion monitoring and leak detection systems [were] being applied within regulations set by the Alaskan authorities." As both parties acknowledged at oral argument, BPXA's non-pigging practice did not violate any statutes or regulations, rendering Johnson's "being applied" statement essentially meaningless.

***6** 8. *Defendant said, in its June 30, 2006 Annual Report for 2005, that "it was assuring compliance with the corrective actions outlined in the [March 15, 2006] order;" alleged to be false because BP had failed to comply with the CAO by failing to smart pig the EOA lines in the time period set in the order.* Plaintiffs have taken this statement out of context in an attempt to create the impression that it is sufficiently deceptive to satisfy the pleading standards. The full statement—that BPXA was *"in discussion with PHMSA on* assuring compliance with the corrective actions outlined in the order" (emphasis supplied)—is not actionable because Plaintiffs do not allege that Defendants were not in discussions with PHMSA at the time the report issued.

9. *Defendant Browne stated on July 25, 2006 that BP was cooperating to the "fullest possible extent" and "doing more;" alleged to be false because BP was violating the CAO by failing to smart pig and therefore was not "cooperating" and "doing more."* "Cooperating" and "doing more" are vague and general terms, incapable of precise definition and difficult to disprove; Plaintiffs do not allege or offer proof that Defendants were actually not "cooperating" or "doing more;" it is merely a conclusory allegation. In fact, by July 25, BP had begun complying with the CAO.

None of the statements attributed to Defendants satisfies the heightened pleading standards of the PSLRA. Plaintiffs also list a series of omissions which they repeat throughout the Complaint as a boilerplate allegation intended to demonstrate the false, misleading nature of Defendants' statements: the OTLs were under-inspected and maintained, corrosion maintenance had been severely curtailed, Defendants had been warned that the pipelines were severely corroded, Defendants had been warned of the necessity of pigging and taken no corrective action, and

Defendants suppressed evidence of corrosion rather than addressing the problem (*see* ¶¶ 136, 148, 150, 156, 161, 167).[FN5] Plaintiffs' conclusory allegations that Defendants were aware of the existence of a corrosion problem do not make any of the statements they attribute to Defendants deceptive at the level required by the PSLRA. Plaintiffs' Complaint does not connect the list of omissions to the challenged statements or show how the facts about Defendants' mismanagement of their pipelines render the statements misleading. The chronicle of omissions and negligent care amount to corporate mismanagement on a massive scale, but that does not make them actionable as securities fraud.

> FN5. In fact, these allegations uniformly read that "BP" was responsible for all this malfeasance; since "BP" is not a defendant in this action, Plaintiffs' pleadings repeatedly violate the requirement that the alleged fraud be attributed to a specific defendant.

The Court finds that Plaintiffs have not asserted sufficient facts to justify retaining any of the Defendants in this lawsuit except BPXA on the basis of 10(b)/10b–5 liability (*but see* § 20(a) control person liability *infra*). This Court has previously found that BPXA was not operating pursuant to the Prudent Operator Standard and had "knowingly refused to implement corrective measures." *In re PBRT,* 2007 WL 3171435, at *4. Rule 10b–5 covers *any* untrue statement. Based on the SEC filings containing representations of their compliance with the Prudent Operator Standard, Plaintiffs have adequately pled fraudulent or misleading statements by BPXA and Defendants are not entitled to dismissal pursuant to FRCP 12.

*7 None of the statements attributed to the remaining Defendants are sufficient to satisfy the pleading standards of federal civil procedure or the PSLRA. The statements of Defendants Browne, Johnson and Marshall have been discussed *supra.* Defendant Massey is not alleged to have *said* anything, and the case for retaining him in this litigation is especially weak. Plaintiffs argue that the spills themselves were the communication of his deceptive acts, which became known to the public when it was disclosed that the spills were the result of corrosion of which he was warned by the Hamel letter in 2004. Setting aside that none of these allegations appear in the Complaint, Plaintiffs' novel argument is supported by neither statutory nor legal authority, any more than their argument that investors were "deceived" by Massey on the basis of their reliance on his "good faith" as head of the environmental committee of the Board of Directors. There is simply no legal justification for Defendant Massey's presence in this lawsuit.

Plaintiffs argue that Massey and BP America, Inc. (which is also not alleged to have communicated anything to investors) are liable on a theory of "scheme liability," a concept which is endorsed by the Supreme Court (*see Stoneridge Inv. Partners, LLC v. Scientific–Atlanta, Inc.,* — U.S. ——, 128 S.Ct. 761, 169 L.Ed.2d 627 (2008)) but which requires some allegation that the "deceptive conduct" of these Defendants was actually relied upon by investors. *Id.* at 769. Plaintiffs have not adequately pled investor reliance or "scheme liability" regarding these two Defendants. Plaintiffs claim that Count I of the Complaint pleads "scheme liability" against all the Defendants (Opposition, p. 27), but, as reliance by investors on the complained-of acts is not adequately alleged against any of them, the argument is no more successful than against Massey and BP America, Inc..

2. Scienter

Having found that securities fraud has not been adequately pled against any other Defendants, this order will only address the issue of scienter as it applies to Defendant BPXA.

In that regard, this Court finds no need to look any further than the plea agreement which BPXA executed to find sufficient evidence of scienter: a "strong inference that the defendant acted with the required state of mind," (15 U.S.C. § 78u–4(b)(2) which is defined as "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193, n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); "deliberate recklessness." *In re Silicon Graphics Inc. Securities Litigation,* 183 F.3d 970, 974 (9th Cir.1999).

The plea agreement contains the following admissions by BPXA:

> BPXA believed that internal corrosion on the OTLs was a low probability. However, production upsets allow water and sediment to leave the separation facility and enter the OTL which in-

creases the likelihood of internal corrosion in a low velocity line such as the OTL. BPXA was aware by 2004 that production upsets were occurring frequently as a result of processing heavier, more viscous oil at gather Center 2(GC2). BPXA knew that the EOA OTL also had sediment collecting in the pipe ... BPXA was aware of sediment build up on the EOA OTL prior to both spills.

***8**

BPXA knew that it had insufficient inspection data on the EOA OTL. BPXA failed in light of these conditions to take necessary action to prevent the leaks on the OTLs. BPXA failed to clean the OTLs with a piece of equipment called a maintenance (or cleaning) pig and inspect the pipe for corrosion activity with a smart pig.

BPXA Plea Agreement, Dkt. No. 116, Ex. A, pp. 10–11.

As alleged in Plaintiffs' Complaint and reflected in the plea agreement, BPXA knew the EOA line had sediment collecting in the pipe prior to both spills, was aware (by 2005) of increased corrosion activity in the OTLs that leaked, failed to pig the lines adequately and did not expend sufficient resources to address the corrosion issue in the OTLs. ¶ 126. The Court has no difficulty finding, against the background of this knowledge, that the BPXA's representation (via their public SEC filings) that their operation of the OTLs was consonant with the Prudent Operator Standard was misleading to a "deliberately reckless" degree. The element of scienter is adequately pled as regards this defendant.

3. Loss causation

Loss causation need not be pled with particularity. In the 9th Circuit, 12(b)(6) dismissal is not appropriate as "long as the complaint alleges facts that, if taken as true, plausibly establish loss causation ... enough facts to raise a reasonable expectation that discovery will reveal evidence of loss causation." *In re Gilead Sciences Sec. Litig.,* 536 F.3d 1049, 1057 (9th Cir.2008).

The Complaint alleges that, in the wake of the announcement of the Prudhoe Bay shutdown on August 6, 2006, the price of BP's ADRs dropped $2.09 share. Defendants attempt to paint this as such a low percentage drop as to be *de minimis.* Plaintiffs point out that, with more than 3 billion shares outstanding, the decline represents a $6+ billion market capitalization loss. The Court denies Defendants' motion to dismiss as regards Plaintiffs' allegation of loss causation.

IV. § 18(a) claims and statute of limitations

§ 18(a) provides an express right of action for a false or misleading statement contained in a document filed with the SEC; the elements are: "(1) a misrepresentation or omission (2) of a material fact (3) contained in an SEC filing (4) upon which the plaintiff relied in the purchase of a security." *In re Redback Networks, Inc.,* 2007 WL 963958, at *6 (N.D.Cal. Mar.30, 2007).

Defendants attack this claim on two fronts: First, as they argue at length in the rest of their briefing, that Plaintiffs have not adequately alleged a false or misleading statement sufficient to satisfy the pleading requirements of FRCP 9 or the PSLRA. In keeping with the above analysis, the Court agrees as to all Defendants except BPXA.

Defendants also argue that the claim is time-barred: a § 18(a) claim must be brought within one year after the discovery of the facts constituting the cause of action. 15 U.S.C. § 78r(c). Based on Plaintiffs' allegation of August 7, 2006 (the announcement of the Prudhoe Bay shutdown) as the "date of discovery" (¶ 183), the filing of the Complaint on November 15, 2007 and the addition of the § 18(a) claim on February 29, 2008, Defendants contend that Plaintiffs are well outside the expiration of the one-year period.

***9** Plaintiffs respond that the Sarbanes–Oxley Act (28 U.S.C. § 1658) extended the statute of limitations to two years for § 18 claims, and cite a number of unpublished, non-precedential district court opinions in support of that contention. *Teachers' Ret. Sys. of La. v. Qwest Comm. Int'l,* 2005 WL 2359311, at *3 (D.Colo. Sept.23, 2005); *In re Adelphia Comm. Corp. Sec. & Derivative Litig.,* 2005 WL 1675940, at *4 (S.D.N.Y. July 18, 2005); *In re Stone & Webster, Inc. Sec. Litig.,* 2006 WL 1738348, at *3 n. 1 (D.Mass. June 23, 2006).

Defendants cite opposing cases, however (*see In re Alstom SA,* 206 F.Supp.2d 402, 420

(S.D.N.Y.2005)), and it is clear that there is (1) a split in authority on this issue, and (2) no Ninth Circuit precedent at all. This Court finds the *Alstom* rationale more persuasive on the following grounds: (1) the extended limitations period applies only to causes of action concerning fraud claims and therefore to claims which require the pleading of fraudulent intent or scienter; and (2) nothing in the language or history of Sarbanes–Oxley indicates a clear intent to overrule express limitations period, and § 18 contains just such an express limitations period. *Id.* Because § 18(a) does not meet either of these conditions (a scienter component or the absence of an express limitation period), Plaintiffs' § 18(a) claims are barred by the statute of limitations.

V. § 20(a) control person liability

A prima facie case for control person liability under § 20(a) must plead (1) "a primary violation of federal securities law" and (2) "that the defendant exercised actual power or control over the primary violator." *No. 84 Employer–Teamster Joint Counsel Pension Trust Fund v. America West Holding Corp.,* 320 F.3d 920, 945 (9th Cir.2003). As the Court observed in *PBRT,*

> [w]hether the defendant is a controlling person is an intensely factual question, involving scrutiny of the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions. *Id.* "Control" is defined in the regulations 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.

2007 WL 3171435, at *8 (W.D.Wash. Oct.26, 2007). Plaintiffs are not required to demonstrate actual participation by Defendants or the exercise of power in order to establish derivative liability under § 20(a) (*No. 84 Employer–Teamster,* 320 F.3d at 945), and general allegations concerning an individual's title and responsibilities are sufficient at the pleading stage. *See In re Adaptive Broadband Sec. Litig.,* 2002 WL 989478, at *19 (N.D.Cal. Apr.2, 2002); *In re Cylink Sec. Litig.,* 178 F.Supp.2d 1077, 1089 (N.D.Cal.2001).

As indicated *supra,* a primary violation of federal securities law has been adequately alleged. The Complaint does not allege sufficient facts to sustain control person liability for Defendant Massey, stating only that he was a "non-executive member of the BP plc board of directors" from 1998 to 2008 and served on the Ethics and Environment Assurance Committee. ¶ 27. These allegations do not speak to any degree of control over the operations of the corporation and certainly no involvement in its day-to-day activities.

***10** The remainder of the individual defendants, however, are alleged to have sufficient involvement in corporate operations to sustain a finding that control person liability has been sufficiently pled. Browne (as CEO of BP plc) and Marshall (as President of BPXA) occupied traditional positions of control and spoke publicly on behalf of their organizations. ¶¶ 28, 75, 117, 119, 155–56, 179, 195. Johnson was a Senior Vice President of BPXA during the Class Period; perhaps more significantly (in light of the Court's findings regarding the relevance of BPXA's SEC filings), the Complaint alleges that Johnson was responsible for information provided by BPXA to the public. ¶ 29.

Regarding the corporate defendants, the motion to dismiss the § 20(a) claim against BP America will be granted. The only allegations contained in the Complaint concerning this business entity are that BPXA was a subsidiary of BP America (¶ 25) and the conclusory allegation that "BP America acted as a controlling person of BPXA within the meaning of Section 20(a) of the Exchange Act." ¶ 197. This is not sufficient.

Control person liability is adequately pled for Defendant BP plc, however. The Complaint contains allegations that BPXA was a wholly-owned subsidiary of BP plc, which exercised control, oversaw BPXA's operations, made decisions about maintenance and production and issued press releases on their behalf. ¶¶ 23, 25, 160–69. These allegations are sufficient to support the inference that the above-named defendants controlled operations at BPXA and thus survive a motion to dismiss, recognizing that these defendants will be permitted to develop the nature of Plaintiffs' proof through discovery and interpose defenses of good faith or lack of participation at a later date.

Conclusion

Plaintiffs' § 18(a) claims are barred by the statute of limitations and will be dismissed in their entirety.

Liability for Defendant Massey and Defendant BP America has not been adequately pled, either as primary violators of 10(b)/10b–5 or under a control person liability theory, and the motion to dismiss those defendants from the lawsuit will be granted.

Primary 10(b)/10b–5 liability has been sufficiently pled against one defendant, BPXA; the motion to dismiss the 10(b)/10b–5 cause of action against the remaining defendants will be granted. But the Court finds that § 20(a) control person liability has been adequately alleged as to the remainder of the defendants (BP plc, Browne, Johnson and Marshall), and the motion to dismiss that claim against them will be denied.

The clerk is directed to provide copies of this order to all counsel of record.

W.D.Wash.,2009.
Reese v. Malone
Not Reported in F.Supp.2d, 2009 WL 506820 (W.D.Wash.), Fed. Sec. L. Rep. P 95,080

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Only the Westlaw citation is currently available.

United States District Court, W.D. Washington, at Seattle.
Jerry RICHARD, Plaintiff,
v.
NORTHWEST PIPE COMPANY, et al., Defendants.

No. C9–5724RBL.
Aug. 26, 2011.

Dan Drachler, Zwerling Schachter & Zwerling, Karl Phillip Barth, Hagens Berman Sobol Shapiro LLP, Seattle, WA, Christopher M. Wood, Christopher P. Seefer, Robbins Geller Rudman & Dowd LLP, San Francisco, CA, Darren J. Robbins, Robbins Geller Rudman & Dowd LLP, San Diego, CA, for Plaintiff.

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ORDER DENYING MOTIONS TO DISMISS [Dkt. # 41, 43, 44]
RONALD B. LEIGHTON, District Judge.

*1 THIS MATTER comes before the Court on Motions to Dismiss filed by defendants Northwest Pipe Company, its former Chief Executive Officer Brian Dunham, and its former Senior Vice President of Finance and Chief Financial Officer Stephanie Welty (collectively, "defendants"). [Dkt. # 41, 43, 44]. Plaintiffs,[FN1] who are suing on behalf of themselves and all others similarly situated, assert that for years, defendants committed accounting improprieties that caused the company to overstate its earnings, in violation of federal securities laws. Plaintiffs allege that when the truth emerged, the stock price fell, damaging all stockholders.

FN1. The Court previously consolidated two actions and granted an unopposed motion to appoint as lead plaintiff Plumbers and Pipefitters Local No. 630 Pension–Annuity Trust Fund.

For the reasons set forth below, the Court denies the Motions to Dismiss.[FN2]

FN2. Because this matter can be resolved based on the parties' submissions and the balance of the record, plaintiffs' request for oral argument is denied.

I. FACTS

This is a federal securities class action brought on behalf of all persons who purchased or otherwise acquired the common stock of Northwest Pipe Company ("Northwest" or the "company") from April 2, 2007 through March 30, 2010 (the "class period"). Northwest is a manufacturer of large-diameter, high-pressure steel pipeline systems for use in water infrastructure applications, primarily related to drinking water systems. [Consolidated Complaint, Dkt. # 29, at ¶ 3]. Plaintiffs allege that during the class period, defendants engaged in numerous accounting improprieties which inflated the company's financial results, violated Generally Accepted Accounting Principles ("GAAP") and SEC disclosure rules, and made contradictory representations. [*Id.* at ¶ 4].

On November 4, 2010, the company announced the completion of its year-long investigation, which resulted in a financial restatement of three years of financial results. [Consolidated Complaint at ¶ 50]. Plaintiffs allege, "When defendants' fraud was exposed, the Company was forced to issue a massive financial restatement which wiped out the Company's entire reported earnings for certain accounting periods, resulting in up to 77% overstatements in gross profit, 152% overstatements of net income, and 154% overstatements of EPS." [*Id.*]. The complaint alleges that defendants committed fourteen separate accounting violations, including improperly recognizing steel as revenue when it was purchased, artificially inflating revenue and earnings by concealing liabilities caused by contractual penalty provisions, liquidated damages and back charges, manipulating expenses related to depreciation of assets, and falsifying the assignment of costs.

Plaintiffs filed this lawsuit on November 20, 2009 alleging that defendants violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Securities Exchange Commission ("SEC") Rule 1 0b–5. The consolidated complaint also contends that the individual defendants are "control persons" subject to liability under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a).

II. DISCUSSION

A. Dismissal Standard

Defendants have filed a 12(b)(6) motion for failure to state a claim upon which relief can be granted. The complaint should be liberally construed in favor of the plaintiff and its factual allegations taken as true. *See, e.g., Oscar v. Univ. Students Co–Operative Ass'n,* 965 F.2d 783, 785 (9th Cir.1992). The Supreme Court has explained that "when allegations in a complaint, however true, could not raise a claim of entitlement to relief, this basic deficiency should be exposed at the point of minimum expenditure of time and money by the parties and the court." *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 558, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007) (internal citation and quotation omitted). A complaint must include enough facts to state a claim for relief that is "plausible on its face" and to "raise a right to relief above the speculative level." *Id.* at 555. The complaint need not include detailed factual allegations, but it must provide more than "a formulaic recitation of the elements of a cause of action." *Id.* A claim is facially plausible when plaintiff has alleged enough factual content for the court to draw a reasonable inference that the defendant is liable for the misconduct alleged. *Ashcroft v. Iqbal,* — U.S. ——, 129 S.Ct. 1937, 1949, 173 L.Ed.2d 868 (2009). "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice." *Id.* at 1949.

B. Loss Causation

***2** "Loss causation is the causal connection between a defendant's material misrepresentation and a plaintiff's loss." *In re Oracle Corp. Sec. Litig.,* 627 F.3d 376, 392 (9th Cir.2010). Plaintiff bears the burden of proving that defendant's unlawful act " 'caused the loss for which the plaintiff seeks to recover damages.' " *In re Gilead Scis. Sec. Litig.,* 536 F.3d 1049, 1055 (9th Cir.2008) (quoting 15 U.S.C. § 78u–4(b)(4)).

The Supreme Court has explained that liability attaches for the loss the purchaser sustains "after the truth became known" regarding defendant's material misrepresentation. *Dura Pharms., Inc. v. Broudo,* 544 U.S. 336, 344, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005). To survive a motion to dismiss, a plaintiff need only provide "some indication of the loss and the causal connection [plaintiff] has in mind." *Id.* at 346–47 (explaining that the pleading rules for loss causation were "not meant to impose a great burden upon a plaintiff" and that plaintiffs must only plead a "short and plain statement" pursuant to Fed.R.Civ.P. 8). Based on *Dura,* the Ninth Circuit has explained that the issue of loss causation should not be decided on a Rule 12(b)(6) motion to dismiss if the "complaint alleges facts that, if taken as true, plausibly establish loss causation." *Gilead,* 536 F.3d at 1057.

> [L]oss causation is not adequately pled unless a plaintiff alleges that the market learned of and reacted to the practices the plaintiff contends are fraudulent, as opposed to merely reports of the defendant's poor financial health generally. The market need not know at the time that the practices in question constitute a 'fraud,' nor label them 'fraudulent,' but in order to establish loss causation, the market must learn of and react to those particular practices themselves. This reaction, in turn, must be the cause of a plaintiff's loss.

In re Oracle, 627 F.3d at 392 (citing *Metzler Inv. GMBH v. Corinthian Colleges, Inc.,* 540 F.3d 1049, 1063 (9th Cir.2008)).

In this case, the price of the company's stock went up when the company announced in July 2010 that it would likely restate earlier financial results, and went up again in November 2010 when the company issued that restatement. Faced with that reality, plaintiffs allege that three other company disclosures triggered the losses. First, on November 12, 2009, the company reported that financial results for 3Q09 were less than analysts were expecting, and that the Company could not timely file its 3Q09 Form 10–Q, due to a pending internal investigation regarding certain "revenue recognition" practices. [Consolidated Complaint at ¶¶ 178–79]. Following that disclosure, the company's stock price declined 14% and an analyst opined, "As a result of the ongoing investigation and uncertainty regarding previously stated results, we lack conviction on the future earnings power of the business pending additional information from the company." *Id.* at ¶ 181. Second, the Complaint alleges that on March 16, 2010, the company announced that it would not file its 2009 Form 10–K on time because the internal investigation had not been completed; the company also disclosed that the SEC had commenced a formal investigation. [Consolidated Complaint at ¶¶ 15, 182]. The stock price declined 16.2%. *Id.* at ¶ 183. Again, an analyst commented on the "uncertainty" of the situation. The analyst noted, "The lack of clarity on business conditions for the water transmission business coupled with uncertainty regarding the outcome and timing of completion of the internal accounting review makes it difficult for us to advocate committing new money into the shares." [*Id.* at ¶ 184].

***3** Third, plaintiffs allege that the market reacted negatively to Dunham's resignation, disclosed on April 2, 2010. Faced with the fact that the stock price dropped before the announcement, plaintiffs contend that the resignation was leaked. That allegation, however, is absent from the Complaint.

However, regarding the first two disclosures, courts have held that the disclosure of an internal investigation is sufficient to plead loss causation. *See, e.g., Rudolph v. UTStarcom,* 2008 U.S. Dist. LEXIS 63990 at *9–12, 2008 WL 4002855 (N.D.Cal. Aug. 21, 2008); *In re New Century,* 588 F.Supp.2d 1206, 1237 (C.D.Cal.2008). Moreover, courts have held that the disclosure of SEC investigations is sufficient to allege loss causation. *See, e.g., Freudenberg v. E* Trade Fin. Corp.,* 712 F.Supp.2d 171, 203 (S.D.N.Y.2010); *In re IMAX Sec. Litig.,* 587 F.Supp.2d 471, 485–86 (S.D.N.Y.2008); *In re Bradley Pharm., Inc. Sec. Litig.,* 421 F.Supp.2d 822, 828 (D.N.J.2006). In contrast, in *Metzler,* the disclosures simply revealed negative financial information and a seemingly isolated problem at one campus. Neither statement "disclosed—or even suggested—to the market that [defendant] was manipulating student enrollment figures company-wide in order to procure excess federal funding." *Metzler,* 540 F.3d at 1063.

The truth need not be disclosed through a single, complete disclosure. *See, e.g., Dura,* 544 U.S. at 342 (explaining that the loss causation element was met where the price dropped after "the relevant truth began to leak out."); *In re Daou Sys.,* 411 F.3d 1006, 1026–27 (9th Cir.2005). In this case, the disclosures that required filings would be delayed and that the company and SEC were investigating revenue recognition practices—the subject of the alleged fraud—are sufficiently linked to defendants' prior statements about the company's financial results and are sufficient to plausibly allege loss causation.

C. Scienter

To adequately plead scienter, a complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u4(b)(2)(A). "A complaint can plead scienter by raising a strong inference that the defendant possessed actual knowledge or acted with deliberate recklessness." *Zucco Partners, LLC v. Digimarc Corp.,* 552 F.3d 981, 991 (9th Cir.2009). A securities fraud complaint will survive a motion to dismiss "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 308, 324, 127 S.Ct. 2499, 168 L.Ed.2d 179 (2007). Therefore, the Court considers the Complaint in its entirety. *Id.* at 322.

Certainly, plaintiffs have not alleged any direct evidence of scienter such as an incriminating statement from either of the individual defendants. Nor are the alleged statements from the anonymous witnesses compelling because, for the most part, the Complaint fails to allege how the witnesses "would possess the information alleged" and to provide "adequate corroborating details." [FN3] *Daou,* 411 F.3d at 1015–16.

> FN3. For example, plaintiffs contend that CW4 states that Dunham had "final authority" for approving settlements of claims, but fails to allege background facts to support that witness's alleged knowledge.

***4** The Court also considers whether the allegations, when taken together, are sufficient. *See Tellabs,* 551 U.S. at 322–23. Although the misapplication of GAAP standards is insufficient alone to support a finding of scienter, the misapplication " 'combined with a drastic overstatement of financial results can give rise to a strong inference of scienter ... [and] the totality and magnitude of the accounting violations [may] constitute strong circumstantial evidence of reckless or conscious misbehavior.' " *New Mexico State Inv. Council v. Ernst & Young LLP,* 641 F.3d

1089 (9th Cir.2011) (quoting *Carley Capital Group v. Deloitte & Touche,* 27 F.Supp.2d 1324, 1339–40 (N.D.Ga.1998)). In this case, the restatement was significant: the company restated three years of financial statements, including significantly revising net income figures, retained earnings figures, and earnings per share results. [Consolidated Complaint at ¶¶ 50, 62, 65, 89, 126–42, 155]. Plaintiffs have also alleged fourteen accounting violations. Although defendants attempt to explain them away, their explanations introduce evidence outside the record and not properly considered on a motion to dismiss. Similarly, to counter plaintiffs' contention that the accounting principles defendants allegedly violated were simple, defendants have attempted to introduce declarations and information about audits, which is beyond the scope of this motion.[FN4]

> FN4. In contrast, in *Zucco,* 552 F.3d at 987, on which defendants rely, it appears that plaintiffs did not contest the complexity of the accounting rules at issue.

In addition, defendants each made an inconsistent statement about the company's revenue recognition practices. During an analyst call in July 2008, Dunham stated that the "shipment date is not really the driver" of when POC revenue was recognized; "[i]t's when it's built that's the driver." [Consolidated Complaint at ¶ 82]. Similarly, Welty stated that "we recognize revenue as the work is completed." [*Id.* at ¶¶ 82–83]. Clearly, those statements are inconsistent with the company's revenue recognition practices and with defendants' argument that their practices were open and notorious. Although defendants attempt to explain away the issue, their explanation is unsupported by any citation or evidence appropriately considered in this motion. Defendants' Reply at p. 11 n. 9. Moreover, plaintiffs convincingly argues that defendants, who were both CPAs and had extensive accounting experience, should have known of the falsity of their statements.

Additional factors suggest scienter. First, plaintiffs have alleged a motive: absent the accounting violations, the company "would have missed Wall Street expectations, which would have devastated the stock price." [Consolidated Complaint at ¶ 156 (citing examples)]. Similarly, plaintiffs allege that "[p]erformance-based incentive compensation made up a significant portion of defendants' compensation.... Awards were based on achievement of certain financial performance measures for the year, including sales and **net incomes measures.**" *Id.* at ¶ 159 (emphasis in original); *see also* Tellabs, 551 U.S. at 325 (explaining that "personal financial gain may weigh heavily in favor of a scienter inference"). In turn, net income was significantly overstated. During the relevant years, defendants Dunham and Welty received significant sums in incentive compensation, sometimes in excess of their base salary. *Id.* at ¶ 160; *see also No. 84 Emp'r–Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.,* 320 F.3d 920, 944 (9th Cir.2003).

***5** Second, both individual defendants certified pursuant to the Sarbanes–Oxley Act of 2002 that after review, the company's financial results were "fairly present[ed] in all material respects ." Plaintiffs' Response at p. 36. The certifications, though insufficient alone, are "probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements." *Glazer Capital Mgmt., LP v. Magistri,* 549 F.3d 736, 747 (9th Cir.2008). Third, the timing and circumstances surrounding the individual defendants' departure from the company support an inference of scienter. Welty resigned on January 20, 2011, shortly after the restatement was issued. Dunham abruptly resigned his position as CEO during the pendency of the company's internal investigation. [Consolidated Complaint at ¶ 165]. He subsequently resigned as President and as a member of the board of directors less than a month before the company issued the restatement. *Id.* at ¶ 166. Standing alone, the departures are insufficient. "But because the changes in management occurred while [the company] was preparing its own internal investigation of revenue recognition practices, the departures 'add one more piece to the scienter puzzle.' " *Fouad v. Isilon Sys.,* 2008 U.S. Dist. LEXIS 105870 at *31–32, 2008 WL 5412397 (W.D.Wash. Dec. 29, 2008) (quoting *In re Adaptive Broadband Sec. Litig.,* 2002 U.S. Dist. LEXIS 5887 at * 14, 2002 WL 989478 (N.D. Cal. April 2, 2002)); *see also In re Impax Labs., Inc. Sec. Litig.,* 2007 U.S. Dist. LEXIS 52356 at *26–27, 2007 WL 7022753 (N.D.Cal. July 18, 2007). Similarly, Dunham's departure was suspicious because the company had previously touted him as essential. [Consolidated Complaint at ¶ 165]; *see also Zucco Partners,* 552 F.3d at 1002 (explaining that a resignation that was "accompanied by suspicious circumstances" could be sufficient to support an "inference that the defendant corporation forced certain employees to resign because of its knowledge of the employee's role in the fraudulent representations."). In sum, taken together, plaintiffs' allegations meet their burden.

D. Control Person Liability

Plaintiffs contend that the individual defendants are liable as "controlling persons" under the Securities Exchange Act of 1934 § 20(a). To prove a prima facie case under that section, plaintiffs must establish: (1) a primary violation of federal securities law; and (2) the defendant exercised actual power or control over the primary violator. *See, e.g., Am. West,* 320 F.3d at 945.

As an initial matter, because Welty began working for the company seven months into the class period, she could not have controlled anything prior to that time. Any control person theory against her based on events that occurred prior to when she joined the company is untenable.

The statute provides:

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

***6** 15 U.S.C. § 78t(a). Welty argues that she was not a controlling person because plaintiffs have not alleged how she controlled Dunham, her boss. However, if the company is alleged to be a violator, as it is in this case, alleging control over the company can be sufficient. *See, e.g., Am. West,* 320 F.3d at 945–46. Furthermore, the Complaint alleges that Welty and Dunham were control persons because of the nature of their positions, the fact that they both participated in the day-to-day affairs of the company, and they had the power to control the company's financial disclosures, including the ones alleged to be false. [Consolidated Complaint at ¶¶ 28, 206–08]. Accordingly, plaintiffs have sufficiently alleged that Welty and Dunham were "control persons."

III. CONCLUSION

For all of the foregoing reasons, the Court DENIES defendants' Motions to Dismiss (Dkt.# 41, 43, 44).

IT IS SO ORDERED.

W.D.Wash.,2011.
Richard v. Northwest Pipe Co.
Slip Copy, 2011 WL 3813073 (W.D.Wash.)

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Only the Westlaw citation is currently available.

United States District Court,
S.D. California.
In re PETCO ANIMAL SUPPLIES INC. SECURITIES LITIGATION.

No. 05-CV-0823-H (RBB).
Docket Nos. 28, 31, 33, 39.
Aug. 1, 2005.

Dennis M. Klein, Peter H. Benzian, Robert J. Blair, Robert G. Knaier, Daniel J. Lenerz, Latham & Watkins LLP, San Diego, CA, for Petco Animal Supplies, Incorporated.

ORDER GRANTING IN PART AND DENYING IN PART MOTIONS TO DISMISS CONSOLIDATED COMPLAINT

MARILYN L. HUFF, District Judge.

*1 Defendants move to dismiss the Consolidated Complaint alleging violations of the Securities Exchange Act of 1934 ("Exchange Act"). The Court held a hearing on the motions on May 22, 2006. Daniel Drosman, Esq., David Thorpe, Esq., and Ted Minahan, Esq. appeared as Lead Counsel for Lead Plaintiff; Peter Benzian, Esq. appeared for Defendant Petco Animal Supplies, Inc. and its corporate officers and executives; Andrew Weissman, Esq., John Valentine, Esq., Timothy Pestontnik, Esq., and Russell Gold, Esq., appeared for Defendant Texas Pacific Group, Inc., its related entities, and individuals; and Eric W ax man, Esq., appeared for Defendant Leonard Green & Partners, L.P., its related entity, and individuals. For the reasons stated below, the Court GRANTS IN PART and DENIES IN PART the motions to dismiss.

I. *Request for Judicial Notice & Motion to Strike*

Before addressing the merit's of the motions to dismiss, the Court must resolve the requests for judicial notice. Fed.R.Evid. 201. Plaintiffs have requested judicial notice of nine documents, while Defendants have joined to lodge fifty documents. Most of the documents are public filings with the Securities and Exchange Commission ("SEC"). Plaintiffs move to strike certain portions of Defendants' exhibits, or in the alternative, convert the motion into a summary judgment motion.

When determining a motion to dismiss for failure to state a claim for relief pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, the court cannot consider matters outside the complaint with exceptions for (1) authenticated documents that have been incorporated into the complaint and (2) facts that are subject to judicial notice. *Lee v. City of Los Angeles,* 250 F.3d 668, 689-90 (9th Cir.2001).

A. *Documents Incorporated into Complaint*

The Consolidated Complaint ("CC") refers to and quotes from several statements that were released to investors by the Defendants. Plaintiffs have quoted substantial portions of the press releases, prospectuses, web-cast telephone conferences, and other SEC filings because these are central to Plaintiffs' case that various statements were misleading. *E.g.,* CC ¶ 94-95 (Aug. 18, 2004 press release and telephone conference and referencing SEC Form 10-Q for second quarter 2004).[FN1] Because Plaintiffs rely on large portions of such statements, it is appropriate to consider the entire statement. Most documents lodged by Defendants are complete copies of the press releases (filed in conjunction with SEC Forms) and the official transcripts of the telephone calls broadcast to investors. *E.g.,* Defs.' Exs. I (press release) & J (conference call transcript).

FN1. Petco's fiscal year ends on the Saturday closest to January 31 (*i.e.,* February 1,2003, January 31, 2004, and January 29, 2005). *See* Pls.' Ex. H at 59. The parties have abbreviated the fiscal year as "FY," and any fiscal quarter as "Q." For example, Q3 2004 refers to the third quarter of fiscal year 2004, and "FY 2004" would have ended on January 29, 2005. The Court uses the same abbreviations.

In some instances, the Consolidated Complaint refers to, but does not quote a SEC filing, and Defendants have lodged the underlying document. *E.g.,* CC ¶ 100 (referencing SEC Form 10-Q for Q2 2004) & 108 (referencing Oct. 22, 2004 SEC Prospectus Supplement); Defs.' Exs. M (SEC Form 10-Q) & F (prospectus supplement Form 424B4). The Court concludes that the underlying documents have been incorporated by reference into Plaintiffs' complaint and can be considered in the Rule 12(b)(6) context. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 986 (9th Cir.1999) (considering SEC filings in a motion to dismiss under the doctrine of incorporation by reference); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1405 n. 4 (9th Cir.1996) (proper to consider prospectus though not mentioned in complaint alleging violations of securities laws).

B. *Judicial Notice*

***2** A district court may take judicial notice of matters of public record, but cannot use this rule to take judicial notice of a fact that is subject to "reasonable dispute" simply because it is contained within a public record. *Lee*, 250 F.3d at 689-90. For example, a court may take judicial notice of the *existence* of a court opinion, but not " 'the truth of the facts recited therein." ' *Id.* at 689 (quoting *Southern Cross Overseas Agencies, Inc. v. Wah Kwong Shipping Group, Ltd.*, 181 F.3d 410, 426-27 (3d Cir.1999)). The district court must reject requests to the extent that parties seek to have the court accept as true the facts contained within public documents. Disputed factual questions are not suitable for judicial notice. *E.g., United States v. Ritchie*, 342 F.3d 903, 908-09 (9th Cir.2003). Nonetheless, the court can take note of the fact that certain *statements were made*. *Lee*, 250 F.3d at 689-90 (distinguishing between fact that person had signed a document waiving his rights *and* the validity of the waiver); *Southern Cross*, 181 F.3d at 426-27 & n. 8 (distinction between truth and existence for judicial notice is similar to analysis of hearsay exception).

Plaintiffs object to a portion of a declaration submitted by Defendants on the ground that it contains facts that conflict with the allegations in their complaint. A defense attorney summarized the sales by insiders before and during the class period in a chart. Decl. Horton ¶ 52-54. Plaintiffs sole example of a conflict is a mathematical error, which has been corrected in a supplemental filing. Decl. Beck-Meloche. The Consolidated Complaint contains calculations of the date, number, and value of the alleged insider stock trades, and Defendants have submitted the SEC Form 4s, which are filed with the SEC to report a sale of stock by an interested party, for those sales and for sales in the preceding year. *Compare* CC ¶ 31 & 288 *with* Defs.' Exs. AD (Devine's sales) & AC (Devine's sales for prior period). From the Court's review, it appears that both sides obtained the trading information from the same source, and neither side has identified a true discrepancy. *Silicon Graphics*, 183 F.3d at 986 ("Although [plaintiff] questions the veracity of the SEC forms, her ongoing and substantial reliance on the forms as a basis for her allegations substantially weakens her position."). To the extent that Defendants' SEC documents report the exercise of stock options, the Court finds it appropriate to take judicial notice of those events. *Id.* (district court properly considered stock options to calculate volume of shares traded by an insider). Consequently, the Court has referred to those SEC documents for specific dates, prices, and amounts of sales by named Defendants. *See also Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir.2001) (requiring plaintiff to allege context of an insider's trading history and noting easy public access to SEC Form 4s).

***3** The Court denies Plaintiffs' request for judicial notice of its exhibits B and I. Exhibit B purports to be a list of the price of Petco's stock price but there is no indication who created the summary or the basis for it. The Court has used the stock price recorded on the SEC Form 4s. Exhibit I, a newspaper article, is not suitable for judicial notice. Similarly, the Court did not need the press release by a competitor. Defs.' Ex. G (PetSmart).

Finally, in the alternative, Plaintiffs move to convert Defendants' motions into motions for summary judgment so that they can conduct discovery. Having reviewed the record, the Court determines that it can resolve the motions to dismiss on the allegations in the Consolidated Complaint (supplemented, when appropriate, by documents incorporated into the complaint or subject to judicial notice) without treating them as summary judgment motions.

The Court has indicated this Order that it relied on particular statement in particular documents by citing to the document.

II. *Background*

For purposes of resolving this motion to dismiss, the Court accepts all well-pleaded facts alleged in the Consolidated Complaint as true. *Gompper v. VISX, Inc.*, 298 F.3d 893, 895 (9th Cir.2002). This factual summary is taken in the light most favorable to Plaintiffs. *Number 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding*

Corp., 320 F.3d 920, 925 n. 2, 931 (9th Cir.2003). Where appropriate, the Court has also considered documents attached to and incorporated into the complaint and has taken judicial notice of certain facts.

A. *Parties*

Plaintiffs are a proposed class of investors who purchased Petco Animal Supplies, Inc., ("Petco") common stock during the period from August 18, 2004 to August 25, 2005 at allegedly inflated prices. Petco is a retail store selling pet food, small companion animals, and supplies. CC ¶ 26; Defs.' Ex. A at 3. Petco is a large, warehouse style store (typically, over 12,000 square feet) that carries specialty pet items not carried by the nearby supermarket, Defs.' Ex. A at 3. As of July 31, 2004, near the commencement of the class period, Petco reported that it had 685 stores nationwide and annual sales of $ 1.8 billion. CC ¶ 94; *see* Defs.' Ex. P at 523 (net sales for 2004).

The defendants fall into two categories. The first group contains the corporation and its key executives. The second group contains two clusters of partnerships that had once owned Petco.

1. *Petco and its Executives*

In the first category, Plaintiffs have sued Petco and several executives of Petco, including James Myers, Chief Executive Officer ("CEO") and director; Rodney Carter, Senior Vice President and Chief Financial Officer ("CFO"); Brian Devine, Executive Chairman of the Board of Directors and member of the Executive Management Committee; Bruce Hall, President and Chief Operating Officer ("COO"); Robert Brann, Senior Vice President of Merchandising; Frederick Major, Senior Vice President of Information Systems; Keith Martin, Senior Vice President of Operations; Janet Mitchell, Senior Vice President of Human Resources; Razia Richter, Senior Vice President of the Supply Chain; William Woodard, Senior Vice President of Business Development; and Julian Day, director and member of Audit, Compensation, and Nominating and Corporate Governance Committees. (In addition to Day, Plaintiffs name other members of the Board of Directors, who are connected to the partnerships.)

2. *The Partnerships TPG and LGP*

***4** The second category consists of two groups of investment partnerships. The Consolidated Complaint does not explain the relationship between the two partnerships, though they appear to have acted together in their relationship with Petco. The private investment partnerships had owned and managed Petco for a year and a half, and during that time, they took simultaneous action to buy and sell their shares.

Texas Pacific Group, Inc., is named along with several related entities; TPG Advisors III, TPG Partners III, L.P., TPG Parallel III, L.P., TPG Dutch Parallel III, C.V., TPG Investors III, L.P., FOF Partners III, L.P., FOF Partners III-B, L.P. Of those, TPG Advisors III acts as general partner of another entity, TPG GenPar III. In turn, TPG GenPar III and TPG GenPar Dutch are general partners of the limited partnerships named. Defendants David Bonderman, Jonathan Coslet, James Coulter, and William Price are officers, directors, and shareholders of the TPG Advisors III entity. Coslet and Price served on Petco's Board of Directors. The parties collectively refer to this group as "TPG."

The other partnership includes Leonard Green & Partners, L.P. and an affiliated entity, Green Equity Investors III, L.P. Defendants John Baumer, John Danhakl, Jonathan Sokoloff, and Peter Nolan are named as managing partners of Leonard Green & Partners, L.P. Baumer and Danhakl served on Petco's Board of Directors. The parties collectively refer to this group as "LGP."

One of the main issues in these motions is the inclusion of TPG and LGP (collectively referred to as the "Partnerships"). They argue they should be dismissed because they sold their stock holdings *before* Petco made any of the alleged false and misleading statements. The Consolidated Complaint describes the history of the ownership, financial, and management relationship between Petco and the Partnerships. Plaintiffs contend that the Partnerships had a special relationship with Petco, and consequently, had direct and indirect control over the company's decisions.

Petco was founded in La Mesa in 1965, and it went public in 1994. In 2000, Petco was taken private when the Partnerships acquired 75% of the stock. CC ¶ 27-28, 53-56; LPG's Br. at 5 (stating that *each* Partnership group owned approximately 37.5%); *see* Defs.' Ex. B at 50 (showing that shares owned by Petco Individual Defendants Brann, Day, Devine, Hall, Martin, Mitchell, Myers, Woodard; and Partnership

Individual Defendants Baumer, Coslet, Danhakl, and Price). Shortly thereafter, TPG and LGP led Petco through a recapitalization transaction and the stock split 22-for-1. CC ¶ 56-59. Concurrent with its purchase of Petco, TPG and LGP entered into a ten-year management services contract with Petco. CC ¶ 58. Simultaneously, two partners from TPG and two partners from LGP served on the five-member Petco Board of Directors. CC ¶ 39-40, 43, 45 (Baummer, Coslet, and Danhakl served since October 2000, and Price from 2000 to April 2004); *see also* Defs.' Ex. B at 65-66 (as of January 2002, Baumer, Coslet, Danhakl, and Price were directors with connections to the partnerships).

***5** In February 2002, TPG and LGP led the company through a public offering. CC ¶ 61; Defs.' Ex. B at 37, 46 (Prospectus for Initial Public Offering of 14.5 million shares of common stock on Feb. 27, 2002 to raise $254 million and to purchase all outstanding shares of preferred stock held by TPG and LGP). Together, the partnerships (through their own reorganization holding company) owned 79.6% of the shares before the public offering, and would own a majority of 55.8% of the stock afterwards (or 27.9% each). Defs.' Ex. B at 50, 72 & n. 2 (Prospectus). As to each of these transactions, Plaintiffs describe how TPG and LGP structured the finances to their benefit. *E.g.*, CC ¶ 55 (buyout in 2000 was structured so "common stock holdings of TPG and LGP were virtually risk-free assets") & 294.

Upon the completion of the public offering in February 2002, Petco's Board of Directors was expanded to nine members, and TPG and LGP each had two nominees. *See* Defs.' Ex. B at 66. TPG and LGP further agreed that they would vote for each others nominees for directors, and as noted above, several partners-including Baumer, Coslet, Danhakl, and Price-served in that capacity. CC ¶ 27-28, 64; *see* Defs.' Ex. A at 11-13 (showing that these four continued to serve through Feb. 2004).

Two years later, in February 2004, Petco announced a public offering of 12.2 million shares. Defs.' Ex. A (SEC Form S-3 Registration Statement filed Feb. 6, 2004); see Defs.' Exs. D, E, & F (supplements). At that time, there were 57.6 million shares outstanding, held by approximately 100 shareholders. Defs.' Ex. A at 19. One of the LGP entities expected to sell 5,855,954 shares; and 6 of the TPG entities, collectively, would sell that same number of shares. Defs.' Ex. A at 14 (Green Equity Investors, III, L.P. could offer 100% of its shares, which accounted for 10.2% of the common stock, with similar numbers dispersed amongst several TPG entities); Pls.' Ex. C & D (sales by Green Equity Investors, III, L.P. in December 2003). Thus, as of February 2004, TPG and LGP were offering to sell most of the 12.2 million shares in that transaction, but assuming all those shares sold, TPG and LGP would collectively still own 11.6% of the outstanding shares (or 5.8% each consisting of 3.3 million shares). *See* Defs.' Ex. D at 174 (Prospectus Supplement dated June 10, 2004 shows the same shares offered in Feb. being offered in June).

In April 2004, Baumer and Price apparently resigned from Petco's Board of Directors. CC ¶ 43 & 45 (alleging terms from 2000 to April 2004); *see* Defs.' Ex. C at 134 (showing two new directors replaced Baumer and Price in April 2004). That left two of Petco's nine directors with connections to the partnerships (TPG's Coslet and LGP's Danhakl). CC ¶ 39 & 40 (alleging current service on Petco's Board); *see* Defs.' Ex. C at 134 (as of April 2004, Baumer and Price were no longer listed, but Coslet and Danhakl were listed); Pls.' Ex. A at 9-11 (same as of July 2005).

***6** All of this background occurred before the beginning of the proposed Class Period for this lawsuit. Plaintiffs allege a Class Period beginning on August 18, 2004. The following facts occur after that date.

In a "Supplement" to the February Prospectus, which was dated October 22, 2004, Petco announced an offer of an additional 6.9 million shares. Defs.' Ex. F. In this offering, TPG and LGP (through their entities) released all of their remaining shares. CC ¶ 107, 294; Defs' Ex. F at 238 (showing both partnerships offered to sell 3,355,954 shares, which amounted to their remaining 5.8% beneficial ownership of Petco).

After that offering, TPG and LGP did not own any Petco common stock. *Id.* However, at least two individuals connected to the partnerships, Coslet and Danhakl, continued to serve on Petco's Board of Directors. CC ¶ 27, 39; *see* Defs.' Ex. H at 305 (listing dates the directors' terms ended); Pls.' Ex. A at 9-11 (same for July 2005 Annual Meeting).

B. *Allegations of Fraud*

Plaintiffs describe two categories of fraud: (1) an improper accounting practice to defer the recording of incurred distribution expenses in order to make quarterly earnings goals; and (2) operational problems that led to slow sales, including an inadequate distribution infrastructure (particularly in the Southeast) and an inefficient store format (called "Pisces"). With regard to each of these problems, Plaintiffs allege that Petco issued false and misleading statements about its financial condition which had the effect of artificially inflating the stock price. The false statements were contained in the press releases announcing financial results and predictions of growth for the relevant quarters and fiscal years, and then repeated in web-cast telephone conference calls for investors and financial analysts. *E.g.,* CC ¶ 94-95. Moreover, Plaintiff alleges that individual defendants sold common stock during the Class Period, at inflated prices, for a combined value of $270 million. *Id.* ¶ 1, 27-38, & 41.

1. *Accounting Improprieties*

Plaintiffs link the accounting scheme to early 2002, when TPG and LGP took the company public but retained a majority of the shares. Plaintiffs allege that in 2002, Petco "launched an aggressive expansion plan (long-term growth plan) in order to boost its stock price." CC ¶ 180. "Realizing that they could not meet their projected profit targets," Plaintiffs allege that Petco "embarked on an accounting scheme to falsify and materially understate its costs and liabilities." *Id.* "In order to achieve their now unreachable earnings targets, defendants established unrealistic and unattainable cost budgets for distribution centers along with instructions from management that the budgets could not be exceeded." *Id* .. In order to meet those budgets, Plaintiffs allege that Petco manipulated the accounting procedures. *Id.* Plaintiffs allege that the accounting scheme continued through April 2005, when it was disclosed to the public. *See* CC ¶ 150. Plaintiffs further allege that when Petco released its 2004 fiscal year results in late June 2005, the company falsely reported that it had remedied the problem by revising it policies with respect to distribution accruals. CC ¶ 141.

*7 Plaintiffs allege securities law violations because "Petco's financial position and results were falsified through the use of an accounting scheme of unrecorded expenses and liabilities, which materially overstated PETCO's net earnings and EPS [earnings per share]." CC ¶ 86. Plaintiffs allege that the statements Petco and its executives made about the company's earnings and prospects were false and misleading because they were based upon the accounting scheme. *See* CC ¶ 94 (press release on 2Q 2004 earnings), 95 (teleconference on same), 100 (SEC Form 10-Q for 2Q 2004), 101 (repeating results at conference), 111 (setting forth statements between August and October 2004, and reasons they were misleading); *accord* CC ¶ 112-59 & 168-98 (identifying allegedly false statements between November 2004 and June 2005 and describing false financial reporting through use of unrecorded invoices at distribution centers).

The Consolidated Complaint does not merely repeat the disclosures that Petco itself made when it announced the accounting problem to the public. Instead, the Consolidated Complaint corroborates the allegations with information from former employees who witnessed and participated in the underlying acts. The percipient witnesses describe in detail the scope of the accounting error. CC ¶ 234-68. For example, former employees describe the accounting procedures followed at the distribution centers to decide "which invoices would be submitted for payment and which ones would be withheld and not recorded." CC ¶ 184. The Consolidated Complaint also includes contemporaneous reports by employees, on a corporate survey, that there was an accounting problem and that they felt coerced into violating Generally Accepted Accounting Procedures ("GAAP") in order to be meet the unrealistic budget. CC Ex. 1 at 4; CC ¶ 275-78. One employee asked "is this not what Enron did[?]" CC Ex. 3. Plaintiffs attached to the Complaint an e-mail from late March 2005, in which a Transportation Manager told Defendants Myers (CEO) and Carter (CFO) that he had resigned because he had been complaining about the held-back invoices and he wanted to alert them to his concern. CC Ex. 2. He attached his own calculations from ledgers that Petco had held-back $3 million of fuel and freight expenses from 2004 and carried the expense into 2005. *Id.*

The Consolidated Complaint also contains factual allegations connecting upper management to the problem. Former employees report that there was tremendous pressure by senior management to meet the budget, and that the distribution centers began to hold onto invoices instead of recording the expenses.

E.g., CC ¶ 181-92, 218. They report conversations with executives who allegedly instructed the employees to "hold onto any invoices because we gotta make the quarter." CC ¶ 5, 218(d) (alleging that Defendant Richter, a Senior Vice President of the Supply Chain, instructed the directors of the distribution centers to "do whatever it takes to be on budget"). Confidential witnesses identify the senior executives who attended the regular monthly meetings to review budget summaries and forecasts that had been assembled with the incorrect data. *E.g.,* CC ¶ 218, 234.

***8** On April 15, 2005, Petco issued a Press Release announcing that it would delay filing its SEC Form 10-K for fiscal year 2004 because of "accounting errors" related to under-accrued expenses in its distribution centers. CC ¶ 85, 126; *see also* CC ¶ 130 (April 29 press release updated status of internal review); CC ¶ 132 (May 23 press release announces SEC issued notice of potential de-listing on NASDAQ due to delay in filing year end reports); CC ¶ 137 (June 24 press release announces internal review ongoing and receipt of SEC notice of failure to timely file 1Q 2005 results). Petco investigated and learned that the distribution centers had not recorded invoices totaling $5.6 million in the proper quarter for an entire fiscal year. CC ¶ 139. Petco acknowledged it had overstated its earnings per share by $0.03 in 3Q 2004, by $0.06 in the 4Q 2004, and by $0.06 for FY 2004. CC ¶ 150(a). On June 28, 2005, Petco filed its Form 10-K for the fiscal year that ended on January 29, 2005, and as revised after its internal investigation of the accounting errors. CC ¶ 139-41; Defs.' Ex. U; *see* CC ¶ 146 (shortly thereafter, SEC ended process to delist and Petco announces that NASDAQ "hearing file has been closed").

2. *Operational Problems in Distribution and Store Format*

Plaintiffs contend that Petco's celebrated "business strategy" was "illusory" because the company suffered from several operational problems. These operational problems include an inadequate distribution infrastructure; an ineffective program to re-model the stores, which in turn affected the same-store sales; and erroneous accounting of tenant improvement allowances on Petco's leases. Plaintiffs contend that Petco hid these related problems from investors while they stated positive forecasts for continued growth. *E.g.,* CC ¶ 111(c)-(f); *accord* CC ¶ 112-52 (repeating theory for statements during Class Period).

Plaintiffs state that Petco touted its aggressive growth strategy to open new stores nationwide, especially in the Southeast region of the United States, but contend it did not similarly expand its distribution infrastructure. *See* CC ¶ 66 & 111. As of February 2002, Petco had 561 stores (14 of those were in the Southeastern states), and Petco had 8 distribution centers (3 central and 5 regional). CC ¶ 67-68, The distribution center in New Jersey filled orders for the stores in the Southeast, and that distant location was expensive and inefficient because of high fuel costs, overtime for truck drivers, and the need for expensive temporary workers. CC ¶ 281-82. Plaintiffs contend that Petco compounded the problem by dramatically expanding its store presence in the Southeast. CC ¶ 66-70. Between February 2002 and January 2004, Petco increased its stores in Southeastern states from 14 to 41, and operated a total of 654 stores nationwide. CC ¶ 66-70 & 2 (alleging Petco "failed to open additional distribution centers where they were greatly needed, especially in Georgia and Florida, where Petco had expanded exponentially"). By 2004, during the Class Period, Plaintiffs allege that Petco planned to build two new distributions centers in Florida and Colorado to serve the Southeast areas but did not tell investors about this planned expense until May 2005. *Id.* ¶ 72-80, 133.

***9** The second operational problem concerned the store format. In August 2004, at the start of the Class Period, Petco began remodeling stores in a format that was more open and "fun" but which did not provide as much shelf space. CC ¶ 82, 285. This was an change from the prior "new and distinct store format known as the Millennium" that had commenced in 2001. CC ¶ 60 ("This new store format incorporated a more dramatic presentation of animals and emphasized higher-margin supplies categories"). Plaintiffs further contend that the Pisces format lead to lower sales because trucks could not distribute product quickly, and the empty shelves caused customers to shop elsewhere. CC ¶ 218(g). Petco hid the problem by raising prices on items but continued to report success with the new format. CC ¶ 287. In addition, Plaintiffs allege that Petco's "same-store sales" forecasts were false because customer traffic had actually decreased. CC ¶ 94-95, 280, 283, 286-87.

Third, Plaintiffs allege that Petco understated its cost of sales because it improperly amortized tenant improvement allowances as a reduction to depreciation, and improperly amortized them. CC ¶ 8.

In summary, Plaintiffs allege that the stock price was artificially inflated because of the under-accrued invoices at the distribution centers and the combined effect of the operational problems. Near the start of the Class Period, Petco common stock had been selling for $33.19. *See* Defs.' Ex. AD at 800 (stock price as of Sept. 1, 2004). The price continued to rise, and by April 1, 2005, had reached $37.41. *See id.* at 840. Once Petco announced the accounting discrepancy on April 15, 2005, "PETCO's stock collapsed to $30.36 per share," which Plaintiffs calculate as "a one day drop of 13.6%." CC ¶ 129 (bold type omitted). Thereafter, the common stock was selling at $28.00 on August 1, 2005, which Plaintiffs contend was inflated by the operational difficulties. *See* Defs.' AC at 848. But when "they released their final bombshell" on August 25, 2005-that the same store sales in the second quarter had increased 2.5% instead of the anticipated 3% to 4%-the "stock plummeted to $21.99 per share." CC ¶ 18-19, 91; *see* CC ¶ 139 (expected 2Q 2005 comparable store net sales increase). "[A] one day drop in price at 13%." CC ¶ 19 (bold type omitted).

C. *Insider Trading*

Plaintiffs allege that the false and misleading statements about Petco had the effect of artificially inflating the price of the stock, and that Defendants sold approximately $270 million worth of inflated common stock during the one year Class Period. CC ¶ 1, 288 (chart of 7.6 million shares sold by insiders during Class Period). Plaintiffs also allege that the insiders routinely delayed announcements of bad news until after they sold stock on the schedule established by their Rule 10b-5 trading plans. CC ¶ 291.

Plaintiffs highlight the public offering on October 22, 2004 as an example of the use of material non-public information by insiders. In October "defendants learned through an employee that PETCO was violating accounting rules by systematically withholding payment for invoices," and after senior management instructed distribution center managers to withhold invoices and falsify budgets so that Petco reported false financial results. CC ¶ 13-14, 294. In bold type, Plaintiffs allege that this "Public Offering not only allowed PETCO insiders the opportunity to sell vast sums of common stock, but it also afforded PETCO's two largest and controlling shareholders, Texas Pacific Group and Leonard Green & Partners, the opportunity to sell-off 100% of their remaining shares of PETCO common stock." CC ¶ 13; *accord* CC ¶ 15-16 (stock trades through April 1, 2005 were based on the same inside information); *see also* CC ¶ 18-19 (attributing sales in July and August 2005 to inside information about the company's operational difficulties)

D. *Causes of Action*

***10** The Consolidated Complaint alleges three causes of action under federal securities law. First, it alleges that all Defendants violated § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder by making false and misleading statements, failing to disclose material adverse facts, or participating in a scheme to deceive investors regarding Petco's business prospects and by artificially inflating the common stock. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; CC ¶ 322-28.

The second cause of action alleges that all Defendants violated § 20(a) of the Exchange Act because they were "controlling persons" of Petco and had the ability to prevent the misleading statements. 15 U.S.C. § 78t(a); CC ¶ 329-32.

The third and final claim alleges that all but two Individual Defendants engaged in insider trading in violation of anti-fraud provisions. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *see* 15 U.S.C. § 78t-1 (§ 20A of PSLRA provides right of private action and defines measure of damages as amount of disgorged profits); CC ¶ 29-48, 333-43.

III. *Discussion of Motion to Dismiss*

"A complaint should not be dismissed under Rule 12(b)(6) 'unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief.' " *Balistreri v. Pacifica Police Dept.,* 901 F.2d 696, 699 (9th Cir.1990) (quoting *Conley v. Gibson,* 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957)).

A. *Falsity and Scienter*

The Private Securities Litigation Reform Act (PSLRA) dictates that a securities complaint must "specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(l). The Ninth

Circuit traditionally analyzes the overlapping issues of falsity and scienter at the same time. *Ronconi*, 253 F.3d at 429 (pleading requirements of PSLRA can be collapsed into a single inquiry because analysis of both factors involves the same facts); *see America West*, 320 F.3d at 932. A securities fraud claim must "state with particularity facts giving rise to a strong inference" that each defendant acted with the intent to defraud or with deliberate recklessness. 15 U.S.C. § 78u-4(b)(2); *America West*, 320 F.3d at 931; *Silicon Graphics*, 183 F.3d at 979 ("deliberate or conscious recklessness").

"[A]n inevitable tension arises between the customary latitude granted the plaintiff on a motion to dismiss under Fed.R.Civ.P. 12(b)(6), and the heightened pleading standard set forth under the PSLRA." *Gompper*, 298 F.3d at 895. The Court accepts as true the Plaintiffs' allegations; however, with regard to the element of scienter, "the court must consider *all* reasonable inferences to be drawn from the allegations, *including inferences unfavorable to the plaintiffs.*" *Id.* at 897 (emphasis added). "Under the PSLRA, the court ultimately reviews the complaint *in its entirety* to determine whether the totality of facts and inferences demonstrate a strong inference of scienter." *Id.* at 895 (emphasis added).

***11** In addition, Rule 9(b) of the Federal Rules of Civil Procedure requires fraud claims to be alleged with particularity. This rule applies to claims brought under § 10(b) and Rule 10b-5. *Stat Elec.*, 89 F.3d at 1401.

1. *Alleged Accounting Fraud*

The Court concludes that Plaintiffs have stated sufficient facts to state a § 10(b) and Rule 10b-5 cause of action against some of the Petco Defendants concerning the allegations of accounting improprieties. Petco acknowledges that the accounting discrepancy occurred, that there were inadequate control systems, and that its prior financial statements had overstated the earnings per share. *See* CC ¶ 126, 130, 132, 137, 139-41 (press release by Petco states that "the Company understated its cost of sales by approximately $3.2 million, $5.6 million, and $5.6 million in 3Q 2004, 4Q 2004, and fiscal year 2004, respectively" and CEO Myers concludes "the errors in under-accruals were limited to our Distribution Operation" and hopes "to prevent such errors in the future"), 146. Therefore, the key question in the motions is whether Plaintiffs have pleaded, "in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct." *Silicon Graphics*, 183 F.3d at 974. To plead that state of mind, "plaintiffs must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity." *Id.*

Plaintiffs have alleged facts showing that the accounting problem was apparent to those in the distribution centers and that employees been considered it an ongoing issue of concern. On October 14, 2004, employees at the Mira Loma distribution center in San Die go completed a "Control Environment Questionnaire." CC Ex 1; CC ¶ 275-78. The survey is attached to the Consolidated Complaint and Plaintiffs have quoted responses from employees, including two of the Confidential Witnesses, who report improper methods of accruing expenses. Confidential Witness No. 7 ("CW7"), a former transportation manager, reported that "[f]reight bills don't get paid so department can meet budget." CC ¶ 277 & Ex. 1 at 3. When asked if there was pressure to meet goals, budgets, or business plans that "compromise my values," CW7 answered that "2003 expenses are carried over to 2004 due to accrual process." CC ¶ 277 & Ex. 1 at 7; *accord* CC ¶ 276 ("Budgets must be real. If you do not account for expenses in the month they were taken, and hold large expenses to level the months and budget against this. You budget [against] the prior year. How?"). Similarly, when asked if there was pressure to meet short-term results and to bypass company policies, one employee emphatically answered yes, "I am directed to do exactly that-not company procedures by rather GAAP in reference to accruals. No invoice in hand no accrual even though we know the expense has happened." CC ¶ 278 & Ex. 1 at 4. Another response said that Petco's company policies were "not always followed by management." CC Ex. 1 at 4. Question 27 asked if Petco's "leaders achieve financial goals without unethical behavior," and one response was: "If the leaders are Director and VP of my department-no. Accruals again. DC give accruals, I submit to Director, she changes and I tell DC's to resumbit. Accruals only when invoice in hand." CC Ex. 1 at 8. Another employee, Confidential Witness No. 2 ("CW2"), a former Director and Operations Manager for the Mira Loma central distribution center, hesitantly answered "Possible," but then described the factual basis for the accounting problem; "I am given direct orders to hold invoices and not show them as they happened. We are about to start the budget process. We will once again make budget against a false prior year. I never thought of this before, but is this not what Enron did." CC ¶ 276 & Ex. 3 (Bates Stamp 054). Another employee indicated that the accounting impropriety was entrenched when he said that "[m]y feeling is that the budgeting process has been going on long before I was here and will be long after I am gone. Budgeting is an issue." CC ¶ 278. These survey responses support Plaintiffs' allegation that the accounting impropriety was systemic and "widely known." CC ¶ 218. The quotations from former employees "offer a substantial window" into Petco's procedures and finances. *Oracle,* 380 F.3d at 1231.

***12** The quotations from employees who felt coerced by their supervisors to violate ethical standards to meet business goals provides circumstantial evidence of scienter. The Consolidated Complaint also includes allegations that upper management specifically instructed the distribution centers to manipulate the accruals. Plaintiffs quote Confidential Witness No. 1 ("CW1"), a former Financial Analyst, who alleges Defendant Richter, a Senior Vice President of the Supply Chain, instructed the directors of the distribution centers to "hold onto any invoices because we gotta make the quarter." CC ¶ 218. Defendant Richter, a Certified Public Accountant ("CPA") and former Controller at Petco, had also held executive positions in inventory management and business development. CC ¶ 37. During a weekly budget meeting, Defendant Richter allegedly instructed the distribution directors to "do whatever it takes to be on budget." CC ¶ 218(d). The Consolidated Complaint alleges that these meetings were attended by Bob Northcutt (Vice President of Logistics) and Sharon Regan (Director of Traffic and Transportation), who are not named as defendants, but who reported to Defendant Richter. CC ¶ 218(a) & (d).

CW2, the former Director and Operations Manager at the Mira Loma central distribution center described above, quotes Northcutt, the Vice President of Logistics, as giving in to the intense pressure by Defendants Myers and Devine to hold back invoices so that it looked like the distribution centers were within their budget. CC ¶ 218(b); *accord* CC ¶ 184 ("Northcutt was under so much pressure from senior management to meet the budget that he threatened to quit several times a week"). Northcutt, the Vice President of Logistics but is not named as a defendant in the action, decided which invoices would be paid and which would be withheld and not recorded. CC ¶ 184; CC Ex 1 at 8 (describing process of giving accruals to director, who then changes them for re-submission). Northcutt reported to Defendant Brann, who reported to Defendant Richter. CC ¶ 167, 234. Defendant Myers, a CPA, joined Petco in 1990, and had been promoted through Finance and Controller positions to become the CEO in 2004. CC ¶ 29. Defendant Devine had previously served as CEO. CC ¶ 31.

CW1 confirms CW2's description of the process by which distribution center reports were changed to appear to be within the budget and also identifies the people involved. CC ¶ 234-268. CW1 states that Northcutt discussed the budget with the distribution centers in weekly telephone calls. CC ¶ 245; *accord* CC ¶ 256 (CW2 states that Defendant Richter joined the weekly telephone calls in October 2004). CW1 states that the budget reports for the distribution centers were taken to monthly management meetings where all department heads presented reports to Devine, Carter, Hall, and Myers. CC ¶ 234.

Another factor probative of scienter is that Plaintiffs have quantified the under-accrued expenses. Plaintiffs rely on a witness who documented the problem and alerted Petco management to a serious financial discrepancy. CW7, the former transportation manager who expressed his concerns in the October 2004 survey, reports that he reviewed the general ledgers and could see the massive amounts of invoices that had been withheld. CC ¶ 218(c). On or about February 2005, CW7 reviewed an eight inch stack of unpaid "freight out" invoices that had not been processed, and ran a general ledger for all eight distribution centers. CC ¶ 273. He estimated that between three and five million dollars worth of invoices had not been recorded as accrued expenses for FY 2004. CC ¶ 218(c). Plaintiffs attached an e-mail to the Complaint from late March 2005, in which CW7 told Defendant Myers (CEO), Defendant Carter (CFO), and another supervisor Doug Beeuwsaert (the Vice President of the Internal Audit, who is not named in this case), that he had resigned because he had been complaining about the held-back invoices and he wanted to alert them to his concern. CC Ex. 2. CW7 attached his calculations and the ledgers showing that Petco had held-back over three million dollars of fuel and freight expenses from 2004, instead, carrying this expense into 2005. CC ¶ 186-87 & Ex. 2. The document identifies dozens of vendors affected by the accounting procedure by listing the invoices, the amounts involved, and the relevant dates. *Id.*

***13** Confidential Witness No. 2 ("CW2"), who had knowledge of Petco's procedure to process invoices, said temporary labor and transportation costs were commonly set aside. CC ¶ 181. CW2 was responsible for reviewing the invoices as they came into the Mira Loma distribution center, and for giving a report to CW1 or Regan for payment. CC ¶ 182. CW2 said that its temporary worker agency was "always getting ready to cut us off because of the four month delays in getting paid. CC ¶ 185. CW1 describes the specific ledgers that showed the accounting discrepancy, and estimates that the Mira Loma distribution center withheld $40,000 to $70,000 of temporary labor expenses every month. CC ¶ 248, 251-52, 261.

Thus, the Consolidated Complaint contains first-hand accounts and documented estimates of the amount of under-accrued expenses of the factual basis of the allegations. *Daou,* 411 F.3d at 1016-20 (irregularities in revenue recognition can be supported by basic information of amount, products, dates, and persons involved, so that court can assess whether violations were technical or significant and widespread; and complaint that included actual witness descriptions of incriminating acts meets PSLRA pleading standard); *Oracle,* 380 F.3d at 1233 (knowledgeable confidential witness described company's accounting practices, provided estimate of discrepancy, and "documents themselves appear to establish improper revenue adjustment").

Plaintiffs further allege that Petco violated GAAP by under-recording its distribution costs. CC ¶ 1174-77. "Violations of GAAP standards can also provide evidence of scienter." *In re Daou Sys.,* 411 F.3d 1006, 1016 (9th Cir.2005), *cert, denied,* 546 U.S. 1172, 126 S.Ct. 1335, 164 L.Ed.2d 51 (2006). The Court agrees that the facts describe a type of manipulation that supports an inference of knowing misconduct. This was not an arcane rule of accounting: a lay person can easily understand the need to record expenses in a timely fashion so that accounts are balanced correctly. *Id.* at 1016-20 (plaintiffs plead details of GAAP violations); *cf. In re Worlds of Wonder Sec. Litig.,* 35 F.3d 1407, 1426 (9th Cir.1994) (in summary judgment context, reasonable accountants could resolve differently the complex issues of accounting, therefore, the misapplication of GAAP did not support *scienter*). Taken together with the quotations that managers were instructed to hold back invoices in order to "make quarter," the alleged facts create a strong inference that the purpose of altering the accounts was to influence the third quarter 2004 results. CC ¶ 218; *Daou,* 411 F.3d at 1016-20 (specific allegations of improper accounting to mislead investors by artificially inflating revenue). The Confidential Witness heard Defendant Richter make the statement shortly before the third quarter period ended on October 31, 2004. Plaintiffs have alleged the chain of command showing that the problem was visible. A direct order to alter the ledgers from a high level executive creates a strong inference that Petco was acting either deliberately or recklessly to inflate the stock price. The totality of Plaintiffs' allegations about the accounting impropriety are sufficient to survive a motion to dismiss under the PSLRA standard. *Nursing Home Pension Fund, Local 144 v. Oracle Corp.,* 380 F.3d 1226, 1230-34 (9th Cir.2004) (factors included confidential witnesses and specific admissions by top executives); *cf. In re Vantive Corp. Sec. Litig.,* 283 F.3d 1079, 1087 (9th Cir.2002) (listing factors).

***14** In their motion to dismiss, the Petco Defendants identify facts that suggest the Petco did not know about the accounting error until the "whistleblower" alerted top executives about Northcutt's and Defendant Richter's conduct, and that once known, the company promptly investigated and corrected the problem. Petco's Br. at 16-17; CC ¶ 9, 87, 139 (June 28, 2005 press release describes discovery of error and comprehensive internal review); *see* Defs.' Exs. S at 570 (during May 25, 2005 conference call with investors, Defendant Myers describes investigation and remedy) (partially quoted at CC ¶ 133). Defendants also argue that the error was minor relative to Petco's financial situation, and that the company did not have to re-state its prior financial results.

Although the promptness with which Petco corrected the accounting mistake weakens the inference of scienter, the Court concludes that the totality of circumstances described in Plaintiffs' allegations satisfies the PSLRA pleading standard. *See Gompper,* 298 F.3d at 895-97 (court must take into account the existence of all plausible inferences to determine scienter from the total mix of alleged facts). The alleged circumstances provide cogent and plausible allegations that indicate "no less than a degree of recklessness that strongly suggests actual intent." Silicon Graphics, 183 F.3d at 979.

Petco's argument that the accounting error was insignificant in its amount is more appropriately directed to the "materiality" element of the securities violation claim. Materiality is a typically a fact-intensive question. *TSC Indus. v. Northway, Inc.,* 426 U.S. 438, 450, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976); *Provenz v. Miller,* 102 F.3d 1478, 1489 (9th Cir.1996). At the pleading stage, the Court accepts the Plaintiffs' reasonable premise information that a company holding back invoices to affect the bottom line "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See Basic Inc. v. Levinson,* 485 U.S. 224, 231-32, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988); *America West,* 320 F.3d at 935 (at motion to dismiss stage, allegation that company concealed information about the "overall economic health" satisfied materiality requirement). The employee's question, "isn't this what Enron did [?]" highlights that an investor might find it relevant that there were pressures to violate company policies by withholding expenses. *See* CC ¶ 128 (quoting a stock analyst that "Petco's discovery of errors related to under-accrual of distribution expenses not only reveals lower profitability in its business but also increases the perception of risk. There could be a credibility issue with investors that may be difficult to recover from in the short term") (emphasis omitted).

The Court now turns to the analysis of whether Plaintiffs have named particular individuals by "indiscriminately grouping all of the ... defendants into one wrongdoing monolith." *Lubin v. Sybedon Corp.,* 688 F.Supp. 1425, 1433 (S.D.Cal.1998). After careful review, the Court finds sufficient allegations against Individual Petco Defendants Brann, Carter, Devine, Hall, Myers, and Richter on the allegations of accounting improprieties. These executives were specifically mentioned by Confidential Witnesses as possessing information about the under-accrual of distribution expenses and either directly instructing or indirectly pressuring employees. *See In re GlenFed Inc., Sec. Litig.,* 42 F.3d 1541, 1549 (9th Cir.1994) (en banc) (*"GlenFed I"*). They were also in the chain of command of the distribution centers where the ledgers were modified and attended regular meetings where the results were discussed. This provides circumstantial evidence for Plaintiffs' allegations that these defendants recklessly disregard information that the earnings were based upon accounting improprieties. *Oracle,* 380 F.3d at 1231.

***15** Defendants Carter and Myers certified that the SEC Forms were correct. CC ¶ 100 (August 30, 2004 Form 10Q) & 198-201 (identifying other SEC forms); Defs.' Exs. H at 307-09 & M at 414-17. "[W]hen a corporate officer signs a document on behalf of the corporation, that signature will be rendered meaningless unless the officer believes that the statements in the document are true." *Howard v. Everex Sys., Inc.,* 228 F.3d 1057, 1061 (9th Cir.2000). Because the Consolidated Complaint contains sufficient factual allegations of scienter, those who sign the documents (even if there are no facts showing they were involved in the preparation) can be held liable as a primary violator of § 10(b) for making a false statement. *Id.*

Defendants Carter, Devine, and Myers were often quoted in press releases which contain statements alleged to be false and misleading. *E.g.,* CC ¶ 112 (Nov. 18, 2004 press release quotes Devine & Myers), ¶ 121 (March 10, 2005 press release quotes Devine & Myers). Having been quoted giving information about Petco's financial returns, it is reasonable to infer that these individuals participated in reviewing or preparing such documents. *See Howard,* 228 F.3d at 1061 ("By standing behind a statement, the public assumes that they can trust the word of the maker of that statement").

Each quarter, Defendants Carter, Devine, Hall, and Myers participated in web-broadcast telephone conference calls that repeated these financial statements to investors and to market analysts, who used the information to evaluate the financial health of the company. CC ¶ 96-99, 105, 110, 114, 116, 119, 128, 135-36, 138, 144-45, & 147-49, 324. Plaintiffs have identified statements made during those conference calls in which these executives held themselves out to the public as sources of reliable information about Petco's financial condition. *E.g.,* CC ¶ 95, 113, 122; Defs' Exs. J, L, & P.

Though Defendants Brann and Richter are not alleged to have made any statements about the stock value, Plaintiffs allege that they participated in the scheme to defraud investors by causing or permitting

Petco to overstate its earnings by recklessly disregarding proper accounting procedures for the distribution centers. The Consolidated Complaint contains sufficient specific facts of their participation in the orders to hold back invoices to sustain their inclusion in the First Claim for Relief on the accounting issue.

Consequently, the Court finds sufficient allegations to state primarily liability claims for the allegedly false and misleading statements at a time when the stock value was allegedly artificially inflated by the under-accrued expenses against Defendants Myers, Carter, Devine, Brann, and Richter, as well as the corporation, Petco itself.

The Consolidated Complaint, however, does not mention Individual Petco Defendants Major, Martin, Mitchell, and Woodard in connection with the under-accrual of expenses problem. Their job descriptions do not reveal an apparent connection with the distribution centers' finances or any particular accounting responsibilities. CC ¶ 32, 34-36, 38. Plaintiffs argue that their allegations against *all* of the individual Petco defendants are justified under "group published" doctrine. CC ¶ 50.

***16** Prior to the PSLRA, the Ninth Circuit accepted the "group published" doctrine: A plaintiff may satisfy Fed.R.Civ.P. 9(b) through reliance upon a presumption that the allegedly false and misleading "group published information" complained of is the collective action of officers and directors. *See Blake v. Dierdorff,* 856 F.2d 1365, 1369 (9th Cir.1988); *Wool v. Tandem Computers, Inc.,* 818 F.2d 1433, 1440 (9th Cir.1987). In cases of corporate fraud where the false and misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other "group-published information," it is reasonable to presume that these are the collective actions of the officers. Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and where possible the roles of the individual defendants in the misrepresentations.

In re GlenFed, Inc. Sec. Litig., 60 F.3d 591, 593 (9th Cir.1995) (*"GlenFed II"*).

Defendants argue that the legal concept of "group publishing" did not survive the enactment of the PSLRA in 1995, which raised the pleading standards in an effort to deter abusive securities fraud claims. *See America West,* 320 F.3d at 931. They rely on the PSLRA language that requires specific acts by "the" defendant, which they interpret as meaning "each" defendant. 15 U.S.C. § 78u-4(b)(2); *e.g.,* LGP's Br. at 9. Defendants cite a Fifth Circuit decision; however, that Circuit did not recognize the doctrine *before* the PSLRA. *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.,* 365 F.3d 353, 363-65 (5th Cir.2004). Defendants also cite district court decisions within the Ninth Circuit that have concluded the doctrine was incompatible with the PSLRA. A district judge in this district held that the "group published doctrine permits an inference of wrongdoing not based on defendant's conduct, but based solely on defendant's status as an officer or director of a corporation." *Allison v. Brooktree Corp.,* 999 F.Supp. 1342, 1350 (S.D.Cal.1998).

Because Defendants have not cited Ninth Circuit authority to question the viability of the doctrine, the Court will apply it to this motion. The Ninth Circuit had the opportunity to reject the group published doctrine in the case of *Silicon Graphics,* 183 F.3d at 973-79. There, the Ninth Circuit first set forth the guiding principles for applying the PSLRA to securities litigation. The district court had relied on the group published doctrine to create a rebuttable presumption that six top executives had participated in the production of the company's prospectuses and other public documents. *In re Silicon Graphics, Inc. Sec. Litig.,* 970 F.Supp. 746, 759 (N.D.Cal.1997), *aff'd,* 183 F.3d at 989. Thereafter, the district court granted an early summary judgment motion to the four executives who filed affidavits stating that they had not been involved in the preparation of those documents. *Id.* The Ninth Circuit neither accepted nor refuted the district court's reliance on this doctrine. This Court will follow suit until the Ninth Circuit expressly rejects the doctrine. *Silicon Graphics,* 183 F.3d at 980. In any event, "[i]t is important to note that the group pleading doctrine allows *attribution of statements to individual defendants;* it has *no application* to the determination of *scienter* as to individual defendants." *In re AFC Enters., Inc. Sec. Litig.,* 348 F.Supp.2d 1363, 1370-71 (N.D.Ga.2004) (emphasis added) (concluding the group pleading doctrine survived PSLRA "provided that the application of the doctrine is kept within proper bounds").

***17** Nonetheless, even using the group published presumption, Plaintiffs have cast too wide a net. When the Ninth Circuit adopted the presumption in *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1441-42 (9th Cir.1987), it dealt with allegations against three individuals who had direct involvement with the day-to-day affairs of the company and, in particular, with the financial statements. The three individuals held the offices of President/Chief Executive Officer, Senior Vice President/Chief Operating Officer, and Vice President/Controller. On those facts, the Ninth Circuit held that it was "reasonable to presume" that false or misleading information conveyed in "prospectuses, registration statements, annual reports, press releases, or other 'group-published information ... are the collective action of the corporate officers." *Id.* "[I]n cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the facts constituting the wrongdoing." *Id.*

The reasonableness of the presumption, however, weakens when an outside director or other venture capital defendants are involved. *Stac Elec.*, 89 F.3d at 1410-11; *GlenFed II*, 60 F.3d at 593 ("Merely because the complaint identifies a corporation's outside directors, various committee assignments, and generic responsibilities for every committee does not mean that the presumption of 'group published information' is applicable.") (citing Fed.R.Civ.P. 9(b)). In such situations, the Ninth Circuit requires the plaintiff to allege that the person participated in the day-to-day corporate activities or participated in preparing or communicating group information at particular times. *Stac Elec.*, 89 F.3d at 1410-11; *GlenFed II*, 60 F.3d at 593; *AFC*, 348 F.Supp.2d at 1371 ("The group pleading doctrine creates a rebuttable presumption that applies to *a limited number of persons* within a given company to be held accountable for the company's public statements.") (emphasis added).

The Court finds that Plaintiffs have exceeded the reasonable bounds of the presumption by including every executive at Petco. Here, Plaintiffs have named the Senior Vice Presidents of Information Systems, CC ¶ 34 (Major), Operations, CC ¶ 35 (Martin), Human Resources and Administration, CC ¶ 36 (Mitchell), and Business Development, CC ¶ 38 (Woodard). Unlike the CEO or CFO, these job titles do not suggest day-to-day involvement with the financial statements of Petco such that it would be reasonable to presume that they participated in communicating information to investors or that they would have access to information about the accounting problem that would make them liable for any misleading statements in the press releases, prospectuses, and other SEC filings.

Martin and Woodard did participate in one of the conference calls that accompanied the release of Petco's quarterly financial statements, but Major and Mitchell did not participate in any of those communications. *See* CC ¶ 95, 113, 134, 152; *accord* Defs.' Exs. J at 321, L at 359, P at 521, & X at 657 (transcripts identify participants). At the August 18, 2004 conference call, Woodard's participation was limited to the subject of new services offered by Petco (such as doggy-day care, canine education, and grooming), and Martin stated that it took up to three weeks in the evening hours to remodel a Millennium store into a Pisces format and commented on the new signs. Defs.' Ex. J at 335-36, 343, 345, 347. Thus, on the one occasion that Woodard and Martin participated in communications to investors and analysts, they did not make statements relative to the allegations in the Consolidated Complaint. Moreover, the date of that call, August 18, 2004, predates the time Plaintiffs' quote Defendant Richter as instructing distribution center directors to hold onto invoices to make the quarter ending on October 31, 2004.

***18** Unlike the specific allegations of statements made by Defendants Myers and Richter, for example, the Consolidated Complaint does not mention these other four individuals. Accordingly, the group pleading presumption does not assist Plaintiffs in this case as to these Petco officers. *Stac Elec.*, 89 F.3d at 1410-11 (dismissing outside director and venture capital defendant under Fed.R.Civ.P. 9(b) when complaint alleged scheming but "provides no specific facts-no names, no meetings, no internal memorandum or documents, no specific conduct-in support of its theory"); *GlenFed II*, 60 F.3d at 593 (same)

In opposing the motion to dismiss the Petco individual defendants, Plaintiffs argue that the stock trades by these individuals were suspicious. "[I]nsider stock sales are only suspicious when they are dramatically out of line with prior trading practices at times calculated to maximum the person benefit from undisclosed inside information." *America West*, 320 F.3d at 938 (quotations and citations omitted). "In determining whether the pattern and amounts of trades is suspicious, the court considers where the trades were made under a pre-set plan. *Id.* Here, Major, Martin, Mitchell, and Woodard regularly made identical trades on the first of each month during the Class Period, and during the preceding year. CC ¶ 288; Defs.' Exs. AG (Major initially sold 833 shares per month in 2003, and then increased to 1,000), AI, AK, & AQ. The amounts are consistent with the SEC Forms 4, which indicate that these automatic trades were "sold in accordance with the reporting person's previously established Rule 10b5-1 sales plan." Defs.' Exs. AG, AH, AI, AJ, AK, AL, AQ, & AR. Each of these defendants also sold a larger block of shares on October 22, 2004, which was the day that TPG and LGP completed the divestment of their own stock and was described in Petco's Supplement to the February 2004 Prospectus. CC ¶ 288. The Court has examined the Form 4s and concludes that those trades are not suspicious in the circumstances described, and they do not provide circumstantial evidence of scienter as to these four individuals. The Court dismisses individual Defendants Major, Martin, Mitchell, and Woodard from the first cause of action.

The Court now considers whether Plaintiffs have provided probative facts that some members of Petco's Board of Directors acted with the requisite scienter.

Defendant Day, a director, presents a close call. The Court examines the allegations that he had access to inside information and that his stock trades were suspicious. Day was a member of the Audit Committee "during all of fiscal 2003 and until his resignation in April 2004." Pls.' Ex. A at 12. Petco describes the duties of the Audit Committee:

> The Audit Committee is responsible for engaging the independent auditors to audit the Company's financial statements, and for reviewing the scope of the audit effort. The Audit Committee oversees the Company's internal audit function, and reports its recommendations as to the approval of the Company's financial statements to the Board of Directors. In addition, the Audit Committee members meet periodically with management, the independent auditors and internal auditors to review matters relating to the Company's financial statements, accounting principles and systems of internal accounting controls.

***19** *Id* at 12-13. Petco disclosed the under-accrual of expenses as a result of findings by its independent auditor, who had been preparing the company's financial statement for the fiscal year 2004 (ending January 29, 2005). A member of the Audit Committee would oversee the process and could learn of the discovery of the accounting impropriety before others. But Day was no longer a member of the Audit Committee at the time that Petco learned of and disclosed the accounting problem in 2005. Day resigned from the Audit Committee the prior year. Thus, this first factor is inconclusive.

In light of this relevant former service, the timing of one of Day's large stock trades is very suspicious because it creates an appearance that he may have had advance knowledge that Petco would disclose the accounting problem to the public on April 15, 2005. On March 30, 2005, Day exercised his option right to buy 15,000 shares of common stock at $19.00, and on the same day, sold those shares at the market price of $37.41. Defs.' Ex. AS at 1595. Plaintiffs suggest that the timing shows Day had learned of that the accounting impropriety might go public because CW7, who had resigned over the problem, had sent an e-mail outlining the scope of the under-accrual to Defendants Myers and Carter in late March 2005. Pls.' Opp. Br. at 50.

"Unusual or suspicious stock sales by corporate insiders may constitute circumstantial evidence of scienter." America West, 320 F.3d at 938 (quotations and citations omitted). The timing and amount of the trades are significant factors, and it is appropriate to compare the challenged trades to the insider's prior history of trading. *Id.* Day's prior trading history shows that he exercised options in both February 2004 and 2005 to acquire 3,000 shares each year; and that he sold 15,901 shares in October 2004. CC ¶ 288; Defs.' Ex. AS. Plaintiffs assert that the October 2004 trades are also suspicious because they coincide with the internal disclosure of the employee survey, which stated Petco had not been properly accounting for its expenses. Pls.' Opp. Br. at 50. All of Day's trades occurred during the proposed Class Period, and the only exception is the exercise of a stock option in February 2004. Plaintiffs contend that the suspicion is heightened because Day was a director for five years, but had not sold any stock during that time. Pls.' Opp. Br. at 51 n. 26 (quoting Horton Decl. ¶ 52) & 53 n. 29. Plaintiffs allege that he waited until after Petco made positive disclosures, or just before Petco made negative disclosures. *Id.*

On this record, the Court finds that the March 30 sale troubling in light of the negative disclosure by Petco on April 15. Day suddenly exercised his option on a large number of shares, and immediately sold those same at a peak price. Oracle, 380 F.3d at 1228-29, 1232. Day did not have a regular pattern of selling Petco shares, and after he sold the 15,000 shares on March 30, he retained only 511 shares. *Id.* (selling a large percentage of one's shares is probative of scienter). The suspicious trade occurred at a time that would have maximized the personal benefit from undisclosed inside information. America West, 320 F.3d at 938-39; Silicon Graphics, 183 F.3d at 986. The Court finds that Plaintiffs' have adequately plead that Day acted with scienter, and denies his motion to dismiss. In making this determination, the Court has in mind the strong, detailed, and corroborated allegations of the accounting improprieties, and finds, on the whole, that the Consolidated Complaint has stated a § 10(b) claim against Defendant Day.

***20** The Consolidated Complaint, however, fails to allege specific facts to support the conclusory allegations that the any other members of Petco's Board of Directors would have known about or participated in the accounting impropriety. Aside from attending an annual meeting, the Plaintiffs rely solely on the position of being a director, but that is insufficient to meet the heightened pleading standard. *Cf.* GlenFed II, 60 F.3d at 593 (pre-PSLRA case, using Rule 9's particularity requirement to dismiss outside directors). There are no factual allegations to substantiate Plaintiffs' bald assertion that the directors would have known about the employee survey, Defendant Richter's directive to the distribution center, or the March e-mail by the Confidential Witness. Prior membership on committees unrelated to financial statements does not assist Plaintiffs' case. Pls.' Ex. A at 12-13 (Compensation Committee makes recommendations on executive salary and bonuses, and Danhakl and Price resigned from that Committee in April 2004, before Class Period). Accordingly, the Court dismisses the § 10(b) claim against Baumer, Coslet, Danhakl, and Price. (These directors also have connections to the Partnerships, which the Court discusses below.)

2. *Operational Problems*

In contrast to the specific and corroborated allegations about the under-accrual of expenses at the distribution centers, Plaintiffs' muddled allegations of operational problems are general and conclusory. The Court concludes that Plaintiffs have not met the heightened pleading standard against any defendant regarding the alleged operational problems. *Vantive,* 283 F.3d at 1086 ("We hardly need elaborate on the inadequacy of these generalized allegations under the heightened pleading standard of the PSLRA. Their deficiency is that they fail to plead falsity or scienter with particularity.") (citation omitted). The operational deficiencies are not connected to each other nor do they relate to the accounting problem at the distribution centers. These allegations diminish the strength of Plaintiffs' core theory, thus, they are not saved by considering them in combination with the accounting problem. *See* Gompper, 298 F.3d at 895 (court must consider totality of circumstances to assess scienter).

Plaintiffs describe several operational problems which undermined Petco's statements to investors that it had a successful business strategy. Plaintiffs allege that Petco issued false forecasts of 5% to 6% growth when the Pisces store format actually afforded less shelf space and sales potential. CC ¶ 10-11, 17, 82, 86, 111(e), 120(e), 131(e), 150(d), 218(f) & (g), 280-87. "Petco's claims of same-store sales growth was an illusion." *Id.* ¶ 218(ii) & (iv). To compound the problems caused by the Pisces format, Plaintiffs allege that Petco raised prices to make up the difference. *Id.* ¶ 150(e), 287. The Consolidated Complaint alleges that "Petco was not executing successfully on its long-term growth strategy, rather defendants had embarked upon a scheme to superficially report increased same-store sales growth forecasts and results." *Id.* ¶ 111(d). Plaintiffs further allege that Petco knew that it did not have an adequate distribution infrastructure to support the new stores opening in the Southeast. CC ¶ 10, 74-80, 111(d), 120(d), 131(e), 150(d), 280-87. Plaintiffs allege that Petco issued the false forecasts despite knowing that these operational problems threatened the likelihood that the company could continue to grow successfully. Another allegation is that Petco erroneously accounted for tenant improvement allowances on its leases, and understated the cost of sales by improperly amortizing its tenant improvement allowances as a reduction to depreciation. CC ¶ 111(c), 120(c), 131(c), 150(c).

***21** "A number of problems cripple this allegation." *Vantive,* 283 F.3d at 1089. Plaintiffs rely on two

Confidential Witnesses for these general allegations, but they provide meager support for Plaintiffs' theory. The PSLRA requires that Confidential Witnesses be described with "sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged" and the complaint contains adequate, reliable, and plausible corroborating details. Daou, 411 F.3d at 1015 (quotations omitted).

First, Plaintiffs rely on Confidential Witness No. 6 ("CW6"), a former director of distribution for the New Jersey and Massachusetts distribution centers, who stated that because the Pisces format had less shelf space, the stores could not keep as many products on the shelves. CC ¶ 166, 218(g), 285. CW6 gives the example of a store in New Jersey that had been a top performer, but "its sales fell out of sight" once it was remodeled in the Pisces format. *Id.* ¶ 285. CW6 cites seventy products that were not carried after the remodeling, and reports that the store tried to boost sales by stocking the best-selling items for that location. *Id.; accord* ¶ 218(f). CW6 complains that these efforts failed because they "took a lot of extra hours for the workers to set up." *Id.* ¶ 285. CW6 reports that "same-store sales in Florida and Georgia in 2005 were performing very poorly." *Id.* ¶ 286, 218(f), 283-84.

Defendant Petco contends that the anecdote of a single store in New Jersey is insufficient to support Plaintiffs' broad claim of an effect on the stock price in any particular quarter. The Court agrees that this information is inadequate. The sales figures of a single store are insufficient when Petco operated nearly 700 stores and reported $1.8 billion in net sales. Petco's financial statements were based on *nationwide* sales, and in a company of its size, the slow performance of a New Jersey store is immaterial. Ronconi, 253 F.3d at 430 (finding it difficult to believe problem was material).

Moreover, the general description of "less shelf space" and "losing sales" is immaterial when Petco as a whole was still profitable.[FN2] *See* CC ¶ 112 (Petco reports net sales of $455.5 million with a comparable store net sales increase of 7% for 3Q 2004). Petco told investors that one of the purposes of the Pisces format was to change the product mix by increasing the number of higher margin items, and by tracking the products that were actually selling in that area. CC ¶ 112 (Nov. 18, 2004 press release attributes rising gross profit to improvements in margin categories); CC ¶ 113 (at Nov. 18, 2004 teleconference, Defendant Hall states that "product mix contributed about half" the increase in "comp sales"); Defs.' Ex. N at 422. Thus, CW6's subjective critique of shelf space in the new store format does not necessarily mean that the remodeling was a "flop." Pls.' Opp. Br. at 21; *Vantive,* 283 F.3d at 1085 (dismissing complaint because "bulk of the alleged adverse facts are generic, subjective, ... and could be alleged against almost any company that has experienced a drop in sales revenue.").

FN2. Defendants illustrate the implausibility of the Plaintiffs' theory by calculating that a 5-6% increase in prices coupled with a 2-3% reduction in customer traffic would result in 4% net growth; yet, Petco reported 6.7% growth in the third quarter of 2004. Petco's Br. at 10. While that oversimplifies the finances, it does show that the Consolidated Complaint relies on vague generalities instead of providing "contemporaneous facts in sufficient detail that would create a strong inference that the alleged adverse facts were known at the time of the challenged statements." *Vantive,* 283 F.3d at 1085.

Plaintiffs characterize the positive statements about the "fun" and "theatrical" new store format as "misleading" but this is a conclusory label attached to an innocuous marketing description. "To be actionable under the securities laws, an omission must be misleading; in other words it must affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." *Brody v. Transitional Hosps. Corp.,* 280 F.3d 997, 1006 (9th Cir.2002).

***22** CW6's report that stores in Florida and Georgia had slow sales in 2005 is weak because it is vague. *Daou,* 411 F.3d at 1015; *Vantive,* 283 F.3d at 1085. An undefined measure of slow sales in a small percentage of new stores would not necessarily affect the overall financial health of a large, nationwide chain. *See* Defs.' Ex. N at 433 (of its 761 stores in January 2005, Florida had 21 and Georgia had 12). In addition, CW6's statement describing low sales is not logically connected to the allegations in Plaintiffs' complaint about operational difficulties or inadequate distribution infrastructure. CW6 gave his opinion that the falling sales were caused by a variety of factors "such as location, competition, and poor store management, particularly on the East Coast," which had the "highest turnover of store managers and poor store location." CC ¶ 284. None of these factors is relevant to Plaintiffs' theory of why defendants were misleading the investing public about Petco's prospects. Generic allegations of mismanagement could be made against any business, and do not support a federal securities fraud lawsuit. *Vantive*, 283 F.3d at 1085.

Second, Plaintiffs rely on Confidential Witness No. 4 ("CW4") to bolster their allegations of operational problems. CW4 was a former district manager in the Chicago area who had trained retail store managers in how to meet sales goals and she reported that "there was approximately 10% increase in the average transaction amount." *Id.* ¶ 164 & 287. "A normal price increase on a PETCO item would generally be 2% to 3%, but during the last six months of 2004, prices were being increased 5% to 6%." *Id.* The same CW states that "stores were not meeting their same-store sales for 2004. Stores were projected to have same-store sales of 5%. Many of these stores were missing their goals by 15%-20%." CC ¶ 80, 287 ("noticeable decrease in customer traffic during 2004").

Defendant challenges CW4 on the ground that a district manager in charge of only fifteen stores in the Chicago, Illinois area would probably not have job skills to understand the nationwide policies of pricing and how to calculate same-store sales. CC ¶ 164. This is a valid observation. *Daou*, 411 F.3d at 1015. In context of Petco's large business, the decline of stores near Chicago would not materially effect the calculations made on a nationwide level. The Court further notes that CW4 was employed "through the fall of 2004," CC ¶ 165, so it is unclear if she would have had complete and reliable information about the company for 2004. And like the statement of CW6, CW4's assertion of "rising prices" in the stores she managed is immaterial when Petco, on average, was profitable. The Court rejects the argument that because CW4 reported price increases of 10% in Chicago stores that Petco falsely reported only 1% price increases because, again, Petco's statements concern the nationwide average of all 654 stores. For these reasons, CW4 does not provide specific facts that create a strong inference that the defendants knew their statements about same-store sales were misleading at the time they made them.

***23** Plaintiffs' allegations about the inadequacy of the distribution infrastructure are not corroborated by inside information, except two comments by CW7. *See* CC ¶ 66 & 111 (defining "Southeast" as Alabama, Florida, Georgia, Louisiana, and Mississippi; but omitting Texas, Oklahoma, Tennessee, Arkansas, North Carolina, and South Carolina, as well as the distribution center in Garland, Texas). First, CW7 stated it was more expensive to transport merchandise to stores in Florida. CC ¶ 218(e) (drivers were paid overtime for longer trips, especially if they stayed overnight), 281-282. It is obvious that driving from New Jersey to Florida would take longer and cost more than a shorter trip, thus, the Confidential Witness's observation does little to support Plaintiffs' fraud theory. CW7's second statement is that *he* had discussed the need for a distribution center in the Southeast with two individuals who are not named as Defendants in the action. CC ¶ 282. This statement sheds no light on what the defendants actually knew, or whether their awareness of the potential need for future distribution centers rendered misleading their positive statements about Petco's finances and growth. *See Brody*, 280 F.3d at 1006-07.

In addition to the weak generalities of the information provided by these Confidential Witnesses, there is no basis to infer that any particular defendant knew the information would affect the truth of their statements about Petco's business strategy or future prospects.[FN3] "It is clearly insufficient for plaintiffs to say that a later, sobering revelation makes an earlier, cheerier statement a falsehood." *GlenFed I*, 42 F.3d at 1548 (footnote omitted), *cited in Yourish v. Cal. Amplifier*, 191 F.3d 983, 997 (9th Cir.1999). While it might be reasonable to infer that some executives reviewed some reports of sales figures, CC ¶ 220-22, the Consolidated Complaint fails to allege that any individual executive knew or consciously disregarded that such isolated operational difficulties would impact the overall financial health of Petco. *See Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1036 (9th Cir.2002). The existence of POLARIS reports does not corroborate the allegation that defendants foresaw that their statements about Petco's successful business strategy were misleading. *Vantive*, 283 F.3d at 1087-88 (access to internal reports about sales inadequate to plead falsity and scienter). "Problems and difficulties are the daily work of business people. That they exist does not make a lie out of any of the alleged false statements." Ronconi, 253 F.3d at 434.

> FN3. The Court takes judicial notice of portions of Petco's statements that Plaintiffs' omitted from the quotations in their Complaint. For example, Defendant Carter disclosed to investors in the teleconference that high fuel costs and increased transportation costs were affecting the results. *Compare* CC ¶ 95 *with* Defs.' Ex. J. at 324; Defs.' Ex. H at 299. Petco cautioned investors that it took at least a year for a new store to become profitable. *Compare* CC ¶ 94 (referring to Form 10-Q) *with* Defs.' Ex. H at 296. The fact that these statements were made further diminishes the inference that Plaintiffs seek to create that the defendants acted with deliberate recklessness.

Defendant Petco challenges the allegations as being illogical because the company had 49 consecutive quarters of profit at or above 4.6%. Petco's Mo. at 5-6; Defs.' Ex R at 563 (press release quoting Defendant Devine). Defendant notes that the Consolidated Complaint contains the facts showing that Petco met its predicted earnings all but one quarter. The Court agrees that Plaintiffs' allegations of fraud are significantly weakened when Petco achieved the goals it had publically announced. *Vantive*, 283 F.3d at 1087 n. 6 (noting weaknesses in complaint alleging false predictions because company actually met it projected goals for fiscal year). The Consolidated Complaint reflects the facts that Petco achieved its forecasted comparable store sales growth during most of the Class Period. On August 18, 2004, Petco announced its second quarter financial results (ending July 31), and predicted comparable store sales increase of 6.7%. CC ¶ 94. On November 18, 2004, Petco announced that it had exceeded that prediction, and had a comparable store net sales increase of 7% during the third quarter (ending October 30). *Id.* ¶ 112. For the upcoming fourth quarter of 2004, Petco predicted a 6% increase. *Id.* Petco did not meet that goal. On March 10, 2005, Petco reported a 5.1% increase of net sales for the fourth quarter, falling short of its prediction, but nonetheless reaching a respectable level of growth. *Id.* ¶ 121 (quoting Myers that "doldrums" and harsh weather negatively affected sales figures). Petco projected that the first quarter of fiscal year 2005 would achieve a 5 to 6% increase. *Id.* On May 25, 2005, Petco announced its first quarter results with a comparable store net sales increase of 5.2%, thereby falling within the predicted range. *Id.* ¶ 133. Because of the planned expense of the new distribution centers, Petco predicted only a 4 to 5% increase during the second quarter of 2005. *Id.* On June 28, 2005, after correcting the accounting problem, Petco revised those expectations and decreased the forecast to 3 to 4%. *Id.* ¶ 139. The Court agrees that this earnings record significantly weakens Plaintiffs' allegations of falsity and scienter. *Ronconi*, 253 F.3d at 434 ("A company could experience 'serious operational problems,' 'substantial difficul[ties],' and 'difficult problems' and still have increasing revenue."); *cf.* *Silicon Graphics*, 183 F.3d at 988 (rejecting generic allegations that conveniently follow a successful company's turn for the worse).

***24** Another weakness is that the Consolidated Complaint does not quantify the financial impact that these operational problems had on Petco. *Cf.* CC ¶ 172-73 (calculating impact of under-recorded distribution costs) & 187 (chart lists $3,129, 180.85 of invoices from vendors deferred into next fiscal year). The vagueness of Plaintiffs' allegations regarding the operational problems significantly weakens the inference they ask the Court to draw about the defendants' supposed knowledge of such a minor and esoteric problem, In contrast to the obvious error of under reporting expenses involved in the accounting impropriety, the amortization of tenant leases is a complex issue and subject to differing interpretations. CC ¶ 175-78. "The mere publication of inaccurate accounting figures, or a failure to follow GAAP, *without more,* does not establish *scienter.*" *Worlds of Wonder*, 35 F.3d at 1426 (quotation omitted & emphasis added). It is not the type of problem that demonstrates the defendants necessarily must have been aware of an accounting violation. *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 387, 390-91 (9th Cir.2002). Plaintiffs rely on the figures that Petco provided in its SEC Form 10K about tenant improvement allowances. *See* Defs.' Ex. N at 460.25-460.26. These circumstances suggest that Plaintiffs are attempting to allege "fraud by hindsight" by including the alleged error regarding tenant improvement allowances on leases and amortizing those allowances as a reduction to depreciation. *See* *Silicon Graphics*, 183 F.3d at 988.

Another critical factor in the Court's decision is that the alleged false and misleading statements about same-store sales are projections of future growth. 15 U.S.C. § 78u-5(c)(1)(B)(i) (PSLRA requires actual knowledge for future statements); *In re Vantive*, 283 F.3d at 1085. The statements are clearly cast as predictive based upon past performance. The *past* sales increases are accurately reported: "Net sales in the second quarter of 2004 were $438.5 million with a comparable store net sales increase of 6.7%." CC ¶ 94. This 6.7% increase is then compared to the *prior* quarter's increase of 6.1%. *Id.* The statement merely states in general that the success "again highlights the consistency and resilience of our business and continues our strong comparable store sales growth trend, now in its twelfth year." *Id.* (quoting Defendant Devine). The company reported that its profits would enable it to "implement such initiatives as our remodel program" which had generated "competitive advantages." *Id.* (quoting Defendant Carter). In the paragraph titled "Outlook for the Third Quarter and Full Fiscal Year 2004," Petco stated that it "currently expects a comparable store net sales increase of approximately 5%-6%" and describes it as an "anticipated increase" based on the second quarter's results. *Id.*

The PSLRA requires the Court to examine the cautionary statements cited by a defendant. 15 U.S.C. § 78u-5(e) ("On any motion to dismiss based upon subsection (c)(1) of this section, the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement, which are not subject to material dispute, cited by the defendant."). The PSLRA does not require that the cautionary statements actually accompany the forecasts, for instance, an oral statement may properly refer listeners to additional risk factors "in a readily available written document," such as a Form 10K. 15 U.S.C. § 78u-5(c)(2)(B)(i);. *Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132 (9th Cir.2004).

***25** Therefore, the Court takes judicial notice of the fact that Petco included cautionary language in its prospectuses and conference call presentations. *Lee*, 250 F.3d at 689-90. Moreover, because the Consolidated Complaint quotes extensively from the conference calls and refers to the other SEC filings prepared by Petco, those documents are incorporated by reference and may be considered in a motion to dismiss. The Court emphasizes that it is not evaluating the truth of the assertions; rather, it is assessing whether, taken as a whole, Petco's forward-looking statements to investors contained "meaningful cautionary statements identifying important factors that could cause actual results to differ materially." 15 U.S.C. § 78u-5(c)(l)(A); *Clorox*, 353 F.3d at 1133 (court can rule as a matter of law in a motion to dismiss "that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud") (quotations and citations omitted).

Here, the SEC forms contain the full text of Petco's press releases. For example, the August 18, 2004 press release, quoted at CC ¶ 94 and alleged to be false and misleading in CC ¶ 111(c)-(f), contains a paragraph warning that states, in part, "[s]tockholders and other readers are cautioned not to place undue reliance on these forward-looking statements. Such forward looking statements involve known and unknown risks, uncertainties and other factors, which may cause actual results of PETCO to be materially different from historical results or from any results expressed or implied by such forward-looking statements." Petco then identifies some of the factors (for example, "performance of new stores, ability to execute expansion strategy and sustain growth," and competition), and states that they are discussed in the company's SEC reports. Defs.' Ex. I at 316. In the SEC report, Petco explained that an investor could identify a forward-looking statement by verbs such as "believe," "expect," "may," "plan," "anticipate," or "project." Defs.' Ex. H at 305. The same is true for the conference call that same day, and the later presentation at an investor and analyst meeting in Philadelphia. CC ¶ 95 & 104. In both instances, Petco expressly cautioned that predictions and forecasts were not guaranteed and investors should not place undue reliance on forward-looking statements because actual results may differ materially. Defs.' Ex. J at 322 (conference call transcript); Defs.' Ex. V at 623 (printout of presentation slides refers to SEC filings).

Many of the statements that Plaintiffs identify as being false contain similar cautions. Defs.' Ex. K at 357 (press release quoted in CC ¶ 112 reports "outlook" and "expect[ations]" for comparable store net sales increase, and contains caution); Defs.' Ex. L at 380 (teleconference quoted at CC ¶ 113, contains caution not to place undue reliance on forward looking statements, and refers investors to SEC forms); Defs.' Ex. M at 412 (cited by CC ¶ 115, warns that discussions of strategy, plans, and intentions involve known and unknown risks that may cause performance and achievement to differ materially from forward-looking statements); Defs.' Ex. N at 425-32 (cited by CC ¶ 140, describes several risk factors that can affect predictions and future growth, including caution that continued growth depends upon ability to increase sales at new and existing stores), 439; Defs.' Ex. O at 511 (quoted at CC ¶ 121, contains warning); Defs.' Ex. P at 522 (cited at CC ¶ 122); Defs.' Ex. R at 565 (quoted at CC ¶ 133, contains warning); Defs.' Ex. S at 569 (quoted at CC ¶ 134, teleconference begins with caution about forward-looking statements); Defs.' Ex. T at 598 (press release quoted at CC ¶ 139, contains caution). One notable example is the report for FY 2004 (dated June 28, 2005). Plaintiffs contend it mislead investors about sales growth because Petco knew it could not achieve more than 2% same-store sales. CC ¶ 140, 150(f). Yet the report plainly states that "our comparable store net sales increases in future periods may be lower than the historical levels or our comparable store net sales may not increase at all." Defs.' Ex. N at 426.

***26** The presence of cautionary language weakens Plaintiffs' assumption that Petco's forecasts of future growth were false or that any defendant knew the positive predictions were misleading at the time made. *Ronconi*, 253 F.3d at 428-30 (not every optimistic statement is fraud because business decisions must be based on predictions of what might work).

Finally, the stock sales do not strengthen the inference of scienter regarding the operational problems. *Vantive*, 283 F.3d at 1092 ("[i]nsider stock sales are not inherently suspicious"). Plaintiffs' conclusory allegation that the defendants manipulated the timing of the announcements to take advantage of the strictures of their Rule 10b-5 trading plans carries no weight. This is particularly true when the allegation that operational problems amounted to fraud are "woefully inadequate" and Petco met its earnings projections in most quarters. *Id.* The regular, steady pattern of sales on the first of each month by the Petco Defendants greatly diminishes any inference of scienter on this aspect of the case. *See* Defs.' Exs. AA-AS.

In sum, the Court agrees with Defendant Petco that these allegations, taken as a whole, are insufficient to plead fraud with the particularity required by the PSLRA. The rumors about operational problems do not come close to showing falsity. *Cf. America West*, 320 F.3d 927-29, 932-3, 941-44 (magnitude of operational problems-deferring maintenance of airplanes which lead to delayed and cancelled flights, failing to conduct safety inspections, impending investigation by Federal Aviation Administration-were sufficiently plead). Nor do the allegations show that any particular corporate executive acted with at least conscious recklessness when describing the company's growth strategy. *Brody*, 280 F.3d at 1006-07; *Ronconi*, 253 F.3d at 429-34. Plaintiffs' attempt to broaden the scope of the alleged fraud fails because these peripheral operational problems do not state a coherent theory of fraud and the tenuous allegations do not have any markers of corroboration or supporting detail. *See* Medhekar v. U.S. Dist. Ct., 99 F.3d 325, 328 (9th Cir.1996).

3. *The Partnerships*

The Court now turns to the inclusion of the LGP and TPG as defendants in this litigation about Petco. TPG and LGP argue, and the Court agrees, that the Consolidated Complaint relies on conclusory allegations to draw these parties into this litigation.[FN4] *E.g.*, CC ¶ 28-29 (alleging that Partnerships "enjoyed a special relationship with Petco"), 219-25. Although the Consolidated Complaint describes the *prior* relationship that TPG and LGP had with Petco, the majority of that information pre-dates the beginning of the Class Period (August 2004). CC ¶ 54-64, 66. TPG and LGP correctly state that the Consolidated Complaint does not mention incriminating actions by a person connected to TPG and LGP after the introduction section, where the parties are described. CC ¶ 27-28, 39-40, 42-47.

> FN4. Because the Court finds that Plaintiffs have not alleged a securities violation on the operational problems, the Court limits this discussion to the accounting problem. The analysis, however, applies with equal force to the alleged operational problems because TPG and LGP are not mentioned in regard to that situation. Plaintiffs allege that Petco falsely stated on August 18, 2004 that the Pisces format would provide the catalyst to accelerate comparable store sales growth. CC

> ¶ 82. At the hearing Plaintiffs argued that this August 2004 statement ties TPG and LGP to the start of the Class Period because the Partnerships still owned 11.6% of Petco stock. This is a tenuous connection. Plaintiffs' theory is undermined by the totality of circumstances that show TPG and LGP were ending their investment in Petco. Nor do the specific facts illustrate any involvement by TPG and LGP in the August 18 statement or the plan to remodel the stores. Petco met its comp store sales prediction for 2Q 2004, which significantly weakens any inference of scienter regarding the August 18 announcement about Pisces.

***27** At one time TPG and LGP were in a position to influence management decisions and to participate in the operation of Petco. For sixteen months beginning October 2000, TPG and LGP owned and controlled Petco, until it was again taken public in February 2002. CC ¶ 27-28 (TPG and LGP acquired Petco in 2000, when they owned a majority of the shares, until they led the company through a public offering in 2002); CC ¶ 61 (public offering on February 27, 2002); Pls.' Exs. C & D (showing LGP sold 850,000 and 1,400,000 shares in December 2003); LPG's Br. at 5 (clarifying that each Partnership owned approximately 37.5% of stock, for a combined total of 75% of the common stock). That ownership relationship ended in June 2004 when TPG and LGP sold all but 11.6% of Petco's outstanding shares (or 5.8% each). *Cf. America West,* 411 F.3d at 937-46 (denying TPG's motion to dismiss because of its significant and controlling involvement in corporate affairs *during class period*). By including the historical facts regarding the investment, Plaintiffs attempt to create the appearance that TPG and LGP were involved in alleged misleading statements. *See* SG Cowan Sec. Corp. v. United States Dist. Ct., 189 F.3d 909, 911 (9th Cir.1999) (Congress enacted the PSLRA heightened pleading requirements to restrict abuse of targeting "deep pocket" defendants). On close inspection, however, only a narrow time frame is relevant, and the Partnerships' conduct during that window does not expose them to potential liability for the securities violations alleged in this action.

By the start of the Class Period on August 18, 2004, TPG and LGP had largely relinquished control of Petco. They owned large blocks of Petco stock (5.6% each), but were no longer majority shareholders. There is no basis for holding a former majority shareholder directly liable for corporate fraud. *Cf.* Berry v. Valence Tech., Inc., 175 F.3d 699 (9th Cir.1999) (after date CEO resigns, he is not responsible company's statements).

The Court agrees with TPG's assertion that the Consolidated Complaint "fails to identify any viable ground for a securities fraud claim based on PETCO's disclosures of Q2 2004 results and Q3 forecasts in the period before TPG [and LGP] sold" their stock. TPG's Br. at 2. The Consolidated Complaint does not allege fraudulent statements in Petco's second quarter results for the period ending July 31, 2004. Plaintiffs quote an August 18, 2004 press release in which Petco announced its financial results for the months of May, June, and July, but do not allege that *the second quarter* results were false or misleading. CC ¶ 94. Instead, Plaintiffs contend that the quoted statements were false and misleading *because of errors in the third quarter.* CC ¶ 111(a) (Q3 earnings per share overstated); 111(b) (failure to record distribution center costs for Q3); 111(c) (error in accounting tenant improvements through Q3); 111(e) ("In announcing PETCO's same-store sales results to the markets, defendants failed to disclose that sales growth throughout the Class Period were primarily due to increased pricing" and stores "were recording reduced customer traffic and sales"). The Consolidated Complaint focuses on the *forecasts for the third quarter* and Petco's predictions of the results for the entire fiscal year 2004. CC ¶ 111(d) ("Petco was not executing successfully on its long-term growth strategy"); 111(f) ("there was no basis in fact for defendants' forecasts that PETCO would continue to achieve same-store sales above 0%-2%"); *see* CC ¶ 103 (Petco re-affirms its expected gains). The PSLRA imposes a higher standard of scienter on forward-looking statements. 15 U.S.C. § 78u-5(c)(l) (B)(i) (PSLRA requires actual knowledge for future statements); *Vantive,* 283 F.3d at 1085. Thus, there are no specific allegations of misconduct by TPG and LGP at the time the fraud allegedly began. The narrow time frame is significant because it demonstrates the weak connection of TPG and LGP to the theory of Plaintiffs' case. When the Partnerships sold the rest of their Petco stock, and it is the primary act by the Partnerships during the proposed Class Period (between August 2004 and August 2005).

***28** Plaintiffs allege TPG and LGP continued to have a special relationship after August 18, 2004, because they selected members of the Board of Directors, and had a management and consulting contract with Petco. CC ¶ 64 (alleging the Partnerships agreed to vote for each others' nominees). Plaintiffs also point out that Defendants Coslet and Danhakl continued to serve as directors and signed Petco's fiscal year end financial statements. CC ¶ 141 (referring to the delayed Form 10-Q for FY 2004, dated June 28, 2005); Pls.' Ex. H at 93 (Form 10-K for FY 2003, signed on April 5, 2005). The Consolidated Complaint also alleges that "Defendant Coslet conveyed the adverse non-material information to defendants TPG, Bonderman, Price and Coulter." CC ¶ 141. Coslet, a partner of the TPG defendants, served on Petco's Board of Directors from 2000 to the present. CC ¶ 39. Plaintiffs repeat the statement against Danhakl regarding LGP. *Id.*

The ability to nominate four of the nine members of the Board of Directors has some weight, but is not overwhelming. Four is a minority, and in actuality, only two people connected to the Partnerships served as directors after April 2004. But the Court gives no weight to the conclusory accusation that Coslet and Danhakl passed inside information to the Partnerships. The statement is wholly lacking in detail.

The fact that those two directors, Coslet and Danhakl, signed the fiscal year financial reports might carry some weight if those statements were alleged to be false, but they are not. *Howard*, 228 F.3d at 1061. The April 2004 signing is irrelevant because occurred before the Class Period and relates to a fiscal year that is not at issue in this litigation. *See* Pls.' Ex. H (Petco'sForm 10-K for FY 2003 covered time between February 2, 2003 to January 31, 2004). The Consolidated Complaint does not identify any misleading statements in the Form 10-K for FY 2004. That financial report was prepared after Petco announced the accounting problem, after the internal investigation, and after the accountants calculated the errors *inprior* financial reports. *See* CC ¶ 150(a), (b), (c) (alleging false reports of overstated net earnings *"[u]ntil* PETCO's Form 10-K filing on June 28, 2005") (emphasis added). There is a passing reference that the Form 10-K "contained materially false and misleading statements *regarding the purported correction of internal controls,"* but the Consolidated Complaint fails to explain how or why Petco's statements were false or misleading. CC ¶ 141 & 150. Thus, Coslet and Danhakl signed a form that is not a necessary component of the accounting theory of Plaintiffs' case against Petco.

The other connection is the financial consulting role. Plaintiffs allege that TPG and LGP still had several years left on their management services contract wherein Petco paid $3.1 million annually for "management, consulting and financial planning services and transaction-related financial advisory and investment banking services." CC ¶ 158. TPG and LGP contend that the contract was terminated in February 2002 (for a lump sum payment of $12.5 million). *See* Defs.' Ex. D at 192. The Court will accept Plaintiffs' allegation as true, but in any event, the management services contract is not sufficient to give TPG and LGP access to day-to-day operations information or the authority to direct corporate affairs. Nor does management and consulting contract give TPG and LGP any incentive to participate in Petco's misleading financial statements, as the Partnerships would be paid under the contract. *See America West*, 320 F.3d at 944-45 (motive or incentive is probative of scienter); *Vantive*, 283 F.3d at 1097.

***29** More importantly, Plaintiffs fail to allege any specific conduct by TPG and LGP *during* the Class Period. *Ronconi*, 283 F.3d at 1094 (affirming Rule 12(b)(6) dismissal of defendant who "is not alleged to have uttered a word, or have participated in preparing statements, during the entire class period"). Plaintiffs fail to allege that any of these parties ever reviewed an internal communication (such as the March e-mail from CW7), the employee control questionnaire, budgets, the general ledgers, or other reports that are alleged to show accounting fraud. There are no allegations that any of the Partnership Defendants visited the distribution centers where they might have seen stacks of unpaid invoices or talked to employees who had been ordered hold back invoices and re-write their reports. There are no allegations to explain how TPG and LGP would have known that distribution center employees were violating GAAP to increase its net earnings by withholding invoices. CC ¶ 218(a) ("it was widely known at the Company that Petco was withholding payment for invoices during the Class Period"). None of the Partnership Defendants signed the SEC forms that contain allegedly overstated earnings, and none participated in the quarterly web broadcasts. None of the seven Confidential Witnesses mentions TPG and LGP or describes and contact with persons affiliated with them. This lack of action dispels an inference of scienter as to TPG and LGP. *Clorox*, 320 F.3d at 939 (considering insider's silence as a factor to determine whether strong inference of scienter has been raised); *Ronconi*, 283 F.3d at 1094.

Plaintiffs defend the claims against TPG and LGP by focusing on the events of October 2004. CC ¶ 13, 109, 294. This is the month when employees returned surveys mentioning that invoices were being held back, and when Defendant Richter allegedly instructed the distribution centers to do "anything" to make the quarter that ended October 31. But the sole action by TPG and LGP during October was to sell their remaining shares. Plaintiffs allege that this sale shows that TPG and LGP were taking advantage of the inflated stock price, but this theory is undermined by two vital facts. First, the October 22, 2004 sale was the culmination of TPG and LGP divestiture of their stock holding that had begun several months earlier and before there was any indication of an accounting problem. Second, the offering occurred *before* Petco issued the allegedly inflated financial information for the third quarter, and the stock price continued to rise another several months. CC ¶ 83, 112 (Petco reported financial results for third quarter ending October 30, 2004 on November 18, 2004 and stock continued to rise to $37 by April 2005); *Vantive*, 283 F.3d at 1093 ("stock sales are helpful only in demonstrating that certain statements were misleading and made with knowledge or deliberate recklessness *when those sales are able to be related to the challenged statements*") (emphasis added). Equally important is that, as described above, the Consolidated Complaint contains no factual support that TPG and LGP could have known about the accounting problem (in particular the employee survey or Defendant Richter's instructions). Therefore, the Court finds nothing suspicious in the October 2004 stock sale, and it does not create an inference that TPG and LGP had the necessary level of scienter to be held accountable for the fraud alleged in the first claim for relief. *Vantive*, 283 F.3d at 1093 ("insufficient allegations of fraud elsewhere in the complaint have a spillover effect" when evaluating whether stock sales are probative of scienter).

***30** In a related theory, Plaintiffs generally allege that a reason the distribution centers felt compelled to hold back invoices was because management had imposed unrealistically-strict budgets, and that TPG and LGP initiated this practice when they owned Petco. CC ¶ 180,226-34,277 (CW7 discussed budget pressure in 2003, when expenses were carried over to 2004); *see also* CC ¶ 65 (alleging Partnerships initiated Petco's aggressive growth strategy), 81 (alleging that while TPG and LGP were majority shareholders, Petco lacked adequate internal controls to detect accounting impropriety), 161-67 (while describing invoices in distribution centers, many CWs mention the "unrealistic budgets and budgetary pressure from upper management"). This theory also fails because there are no specific facts showing that TPG and LGP participated in or directed the under-accrual of distribution center expenses during the Class Period. As Defendant Petco notes, "[t]here is nothing fraudulent about strict budgets." Petco's Br. at 17 n.l0.

In sum, while Plaintiffs are entitled to have their allegations construed in their favor, the Court must consider the most plausible inferences when evaluating scienter. *Gompper*, 298 F.3d at 896-97. The Court finds the totality of circumstances negate any inference of scienter as to the Partnerships.

B. *Control Person Liability*

The 1934 Exchange Act imposes primary liability on those who violate the securities laws, but also imposes secondary liability on collateral participants who qualify as "control" persons. Plaintiffs' second claim for relief asserts that "all" individual defendants have violated § 20(a) of the Exchange Act. CC ¶ 329-32; *see* CC ¶ 48 (defining "Individual Defendants"). Plaintiffs allege broadly and generally that "all" defendants by virtue of "their high-level positions, and participation in and/or awareness of the Company's operations" had the "power to influence and control" Petco's decisions, press releases, SEC filings, and financial statements. CC ¶ 330.

"Section 20(a) provides joint and several liability for controlling persons who aid and abet violations of the 1934 Act absent a finding of good faith and lack of inducement." *America West*, 320 F.3d at 945 (footnote omitted); 15 U.S.C. § 78t(a). In order to plead control person liability, the plaintiff must allege (1) a primary violation of the securities law and (2) " 'that the defendant exercised actual power or control over the primary violator.' " *America West*, 320 F.3d at 945 (quoting *Howard*, 228 F.3d at 1065). Scienter is not an element of control person liability, because the primary violation suffices; instead, the defendant may assert the affirmative defense of good faith by proving the absence of scienter. Howard, 228 F.3d at 1065 (citing *Arthur Children's Trust v. Keim,* 994 F.2d 1390, 1398 (9th Cir.1993)). Here, the first element is met because the Court finds that Plaintiffs have alleged a primary violation by Petco and some of its executives of the securities laws in regard to accounting impropriety.

***31** The motion to dismiss concerns the second element of "control." The SEC's regulations define "control" as the direct or indirect power to "cause the direction of management and policies of a person whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405. The Ninth Circuit looks to "the defendant's participation in the day-to-day affairs of the corporation and the defendant's power to control corporate actions." *Howard,* 228 F.3d at 1065 (quoting *Kaplan v. Rose,* 49 F.3d 1363, 1382 (9th Cir.1994)). Factors include whether the person has previously lent money to the corporation, whether she owns stock, and whether she is a member of the board. *Id.* (citing *Paracor Fin., Inc. v. GE Capital Corp.,* 96 F.3d 1151, 1162 (9th Cir.1996)).

The Petco Defendants make a blanket assertion that the Consolidated Complaint fails to adequately plead control person liability against any of the individual executives. The Court agrees except as to CEO Myers (CEO), Carter (CFO), Devine (Chair), and Hall (COO). The extensive level of their control over general company decisions is apparent in the factual allegations and their public statements about Petco's operations. *Paracor,* 96 F.3d at 1162-63. If, however, Plaintiffs intend to pursue their control person claims against any other executive at Petco, the amended pleaded must provide facts to support the standard allegations in Paragraph 330. As to Brann and Richter, there are allegations suggesting they had the power to influence the specific accounting procedures at issue, but no facts to show any power over general corporate policies. *Paracor,* 96 F.3d at 1162 (control person "inquiry must revolve around 'management and policies' of the corporation, not around discrete transactions"). No facts show that Major, Martin, Mitchell, and Woodard would have had power over general or specific corporate policies. Accordingly, the Court dismisses Defendants Brann, Day, Major, Martin, Mitchell, Richter, and Woodard from the second claim for relief.

TPG and LGP argue that Plaintiffs have not identified specific facts to state a claim that they are liable as control persons. They argue that Plaintiffs have not identified specific facts that any of the partners participated in the accounting process or the public statements, or that they had access to information that would allow them to discover the problem.

The Court concludes that the Consolidated Complaint contains the proper boilerplate allegations of control, but lacks sufficient facts to apply the theory to TPG and LGP. Plaintiffs broadly allege that "TPG and LGP had direct involvement or intimate knowledge of the day-to-day operations of the Company during the Class Period. Therefore, each is presumed to have had the power to control or influence the particular transactions" described in the complaint. CC ¶ 331. But the facts set forth in the pleading describe the relationship that TPG and LGP *had* with Petco *before* the beginning of the Class Period. A close reading of the allegations reveals that only a very narrow time frame is relevant when analyzing conduct by TPG and LGP. The factual allegations describing TPG's and LGP's control over Petco relate to the time that the Partnerships owned the corporation from October 2000 to February 2002. TPG and LGP were majority shareholders in Petco in February 2002; however, they sold those controlling percentages by June 2004. Plaintiffs allege that the Class Period began in August 2004, and by that time, TPG and LGP each owned 5.8% of Petco's shares. This is a large block of stock, but soon thereafter those shares were sold. TPG and LGP sold the rest of their stock on October 22, 2004. Yet, the Consolidated Complaint does not allege or identify any false statements *until* November 18, 2004 when Petco reported the third quarter earnings. *See* CC ¶ 111(a), (b) (accounting fraud rendered *Q3* 2004 earnings misleading), 112. The Consolidated Complaint does not contain facts that TPG or LGP could have influenced Petco's general policies or any specific accounting procedures *after* they sold their stock on October 22, 2004.

***32** Turning to activity after October 2004, Plaintiffs rely on the management services contract and the directors. The management consulting contract indicates that TPG and LGP were outside advisors, not controlling persons. And while two of the directors had connections to the Partnerships, membership on the board is not sufficient to support an allegation that these individuals were involved in the day-to-day operations of the company. *Paracor*, 96 F.3d at 1163 (being a director is "a sort of red light" but does not create any presumption of control) (quotation omitted). The Consolidated Complaint lacks underlying factual support for its vague conclusion that the Partnerships could control Petco's corporate actions. Rather than facts, Plaintiffs have alleged only status.

Plaintiffs argue that this case is governed by *America West,* in which TPG (along with related entities, Coulter individually, and co-defendant Continental Airlines, Inc.) was alleged to be a control person liable for the securities violations by America West Airlines. *America West*, 320 F.3d at 945. The district court had dismissed TPG from the second amended complaint for failing to plead § 20(a) liability, but the Ninth Circuit reversed. The Ninth Circuit held that all three factors indicated that TPG had direct or indirect power to control corporate operations. TPG had owned shares in the airline from 1994 through 1998, which included the class period. TPG owned 49% of the Class A stock, and entered into a Stockholder's Agreement that required the investors to retain two shares of Class B stock for every share of Class A stock traded. *Id.* at 925. That Agreement further provided that the shareholders would select nine of the fifteen board directors. *Id.* & nn. 3 & 4. "By virtue of their ownership of the 'supervoting Class A stock, TPG and Continental constituted a majority of the stockholders." *Id.* "Coulter, a TPG officer, was appointed a director of America West and served on its Executive Committee, which exercised all powers of the Board of Directors between full Board meetings." *Id.* The complaint further alleged that TPG sought to raise the stock price so it could exercise stock options under the Stockholder's Agreement. *Id.* at 927. "To accomplish this goal, TPG and Continental allegedly joined forces to exert undue influence on America West officers, taking advantage of their position as majority owners who controlled the Board of Directors and related committees." *Id.* The complaint alleged that TPG contributed to a marketing campaign to influence the stock price, including giving misinformation to stock analysts. *Id.* The complaint alleged that TPG manipulated the stock price by forcing America West to re-purchase $100 million of its own stock. *Id.* at 928, 940. After the stock price "soared to an all-time high," TPG sold 99% of its Class B stock for $44 million, which the Stockholder's Agreement permitted it to do without having to give up its supervoting Class A shares. *Id.* at 928.

***33** The Ninth Circuit held that the complaint alleged sufficient facts to state a § 10(b) claim against TPG, even though it had not made any of the allegedly misleading statements. *Id.* at 937-41. The Court held that the factual allegations also showed that TPG knew about America West's underlying problems. *Id.* at 942-43. The Ninth Circuit noted that Coulter, a director of TPG and a director of America West, had been to most of the eleven board meetings in 1997. *Id.* at 943 & n. 21.

Based upon these allegations, the Ninth Circuit rejected TPG's argument that it could not be considered a "control person" for § 20(a). The Court found that three factors indicated that TPG had direct or indirect power to direct America West's management and policies. TPG had been a shareholder from 1994, through the class period of 1997 to 1998. When combined with Continental's shares, TPG was the largest shareholder and controlled 57.4% of the total voting power. TPG, with Continental, could appoint the majority of the members of the Board of Directors, and TPG had taken advantage of that opportunity by selecting two of its own partners to serve. *Id.* at 945-46.

The crucial difference between the *America West* case and the instant case is timing. In *America West,* TPG was, *at the time of the alleged securities violations,* able to exercise control over the corporation. In this case, TPG and LGP had a strong *prior* relationship with Petco, but the Partnerships had largely severed those ties by the start of the class period. If Plaintiffs had sued Petco for conduct during 2000 to early 2004, then the level of involvement of TPG and LGP might be closer to the circumstances in the *America West* case. By contrast, in this case, by the start of the class period in August 2004, TPG and LGP (if considered together) held 11.8% of the shares, not a majority of shares nor a supervoting class of shares. By August 2004, two of the directors connected with TPG and LGP had already resigned, and only two members (Danhakl and Coslet) remained on Petco's nine-person board of directors. CC ¶ 39-40, 43, 44; *see* Defs.' Ex. C at 134 (dated May 3, 2004); Pls.' Ex. A at 9-11 (dated July 1, 2005); *Paracor*, 96 F.3d at 1163 (mere fact defendant served as director does not create presumption of control). According to the allegations in the Complaint, TPG and LGP were still under the ten-year contract to provide management, consulting, and financial planning services to Petco. But even the presence a services contract confirms that TPG and LGP were no longer "controlling" Petco because they had shifted to an advisory role. This current litigation alleges securities violations after TPG and LGP had relinquished control, and that timing distinguishes this case from *America West. Cf. Berry*, 175 F.3d 699 (after the date CEO resigned, he is not responsible company's statements). When studied with care, the Consolidated Complaint fails to plead any facts from which it could be reasonably inferred that TPG and LGP were control persons when Petco allegedly made misleading statements about the company's earnings per share because the distribution centers had not properly reported expenses.

***34** Accordingly, the Court grants the motion to dismiss the TPG and LGP defendants from the second claim for relief.

C. *Trading on Non-Public, Material Information*

The third cause of action alleges that the Individual Defendants, except Petco executives Carter and Day, engaged in "insider trading." CC ¶ 334 & ¶ 288-98 (cataloging insider sales); *see* CC ¶ 48 (defining "Individual Defendants"). Plaintiffs allege that "each of the Individual Defendants occupied a position with PETCO that allowed access to confidential information concerning the Company, its operations, finances, financial condition and future business prospects. Individuals Defendants' public representations on these subject set forth herein were materially false and misleading." CC ¶ 335. Plaintiffs allege that the Individual Defendants failed to disclose the material adverse facts, yet sold their own stock holding using that non-public information. CC 1339; *accord* CC ¶ 288-98.

Trading on inside information damages the integrity of the stock market by giving an unfair advantage to a small group of individuals with non-public material information about a company's stock. *See Basic Inc. v. Levinson,* 485 U.S. 224,247(1988). Liability for insider trading arises from § 10(b) of the Exchange Act, which imposes civil liability for "manipulative or deceptive" acts in connection with the sale of stock. *See* United States v. O'Hagan, 521 U.S. 642, 651-54, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997) (describing and adopting theory in context of criminal case). In turn, SEC Rule 10b-5 to forbids any "artifice to defraud" or any act "which operates or would operate as a fraud or deceit." *Id.* at 651. The traditional type of insider trading violates this statute and regulation "when a corporate insider trades in the securities of his corporation on the basis of material, non-public information." *Id.* at 651-52. "Trading on such information qualifies as a 'deceptive device' under § 10(b) ... because 'a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.' " *Id.* at 652 (quoting *Chiarella v. United States,* 445 U.S. 222, 228, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980)). The traditional theory applies to officers, directors, and "other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation." *Id.*

Though commonly called "insider" trading, liability extends to a corporate "outsider" under the misappropriation theory. A person who commits fraud in connection with a securities transaction by misappropriating confidential information that exclusively belongs to the corporation. *Id.* at 652, 654. The corporation entrusted access to confidential information, and the trader breached a duty owed to the source of the information. *Id.* at 652-54. "A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public." *Id.* at 656. The misappropriation theory "catches fraudulent means of capitalizing on [confidential] information through securities transactions." *Id.*

***35** Scienter is an element of an either theory of insider trading, therefore, must be plead with particularity under the PSLRA. *See* United States v. Smith, 155 F.3d 1051, 1063-64(9th Cir.1998) (setting forth scienter element in criminal case, citing a SEC enforcement action); *SEC v. Clark,* 699 F.Supp. 839, 844 & n. 4 (W.D.Wash.1988) (elements are same in criminal, administrative, or civil proceedings). In addition, because a claim that a person used non-public material information in a securities transaction arises out of the anti-fraud provisions of Rule 10b-5 and § 10(b), plaintiff must comply with Rule 9(b) and plead the circumstances with particularity. *See Stat Elec.,* 89 F.3d at 1404-5 & nn. 2-3.

1. *Scienter of Defendants*

In order for a person to be liable for a § 20A insider trading claim, there must be an independent violation of § 10(b). *In re VeriFone Sec. Litig.*, 784 F.Supp. 1471, 1488-89 (N.D.Cal.1992), *aff'd*, 11 F.3d 865, 871-72 (9th Cir.1993). The Court has narrowed the claims because the Plaintiffs' theory of operational problems has not been sufficiently plead, but the alleged accounting fraud claim has survived this motion to dismiss as to some of the Petco Defendants.

Because the Court has dismissed the § 10(b) claims against Petco Defendants Major, Martin, Mitchell, and Woodard, the Court also dismisses the § 20A claims against these four parties. Though Plaintiffs have generally alleged that these executives had access to material, nonpublic information, their job status alone does meet the heightened pleading standard of the PSLRA. Plaintiffs have not identified specific facts that would support an inference that these four executives knew about the accounting problem in the distribution centers. The timing and amount of their stock trades do not indicate an awareness of the accounting problem. The additional trades on October 22, 2004 occurred *before* Petco made any allegedly false statements on that issue. CC ¶ 296. All other trades regularly occurred on the first of each month pursuant to their Rule 10b-5 trading plans. *See* Defs.' Exs. AG & AH (Major), AI & AJ (Martin), AK & AL (Mitchell), AQ & AR (Woodard). While each appears to have suspended trading in May and June 2005, the reasonable inference is that they were responding to the *public* disclosure on April 15, 2005 about the accounting errors; and they resumed the normal schedule once Petco corrected its statement on June 28, 2005. The percentages sold during the Class Period is not dramatically out of line with the history of trading in the prior year. *E.g.*, Defs.' Exs. AQ & AR (Woodard beneficially owned 330,000 shares in August 2003, regularly sold 4,000 shares a month, and exercised stock options, which left him with 212,000 shares in August 2005).

As for the insider trading claim against the partnerships, TPG & LPG first challenge the inclusion of the individual partners. The Consolidated Complaint does not identify any stock trades by Defendants Baumer, Bonderman, Coslet, Coulter, Danhakl, Nolan, Price, or Sokoloff. CC ¶ 288 & 294. The Court appreciates that the Partnerships' entities are interrelated, CC ¶ 27 (Bonderman, Coulter, and Price are directors and officers of TPG Advisors III, and that entity is the general partner of TPG GenPar III, which is the sole general partner of six other TPG entities). But in order to state an insider trading claim against the individuals, Plaintiffs must articulate a theory of liability. It is not enough to allege that "all" defendants traded stock, and then identify trades by half of the named parties.

***36** The insider trading allegations against the TPG and LGP defendants also fail because Plaintiffs have not alleged specific facts that create a strong inference of scienter. As the Court found in the primary § 10(b) claim, Plaintiffs fail to show a connection between the alleged fraud (as narrowed by the Court to the under reporting distribution center expenses to inflate the stock) *with* the October 22, 2004 stock sale. The first statement that Plaintiffs identify as being affected by the accounting fraud was Petco's November 2004 report of its third quarter financial results. CC ¶ 111(a), (b), 120(a), (b). The October 22 sale preceded that November statement, nor was the sale suspicious when considered in the context of the Partnerships' investment relationship with Petco. Plaintiffs have identified internal information showing Petco was aware of the accounting problem in October 2004, but they have not identified how TPG and LGP would have had access to those internal communications. The conclusory assertion that Coslet and Danhakl told the others is not supported by facts. The presence of two directors on Petco's Board is not enough in these circumstances. The Consolidated Complaint fails to allege sufficient facts that these parties acted with scienter in executing their decisions to sell their Petco stock whether they would have been considered either insiders or outsiders on October 22, 2004. Accordingly, the Court grants the motion to dismiss as to TPG and LGP on the third claim for relief.

2. *Contemporaneous Trades by Plaintiffs*

Defendants raise a question of standing by arguing that the Plaintiffs have failed to allege "contemporaneous" stock trades. 15 U.S.C. § 78t-l(a). Section 20A of the Exchange Act provides a private right of action when a person who sells or purchases a security "while in possession of material, nonpublic informatio" is liable "to any person who, contemporaneously with the purchase or sale of securities" in the same class. 17 U.S.C. § 78t-1(a).

The Consolidated Complaint broadly alleges that members of the proposed class purchased shares of common stock during the time that the Petco Defendants traded. CC ¶ 289 & 338. The only example is that West Virginia Laborers Pension Trust Fund acquired 400 shares on March 1, 2005. CC ¶ 289. At that time, the share price was allegedly inflated by the accounting impropriety (which was announced to the public on April 15, 2005). The Lead Plaintiff, however, is the Plumbers and Pipefitters Local 51 Pension Fund. Order Appointing Lead Plaintiff (Aug. 17, 2005) [Doc. No. 13]. In their certification of their stock trades, the Lead Plaintiff list purchases with "settlement dates" on February 16, 2005, February 22, 2005, and March 9, 2005. CC Ex. 4 (Schedule A).

Defendants argue that Plaintiffs have failed to show that they purchased shares at the inflated prices "contemporaneous" to the sales by Defendants, which is a requirement for standing under the PSLRA. Petco argues that the purchases were too far removed to count.

***37** The Ninth Circuit has adopted the Second Circuit's approach to defining the scope of a "contemporaneous" period. *See* Neubronner v. Milken, 6 F.3d 666, 670 (9th Cir.1993) (citing *Wilson v. Comtech Telecomm. Corp.,* 648 F.2d 88 (2d Cir.1981)). "[C]ontemporaneous trading must be pleaded with particularity under Rule 9(b)." *Id.* This rule "ensures that only private parties who have traded with someone who had an unfair advantage will be able to maintain insider trading claims." *Id.* Although the Ninth Circuit did not define with precision an acceptable time range, it has held that two months is too distant. *See* Brody, 280 F.3d at 1002; Neubronner, 6 F.3d at 670 ("The delineation of how far apart in time trades may be without being too far apart to satisfy the contemporaneous trading requirement is best worked out in cases much closer to a probable borderline than this one.").

When Congress adopted the "contemporaneous" requirement, it left the development of a definition to the courts, but it did cite with approval a district court case, *O'Connor & Assoc. v. Dean Witter Reynolds, Inc.,* 559 F.Supp. 800 (S.D.N.Y.1983), that held a trade within seven days was "clearly" contemporaneous. H.R.Rep. No. 910, 100th Cong., 2d. Sess. 27 (1988) *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064, *cited in* *In re Verifone Sec. Litig.,* 784 F.Supp. at 1488-89 (the appeal did not consider definition of contemporaneous).

Here, the Petco Defendants have provided the SEC Form 4s that list the dates of their transactions. Petco Defendants Devine, Hall, Myers, and Richter each sold shares on March 1, 2005, so the trading by Plaintiff West Virginia Laborers Pension Trust Fund on that same day was contemporaneous under any test. Thus, the Consolidated Complaint pleads with particularity the contemporaneous sales by a member of the proposed class.

The status of the Lead Plaintiff Plumbers and Pipefitters Local 51 Pension Fund is less clear.[FN5] The Lead Plaintiff purchased shares on Wednesday, March 9, 2005, and that is eight days after the insiders' sold shares on Tuesday, March 1, 2005. The Lead Plaintiff also purchased shares on Tuesday, February 22, 2005, which is one week before the insiders sold shares on Tuesday, March 1. The district courts have reached conflicting decisions when the time period is around seven days, and the parties have cited numerous published and unpublished district court decisions to support their view.

> FN5. The Lead Plaintiff purchased shares on March 9, 2005-the day before Defendant Devine exercised a stock option to purchase 100,000 shares on March 10, 2005. *See* Defs.' Ex. AD at 837. That purchase by Devine, however, is not identified by Plaintiffs in the Complaint. CC ¶ 288 & 294. Moreover, Devine's *purchase* of an additional 100,000 shares runs counter to Plaintiffs' theory that the stock price was inflated at that time and that Devine was acting on that undisclosed information when he *sold* shares for personal profit.

The Court concludes that Lead Plaintiff has alleged contemporaneous trades sufficient to state an insider trading claim. The Lead Plaintiff's trades within seven or eight days of sales by insiders is on the border of an acceptable time period. *O'Connor,* 559 F.Supp. at 803 *cited by* H.R.Rep. No. 910. The purpose of the contemporaneous requirement is to protect investors who trade within the same period as those with non-public information, while protecting traders from limitless liability "to all the world." *Neubronner,* 6 F.3d at 670 (quoting *Wilson,* 648 F.2d at 94). Section 20A requires the defendant to disgorge the illegal profit, thus, the plaintiff must have been harmed by the failure to disclose material information. The distance between the trades of the Lead Plaintiff and the Petco Defendants in this case strikes a reasonable balance. This is particularly true because the Lead Plaintiff's purchases in February and March 2005 were made at a time when the Consolidated Complaint alleges the stock price was artificially inflated by the under-accrued expenses, and that information was disclosed soon thereafter, in mid-April 2005.

III. *Leave to Amend*

***38** Plaintiffs request leave to amend so that they may attempt to correct the deficiencies. The Court grants this request. Fed.R.Civ.P. 15(a).

CONCLUSION

Upon due consideration of the parties' memoranda and exhibits, the arguments of counsel, a review of the record, and for the reasons set forth above:

1. The Court GRANTS IN PART AND DENIES IN PART Plaintiffs' motion to strike [# 39-1], and DENIES Plaintiffs' alternative motion to convert motions into summary judgment motions. [# 39-2]

2. The Court GRANTS IN PART AND DENIES IN PART Defendants' motions to dismiss the Consolidated Complaint. [# 28, 31, & 33] The Court dismisses without prejudice Defendants Frederick Major, Keith Martin, Janet Mitchell, William Woodard, Texas Pacific Group, Inc., TPG Advisors III, TPG Partners III, L.P., TPG Parallel III, L.P., TPG Dutch Parallel III, C.V., TPG Investors III, L.P, FOF Partners III, L.P., FOF Partners III-B, L.P., David Bonderman, William Price, James Coulter, Leonard Green & Partners, L.P., Green Equity Investors III, L.P., John Baumer, Jonathan Sokoloff, and Peter Nolan from these consolidated proceedings.

3. Lead Plaintiff may file its First Amended Consolidated Complaint ("FACC") on or before **September 1, 2006.** Those Defendants who choose to answer the FACC shall do so by **September 18, 2006.** If Defendants instead choose to file motions to dismiss, they shall meet and confer with all counsel as to a briefing schedule, and contact the law clerk for a hearing date.

IT IS SO ORDERED.

S.D.Cal.,2005.
In re Petco Animal Supplies Inc. Securities Litigation
Not Reported in F.Supp.2d, 2005 WL 5957816 (S.D.Cal.)

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Only the Westlaw citation is currently available.

United States District Court,
S.D. New York.
SEDONA CORPORATION, Plaintiff,
v.
LADENBURG THALMANN & CO., INC., et al., Defendants.

No. 03Civ.3120(LTS)(THK).
Aug. 9, 2005.

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Siller Wilk LLP, By: Jay S. Auslander, Eric Snyder, Natalie Shkolnik, New York, NY, for Defendants Thomas Tohn, Michael Vasinkevich, and Joseph Smith.

Arkin Kaplan LLP, By: Howard J. Kaplan, New York, NY, for Defendants Ladenburg Thalmann & Co. and David Boris.

DLA Piper Rudnick Gray Cary U.S. LLP (N.Y.C), By: Caryn G. Mazin, Howard S. Schrader, New York, New York, for Defendants Westminster Securities Corporation, Rhino Advisors, Inc., Amro International, S.A., Roseworth Group Ltd., Cambois Finance Inc., Thomas Badian, Ultrafinanz AG, Creon Management, S.A., and H.U. Bachofen.

Sheldon Eisenberger, By: Sheldon Eisenberger, New York, New York, for Defendants Markham Holdings Ltd. and J. David Hassan.

Michael S. Rosenblum, By: Michael S. Rosenblum, Karen A. Clark, Los Angeles, CA, for Defendant David Sims.

Law Offices of Kenneth A. Zitter, By: Kenneth A. Zitter, New York, NY, for Defendants Dr. Batliner and Partner, Dr. Herbert Batliner, and Hans Gassner.

OPINION AND ORDER

SWAIN, J.

***1** Plaintiff Sedona Corporation ("Plaintiff" or "Sedona") brings this securities action against defendants Ladenburg Thalmann & Co., Inc. ("Ladenburg"); Pershing, LLC ("Pershing"), Westminster Securities Corporation ("Westminster"); Wm. V. Frankel & Co., Inc. ("Frankel"); Rhino Advisors, Inc. ("Rhino"); Markham Holdings Limited ("Markham"); Aspen International Ltd. ("Aspen"); Amro International, S.A., Roseworth Group Limited, and Cambois Finance Inc. (collectively, the "Amro Defendants"); Creon Management, S.A. ("Creon"); Thomas Badian ("Badian"); Thomas Tohn ("Tohn"); David Boris ("Boris"); Michael Vasinkevich ("Vasinkevich"); David Sims ("Sims"); H.U. Bachofen ("Bachofen") and Ultrafinanz AG (collectively, the "Ultrafinanz Defendants"); Dr. Batliner and Partner, Hans Gassner, and Dr. Herbert Batliner (collectively, the "Batliner Defendants"); Joseph A. Smith ("Smith"); J. David Hassan ("Hassan"); Anthony L.M. Inder Rieden ("Rieden"); and John Does 1 to 150 ("John Does") [FN1] (collectively, "Defendants"). [FN2] Sedona's First Amended Complaint ("Compl.") asserts the following claims for relief against various combinations of the Defendants: [FN3] misrepresentation in violation of

Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b) ("Section 10(b)"), and Rule 10b-5 ("Rule 10b-5") promulgated by the Securities and Exchange Commission ("SEC") thereunder (First Cause of Action); manipulation in violation of Section 10(b) and Rule 10b-5 (Second Cause of Action); tortious interference with contract and tortious interference with business relationship (Third Cause of Action); violation of Section 1-401 of the Pennsylvania Securities Act of 1972 ("Pennsylvania Act"), 70 Pa. Stat. Ann. § 1-401 (Fourth Cause of Action); common law fraud and deceit (Fifth Cause of Action); civil conspiracy to commit fraud (Sixth Cause of Action); breach of contract (Seventh Cause of Action); disgorgement of profits from fraudulent and manipulative conduct and restitution under various provisions of the Exchange Act (Eighth Cause of Action); breach of fiduciary duty (Ninth Cause of Action); negligence (Tenth Cause of Action); negligent misrepresentation (Eleventh Cause of Action); and control person liability under Section 20 of the Exchange Act (Twelfth Cause of Action). (Compl.¶¶ 107-67.) Among other relief, Sedona seeks an accounting of Defendants' profits from sales of Sedona stock, injunctive relief, and damages of at least $2,660,000,000.00. (*Id.* at 68-69.) This Court has jurisdiction of the instant action pursuant to 28 U.S.C. § 1331.

FN1. "John Does 1 to 150 are fictitious names alleged for the purpose of substituting names of defendants whose identity will be disclosed in discovery and should be made parties to this action." (Compl.¶ 29.)

FN2. Defendants Geoffrey M. Lewis ("Lewis"), The Cuttyhunk Fund Limited c/o Optima Fund Management L.P. ("Cuttyhunk"), and the George S. Sarlo 1995 Charitable Remainder Trust (the "Sarlo Trust"), were dismissed from the action pursuant to a stipulation so ordered by District Judge Kimba M. Wood on December 2, 2003. Defendants Aspen and Rieden have apparently been served, but have yet to appear or move in this action.

FN3. Sedona asserts claims 2-4, 6, and 8 against all Defendants; claim 12 against the Ultrafinanz Defendants, Rhino, Badian, the Batliner Defendants, Creon, Sims, Hassan, Rieden, Vasinkevich, Boris, Tohn, and Smith; claims 1 and 5 against Ladenburg, Rhino, Markham, Aspen, the Amro Defendants, Badian, Tohn, Boris, Vasinkevich, and Smith; claim 7 against Ladenburg, Markham, Aspen, the Amro Defendants, and Boris; claim 11 against Ladenburg, Rhino, Markham, Aspen, and the Amro Defendants; and claims 9 and 10 solely against Ladenburg. (Compl.¶¶ 107-67.)

Defendants have interposed a number of motions to dismiss the Complaint in its entirety with prejudice, moving pursuant to Rules 12(b)(2), 12(b)(6), and 9(b) of the Federal Rules of Civil Procedure, as well as under the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Pursuant to Rule 12(b)(1) of the Federal Rules of Civil Procedure, certain defendants also move to dismiss the Plaintiff's state statutory and common law claims for lack of subject matter jurisdiction under 28 U.S.C. § 1367(c)(3). Defendants Vasinkevich, Smith, and Tohn further move for costs and attorneys' fees. Plaintiff also moves for partial relief from the discovery stay imposed by the PSLRA,[FN4] to obtain document preservation subpoenas and Wells submissions.

FN4. "In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C.A. § 78u-4(b)(3)(B) (West 2005).

***2** For the following reasons, Defendants' motions to dismiss are granted in part and denied in part. Defendants Vasinkevich, Smith, and Tohn's motions for costs and attorney's fees are denied. Plaintiff's motions are denied as moot.

BACKGROUND

Plaintiff's allegations in its first Amended Complaint as to the facts underlying this action are taken as true for the purposes of these motions. Pennsylvania corporation Sedona, headquartered in King of Prussia, Pennsylvania, provides "Customer Relationship Management (CRM) application software and services for small to mid-sized businesses," specifically targeting institutions that provide financial services. (Compl.¶ 44.) Sedona was a leading provider of CRM application software, but needed to secure more capital in order to fully capture its own substantial corner of the CRM application software market. (*Id.*)

On July 1, 1999, Sedona was solicited by defendants Vasinkevich and Tohn, who submitted a proposal to Sedona offering their investment banking and capital financing services. (*Id.* ¶ 47.) One month later, Vasinkevich, who was a principal of defendant Ladenburg, again solicited Sedona. In an August 19, 1999 letter, Vasinkevich depicted Ladenburg as a "123-year old full-service investment bank" that "ha[d] access to more than $50 Billion in investment capital," and "specialize[d] in providing a method of financing that 'offers market ambiguity as to timing and dollars raised, keeping short sellers and arbitrageurs at bay." ' (*Id.*) Sedona accepted Vasinkevich and Tohn's solicitations. Following the August letter, Bill Williams ("Williams"), Sedona's Chief Financial Officer, engaged in discussions with Vasinkevich and Tohn, who described Ladenburg as the "Goldman Sachs of small cap companies" with funding methods that were "non-toxic" and "minimized dilution." (*Id.* ¶ 51.) In a letter dated December 28, 1999, Vasinkevich reiterated Ladenburg's desire and ability to help Sedona realize the capital investment it required to achieve its business goals. (*Id.*)

On the basis of these communications, Sedona decided to hire Ladenburg as its financial advisor and investment banker. (*Id.* ¶ 53.) It was at this time that Vasinkevich introduced defendant Badian to Sedona as a major investor. (*Id.* ¶ 54.) Badian, a principal of defendant Rhino, assured Sedona that Rhino was an accredited and long-term investor that had only Sedona's best interest in mind. (*Id.*) Sedona memorialized its hiring decision by signing a January 24, 2000, engagement letter. (*Id.* ¶ 55.) Shortly thereafter, Vasinkevich and Tohn persuaded Sedona to "increase the proceeds of the shelf registration to $50 Million," and Williams and defendant Boris, Ladenburg's Executive Vice President, executed an amended engagement letter, dated March 8, 2000 ("Engagement Letter"),FN5 reflecting the increase in the anticipated funding. (*Id.* ¶ 56.)

FN5. The March 8, 2000 amendment increased the gross proceeds from the proposed offering from $15,000,000.00 to $50,000,000.00. (Compl.¶ 56.)

Ladenburg and Rhino convinced Sedona that they, along with other investors they would procure, including Markham, Aspen, Amro, Cuttyhunk, and the Sarlo Trust, would provide the $50 million. (*Id* . ¶¶ 56-57.) The initial financing was arranged through a February 25, 2000, purchase agreement for convertible debentures and warrants ("Purchase Agreement") executed by defendant Hassan on behalf of Markham, defendant Rieden on behalf of Aspen, defendant Bachofen on behalf of Amro, and Lewis on behalf of Cuttyhunk. (*Id.* ¶¶ 57-62.) Sarlo Trust also invested in the initial tranche. (*Id.* ¶ 57.) The Series G convertible preferred shares ("Series G") issued pursuant to the Purchase Agreement "were issued as a bridge loan to fund Sedona until it could draw down on the $50 million shelf registration promised by Ladenburg." (Pl.'s Mem. of Law in Opp'n to Defs. Rhino's and Badian's Mot. to Dismiss at 9 ("Pl.'s Opp'n"); Compl. ¶ 67.) Sedona, however, never received the full amount of funding from the investors, and Sedona now contends that the defendant investors "never intended to fund any material part of this $50 million." (Compl.¶ 64.)

***3** During the first week of March 2000, around the time the initial financing for the Series G closed, Sedona's stock traded at its highest volume in history. (*Id.* ¶¶ 64-66.) "[I]n hindsight," Sedona claims that this "irregularit[y]" was a result of the Defendants' manipulation of the market. (*Id.* ¶ 64.) That is, Sedona views this high level of trading as representing what it characterizes as the "pump" portion of the Defendants' alleged scheme, with the stock peaking at a share price of $10.25, "before beginning its long and continuous slide to its February 2003 level of $0.19," as the stock was systematically "dumped." (*Id.* ¶ 66.) Sedona did not have to wait until February of 2003 to see its stock plummet, however, as by "June and July of 2000 ... the stock ... [was] down to a consistent and declining closing price of around $3.00 per share, a decline in market capitalization of $195,000,000.00 in approximately 90 days." (*Id.*)

In the Complaint, Plaintiff principally alleges that the Defendants "manipulate[d] downward the stock price of Sedona with the cooperation of U.S. broker-dealers and market makers in order to profit from the manipulation and price decline and to take advantage of increased conversion rights resulting from the manipulation." (*Id.* ¶ 32.) According to Sedona, this type of "death spiral" scheme FN6 was not novel to the Defendants, who are allegedly "accomplished practitioners of ... stock manipulation and stock fraud." (*Id.* ¶ 33.) In support of its assertion, Sedona includes in its Complaint a chart listing a number of companies with drastic reductions in stock price, all of which, Sedona claims, were the result of similar manipulations by Defendants. (*Id.* ¶ 43.) In addition, Sedona refers to a February 26, 2003, SEC Complaint ("SEC Complaint") against defendants Rhino and Badian concerning their involvement with Sedona.FN7 The SEC Complaint includes allegations that Rhino and Badian ignored a Purchase Agreement provision prohibiting short sales and "engaged in extensive short selling and pre-arranged trading on behalf of [their] client prior to exercising the conversion rights under the [Purchase Agreement]." (*Id.* ¶ 36; SEC Compl., Howard J. Kaplan Aff. ("Kaplan Aff.") Ex. F ¶ 2.) As a result, "Rhino and Badian manipulated Sedona's stock price to enhance a client's economic interest." (*Id.*) Rhino and Badian paid a $1 million dollar fine to settle the SEC claim. (Compl.¶ 36.)

FN6. For descriptions of "death spiral schemes," see, for example, *Endovasc Ltd., Inc. v. J.P. Turner & Co., LLC, et al.,* No. 02 Civ. 7313(LAP), 2004 WL 634171 (S.D.N.Y. Mar. 20, 2004); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC,* No. 02 Civ. 9767(LBS), 2004 WL 31819207 (S.D.N.Y. Oct. 10, 2002); *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC,* 223 F.Supp.2d 474 (S.D.N.Y.2002); and *Global Intellicom, Inc. v. Thomason Kernaghan & Co.,* No. 99 Civ. 642(DLC), 1999 WL 544708 (S.D.N.Y. July 27, 1999).

FN7. Although the SEC Complaint deals specifically with alleged actions of defendants Rhino and Badian on behalf of their client, Amro, Sedona asserts that the alleged fraudulent actions taken against Sedona were conducted by all of "the defendants herein ..., cloaked by the use of other names, nominee shell companies, and dummy accounts, along with cooperating U.S. and Canadian broker dealers and market participants." (Compl.¶ 70.)

On November 22, 2000, Sedona entered into a second convertible debenture purchase agreement with Amro, which provided Sedona with $3 million dollars in gross funding. (Kaplan Aff. Ex. E.) Sedona used approximately $2,246,000 of the proceeds from that transaction to "retire the Series G." (Compl.¶ 82.) Following the execution of the second purchase agreement, Rhino and Badian allegedly conducted so many short sales in Amro's account, that "on March 22, 2001, the [National Association of Securities Dealers Automatic Quotation system ('NASDAQ')] placed a short restriction on Sedona stock that required that any future sales of Sedona would be subject to a mandatory closeout if there were a failure to deliver the securities after ten (10) days." (*Id.* ¶ 88.) Nonetheless, the NASDAQ restrictions did not prevent Defendants from continuing to sell Sedona's stock short. Rhino held an account for Amro with a Canadian broker-dealer who was not a member of the National Association of Securities Dealers, Inc. ("NASD"), and thus was not subject to the short sale restriction. (*Id.* ¶ 90.) It was through the Canadian account that Rhino continued to sell short Sedona's stock, from March 30, 2001 through mid-April 2001. (*Id.*)

***4** Several months later, in September 2001, Sedona received an anonymous report "alleging that manipulation and fraud had been perpetrated against it." (*Id.* ¶ 100.) In October 2001, based upon the allegations contained in the report, Sedona "refused to honor any more conversions from the [Purchase Agreement], and asked the SEC to investigate the allegations." (*Id.*) Amro sued Sedona in the Southern District of New York on October 24, 2001, *Amro Int'l, S.A. v. Sedona Corp.,* No. 01 Civ. 9344(NRB) (the "*Amro* action"), for Sedona's failure to honor the conversions. (*Id.*) The *Amro* action was ultimately terminated and Sedona entered into settlement agreements with Roseworth, Cambois, Amro, and Rhino (collectively, the "Amro Settlement Defendants"), that included a release from future related liability ("the Release") for each of those defendants and their affiliates.FN8 (*Id.* ¶ 101.)

FN8. The Release by its terms also relieves the "officers, directors, and employees of such affiliates" from liability. Thus, the terms of the Release also cover director defendants Badian (Rhino), Sims (Roseworth and Cambois), and Bachofen (Amro).

In the instant action, Sedona asserts that the Defendants' alleged market manipulation and fraudulent acts have made it "virtually impossible for Sedona to obtain additional financing or an investment of any type, except on a limited basis through existing shareholders." (*Id.* ¶¶ 102, 106.) Further, Sedona alleges that Defendants directly caused Sedona to be de-listed from the NASDAQ SmallCap Market on January 9, 2003, allowing Defendants more freedom to engage in illegal behavior, "as market participants were now governed by a less-regulated atmosphere in which to conduct their manipulative activity." (*Id.* ¶ 102.)

DISCUSSION

Motion to Dismiss Standard

In deciding the Defendants' motions brought pursuant to Federal Rule of Civil Procedure 12(b)(6), the Court must take as true all well-pleaded facts alleged in Sedona's First Amended Complaint and draw all reasonable inferences in Sedona's favor. *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit,* 507 U.S. 163, 164 (1993); *Hernandez v. Coughlin,* 18 F.3d 133, 136 (2d Cir.1994). The Court must not dismiss the complaint "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of [its] claim which would entitle [it] to relief." *Conley v. Gibson,* 355 U.S. 41, 45-46 (1957).

Although the Court generally should not look outside of the pleadings to decide a motion to dismiss a complaint, the Court may consider "any written instrument attached to [the complaint] as an exhibit or any statements or documents incorporated in [the complaint] by reference." *Rothman v. Gregor,* 220 F.3d 81, 89 (2d Cir.2000). Further, in securities actions, the Court may consider "public disclosure documents required by law to be, and that have been, filed with the SEC, and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit." *Id.* (citations omitted).

Claims Against the Amro *Settlement Defendants*

The *Amro* Settlement Defendants move to dismiss the Complaint as against them on the basis of the Release executed and delivered by Sedona in connection with the settlement of the *Amro* litigation. In apparent anticipation of such a motion, Sedona pleads in the Complaint that the Release is void and unenforceable by reason of having been entered into under "fraud and duress," at a time when "Sedona felt that it had no other option but to settle the outstanding litigation." (Compl.¶ 101.) Sedona further argues that construction of the Release to cover the instant fraud and related claims would be inequitable because the *Amro* Settlement Defendants were actively working to conceal the relevant facts as to their conduct at the time the Release was given.

***5** Because the Release contains a New York choice of law provision and the parties rely on New York case law in their briefs, the Court interprets the Release in accordance with New York law. *See, e.g., Nasik Breeding & Research Farm Ltd. v. Merck & Co., Inc.,* 165 F.Supp.2d 514, 526 (S.D.N.Y.2001) (finding that courts in the Second Circuit "have routinely enforced similar choice of law provisions even when a party challenges the contract as fraudulent" (citations omitted)). Under New York law, "a valid release which is clear and unambiguous on its face and which is knowingly and voluntarily entered into will be enforced as a private agreement between parties." *DuFort v. Aetna Life Ins. Co.,* 818 F.Supp. 578, 581 (S.D.N.Y.1993) (quoting *Skluth v. United Merchs. & Mfrs., Inc.,* 559 N.Y.S.2d 280, 282 (1st Dept.1990)). Such a release will be binding on the parties unless a legal defense such as fraud or duress is adequately asserted. *Id.*

The Release provides in pertinent part that:

> Sedona Corporation and its officers and directors in their individual capacity ..., in consideration of good and valuable consideration received from Amro International, S.A., its officers, directors, affiliates, employees, agents, and advisors, including Rhino Advisors, Inc. (as well as the officers, directors, and employees of such affiliates and advisors) (collectively, the "Releasees"), ... in full satisfaction hereby waive all claims, offsets, and defenses that they may have or have had against Releasees and hereby release, forever discharge and agree to hold harmless Releasees from and against all actions, causes of action, claims, suits, contracts, controversies, penalties, offsets, or damages, whether in law or equity, and *whether known or unknown,* that may have occurred prior to the date of this Release, *including, but not limited to,* those arising in connection with the Convertible Debentures and Warrants Purchase Agreement, dated as of November 22, 2000, ... Sedona Corporation's 5% Convertible Debentures Due March 22, 2001 (as amended by an

Agreement, dated as of April 26, 2001), and related Warrants and those asserted or that could have been asserted as a claim, counterclaim, offset or defense in, the [*Amro* action].... This Release shall be governed by the laws of the State of New York.

(Maryann Peronti Decl. in Support of Pl.'s Mem. of Law in Opp'n to Amro Defs.' Mot. to Dismiss ("Peronti Decl.") Ex. 2 (emphasis added).)

Breadth of the Release

The Release clearly and unambiguously provides that Sedona waives all claims, "known and unknown," against the Releasees, "including but not limited to" those claims "asserted or that could have been asserted as a claim, counterclaim, offset or defense in, the [*Amro* action]." (*Id.*) Although Sedona argues that the Release should not be construed to cover the alleged fraud at issue in this litigation because Defendants' alleged market manipulation was being concealed from Sedona at the time the *Amro* case was settled, the Complaint makes it clear that Sedona was aware of, and raised with the court the possibility of, market manipulation activity in the course of the *Amro* litigation. (*See* Compl. ¶ 100.) In addition, the settlement agreement itself includes a provision under which Amro agreed not to sell short Sedona stock either directly or through Rhino. Short sales are central to Plaintiff's market manipulation allegations in this case.

***6** Furthermore, the broad language of the Release specifically includes claims that may not have been known to the Plaintiff at the time of execution, such as those asserted herein. Accordingly, the terms of the Release cover Sedona's current claims. Because Sedona may, however, be able to prove that it executed the Release under duress, the Court will not dismiss Sedona's claims against the *Amro* Settlement Defendants, pursuant to the Release, at this stage of the litigation.

Duress & Fraud Allegations

Under New York law, a contract may be voided on grounds of duress upon proof that the defendant exerted an unlawful threat, which precluded the plaintiff's exercise of free will, during a situation in which the circumstances permitted no other alternative for the plaintiff. *See Nasik Breeding & Research Farm Ltd. v. Merck & Co., Inc.,* 165 F.Supp.2d 514, 527 (S.D.N.Y.2001). Sedona claims that the Release was entered into under economic duress, alleging that "[t]he defendants ... took advantage of Sedona, and threatened litigation and a default action, at a time when Sedona's finances were very limited due to the fraudulent misrepresentations and market manipulations of the defendants." (Compl.¶ 101.) Sedona also quotes a January 4, 2002, e-mail from Badian to Marco Emrich, Sedona's then President and CEO, which "threaten[ed], 'as I am sure you are aware, a public company that defaults on any debt security loses its eligibility for S-3 registrations and must file the more cumbersome and expensive SB-2 or S-1 if it wishes to register shares. There are of course other consequences." ' (*Id.*)

It is well-settled that "[a] threat to do that which one has the right to do does not constitute duress." *DuFort v. Aetna Life Ins. Co.,* 818 F.Supp. 578, 582 (S.D.N.Y.1993) (quoting *Gerstein v. 532 Broad Hollow Road Co.,* 429 N.Y.S.2d 195, 199 (1st Dep't.1980)). However, although such threats are not inherently unlawful, a claim of economic duress may be viable where threats are made in conjunction with a financial situation unlawfully caused by a defendant. *See Weinraub v. Int'l Banknote Co., Inc.,* 422 F.Supp. 856, 860 (S.D.N.Y.1976) (denying summary judgment and finding a genuine issue of material fact as to whether Plaintiff was a victim of economic duress following the court's determination that, "[i]f the marked decrease in the value of that stock which jeopardized [plaintiffs'] loan was due to the misrepresentation and omissions of defendants, then one could well argue that plaintiffs' position [of financial hardship] ... was occasioned by the fraudulent acts of defendants"). "The alleged duress must [ultimately] be proven to have been the result of defendant's conduct and not of the plaintiff's own necessities." *Id.* at 859 (citation omitted). Plaintiff claims such duress here.

The very basis of Sedona's action is the claim that Defendants', including the *Amro* Settlement Defendants', manipulation of its stock led to financial hardship for Plaintiff. Sedona claims that, once placed in this situation, it was unable to exercise its free will by choosing not to settle and execute the releases. (*See* Compl. ¶ 101.) This lack of free choice is "[a] crucial element of coercion or duress." *Korn v. Franchard Corp.,* 388 F.Supp. 1326, 1333 (S.D.N.Y.1975). Sedona further alleges that "the [Settlement Defendants] continued to manipulate Sedona's stock, as before, during and after the releases were entered, intentionally concealing the manipulation from Sedona at the time it entered into the releases." (Compl.¶ 101.) The Court finds that Sedona has sufficiently pled facts on the basis of which it may be able to defeat enforcement of the Release. Accordingly, the motion of the *Amro* Settlement Defendants to dismiss the Complaint on the basis of the Release is denied.

Sedona's Federal Securities Claims Are Not Time Barred

***7** The moving Defendants' principal assertion in their motions to dismiss is that Sedona brought its federal securities claims outside of the relevant statute of limitations period, and that the claims thus must be dismissed as time barred. After a thorough review of the Complaint, documents incorporated therein, and relevant public disclosures, the Court finds that Plaintiff's federal securities law causes of action, as presented in the current pleadings, are not clearly untimely. Therefore, for the reasons explained below, Defendants' motions to dismiss Sedona's federal securities fraud claims as time barred are denied.

Relevant Statute of Limitations

Pursuant to Section 804(b) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of ... the [federal] securities laws ... may be brought not later than the earlier of-(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." 28 U.S.C.A. 1658(b) (West 2002). This statute of limitations applies to all federal securities actions brought on or after July 30, 2002, the enactment date of Sarbanes-Oxley. *Id.* The instant action was commenced on May 5, 2003.

Whether Sedona Was on Notice of the Alleged Violations Prior to May of 2001

The passage of the Sarbanes-Oxley Act did not change the well settled law in this Circuit as to what constitutes "discovery of facts" sufficient to trigger the statute of limitations in a securities fraud action. The statute of limitations begins to run "when a reasonable investor of ordinary intelligence would have discovered the existence of fraud." *Newman v. Warnaco Group, Inc.*, 335 F.3d 187, 193 (2d Cir.2003) (quoting *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir.1993)). Discovery of facts constituting a violation of the securities laws "includes constructive or inquiry notice as well as actual notice." *Id.* at 193 (quoting *Rothman v. Gregor*, 220 F.3d 81, 96 (2d Cir.2000) (internal quotation marks omitted)). Inquiry notice arises when "the circumstances are such as to suggest to a person of ordinary intelligence the probability that the person has been defrauded." *Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., Inc.*, 32 F.3d 697, 701 (2d Cir.1994) (quoting *Armstrong v. McAlpin*, 699 F.2d 79, 88 (2d Cir.1983) (internal quotations omitted)). However, "[t]he fraud must be probable, not merely possible." *Newman*, 335 F.3d at 193.

If the relevant information is contained within the Complaint and the papers incorporated by reference therein, the question of whether Sedona had notice of Defendants' alleged fraud may be determined as a matter of law at the motion to dismiss stage. *See, e.g., LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 156 (2d Cir.2003) (noting that it is appropriate on a motion to dismiss for the Court to determine whether Plaintiff was aware of the fraud as long as that information is contained within the complaint and incorporated papers) and cases cited therein. The Court must utilize an objective standard to determine whether the available information was sufficient to put the plaintiff on inquiry notice. *See, e.g., Clark v. Nevis Capital Mgmt., LLC*, No. 04 Civ. 2702(RWS), 2005 WL 488641, at *7 (S.D.N.Y. Mar. 2, 2005) ("The test as to when fraud should with reasonable diligence have been discovered is an objective one.") (citing *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir.1993)).

***8** While Defendants argue that Sedona had knowledge of the alleged manipulation "no later than June 2000," when Sedona's Finance Committee questioned Vasinkevich about perceived market manipulation, Sedona, pointing to the lapse of time between its late 2001 requests that the SEC investigate trading activities in the company's stock and the filing of the SEC Complaint against Rhino and Badian, argues that, if "it took the SEC 17 months ... to bring its complaint" against Badian and Rhino, "[i]t would not be just to believe that members of a computer software company could unravel this labyrinth of deceit in less time." (Pl.'s Opp'n at 8.) Nonetheless, it is not necessary for Sedona to "have notice of the entire fraud being perpetrated to be on inquiry notice." *Dodds*, 12 F.3d at 351-52. Rather, "the information provided must trigger notice 'with sufficient storm warnings to alert a reasonable person to the probability" ' of fraud. Morin v. Trupin, 809 F.Supp. 1081, 1097 (S.D.N.Y.1993) (quoting *Quantum Overseas, N.V. v. Touche Ross & Co.*, 663 F.Supp. 658, 664 (S.D.N.Y.1987)).

Although Sedona's Complaint and incorporated documents indicate that Sedona was aware of such storm warnings, it cannot be said that those initial storm warnings were sufficient to "alert a reasonable person to the probability" that defendants in the instant action were the perpetrators of that fraud. Further, there is nothing on the face of the Complaint or in the documents that are relevant at this stage of the litigation to indicate that reasonable inquiry prior to May 2001 would have been effective to uncover sufficient facts to have enabled Sedona to bring suit against identifiable perpetrators within a limitations period measured from these early storm warnings. This is particularly so in light of Sedona's allegations of the measures certain Defendants took to hide their alleged fraudulent activity.

For example, Sedona twice queried Vasinkevich, in his capacity as a Ladenburg representative, about market irregularities. (*See* Compl. ¶¶ 71-72.) Vasinkevich denied any wrongdoing, and allegedly "assur[ed Sedona] that the investors placed through Ladenburg, which included Markham, Aspen, and Amro, "were long-term investors," "were not responsible for any manipulation or any events which were not in the best interest of SEDONA; and [that] ... those investors did not cause, directly or indirectly, any aspect of SEDONA's continuing stock decline." (*Id.* ¶ 72.) Vasinkevich then represented he could replace the current investors with new investors, specifically defendants Roseworth and Cambois,[FN9] which were wholly-owned subsidiaries of defendant Creon. (*Id.* ¶¶ 73-74.)

FN9. Defendants Gassner, Batliner, Batliner Partners, and Sims all "had the power to direct or cause the direction of the management and policies of each of Roseworth and Cambois." (*Id.* ¶ 76.) Sedona claims that this new group of defendant investors, who were "known perpetrators of stock manipulation," continued the "conspir[acy] to destroy the stock price of Sedona." (*Id.* ¶ 81.)

The Second Circuit has stated that "reassuring statements will prevent the emergence of a duty to inquire or dissipate such a duty." *LC Capital Partners*, 318 F.3d at 155. Such prevention occurs "only if a[plaintiff] of ordinary intelligence would reasonably rely on the statements to allay the [plaintiff's] concern ." *Id.* Plaintiff's allegations could support a determination that Vasinkevich's alleged representations on behalf of the Ladenburg Investors [FN10] serve to dissipate Sedona's duty to inquire, as an investor of ordinary intelligence could reasonably rely on its financial advisor's statements that its affiliated investors were not involved in any fraudulent conduct.

FN10. The term "Ladenburg Investors" is defined by Sedona to include Defendants Markham, Aspen, Amro, Roseworth, Cambois, and Boris. (*Id.* ¶ 41.)

***9** Therefore, on the facts as plead by Plaintiff in the Complaint and shown in incorporated documents, it cannot be said that moving Defendants are entitled to judgment as a matter of law on statute of limitations grounds, and Plaintiff is entitled to litigate the question of timeliness of the action.

Certain of the Defendants also move to dismiss Sedona's Pennsylvania state fraud claim as untimely and, for substantially the reasons discussed above, those motions are denied.

The Court now turns to the elements of Defendants' motions that are directed to Sedona's pleading of its claims for relief.

Certain of Sedona's Fraud Claims Must be Replead

All moving Defendants request the Court to dismiss Plaintiff's Complaint pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted and pursuant to Rule 9(b) for failure to plead fraud with particularity. For the following reasons, Defendants' motions to dismiss are granted in part and denied in part. Plaintiff will be afforded an opportunity to replead the claims.

Claims for Relief

In its First Claim for Relief, Plaintiff alleges that Defendants Ladenburg, Rhino, Markham, Aspen, the *Amro* Defendants, Badian, Tohn, Boris, Vasinkevich, and Smith violated Section 10(b) and Rule 10b-5 in connection with Plaintiff's sales of securities to Ladenburg and the Ladenburg Investors. Plaintiff asserts that "Defendant Ladenburg, by and through its principals, officers, directors or agents, including, without limitation, Badian, Tohn, Boris, Vasinkevich and Smith made the misrepresentations and omissions alleged" in specified paragraphs of the Complaint. (*See* Compl. ¶¶ 108, 110 and allegations referenced therein.) Plaintiff asserts that Defendants Badian, Tohn, Vasinkevich, and Smith each knew the misrepresentations and omissions were untrue at the time they were made, and that each reconfirmed individually misrepresentations he had made as an agent of Ladenburg, as detailed in specified paragraphs of the Complaint. (*Id.* ¶ 109 and allegations referenced therein.) These Defendants and Ladenburg are alleged to have acted, together with the other Defendants named in the First Claim for Relief, with scienter; Plaintiff further asserts that their actions "dramatically and adversely affected the price and terms of" Plaintiff's sales of securities to Ladenburg and investors placed by Ladenburg. (*Id.* ¶¶ 111-12.)

Plaintiff's Fifth Claim for Relief accuses the same group of Defendants of common law fraud and deceit, specifically, making the misrepresentations and omissions of material fact alleged in the preceding portions of the Complaint. (*Id.* ¶¶ 130-32.)

Plaintiff's Second Claim for Relief, asserted against all of the Defendants named in the Complaint, accuses all Defendants of violating Section 10(b) and Rule 10b-5 by participating in a scheme to defraud Plaintiff by manipulating the price of Plaintiff's stock. (*Id.* ¶¶ 114-18.)

Legal Standards

***10** The elements of a Section 10(b) and Rule 10b-5 cause of action premised on material misstatements or omissions of fact are as follows: Defendants "(1) made misstatements or omissions of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which plaintiffs relied; and (5) that plaintiffs' reliance was the proximate cause of their injury." *Lentell v. Merrill Lynch & Co., Inc.,* 396 F.3d 161, 172 (2d Cir.2005) (quoting *In re IBM Sec.* Litig., 163 F.3d 102, 106 (2d Cir.1998)). Similarly, a properly pled market manipulation claim under Section 10(b) and Rule 10b-5 requires allegations of:

(1) damage [to the plaintiffs], (2) caused by reliance on defendants' misrepresentations or omissions of material facts, or on a scheme by the defendants to defraud, (3) scienter, (4) in connection with the purchase or sale of securities, (5) furthered by the defendants' use of the mails or any facility of a national securities exchange.

Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC, No. 02 Civ. 0767(LBS), 2002 WL 31819207, at *6 (S.D.N.Y. Oct. 10, 2002) (quoting *Schnell v. Conseco, Inc.,* 43 F.Supp.2d 438, 448 (S.D.N.Y.1999)). "The essence of a market manipulation claim is the allegation of conduct intended to deceive or defraud investors by conditioning or artfully affecting the market for securities." *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC,* 223 F.Supp.2d 474, 486 (S.D.N.Y.2002).

In order properly to plead a claim for common law fraud and deceit under New York law, the plaintiff must allege that (1) the defendant made a material misrepresentation, (2) the defendant knew the representation was false, (3) the defendant made the misrepresentation with the intent to defraud the plaintiff, (4) the plaintiff reasonably relied upon the defendant's material misrepresentation, and (5) as a result of such reliance, the plaintiff suffered damages. *See City of New York v. Cyco.Net, Inc.,* No. 03 Civ. 383(DAB), 2005 WL 174482, at *33 (S.D.N.Y. Jan. 27, 2005). If plaintiff fails to adequately plead one of these five essential elements, the claim must be dismissed. *In re Simon II Litig.,* 211 F.R.D. 86, 139 (E.D.N.Y.2002), *vacated on other grounds by* 407 F.3d 125 (2d Cir.2005).

The pleading standard set forth in Rule 9(b) must also be met with respect to each of these fraud-based claims. *See* Fed.R.Civ.P. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."); *Olsen v. Pratt & Whitney Aircraft, A Div. of United Techs. Corp.,* 136 F.3d 273, 276 (2d Cir.1998) ("Fed.R.Civ.P. 9(b) requires that all fraud claims be pleaded with particularity."); *see also AIG Global Sec. Lending Corp. v. Banc of Am. Sec. LLC,* 254 F.Supp.2d 373, 389 (S.D.N.Y.2003) ("A claim for common law fraud under New York law must also satisfy the requirements of Fed.R.Civ.P. 9(b)."). To satisfy the Rule 9(b) pleading standard, a fraud claim alleging material misstatements or omissions must: "(1) detail the statements (or omissions) that the plaintiff contends are fraudulent, (2) identify the speaker, (3) state where and when the statements (or omissions) were made, and (4) explain why the statements (or omissions) are fraudulent." Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of New York, 375 F.3d 168, 187 (2d Cir.2004) (quoting Harsco Corp. v. Segui, 91 F.3d 337, 347 (2d Cir.1996)); *see also* Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC, No. 02 Civ. 0767(LBS), 2002 WL 31819207, at *3 (S.D.N.Y. Oct. 10, 2002). Further, while "market manipulation claims are subject to a more relaxed pleading standard than other claims involving alleged affirmative misrepresentations[,] ... 'because the facts relating to a manipulation scheme are often known only by the defendants[,]' ... [a]t a minimum, it is 'clear that a market manipulation claim must still specify "what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue." " ' Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F.Supp.2d 474, 486 (S.D.N.Y.2002) (citations omitted).

***11** Certain of the Defendants also move to dismiss the Complaint pursuant to the PSLRA, which incorporates the pleading requirements of Section 10(b), Rule 10b-5, and Rule 9(b). Under the PSLRA, a complaint alleging material misrepresentations and/or omissions "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 or belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C.A. § 78u-4(b)(1) (West 2005). As to scienter, the PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind." *Id.* § 78u-4(b)(2).

The Complaint, which details many alleged misrepresentations and omissions and the nature of the alleged scheme, as well as the effect the scheme allegedly had on the market, Plaintiff's own business prospects, and financing opportunities, is generally sufficient to address the securities nexus, reliance, causation, and damages elements of the relevant standards. As explained below, it also adequately alleges scienter as to certain Defendants. It fails, however, sufficiently to allege common law fraud, misrepresentations or omissions, and/or market manipulation, by a number of the named defendants.

Material Misrepresentations & Omissions of Fact

In Plaintiff's First and Fifth Claims for Relief, Sedona alleges material misrepresentations and omissions of fact made by certain Defendants. However, of those particular Defendants, the only ones as to whom these misrepresentations and omissions are pled with the requisite particularity are Ladenburg, Rhino, Badian, Tohn, and Vasinkevich. With respect to these Defendants, the Complaint specifies statements made, as well as when and to whom statements were made, and details allegedly material omissions in connection with such statements. (*See, e.g.,* Compl. ¶¶ 39 (Ladenburg), 47-48 (Ladenburg, Vasinkevich, and Tohn), 50 (Vasinkevich and Ladenburg), 51 (Vasinkevich and Tohn), 52 (Ladenburg, Vasinkevich, and Tohn), 54 (Badian, Rhino, and Vasinkevich), 56 (Ladenburg, Rhino, Vasinkevich, and Tohn), 57 (Ladenburg), 71 (Vasinkevich and Ladenburg), 72 (Vasinkevich), 73 (Vasinkevich and Ladenburg), 82 (Vasinkevich, Badian, Ladenburg, Roseworth, Cambois, Rhino, and Creon), 97 (Vasinkevich and Badian), 108 (Ladenburg), 109 (Badian, Tohn, Vasinkevich, and Smith).)

The Complaint does not, however, make any specific allegations of material misstatements or omissions by any of the other Defendants named in counts One and Five. Rather, Plaintiff alleges simply that Ladenburg represented and acted as "agent for each" of the Ladenburg Investors (defined in paragraph 41 to comprise Amro, Markham, Aspen, Cuttyhunk, and the Sarlo Trust) "in connection with the transactions complained of herein." (*Id.* ¶ 41.) The generalized references to agency in connection with "transactions" and representation are insufficiently specific to meet the requirements of Rule 9(b) as to alleged misrepresentations or omissions by those defendants, particularly where, as here, Ladenburg is alleged to have acted on those parties' behalf in connection with specific financial transactions. The Complaint is similarly deficient with respect to Boris, as to whom its allegations are confined to his position and alleged control relationship with Ladenburg and his having signed the document increasing the funding commitment to $50 million, and Smith, as to whom the Complaint's allegations are confined to control. In Paragraph 81, Plaintiff alleges merely that Roseworth and Cambois failed to disclose their affiliation with Creon, a company managed by Rhino, in connection with their agreement with Sedona "to sell equity off their existing shelf registration." (*Id.* ¶ 81.) Plaintiff does not spell out the materiality of this omission. The Complaint is devoid of allegations of misrepresentations or omissions by any of the other named Defendants.

***12** In a case such as this one, where misrepresentation claims are asserted against numerous defendants, "[b]road allegations that several defendants participated in a scheme, or conclusory assertions that one defendant controlled another, or that some defendants are guilty because of their association with others, do not inform each defendant of its role in the fraud and do not satisfy Rule 9(b)." *Kolbeck v. LIT America, Inc.*, 923 F.Supp. 557, 569 (S.D.N.Y.1996). Such allegations fail to adequately inform the individual defendants of the charges against them, and "[t]his type of 'clump [ing][of] defendants together in vague allegations of fraud' is the very type of inadequate pleading that Rule 9(b) ... sought to prevent." *Endovasc Ltd., Inc. v. J.P. Turner & Co., LLC*, No. 02 Civ. 7313(LAP), 2004 WL 634171, at *6 (S.D.N.Y. Mar. 30, 2004) (quoting *In re Blech Sec. Litig.*, 928 F.Supp. 1279, 1294 (S.D.N.Y.1996) (alterations in original)). Accordingly, Defendants Markham, the Amro Defendants, Boris, and Smith's motions to dismiss Claims for Relief One and Five of the Complaint are granted. Ladenburg, Rhino, Badian, Tohn, and Vasinkevich's motions are denied. Plaintiff has leave to replead to the extent specified below.

Market Manipulation

Plaintiff's Second Claim for Relief, asserted against all Defendants, alleges violations of Section 10(b) and Rule 10b-5 on the basis of market manipulation. As noted above, the Rule 9(b) pleading standards are construed in a more relaxed fashion for market manipulation claims. A plaintiff must, however, "still specify 'what manipulative acts were performed, which defendants performed them, when the manipulative acts were performed, and what effect the scheme had on the market for the securities at issue." ' *Internet Law Library*, 223 F.Supp.2d at 486 (citation omitted).

Here, the Complaint provides a great deal of detail regarding the nature of the conduct and techniques allegedly employed in the market manipulation scheme, and numerous details regarding transactions and/or the participation of specific defendants in transactions. Specific allegations regarding the entry into, or facilitation of, transactions in aid of the alleged scheme are made as to defendants Ladenburg, Rhino, the Amro Defendants, Markham, Aspen, Vasinkevich, Badian, Tohn, Boris, Frankel, Westminster, and Pershing. As to the remaining individual and commercial entity defendants, however, Plaintiff's allegations are confined to ability to control the alleged bad actors, or generalized allegations that "all defendants" engaged in, or are believed to have engaged in, various categories of manipulative conduct. Neither allegations of ability to control or lumped-together accusations of wrongdoing by undifferentiated groups of defendants, is sufficient to satisfy Rule 9(b). *See, e.g., Endovasc Ltd., Inc. v. J.P. Turner & Co., LLC*, No. 02 Civ. 7313(LAP), 2004 WL 634171, at *6 (S.D.N.Y. Mar. 30, 2004) (quoting *In re Blech Sec. Litig.*, 928 F.Supp. 1279, 1294 (S.D.N.Y.1996) (omissions in original)); *Kolbeck v. LIT America, Inc.*, 923 F.Supp. 557, 569 (S.D.N.Y.1996). Accordingly, the motions of Defendants Creon, the UltraFinanz Defendants, Smith, Sims, the Batliner Defendants, and Hassan, to dismiss Plaintiff's second claim for relief, are granted. Plaintiff has leave to replead as specified below.

Scienter

***13** Certain of the Defendants further argue that the Complaint fails to plead the scienter element of Plaintiff's common law, market manipulation, and misrepresentation and/or omission fraud claims with sufficient particularity. Fraud claims brought under the common law and pursuant to Section 10(b), Rule 10b-5, and the PSLRA, must include allegations that defendants' misrepresentations or omissions, or challenged schemes, were undertaken with the intent to defraud the plaintiff. *See Lentell v. Merrill Lynch & Co., Inc .*, 396 F.3d 161, 172 (2d Cir.2005) (quoting *In re IBM Sec. Litig .*, 163 F.3d 102, 106 (2d Cir.1998)); *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 214 (3d Cir.2001) (quoting *Rosen v. Communication Serv. Group, Inc.*, 155 F.Supp.2d 310, 321 n. 14 (E.D.Pa.2001)); *City of New York v. Cyco.Net, Inc.*, No. 03 Civ. 383(DAB), 2005 WL 174482, at *33 (S.D.N.Y. Jan. 27, 2005). The complaint must "plead those events which give rise to a strong inference that the defendant[ ] had an intent to defraud, knowledge of the falsity, or a reckless disregard for the truth." *Caputo v. Pfizer, Inc.*, 267 F.3d 181, 191 (2d Cir.2001) (quoting *Connecticut Nat'l Bank v. Fluour Corp.*, 808 F.2d 957, 962 (2d Cir.1987) (internal quotation marks and citation omitted)). A plaintiff may support such inference by sufficiently pleading that the defendant had "either (a) ... both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC, No. 02 Civ. 0767(LBS), 2002 WL 31819207, at *4 (S.D.N.Y. Oct. 10, 2002) (quoting *Kalnit v. Eichler,* 264 F.3d 131, 138-39 (2d Cir.2001)). However, Sedona alleges facts sufficient only to support a strong inference of intent to defraud on the part of Ladenburg, Rhino, Markham, Aspen, the Amro Defendants, Boris, Frankel, and Westminster, to the extent that they were holders of or managed Sedona's stock.

Sedona alleges that "the structure of the financing agreement gave the defendants both the motive and the opportunity to defraud Sedona." (Compl.¶ 111.) Specifically, the structure of the convertible stock and debentures was such that, if Sedona's stock price were pushed downward, the defendants could acquire more stock through the conversion, thus providing an incentive to manipulate Sedona's stock downward. (*Id.* ¶ 34.) Indeed, this allegation does give rise to a strong inference of motive and opportunity as to the direct holders of the Debentures and their fund managers, such as Rhino and Ladenburg. [FN11] However, that strong inference is lacking as to those entities' representatives, Badian, Tohn, and Vasinkevich.

> FN11. According to the settlement agreement between Amro and Sedona, "Sedona issued and delivered ... Warrants to Ladenburg ... for 167,576 shares, expiring November 12, 2003." (Peronti Decl. Ex. 1.) "Rhino is listed as the fund manager of Amro in publicly-filed documents with the SEC." (Compl.¶ 62.)

While the Court could surmise that Badian, Tohn, and Vasinkevich could profit from these transactions, it is Plaintiff's duty to allege specifically the relevant connections. Without more specific allegations as to why Ladenburg's officers would want to manipulate Sedona's stock, Sedona fails to plead adequately the motive requirement as to these three defendants. Therefore, the motions to dismiss Sedona's Second Claim for Relief are granted as to Defendants Badian, Tohn, Vasinkevich, and Pershing, with leave to replead, and denied as to Defendants Ladenburg, Rhino, Markham, Westminster, Frankel, Boris, and the Amro Defendants.

Sedona's Claim for Relief Pursuant to Section 1-401 of the Pennsylvania Act Must be Replead

***14** In its Fourth Claim for Relief, Plaintiff asserts a claim against all Defendants for violation of the Pennsylvania Act. The Pennsylvania Act makes it "unlawful for any person, in connection with the offer, sale or purchase of any security in [Pennsylvania], directly or indirectly: (a) [t]o employ any device, scheme or artifice to defraud; [and] (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made ... not misleading." 70 Pa. Stat. Ann. § 1-401. This provision is " 'functionally identical' to ... Section 10(b) of the Exchange Act," and "is modeled after Rule 10b-5 ... and requires virtually the same elements of proof." *GFL Advantage Fund, Ltd. v. Colkitt,* 272 F.3d 189, 214 (3d Cir.2001) (quoting *Rosen v. Communication Serv. Group, Inc.,* 155 F.Supp.2d 310, 321 n. 14 (E.D.Pa.2001)).

The parties disagree as to whether this claim for relief is precluded by the New York choice-of-law provisions of: (1) the Engagement Letter between Sedona and Ladenburg; (2) the Purchase Agreement between Sedona, Markham, Amro, Aspen, and Cuttyhunk; (3) the Settlement Agreement among, Sedona and Amro; and (4) the Releases between Sedona and the Settlement Defendants.[FN12] The forum selection clause and choice-of-law provision contained within the Engagement Letter provides in pertinent part that

> FN12. Because Sedona's claim of duress raises a legitimate question as to whether the Release is invalid, the Court will not, at this stage of the litigation, grant motions to dismiss Sedona's Pennsylvania law claim based on the choice of law provision contained in the Release.

[Sedona] hereby irrevocably: (a) submits to the jurisdiction of any court of the State of New York or any federal court sitting in the State of New York for the purposes of any suit, action or other proceeding arising out of the Agreement between [Sedona] and [Ladenburg] which is brought by or against [Sedona] or [Ladenburg]; (b) agrees that all claims in respect of any suit, action or proceeding may be heard and determined in any such court.... This [Engagement Letter] shall be governed by and construed in accordance with the laws of the State of

New York, without regard to conflicts of law principles.

(Engagement Letter, Kaplan Aff. Ex. B at 10.) The choice-of-law provision in the Purchase Agreement provides that the "[Purchase Agreement] shall be governed by and construed in accordance with the laws of the State of New York applicable to contracts made in New York by persons domiciled in New York City and without regard to its principles of conflicts of laws." (Purchase Agreement, Kaplan Aff. Ex. C § 10.1.) Similarly, the choice-of-law provision contained in the Settlement Agreement states that the "[Settlement Agreement] shall be governed by and construed and enforced in accordance with the internal laws of the State of New York." (Settlement Agreement, Peronti Decl. Ex. 1 ¶ 7(e).)

When deciding conflict of laws issues arising in diversity cases, a federal court must look to the laws of the forum state. *See, e.g .,* *Klaxon Co. v. Stentor Elec. Mfg. Co.,* 313 U.S. 487, 496 (1941); *Terwilliger v. Terwilliger,* 206 F.3d 240, 245 (2d Cir.2000); *CAP Gemini Ernst & Young U.S. LLC v. Nackel,* No. 02 Civ. 6872(DLC), 2004 WL 569554, at *3 (S.D.N.Y. Mar. 23, 2004). Under New York law, contractual choice-of-law provisions are generally valid and enforceable. *Terwilliger,* 206 F.3d at 245 (quoting *Marine Midland Bank, N.A. v. United Missouri Bank, N.A.,* 643 N.Y.S.2d 528, 530 (N.Y.App.Div.1996)). Where, as here, there is an express choice-of-law provision in a contract, "a court is to apply the law selected in the contract as long as the state selected has sufficient contacts with the transaction." *Hartford Fire Ins. Co. v. Orient Overseas Containers Lines (UK) Ltd.,* 230 F.3d 549, 556 (2d Cir.2000). However, "[u]nder New York law, a choice-of-law provision indicating that the *contract* will be governed by a certain body of law does not dispositively determine that law which will govern a claim of *fraud* arising incident to the contract." *Krock v. Lipsay,* 97 F.3d 640, 645 (2d Cir.1996) (citations omitted). Rather, "in order for a choice-of-law provision to apply to claims for tort arising incident to the contract, the express language of the provision must be 'sufficiently broad' as to encompass the entire relationship between the contracting parties." *Id.* (finding that choice-of-law provision providing that "[t]his Mortgage shall be governed by and construed in accordance with the laws of the Commonwealth of Massachusetts," was not sufficiently broad to apply to a claim of fraudulent misrepresentation).

***15** Here, Sedona's securities fraud claims asserted under Pennsylvania law arise incident to transactions contemplated by the Engagement Letter, Purchase Agreement, and the Settlement Agreement. The language of the choice-of-law provisions contained in the Purchase Agreement and the Settlement Agreement, which merely refer to actions arising directly from those contracts, is not sufficiently broad for the Court to apply the New York choice-of-law provisions contained therein to defeat Sedona's Pennsylvania securities law claim. Further the broader language in the forum selection clause of the Engagement Letter, which refers to any actions arising out of the Engagement Letter, does not serve to expand the scope of the narrower choice-of-law provision contained in the same contract. *See Fin. One Pub. Co. Ltd. v. Lehman Bros. Special Fin., Inc.,* 414 F.3d 325, 2005 WL 1619852, at *7 (2d Cir. July 12, 2005) ("Under New York law, ... tort claims are outside the scope of contractual choice-of-law provisions that specify what law governs construction of the terms of the contract, even when the contract also includes a broader forum-selection clause." (citations omitted).) Accordingly, the Court denies the motions to dismiss Sedona's Pennsylvania Act claim for relief to the extent the motions rely on the choice-of-law provisions of the Engagement Letter, Purchase Agreement, and Settlement Agreement.

However, as noted above, the Pennsylvania Act "requires virtually the same elements of proof" as a federal claim brought pursuant to Rule 10b-5. *See GFL Advantage Fund, Ltd. v. Colkitt,* 272 F.3d 189, 214 (3d Cir.2001) (quoting *Rosen v. Communication Serv. Group, Inc.,* 155 F.Supp.2d 310, 321 n. 14 (E.D.Pa.2001)). [Therefore, the motions of Defendants Boris, Creon, Hassan, Smith, Sims, the Amro Defendants, the Batliner Defendants, and the UltraFinanz Defendants to dismiss Sedona's state claim are granted, with leave to replead.]

Further, there is no private right of action under the statutory provision Plaintiff cites and Sedona's fourth claim for relief must for that reason be dismissed. *See, e.g., In re Catanella & E.F. Hutton & Co., Inc. Sec. Litig.,* 583 F.Supp. 1388, 1439 (E.D.Pa.1984) (finding that the Pennsylvania Act "do[es] not expressly grant a private remedy"). Nonetheless, Pennsylvania courts have found that a private right of action under Section 1-401 is available through Section

1-501 of the Pennsylvania Act. *See, e.g.,* *Feret v. First Union Corp.,* 1999 WL 80374, at *16 (E.D.Pa Jan. 25, 1999) (" § 1-401 of the Pennsylvania Securities Act, ... provides a private cause of action in § 1-501."). Accordingly, the Fourth Claim for Relief is dismissed, with leave to amend the Complaint to assert the Pennsylvania state fraud claim under Sections 1-401 *and* 1-501 of the Pennsylvania Act, as well as to include allegations sufficient to adequately plead a securities fraud claim under the Pennsylvania Act.

The Motions to Dismiss Sedona's Control Person Liability Claim are Denied in Part

***16** Plaintiff's Twelfth Claim for Relief, pursuant to Section 20 of the Exchange Act, alleges control person liability as against the UltraFinanz Defendants, Rhino, Badian, the Batliner Defendants, Creon, Sims, Hassan, Rieden, Vasinkevich, Boris, Tohn, and Smith. For the following reasons, Defendants' motions to dismiss Sedona's control person liability claim are granted only as to Defendant Creon.

Pursuant to Section 20(a) of the Exchange Act,

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

15 U.S.C.A. § 78t(a) (West 2005). A plaintiff may establish a prima facie case of control person liability under Section 20(a) by showing (1) "a primary violation ... by the controlled person"; (2) "control of the primary violator by the targeted defendant"; and (3) "that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person." *Ganino v. Citizens Utils. Co.,* 228 F.3d 154, 170 (2d Cir.2000) (quoting *SEC v. First Jersey Sec., Inc.,* 101 F.3d 1450, 1472 (2d Cir.1996)). A plaintiff's pleading as to these elements must meet the requirements of Federal Rule of Civil Procedure Rule 8(a), which requires only a "short and plain statement," rather than the particularity requirements of Rule 9(b), since "[n]either the PSLRA (because scienter is not an essential element), nor Rule 9(b) (because fraud is not an essential element), apply to a Section 20(a) claim." *In re Initial Public Offering Sec. Litig.,* 358 F.Supp.2d 189, 208 (S.D.N.Y.2004).

In the Complaint, Sedona describes various officer, director, and other authority relationships with alleged perpetrators of fraud in support of its control person liability claim. (*See, e.g.,* Compl. ¶¶ 158 (UltraFinanz Defendants, Rhino, and Badian), 159 (Batliner Defendants), 160 (Sims, Creon, Rhino, and Badian), 161 (Hassan), 162 (Rieden), 164 (Vasinkevich, Boris, Tohn, and Smith), 165 (Badian).) However, Sedona's Section 20(a) claim is not pled sufficiently as against Defendant Rieden, as Sedona has not alleged an underlying primary violation of either Section 10(b) or Rule 10b-5 by Aspen. Sedona's claim is also insufficient as to Defendant Creon, since Sedona has failed to allege facts sufficient to show that Creon was "in some meaningful sense a culpable participant in the fraud" allegedly perpetrated by Defendants Roseworth and Cambois. Rather, in support of its allegation of control person liability against Creon, Sedona merely states that "publicly-filed documents with the SEC indicate that Roseworth and Cambois are wholly-owned subsidiaries of Creon." (*Id.* ¶ 160.) Therefore, Defendant Creon's motion to dismiss Sedona's Twelfth Claim for Relief as against Creon is granted with leave to replead.

***17** As for the remaining Defendants named in the claim, it cannot be said that Sedona has not alleged control and culpable participation, particularly with respect to Defendant signatories and representatives of entities which were alleged fund managers and/or holders of Sedona stock. Accordingly, the motions to dismiss Sedona's Twelfth Claim for Relief as against Defendants Rhino, Vasinkevich, Boris, Tohn, Smith, Badian, Sims, the Batliner Defendants, Hassan, and the UltraFinanz Defendants, are denied.

The Motions to Dismiss Sedona's Civil Conspiracy Claim are Granted in Part

The Supreme Court has noted that "a plaintiff [can] bring suit for civil conspiracy only if he [has] been injured by an act that was itself tortious." *Beck, II v. Prupis,* 529 U.S. 494, 501 (2000) (citations omitted). There is no cognizable claim for civil conspiracy on its own under New York law, a rule that is well-settled among the courts. *See, e.g.,* *Endovasc Ltd., Inc. v. J.P. Turner & Co., LLC, et al.,* No. 02 Civ. 7313(LAP), 2004 WL 634171, at *14 (S.D.N.Y. Mar. 20, 2004) ("There is no cognizable claim for the tort of civil conspiracy in New York."); Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, 223 F.Supp.2d 474, 490 (S.D.N.Y.2002) ("It is well-settled that New York law does not recognize an independent cause of action for civil conspiracy."). However, New York law recognizes civil conspiracy as a cause of action derivative of an underlying tort claim. *See* Fisher v. Big Squeeze (N.Y.), Inc., 349 F.Supp.2d 483, 488 (E.D.N.Y.2004) ("A claim for conspiracy to commit a tort is recognized in New York only to the extent that the plaintiff well pleads the underlying tort.").

Here, Sedona asserts its civil conspiracy to commit fraud claim against all Defendants in the action. However, Sedona has only properly alleged securities and common law fraud claims against Defendants Ladenburg, Rhino, Badian, Tohn, Boris, Vasinkevich, the Amro Defendants, Markham, Pershing, Westminster, and Frankel. Thus, as to all other Defendants, there can be no viable civil conspiracy cause of action, and the Court accordingly grants their motions to dismiss Plaintiff's Sixth Claim for Relief, with leave to replead.

As for the Defendants against whom there remain viable fraud claims, a properly pled claim for civil conspiracy requires allegations of "(1) a corrupt agreement between two or more persons, (2) an overt act, (3) their intentional participation in the furtherance of a plan or purpose, and (4) the resulting damage." *Melnitzky v. Rose,* 299 F.Supp.2d 219, 227 (S.D.N.Y.2003). Although Sedona has alleged sufficiently an overt act of fraud with resulting damage to Plaintiff, there are no allegations of an express agreement among these particular Defendants to intentionally participate in a conspiracy to defraud Sedona. Nonetheless, "[t]he lack of an express allegation of an agreement is not fatal to the plaintiff[']s conspiracy claims. The courts have held that disconnected acts, when taken together, may satisfactorily establish a conspiracy." *First Fed. Sav. & Loan Assoc. v. Oppenheim, Appel, Dixon & Co.,* 629 F.Supp. 427, 443-44 (S.D.N.Y.1986).

***18** Sedona asserts that "[t]he conspiracy is evidenced by, among other things, the many connections and interrelationships between the defendants herein and the pattern of 'death spiral' financing schemes caused by the defendants and their affiliates." (Compl.¶ 134.) Indeed, Sedona's allegations of (1) significant relationships between Ladenburg, Vasinkevich, Tohn, Badian, Boris, and Rhino prior to Ladenburg's affiliation with Sedona; (2) Ladenburg and Vasinkevich's role in introducing the Amro Defendants to Sedona as investors; (3) Ladenburg having knowledge of Rhino's alleged fraudulent activity in general; (4) Ladenburg and Rhino as known manipulators of stock; and (5) the trading relationships and knowledge of impropriety between Westminster, Frankel, and Pershing, are sufficient for an inference of a conspiracy. Accordingly, the motion to dismiss Sedona's sixth claim for relief is denied as to Ladenburg, Rhino, Badian, Tohn, Boris, Vasinkevich, the Amro Defendants, Markham, Pershing, Westminster, and Frankel.

Sedona Has Not Adequately Pled Tortious Interference with Contract and Tortious Interference with Business Relations

In its third claim for relief, Sedona alleges that all Defendants in the action have tortiously interfered with certain of Sedona's contracts and with its business relationships with other entities, as a result of Defendants, "with knowledge and forethought, dr[iving] down the price of Sedona's stock so much that it precluded Sedona from obtaining additional financing ... [and] from maximizing its ability to profit from certain contracts." (*Compl.* ¶ 120-21.) Sedona's Complaint fails to plead sufficient facts to state a cause of action in this regard. The third claim will therefore be dismissed with leave to replead.

Tortious Interference with Contract

"[W]here there is an existing, enforceable contract and a defendant's deliberate interference results in a breach of that contract, a plaintiff may recover damages for tortious interference with contractual relations even if the defendant was engaged in lawful behavior." *NBT Bancorp Inc. v. Fleet/Norstar Fin. Group, Inc.,* 664 N.E.2d 492, 496 (N.Y.1996). The elements of a properly pled tortious interference with contract claim under New York law are: "(a) that a valid contract exists; (b) that a third party had knowledge of the contract; (c) that the third party intentionally and improperly procured the breach of the contract; and (d) that the breach resulted in damage to the plaintiff." *Millar v. Ojima,* 354 F.Supp.2d 220, 229-30 (E.D.N.Y.2005) (quoting *Finley v. Giacobbe,* 79 F.3d 1285, 1294 (2d Cir.1996)). A plaintiff must also "identify a specific contractual term that was breached." *Id.* (quoting *Risley v. Rubin,* 708 N.Y.S.2d 377, 378 (1st Dep't.2000)). Further, allegations of causation are required, as the plaintiff "must allege in the complaint that there would not have been a breach but for defendants' conduct." *Aim Int'l Trading, L.L.C. v. Valcucine S.P.A., IBI, L.L.C.,* No. 02 Civ. 1363(PKL), 2003 WL 21203503, at *4 (S.D.N.Y. May 22, 2003).

***19** In support of its tortious interference with contract claim, Sedona alleges that Defendants drove Sedona's stock price down "to such a level that it [sic] substantially precluded SEDONA from maximizing its ability to profit from certain contracts, including those agreements with existing partners, acquired targets such as Acxiom Corporation, and potential partners, implementing various parts of its business plan, completing transactions with third parties or obtaining additional financing." (Compl. ¶ 120; *see also id.* ¶ 121.) Knowledge and causation are alleged as follows: "Defendants ... knew or should have known that their actions described above would proximately cause SEDONA to be unable to complete such business or financing transactions." (*Id.* ¶ 122.)

Plaintiff's allegations are plainly insufficient to address the most basic elements of the tortious interference with contract cause of action. Even if the Court construed Sedona's references to "agreements with existing partners, acquired targets such as Acxiom Corporation, and potential partners" as allegations identifying specific contracts, Sedona fails to allege any breaches of those contracts. The Complaint is also devoid of allegations that any specific Defendants had knowledge of any specific contracts, or that any Defendant intentionally and improperly procured the breach of any contract.

Tortious Interference with Business Relations

"Where there has been no breach of an existing contract, but only interference with prospective contract rights, ... the plaintiff must show more culpable conduct on the part of the defendant." *NBT Bancorp Inc.,* 664 N.E.2d at 496 (citations omitted). "[A]s a general rule, the defendant's conduct must amount to a crime or an independent tort." *Carvel Corp. v. Noonan,* 818 N.E.2d 1100, 1103 (N.Y.2004). Under New York law, in order to plead a valid claim of tortious interference with business relations, Sedona must allege that "(1) there is a business relationship between the plaintiff and a third party; (2) the defendant, knowing of that relationship, intentionally interferes with it; (3) the defendant acts with the sole purpose of harming the plaintiff, or, failing that level of malice, uses dishonest, unfair, or improper means; and (4) the relationship is injured." *Discover Group, Inc. v. Lexmark Int'l, Inc.,* 333 F.Supp.2d 78, 86 (E.D.N.Y.2004) (quoting *Goldhirsh Group, Inc. v. Alpert,* 107 F.3d 105, 108-09 (2d Cir.1997)). Sedona must further allege "relationships with specific third parties with which the [defendants] interfered," that those relationships were "in existence at the time of the interference," and "how the defendant[s] interfered in those relationships." *Aim Int'l,* at *22.

Here, Sedona alleges that Defendants' actions "interfered with the ... business relationships of SEDONA with all entities who SEDONA intended would become business partners, transaction targets and/or financiers, and have jeopardized those relationships and contracts and caused SEDONA to lose credibility in those relationships." (Compl.¶ 123.) However, Sedona fails to identify which particular business relationships it claims were injured as a result of Defendants' alleged market fraud and manipulation, and whether any of the Defendants had knowledge of those relationships. Sedona also fails to adequately allege in the Complaint that the Defendants intentionally interfered with those business relationships. Sedona's third claim for relief is, accordingly, dismissed as to all Defendants, with leave to replead.

Sedona's Breach of Contract Claim is Dismissed

***20** Sedona's breach of contract claim is dismissed for the following reasons. In order to assert a valid breach of contract claim, the "complaint need only allege (1) the existence of an agreement, (2) adequate performance of the contract by the plaintiff, (3) breach of contract by the defendant, and (4) damages." *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of New York,* 375 F.3d 168, 177 (2d Cir.2004) (quoting *Harsco Corp. v. Segui,* 91 F.3d 337, 347 (2d Cir.1996)); *Internet Law Library, Inc. v. Southridge Capital Mgmt., LLC, et al,* 223 F.Supp.2d 474, 490 (S.D.N.Y.2002). The complaint must also "allege the provisions of the contract upon which the claim is based." *Valley Cadillac Corp. v. Dick,* 661 N.Y.S.2d 105, 106 (4th Dep't.1997). Thus, "at a minimum, the terms of the contract, each element of the alleged breach and the resultant damages," must be alleged. *Kaplan v. Aspen Knolls Corp.,* 290 F.Supp.2d 335, 337 (E.D.N.Y.2003). Although a plaintiff is required only to make a "short and plain statement" of the breach of contract claim pursuant to

Rule 8(a)(2), the plaintiff still must "give the defendant fair notice of what plaintiff's claim is and the grounds upon which it rests." *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506, 515 (2002) (quoting *Conley v. Gibson*, 355 U.S. 41, 47 (1957)).

In its seventh claim for relief, Sedona alleges that Defendants Ladenburg, Markham, Aspen, Boris, and the Amro Defendants were in material breach of various written and oral agreements. Specifically, Sedona claims that Ladenburg and the Ladenburg Investors "failed to fully fund [the] contract" underlying the Engagement Letter up to $50 million dollars. (Compl.¶ 136.) In addition, Sedona alleges that Ladenburg and the Ladenburg Investors breached most of their oral and written agreements with Sedona, and that they engaged in unspecified "acts that were not in the best interest of Sedona." (*Id.* ¶ 137.)

With regard to the Engagement Letter, to the extent Ladenburg and Boris are the only signatories thereon, Sedona has adequately pled three of the four required elements of a breach of contract claim. The Complaint alleges the existence of the Engagement Letter, that Ladenburg and Boris breached the agreement through their failure to procure the $50 million dollar funding, and that Sedona was "damaged in the amount of at least $160 million by defendants' breach of contract, in addition to attorney's fees and interest pursuant to the contract transactional documents." FN13 (*Id.* ¶ 138.) However, the Complaint fails to allege that Sedona adequately performed under the contract. Therefore, the Court dismisses the breach of contract claim as against the named Defendants herein without prejudice, to the extent the claim includes a breach of the Engagement Letter, with leave to replead.

FN13. The Complaint is not clear, however, as to whether the damages pled represent the aggregate total damages from all the alleged breaches, made by all the defendants.

"Oral and Written Agreements"

Although Sedona provides a laundry list of alleged breaches, the Court, and the Defendants, are left to guess which of myriad alleged oral and written agreements Ladenburg, Boris, Markham, Aspen, and the Amro Defendants are charged with breaching, much less what specific provisions of those agreements were breached. In addition to not identifying which agreements are referred to in this claim for relief, Sedona states that "most," but not all of the agreements, were breached thus leaving the reader confused as to both the identity and terms of the specific agreements and which of the defendants were alleged to have entered into them. Hence, the Complaint does not provide Markham, Aspen, the Amro Defendants, and Ladenburg and Boris, in relation to contracts other than the Engagement Letter, with sufficient notice of the breach of contract charges lodged against them.

***21** Accordingly, the Defendants' motions to dismiss Plaintiff's breach of contract claim are granted, but Plaintiff has leave to replead.

Sedona's Negligence, Negligent Misrepresentation, and Breach of Fiduciary Duty Claims Fail as a Matter of Law

Defendants Ladenburg, Markham, Rhino, and the Amro Defendants assert that Sedona's common law claims are precluded by the Martin Act, N.Y. Gen. Bus. Law, Art. 23-A, § 352 (McKinney 1996), which is New York State's securities, or "blue sky," law. Plaintiff contends that the Martin Act should not apply herein because, for example, the alleged negligent misrepresentations "were not made in connection with the purchase or sale of securities in New York, as they (i) were made to Sedona at its Pennsylvania offices and (ii) involved, among other things, the legitimacy of defendants and whether or not the manipulative actions were taking place." (Compl.¶ 154.) It is true that a necessary prerequisite for a Martin Act preemption of a common law securities fraud claim is that the underlying transaction was "within or from" New York. N.Y. Gen. Bus. Law § 352-c(1); *Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, 179 F.Supp.2d 159, 162 (S.D.N.Y.2001) (recognizing that a finding "that the transactions were ... "within or from" New York, [is] a nexus expressly required under the Martin Act"). The scope of the Martin Act, however, includes more the actual purchase or sale of securities within or from New York. Related investment advice and negotiation over securities are activities within the Martin Act's purview, as are any

(a) ... fraud, deception, concealment, suppression, false pretense ...;

(b) ... promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;

(c) ... representation or statement which is false, where the person who made such representation or statement; (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities ..., regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.

N.Y. Gen. Bus. Law § 352-c(1) (McKinney 1996).

According to the Complaint, much of the activity Plaintiff alleges involved negligence, misrepresentations, or breach of fiduciary duty occurred in the course of investment advice and negotiations concerning securities, such as the convertible debentures and related agreements. For example, allegedly negligent misrepresentations included misrepresentations as to "the meritorious nature of the advisory and consulting services performed by Ladenburg." (Compl.¶ 154.) Next, with respect to the negligence claim, Sedona alleges that Ladenburg was negligent in its duty "to negotiate on behalf of Sedona, to advise Sedona with respect to negotiations engaged in directly by Sedona regarding contract terms which would be in the best interest of Sedona, [as well as] to monitor trading activities in Sedona stock and to advise Sedona regarding such trading activities." (*Id.* ¶ 151.) Finally, in Plaintiff's breach of fiduciary duty claim, Sedona alleges that Ladenburg breached its duty to provide the investment and financial advisory services detailed in its engagement letter. (*Id.* ¶ 144.)

***22** The Complaint alleges that Ladenburg, an entity situated in New York, conducted many of the complained of transactions with Sedona via telephone and mailings (including the Engagement Letter) from New York. In addition, the underlying securities, though registered to Sedona, a Pennsylvania company, were allegedly manipulated and sold short in New York markets. Further, in alleging proper venue in the Complaint, Sedona states that "a substantial part of the events or omissions giving rise to the claims herein occurred in [the Southern District of New York]." (*Id.* ¶ 31.)

Thus, on the face of the Complaint, the allegations Sedona uses as the foundation for its common law claims involve activity contemplated by the Martin Act, and that have a sufficient nexus with New York. *Cf. Lehman Bros. Commercial Corp.,* 179 F.Supp.2d at 165 (determining that the negotiation of the sale of securities between traders located in London, Hong Kong, and Beijing did not meet the Martin Act requirement of within or from New York).

Plaintiff further argues that, even if the conduct on which its common law claims are based fall within the scope of the Martin Act, Plaintiff's claims are not preempted by that Act. Plaintiff cites the decisions in *Scalp & Blade, Inc. v. Advest, Inc.,* 722 N.Y.S.2d 639, 640 (4th Dep't.2001), and *Cromer Fin. Ltd. v. Berger,* No. 00 Civ. 2498(DLC), 2001 WL 1112548, at *4 (S.D.N.Y. Sept. 19, 2001), which held that the Martin Act did not abrogate claims of breach of fiduciary duty and negligent misrepresentation (*Scalp & Blade*), and negligence and gross negligence (*Cromer*). *See Scalp & Blade,* 722 N.Y.S.2d at 640 ("Nothing in the Martin Act ... precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act."); *Cromer,* at *4 ("[T]here is nothing ... in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action."). The *Cromer* and *Scalp & Blade* decisions have, however, been described as "solitary islands in a stream of contrary opinion." *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC,* No. 02 Civ. 0767(LBS), 2003 WL 22052894, at *4 (S.D.N.Y. Sept. 2, 2003). Both *Scalp & Blade'* s and *Cromer'* s determinations that the text of the Martin Act does not include support for preclusion of common law claims are insufficiently persuasive in the face of substantial contrary authority.

The Martin Act provides the New York Attorney-General with the sole discretion to investigate securities violations within or from the state of New York. *See* N.Y. Gen. Bus. Law § 352(1). Allowing private plaintiffs to pursue a related cause of action "is not consistent with the legislative scheme underlying the Martin Act ." *CPC Int'l Inc. v. McKesson Corp.,* 514 N.E.2d 116, 119 (N.Y.1987). In particular, causes of action related to a plaintiff's securities fraud claim that do not include scienter as an essential element are typically preempted by the Martin Act, in contrast to a claim requiring intent, such as a claim for common law fraud. *See, e.g., Nanopierce,* at *4 ("[N]egligent misrepresentation and breach of fiduciary duty claims ... like the Martin Act itself, do not require proof of deceitful intent; common law fraud, however, does.") This is because allowing a plaintiff to go forward on such a claim "would effectively permit a private action under the Martin Act." *Dujardin v. Liberty Media Corp.,* 359 F.Supp.2d 337, 355 (S.D.N.Y.2005). Indeed, the weight of authority holds that common law claims of negligent misrepresentation, negligence, and breach of fiduciary duty arising from securities fraud are preempted by the Martin Act. *See, e.g., Dujardin,* 359 F.Supp.2d at 354-55 (dismissing a negligent misrepresentation claim as preempted by the Martin Act); *Marcus v. Frome,* 329 F.Supp.2d 464, 475-76 (S.D.N.Y.2004) (same); *Spirit Partners, L.P. v. audiohighway.com,* No. 99 Civ. 9020(RJW), 2000 WL 685022, at *6 (S.D.N.Y. May 25, 2000) (same); *Nairobi Holdings Ltd. v. Brown Bros. Harriman & Co.,* No. 02 Civ. 1230(LMM), 2002 WL 31027550, at *10 (S.D.N.Y. Sept. 10, 2002) (same); *Nanopierce,* at *2-*3 (same); *Gabriel Capital, L.P. v. Natwest Fin., Inc.,* 137 F.Supp.2d 251, 266-67 (S.D.N.Y.2000) (dismissing a negligence claim as violative of the Martin Act); *Nairobi Holdings Ltd. v. Brown Bros. Harriman & Co.,* No. 02 Civ. 1230(LMM), 2002 WL 31027550, at *10 (S.D.N.Y. Sept. 10, 2002) (dismissing a breach of fiduciary claim as violative of the Martin Act); *Bibeault v. Advanced Health Corp.,* No. 97 Civ. 6026(RJW), 1999 WL 301691, at *10 (same), *disagreed with on other grounds by Fin. One Pub. Co. Ltd. v. Lehman Bros. Special Fin., Inc.,* 414 F.3d 325, 2005 WL 1619852, at *6 (2d Cir. July 12, 2005). Further, the Second Circuit has considered the preclusive nature of the Martin Act and determined that "principles of federalism and respect for state courts' interpretation of their own laws counsel against ignoring the rulings of those New York courts that have taken up the issue." *Castellano v. Young & Rubicam, Inc.,* 257 F .3d 171, 190 (2d Cir.2001) (upholding district court dismissal of a breach of fiduciary duty claim pursuant to the Martin Act).

***23** In light of myriad holdings supporting preemption, as well as this Court's recent decision in *Dujardin v. Liberty Media Corp.,* 359 F.Supp.2d 337 (S.D.N.Y.2005), the Court declines Plaintiff's request to follow the *Cromer* and *Scalp & Blade* decisions with respect to its common law claims sounding in negligence and breach of fiduciary duty, and accordingly dismisses Plaintiff's Ninth, Tenth, and Eleventh Claims For Relief as precluded by the Martin Act.

Sedona May Not Assert A Claim for Relief Pursuant to Section 15(c)(1) of the Exchange Act

In its Eighth Claim for Relief, Sedona seeks disgorgement of profits Defendants made from their allegedly fraudulent conduct, and restitution for the damages Sedona incurred as a result of such alleged conduct. Sedona asserts this claim under three separate sections of the Exchange Act: (1) Section 3(a)(4)-(5) of the Exchange Act, as amended 15 U.S.C. § 78c(a)(4)-(5), which provides the definitions for the terms "broker" and "dealer"; (2) Section 28(a) of the Exchange Act, as amended 15 U.S.C. 78bb(a), which states that the "rights and remedies provided by [the Exchange Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity"; and (3) Section 15(c)(1), as amended 15 U.S.C. § 78o(c)(1), which prohibits brokers and dealers from using fraudulent means to "effect any transaction in, or to induce or attempt to include the purchase or sale of, any security ... otherwise than on a national securities exchange of which it is a member."

Here, the Court need not address the issues of whether the Defendants in this action are "brokers" and/or "dealers" as defined by the statute, and if so, whether those Defendants have conducted transactions proscribed by Section 15(c)(1). The Second Circuit has made clear that Section 15(c)(1) "does *not* create a private cause of action." *Philips, Appel & Walden, Inc.,* 867 F.2d 776, 777 (2d Cir.1989). While there is case law in this district suggesting that a party may go forward on a Section 15(c)(1) cause of action, those decisions were rendered in the context of actions brought by the SEC, which is a government entity, rather than a private litigant. *See, e.g., SEC v. Tanner,* No. 02 Civ. 0306(WHP), 2003 WL 21523978 (S.D.N.Y. July 3, 2003); *SEC v. Follick,* No. 00 Civ. 4385(KMW)(GWG), 2002 WL 31833868 (S.D.N.Y. Dec. 18, 2002). The Court therefore dismisses Sedona's eighth cause of action in its entirety, with prejudice.

Further, to the extent Sedona seeks disgorgement solely as a remedy under its federal securities fraud claims, since the Court has dismissed the underlying claims as to certain Defendants, Sedona may not seek such remedy as to those Defendants on its current pleading. *See Follick,* at *8 ("As for the possibility of disgorgement, the appropriateness of this remedy is properly determined only in the event [a defendant] is found liable for the violations of the securities laws.").

Plaintiff's Motions to Lift the PSLRA Discovery Stay are Denied as Moot

***24** Also before the Court are Plaintiff's three separate motions to lift the automatic discovery stay imposed under the PSLRA during the pendency of a motion to dismiss. Pursuant to the PSLRA,

> In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

15 U.S.C.A. § 78u-4(b)(3)(B) (West 2005). The instant opinion and order resolves all of the pending motions to dismiss. Accordingly, Plaintiff's motions to lift the PSLRA discovery stay are denied as moot.[FN14] *See, e.g., In re Sterling Foster & Co., Inc., Sec. Litig.,* 222 F.Supp.2d 216, 288 (E.D.N.Y.2002) (finding moot Plaintiff's motion to lift the PSLRA automatic discovery stay since there were no longer any pending motions remaining in the litigation).

> FN14. This Order denies as moot all of Plaintiff's motions to lift the PSLRA discovery stay, which have been docketed as numbers 155, 189, and 206.

Plaintiff's Request to Replead is Granted

The aforementioned defects in the Complaint may be cured if Plaintiff repleads certain claims for relief in accordance with the applicable pleading requirements. The Court is accordingly granting Plaintiff's request to replead, within 20 days from the date of this Opinion and Order, those claims and causes of action that have been dismissed without prejudice. *See, e.g., Olsen v. Pratt & Whitney Aircraft, A Div. of United Technologies Corp.,* 136 F.3d 273, 276 (2d Cir.1998) ("Plaintiffs whose complaints are dismissed pursuant to Rule 9(b) are typically given an opportunity to amend their complaint.")

CONCLUSION

For the foregoing reasons, Defendants' motions to dismiss Plaintiff's Claims for Relief are denied in part and granted in part as follows: (1) Defendant Ladenburg's motion to dismiss is granted as to Claims for Relief Three, Four, Seven, Eight, Nine, Ten, and Eleven, and denied as to Claims for Relief One, Two, Five, and Six; (2) Defendant Rhino's motion to dismiss is granted as to Claims for Relief Three, Four, Eight, and Eleven, and denied as to Claims for Relief One, Two, Five, Six, and Twelve; (3) the Amro Defendants' motions are granted as to Claims for Relief One, Three, Four, Five, Seven, Eight, and Eleven, and denied as to Claims for Relief Two, and Six; (4) Pershing's motion to dismiss is granted as to Claims for Relief Three, Four, and Eight, and denied as to Claims for Relief Two and Six; (5) Westminster's motion to dismiss is granted as to Claims for Relief Three, Four, and Eight, and denied as to Claims for Relief Two and Six; (6) Frankel's motion to dismiss is granted as to Claims for Relief Three, Four, and Eight, and denied as to Claims for Relief Two and Six; (7) Markham's motion to dismiss is granted as to Claims for Relief One, Three, Four, Five, Seven, Eight, and Eleven, and denied as to Claims for Relief Two and Six; (8) the UltraFinanz Defendants' motions to dismiss are granted as to Claims for Relief Two, Three, Four, Six, and Eight, and denied as to Claim for Relief Twelve; (9) the Batliner Defendants' motions to dismiss are granted as to as to Claims for Relief Two, Three, Four, Six, and Eight, and denied as to Claim for Relief Twelve; (10) Creon's motion to dismiss is granted as to all Claims for Relief asserted against it; (11) Badian's motion to dismiss is granted as to Claims for Relief Two, Three, Four, and Eight, and denied as to Claims for Relief One, Five, Six, and Twelve; (12) Tohn's motion to dismiss is granted as to Claims for Relief Two, Three, Four, and Eight, and denied as to Claims for Relief One, Five, Six, and Twelve; (13) Boris' motion to dismiss is granted as to as to Claims for Relief One, Three, Four, Five, Seven, and Eight, and denied as to Claims for Relief Two, Six, and Twelve; (14) Vasinkevich's motion to dismiss is granted as to as to Claims for Relief Two, Three, Four, and Eight, and denied as to Claims for Relief One, Five, Six, and Twelve; (15) Smith's motion to dismiss is granted as to as to Claims for Relief One, Two, Three, Four, Five, Six, and Eight, and denied as to Claim for Relief Twelve; (16) Sims' motion to dismiss is granted as to all Claims for Relief asserted against him, except for Claim for Relief Twelve, which is denied; and (17) Hassan's motion to dismiss is granted as to as to Claims for Relief Two, Three, Four, Six, Alexander and Green PC, and Grant Thornton LLP) filed motions to dismiss, but settled with Plaintiff prior to issuance of this order.

FN2. Upon review of the written pleadings, it was the Court's opinion that Plaintiff had failed to respond to many of the Defendants' arguments. At oral argument, Plaintiff's counsel cited to those portions of his pleadings which he considered responsive to the areas mentioned by the Court; the Court re-read those portions of Plaintiff's briefing and considered them fully in reaching this decision.

IT IS ORDERED that the motions of Defendant Buss and Defendants Hayes Street Management and Morley, Inc. to dismiss for lack of personal jurisdiction are GRANTED.

IT IS FURTHER ORDERED that the motions of Defendants Pfaff, Larson and Makov to dismiss for lack of personal jurisdiction are DENIED; the motions of Pfaff and Larson to dismiss for failure to state a claim upon which relief can be granted are DENIED, and the Court calls for further briefing on whether dismissal of their claims on FRCP 12(b)(6) grounds is warranted.

IT IS FURTHER ORDERED that the motion of Defendant Makov to dismiss for failure to state a claim upon which relief can be granted (FRCP 12(b)(6)) is GRANTED.

IT IS FURTHER ORDERED that the motion of the Presidio Defendants to dismiss for failure to state a claim upon which relief can be granted (FRCP 12(b)(6)) is PARTIALLY DENIED and PARTIALLY GRANTED. The following claims against Presidio are dismissed: constructive trust (Claim 4); violations of §§ 12, 15 and 20(a) of the Securities Exchange Act (a portion of Claim 5); violation of the Investment Advisers Act (Claim 6); professional negligence (a portion of Claim 7); breach of contract (Claim 9); unjust enrichment (Claim 10); rescission (Claim 11); and violation of the Washington Criminal Profiteering Act (Claim 12). The following claims against Presidio will not be dismissed: conspiracy (Claim 1); fraud/misrepresentation (Claim 2); breach of fiduciary duty (Claim 3); violations of § 10(b) and Rule 10b–5 of the Securities Exchange Act (a portion of Claim 5); violation of the Washington State Securities Act (Claim 7); and negligent misrepresentation (a portion of Claim 8).

***2** IT IS FURTHER ORDERED that the Plaintiff will not be granted leave to further amend those claims dismissed pursuant to FRCP 12(b) (6), based on the Court's findings that further amendment would be both futile and not in the interests of justice or judicial economy.

IT IS FURTHER ORDERED that Plaintiff's motion for partial summary judgment is DENIED.

IT IS FURTHER ORDERED that the trial date of May 14, 2008 is STRICKEN; the remaining parties are directed to file an updated Joint Status Report by May 12, 2008.

Background

On February 13, 2004, this Court granted in part and denied in part the motions of the defendants to dismiss Plaintiff's original complaint. *Swartz v. KPMG et al.,* 402 F.Supp.2d 1146 (W.D.Wash.2004) (*"Swartz I"*); Dkt. No. 97. Plaintiff appealed both the order of dismissal and the Court's refusal to permit him leave to amend. The Ninth Circuit affirmed the majority of the ruling ("[w]ith the exception of its holding that the allegations in the complaint ruled out 'reasonable reliance' as a matter of law, the district court did not err in *Swartz I* and we adopt its decision in large measure"), but ruled that Plaintiff should be granted leave to amend his state law claims, specifically those sounding in fraud. *Swartz v. KPMG et al.,* 476 F.3d 756 (9th Cir.2007) (*"Swartz II"*).

Plaintiff responded to that reprieve with a 133–page, 437–paragraph document, adding a host of new defendants and a plethora of new causes of action. (Dkt. No. 184.) The following factual allegations are drawn from Plaintiff's Third Amended Complaint ("TAC"), filed October 9, 2007:

In 1999, Plaintiff Theodore C. Swartz realized profits of some $18 million from the sale of a business. (¶ 122.) Plaintiff's broker contacted former defendant KPMG, a large accounting firm, and KPMG in turn approached Plaintiff about investing in the Bond Linked Issue Premium Structure ("BLIPS") program. (*Id.*) KPMG introduced Plaintiff to Defendant Presidio Growth, LLC. ("PG, LLC," ¶ 131.) Presidio

Growth provided Plaintiff with a Strategic Investment Funds Confidential Memorandum ("Confidential Memorandum") in August 1999, which indicated that Presidio Growth was a registered investment advisor whose parent company was Defendant Presidio Advisory Services, LLC. (*Id.*) The Confidential Memorandum named Presidio Growth as the Fund Manager that would seek to provide investors "with a high total return" through a three-stage, seven-year investment program that sought to "exploit trading opportunities in the markets for foreign debt securities and currencies[.]" (¶ 132.) According to the prospectus in the Confidential Memorandum, this would be accomplished by utilizing a high-degree of leverage produced by a loan with an above-market interest rate. (¶ 133.)

On August 24, 1999, Presidio formed Longs Strategic Investments, LLC (Longs) as a Delaware LLC, to serve as "the vehicle through which Swartz participated in the investment program." (¶ 136.) Presidio Advisory, LLC created Presidio Growth and Presidio Resources, LLC to serve as the Managing Member of Longs, which would "direct and control a 'Strategic Investment Fund' partnership specific to each BLIPS client." (¶ 277.) Presidio also hired a law firm (former defendant Walter Conston Alexander & Green PC) to organize Gascoyne Ventures, LLC ("Gascoyne"), which was owned entirely by Plaintiff. (¶ 137.) Presidio Resources made an initial cash contribution to Longs of $140,000, Presidio Growth as Managing Member contributed $15,554, and Gascoyne contributed $54.4 million, which included a $1.4 million cash contribution from Plaintiff and a $53 million loan obtained through Defendant Deutsche Bank AG. ("DB") (¶¶ 140, 153–54.)

***3** In its Engagement Letter with Plaintiff, sent September 1, 1999, KPMG described Presidio's general role in the BLIPS investment program: "KPMG understands that Client (Swartz) intends to engage Presidio Advisors, LLC to provide Client with investment advisory services and trading strategies with respect to the foreign exchange contracts entered into pursuant to the [BLIPS program]. Presidio will assist Client in structuring the requisite financing package by advising clients as to the structure of the financing arrangement [.]" (¶¶ 124–25.) The Engagement Letter also stated: (1) that Presidio will "act as Investment Advisor to the limited partnership ... and will facilitate the purchase of foreign currency contracts and other financial instruments;" (2) that the "Client has independently determined that there is a reasonable opportunity for Client to earn a reasonable pre-tax profit from the Investment Program and this determination has been confirmed by Presidio and/or other investment advisors," (¶ 126);" and (3) that "[a]ny tax opinion issued by KPMG ... would provide that with respect to the tax consequences describedin the opinion, there is a greater than 50 percent likelihood that those consequences will be upheld if challenged by the [IRS]." (¶ 126.)

In a document dated September 30, 1999, DB and Gascoyne entered an Account Control Agreement that put the investment account "under the sole dominion and control of Deutsche Bank AG," superseding the authority over the investment account that would have been exercised by either Gascoyne or Presidio. (¶¶ 141–46.) On October 12, 1999, Presidio Growth and Gascoyne executed the Agreement of Longs Strategic Investment Fund, LLC ("Longs Agreement"), which allocated the Net Profits and Net Losses according to the class of the membership in Longs and the amount contributed. (¶ 153.)

After Gascoyne contributed the accumulated funds into Longs, Longs deposited the money into an account controlled by DB (¶ 170) and a series of foreign currency and stock transactions were undertaken. (¶¶ 171–72.) Presidio then employed an accounting firm (former defendant Grant Thornton LLC) to prepare the tax returns for Longs; the firm reported a tax loss based on the foreign currency and stock transactions and also both a management fee of $550,000 to Presidio and various fees paid to DB. (¶ 175.) In their preparation of the schedule K–1, the accounting firm indicated that there "was a capital loss of $20,956,969" for Gascoyne. (¶¶ 175–77.)

On December 31, 1999, Swartz received the tax opinion letters from KPMG and a law firm (former defendant Brown & Wood) stating that there was greater than 50% likelihood that the tax outcome from the BLIPS program would be upheld if challenged by the Internal Revenue Service ("IRS"). (¶ 178.) Plaintiff also received "opinion letters regarding the investment program" created by the defendant law firm of Holland & Hart LLP ("H & H"). Plaintiff alleges that H & H (along with other law firms employed by Defendants) were "partners in the joint venture" and not the independent legal advisers that Presidio represented them to be. (¶¶ 245–46.) Plaintiff alleges that all the defendants "knew the form and substance of these opinion letters long before they were ever provided to Plaintiff" and "that the opinion letters contained material misrepresentations of fact" and "contained opinions that were phony." (¶¶ 245–247.) He further claims that H & H could not be relied upon to provide an independent opinion, that "all of the joint venture partners knew" this, and that no one ("including anyone from any of the law firms") told Plaintiff. (¶ 255.)

***4** Plaintiff bases his claims against Presidio on alleged misrepresentations made in three documents:

1. The *KPMG Engagement Letter* from September 1, 1999 wherein Presidio confirmed that there was a reasonable opportunity for Swartz to earn a reasonable pre-tax profit. (¶ 126.) Plaintiff alleges that he relied on this representation, among others, in deciding to enter into the BLIPS investment program. (¶ 128; *see* Exhibit 2, Parts 4–5.)

2. The *Confidential Memorandum* from August 1999 representing that the investment plan consisted of "investment pools" which would use premium loans for leverage, that the program would take seven years, and that there was a reasonable opportunity for the Investor (Swartz) to earn a reasonable pre-tax profit. (¶¶ 132, 210.) Plaintiff alleges these are misrepresentations because the investment funds were only designed to create the appearance of economic substance for the BLIPS program and that the chance of an investor achieving a profit was "remote." (¶ 212.)

3. The *Longs Agreement* between Presidio Growth, and Gascoyne Ventures that purported to allocate the net profits and losses. (¶ 153.)

Plaintiff alleges that the defendants, including Presidio Defendants, designed BLIPS to deceive investors into thinking that it would provide a legitimate vehicle to earn money, but knew the "investment program lacked economic substance" because the loan proceeds that were supposed to be integral to the program were never made available for investment. (¶ 180.) Plaintiff also alleges that the Presidio Defendants fraudulently took management fees from Plaintiff's initial contribution, despite not having the alleged loan funds under their control to invest. (*Id.*) Plaintiff alleges further that the fraudulent action caused injury "in his business and property in that he has paid Defendants fees and has incurred losses in excess of $2 million[.]" (¶ 318.)

Defendant Steven Buss (along with co-defendants Makov, Pfaff and Larson) is alleged to be a principal and agent of all the Presidio entities (¶ 114), which are further alleged to be "mere shell companies." (¶¶ 117–18.) Plaintiff's TAC contains a 66–item "list of contacts" with the forum state (¶¶ 27–93)—Buss is named in five of them:

1. A letter to Plaintiff concerning wire transfer instruction (¶ 77)

2. A fax concerning a Longs contribution by Gascoyne (¶ 78)

3. Two faxes to DB on which Plaintiff was copied (¶¶ 87, 88)

4. A cover letter to Gascoyne attaching the Longs Schedule K–1 form (¶ 89).

There is one other mention of Buss in the TAC: on November 29, 1999, as Managing Director of Presidio Growth and Presidio Advisory Services, he dissolved Longs and terminated the DB Line of Credit. (¶ 173.)

Plaintiff alleges twelve causes of action against all of the defendants: 1) a "Joint Venture Conspiracy" to defraud Plaintiff (¶¶ 307–18); 2) Fraud and Misrepresentation (¶¶ 319–39); 3) Breach of Fiduciary Duty and Aiding and Abetting Breach of Fiduciary Duty (¶¶ 340–58); 4) Constructive Trust (¶¶ 359–61); 5) Violations of Sections 10(b), 12, 15, and 20(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b–5 (¶¶ 363–84); 6) Violation of the Investment Advisers Act of 1940 and Aiding and Abetting Violation of the Investment Advisers Act of 1940 (¶¶ 385–90); 7) Violation of the Washington State Securities Act (¶¶ 391–403); 8) Professional Negligence and Negligent Misrepresentation (¶¶ 404–11); 9) Breach of Contract (¶¶ 412–18); 10) Unjust Enrichment (¶¶ 419–26); 11) Rescission (¶¶ 427–30); and 12) Violation of the Washington Criminal Profiteering Act (¶¶ 431–37).

Discussion

I. Standard of review

***5** In a motion to dismiss under F.R.C.P. 12(b), all well-pleaded allegations of material fact in the complaint are taken as true and construed in the light most favorable to the nonmoving party. *Zimmerman v. City of Oakland,* 255 F.3d 734, 737 (9th Cir.2001). A complaint should not be dismissed unless it offers no set of facts in support of the claim that would entitle the plaintiff to relief. *No. 84 Employer–Teamster Joint Council v. America West Holding Corp.,* 320 F.3d 920, 931 (9th Cir.2003). However, conclusory allegations and unwarranted inferences are insufficient to defeat a motion to dismiss. *Warren v. Fox Family Worldwide, Inc.,* 328 F.3d 1136, 1139 (9th Cir.2003) (citations omitted). A plaintiff's obligation in his pleadings extends beyond merely repeating the elements of a cause of action, and must provide the factual grounds for his entitlement to relief. *Bell Atlantic Corp. v. Twombly,* — U.S. ——, —— – ——, 127 S.Ct. 1955, 1964–65, 167 L.Ed.2d 929 (2007). Also, a court is not required to accept facts in the complaint that contradict facts in documents referred to in the complaint. *Steckman v. Hart Brewing Inc.,* 143 F.3d 1293, 1295–96 (9th Cir.1998) (citation omitted).

Concerning Plaintiff's motion, summary judgment is not warranted if a material issue of fact exists for trial. *Warren v. City of Carlsbad,* 58 F.3d 439, 441 (9th Cir.1995), *cert. denied,* 516 U.S. 1171, 116 S.Ct. 1261, 134 L.Ed.2d 209 (1996). The underlying facts are viewed in the light most favorable to the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). "Summary judgment will not lie if ... the evidence is such that a reasonable jury could return a verdict for the nonmoving party." *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). The party moving for summary judgment has the burden to initially show the absence of a genuine issue concerning any material fact. *Adickes v. S.H. Kress & Co.,* 398 U.S. 144, 159, 90 S.Ct. 1598, 26 L.Ed.2d 142 (1970). This can be done by either producing evidence negating an essential element of plaintiff's claim, or by showing that plaintiff does not have enough evidence of an essential element to carry its ultimate burden at trial. *Nissan Fire & Marine Ins. Co. v. Fritz Companies, Inc.,* 210 F.3d 1099, 1103 (9th Cir.2000). However, once the moving party has met its initial burden, the burden shifts to the nonmoving party to establish the existence of an issue of fact regarding an element essential to that party's case, and on which that party will bear the burden of proof at trial. *Celotex Corp. v. Catrett,* 477 U.S. 317, 323–24, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986). To discharge this burden, the nonmoving party cannot rely on its pleadings, but instead must have evidence showing that there is a genuine issue for trial. *Id.* at 324.

There are certain aspects of the motions to dismiss for which a common analysis and disposition is appropriate. Those elements will be discussed and disposed of first.

II. Judicial notice

***6** Plaintiff requests that the Court take judicial notice that on September 10, 2007, David Amir Makov, a managing member of Presidio and a defendant in this case, entered a plea of guilty to the charge of conspiracy to violate the Internal Revenue Code with other Presidio actors. Plaintiff requests that the Court take judicial notice of the Superseding Information filed against Makov, the transcript of his guilty plea ("the Allocution") and assorted other documents related to Makov's criminal conviction,[FN3] and relies on references to the Makov plea and superseding information repeatedly in support of the arguments in his briefs. Defendants argue that references to the contents of the Makov Allocution and Superseding Information should be stricken as they are materials outside the pleadings, and are not judicially noticeable. Plaintiff also requests that the Court take judicial notice of the 2005 Senate Report from hearings held in November 2003, entitled "The Role of Professional Firms in the U.S. Tax Shelter Industry."

> FN3. None of these documents are referenced in Plaintiff's TAC.

The Court will consider the contents of the 2005 Senate Subcommittee Report because it is referenced in the TAC. It is proper in ruling on the sufficiency of a complaint to consider exhibits attached to the complaint and matters properly the subject of judicial notice. *See Hal Roach Studios v. Richard Feiner & Co., Inc.,* 896 F.2d 1542, 1555 n. 19 (9th Cir.1990); *Lee v. City of Los Angeles,* 250 F.3d 668, 688–89 (9th Cir.2001).

The contents of the Makov allocution and the Superseding Information, however, are beyond the proper scope of what the Court may consider. Neither document was attached to nor referenced in the TAC, and, while the existence of the plea is properly subject to judicial notice, the contents of the documents Plaintiff submitted are not judicially noticeable for the purpose for which Plaintiff introduces them; i.e., the truth of the matters contained therein.

Public records are subject to judicial notice. *Lee v. City of Los Angeles, supra.* Under Federal Rule of Evidence ("FRE") 201(a)-(b), a court may take judicial notice of adjudicative facts "not subject to reasonable dispute [.]" In *Lee,* the Ninth Circuit reversed the trial court, not for taking judicial notice of the existence of a particular hearing, but for taking judicial notice of the facts contained in those noticeable matters of public record. 250 F.3d at 689–90. Plaintiff has not established that the contents of either the Superseding Information or the Allocution are undisputed. This Court will take judicial notice of the existence of Makov's guilty plea, but not of the truth of the matters stated within those materials. *See Wyatt v. Terhune,* 315 F.3d 1108, 1114 (9th Cir.2003) (concluding that taking judicial notice of the findings of fact from another case exceeds scope of FRE 201).

III. Statute of limitations

Almost all the remaining defendants (with the exception of Defendant Buss, whose primary theory of dismissal is lack of personal jurisdiction) attack Plaintiff's lawsuit on statute of limitation grounds.

***7** Plaintiff's TAC combines state and federal causes of action. In Washington, the statute of limitations for actions seeking relief based on fraud is three years from the date of discovery. *See Hudson v. Condon,* 101 Wash.App. 866, 872, 6 P.3d 615 (2000) (citing RCW 4.16.080(4)). The court can infer actual knowledge of the fraud if the aggrieved party, through due diligence, could have discovered the fraud. *Sherback v. Estate of Lyman,* 15 Wash.App. 866, 868–69, 552 P.2d 1076 (1976) (citation omitted). Thus, the statute of limitations clock is triggered when the aggrieved party discovers, or should have discovered, the facts of the fraud and sustains some damage as a consequence. *First Maryland Leasecorp. v. Rothstein,* 72 Wash.App. 278, 283, 864 P.2d 17 (1993). The discovery rule tolls the date of accrual until the plaintiff " 'knows or ... should have known' all the facts necessary to establish a legal claim." *Crisman v. Crisman,* 85 Wash.App. 15, 20, 931 P.2d 163 (1997) (citation omitted). This rule can be applied when a defendant "has fraudulently concealed a material fact from a plaintiff, depriving the plaintiff of the knowledge of the accrual of the cause of action" (*Burns v. McClinton,* 135 Wash.App. 285, 299–300, 143 P.3d 630 (2006) (citation omitted)), and can be applied to both tort and contract claims. *See Wm. Dickson Co. v. Pierce County,* 128 Wash.App. 488, 495–96, 116 P.3d 409 (2005).

Plaintiff's federal claims all sound in fraud. The federal statute of limitations for securities fraud under the Exchange Act begins to run when a plaintiff has actual or inquiry notice of the fraudulent misrepresentation. *Reeves v. Teuscher,* 881 F.2d 1495, 1500–01 (9th Cir.1989) (citation omitted). The Ninth Circuit has adopted the "inquiry-plus-reasonable-diligence test." *Betz v. Trainer Wortham & Co., Inc.,* 519 F.3d 863, 2008 WL 495890 *11 (9th Cir.2008). A plaintiff is on inquiry notice of a securities fraud claim when "there exists sufficient suspicion of fraud to cause a reasonable investor to investigate the matter further." *Id.* The facts constituting inquiry notice "must be sufficiently probative of fraud—sufficiently advanced beyond the stage of mere suspicion ... to incite the victim to investigate." *Id.* (citation and internal quotation marks omitted). Once the court determines that a plaintiff was on inquiry notice, it then determines whether the objective investor, in the exercise of reasonable diligence, should have discovered the facts constituting the alleged fraud. *Id.*

The Ninth Circuit has held that the issue of whether a plaintiff knew or should have known of a cause of action in the federal securities context presents a question for the trier of fact. *Volk v. D.A. Davidson,* 816 F.2d 1406, 1417 (9th Cir.1987) (citation omitted); *see also Betz,* 519 F.3d 863, 2008 WL 495890 *8 (reversing trial court's grant of summary judgment because issue of material fact existed as to whether plaintiff was on inquiry notice of fraud). The Ninth Circuit has a high bar for deciding the inquiry notice issue as a matter of law, holding that it is appropriate only when "uncontroverted evidence irrefutably demonstrates plaintiff discovered or should have discovered the fraudulent conduct." *Gray v. First Winthrop Corp.,* 82 F.3d 877, 881 (9th Cir.1996) (citation and internal quotation marks omitted) (reversing trial court's grant of summary judgment); *see also S.E.C. v. Seaboard Corp.,* 677 F.2d 1301, 1309–10 (9th Cir.1982) ("question of notice of fraud is for trier of fact, [and the] party seeking summary disposition has extremely difficult burden[.]")

***8** The issue of when Plaintiff discovered or should have discovered the fraud which he alleges in his complaint is hotly disputed. Defendants claim that Plaintiff had ample notice that something was amiss back in 1999 and 2000, with the occurrence of such events as the IRS notices announcing the questionable (and possibly criminal) nature of tax schemes such as BLIPS (Pltf. Response to H & H Motion, Isaacson Decl., Exs. 3 and 4) or the withdrawal of Plaintiff's accounting firm, Moss Adams, from preparation of his tax return based on its doubts about the legitimacy of the claimed BLIPS deductions. Plaintiff points in turn to countervailing communications from the defendants assuring him of the continuing viability of the program and of their confidence that the scheme would withstand IRS scrutiny, as well as allegedly perjured Senate testimony from as late as July 2005 (*Id.,* Ex. 2, p. 24) to buttress his argument that he cannot be found as a matter of law to have been on inquiry notice for statute of limitation purposes during the period when the BLIPS scheme was actually being promoted and played out.

The Court agrees with Plaintiff to the extent that it finds the issue of when he received sufficient inquiry notice for statute of limitations purposes to be a question of fact appropriate for the trier of fact. To that end, and in the interests of judicial economy, the Court will consider bifurcating the case (should it move forward towards trial), permitting discovery only on the notice issue, then conducting a separate and preliminary trial on the statute of limitations issue. Defendants' argument that the Court can find in their favor on statute of limitations grounds as a matter of law is rejected and that portion of their motions is denied.

IV. Specially-appearing Defendants and Defendant Makov

A. Defendants Larson, Pfaff, Hayes Street Management and Morley, Inc.

The Presidio Defendants argue that specially-appearing Defendants John Larson, Robert Pfaff, Hayes Street Management ("Hayes"), and Morley, Inc. ("Morley") should have the claims against them dismissed for lack of personal jurisdiction. Specifically, they argue that Plaintiff has failed to allege any wrongdoing on the part of either Morley or Hayes and that Plaintiff has failed to allege any connection to Washington for Defendants Larson and Pfaff.

Plaintiff bears the burden of establishing that the Court has personal jurisdiction over Defendants. *Fields v. Sedgwick Associated Risks, Ltd.,* 796 F.2d 299, 301 (9th Cir.1986) (citation omitted). Section 27 of the Exchange Act grants jurisdiction to the federal courts and provides for venue and service of process. *Touche Ross & Co. v. Redington,* 442 U.S. 560, 577, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979); *see* 15 U.S.C. § 78aa. The Exchange Act provides exclusive jurisdiction in district courts for claims brought under its provisions. *Clark v. Watchie,* 513 F.2d 994, 997 (9th Cir.1975). Because the Exchange Act is a federal law within the meaning of 27 U.S.C. § 1331, claims brought under it establish general jurisdiction over the cause. *Sec. Investor Protection Corp. v. Vigman,* 764 F.2d 1309, 1316 (9th Cir.1985). The relevant jurisdictional question is thus whether the defendant has sufficient contacts with the United States, not the forum state. *See Nelson v. Quimby Island Reclamation Dist. Facilities Corp.,* 491 F.Supp. 1364, 1378 (N.D.Cal.1980). Therefore, if a defendant has minimum contacts with the United States, § 27 of the Exchange Act confers personal jurisdiction over the defendant in any federal district court. *Vigman,* 764 F.2d at 1316. Because the specially-appearing Defendants had contacts within the boundaries of the United States, the "minimum contacts" required to satisfy the federal court's exercise of power over them are present. *See Mariash v. Morrill,* 496 F.2d 1138, 1143 (C.A.N.Y.1974) (where the defendants "reside within the territorial boundaries of the United States, the 'minimal contacts' [required] are present").

***9** Despite the existence of personal jurisdiction over the Hayes and Morley defendants, Plaintiff still fails to state a claim against either entity upon which relief may be granted. At most Plaintiff has attempted to allege a conspiracy claim against them. Although in a conspiracy allegation a plaintiff need only "set out a generalized statement of facts from which [a] defendant will be able to frame a responsive pleading," he must "set out more than mere bald allegations of a claim." *Vigman,* 764 F.2d at 1318. Defendant fails to do this as to the Morley or Hayes entities.

Swartz's only mention of Morley is that it is the "sole member" of Presidio Advisory Services and "is a company of unknown origin." (TAC ¶ 107.) Likewise, the sole reference to Hayes is that it is a corporation of "unknown origin" and a member of Presidio Growth. (TAC ¶ 108.) Plaintiff bases his assertion of federal jurisdiction over the entities only on their alleged participation in the marketing of BLIPS in Washington. (TAC ¶ 22.) Plaintiff fails to assert that either entity committed any wrongdoing or what these entities' respective roles in the alleged scheme were. Merely lumping the Hayes and Morley defendants together with "Presidio" is insufficient, as this Court and the Ninth Circuit have previously pointed out. The motion to dismiss Hayes and Morley will be granted.

The general jurisdiction provision of the Exchange Act cited *supra* is sufficient to defeat the motions to dismiss Defendants Pfaff and Larson for lack of personal jurisdiction. There is no allegation that they are not United States residents and thus "minimal contacts" for purposes of federal securities fraud jurisdiction are present. It is not clear from Presidio's briefing which portions of their Pfaff–Larson arguments (Mtn to Dismiss, pp. 17–21) are directed at the jurisdiction issue and which are directed to dismissal on 12(b)(6) grounds.[FN4] It is the Court's intention, with respect to these two individual Defendants, to call for a further round of briefing on the issue of dismissal for failure to state a claim upon which relief may be granted.

> FN4. By way of example, in the section entitled "Plaintiff Does Not Allege Any Wrongful Acts by the Specially Appearing Defendants"—which suggests a 12(b)(6) analysis—Presidio argues that "[w]ith respect to the individual defendants John Larson and Robert Pfaff, ... none [of Plaintiff's factual allegations] has anything to do with Washington State or Swartz" (Mtn to Dismiss, p. 17), which suggests an argument aimed at the jurisdictional issue.

Within one week from the filing of this order, defense counsel for Presidio are directed to file a six-page brief addressing the issue of 12(b)(6) dismissal relative to Pfaff and Larson. This briefing may not include any "me, too" arguments (joining in the arguments or analysis of any of the other defense briefing) but must state concisely the grounds on which Defendants Pfaff and Larson contend that Plaintiff has failed to state a cause of action against them. Plaintiff's response, which is also limited to six pages, is due seven days after the defense brief is filed and must likewise stand on its own merits without reference to previous briefing. There will be no reply brief.

In their briefing, the parties are directed to respond to a question which they were invited to address at oral argument but failed to do: namely, on what basis are these defendants alleged to be liable in their *individual* capacities (as opposed to simply being representatives of the various Presidio entities)?

B. Defendant Buss

***10** Plaintiff acknowledges that Buss is not subject to general jurisdiction (which requires "substantial and continuous contacts," but attempts to establish specific jurisdiction over this defendant individually on two separate but related theories.

The elements which must be satisfied to assert specific jurisdiction require positive answers to the following questions:

> I. Did Buss "purposely avail" himself of the privilege of doing business in this jurisdiction?
>
> II. Do Plaintiff's injuries "arise out of or relate to" Buss's actHivities?
>
> III. Would the assertion of jurisdiction "offend traditional notions of fair play and substantial justice"?

Burger King Corp. v. Rudzewicz, 471 U.S. 462, 472–78, 105 S.Ct. 2174, 85 L.Ed.2d 528 (1985).

Plaintiff's attempt to establish personal jurisdiction over Defendant Buss suffers from two problems. The first is that, although he states "on information and belief" that the Presidio entities are "mere shell companies" (TAC ¶ 118), Plaintiff makes no allegations that the Presidio Defendants are the "alter ego" of Buss, nor does he make any arguments or requests for the Court to pierce the corporate veil and hold Buss personally liable for the actions of the Presidio Defendants.

Second, even if Plaintiff had plead "alter ego" liability, his allegations regarding Buss's actions do not satisfy the threshold requirements for personal jurisdiction. The communications which Plaintiff cites in the TAC do not support his theory that Buss "availed" himself of the privilege of doing business in Washington by making "fraudulent inducements" from California to Washington (Plaintiff's first theory of personal jurisdiction). The documents are more accurately described as "ministerial communications"—transmitting transactional documents for Plaintiff's records, often merely copying him on communications with Deutsche Bank. Moreover, almost all of them post-date Plaintiff's decision to invest in the BLIPS scheme and thus cannot be characterized as "inducements" of any kind (the "smoking gun" letter which Plaintiff cites—an October 7, 1999 letter to Gascoyne/Attn: T.C. Swartz—merely says *"In the event you choose to invest* in [Longs], please sign the enclosed wire transfer instructions ..."; Swartz Decl., Ex. 5; emphasis supplied). The causal relationship between Buss's activities and Plaintiff's injuries is missing. Although Plaintiff clearly wants to tie Buss into BLIPS as a "control person," there are no allegations in the TAC which allege that Buss developed, marketed or promoted the product. So Plaintiff's first "personal jurisdiction" theory, that Buss "availed" himself of the privilege of doing business in this forum, is not persuasive.

Plaintiff proposes as an alternate theory that the Court employ the "effects" test enunciated in Calder v. Jones, 465 U.S. 783, 790, 104 S.Ct. 1482, 79 L.Ed.2d 804 (1984), which held that individual defendants' status as employees of a defendant business entity would not insulate them from liability where they had been "primary participants" in the alleged wrongdoing; "i.e., where the individual had 'control of, and direct participation in the alleged activities.' " *Wolf Designs, Inc. v. DHR Co.,* 322 F.Supp.2d 1065, 1072 (C.D.Cal.2004). In those circumstances, the "effects" of the individual's participation within the forum jurisdiction would be measured.FN5

> FN5. Buss attempts to attack this alternate theory on the grounds that it has been confined to certain kinds of tort allegations and that the 9th Circuit analyzes cases arising out of contractual relationships under a "purposeful availment" standard. *Schwarzenegger v. Fred Martin Motor Co.,* 374 F.3d 797, 802 (9th Cir.2004); *Dial Up Svcs v. Oregon,* 2007 U.S. Dist. LEXIS 89679 (D. Ariz. Nov. 27 2007). This is not a persuasive counter-argument in a complaint with combined contract and tort allegations.

***11** But Plaintiff runs into the same problem as in his "availment" argument—nothing in his allegations or in his documentary evidence establishes Buss as a "primary participant," a person in control of and directly participating in the fraudulent inducement at the heart of this complaint. Plaintiff is reduced to innuendo FN6 in his effort to portray Buss as a primary participant, but the evidence and the allegations contained in the TAC simply do not support this characterization.

> FN6. E.g., alluding to Buss's qualifications as a Certified Public Accountant when there is no indication he functioned in that capacity; referring to "Mr. Buss' falsely prepared K–1" when Buss isn't alleged to have prepared that document. (Pltf. Response to Buss Mtn, pp. 8, 17.)

Plaintiff has failed to satisfy the elements of specific jurisdiction with regard to this individual defendant, and Defendant Buss is entitled to have the complaint against him dismissed on that ground.

Regarding the actual claims alleged against him in the TAC, Defendant Buss both joins in the motions of his co-defendants and briefly lists some arguments of his own regarding the causes of action to which he has been joined. Having dismissed him from this suit on the grounds of lack of personal jurisdiction, the Court does not feel compelled to analyze the arguments on each individual claim vis a vis this defendant, with one exception.

As will become evident from the "Securities Exchange Act Claims" § V. E., *infra,* this Court finds that Plaintiff's federal securities claims under 10(b) and Rule 10b–5 against the Presidio Defendants survive the 12(b)(6) challenge. Jurisdiction under this federal statutory scheme is established generally, not specifically, and it is required only that a defendant have sufficient contacts with the United States (not the forum state) for a court to exercise jurisdiction. *Vigman,* 764 F.2d at 1316.

While the Court has no doubt that Defendant Buss has sufficient contacts with the United States to warrant the exercise of jurisdiction concerning this particular claim, this does little to avail Plaintiff of the relief he requests. As will be discussed in greater detail *infra,* there is a heightened pleading standard regarding allegations of fraud under the federal securities regulations. A plaintiff alleging that a defendant made a false or misleading statement in connection with the sale of a security must "(1) specify each statement alleged to have been misleading and the reason or reasons why the statement is misleading" and (2) "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)-(2). Plaintiff has identified some documents to which Buss's signature was affixed, but he has failed to plead with any particularity why the documents are misleading or state any facts which infer that Buss acted with the requisite scienter. Additionally, he has failed to allege that any action by Buss was instrumental in inducing him to enter into the investment scheme. Defendant Buss's 12(b)(6) motion with regard to the federal securities claim will therefore be granted.

Concerning the remainder of the claims against this defendant, the Court finds, for the same reasons cited *infra* for the dismissal of Plaintiff's causes of action against the other defendants (particularly Defendant Makov), that Plaintiff has also failed to adequately allege any of his claims against Defendant Buss as an individual.

V. Defendants' 12(b)(6) Motions to Dismiss/Motion for Summary Judgment

***12** The Court will now turn to a claim-by-claim analysis of Plaintiff's TAC and the remaining defendants.[FN7]

> FN7. Wherever used, the terms "Presidio" or "Presidio Defendants" encompass the following parties to the suit: Presidio Advisory Services, LLC; Presidio Growth, LLC; Presidio Resources, LLC; Presidio Volatility Management; and Presidio Financial Group.

A. Claim 1: Conspiracy

Plaintiff alleges that all the defendants were partners in a joint venture conspiracy to design, promote, market, and sell to investors, including Plaintiff, "abusive" tax shelters such as BLIPS. Under Washington law, an action for civil conspiracy lies "where there is an agreement by two or more persons to accomplish some purpose, not in itself unlawful, by unlawful means." *Sterling Business Forms, Inc. v. Thorpe,* 82 Wash.App. 446, 451, 918 P.2d 531 (1996) (citations omitted). Plaintiff must show this by clear and convincing evidence, and showing "[m]ere suspicion or commonality of interests is insufficient to prove a conspiracy." *All Star Gas, Inc., of Washington v. Bechard,* 100 Wash.App. 732, 740, 998 P.2d 367 (2000) (citations and internal quotation marks omitted). When the object of the alleged conspiracy is fraudulent, the plaintiff must meet the heightened pleading requirements under F.R.C.P. 9(b). *See Swartz II.* The liability of co-conspirators is joint and several, making each defendant liable for acts committed by any of the parties in furtherance of the common design. *Sterling Business,* 82 Wash.App. at 454, 918 P.2d 531.

Plaintiff's conspiracy claim as to the Presidio Defendants survives. Although Plaintiff fails to point to an actual agreement between Presidio and any other defendant to defraud Swartz, this is not fatal to his civil conspiracy claim. Washington courts hold that because the evidence of the conspiracy is typically in control of the alleged conspirators, "conspiracy is usually susceptible of no other proof than that of circumstantial evidence." *Sterling Business, Id.* at 453–54, 918 P.2d 531 (citations omitted); *see also Lyle v. Haskins,* 24 Wash.2d 883, 899, 168 P.2d 797 (1946) (holding that it is sufficient to show proof of concert of action or other circumstances giving rise to a "natural inference" that the acts were done pursuant to a common design.)

In the case of Presidio, the TAC and the Senate Report it references provide adequate circumstantial evidence to properly allege that Presidio participated in a conspiracy to defraud Swartz. The pleading indicates that Presidio and its agents developed the BLIPS investment program and participated in the marketing, and implementation of 186 BLIPS transactions related to 186 KPMG clients. The Engagement Letter from KPMG expressly references and explains Presidio's role in the investment scheme. Plaintiff adequately pleads that several of the terms of the agreements between Swartz and Presidio were false, and the meetings cited by Swartz in April and May of 1999, prior to the onset of the disputed transactions, indicate that both KPMG and Deutsche Bank were aware that the terms presented to Swartz were false. These pleadings provide circumstantial evidence that a conspiracy to defraud Swartz existed.

The Ninth Circuit ruled that in order to plead a conspiracy claim, Plaintiff must explain in sufficient detail the roles of each defendant in the alleged conspiracy to defraud. *See* Swartz II, 476 F.3d at 765. This Court finds that he has accomplished that in regards to Presidio in the TAC, describing in detail the role Presidio and some of its entities played in the investment scheme. Reviewing the TAC in the light most favorable to Plaintiff, he has alleged sufficient facts for a finder of fact to conclude that Presidio may have participated in the alleged conspiracy; therefore, Plaintiff's civil conspiracy claim against the Presidio Defendants will not be dismissed on 12(b)(6) grounds.

***13** Plaintiff's claim for conspiracy against Defendant Makov fails because it does not meet the heightened pleading requirements of FRCP 9(b). *Vess v. Ciba–Geigy Corp. USA,* 317 F.3d 1097, 1107 (9th Cir.2003) (claim for conspiracy to commit fraud subject to FRCP 9(b) pleading requirements). FRCP 9(b) requires that Plaintiff allege "the who, what, when, where, and how" of the misconduct charged. *Cooper v. Pickett,* 137 F.3d 616, 627 (9th Cir.1997). Plaintiff has failed to identify any allegedly false statements made to Plaintiff by Makov and has offered no specific allegations detailing Makov's contribution to the conspiracy. The particularity requirements for an averment of fraud cannot be met by general allegations concerning misconduct of the " Presidio Defendants." *Swartz II,* 476 F.3d at 764–765 ("Rule 9(b) does not allow a complaint to merely lump multiple defendants together but requires plaintiffs to differentiate their allegations when suing more than one defendant and inform each defendant separately of the allegations surrounding his alleged participation in the fraud.") (citation and internal quotation marks omitted). Defendant Makov is entitled to have the conspiracy allegation against him dismissed for failure to state a claim upon which relief can be granted.

B. Claim Two: Fraud/misrepresentation

Under FRCP 9(b), "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." *See Vess,* 317 F.3d at 1107. The Ninth Circuit's *Swartz II* opinion is replete with warnings to Plaintiff to refrain from general conclusory allegations against "the defendants" in the aggregate "without any stated factual basis." 476 F.3d at 765.

Plaintiff bases his claims of fraud and negligent misrepresentation against Presidio on several alleged misrepresentations contained in the Confidential Memorandum and statements related to Presidio from other defendants. The primary misrepresentations specific to Presidio include the statement in the Confidential Memorandum wherein Presidio represents that BLIPS presented a reasonable opportunity to earn a pre-tax profit; Presidio's statement that BLIPS was a 7–year investment plan based on a high interest loan providing leverage; and Presidio's statement that it acted independently from Deutsche Bank.

In the instant complaint, the Court finds that Plaintiff pleads sufficient facts to support a fraud claim against Presidio. Swartz pleads with particularity that Presidio misrepresented the viability of the BLIPS investment program, the duration of the program, the role of Deutsche Bank's loan and how much control DB exercised in the program, and the calculation of fees. (TAC ¶¶ 15, 132, 207, 210, 214, 232, 233, 236, 237, 266.)

The Court finds that Plaintiff's TAC provides specific representations from Presidio alleged to be false; when they were made, and to whom; reasons why the alleged misrepresentations were false; and the factual circumstances in which they were made.

***14** The Presidio Defendants also attack the adequacy of Plaintiff's fraud-based pleadings on the ground that he is unable to demonstrate the requisite element of reliance. They make the argument that express disclaimers within the agreements with Presidio preclude this Court from finding reasonable reliance on their alleged misrepresentations. Presidio argues that these "express disclaimers" of reliance on Presidio for tax or investment advice, coupled with Swartz's affirmative representations as to his business sophistication and reliance on his own independent advisers, preclude this Court from finding reasonable reliance as a matter of law.

In the Confidential Memorandum, there were provisions that stated that nobody involved in the Longs Fund was providing any tax advice and that prospective investors "should consult their own tax advisers." (Presidio Mtn., Bauer Decl., Ex. A at 17.) The Limited Liability Agreement stated, under "Investment Representations," that the signing member has had an opportunity to question the Managing Member and that the signer has sufficient experience to "evaluate the merits and risks" involved in investing into Longs. (Bauer Decl., Ex. B at 11.) FN8

> FN8. Swartz also signed a Subscription Agreement with Presidio Growth on September 30, 1999 to purchase an interest in the Strategic Investment Fund (Bauer Decl, Ex. C.) which contained a disclaimer that "[t]he Investor has relied ... solely on the information contained in the Confidential Memorandum ... and the Limited Liability Agreement, and the Investor is not relying on the Managing Member ... with respect to individual and partnership tax and other economic considerations involved in this investment." (*Id.* at 3–4.) This agreement was not explicitly referenced in the TAC; however, a court may consider a writing referenced in a complaint, but not incorporated into it if the complaint relies on it and its authenticity is unquestioned. Lee, 250 F.3d at 688. Because Plaintiff bases Presidio's liability on alleged misrepresentations in "oral and written contracts," the Court has considered the contents of the Subscription Agreement in this 12(b) (6) motion.

Presidio's arguments regarding the lack of reasonable reliance based on the disclaimers are ultimately unpersuasive. First, the Ninth Circuit, in reversing this Court on its ruling that Swartz had not shown reasonable reliance in his original fraud claims as a matter of law, cited state case law demonstrating that whether a plaintiff justifiably relied on a party's misrepresentation is an issue of fact which requires consideration of the surrounding circumstances. *Swartz II*, 476 F.3d at 762–63 (citations omitted). This finding, according to the Ninth Circuit, "is necessarily fact-intensive" and involves multiple considerations, including the education level and relative experience level of the plaintiff, and also whether "oral misrepresentations were 'contradicted' by written documents in the representee's possession." *Id.*

The disclaimer provisions cited by Presidio fall into the same category as other indicia of unjustified reliance (e.g., the aforementioned IRS Notices and warnings from Plaintiff's accountants Moss Adams): "While these facts may also undermine Swartz's claim of reasonable reliance, they not do not warrant dismissal under the demanding 12(b)(6) standard." *Swartz II*, 476 F.3d at 763. The Ninth Circuit employs a similar fact-based approach in claims under the Exchange Act, as does the forum state in claims under the Washington State Securities Act (WSSA). *See Stewart v. Estate of Steiner*, 122 Wash.App. 258, 274, 93 P.3d 919 (2004) (holding a non-reliance clause in subscription agreement was not dispositive on the issue of justifiable reliance as a matter of law).

Second, much of Plaintiff's frauds claim against Presidio are based on the terms of the agreements he executed with Presidio and the misrepresentations he alleges that they contained. Swartz is alleging that (1) Presidio charged management fees in a manner that deviated from the express terms of the Confidential Memorandum, and (2) created agreements which misrepresented the manner in which the supposed loan from Deutsche Bank financed the investment pools, issues unrelated to relying on Presidio for tax or legal advice, or relying on any representations extraneous to the agreements themselves. For the above-cited reasons, the Court will not find as a matter of law that Plaintiff cannot adequately plead reliance as an element of his fraud claims.

***15** Plaintiff does not fare so well with his fraud-based claims concerning Defendant Makov. The complaint is utterly lacking in specificity or particularity as regards this defendant. The fraud section of the TAC (¶¶ 91–110) makes no mention of Makov: there is no allegation that this individual made a false statement or misrepresentation, there are only general conclusory allegations that Makov had knowledge of any fraud in the scheme, and there are no allegations that Plaintiff relied on anything that Makov himself represented (or failed to disclose) prior to entering into the transaction which forms the basis of this complaint. Plaintiff's allegations regarding this individual defendant fall far short of the requirements of FRCP 9(b). For these reasons, and for the reasons cited *supra* in the "Conspiracy" section, Defendant Makov is entitled to dismissal of the fraud claim against him.

C. Claim Three: Breach of fiduciary duty/aiding and abetting breach of a fiduciary duty

Under Washington law, the "existence of a fiduciary relationship is not simply a matter of 'reposing trust and confidence in the integrity of another ... There must be additional circumstances, or a relationship that induce the trusting party to relax the care and vigilance which he would ordinarily exercise for his own protection.' " Moon v. Phipps, 67 Wash.2d 948, 954, 411 P.2d 157 (1966). A fiduciary duty will be found to exist when one party "occupies such a relation to the other party as to justify the latter in expecting that his interests will be cared for[.]" Liebergesell v. Evans, 93 Wash.2d 881, 889–90, 613 P.2d 1170 (1980) (citation omitted). Whether or not a fiduciary relationship exists is a question of law. Hansen v. Friend, 118 Wash.2d 476, 479, 824 P.2d 483 (1992). Whether or not a party has breached a fiduciary duty owed to another is generally a question of fact. Valentine v. Dept. of Licensing, 77 Wash.App. 838, 846, 894 P.2d 1352 (1995).

Presidio's arguments that Presidio was not a fiduciary to Swartz because financial advisers are not fiduciaries and because they dealt with each other at arm's length are unpersuasive. First, financial advisers can be fiduciaries. Presidio Growth, as alleged in the TAC (¶ 346), is a registered investment advisor under the Investment Advisers Act of 1940, 15 U.S.C.S. § 80(b)–2(11). The Supreme Court explicitly recognized that financial advisers are fiduciaries, who have an "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts," as well as the affirmative obligation 'to employ reasonable care to avoid misleading [their] clients.' " S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180, 194, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963) (citations omitted).

Second, the allegations in the TAC do more than merely allege that Swartz had "trust and confidence" in Presidio in executing their contractual obligations. As the Managing Member of Longs, Presidio represented in the Limited Liability Agreement that "the overall management and control of the business and affairs of the Company (Longs) shall be vested solely" in them, and that "[a]ll matters concerning the valuation of securities and other assets and the liabilities of the Company, the allocation of profits, gains and losses among the Members ... shall be determined" by them. (*See* Bauer Decl., Ex. B at 20.) The terms of the agreements between Swartz and Presidio suggest more than an "arm's length" relationship. Even if the terms of the agreements between the parties did not create a fiduciary duty on their face, the material facts Presidio allegedly concealed give rise to fiduciary-like duties. *See* Tokarz v. Frontier Federal Sav. And Loan Ass'n, 33 Wash.App. 456, 459, 656 P.2d 1089 (1982) (one with special knowledge of material facts unknown to the other party may have duty to speak).

***16** Presidio also argues that Swartz signed an express understanding within the Limited Liability Agreement with Presidio that none of the members of Longs would be a fiduciary to the others, enforceable by Delaware law:

> No member shall be a fiduciary of or have any fiduciary obligations to the other Members in connection with the Company or this Agreement or such Member's performance of its obligations under this Agreement, and each Member hereby waives to the fullest extent permitted by applicable law any rights it may have to claim any breach of fiduciary obligations under this Agreement or in connection with the Company.

Bauer Decl., Ex. B at 23, § 5.06(a).

Even assuming Delaware law applies (and Plaintiff does not argue that it does not), that same section of Delaware law cited by Presidio provides that a limited liability company agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." DLLCA § 18–1101(c). Also, it is unclear under Delaware law whether provisions seeking to eliminate all fiduciary duties are valid when a member manages the entity in an illegal fashion. *See* Metro Comm'cn Corp. BVI v. Advanced Mobilecomm Techs., Inc., 854 A.2d 121, 131 (Del.Ch.2004).

Taking the facts alleged in the TAC as true for purposes of the 12(b)(6) motion, Plaintiff has adequately plead bad faith acts by Presidio in advancing an illegal tax shelter scheme and misrepresenting several of the key functions of the scheme. Thus, these defendants are not shielded by the disclaimer of fiduciary relationship to Swartz (as Gascoyne) in the Limited Liability Agreement. This Court finds that Plaintiff has plead the elements of a breach of fiduciary duty claim against Presidio sufficiently to avoid dismissal pursuant to 12(b)(6).

Plaintiff's breach of fiduciary duty claim as regards Defendant Makov will be dismissed for failure to plead circumstances that give rise to a fiduciary relationship. Plaintiff does not allege that he had any relationship with Makov as an individual. Even a theory that Makov aided and abetted a breach of fiduciary duty cannot survive without allegations that this defendant had knowledge of a primary tortfeasor's intent to breach and substantially assisted that breach. *See* Rest.2d of Torts, § 876; *see also Chem–Age Indus. v. Glover,* 2002 SD 122, P45, 652 N.W.2d 756 (S.D.2002). Plaintiff's TAC contains no such allegations.

D. Claim Four: Constructive trust

Under the remedy of constructive trust, "[w]hen a property has been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest, equity converts him into a trustee." *Ellis v. Schwank,* 37 Wash.2d 286, 289, 223 P.2d 448 (1950) (citation and internal quotation marks omitted). Notions of equity allow a court to impress upon a party a constructive trust in favor of the wronged party, who may reclaim their property from one that used fraud, misrepresentation, or otherwise similar circumstances to acquire it. *Bangasser & Associates, Inc. v. Hedges,* 58 Wash.2d 514, 516–17, 364 P.2d 237 (1961). Under Washington law, constructive trust is an equitable remedy imposed by the court at law, principally to prevent unjust enrichment. *Thor v. McDearmid,* 63 Wash.App. 193, 207, 817 P.2d 1380 (1991) (citation omitted).

***17** Plaintiff alleges that all Defendants have acquired Plaintiff's property as a result of their acts and omissions and that they are holding the property in "constructive trust." (TAC ¶¶ 359–61.) Plaintiff also argues that all Defendants are in "violation" of a constructive trust. (TAC ¶ 358.) Several defendants have put forth the argument that constructive trust is an equitable remedy, not a cause of action. Plaintiff has failed to respond to these arguments. The Court's own research has failed to uncover any authority which would permit Plaintiff to assert an equitable remedy as a cause of action. In the absence of any argument by Plaintiff to the contrary, the claim will be dismissed against all remaining defendants.

E. Claim Five: Securities Exchange Act violations

Plaintiff argues that each of the Defendants "have violated and are each primary violators of Section 10(b) of the Exchange Act and Rule 10b–5 promulgated thereunder." (TAC ¶¶ 362–373.)

Presidio argues that Plaintiff has failed to meet the heightened pleading standard under the Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u–4(a) *et seq.;* that his claim is better characterized as an aiding and abetting claim, which has no private right of action under § 10(b); and that Plaintiff has not adequately alleged loss causation. Plaintiff's response fails to make any mention of his claims under the Exchange Act except on a personal jurisdiction issue. (*See* Pltf. Response to Presidio Mtn at 19.)

Section 10(b) of the Exchange Act forbids the "use or employ, in connection with the purchase or sale of any security ..., [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary [.]" 15 U.S.C. § 78(j)(b). Rule 10b–5 creates liability to any person who "make[s] any untrue statement of a material fact" or "omit[s] to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading." 17 C.F.R. § 240.10b–5. To plead a claim under Rule 10b–5, a plaintiff must show (1) a material misrepresentation or omission; (2) made with a wrongful state of mind ("scienter"); (3) in connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation, a causal connection between the material misrepresentation and the loss. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336, 341–42, 125 S.Ct. 1627, 161 L.Ed.2d 577 (2005).

The PSLRA imposes a heightened pleading standard on private actions brought under the Exchange Act. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* —U.S. ——, ——, 127 S.Ct. 2499, 2508, 168 L.Ed.2d 179 (2007). If a plaintiff alleges that a defendant made a false or misleading statement, his complaint must "(1) specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading," and (2) "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)-(2).

***18** Plaintiff's factual allegations are sufficient to support a § 10(b) claim against Presidio under the Exchange Act. First, Plaintiff's interest in Longs LLC constitutes a security. Investment contracts are explicitly listed in the definition of "security" under 15

U.S.C.A. § 78b(A)(1). An investment contract is defined as (1) an investment of money (2) in a common enterprise (3) with the expectation of profits produced by the efforts of others. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298–99, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946); S.E.C. v. Alliance Leasing Corp., 28 Fed.Appx. 648, 651 (9th Cir.2002).

Here, the Confidential Memorandum and Limited Liability Agreement expressly indicate that all the parties to the transaction were to pool their resources, including initial capital contributions; that Presidio would act as the Managing Member in Longs, empowered to make all investment decisions; and that the program was intended to produce a profit. (*See* Bauer Decl., Ex. A.)

Second, Plaintiff satisfies the pleading requirements of the PSLRA because he identifies each material statement within the Confidential Memorandum that is allegedly false, gives reasons why they are false, and provides supporting facts that form the basis of his allegations. *See* "Fraud" § V. B., *supra.* Rule 10b–5 requires that an omission or false statement be related to a "material" fact in order to be actionable. 17 C.F.R. § 240.10b–5. An omitted fact is related to a material fact if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available." *Basic,* 485 U.S. at 231–32 (citations omitted). The facts alleged, that the chance for a return profit from the BLIPS program was "remote" and that the length of the loan was only 60 days as opposed to 7 years, were material. Further, Plaintiff provides facts that, assuming their truth for purposes of this motion, demonstrate that Presidio had actual knowledge that what it represented in its Confidential Memorandum and Limited Liability Agreement were false. Again, *see* "Fraud" § V. B., *supra.*

Third, Plaintiff has alleged that he relied on the representations in the Confidential Memorandum; in fact, in the Subscription Agreement, Swartz expressly represented that he was relying on the terms of the Confidential Memorandum and Limited Liability Agreement in deciding to invest in Longs. [FN9] Further, he adequately alleges that he lost over a half a million dollars to the Presidio Defendants in fees charged under allegedly false pretenses. The Court finds that Plaintiff has adequately plead reliance, loss, and causation based on the allegedly false statements of Presidio. Plaintiff's claim against Presidio under § 10(b) will not be dismissed on 12(b)(6) grounds.

FN9. The Presidio Defendants' argument that Plaintiff was not entitled to plead reliance based on the disclaimer provisions of their agreements has been addressed *supra* in the "Fraud" section as well.

Plaintiff's § 20(a) claim is unnecessary as applied to the Presidio Defendants, since they are properly alleged to be a primary violator under § 10(b) and Rule 10b–5. Section 20(a) states in relevant part:

> ***19** Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable[.]

To prevail on a claim under § 20(a), Plaintiff must show a violation of § 10(b) or Rule 10b–5 by more than one of the defendants. *Lipton v. Pathogenesis Corp.,* 284 F.3d 1027, 1035 n .15 (2002). As discussed *infra,* Plaintiff has failed to state a claim against any of the other defendants under § 10(b), so Presidio necessarily could not be a controlling party over any other primary violator. The federal securities violation claimed under § 20(a) against Presidio will be dismissed for failure to state a claim upon which relief can be granted.

Plaintiff also alleges violations of §§ 12 and 15 of the Exchange Act. Sections 12 and 15 of the Exchange Act of 1934 are concerned with the registration of securities, which Plaintiff has unquestionably failed to plead against any of the defendants. In fact, it is unlikely he even meant to. More likely, Plaintiff intended to plead the liability of the defendants under §§ 12 and 15 of the 1933 Securities Act, which concern misrepresentations in prospectuses. *See* 15 U.S.C.A. § 78l et seq. Plaintiff does not respond to the arguments that he plead under the wrong statute, leaving the Court to speculate about his intentions. However, even if Plaintiff did intend to plead liability under §§ 12 and 15 of the Exchange Act, those claims would fail as well—there is no private cause of action under § 15, 15 U.S.C.A. § 78o, recognized by the Ninth Circuit (*see* S.E.C. v. The Seaboard Corp., 677 F.2d 1301, 1313–14 (9th Cir.1982) and Plaintiff fails to plead in what manner Presidio violated § 12.

The only way for Plaintiff to plead facts sufficient to support a cause of action for federal securities violations against Defendant Makov as an individual is to adequately allege that he was a "control person" in the transaction. Swartz has not adequately plead control person liability. These claims require a showing that:(1) Presidio committed a primary violation of securities laws; and (2) Makov exercised actual power or control over Presidio. *Howard v. Everex Sys.,* 228 F.3d 1057, 1065 (9th Cir.2000); *see also Hines v. Data Line Sys.,* 114 Wash.2d 127, 135–37, 787 P.2d 8 (Wash.1990). Whether a defendant is a control person is an intensely factual question, and a plaintiff will survive a motion to dismiss on allegations that individual defendants, by virtue of their executive and managerial positions, could and did control and influence the company. *See In re Cylink Secs. Litig.,* 178 F.Supp.2d 1077, 1089 (N.D.Cal.2001) (allegations "that the individual defendants, by virtue of their executive and managerial positions had the power to control and influence [Cylink], which they exercised" are "sufficient to support an inference that the individual defendants controlled Cylink and its operations"); *see also In re Adaptive Broadband Sec. Litig.,* 2002 U.S. Dist. LEXIS 5887, 2002 WL 989478, 57–59 (N.D.Cal. Apr. 2, 2002) ("allegations that the Individual Defendants held the highest offices in the corporation, spoke frequently on its behalf, and made key decisions in how to present its financial results are sufficient"); *Marks v. Simulation Sciences,* 2000 U.S. Dist. LEXIS 4536, 2000 WL 33115589 (C.D.Cal. Feb. 28, 2000) ("general allegations about the titles of these defendants and their day-to-day control over SimSci affairs" are sufficient); *In re Metawave Communs. Corp. Secs. Litig.,* 298 F.Supp.2d 1056, 1091 (W.D.Wash.2003) ("At the motion to dismiss stage, general allegations concerning an individual's title and responsibilities are sufficient to establish control.").

***20** Plaintiff's allegations fail to meet this standard. The TAC offers only the general (and factually unsupported) conclusion that Makov controlled Presidio, stating that "Presidio, [etc.] are merely shell companies, owned, operated and controlled by Defendants Buss, Larson and Makov." (TAC ¶¶ 117, 118). Plaintiff does not offer any factual allegations that could support a claim for control person liability. The assertion that Presidio hired Makov "[t]o develop the [BLIPS] idea" and "to provide economic and investment expertise" is not an allegation of control. (TAC ¶ 205.) In an attempt to correct this deficiency, Plaintiff asks the Court to take judicial notice of Presidio Growth LLC's Form ADV, which listed Makov's job title as an employee of Presidio Growth LLC and Presidio Advisory Services, Inc. (*See* Pltf Response to Makov Mtn, Swartz. Decl., Ex. 37.) The Court has no authority to take judicial notice of the filing because Plaintiff has failed to establish that the document satisfies the requirements of FRE 201(b); i.e., that it is "generally known within the territorial jurisdiction of the trial court or ... capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." The TAC has insufficiently alleged control person liability and the Exchange Act Rule 10b–5 and 20(a) claims against this individual defendant are dismissed. For the identical reasons cited *supra,* the §§ 12 and 15 claims are dismissed as well.

F. Claim Six: Investment Advisers Act

The anti-fraud provision in the Investment Advisers Act ("IAA") provides in part that:

> It shall be unlawful for any investment adviser ... [to] (1) to employ any device, scheme, artifice to defraud any client or prospective client; (2) to engage in any ... course of business which operates as a fraud or deceit upon any client or prospective client; ... (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative[.]"

Plaintiff alleges that Presidio Growth is a registered investment advisor under the Registered Investment Advisers Act of 1940 and that they, with the other defendants, "are liable jointly and severally ... in violation of 15 USCA § 80b–6(1), (2), and (4)." (TAC ¶¶ 386–90.) The Supreme Court explicitly held that there is no right of private action under § 80b–6 of the IAA in *Transamerica Mortgage Advisers, Inc. (TAMA) v. Lewis,* 444 U.S. 11, 24, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979). Only the Securities and Exchange Commission has the authority to bring an action to enjoin the fraudulent acts and to enforce compliance with the rules from the IAA. *See* 15 U.S.C.A. § 80(b)–9(e). The Court held that the only provision that carries an implied right of private action under the IAA is § 80b–15, which is limited to voiding an investment adviser contract that violates § 80b–6, and is not applicable when seeking damages. *TAMA*, 444 U.S. at 24–25; *see also Washington v. Baezinger*, 656 F.Supp. 1176, 1177–78 (N.D.Cal.1987). Since Plaintiff has brought his IAA claim under a provision that affords no private right of action, this claim must be dismissed. Even if Plaintiff was permitted to amend this claim, he has not plead the existence of an investment advisers contract between himself and Presidio (TAC ¶ 148), and failed to respond at oral argument when provided with a question regarding the existence of such a contract.

***21** Defendant Makov asserts his right to dismissal of the IAA claim on identical grounds: nowhere is it alleged that he is an investment adviser. Plaintiff's only response to this is to "incorporate by reference its arguments and legal authorities" in its responsive briefs to the Presidio, DB, Walter Conston and Grant Thornton motions, but this avails Plaintiff nothing, as those pleadings do nothing to remedy the facial deficiency of failure to plead Makov's "investment adviser" status or the existence of an investment advisory contract with this defendant. Makov's motion to dismiss the IAA claim will be granted. *See Neely v. Bar Harbor Bankshares*, 270 F.Supp.2d 44, 49 (D.Maine 2004) (a plaintiff pleading an IAA violation must show the existence of adviser contract).

G. Claim Seven: Washington State Securities Act

Plaintiff alleges that Defendants are liable under the Washington State Securities Act ("WSSA") for violations of

1. RCW 21.20.010(1)-(3):

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (1) To employ any device, scheme, or artifice to defraud;
>
> (2) 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.
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person

2. RCW 21.20.430, which entitles those injured in violation of the WSSA to sue

> in law or equity and establishes liability for anyone who directly or indirectly controls a seller ... liable under [the WSSA], every partner, officer, director or person who occupies a similar status or performs a similar function of such seller or buyer ...
>
> as well as employees, broker-dealers and salespersons.

The WSSA is modeled after the federal securities statute, and Washington courts look to federal law for guidance in interpreting the state legislation. *See Helenius v. Chelius*, 131 Wash.App. 421, 448, 120 P.3d 954 (2005). However, the purposes of the WSSA differ from that of the federal securities statutes in that there is a special emphasis on protecting individual investors, and not only the integrity of the market place. *Haberman v. Washington Pub. Power Supply Sys.*, 109 Wash.2d 107, 125–26, 744 P.2d 1032 (1987). The provisions of the Act are therefore interpreted broadly. *Id.* at 126, 744 P.2d 1032.

The Presidio Defendants argue that because Plaintiff signed a disclaimer of reliance in the Subscription Agreement, this claim must fail. Plaintiff responds generally that the disclaimers are invalid. Regarding this specific claim, he only recites the applicable statute and states "[i]t is undisputed that the transaction was in connection with the purchase and sale of a security." (Pltf. Response to Presidio Mtn, p. 15.) The Court has previously analyzed Presidio's "reliance disclaimer" defense and will not repeat that analysis here. Suffice it to say that the disclaimer provisions do not entitle Presidio to dismissal of this cause of action.

***22** In order to maintain an action under the WSSA, the plaintiff must show the defendant made either an untrue statement of material fact or omitted such a fact in connection with a security transaction and that the defendant was a seller or offeror of the security. *Shinn v. Thrust IV, Inc.*, 56 Wash.App. 827, 851, 786 P.2d 285 (1990); *see also Kinney v. Cook*, 159 Wash.2d 837, 842, 154 P.3d 206 (2007). A party qualifies as a seller "if his or her acts were a substantial contributive factor in the sales transaction." *Haberman,* 109 Wash.2d at 131, 744 P.2d 1032. To determine whether the acts constitute a substantial contributive factor, Washington courts consider: (1) the number of other factors which contribute to the sale and the extent of the effect they have in producing it; (2) whether the defendant's conduct has created a force or series of forces which are in continuous and active operation up to the time of the sale, and (3) lapse of time. *Id.* at 131–32, 744 P.2d 1032.

Plaintiff has sufficiently plead his WSSA claim against Presidio. Regarding the first element for WSSA liability under RCW 21.20.010, Plaintiff has sufficiently plead that Presidio either made patently false statements in their Confidential Memorandum, or omitted key aspects of the BLIPS loans. *See* discussion in "Fraud" § V. B., *supra.* These allegedly false statements are, if proven, adequate to constitute a violation of RCW 20.010(2) and survive a 12(b)(6) motion to dismiss. *See Kinney,* 159 Wash.2d at 842–43, 154 P.3d 206 (plaintiff payers of promissory note meet first element by showing holder of promissory note failed to mention he had burdened the corporation with millions in debt).

Plaintiff's TAC satisfies the second element of the WSSA claim against Presidio because the interest in Longs qualifies as a security, and Presidio qualifies as a seller of a security. In defining a "security," Washington courts mirrors the federal definition of security and applies a "flexible rather than static principle" in order to keep up with the countless "schemes" devised by those who use the money of others. *State v. Pedersen,* 122 Wash.App. 759, 764, 95 P.3d 385 (2004). It is a question of law whether an investment scheme constitutes a security. *De Luz Ranchos Inv. Ltd. v. Coldwell Banker & Co.,* 608 F.2d 1297, 1299–1301 (9th Cir.1979). RCW 20.020.005(12) defines security very broadly, and includes any "investment contract" or "investment of money ... in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture[.]" *See Shinn,* 56 Wash.App. at 849 n. 5, 786 P.2d 285; *see also* discussion in "Securities Exchange Act" § V.E. *supra.*

The Longs investment qualifies as a security, and Plaintiff alleges sufficient information to qualify Presidio as a "seller" of a security. Plaintiff's allegations that Presidio and KPMG approached him about participating in the BLIPS investment program and that Presidio provided him with a prospectus in their Confidential Memorandum explaining how the BLIPS investment program worked, constitutes an adequate pleading of promotional conduct. Furthermore, Plaintiff's allegations that Presidio was the source of the BLIPS scheme and "was thoroughly involved in the development, marketing and implementation of the product" (TAC ¶ 262) qualifies Presidio as a "seller" under the substantial contributive factor test. *Haberman, supra.* The Court declines to dismiss the WSSA claim against Presidio on 12(b)(6) grounds.

***23** As regards Defendant Makov and the WSSA claim, Plaintiff's TAC is devoid of any allegations specific to Makov that would suffice to state a claim under RCW 21.20.010(1)-(3). Nor are Plaintiff's allegations adequate to state a claim against Makov for a violation of RCW 21.20.430(3). While he is unquestionably alleged to be an "officer or director," the statute requires more than that. A defendant must "occup[y] a similar status or perform[ ] a similar function of [a] seller or buyer ... or ... materially aid[ ] in the transaction," and Plaintiff has failed to allege sufficient facts to establish Makov as such an individual, in much the same way as he failed to adequately allege "control person" liability against Makov in his federal securities pleadings. *See* analysis in § V. E., *supra.* The WSSA claim against Defendant Makov is dismissed.

H. Claim Eight: Professional negligence/negligent misrepresentation

i. *Professional Negligence*

In Washington, a claim for professional negligence exists against a limited group of licensed professionals, such as health care providers, attorneys, real estate professionals, accountants, clergy, and insurance agents. *See Sharbono v. Universal Underwriters Ins. Co.* 139 Wash.App. 383, 161 P.3d 406 (2007) (insurance agent); *see also Hunter v. Knight, Vale & Gregory,* 18 Wash.App. 640, 571 P.2d 212 (1977) (accountant). Although Plaintiff alleges in a general, conclusory fashion that "Defendants, and each of them, owed Swartz a duty of care," Plaintiff cites no authority establishing that investment advisers like Presidio can be held liable under a professional negligence theory, nor does he to respond to any of Presidio's arguments for dismissal of this cause of action. Accordingly, the Court will grant Presido's motion to dismiss this claim pursuant to 12(b)(6).

Regarding Defendant Makov, Plaintiff has also failed to allege that this individual defendant falls within the class of professions intended to be covered by this tort. and it is likewise appropriate to grant his motion to dismiss on 12(b)(6) grounds.

ii. *Negligent Misrepresentation*

To establish a claim for negligent misrepresentation in Washington, a plaintiff must show that the defendant:

> negligently supplied false information the defendant knew, or should have known, would guide the plaintiff in making a business decision, and that the plaintiff justifiably relied on the false information ... [and that] the false information was the proximate cause of the claimed damages.

Van Dinter v. Orr, 157 Wash.2d 329, 333, 138 P.3d 608 (2006) (citation omitted). If a party has a duty to disclose information and fails to do so, that failure can constitute negligent misrepresentation. *Colonial Imports, Inc. v. Carlton, N.W., Inc.,* 121 Wash.2d 726, 731–33, 853 P.2d 913 (1993). Normally the duty to disclose unknown material facts exists only when there is a fiduciary relationship between the parties, but can arise when there is a "quasi-fiduciary" relationship; i.e., where a special relationship of trust and confidence exists and one party is privy to material facts "not easily discoverable" by the other, or when one party relies on the specialized knowledge of the other. *Id.* at 732, 853 P.2d 913.

***24** Although Swartz is a sophisticated businessman, and employed his own independent accountants and lawyers in his transactions with Presidio, he has sufficiently plead that Presidio was privy to material facts that were not readily discoverable. Again, as analyzed in the "Breach of fiduciary duty" § V. C., *supra,* Plaintiff has alleged sufficient facts to suggest a duty flowing from Presidio to himself, and that duty can likewise give rise to a claim for negligent misrepresentation. The Court denies Presidio's request to dismiss this claim and permit it to go forward.

For all the reasons cited in the preceding subsection, Plaintiff is found not to have alleged adequate facts to infer a duty between the individual Makov and himself, and therefore no claim for negligent misrepresentation will stand against this defendant.

I. Claim Nine: Breach of contract

Plaintiff bases his breach of contract claim on unspecified "oral and written contracts" to provide him with a variety of services, premised on a breach of the duty of good faith and fair dealing; specifically, Plaintiff alleges that Defendants promised performance they "should have known they could not deliver," and "took advantage of superior knowledge" by failing to disclose information they had a duty to disclose. (TAC ¶¶ 412–18.) In addition to failing to identify which contracts (written or oral) were breached, Plaintiff fails to specify which provisions of those contracts were breached. His allegations of the nature of the breach are made in the most general and conclusory manner possible, and he fails to specify which defendant breached a contract and in what manner.

Under Washington law, to bring a cause of action for breach of contract, Plaintiff must establish (1) the existence of a valid and enforceable contract; (2) the rights of the plaintiff and obligations of the defendant under contract; (3) violation of the contract by the defendant; and (4) damages to the plaintiff. *Citoli v. City of Seattle,* 115 Wash.App. 459, 476, 61 P.3d 1165 (2002) (citation omitted).

The only remaining defendants who actually entered into written agreements with Plaintiff are the Presidio Defendants. As mentioned *supra,* Plaintiff fails to articulate which contract Presidio breached, or how it breached a contract, and refers only generally to all "Defendants" in his allegations. Moreover, the gravamen of Plaintiff's claim appears to be that Defendants breached their contracts with Swartz by breaching their fiduciary duties and duties to disclose material information; i.e., Swartz bases his breach of contract claim on the same incidents and theories upon which he bases his fraud and fiduciary duty claims.

Alleging only that a defendant breached its duties of good faith and fair dealing is inadequate. *See Badgett v. Sec. State Bank,* 116 Wash.2d 563, 570, 807 P.2d 356 (1991) (no breach of duty of good faith when "a party simply stands on its rights to require performance of a contract according to its terms") (citation omitted). This "reframing" of the claim is not sufficient, as this Court has previously concluded. *See Swartz I,* 401 F.Supp.2d at 1154 (breach of contract claim against KPMG fails because only a reframing of a negligence or malpractice claim). This ruling is not one of those on which the Ninth Circuit reversed and remanded this Court. Plaintiff has done nothing to correct the deficiencies noted over three years ago. Presidio's motion to dismiss the breach of contract claim is granted.

***25** Defendant Makov has denied that he entered into any contracts with Plaintiff, who has not responded with evidence or allegations to the contrary. Makov's motion to dismiss this cause of action will likewise be granted.

J. Claim Ten: Unjust enrichment

Plaintiff bases his unjust enrichment claim against Presidio on the theory that these defendants were unjustly enriched by charging management fees and interest for managing investment programs that had no economic substance. (TAC ¶ 423.) Under Washington law, unjust enrichment is a claim that can be brought when there is an implied contract, either in fact or in law. *Lynch v. Deaconess Medical Center,* 113 Wash.2d 162, 164–65, 776 P.2d 681 (1989). Implied contracts in law, "quasi-contracts," are not contracts at all, but can be found by a court to provide obligations to prevent unjust enrichment. *Eaton v. Engelcke Mfg., Inc.,* 37 Wash.App. 677, 680, 681 P.2d 1312 (1984) (citation omitted).

Generally, a party to an express contract may not bring an action under an implied contract "relating to the same matter." *Moses Lake Const. Co., Inc. v. Johnson,* 134 Wash.App. 1011, 2006 WL 2147602 *5 (July 27, 2007) (citation omitted). Plaintiff is not arguing that he had an implied contract with the Presidio Defendants. Because he is suing based on the express terms of the written agreements he signed with them, the unjust enrichment claim is inappropriate and Presidio's motion to dismiss it will be granted.

Defendant Makov was not in contractual privity with Plaintiff and (as has been discussed *supra*) Plaintiff has failed to allege sufficient facts to plead that this defendant owed him a fiduciary (or any other kind of) duty. Plaintiff has neither plead nor argued the existence of a quasi-contractual relationship with Makov and therefore no grounds exist under which to bind him to this cause of action. Additionally, there is no allegation that any money or property of Plaintiff's came into Makov's hands. The unjust enrichment claim against Makov will be dismissed upon its motion.

K. Claim Eleven: Rescission

Plaintiff alleges that "[a]ny and all agreements Swartz entered into in order to execute the loans and transactions pertaining to the investment program were procured by fraud and overreaching" and "Plaintiff is entitled to rescind all agreements entered into with the Defendants pertaining to any of the investment program transactions." (TAC ¶¶ 427–30.)

The Presidio Defendants argue that rescission is only a remedy and not a cause of action (citing *Zola v. Gordon,* 685 F.Supp. 354, 374 (S.D.N.Y., 1988)), and that a plaintiff may not seek to both repudiate the contract and collect damages for its breach in the same cause of action. "A party induced to enter into a contract by fraud or misrepresentation must make a choice; the party may either elect to accept the situation created by the fraud and seek to recover his damages or he may elect to repudiate the transaction and seek to be returned to the status quo," but "as a general rule ... the defrauded party cannot both rescind and maintain an action for deceit." *Ballow Brasted O'Brien and Rusin P.C. v. Logan,* 435 F.3d 235, 238 (2nd Cir.2006).

***26** Plaintiff fails to respond to Defendants' arguments against the rescission claim except to argue that there is a private cause of action for rescission for contracts in violation of the IAA under 15 U.S.C.A § 80b–6. (*See* Pltf. Response to Presidio Mtn, p. 13.) As discussed *supra,* there is no private cause of action under § 80b–6 except for the limited private remedy of rescission under § 80b–15. *See* discussion in "IAA" § V. F., *supra.* Plaintiff's TAC does not cite to this section of the statute at all, and therefore his own complaint does not support his argument.

Additionally, in order to bring such an action, there must be an existing investment advisor contract between the parties. *See Neely v. Bar Harbor Bankshares,* 270 F.Supp.2d 44, 49 (D.Me.2003). The TAC states that "[a]s of October 1, 1999, Gascoyne (Swartz) *had not* entered into an advisory contract with Presidio Advisory Services. (TAC ¶ 148.) (emphasis added). The disputed transactions with Presidio occurred prior to this date. Although the TAC repeatedly refers to Presidio Growth as a registered financial adviser, and makes statements that "Presidio Defendants were employed by Plaintiff in their capacities as 'registered investment advisers' " (TAC ¶ 344), nowhere does Plaintiff plead facts indicating the existence of an investment adviser contract between him and Presidio Growth. For all the foregoing reasons, his rescission claim against Presidio will be dismissed pursuant to their motion.

Plaintiff's rescission claim against both Defendant Makov suffers from the same defect: he alleges no contract between himself and this individual defendant. Nor does he respond to Makov's argument pointing this out. The Court will grant these parties' request to dismiss the rescission claim alleged against him.

L. Claim Twelve: Washington Criminal Profiteering Act [RCW 9A.82.010(8)]

As enacted in 1985, the Criminal Profiteering Act ("CPA") contained a 10–year "sunset clause" that automatically repealed the Act on July 1, 1995. Plaintiff does not dispute that the CPA was not re-enacted until May 9, 2001 and that, between July 1, 1995 and May 9, 2001, the CPA was no in existence. All of the events concerning the BLIPS transactions took place within this time and all defendants argue that, as a result, the CPA was not in effect at the time these causes of action arose.

Plaintiff defends this claim with the allegation that, as late as July 2005, Defendant Makov was perjuring himself before the U.S. Senate in furtherance of the conspiracy, well within the re-activated period of the CPA. This argument is not persuasive. Plaintiff cannot create an ongoing endless conspiracy out of post-fraud coverup activity; the attempt ignores the long-standing rule of *Grunewald v. United States,* 353 U.S. 391, 77 S.Ct. 963, 1 L.Ed.2d 931 (1957):

> Acts of covering up, even though done in the context of a mutually understood need for secrecy, cannot themselves constitute proof that concealment of the crime after its commission was part of the initial agreement among the conspirators ... Sanctioning [this] theory would for all practical purposes wipe out the statute of limitations in conspiracy cases ...

***27** *Id.* at 402; *see also* U.S. v. Magluta, 418 F.3d 1166, 1178–79 (11th Cir.2005).

The acts which comprise the alleged conspiracy were concluded prior to the reenactment of the CPA; the statute was not in effect at the time of the events comprising the causes of action in the TAC and those claims will be dismissed against all defendants.

VI. Amendment would be futile and wasteful

The remaining issue concerning the motions to dismiss pursuant to FRCP 12(b)(6) is whether the Court should grant Plaintiff leave to amend his complaint yet again in a further attempt to correct the deficiencies noted in the preceding 45 pages. If further amendment would be futile, the Court may order dismissal with prejudice. *Moreno v. State of California,* 25 F.Supp.2d 1060, 1062 (N.D.Cal.1998). A trial court has considerable discretion to grant or deny leave to amend, but that discretion "must be guided by the command of Fed.R.Civ.P. 15(a), which provides that 'leave shall be freely given when justice so requires.' " *Allen v. City of Beverly Hills,* 911 F.2d 367, 373 (9th Cir.1990) (citation omitted). The Court finds not only that further amendment of this complaint would be futile, but that the dictates of justice and judicial economy require that this merry-go-round of re-wording, re-fashioning and reinventing the nature of this litigation be halted.

The discretion of this Court to grant or deny leave to amend a complaint is "particularly broad where plaintiff has previously amended the complaint." *Allen,* 911 F.2d at 373 (citation omitted); *see also Mir v. Fosburg,* 646 F.2d 342, 347 (9th Cir.1980) ("[A] district court has broad discretion to grant or deny leave to amend, particularly where the court has already given a plaintiff one or more opportunities to amend his complaint to allege federal claims.")

One of the factors to consider is the existence of "repeated failure to cure deficiencies by amendments previously allowed." *Zochlinski v. University of California,* 2006 WL 2417649 *5 (E.D .Cal.2005.) This is Plaintiff's fourth version of his complaint, filed over four years after his original complaint. *See Dumas v. Kipp,* 90 F.3d 386, 393 (9th Cir.1996) (holding that dismissal without leave to amend was appropriate when the plaintiff had filed four complaints and yet continued to allege insufficient facts).

Further, Plaintiff has been given specific instruction by both this Court and the Ninth Circuit on how to properly meet his pleading burden. *See* Swartz II, 476 F.3d at 765 (allowing Plaintiff to replead conspiracy and fraud claims, but holding that his conclusory allegations "without any stated factual basis are insufficient as a matter of law.") Despite a further opportunity permitted by the Ninth Circuit, Plaintiff failed to plead with particularity or state a claim against most defendants, in addition to making claims under erroneous or inactive statutes. *See* Zochlinski, 2005 WL 2417649 at *6 (holding that granting leave to amend would be futile because "[p]laintiff has demonstrated time and again his inability to cure deficiencies in his complaints despite ample opportunity [and] specific instruction").

***28** In addition to failing to plead with particularity, Plaintiff has repeatedly demonstrated an inability to plead with simplicity and clarity. Despite the clear mandate of FRCP 8(a)(2) ("A pleading that states a claim for relief must contain ... a short and plain statement of the claim showing that the pleader is entitled to relief"), Plaintiff responded to the Ninth Circuit's guidance with a 133–page, 437–paragraph complaint adding a multiplicity of new defendants and causes of action and comprised of a modicum of factual allegation floating on a sea of sweeping generalizations and legal conclusions about the actions of "Defendants." The fact that Plaintiff's fraud claims subject to him to heightened pleading standards does not excuse lack of compliance with FRCP 8(a). *See McHenry V. Renne,* 84 F.3d 1172, 1178 (9th Cir.1996) (court affirmed dismissal with prejudice for failure to follow Rule 8(a), holding that a "[h]eightened pleading standard is not an invitation to disregard Rule 8's requirement of simplicity, directness and clarity").

Additionally, the Court is mindful that one of the purposes of the requirement that claims sounding in fraud be plead with particularity is to avoid exactly the situation which Plaintiff's multitude of exceedingly lengthy complaints has created: plaintiffs are required to spell out with specificity the "who, what, where, how and when" of their allegations from the onset of their litigation in order to avoid the endless and costly cycle of challenge and clarification that general and conclusory pleadings can invite. The Court will not guess at the legal costs that have been generated in this nearly five year, multi-defendant, multi-claim piece of litigation, but the Court is compelled to point out that multiple parties have paid dearly to defend against claims that Plaintiff has failed to justify when challenged. The Court refuses to put the remaining parties through the expense (and this Court through the agony of sorting through) the next round of 12(b) (6) challenges that a fourth amended complaint would undoubtedly generate.

All claims which have been dismissed on 12(b)(6) grounds are dismissed with prejudice and no leave to amend the complaint further will be granted.

VII. Plaintiff's Motion for Partial Summary Judgment

Plaintiff's motion for partial summary judgment against the Presidio Defendants (Dkt. No. 252) is denied. Plaintiff filed his TAC on October 9, 2007. On November 30, 2007, the defendants' first motion to dismiss was filed, triggering an automatic stay of discovery until all motions to dismiss are ruled on. 15 U.S.C.S. § 78u–4. On December 14, 2007, Plaintiff brought a motion to lift the discovery stay (Dkt. No. 210, amended at 213), which the Court denied on February 26, 2008 (Dkt. No. 295). Despite the fact that no discovery had been conducted and the motions to dismiss had not yet been decided, Mr. Swartz brought a motion for partial summary judgment on January 17, 2008.

***29** Plaintiff supports his motion with scant evidence that is largely inadmissible. The Court does not understand the timing of Plaintiff's motion and can only conclude that it was brought in an effort to gain tactical advantage by placing information before the Court as it reviewed the defendants' motions to dismiss. The motion is denied for lack of sufficient evidence.

VIII. The trial date is stricken

Discovery has yet to be conducted in this matter and the current trial date of May 14, 2008 is clearly unrealistic. The Court directs the remaining parties to confer and prepare a Joint Status Report ("JSR") on the remaining claims. That report should comment on the Court's proposal to bifurcate discovery on the statute of limitations and liability issues and seek an accelerated trial on the statute of limitations issue. Although the parties will not know prior to submitting the JSR whether individual Defendants Pfaff and Larson will remain in the case, the Court does not anticipate that this will significantly impact the process of charting the course of events leading up to trial.

The parties are directed to file their Joint Status Report no later than **May 12, 2008.**

The clerk is directed to provide copies of this order to all counsel of record.

W.D.Wash.,2008.
Swartz v. Deutsche Bank
Not Reported in F.Supp.2d, 2008 WL 1968948 (W.D.Wash.), Fed. Sec. L. Rep. P 94,716

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Only the Westlaw citation is currently available.

United States District Court, W.D. Washington, at Seattle.
SWARTZ, Plaintiff(s),
v.
PRESIDIO ADVISORY GROUP, et al., Defendant(s).

No. C03–1252MJP.
June 24, 2008.

Brian Gary Isaacson, Mark Jeffrey Wilson, Steven M. Graham, Isaacson & Wilson PS, George Kargianis, Kargianis Werner, Seattle, WA, Philip A. Talmadge, Talmadge Law Group, Tukwila, WA, for Plaintiffs.

Adam J. Kaiser, Amy L. Rudd, Benjamin Sokoly, Danielle T. Sugarman, Kelly Librera, Lawrence M. Hill, Matthew C. Oxman, Richard A. Nessler, Seth C. Farber, Staci L. Gruen, Dewey Leboeuff LLP, New York, NY, David Hugh Smith, Huyen–Lam Q. Nguyen–Bull, Garvey Schubert Barer, Stephen C. Willey, Savitt & Bruce LLP, Mary C. Eklund, Eklund Rockey Stratton, Philip S. McCune, Summit Law Group, Seattle, WA, Margaret A. Tough, Steven M. Bauer, Latham & Watkins, Justin E. Aragon, Nancy E. Harris, Walter F. Brown, Jr., Orrick Herrington & Sutcliffe, Douglas R. Young, Ruth Ann E. Castro, Stephanie Powers Skaff, Farella Braun & Martel, San Francisco, CA, for Defendants.

ORDER ON MOTION TO DISMISS CLAIMS AGAINST INDIVIDUAL DEFENDANTS PFAFF AND LARSON

MARSHA J. PECHMAN, District Judge.

***1** The above-entitled Court, having received and reviewed:

1. Presidio Defendants' Supplemental Brief in Support of Motion to Dismiss Plaintiff's Third Amended Complaint against Individual Defendants John Larson and Robert Pfaff (Dkt. No. 328)

2. Plaintiff's Opposition to Presidio Defendants' Supplemental Brief in Support of Motion to Dismiss Plaintiff's Third Amended Complaint against Individual Defendants John Larson and Robert Pfaff (Dkt. No. 333)

and all exhibits and declarations attached thereto, makes the following ruling:

IT IS ORDERED that the motion to dismiss individual defendants Pfaff and Larson is GRANTED.

Discussion

In the Court's previous Order on Motions to Dismiss and for Partial Summary Judgment (Dkt. No. 327, hereinafter "Order"), the issue of dismissal of individual defendants Robert Pfaff and John Larson was left unresolved and further briefing was invited. Having reviewed that briefing, it is the finding of this Court that Plaintiff has failed to state any claim against either individual upon which relief can be granted.

Preliminarily, the Court notes that Plaintiff does not address the following claims (which were dismissed against all—or almost all—other Defendants in the previous order):

- Constructive trust (Claim 4)
- Investment Advisors Act (Claim 6)
- Professional negligence (Claim 8)
- Breach of contract (Claim 9)
- Unjust enrichment (Claim 10)
- Rescission (Claim 11)
- WA Criminal Profiteering Act [RCW 9A.82.101(8)] (Claim 12)

In the face of Plaintiff's failure to contest the invalidity of these claims, the Court is not inclined to repeat at length the analysis in which it has already engaged concerning the insufficiency of these claims as regards the individual defendants in this case. The parties are referred to the Court's previous order and the already-articulated legal analysis and rationales for dismissal of these claims. The situation of Defendants Pfaff and Larson is indistinguishable from Defendant Makov as regards these causes of action, and the result is identical.

Judicial notice

The Court has previously indicated that it would consider the 2005 Senate Subcommittee Report referenced in the TAC. Order, p. 10. Plaintiff also requests consideration of the allegations in the September and October 2005 Criminal Indictments against Pfaff and Larson, which are likewise cited in the TAC (¶ 11). Plaintiff makes reference to the Superseding Indictment ("SI") at several points throughout his briefing, and the Court agrees that he is entitled to cite to it as a "document whose contents are alleged in a complaint and whose authenticity no party questions" (*Branch v. Tunnell,* 14 F.3d 449, 454 (9th Cir.1994). However, as enumerated below, the documents do not advance Plaintiff's legal position in any meaningful fashion:

1. Many of the allegations referenced in the SI are *nowhere* to be found in the TAC (see *infra*). Defendants are entitled to know from the face of the complaint what they are alleged to have done. A plaintiff may rely on referenced documents to support or perhaps elaborate on allegations in the complaint, but Plaintiff cites no authority that referencing or attaching a document to a complaint relieves him of the requirement to allege fraud with particularity in the complaint itself.

***2** 2. In the multiple paragraphs in the SI to which Plaintiff cites, Pfaff and Larson are constantly listed as two individuals among a group of *twelve* individual defendants alleged to have committed various acts of wrongdoing. [FN1] This may be adequate for criminal indictments, but it does not meet the particularity and specificity requirements of federal fraud pleading. Similarly, Plaintiff makes it clear that (as stated in ¶ 115 of the TAC) whenever the complaint refers to "the Presidio Defendants," this phrase includes Defendants Larson, Pfaff, Makov and Buss (Pltf.Opposition, p. 1). Again, this is simply not commensurate with the level of specificity required—each individual defendant is entitled to know what it is alleged that he personally did.

FN1. The exception to this is ¶ 63, in which Defendant Larson is identified individually as having "provided false and misleading testimony" to the Senate investigating committee. Lying to cover up the existence of a conspiracy is not considered an overt act in furtherance of a conspiracy. "Acts of covering up, even though done in the context of a mutually understood need for secrecy, cannot themselves constitute proof that concealment of the crime after its commission was part of the initial agreement among the conspirators." *Grunewald v. U.S.,* 353 U.S. 391, 402, 77 S.Ct. 963, 1 L.Ed.2d 931 (1957).

So, while the Court is obligated to consider documents which are referenced in a complaint for 12(b)(6) purposes, the documents cited by Plaintiff are of little use in defeating this motion to dismiss.

Conspiracy

Plaintiff points out, again correctly, that he is entitled to rely on circumstantial evidence for proof of concerted action between co-conspirators. Plaintiff refers to multiple paragraphs in the SI "detailing the conspiracy and refer[ring] *specifically* to Pfaff and Larson's fraudulent participation in connection with BLIPS." (*Id.,* p. 2; emphasis supplied.) Actually, *specific* references to Pfaff and Larson are precisely what is missing—the two individuals are simply included in a list of twelve individuals who are alleged collectively to have conspired to design, market and implement the BLIPS scheme.

Plaintiff cites to an exhibit appended to the Senate Report which represents that John Larson would be one of the primary BLIPS marketers. Senate Report, Exh. 70. The document does in fact contain that statement. However, Plaintiff cites to no portion of the TAC where a specific allegation naming Defendant Larson in this capacity can be found, nor is there an allegation that Defendant Larson actually *did* market the BLIPS program. Representing that an individual *would* be involved in an alleged conspiracy may be some circumstantial evidence of involvement, but without more it is certainly not sufficient to withstand a 12(b)(6) motion..

Finally, and least effectively, Plaintiff cites to an e-mail from Makov to a Deutsche Bank officer (Senate Report, Exh. 69) concerning the "end game" of the BLIPS program (the document discusses how the investor would "exit and unwind" all the trades and how fees for the bank and investment advisors would be calculated) on which Pfaff and Larson were *copied.* Plaintiff's argument is that the fact the two were copied on the e-mail is proof of "awareness" of the plan and thus "indicates they were part of the common plan" to divide Plaintiff's capital contribution among the co-conspirators. Pltf. Opposition, p. 3. This is simply not circumstantial evidence of an agreement to commit the unlawful acts of which this conspiracy is accused. As with Defendant Makov, there are no allegations of false statements by these individuals to Plaintiff and no allegations of specific individual acts by them in furtherance of the conspiracy.

Fraud/Negligent misrepresentation

***3** Plaintiff's support for his claims of fraud and misrepresentation against these two individuals is (1) a paragraph (¶ 287) in the TAC alleging that "Presidio" charged a fee of $550,000 without disclosing an agreement between "Presidio and Deutsche Bank" to prematurely terminate the credit agreement and (2) a paragraph (¶ 39) in the SI alleging that twelve individuals (two of whom are these individual defendants) "generated and caused to be generated false and fraudulent documentation to support the transactions." The Court finds these allegations inadequate in terms of the FRCP requirements of specificity and particularity in pleadings of fraud (nor is there any citation by Plaintiff to a paragraph in the TAC where Pfaff or Larson is alleged to have "generated or caused to be generated false and fraudulent documentation to support the transactions.").

Aiding and abetting breach of fiduciary duty

Plaintiff alleges no fiduciary duty between Pfaff and Larson as individuals and Plaintiff, and instead asserts a claim for "aiding and abetting a breach of fiduciary duty." This Court has previously ruled that Presidio as an entity was in a fiduciary relationship with Plaintiff. To establish a claim for aiding and abetting a breach of that fiduciary relationship, Plaintiff must allege "substantial assistance" by these individuals and knowledge that the fiduciary's conduct was in breach.

Plaintiff cites to ¶ 11 of the TAC for the allegation of "substantial assistance," but again Defendants Pfaff and Larson are two among four individuals mentioned and the TAC claims nothing more than that "Defendants" committed the various acts alleged to constitute the breaches and aiding and abetting thereof. There is no way to ascertain from Plaintiff's pleadings what these two individual are alleged to have done which constitutes the alleged violation.

And Plaintiff again relies on the Makov e-mail to the Deutsche Bank officer on which Pfaff and Larson were copied to "indicate that Defendants Pfaff and Larson were aware of the plan" (Pltf.Opposition, p. 4), as if "awareness" somehow equated with "assistance." It is an unpersuasive argument.

Securities violations

§ 20(a) of the Securities Exchange Act states that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable[.]

To prevail on a claim under § 20(a), Plaintiff must show a violation of § 10(b) or Rule 10b–5 by more than one of the defendants. *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035 n .15 (2002). Having ruled that a violation of 10(b) has been adequately plead against Presidio, that prong of the proof is satisfied.

The Court has already ruled that Defendant Makov was entitled to dismissal of the § 20(a) claim against him because Plaintiff failed to adequately allege that he was a "control person" for purposes of the statute. For the same reasons that the Makov allegations were found to be insufficient, the Pfaff–Larson allegations fail. ¶ 118 of the TAC states that Pfaff and Larson were "principals" of a Presidio entity; ¶ 205 states that the idea of BLIPS "originated" with Pfaff and Larson; ¶ 292 alleges that Presidio was "formed" by those two individuals. None of this alleges with the requisite specificity or heightened particularity in what manner or by what acts Pfaff or Larson "controlled" the Presidio entities.

***4** Plaintiff again cites to the language at Exhibit # 70 of the Senate Report that BLIPS "would be marketed" by Larson; how this provisional language establishes "control" is unclear. Plaintiff spends an entire paragraph (Pltf.Opposition, p. 6) listing all the references to Pfaff and Larson in the SI, but (1) none of these allegations is contained in the TAC and (2) as previously mentioned, Pfaff and Larson are simply listed as two individuals among twelve, completely bypassing the requirement that their individual actions be alleged with specificity. Plaintiff's allegations are insufficient to state a claim for security violations (of either federal or state law) against Defendants Pfaff or Larson.

Conclusion

Plaintiff does not contest the validity of certain of his claims against these individual defendants, and these will be dismissed without any further analysis than the Court has already undertaken in the previous Order. As for those claims which Plaintiff does contend are adequately plead, the Court finds that Plaintiff has failed to state a claim upon which relief can be granted against either Defendant Pfaff or Defendant Larson, and these individuals' motion to dismiss pursuant to FRCP 12(b)(6) will be GRANTED.

For the reasons stated in the Court's earlier ruling (*see* Order, pp. 46–49), the Court finds that further amendment would be futile and dismisses these claims with prejudice.

The clerk is directed to provide copies of this order to all counsel of record.

W.D.Wash.,2008.
Swartz v. Presidio Advisory Group
Not Reported in F.Supp.2d, 2008 WL 2545054 (W.D.Wash.)

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This case was not selected for publication in the Federal Reporter.

Not for Publication in West's Federal Reporter See Fed. Rule of Appellate Procedure 32.1 generally governing citation of judicial decisions issued on or after Jan. 1, 2007. See also Ninth Circuit Rule 36-3. (Find CTA9 Rule 36-3)

United States Court of Appeals,
Ninth Circuit.
TUMELSON FAMILY LIMITED PARTNERSHIP; et al., Plaintiffs-Appellees,
v.
WORLD FINANCIAL NEWS NETWORK, Defendant,
and
Ronald J. Slaughter; et al., Defendants-Appellants.
Tumelson Family Limited Partnership; et al., Plaintiffs-Appellees,
v.
World Financial News Network, Defendant,
and
Kelvin Chin, Defendant-Appellant.
Tumelson Family Limited Partnership; et al., Plaintiffs-Appellees,
v.
World Financial News Network, Defendant,
and
Ronald J. Slaughter; et al., Defendants-Appellants.

Nos. 05-35813, 05-35821, 05-35995.
Argued and Submitted Feb. 8, 2007.
Filed Feb. 28, 2007.

Background: Investors brought action against corporation, its employee, and another shareholder, alleging claims under federal securities law and the Washington State Securities Act (WSSA), and for breach of fiduciary duty, fraud, and negligent misrepresentation. After jury verdict in favor of investors, the United States District Court for the Western District of Washington, James L. Robart, J., 2005 WL 1871116, awarded investors $409,972.74 in attorney fees and costs, and on subsequent determination, 2005 WL 2293588, reduced fee award to $403,684.72. Defendants appealed.

Holdings: The Court of Appeals held that:
(1) shareholder's acts were not a substantial contributing factor in the sales transaction, as required for liability under the WSSA;
(2) shareholder was not a control person who materially aided sale of corporation's stock, as required for control person liability under the WSSA;
(3) shareholder lacked intent required to be liable for breach of fiduciary duty; and
(4) employee who held himself out as corporation's chief financial officer was a control person who materially aided sale of corporation's stock.

Reversed and vacated in part, and affirmed in part.

West Headnotes

[1] Securities Regulation 349B ⚷302

349B Securities Regulation
349BII State Regulation
349BII(B) Civil Effects of Violations
349Bk291 Rights, Liabilities, and Remedies
349Bk302 k. Persons liable. Most Cited Cases

Shareholder's acts were not a substantial contributing factor in sales transaction in which other investors purchased corporation's stock, as required for liability under the Washington State Securities Act (WSSA), where those acts occurred after investors had invested most of their money, and there was no evidence that investors and shareholder discussed buying stock, that shareholder had the attributes of a seller, or that investors relied on shareholder to make their investment decisions, much less that any reliance would have been reasonable. West's RCWA 21.20.430(1).

[2] Securities Regulation 349B ⚷302

349B Securities Regulation
349BII State Regulation
349BII(B) Civil Effects of Violations

349Bk291 Rights, Liabilities, and Remedies
349Bk302 k. Persons liable. Most Cited Cases

Shareholder was not a control person who materially aided sale of corporation's stock, as required for control person liability under the Washington State Securities Act (WSSA), where there was no evidence that he played any role whatsoever in day-to-day operations of the corporation when other investors bought its stock. West's RCWA 21.20.430(3).

[3] Corporations and Business Organizations 101 1526(1)

101 Corporations and Business Organizations
101VI Shareholders and Members
101VI(B) Rights and Liabilities as to Corporation and Other Shareholders or Members
101k1522 Nature of Relation
101k1526 Duty of Shareholders or Members to Other Shareholders or Members
101k1526(1) k. In general. Most Cited Cases
(Formerly 101k174)

Under Nevada law, shareholder whose alleged misrepresentations induced other investors to buy corporation's stock lacked intent required to be liable for breach of fiduciary duty, where shareholder did not know about improprieties at the corporation at time he allegedly made the misrepresentations. West's NRSA 78.138(7)(b).

[4] Securities Regulation 349B 302

349B Securities Regulation
349BII State Regulation
349BII(B) Civil Effects of Violations
349Bk291 Rights, Liabilities, and Remedies
349Bk302 k. Persons liable. Most Cited Cases

Employee who held himself out as corporation's chief financial officer was a control person who materially aided sale of corporation's stock, as required for control person liability under the Washington State Securities Act (WSSA), where he made at least one statement about health of the corporation that was specific, factual, and material, which investors relied on when they bought corporation's stock. West's RCWA 21.20.430(3).

***386** Melinda M. Riddle, Esq., Stephen P. Vanderhoef, Esq., Leslie C. Boyd, Esq., Cairncross & Hempelmann PS, Seattle, WA, for Plaintiffs-Appellees.

Michael Craig Nance, Esq., Law Office of Michael Nance, Seattle, WA, for Defendant.

David F. Jurca, Esq., Phillip D. Noble, Esq., Helsell Fetterman, Seattle, WA, for Defendants-Appellants.

Appeals from the United States District Court for the Western District of Washington, James L. Robart, District Judge, Presiding. D.C. No. CV-03-01340-JLR.

Before: GRABER, PAEZ, and BEA, Circuit Judges.

MEMORANDUM [FN*]

FN* This disposition is not appropriate for publication and is not precedent except as provided by 9th Cir. R. 36-3.

****1** Plaintiffs collectively invested $275,000 in World Financial News Network Corp. ("WFNN"), an Internet start-up company incorporated in Nevada, over the course of seven months in 1999 and 2000. Plaintiffs sued WFNN and individuals associated with the company, including Defendants Slaughter and Chin.[FN1] A jury found Defendant Slaughter liable for $275,000 under the Washington State Securities Act ("WSSA") and for breach of fiduciary duty; the jury found Defendant Chin liable for $255,000 under the WSSA and federal securities law, and for breach of fiduciary duty, fraud, and negligent misrepresentation. The district court denied Defendants' motions for judgment as a matter of law and for a new trial and entered judgment on the jury's verdict. The district ***387** court also awarded Plaintiffs $409,972.74 in attorney fees and costs and held all remaining defendants jointly and severally liable for the entire amount of fees. Defendants Slaughter and Chin appeal the judgment on the jury's verdict, and Defendant Slaughter appeals the award of attorney fees and costs.

FN1. Plaintiffs sued Ronald J. and Jane Doe Slaughter as a marital community, but their allegations concerned only Ronald J. Slaughter. Thus, for the sake of clarity, we will refer to them collectively as Defendant Slaughter.

We review de novo a district court's denial of a motion for judgment as a matter of law. *Bell v. Clackamas County,* 341 F.3d 858, 865 (9th Cir.2003). We review for abuse of discretion a district court's denial of a motion for a new trial. *McEuin v. Crown Equip. Corp.,* 328 F.3d 1028, 1032 (9th Cir.2003).

We reverse the district court's denial of Defendant Slaughter's motion for judgment as a matter of law and vacate the judgment against him. Consequently, we vacate the district court's award of attorney fees and costs against Defendant Slaughter. We affirm the judgment against Defendant Chin.

[1] 1. Defendant Slaughter was entitled to judgment as a matter of law on Plaintiffs' WSSA claim. Primary liability under the WSSA can attach only if a defendant's acts were a substantial contributing factor in the sales transaction. Wash. Rev.Code § 21.20.430(1); *see also Haberman v. Wash. Pub. Power Supply Sys.,* 109 Wash.2d 107, 744 P.2d 1032, 1052 (1987) (establishing the substantial contributing factor test); *Hoffer v. State,* 113 Wash.2d 148, 776 P.2d 963, 964-65 (1989) (reaffirming the substantial contributing factor test after the Supreme Court adopted a strict privity test for federal securities law in *Pinter v. Dahl,* 486 U.S. 622, 108 S.Ct. 2063, 100 L.Ed.2d 658 (1988)). Here, Plaintiffs testified only to vague, impressionistic generalities about two conversations with Defendant Slaughter at the WFNN Christmas party on December 17, 1999, each of which occurred after Plaintiffs had invested most of their money, and five months before Plaintiffs reaffirmed their investments. There was no evidence that they discussed buying stock, that Defendant Slaughter had the attributes of a seller, or that Plaintiffs relied on Defendant Slaughter to make their investment decisions, much less that any reliance would have been reasonable.

[2] Secondary liability can attach to control persons, directors, or employees who materially aid sellers. Wash. Rev.Code § 21.20.430(3). To determine control person liability, the Washington Supreme Court has applied the federal two-part test that requires that a defendant have exercised control over the operations of the corporation *and* possessed the power to control the transaction that violated the securities law. *See Hines v. Data Line Sys., Inc.,* 114 Wash.2d 127, 787 P.2d 8, 13-14 (1990) (applying both the federal two-part test and the federal culpable participation test, but stating that the text of section 21.20.430(3) does not accord with the requirements of the more stringent culpable participation test). Here, there was no evidence that Defendant Slaughter played any role whatsoever in the day-to-day operations of WFNN when Plaintiffs made their investment decisions, and therefore he was not a control person. *See Paracor Fin., Inc. v. Gen. Elec. Capital Corp.,* 96 F.3d 1151, 1162 (9th Cir.1996) (requiring that control be determined by examining a defendant's day-to-day affairs in a corporation (citing *Kaplan v. Rose,* 49 F.3d 1363, 1382 (9th Cir.1994))). In addition, the district court held that, as a matter of law, Slaughter was not a director, and instructed the jury to that effect; that ruling has not been appealed.

****2** [3] 2. Defendant Slaughter was entitled to judgment as a matter of law on Plaintiffs' claim for fiduciary duty liability. ***388** Under Nevada law, liability attaches only if a fiduciary commits “intentional misconduct, fraud or a knowing violation of law.” Nev.Rev.Stat. § 78.138(7)(b). Here, the district court found that “a jury verdict based on Dr. Slaughter's *knowing* misrepresentation to the Tumelsons would be unsupportable.” (Emphasis added.) No evidence in the record suggests otherwise. Indeed, the fact that Defendant Slaughter invested $200,000 in WFNN after the Christmas party suggests that he did not know about the improprieties at WFNN. In short, there was no evidence that Defendant Slaughter had the intent required for fiduciary duty liability to attach.

3. The district court awarded attorney fees and costs pursuant to Defendant Slaughter's liability under the WSSA. *See* Wash. Rev.Code § 21.20.430(1) (allowing for the award of attorney fees and costs to prevailing plaintiffs). Because we vacate the judgment on that claim, we also vacate the district court's award of attorney fees and costs against Defendant Slaughter. FN2

FN2. Consequently, we need not reach Defendant Slaughter's challenges to the verdict form, jury instructions, evidentiary rulings, or reasonableness of the attorney fees award.

[4] 4. We affirm Defendant Chin's liability under the WSSA. The jury could have found that Chin was an employee who materially aided the sale of securities. Chin gave a 20-minute PowerPoint presentation to investors at which he held himself out as the Chief Financial Officer. He made at least one statement about the health of WFNN that was specific, factual, and material that he knew he had no basis whatsoever to make. Although the WSSA jury instruction erroneously omitted the element of Plaintiffs' reliance on Chin, this error was harmless. For example, Plaintiff Kelly Tumelson testified that Chin's statement, which occurred before Plaintiffs purchased additional WFNN stock and before they affirmed their investments in WFNN, was "good news to me" and "important to me." The jury necessarily found reliance when it held Chin liable for fraud, negligent misrepresentation, and violating federal securities law.

Chin's WSSA liability is an independent and adequate basis with which to uphold the jury's verdict. However, Chin's actions also support the jury's verdict on fiduciary duty liability, *see* Nev.Rev.Stat. § 78.138(7)(b) (establishing fiduciary duty under Nevada law); federal securities law violation, *see* *Sparling v. Daou (In re Daou Sys., Inc.),* 411 F.3d 1006, 1014 (9th Cir.2005) (discussing the five elements of a claim under 17 C.F.R. § 240.10b-5), *cert. denied*, 546 U.S. 1172, 126 S.Ct. 1335, 164 L.Ed.2d 51 (2006); fraud, *see Stiley v. Block,* 130 Wash.2d 486, 925 P.2d 194, 204 (1996) (discussing the nine elements of a fraud claim under Washington law); and negligent misrepresentation, *see* *ESCA Corp. v. KPMG Peat Marwick,* 135 Wash.2d 820, 959 P.2d 651, 654 (1998) (discussing Washington's adoption of the Restatement for negligent misrepresentation).

5. Defendant Chin's remaining arguments are unpersuasive. The district court did not abuse its discretion in choosing when and how to instruct the jury on the use of the confidential private offering memorandum and executive summary as evidence. Fed.R.Evid. 105; *see also* *United States v. Butcher,* 926 F.2d 811, 816 (9th Cir.1991) (reviewing for abuse of discretion). Chin waived his request for attorney fees by failing to raise the issue below, *Smith v. Marsh,* 194 F.3d 1045, 1052 (9th Cir.1999); he also fails on the merits because he was neither the plaintiff nor the prevailing party, *see* Wash. Rev.Code § 21.20.430(1) (awarding attorney fees to prevailing plaintiffs). Finally, the jury's ***389** verdict was not irreconcilably inconsistent. *See* *Zhang v. Am. Gem Seafoods, Inc.,* 339 F.3d 1020, 1038 (9th Cir.2003) (requiring an irreconcilable inconsistency to overturn a jury's verdict). As the district court noted, the $20,000 investment for which the jury did not hold Defendant Chin liable was a unique investment created by a co-defendant.

****3** REVERSED and VACATED as to Defendant Slaughter (Nos. 05-35813, 05-35995); AFFIRMED as to Defendant Chin (No. 05-35821).

C.A.9 (Wash.),2007.
Tumelson Family Ltd. Partnership v. World Financial News Network
242 Fed.Appx. 385, 2007 WL 650329 (C.A.9 (Wash.))

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United States Bankruptcy Court,
D. Delaware.
In re WASHINGTON MUTUAL, INC., et al., Debtors.
Nadia Youkelsone, Plaintiff,
v.
Washington Mutual, Inc., Defendant.

Bankruptcy No. 08–12229 (MFW).
Adversary No. 09–50039 (MFW).
Aug. 13, 2010.

Nadia Youkelsone, pro se.

Lee E. Kaufman, Richards, Layton & Finger, P.A., Wilmington, DE, for Defendant.

MEMORANDUM OPINION [FN1]

FN1. The Court is not required to state findings of fact or conclusions of law when ruling on a motion under Rule 12. Fed. R. Bankr.P. 7052(a)(3). Accordingly, the Court herein makes no findings of fact or conclusions of law but accepts the facts as averred in the Amended Complaint.

MARY F. WALRATH, United States Bankruptcy Judge.

***1** Before the Court is the Defendant's Motion to Dismiss the Amended Complaint filed by Nadia Youkelsone ("Youkelsone"). For the reasons set forth below, the Court will grant the Motion.

I. *BACKGROUND*

The Defendant, Washington Mutual, Inc. ("WMI"), a Washington corporation, was a savings and loan holding company whose primary asset was Washington Mutual Bank ("WMB"). On September 25, 2008, the Office of Thrift Supervision seized WMB and appointed the Federal Deposit Insurance Corporation ("FDIC") as receiver. Immediately following its appointment as receiver, the FDIC sold substantially all the assets and liabilities of WMB to JPMorgan Chase Bank, National Association ("JPM"). On September 26, 2008, WMI filed a petition for relief under chapter 11 of the Bankruptcy Code.

On January 21, 2009, Youkelsone, proceeding pro se,[FN2] filed a complaint against WMI. On February 20, 2009, WMI filed a motion to dismiss the complaint. On October 8, 2009, the Court issued an Order granting WMI's Motion to Dismiss. Youkelsone then filed an amended complaint on November 6, 2009 (the "Amended Complaint"). The Amended Complaint alleges the following:

FN2. As Youkelsone appears *pro se,* this Court interprets her pleadings liberally. *See, e.g.,* *Alson v. Parker,* 363 F.3d 229, 234 (3d Cir.2004) (noting that pro se complaints in particular should be construed liberally).

• WMI, through WMB, owned and/or serviced the mortgage on Youkelsone's two-family dwelling. (Am.Compl.¶ 36.)

• WMI "operated its banking and related financial operation[s] exclusively through" WMB. *(Id.* at ¶ 7.)

• In September 2001, the Federal National Mortgage Association ("FNMA") commenced a foreclosure action against Youkelsone's property, claiming that the mortgage had been assigned to it from WMI. *(Id.* at ¶ 44.)

• At the time of the foreclosure action Youkelsone's equitable interest in the property, over $600,000, far exceeded the value of the note, approximately $153,000. *(Id.* at ¶¶ 45–46.)

• WMI continuously rejected Youkelsone's requests to allow her to sell the premises through a private sale. *(Id.* at ¶ 65.)

• Youkelsone entered into a workout plan with WMI and on February 5, 2004, provided WMI with all the required documents and information. *(Id.* at ¶¶ 67–68.)

• WMI made no determination on Youkelsone's application to cure the default. Instead, WMI moved to foreclose on Youkelsone's property and scheduled a foreclosure sale on February 26, 2004. *(Id.* at ¶¶ 62–63.)

• Youkelsone subsequently obtained WMI's express permission to sell the property privately to a third party for less than fair market value. *(Id.* at ¶¶ 71–72.)

• On June 21 and 29, 2004, Youkelsone requested the payoff statement and closing papers. *(Id.* at ¶¶ 75 & 77.) On June 30, 2004, WMI sent a letter to Youkelsone demanding all sums due on the note. *(Id.* at ¶ 78.) Following WMI's demand letter, Youkelsone unsuccessfully requested the payoff statement at least five more times. *(Id.* at ¶ 79.)

• On October 22, 2004, WMI again moved to foreclose on the property, scheduling an auction for November 18, 2004. *(Id.* at ¶ 80.)

***2** • On October 24, 2004, WMI provided Youkelsone with the payoff statement, which included finance charges, attorneys' fees, private mortgage insurance charges, late fees, and other charges. *(Id.* at ¶¶ 83–84.)

Based on these allegations, Youkelsone's Amended Complaint asserts the following nine causes of action against WMI: (1) abuse of process, (2) economic duress, (3) breach of contract, (4) unjust enrichment, (5) bad faith, (6) conduct in violation of section 1921(4) of the New York Real Property Actions and Proceedings Law (the "NYRPAPL"), (7) conduct in violation of section 1639 of the Truth in Lending Act ("TILA"), (8) deceptive practices, (9) misrepresentation, fraud, and deceit, and (10) intentional infliction of emotional harm.

On December 4, 2009, WMI filed a Motion to Dismiss the Amended Complaint. Youkelsone opposes the Motion. This matter has been fully briefed and is ripe for decision.

II. *JURISDICTION*

The Court has jurisdiction over this core proceeding pursuant to 28 U.S.C. §§ 1334 & 157(b)(2)(A), (B) & (O).

III. *DISCUSSION*

WMI moves to dismiss the Amended Complaint pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. *See* Fed. R. Bankr.P. 7012. WMI contends that Youkelsone's claims are barred by the statute of limitations, that Youkelsone is estopped from litigating her claims by issue preclusion (collateral estoppel), and that Youkelsone has failed to state a claim upon which relief can be granted.

A. *Standard on a Rule 12(b)(6) Motion to Dismiss*

In order for Youkelsone to survive a Rule 12(b)(6) motion, her claims must meet the standards of pleading. The Supreme Court's recent decisions in *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007) and *Ashcroft v. Iqbal,* — U.S. ——, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009) have shifted federal pleading standards from notice pleading to a heightened standard of pleading. *Fowler v. UPMC Shadyside,* 578 F.3d 203, 210 (3d Cir.2009). This heightened pleading requirement applies to all civil suits in federal courts. *Id.*

To survive a motion to dismiss under the new pleading standard, a complaint must contain "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." *Iqbal,* 129 S.Ct. at 1940. A claim is facially plausible "when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.* at 1949. "[A] pleading offering only labels and conclusions or a formulaic recitation of the elements of a cause of action will not do." *Fowler,* 578 F.3d at 210. "Courts have an obligation in matters before them to view the complaint as a whole and to base rulings not upon the presence of mere words but, rather, upon the presence of a factual situation which is or is not justiciable." *Doug Grant, Inc. v. Greate Bay Casino Corp.,* 232 F.3d 173, 184 (3d Cir.2000). A court must "draw on the allegations of the complaint, but in a realistic, rather than a slavish, manner." *Id.*

***3** Determining whether a complaint is "facially plausible" is "a context-specific task that requires the reviewing court to draw on its judicial experience and common sense." *Iqbal,* 129 S.Ct. at 1950. However, "where the well-pleaded facts do not permit the court to infer more than the mere possibility of misconduct, the complaint has alleged—but it has not shown—that the pleader is entitled to relief." *Id.*

In *Fowler,* the Third Circuit instructed courts to conduct a two-part analysis. *Fowler,* 578 F.3d at 210. "First the factual and legal elements of a claim should be separated," with the reviewing court accepting "all of the complaint's well-pleaded facts as true, but ... disregard[ing] any legal conclusions." *Id.* at 210–11. Next, the reviewing court must "determine whether the facts alleged in the complaint are sufficient to show that the plaintiff has a plausible claim for relief." *Id.*

B. *Affirmative Defenses under Rule 12(b)(6)*
The statute of limitations and issue preclusion are affirmative defenses. Fed.R.Civ.P. 8(c). Typically, affirmative defenses are raised in a defendant's answer. *Id.* However, any affirmative defense "apparent on the face of the complaint" may be raised in a Rule 12(b)(6) motion. *Rycoline Prods., Inc. v. C & W Unlimited,* 109 F.3d 883, 886 (3d Cir.1997) *(citing Bethel v. Jendoco Constr. Corp.,* 570 F.2d 1168, 1174 (3d Cir.1978)).

When an affirmative defense is raised in a motion under Rule 12(b)(6), the evaluation of the defense is not limited to the four corners of the complaint. *See O'Boyle v. Braverman,* 337 F. App'x 162, 164 (3d Cir.2009). A court may also consider matters of which judicial notice may be taken. *Id.* Therefore, "a court may properly look at public records, including judicial proceedings, in addition to the allegations in the complaint." *Id.* A court "may take judicial notice of another court's opinion—not for the truth of the facts recited therein, but for the existence of the opinion...." *Id.* at 164–65.

1. *Statute of Limitations*
WMI argues that Youkelsone's claims are time-barred under Delaware's statute of limitations and therefore should be dismissed for failure to state a claim upon which relief can be granted. Youkelsone responds that the New York statute of limitations should apply to her claims, but contends that her claims are not time-barred even if Delaware law were to apply. Youkelsone further argues that the statute of limitations should be tolled regardless of what law applies because the underlying basis of her claims is fraud.

A choice of law determination should only be undertaken if there is an actual conflict between the relevant laws. *See, e.g., Parlin v. Dyncorp Intern., Inc.,* No. 08c–01–136 FSS, 2009 WL 3636756, at *3 n. 16 (Del.Super.Ct. Sept.30, 2009) (stating that the court should avoid choice of law question where the laws of two jurisdictions would produce the same result on the particular issue presented). Therefore, it is necessary to determine whether the relevant Delaware and New York statutes conflict.

a. *Delaware Statute of Limitations*
***4** Delaware applies a general three-year statute of limitations. Del.Code Ann. tit. 10 § 8106. However, Youkelsone argues that her claims are subject to a six-year statute of limitations. Del.Code Ann. tit. 10 § 8109 (a six-year statute of limitations applies to a cause of action arising "from a promissory note, bill of exchange, or acknowledgment under the hand of the party of a subsisting demand .")

Youkelsone is correct that section 8109 applies to a cause of action arising from an obligation created by a mortgage note. *See, e.g., F.D.I.C. v. Brossman,* No. Civ.A 81C–DE–116, 1984 WL 553542, at * (Del.Super.Ct., June 12, 1984) (applying six-year statute of limitations to action brought by mortgage assignee to collect deficiency after foreclosure). However, section 8109 does not apply to Youkelsone's causes of action because they are not based on obligations created by the mortgage note. The mortgage note requires payment *by* Youkelsone, not payment to Youkelsone. *See, e.g., Security Storage Co. v. Equitable Sec. Trust Co.,* 147 A.2d 507, 510–11 (Del.Super.Ct.1958) (stating that the six-year statute of limitations applies only "to contracts, obligations, or liabilities growing, not remotely or ultimately, but immediately, out of written instruments; and the written instrument relied on must itself contain a contract to do the thing for the nonperformance of which the action is brought"). Section 8109 does not apply unless the mortgage note itself creates liability for Youkelsone's claims. Youkelsone has not relied on any language in the mortgage note as the basis of her claims, and therefore, the Court concludes that her claims would not be subject to the six-year statute of limitations pursuant to section 8109.

Rather, the Court finds that under Delaware law Youkelsone's claims would be subject to the general three-year statute of limitations under section 8106. *See, e.g., Medtronic Vascular, Inc. v. Advanced Car-*

diovascular Sys., Inc., No. Civ. 98–80–SLR, 2005 WL 46553, at *4 (D.Del. Jan.5, 2005) (applying § 8106 to claims for unjust enrichment and fraud); *Thor Merritt Square, LLC v. Bayview Malls LLC*, 2010 WL 972776, at *3 n. 6 (Del.Ch. Mar.5, 2010) (applying § 8106 to breach of contract claims); *Crowhorn v. Nationwide Mut. Ins. Co.*, No. Civ. A 00C–06–01WLW, 2002 WL 1767529, at *5 (Del.Super.Ct. Jul.10, 2002) (applying § 8106 to claim for bad faith).

b. *New York Statute of Limitations*

Youkelsone's claims for abuse of process and intentional infliction of emotional distress would be subject to a one-year statute of limitations. N.Y.C.P.L.R. 215[3] (McKinney 2010). *See, e.g., Dinerman v. City of New York Admin. for Children's Services,* 50 A.D.3d 1087, 857 N.Y.S.2d 221 (App.Div.2008) (applying one-year limitations period of Rule 215[3] to claims for abuse of process and intentional infliction of emotional distress). In addition, her claim under TILA is also subject to a one-year statute of limitations. 15 U.S.C. § 1640(e) (stating that action for violation of TILA section 1639 may be brought within one year from the date of the occurrence of the violation).

***5** The remainder of Youkelsone's claims would be subject to New York's general six-year statute of limitations. N.Y.C.P.L.R. 213 (McKinney 2010). *See, e.g., Key Bank of New York v. Del Norte Inc.*, 251 A.D.2d 740, 673 N.Y.S.2d 788, 789 (App.Div.1998) (applying rule 213 to cause of action for violation of NYRPAPL); *Benyo v. Sikorjak*, 50 A.D.3d 1074, 858 N.Y.S.2d 215, 217 (App.Div.2008) (applying rule 213[7] to a claim for fraud); *Second Presb. Church in City of New York v. Cenpark Realty LLC*, 65 A.D.3d 979, 885 N.Y.S.2d 418 (App.Div.2009) (applying rule 213[2] to a breach of contract claim); *Sirico v. F.G.G. Prods., Inc.*, 71 A.D.3d 429, 896 N.Y.S.2d 61, 66 (App.Div.2010) (applying rule 213[1] to a claim for unjust enrichment). Therefore, there is a conflict between Delaware's and New York's limitations periods.

c. *Borrowing Statute*

WMI contends that Delaware's borrowing statute requires the Court to apply Delaware's general three-year statute of limitations. The borrowing statute directs the Court to compare Delaware's applicable limitations period with that of the state in which the cause of action arose and to apply the shorter period. Del.Code Ann. tit. 10, § 8121 (2010).

The purpose of the borrowing statute is to prevent forum-shopping. *Saudi Basic Indus. Corp. v. Mobil Yanbu Petrochemical Co.*, 866 A.2d 1, 16 (Del.Super.Ct.2005). It prevents parties from using Delaware as a forum in order to benefit from its more favorable limitations period. *Id.* In the typical scenario, the statute prohibits a plaintiff from bringing an out-of-state claim, barred by the foreign state's statute of limitations, to Delaware where the claim is not time-barred. *Id.* at 16–17. However, the statute will not be applied to permit a party to take advantage of Delaware's shorter limitations period, as this "would basically turn the borrowing statute on its head for the purpose for which it was enacted." *Id.* at 15.

WMI seeks to limit the reasoning of *Saudi Basic* to situations in which plaintiffs choose a forum in order to prevent time-barred counterclaims. The Court disagrees, as this narrow construction fails to consider the primary purpose of Delaware's borrowing statute. The borrowing statute is meant to prevent *either party* in a suit from circumventing the statute of limitations of another jurisdiction by choosing Delaware as the forum state.

Similar rationales apply when debtors file for bankruptcy in Delaware. *See In re W.R. Grace & Co.*, 418 B.R. 511, 516–19 (D.Del.2009). A debtor's filing for bankruptcy in Delaware sets Delaware as the forum and requires that a creditor pursue all its claims here. *Id.* at 518 n. 4. Allowing Delaware's borrowing statute to determine the applicable statute of limitations in such a scenario would "subvert the fundamental purpose of the statute and encourage forum-shopping by debtors seeking statute of limitations protection." *Id.*

When WMI filed for bankruptcy in Delaware, it chose Delaware as the forum in which creditors must bring all of their claims. To allow WMI to use the benefit of Delaware's shorter limitations period would subvert the anti-forum-shopping purpose of the borrowing statute. Therefore, the Court will not apply Delaware's borrowing statute.

d. *Delaware's General Choice–of–Law Provision*

***6** When the borrowing statute is inapplicable, Delaware's general choice-of-law rules determine which state's statute of limitations applies where there is a conflict. *W.R. Grace*, 418 B.R. at 518. Delaware courts determine choice of law through application of the "most significant relationship test set forth in the Restatement (Second) of Conflicts of Laws." [FN3] Shandler v. DLJ Merchant Banking, Inc., No. 4797–VCS, 2010 WL 2929654, at *17 n. 149 (Del.Ch. July 26, 2010). To determine which state has the most significant relationship, the court considers: the place where the injury occurred, the place where the conduct causing the injury occurred, the domicile, residence, nationality, place of incorporation and place of business of the parties, and the place where the relationship, if any, between the parties is centered. W.R. Grace, 418 B.R. at 519. The importance of these contacts are evaluated according to their relevance to the particular issue. *Id.* The test requires the court to apply the law of the state with the most significant contacts, not simply the largest number of contacts. Travelers Indem. Co. v. Lake, 594 A.2d 38, 48 (Del.1991).

FN3. Restatement (Second) of Conflicts of Laws § 145(1) (1971).

Youkelsone's Amended Complaint includes primarily tort and contract claims. All of the claims are generally related to the mortgage contract on Youkelsone's New York residence. New York has substantial connections to the causes of action as all of Youkelsone's alleged injuries occurred in New York, Youkelsone was domiciled in, and a resident of, New York at the time the injuries arose, and any relationship between WMI and Youkelsone was centered in New York. Washington is the only other jurisdiction with any relevant contacts, as WMI was both incorporated and headquartered there. Because Washington was WMI's main place of business, it was likely the place where some of the conduct by WMI which allegedly caused Youkelsone's injury occurred. Delaware is the jurisdiction with the least important contacts, as the only relevant contact is WMI's bankruptcy case.

Viewing these contacts for their significance to the causes of action, the Court concludes that New York has the most significant relationship. *See, e.g.,* Cervantes v. Bridgestone/Firestone North, Tire Co., LLC, No. 07C–06–249 JRJ, 2010 WL 431788, at *2 (Del.Super.Ct. Feb. 8, 2010). Therefore, the Court will apply New York's statute of limitations.

e. *Applying New York Statute of Limitations*

The effective date for the purposes of evaluating the limitations period is September 26, 2008, the date of WMI's chapter 11 filing.[FN4] As noted above, Youkelsone's claims for abuse of process, intentional infliction of emotional distress, and violation of TILA are not included in the general statute of limitations, but are subject to a one-year statute of limitations. Therefore, these causes of action must have accrued after September 27, 2007. Because Youkelsone has not pleaded any factual allegations with respect to those claims arising after that date,[FN5] these claims are time-barred.

FN4. The commencement or continuation of any action against WMI was stayed by WMI's chapter 11 filing pursuant to section 362 of the Bankruptcy Code. 11 U.S.C. § 362(a). The time to file a claim or action is tolled until 60 days after relief from the automatic stay is granted. *Id.* at § 108(b). Similarly, New York Law provides that "[w]here the commencement of an action has been stayed by a court or by statutory prohibition, the duration of the stay is not a part of the time within which the action must be commenced." N.Y.C' .P.L.R. 204(a) (McKinney 2010).

FN5. Although Youkelsone makes allegations relating to December 2008 and June 2009 (Am.Compl.¶ 53) and states that the WMI maintains an action that "is still pending as of now in the State Court" (Am Compl. ¶ 92), these allegations relate to the Mortgage Action, which Youkelsone is barred by issue preclusion from alleging against WMI, as discussed below.

*7 As discussed above, however, Youkelsone's claims for breach of contract, unjust enrichment, fraud, and violations of NYRPAPL do fall under the general six-year statute of limitations. Therefore, the critical date after which these causes of action must have accrued is September 26, 2002. The Amended Complaint alleges conduct by WMI from 2003 to 2004 that relates to all of these causes of action. (Am.Compl.¶¶ 55–85.) Therefore, the Court will not grant WMI's motion to dismiss those claims based on the statute of limitations.

2. *Issue Preclusion*

WMI argues that Youkelsone is barred by issue preclusion from pursuing her remaining claims because a New York court has found that Youkelsone's mortgage was validly assigned by Washington Mutual Home Loans, Inc. ("WMHL") to FNMA. WMI argues that the effect of the previous litigation is to bar Youkelsone from stating any cause of action against WMI to the extent it depends on WMI's ownership of Youkelsone's mortgage note.

On October 2, 2001, FNMA initiated an action in the New York State Court to foreclose upon Youkelsone's residence (the "Foreclosure Action"). *Federal Nat'l Mortgage Ass'n v. Youkelsone,* 36834/01 (N.Y.Sup.Ct.2001). In response, Youkelsone filed a motion to dismiss, alleging that the assignment of her mortgage by WMHL to FNMA was invalid and that FNMA lacked standing to sue. *Id.* The court denied the motion to dismiss, finding that the assignment to FNMA was valid. *Id.* On appeal, the order denying Youkelsone's motion to dismiss was affirmed. *FNMA v. Youkelsone,* 303 A.D.2d 546, 755 N.Y.S.2d 730 (N.Y.App.Div.2003).

While the Foreclosure Action was pending, Youkelsone initiated a separate lawsuit on December 24, 2001, in New York State Court (the "State Court Action") against WMHL, Fleet Mortgage Corporation, and Fleet Financial Group, Inc. Youkelsone again alleged wrongful conduct related to the foreclosure on her home. The defendants filed a motion to dismiss, which was granted and affirmed, because to the extent Youkelsone's claims were dependant upon issues asserted and decided in the Foreclosure Action, she was collaterally estopped from raising them again. *Youkelsone v. FNMA,* 309 A.D.2d 655, 765 N.Y.S.2d 792 (N.Y.App.Div.2003).

Youkelsone argues that collateral estoppel is inapplicable because the Amended Complaint alleges different issues and facts from the previous Foreclosure and State Court Actions. She contends that the current claims relate to WMI's wrongdoing from June 2003 to present, while the previous litigation reflected the period of 1999 to 2001. Youkelsone also argues that because WMI's actions prevented her from litigating and pursuing her remedies under the law, the previous state court decisions were not made on the merits.

Under the principle of issue preclusion, a party may not re-litigate an issue that was fully litigated in a previous action. *Board of Trustees of Trucking Employees of North Jersey Welfare Fund, Inc., v. Centra,* 983 F.2d 495, 505 (3d Cir.1992). The full faith and credit statute directs federal courts to refer to the law of the state in which judgment was rendered in determining whether issue preclusion applies. 28 U.S.C. § 1738. *See also Marrese v. Am. Acad. of Orthopaedic Surgeons,* 470 U.S. 373, 380, 105 S.Ct. 1327, 84 L.Ed.2d 274 (1985). As both the Foreclosure Action and the State Court Action occurred in New York, the Court applies the preclusion law of New York, which bars claims "if (1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in that proceeding; (3) the party against whom issue preclusion is asserted had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits." *Congregation Adas Yereim v. City of New York,* 673 F.Supp.2d 94, 108 (E.D.N.Y.2009) *(citing Uzdavines v. Weeks Marine, Inc.,* 418 F.3d 138, 146 (2d Cir.2005)). The "tribunals or causes of action" need not be the same, but the issue that was raised previously "must be decisive of the present action." *LaFleur v. Whitman,* 300 F.3d 256, 271 (2d Cir.2002).

***8** Youkelsone argues that collateral estoppel does not apply because the instant action alleges different issues and facts from the prior actions. Although the parties, facts, or causes of action may be different, a plaintiff is still barred from pursuing a claim where an essential element of the claim has already been determined. *See, e.g., Quality Measurement Co. v. IPSOS S.A.,* 56 F. App'x 639, 645–46 (6th Cir.2003); *Singleton Management, Inc. v. Compere,* 243 A.D.2d 213, 673 N.Y.S.2d 381, 383 (App.Div.1998) (stating that where requirements of collateral estoppel are met, "there is no need, as there is with res judicata, that the cause of action sought to be barred be substantially identical to one decided in the prior action or that the party seeking to invoke the doctrine have had any connection to the prior action.").

In the Foreclosure Action, Youkelsone attempted to contest the validity of the assignment of the mortgage, and the court held that the assignment was valid because it was in writing and signed by the agent of the assignor. *FNMA v. Youkelsone,* 755 N.Y.S.2d at 730. In the subsequent State Court Action, the court held that Youkelsone's claims were barred by collateral estoppel to the extent that they were dependent upon an alleged invalidity of the assignment of the mortgage. *Youkelsone v. FNMA,* 309 A.D.2d 655, 765 N.Y.S.2d 792. Therefore, although Youkelsone may allege a different set of facts against a different party, her claims may still be barred to the extent ownership of the mortgage is an essential element of the claims.

Youkelsone also alleges that the acts of WMI prevented her from fully litigating her claims and notes that her cause of action for abuse of process is evidence of this. In her abuse of process cause of action in this Court, Youkelsone alleges that WMI "improperly influenced the courts by using deceptive means, false documents and false claims." (Am.Compl.¶ 99.) She does not identify any of these documents or claims, however, nor does she explain how they prevented her from raising any factual or legal issues she may have asserted to contest the assignment of the mortgage. The Court finds that Youkelsone had a full and fair opportunity to litigate the validity of the assignment of the mortgage note in the previous action.

Youkelsone argues that neither of the previous decisions were issued on the merits but again presents no facts to support that assertion. A judgment is rendered on the merits if based on an independent analysis of the claims. *See, e.g., Tang v. State of R.I., Dept. of Elderly Affairs,* 904 F.Supp. 69, 74 (D.R.I.1995). The finding of the court in the Foreclosure Action was clearly on the merits. Youkelsone previously argued in state court that the fact that only token consideration for the assignment was given indicates that the assignment was fraudulent. *FNMA v. Youkelsone,* 755 N.Y.S.2d at 730. The court determined after independent review that the assignment was valid and that FNMA therefore had standing to sue on the mortgage note. The "full and fair opportunity" prong of the collateral estoppel doctrine is met if the party in the previous state court proceeding was fully able to raise the same factual or legal issues that are now asserted. *LaFleur v. Whitman,* 300 F.3d at 274.

***9** In this case, the principles of collateral estoppel are met. Youkelsone has not identified any reason why the previous actions should not be given preclusive effect. *See In re City of New York,* No. 14010/00, 2007 WL 509797, at *15 (N.Y.Sup.Ct. Feb. 15, 2007) (stating that collateral estoppel is based upon the general notion that it is not fair to permit a party to relitigate an issue that has already been decided against it and considering whether relitigation should be permitted requires analysis of "competing policy considerations, including fairness to the parties, conservation of the resources of the court and the litigants, and the societal interests in consistent and accurate results"). Allowing Youkelsone to relitigate the validity of the assignment of the mortgage would allow her to contest an issue that has already been fully litigated, decided, and affirmed on appeal. Therefore, the Court concludes that Youkelsone's claims are barred to the extent ownership of the mortgage is an essential element of those claims.

The Amended Complaint includes a number of allegations relating to the commencement and pursuit of the Foreclosure Action and alleges that WMI "was [the] ultimate party in interest in the Foreclosure action." (Am.Compl.¶ 51.) Under New York law a plaintiff seeking to foreclose "must establish that it was the owner or holder of the note and mortgage at the time that it commenced the foreclosure action." *Financial Freedom SFC v. Slinkosky,* No. 11879/2009, 2010 WL 2802170, at *1 (N.Y. Sup.Ct. June 24, 2010) *(citing FNMA v. Youkelsone,* 393 A.D.2d at 546). Because Youkelsone is barred from contesting the ownership of the mortgage note, the Court concludes that claims relating to the Foreclosure Action are barred by issue preclusion because ownership of the note is an essential element of those claims.

3. *Plausibility of Remaining Claims for Relief*

Youkelsone's remaining claims for violation of NYRPAPL, unjust enrichment, and fraud must be evaluated under Rule 12(b)(6) to determine if they "contain sufficient factual matter, accepted as true, to state a claim for relief that is plausible on its face." *Iqbal,* 129 S.Ct. at 1940.

Youkelsone alleges two alternative bases for WMI's liability: (1) *direct* liability for various wrongs related to the servicing of her mortgage and (2) *indirect* liability for the actions of its banking subsidiary, WMB, in its servicing of her mortgage.

WMI argues that Youkelsone has failed to state a claim upon which relief can be granted. WMI contends that Youkelsone has sued the wrong party because WMI never owned or serviced Youkelsone's mortgage. Further, WMI argues that the Amended

Complaint does not allege sufficient facts to justify disregarding the corporate form and finding WMI liable for WMB's alleged acts.

a. *Direct Liability*

In order to assert a direct liability claim against WMI, Youkelsone alleges that WMI "formally acquired the Mortgage" and "was the actual owner of the subject mortgage and note." (Am. Comp. ¶ 37 & 39.) Because as noted above Youkelsone is barred from contesting the ownership of the mortgage, the direct liability claim against WMI based on ownership of the mortgage is not plausible.

***10** Youkelsone also asserts causes of action relating to the servicing of her mortgage. Youkelsone alleges that "[a]t all times [WMI] serviced the mortgage." *(Id.* at ¶ 34.) Mortgage servicing is often assigned to third parties by the note holder, making the third party responsible for collecting the borrower's payments, maintaining all of the necessary accounts, and making the necessary disbursements to the mortgage note holder. Deerman v. Federal Home Loan Mortg. Corp., 955 F.Supp. 1393, 1396 (N.D.Ala.1997). The Amended Complaint alleges that WMI serviced her mortgage, and "assessed various fees, excessive interest rate, PMI charges on the loan account and inflated the amount due to egregious extent." (Am.Compl.¶ 34.) Youkelsone's allegations relating to the servicing of her mortgage are included in her causes for unjust enrichment, fraud, breach of contract, and violation of NYRPAPL.

Whether Youkelsone can pursue any of these causes of action depends on whether a mortgage servicer can be held liable to the mortgagor. Youkelsone has failed to allege any contractual relationship existed between her and WMI as mortgage servicer. Under New York law, unless the mortgage servicer is a party to the mortgage contract, only the mortgagee can be held liable to the mortgagor. *See, e.g.,* Fellows v. CitiMortgage, Inc., No. 07 Civ. 2261(DLC), 2010 WL 1857243, at *15 (S.D.N.Y. May 11, 2010). As the mortgage holder, only FNMA had a contractual relationship with the servicer and it is the only party with a right to enforce the servicer's obligations pursuant to the servicing contract. *Id.* Youkelsone was not a party to the servicing contract and has no standing to enforce it, even as a third party beneficiary. *Id.* at 16. Therefore, the Court concludes that Youkelsone does not have a plausible claim for breach of contract based on the improper servicing claims.

The Court concludes that the Amended Complaint does not state a plausible claim for relief that WMI is directly liable to Youkelsone for the misconduct related to the ownership or servicing of her mortgage.

b. *Indirect Liability*

The Amended Complaint also alleges that WMI can be held indirectly liable for the acts of its subsidiary bank, WMB. WMI argues that it cannot be held liable for any of the acts allegedly perpetrated by WMB because Youkelsone has failed to plead facts sufficient to disregard the separate corporate forms of WMI and WMB. WMI argues that Youkelsone's allegations are "mere conclusory statements parroting the elements required for piercing the corporate veil without providing any substance" and asserts that Youkelsone's claims "are either meaningless, contrary to undisputed facts in the public record of which the Court can take judicial notice, contrary to the record of the case, or are simply bald and unsupported legal assertions."

Youkelsone responds that piercing the corporate veil is not necessary to hold WMI liable, that it is not a proper subject for resolution on a motion to dismiss, and that the Amended Complaint has pled facts sufficient to pierce the corporate veil and hold WMI liable under both alter ego and agency theories.

***11** First, Youkelsone is incorrect in her assertion that piercing the corporate veil is unnecessary. It is a basic tenet of American corporate law that "the corporation and its shareholders are distinct entities." Dole Food Co. v. Patrickson, 538 U.S. 468, 474, 123 S.Ct. 1655, 155 L.Ed.2d 643 (2003). Therefore, a parent corporation will not be held liable for the actions "of its wholly owned subsidiaries absent evidence that would justify piercing the corporate veil." Minton v. Ralston Purina Co., 146 Wash.2d 385, 47 P.3d 556, 557 (Wash.2002).

Youkelsone is also mistaken in her contention that whether sufficient facts are pled to pierce the corporate veil is not a proper subject for resolution on a motion to dismiss, as courts routinely consider, and grant, motions to dismiss for failure to allege facts sufficient to support the imputation of liability on an alleged alter ego. *See, e.g.,* Spagnola v. Chubb Corp., 264 F.R.D. 76, 86 (S.D.N.Y.2010) (citing cases from various jurisdictions).

Delaware's choice-of-law rules require a court sitting in Delaware to look to a company's state of incorporation to determine the relationship between the corporate entity and its shareholders. *Rosenmiller v. Bordes*, 607 A.2d 465, 468 (Del.Ch.1991). Because both WMI and WMB are incorporated in the state of Washington, the Court applies Washington law in deciding whether WMI can be held liable for WMB's actions, based on the allegations in the Amended Complaint.

Washington law generally recognizes parent corporations and their subsidiaries as distinct legal entities; under either the doctrine of corporate disregard or the alter ego theory, however, a parent corporation may be held liable for the acts of its subsidiary. *See, e.g., In re Wade Cook Fin. Corp.*, 375 B.R. 580, 598 (B.A.P. 9th Cir.2007).

i. *Corporate Disregard*

The doctrine of corporate disregard holds shareholders liable for the corporation's acts when the corporation has been intentionally used to violate or evade a duty owed to another. *See, e.g., Stockton v. Nenadic Invs., Ltd.*, No. 56282–7–I, 2006 Wash.App. LEXIS 2834 at *17–18, 2006 WL 3775850 (Wash.Ct.App. Dec.26, 2006). Under Washington law, a plaintiff seeking to invoke the doctrine of corporate disregard must show: (1) the corporate form was intentionally used to violate or evade a duty and (2) disregard of the corporate form is necessary to prevent unjustified loss to the injured party. *Campagnolo S.r.l. v. Full Speed Ahead, Inc.*, No. C08–1372 RSM, 2010 WL 2079694, at *6 (W.D.Wash. May 20, 2010) *(citing Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wash.2d 403, 645 P.2d 689, 692 (Wash.1982)). The first element "requires an abuse of the corporate form, which typically involves fraud, misrepresentation, or some form of manipulation of the corporation to the stockholder's benefit and creditor's detriment." *Id.* The second element "requires that the wrongful corporate activities cause the harm suffered by the party seeking relief." *Id. (citing Meisel*, 645 P.2d at 692–93).

***12** In order to satisfy the first element, Youkelsone must allege fraud related to the corporate form itself. *Meisel*, 645 P.2d at 692. Alleging that the corporate form is fraudulent requires more than a close relationship. It is presumed that corporations are structured in certain ways because they are advantageous. Absent a showing of fraud, the business judgment of the parties will not be questioned. *See, e.g., Rena–Ware Distributors, Inc. v. State*, 77 Wash.2d 514, 463 P.2d 622, 625 (Wash.1970) (holding that the fact that the parent and subsidiary are joined through ownership of stock, the same officers, employees, etc., does not justify disregarding the separate corporate identities unless they are structured for the purpose of working a fraud upon a third person); *J.I. Case Credit Corp. v. Stark*, 64 Wash.2d 470, 392 P.2d 215, 218 (Wash.1964) (holding that piercing the corporate veil was inappropriate even where parent and wholly owned subsidiary shared officers who were paid by the parent, had common employees, the same address, the same lawyers, the same nonresident agent, and the same auditors, and where the subsidiary's sole business was performing services for the parent).

In the Amended Complaint, Youkelsone makes a number of allegations related to the corporate structure and the close relationship between WMI and WMB. This includes allegations that the two filed consolidated tax returns (Am.Compl.¶ 20), operated a centralized cash management system *(id.* at ¶ 21, 392 P.2d 215), conducted business from the same offices *(id.* at ¶ 13, 392 P.2d 215), shared identical directors and officers *(id.* at ¶ 14, 392 P.2d 215), shared the same president *(id.* at ¶ 15, 392 P.2d 215), and shared common employees *(id.* at ¶ 16, 392 P.2d 215). Youkelsone does not allege, however, that any of these arrangements served a fraudulent purpose. These allegations indicate nothing more than a close relationship between a parent and a subsidiary and are not sufficient to sustain a claim under the doctrine of corporate disregard. *Minton*, 47 P.3d at 563; *J.I. Case*, 392 P.2d at 218.

Youkelsone does allege various fraudulent acts relating to WMB's servicing of her mortgage. The Amended Complaint alleges that WMB engaged in a "vast scheme of fraud and extortion by [assessing] ... outrageous fees and penalties on the account; misapply[ing] and reject[ing]" payments, and failing "to provide closing documents within [a] reasonable period of time." (Am.Compl.¶ 35.) Youkelsone also alleges that WMB "engaged in [a] continuous scheme with intent to deprive the plaintiff of her property by unjustifiably rejecting and/or misapplying the plaintiff's payments towards the mortgage." (Id. at ¶ 58, 392 P.2d 215.) Despite the allegations of fraudulent conduct on behalf of WMB, the claims do not relate to a fraudulent misuse of the corporate form, as "a mere assertion of fraud on the part of a subsidiary does not constitute an abuse of the corporate form." In re Washington Mutual, Inc., 418 B.R. 107, 115 (Bankr.D.Del.2009) (citing Trevino v. Merscorp, Inc., 583 F.Supp.2d 521, 530 (D.Del.2008)). Youkelsone's claim of fraudulent conduct by WMB does not allege abuse of the corporate form, and therefore, the Court finds it insufficient to state a claim for relief against WMI under the doctrine of corporate disregard.

ii. *Alter Ego*

***13** In a parent-subsidiary relationship, the general principle that the parent corporation is not liable for the acts of its subsidiaries is ignored only in exceptional cases. Campagnolo S.r .l., 2010 WL 2079694, at *2 *(quoting* U.S. v. Bestfoods, 524 U.S. 51, 61, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998)). Under the alter ego theory, a parent corporation will be found liable for acts of its subsidiary only if piercing the corporate veil is necessary to prevent fraud or injustice to third parties and the parent "so dominates and controls [the subsidiary] as to make [it] merely an adjunct to [the parent]." Superior Portland Cement, Inc. v. Pac. Coast Cement Co., 33 Wash.2d 169, 205 P.2d 597, 620 (Wash.1049).

> [T]here must be such a commingling of the affairs of two corporations as to work an injustice on third parties if their separate status is recognized.... Their property rights must be so commingled and their affairs so intimately related in management as to render it apparent that they are, in fact and in intent, one, and so related, to have them regarded otherwise would work a fraud upon third persons.
>
> Wade Cook, 375 B.R. at 599.

The Amended Complaint makes numerous claims related to WMI's control and domination of WMB. Many of these claims, however, are merely conclusory allegations of law, unreasonable inferences or deductions of fact, or threadbare recitals of the elements of alter ego. Therefore, they need not be accepted as true by the Court. These include allegations that WMI "controlled, supervised, directed, and completely dominated all of the Bank's financial operations, Bank's policies and business practices in respect to all transactions generated by the Bank" (Am.Compl.¶ 12), "completely directed, managed and controlled" the business affairs of the Bank (*id.* at ¶ 18), "directed, supervised and controlled all decision making, treasury, cash management, finance, governance, regulatory and executive functions of the Bank" *(id.* at ¶ 25), had common divisions, subdivisions, and departments as WMB *(id.* at ¶ 17), "operated the Bank the same as if it were one of the division of the Defendant rather than a wholly owned subsidiary" *(id.* at ¶ 26), had its "business affairs, assets and liabilities ... so connected, commingled and intertwined [with WMB] that no separation of the corporate entity is possible" *(id.* at ¶ 28), controlled and directed Bank's transactions for its own benefit *(id.* at ¶ 29), and "used its subsidiary Bank as mere instrumentality, completely dominated and controlled all financial operations, policies, and business practices to the extent that the Defendant is the ultimate party in interest and should be regarded in law and in fact as a sole party liable for its subsidiary Bank's acts, omissions and wrongdoings" *(id.* at ¶ 30).

These claims offer mere conclusions that WMI controlled WMB but offer no factual allegations which would lead to a plausible inference that WMI directed WMB to engage in misconduct specifically related to the servicing of Youkelsone's mortgage. The Court need not accept as true any conclusory statements or legal conclusions in the Complaint. Iqbal, 129 S.Ct. at 1949–50. Therefore, these statements are not accepted as true in assessing whether Youkelsone states a claim of alter ego.

***14** The Amended Complaint also includes allegations which are not plausible in light of the public record. *See, e.g.,* Sprewell v. Golden State Warriors, 266 F.3d 979, 988 (9th Cir.2001) (holding that the court need not accept as true anything in the complaint which contradicts facts of which the court may take judicial notice); O'Boyle, 337 F. App'x at 164 (holding that courts may take judicial notice of public records).

For example, the allegation that WMI "maintained no separate legal formalities such as filing necessary papers, reports and corporate tax reports" (Am.Compl.¶ 27) is contrary to the public record. WMI was a public company whose securities traded on the New York Stock Exchange and was subject to strict regulation, including the informational disclosure requirements of the Securities Exchange Act of

1934. The public record discloses that WMI filed annual, quarterly, and current reports and other information with the SEC under its own name. Similarly, WMB was a national bank subject to extensive regulation by the OTS, FDIC and other agencies. Also, the August 31, 1999 Tax Sharing Agreement is evidence that WMI and WMB did adhere to legal formalities required by the IRS with respect to corporate taxes. *See* 26 U.S.C. § 1501 ("An affiliated group of corporations shall ... have the privilege of making a consolidated return ... for the taxable year in lieu of separate returns.").

Consistent with the analysis required under Rule 12(b)(6), the Court does accept as true the factual allegations that WMI and WMB had the same offices (Am.Compl.¶ 13), shared directors and officers *(id.* at ¶ 14), shared common employees *(id.* at ¶ 16), conducted all business affairs, and issued all correspondence "under combined name most commonly known as 'WaMu' " *(id.* at ¶¶ 22 & 24), filed consolidated tax returns *(id* . at ¶ 20) and "operated a centralized cash management system" *(id.* at ¶ 21).

While Youkelsone's allegations may allege a close relationship, they are not sufficient to impose alter ego liability. That a parent and subsidiary corporation "are intimately related in carrying on their business for the purpose of mutual benefit is not enough to characterize a corporation as the alter ego of another corporation." *Wade Cook,* 375 B.R. at 599. Even common officers, directors and employees is acceptable because "it is a well established principle of corporate law that directors and officers holding positions with a parent and subsidiary can and do 'change hats' to represent two corporations separately." *Wyatt v. Ford Motor Co.,* No. C04–5666 RBL, 2006 WL 1663676, at *4 (W.D.Wash. June 13, 2006) *(quoting Bestfoods,* 524 U.S. at 69). Furthermore, a common trade name is frequently used in parent-subsidiary relationships and is not a basis for disregarding the corporate form. *See, e.g., Bagel Bros. Maple, Inc. v. Ohio Farmers, Inc.,* 279 B.R. 55, 67 (W.D.N.Y.2002). Youkelsone has failed to plead any factual allegations that WMI used the corporate form for fraudulent or improper purposes and has failed to offer any factual allegations leading to the plausible inference that WMI controlled and directed WMB in its misconduct related to servicing her mortgage. Therefore, the Court concludes that Youkelsone has failed to state a cause of action under the alter ego theory.

iii. *Agency*

***15** Youkelsone asserts nonetheless that the Amended Complaint sufficiently pleads facts to hold WMI liable on an agency theory, because it asserts that WMI operated and managed WMB through the same board of directors, from the same office, and with the same employees.

Under Washington law, the elements of agency are mutual consent and control by the principal of the agent. *Uni–Com Northwest, Ltd. v. Argus Pub. Co.,* 47 Wash.App. 787, 796–797, 737 P.2d 304 (1987). The crucial factor is control. It is not established if the asserted principal merely retains the right to supervise performance; it must control the manner of performance. *Id.* While courts have expressed doubt as to whether a separate agency theory exists to hold a parent corporation liable, it is clear that a higher degree of control is necessary to find agency in parent-subsidiary relationships. *See Campagnolo S.r.l.,* 2010 WL 2079694, at *7 (stating that the court doubts whether alter ego and agency theories for parent liability are in fact separate and noting that to hold shareholder liable for corporation's wrongs through agency principles would seem to be a disguised way of finding corporate disregard). Imposing liability on a parent through agency "requires that the parent exercise total control over the subsidiary, well beyond the normal control exercised." *Id.* "A parent has no liability on an agency theory where it does not 'direct ... and authorize ... the manner in which the subsidiary conduct[s] its business.' " *Id.* Whether the parent and subsidiary respected corporate formalities is relevant to the question of whether the parent so dominated the subsidiary that the subsidiary is a mere agent of the parent. *Id.*

The Court concludes that Youkelsone has failed to allege the complete control necessary to hold WMI liable for WMB's acts under Washington agency law. The allegations accepted as true by the Court in the Amended Complaint establish that a lawful parent-subsidiary relationship existed but fail to establish that WMI exercised complete control by directing and managing the manner in which WMB conducted business. Furthermore, the close regulation and adherence to corporate formalities discussed above negates the type of domination necessary to find WMB a mere agent of WMI.

Youkelsone argues that this Court has already found WMI to be liable for a contract entered into by WMB in another action because "WMB had at least implied authority to act as WMI's agent and to bind it to the Agreement." *In re Washington Mutual, Inc.*, 421 B.R. 143, 150 (Bankr.D.Del.2009). That holding, however, was based on "traditional principles of agency" rather than merely the corporate relationship alleged by Youkelsone. In the prior action, this Court found that an agency relationship existed based on a contract entered into by WMB, which "was structured so that WMB was acting as WMI's agent." *Id.* at 150. In this case, Youkelsone did not allege sufficient facts to establish that WMB was acting as WMI's agent in servicing her mortgage; WMI was not in the business of mortgage servicing. "Where a subsidiary is engaged in a completely different line of business, it cannot be said that the business of the parent is carried out by the subsidiary." *Gallelli v. Crown Imports, LLC*, 2010 WL 1177449, at *7 (E.D.N.Y. March 20, 2010) (holding that subsidiary corporations were not agents of parent holding company under New York law for tort action against subsidiary "where business of subsidiaries was beer brewing and distribution, and business of holding company was investment.") Therefore, the Court concludes that Youkelsone has failed to state a cause of action against WMI based on agency.

IV. *CONCLUSION*

***16** For the reasons set forth above, the Court will grant the Defendant's Motion to Dismiss.

An appropriate order is attached.

ORDER

AND NOW, this **13th** day of **August, 2010,** upon consideration of the Motion to Dismiss filed by WMI and for the reasons set forth in the accompanying Memorandum Opinion, it is hereby

ORDERED that the Motion to Dismiss is **GRANTED,** and it is further

ORDERED that the Complaint filed by Nadia Youkelsone is DISMISSED.

Bkrtcy.D.Del.,2010.
In re Washington Mut., Inc.

Not Reported in B.R., 2010 WL 3238903 (Bkrtcy.D.Del.)

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33 Misc.3d 1226(A), 939 N.Y.S.2d 745, 2011 WL 5962804 (N.Y.Sup.), 2011 N.Y. Slip Op. 52121(U)
(Table, Text in WESTLAW), Unreported Disposition
(Cite as: 33 Misc.3d 1226(A), 2011 WL 5962804 (N.Y.Sup.))

C
NOTE: THIS OPINION WILL NOT APPEAR IN A PRINTED VOLUME. THE DISPOSITION WILL APPEAR IN A REPORTER TABLE.

Supreme Court, New York County, New York.
Peter A. ZUTTY and Robert N. Zutty, Plaintiffs,
v.
RYE SELECT BROAD MARKET PRIME FUND, L.P., Rye Select Broad Market XL Fund, L.P., Tremont Partners, Inc., Tremont Group Holdings, Inc., Massachusetts Mutual Life Insurance Company, Oppenheimer Acquisition Corp., Goldstein Golub Kessler & Company, P.C., a/k/a Goldstein Golub Kessler & Company, LLC, McGladrey & Pullen LLP, KPMG LLP, BNY Alternative Investment Services, Inc., The Bank of New York Mellon Corporation, Fiserv Inc., Sandra L. Manzke, Robert I. Schulman, Suzanne S. Hammond, Stephen T. Clayton, Stuart Pologe, Patrick Kelly, Harry Hodges, Rubert A. Allan, Cynthia J. Nicoll, Ileana Lopez–Balboa, Robert I. Rosenbaum, Stephen Jupp, Lynn Keeshan, and James G. McCormick, Defendants.

No. 113209/09.
April 15, 2011.

Jaspan Schlesinger LLP, for Plaintiff.

Skaddan ArpsSlate Meacher, Sidley Austin LLP, Bingham McCutchen LLP, for Defendant.

RICHARD B. LOWE, J.

*1 This action is one of several on behalf of investors who suffered losses due to the Ponzi scheme perpetrated by Bernard L. Madoff (Madoff) and his company, Bernard L. Madoff Investment Securities (BLMIS). Plaintiffs Peter A. Zutty and Robert N. Zutty, unable to sue Madoff or BLMIS, have brought claims against several individuals and entities, including Tremont Partners, Inc. (TPI), which served as the general partner of defendants Rye Select Broad Market Prime Fund, L.P. (the Prime Fund), and Select Broad Market XL Fund, L.P. (the XL Fund); Massachusetts Mutual Life Insurance Company (MassMutual) and Oppenheimer Acquisition Corp. (OAC), TPI's corporate parents; KPMG LLP (KPMG), which served as the independent auditor of the XL Fund's financial statements; and defendant The Bank of New York Mellon Corporation, which acted as fund administrator for the XL Fund.

Motion Sequence Nos. 006, 007, 008, 009, 010, 011 and 012 are consolidated for disposition. In Motion Sequence No. 006, defendant MassMutual moves, pursuant to CPLR 3211(a) and 3016(b), for dismissal of the claims alleged as against it for failure to state a cause of action, and failure to plead fraud with particularity.

In Motion Sequence No. 007, defendants TPI, Tremont Group Holdings, Inc. (TGH), Robert I. Schulman, Stephen T. Clayton, Stuart Pologe, Patrick Kelly, Harry Hodges, Rupert A. Allan, Cynthia J. Nicoll, Ileana Lopez–Balboa, Robert I. Rosenbaum, Stephen Jupp, Lynn Keeshan and James G. McCormick (collectively, the Tremont defendants) move, pursuant to CPLR 3016(b), 3211(a)(1) and 3211(a)(7), for an order dismissing the complaint as against them.

In Motion Sequence No. 008, defendant KPMG moves for an order compelling arbitration and staying the action as against it, or, alternatively, dismissing the complaint as against it.

In Motion Sequence No. 009, defendants Sandra L. Manzke and Suzanne S. Hammond move to dismiss the complaint as against them.

In Motion Sequence No. 010, defendant The Bank of New York Mellon Corporation, on behalf of itself and dissolved entity BNY Alternative Investment Services, Inc. (BNY Mellon) moves for an order dismissing all claims as against it.

In Motion Sequence No. 011, defendants the Prime Fund and the XL Fund move, pursuant to CPLR 3211(a) and 3016(b), for an order dismissing the complaint as against them.

In Motion Sequence No. 012, defendant OAC moves, pursuant to CPLR 3211(a) and 3016(b), for an order dismissing the complaint as against it.

BACKGROUND

Plaintiffs allege that they are investors in the Prime Fund and the XL Fund, which are hedge funds organized as limited partnerships under Delaware law (collectively, the Funds) (Complaint, ¶¶ 1–3, 5). TPI, the general partner of each Fund (*id.,* ¶¶ 42, 56), invested the Funds' assets with Madoff's firm, BLMIS, before learning on December 11, 2008 that Madoff's operations were a sham.

Plaintiffs first invested in the Prime Fund in 2001 (*id.,* ¶¶ 28, 35). Peter Zutty alleges that he initially invested $250,000 in the Prime Fund and that, "[a]s of October 31, 2008, the stated value of the [his] account was no less than $735,663.62" (*id.,* ¶¶ 28, 30). Robert Zutty alleges that he invested $250,000 in the Prime Fund and that, "[a]s of October 31, 2008, the stated value of [his] account was no less than $462,716.00" (*id.,* ¶¶ 35, 37).

***2** Plaintiffs also claim that they invested in the XL Fund. Peter Zutty alleges an initial investment of $150,000 in the XL Fund in October 2008 and an account value of no less than $149,136.14 as of October 31, 2008 (*id.,* ¶¶ 31, 34). Robert Zutty alleges that he invested $250,000 in the XL Fund in April 2007, and that as of October 31, 2008, the stated value of his account was no less than $820,072.00 (*id.,* ¶¶ 38, 41).

Under the terms of the Funds' limited partnership agreement, TPI, the general partner of the Funds, was authorized to delegate responsibility for investing the Funds' assets to an investment advisor or advisors selected by TPI in its sole discretion (Prime Fund Amended and Restated Limited Partnership Agreement [Prime LPA], § 2.2 [Aff. of Jason C. Vigna, Exh A]; XL Fund Amended and Restated Limited Partnership Agreement [XL LPA], § 2.2 [Vigna Aff., Exh B]). Pursuant to that authority, TPI selected BLMIS to invest the Funds' assets (Complaint, ¶¶ 65, 90–91, 109–110).

TGH is the parent company of TPI (*id.,* ¶¶ 6–7). Plaintiffs allege that individual defendants Schulman, Clayton, Pologe, Kelly, Hodges, Allan, Nicoll, Balboa, Rosenbaum, Jupp, Keeshan, McCormick, Manzke and Hammond (the Tremont Individuals) were "decision-makers" charged with administering TGH, TPI, and the Funds (*id.,* ¶¶ 70; 72–73; 75–86).

Prior to becoming limited partners of the Funds, plaintiffs received private placement memoranda (the PPMs), which disclosed the material terms and risks of investing in the Partnerships (*id.,* ¶¶ 42, 56). According to the PPM for the Prime Fund (the Prime PPM) and the PPM for XL Fund (the XL PPM), TPI, as general partner, was responsible for managing the day-to-day operations and investment management of the Funds (*id.,* ¶¶ 51, 53, 57, 66, 68).

The Prime PPM disclosed that, under the direction of TPI, "the Partnership allocates its investment portfolio to one Investment Advisor" and that "[t]he overall success of the Partnership depends upon the ability of the present Investment Advisor to be successful in his own strategy" (Prime PPM, at i, ii-iii, 1–2, 6, 18 [Vigna Aff., Exh C]). The Prime PPM also warned that "[w]hen the Partnership invests with an Investment Advisor, the Partnership does not have actual custody of the assets" (*id.* at 24, 27). It further disclosed that "[a]lthough the General Partner attempts to monitor the performance of each Investment Advisor, the Partnership ultimately must rely on ... the accuracy of the information provided to the Partnership" (*id.* at 25).

The XL Fund is a leveraged version of the Rye Select Broad Market Fund, L.P,, another fund that invested its assets through Madoff. The XL PPM explained that the XL Fund's strategy was to provide "a return linked to a three times levered exposure to the economic performance of the Rye Select Broad Market Fund, L.P. (the Reference Entity)" (XL PPM, at 1 [Vigna Aff., Exh D]). The XL PPM described the Reference Entity as a fund seeking capital appreciation "by investing the majority of [its] assets with one investment manager who employs a split strike conversion' investment strategy" (*id.* at 3). The Reference Entity's PPM further explained that the investment manager would control the Reference Entity's assets, the Reference Entity's success depended on the skill of the investment manager, and the Reference Entity's general partner, TPI, might receive limited information from the investment manager (Rye Select Broad Market Fund, L.P. Amended and Restated Confidential Private Placement Memorandum [Broad Market PPM], at 9, 20, 18, 32–33, 40 [Vigna Aff., Exh E]).

***3** Because of the significant risks of investing in the Funds, investors were required under the federal securities laws to have substantial net worth and investment experience before TPI could accept their subscriptions for partnership interests (Prime PPM, at 4, 12–16; XL PPM, at 10–14). Thus, the PPMs advised that investors needed to be willing and able "to bear the potential loss of their entire investment" (Prime PPM, at 12; XL PPM, at 10).

Pursuant to the LPAs, the Funds paid TPI monthly management and administration fees (Prime LPA, § 2.3; XL LPA, § 2.3). The LPAs also included a provision exculpating TPI and its members, officers and affiliates from liability to the Funds and their limited partners "to the fullest extent permitted by law" for any "errors in judgment or for action or inaction, whether or not disclosed, which said party reasonably believed to be in the best interests of the Partnership" (Prime LPA, § 2.7; XL LPA, § 2.6).

Plaintiffs purchased partnership interest in the Funds between 2001 and 2008 (Complaint, ¶¶ 28–41). Prior to purchasing their interests, plaintiffs signed subscription agreements in which they represented and warranted that they: (1) possessed sufficient "knowledge and experience in financial and business matters [such] that [they were] capable of evaluating the merits and risks" of investing in the Funds; (2) had obtained "sufficient information from the [Funds or] authorized representatives to evaluate the merits and risks" of such an investment; and (3) could "afford a partial or complete loss" of their investments (Peter Zutty Prime Fund Subscription Agreement, at S–20 [Vigna Aff., Exh F]; Peter Zutty XL Fund Subscription Agreement, at 20 [Vigna Aff., Exh G]; Robert Zutty Prime Fund Subscription Agreement, at S–20 [Vigna Aff., Exh H]; Robert Zutty XL Fund Subscription Agreement, at 22 [Vigna Aff., Exh I]). Plaintiffs further represented and warranted that they had "consulted with [their] own advisors" about investing in the Funds (Peter Zutty Prime Fund Subscription Agreement, at S–22; Peter Zutty XL Fund Subscription Agreement, at 22; Robert Zutty Prime Fund Subscription Agreement, at S–22; Robert Zutty XL Fund Subscription Agreement, at 24).

Thereafter, they received account statements disclosing, among other things, that the Funds' portfolio of securities investments "have been and will continue to be custodied for the benefit of the portfolio at Bernard L. Madoff Investment Securities, LLC" (*see* July 31, 2007 Clients Statements addressed to Peter Zutty and Robert Zutty [Vigna Aff., Exhs J and K]).

BLMIS was a broker-dealer and investment advisor registered with the Securities and Exchange Commission (the SEC) (Complaint, ¶ 88). For years, Madoff reported "high rates of return" to its investors (*id.,* ¶ 89), using an options trading strategy known as "split-strike conversion." Plaintiffs allege that Madoff's security trades were fictitious, and that, rather than buying and selling securities, Madoff paid "fictitious returns to the other investors of [BLMIS] as part of [a] Ponzi scheme" (*id.,* ¶ 206).

***4** On December 11, 2008, Madoff confessed that BLMIS was a well-orchestrated Ponzi scheme that had been going on for years, through which he misappropriated assets entrusted to him by numerous hedge funds and other investors, including the Funds (*id.,* ¶¶ 95–96). Prior to his confession, Madoff successfully concealed his scheme from the SEC, prominent financial institutions, hedge funds, charitable organizations, and thousands of sophisticated investors. Despite this long history of concealment, plaintiffs contend that "numerous red flags" should have revealed Madoff's fraud (*id.,* ¶ 207).

Chiefly, plaintiffs bring claims against TGH, TPI and the Tremont Individuals for breach of fiduciary (first cause of action), fraud (second cause of action), and unjust enrichment (third cause of action). Plaintiffs allege that TPI's failure to detect Madoff's fraud before he publicly confessed to it demonstrates that TPI must not have acted in good faith to monitor the Funds' investments (*id .,* ¶¶ 92–94). Plaintiffs also suggest that Madoff's fraud should have been obvious to TPI because a competing investment advisor, Harry Markopolos, "wrote several letters to the SEC in 1999 and 2005 claiming [that] BLMIS was a Ponzi scheme" (*id.,* ¶ 89).

Plaintiffs assert that the Tremont defendants "fail[ed] to perform proper due diligence with respect to Madoff and BLMIS," "ignor[ed] the red flags raised with respect to the activities of Madoff and BLMIS," and "abdicated their responsibilities to manage and control the assets of the Funds" (*id.,* ¶ 114). According to plaintiffs, this alleged inaction caused a diminution in value of their partnership interests in the XL Fund and "rendered worthless" their investments (*id.,* ¶¶ 116–118).

Plaintiffs also asserts fraud claims against the

Prime Fund and the XL Fund (fourth cause of action) and MassMutual and OAC (fifth cause of action); claims for professional malpractice (eighth cause of action) and breach of contract (ninth cause of action) against KPMG; and claims for conspiracy (tenth cause of action) and unjust enrichment (eleventh cause of action) against BNY Mellon.

DISCUSSION

Although on a motion to dismiss a complaint pursuant to CPLR 3211(a)(7), "the pleading is to be afforded a liberal construction," and "the facts as alleged in the complaint [are presumed] as true" (*Leon v. Martinez,* 84 N.Y.2d 83, 87 [1994]; *see also* *Rovello v. Orofino Realty Co.,* 40 N.Y.2d 633 [1976]), "factual claims [that are] either inherently incredible or flatly contradicted by documentary evidence are not entitled to such consideration' " (*Mark Hampton, Inc. v. Bergreen,* 173 A.D.2d 220, 220 [1st Dept 1991] [citation omitted], *lv denied* 80 N.Y.2d 788 [1992]; *see also* *Caniglia v. Chicago Tribune–N.Y. News Syndicate,* 204 A.D.2d 233 [1st Dept 1994]).

In order to prevail on a motion to dismiss based upon documentary evidence, the movant must demonstrate that the documentary evidence conclusively refutes the plaintiff's claims (*AG Capital Funding Partners, L.P. v. State St. Bank and Trust Co.,* 5 NY3d 582 [2005]). In addition, "[f]actual allegations presumed to be true on a motion pursuant to CPLR 3211 may properly be negated by affidavits and documentary evidence" (*Wilhelmina Models, Inc. v. Fleisher,* 19 AD3d 267, 269 [1st Dept 2005]). Thus, dismissal is warranted where, as here, documentary evidence establishes that "the allegations of the complaint fail to state a cause of action" (*L.K. Sta. Group, LLC v. Quantek Media, LLC,* 62 AD3d 487, 491 [1st Dept 2009]; *see e.g.* *Hallman v. Kantor,* 72 AD3d 895, 896 [2d Dept], *lv denied* 15 NY3d 706 [2010] [granting motion to dismiss where clear language in the retainer agreement "conclusively established a defense to the plaintiff's claims of malpractice"]).

Motions to Dismiss by the Tremont Defendants (Motion Sequence No. 007); Manzke, and Hammond (Motion Sequence No. 009); and the Prime Fund and the XL Fund (Motion Sequence No. 011)

1. ***Breach of Fiduciary Duty and Unjust Enrichment Against the Tremont Defendants and Manzke and Hammond***

***5** Plaintiffs' claims for breach of fiduciary duty and unjust enrichment must be dismissed on the ground that plaintiffs lack standing to assert derivative claims on behalf of the Funds. Whether claims must be brought derivatively is determined by the law of the state in which the relevant entity was organized (*see* *Matter of Hakimian (Bear Stearns & Co., Inc.),* 46 AD3d 294 [1st Dept 2007]). Because the Funds are Delaware limited partnerships (*see* Complaint, ¶ 5), Delaware law dictates whether plaintiffs, who are limited partners in the Funds, can maintain direct causes of action against the moving defendants, or whether they are required to assert any causes of action derivatively on behalf of the Funds.

Under Delaware law, whether plaintiffs' causes of action are direct or derivative turns on two questions—"(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)?" (*Tooley v. Donaldson, Lufkin & Jenrette, Inc.,* 845 A.2d 1031, 1033 [Del 2004]).

In considering the alleged misconduct and the nature of the relief sought, it is clear that the Funds, not plaintiffs individually, suffered the alleged injuries, and hence, would receive the benefit of any recovery. Thus, plaintiffs' claims for breach of fiduciary duty and unjust enrichment are derivative in nature because they are based on alleged injuries—i.e., the loss of Fund assets and the Funds' payment of allegedly unjustified fees to TPI (Complaint, ¶¶ 116–118, 137–143)—that were suffered directly by the Funds, and only indirectly by plaintiffs by virtue of their limited partnership interests in the Funds.

For instance, plaintiffs contend that their investments "have been rendered worthless, have been decimated and have been lost" (Complaint, ¶ 116), as a result of Madoff's theft of the Funds' assets, and the use of a portion of those assets to pay TPI's management fees. This is not a direct injury because it was the Funds, not the limited partners, who suffered the direct injury from Madoff's theft. Plaintiffs' alleged injuries occurred only secondarily, and as a function of their investments in the Funds. Thus, plaintiffs' claims are derivative (*see e.g. Cocchi v. Tremont Group Holdings, Inc.,* No. 502009CA016230 [Fl Cir

Ct 2010] [claims by investors in the XL Fund were derivative because plaintiffs could not prevail without showing harm to the XL Fund]; *Ernst & Young Ltd. v. Quinn,* 2009 WL 3571573 [D Conn 2009] [investors' claims were derivative under Delaware law where they stemmed from the fact that the fund suffered a direct injury]; *TIFD III–X LLC v. Fruehauf Prod. Co.,* 883 A.2d 854, 859 [Del Ch 2004] [claims were derivative because they involved "harms that fell, in the first instance, on the Partnership as a whole and only affected (the partner) indirectly, as a consequence of its ownership interest in the Partnership"]).

***6** In addition, plaintiffs do not contend that they suffered any injuries independent of the Funds. Rather, they suffered the same harm—a diminution in the value of their limited partnership interests. Such an injury is "classically derivative in nature" (*Ernst & Young Ltd. v. Quinn,* 2009 WL 3571573 at * 9 ["claim predicated on the diminution of the value of a business entity is classically derivative in nature (citation omitted)' "]; *see also* *Longo v. Butler Equities II, L.P.,* 278 A.D.2d 97, 98 [1st Dept 2000]) [upholding dismissal of direct claim for breach of fiduciary duty because defendants' alleged misconduct, which "could only have reduced the value of the partnership's investment in the target company, impact(ed) on plaintiff only insofar as his pro-rata share was concerned" and thus did not plead "any direct injury to plaintiff independent of the injury caused to the partnership"]).

Accordingly, these derivative claims may be pursued solely by or on behalf of the Funds, and not by plaintiffs directly (*see Alpert v. National Assn. of Sec. Dealers, LLC,* 7 Misc.3d 1010[A], 2004 N.Y. Slip Op 51872[U], *16–17 & n5 [Sup Ct, N.Y. County 2004] [holding that standing to assert claims premised on injury to a company is determined by the law of the company's state of organization (Delaware) and Delaware law precludes "direct" claims premised on such injury]; *Feldman v. Cutaia,* 951 A.2d 727, 733 [Del 2008] [where, as here, "all of a (company's members) are harmed and would recover *pro rata* in proportion with their ownership of the (company) solely because they are (members), then the claim is derivative in nature"]).

In order for investors to assert derivative claims on behalf of a company, they must (1) first make a pre-suit demand on the company's directors or general partner to redress the defendants' alleged wrongdoing; or (2) adequately allege with particularity in their complaint facts sufficient to show that pre-suit demand is excused as futile (*see* *Wood v. Baum,* 953 A.2d 136, 140 [Del 2008]). Plaintiffs do not allege that they have satisfied either requirement. Thus, they lack standing to maintain the derivative claims alleged in the complaint, and the breach of fiduciary duty and unjust enrichment claims must be dismissed (*see* *Hribar v. Marsh & McLennan Cos.,* 73 AD3d 859 [2d Dept 2010]; *Longo v. Butler Equities II, L.P.,* 278 A.D.2d 97, *supra* [each affirming dismissal of derivative claims that were improperly asserted directly]; *accord* *West Palm Beach Police Pension Fund v. Collins Capital Low Volatility Performance Fund II, Ltd.,* 2010 WL 2949856 [SD FL 2010] [dismissing breach of fiduciary duty and unjust enrichment claims against manager of an investment fund that failed to detect Madoff's fraud, as improperly asserted directly rather than derivatively]).

In opposition to the motion, plaintiffs contend that these claims should nevertheless be deemed direct under a limited exception to the general rule found in two decisions of the Delaware Chancery Court: *In re Cencom Cable Income Partners, L.P.* (2000 WL 130629, * 4–6 [Del Ch 2000] [permitting claims that "appeared derivative" to be pled directly where company in which plaintiffs invested had completed liquidation proceedings, company was no longer actively managed by the general partners, all the company's stakeholders were parties to the action, and the alleged wrongdoers would obtain a significant portion of any derivative recovery]); and *Anglo Am. Sec. Fund, L.P. v. S.R. Global Intl. Fund, L.P.* (829 A.2d 143, 151 [Del Ch 2003] [finding claims that otherwise "might be classified as derivative" to be brought directly "in order to enable the injured parties (who were no longer limited partners) to recover while preventing a windfall to individuals or entities (who invested later and) whose interests were not injured"]). These cases, however, are completely inapposite.

***7** The holding in *Cencom* has been "limited to its own unique set of facts" (*Agostino v. Hicks,* 845 A.2d 1110, 1125 [Del Ch 2004]). That case has no application here because the complaint does not allege that the Funds are in liquidation, or that they are no longer managed by TPI. The complaint also fails to allege that any of the Funds' stakeholders other than plaintiffs are before the court, or that the Tremont defendants would receive any recovery if this case were maintained as a derivative action (*see* Newman v. Family Mgt. Corp., 748 F Supp 2d 299, 2010 WL 4118083 [SD N.Y.2010]; Trump v. Cheng, 2006 WL 6484047 [Sup Ct, N.Y. County 2006] [both distinguishing *Cencom*]).

Anglo American is similarly inapposite. In contrast to the plaintiffs in *Anglo American,* plaintiffs here not only remain limited partners in the Funds, but they also fail to allege that they would be unable to share in any recovery obtained in a derivative action, or that any new investors have been admitted to the Funds who would receive a "windfall" in that action (*see* Trump v. Cheng, 2006 WL 6484047, *supra;* Ernst & Young Ltd. v. Quinn, 2009 WL 3571573, *supra* [each distinguishing *Anglo American*]).

Plaintiffs' claim for breach of fiduciary duty is also barred by the exculpation clauses of the Funds' limited partnership agreements. Section 2.7 of the Prime LPA and section 2.6 of the XL LPA provide that TPI, and its members, officers and affiliates shall be exculpated from liability to the Funds and their partners, including plaintiffs, "to the fullest extent permitted by law."

Because the Funds are organized under the laws of Delaware, claims like the one asserted here, i.e., a claim of breach of duty pertaining to the conduct of the Funds' internal affairs, are governed by Delaware Law (*see* Partnership Law, § 121–901). Under Delaware law, the language of this clause operates to bar all claims alleging breaches of the duty of care, including claims involving "reckless indifference" to one's duties and/or alleged failures to be informed of available material facts (McPadden v. Sidhu, 964 A.2d 1262 [Del Ch 2008]). Thus, claims brought against defendants who are protected by such a clause must be dismissed unless the plaintiff "plead[s] ... facts that demonstrate that the [defendants] acted with scienter, i.e., that they had actual or constructive knowledge' that their conduct was legally improper (citation omitted)" (Wood v. Baum, 953 A.2d at 141; *see also* McPadden v. Sidhu, 964 A.2d at 1274 [a complaint must allege facts sufficient to show a breach of the duty of good faith, meaning an "intentional dereliction of duty or ... conscious disregard for one's responsibilities"]).

Plaintiffs make only the conclusory allegation that the moving defendants acted in "bad faith" because they allegedly "knowingly disregarded [unidentified] red flags with regard to the activities of Madoff and BLMIS" (Complaint, ¶¶ 93, 94, 104, 115, 131). This bare allegation is completely insufficient to demonstrate scienter, and thus, fails to overcome the bar of the contractual exculpation provisions applicable to plaintiffs' claim for breach of fiduciary duty (*see* SNS Bank v. Citibank, 7 AD3d 352, 355 [1st Dept 2004] ["Even on a motion to dismiss, a court need not accept as true conclusory allegations that a defendant ... acted willfully, in bad faith or with reckless disregard of its duties"]).

***8** For instance, in *In re Citigroup Inc. Shareholder Derivative Litigation* (964 A.2d 106 [Del Ch 2009]), the Delaware Court of Chancery dismissed, pursuant to a similar exculpation clause and the "business judgment rule," claims that the directors of Citigroup, Inc. breached their fiduciary duties by failing to disclose or prevent monumental losses to its inventory of "subprime" loans, which the directors allegedly knew, or should have known, were imminent in light of various "red flags" (*id.* at 129–131). In reaching this decision, the court explained that "[i]n any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong," but such "signs," without more, are insufficient to demonstrate that the decisionmaker consciously disregarded his duties (*id.* at 131).

Likewise here, plaintiffs have alleged no facts which, if accepted as true, would show that the Tremont defendants, or Manzke and Hammond, engaged in knowing misconduct. Accordingly, plaintiffs' cause of action for breach of fiduciary is barred by the exculpation clauses of the Funds' limited partnership agreements, and must be dismissed (*see e.g.* SNS Bank v. Citibank, 7 AD3d at 355 [affirming dismissal of claims that defendant made "improper, imprudent, and unsuitable investments" where, as here, they were barred by the exculpation provisions of the parties' contract]).

In opposition to the motion, plaintiffs assert that the facts that Harry Markopolos privately complained to the SEC about Madoff, and that certain unidentified "advisors" had "suspicions" regarding Madoff, are sufficient to overcome this clause (Pl Opp., at 8–9). However, the complaint does not allege that the moving defendants had any knowledge about

Markolopos's allegations, or the "suspicions" of other advisors. Thus, plaintiffs fail to allege anything that would create an inference that the moving defendants acted in bad faith, i.e., that they knew about Madoff's Ponzi scheme, but nevertheless invested with him.

Plaintiffs' claim for unjust enrichment must also be dismissed on the separate ground that it is barred by an express contract. Plaintiffs allege that TPI, TGH and the Tremont Individuals were "unjustly enriched" by fees and other payments that they received from the Funds (Complaint, ¶¶ 139–140). This claim is foreclosed, however, by the existence of express contractual provisions in the Funds' limited partnership agreements governing the fees at issue (Prime LPA, § 2.3; XL LPA, § 2.3).

Under New York law, the existence of a written contract covering the particular subject matter of the claims asserted precludes recovery in quasi contract (Clark–Fitzpatrick, Inc. v. Long Is. R.R. Co., 70 N.Y.2d 382, 388 [1987] ["The existence of a valid and enforceable written contract governing a particular subject matter ordinarily precludes recovery in quasi contract for events arising out of the same subject matter"]; *see also* Goldstein v. CIBC World Mkts. Corp., 6 AD3d 295, 296 [1st Dept 2004] ["A claim for unjust enrichment, or quasi contract, may not be maintained where a contract exists between the parties covering the same subject matter"]).

***9** The LPAs are such contracts, and thus bar plaintiffs' unjust enrichment claim here (*see e.g.* Sheiffer v. Shenkman Capital Mgt., 291 A.D.2d 295, 295 [1st Dept 2002] ["the existence of a valid and enforceable written contract governing the disputed subject matter precludes plaintiffs from recovering in quantum meruit"]; Scavenger, Inc. v. GT Interactive Software Corp., 289 A.D.2d 58, 59 [1st Dept 2001] ["since the matters here in dispute are governed by an express contract, defendant's counterclaim for unjust enrichment was properly found untenable"]).

2. *Fraud Against the Tremont Defendants, Manzke, Hammond, the Prime Fund and the XL Fund*

To properly plead a common-law fraud claim, a plaintiff must allege a misrepresentation of a material fact, falsity of the misrepresentation, scienter, plaintiff's reasonable reliance on the alleged misrepresentation, and injury resulting from the reliance (Small v. Lorillard Tobacco Co., 94 N.Y.2d 43 [1999]; *see also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Wise Metals Group, LLC, 19 AD3d 273, 275 [1st Dept 2005]; P.T. Bank Cent. Asia, N.Y. Branch v. ABN AMRO Bank N.V., 301 A.D.2d 373 [1st Dept 2003]). The absence of any of these elements is fatal to a recovery on a claim for fraud (Shea v. Hambros PLC, 244 A.D.2d 39 [1st Dept 1998]).

In addition, pursuant to CPLR 3016(b), "[w]here a cause of action ... is based upon ... fraud ... the circumstances constituting the wrong shall be stated in detail." "[C]onclusory allegations" of fraud are insufficient (Greschler v. Greschler, 51 N.Y.2d 368, 375 [1980]). In particular, "CPLR 3016(b) requires that a complaint for fraud articulate the misconduct complained of, in sufficient detail to clearly inform each defendant of what their respective roles were in the incidents complained of" (*Williams v. Sidley Austin Brown & Wood, L.L.P.,* 15 Misc.3d 1125[A], *4, 2007 N.Y. Slip Op 50846[U], *3 [Sup Ct, N.Y. County 2007] [citing P.T. Bank Cent. Asia, N.Y. Branch v. ABN AMRO Bank N.V., 301 A.D.2d at 377; *see also* Sherman v. Eisenberg, 267 A.D.2d 29 [1st Dept 1999], *lv dismissed* 94 N.Y.2d 899 [2000]). Hence, "[e]ach of the foregoing elements must be supported by factual allegations containing the details constituting the wrong sufficient to satisfy CPLR 3016(b)" (Cohen v. Houseconnect Realty Corp., 289 A.D.2d 277, 278 [2d Dept 2001]). Accordingly, dismissal of a claim for fraud is warranted where the requisite elements are not pleaded with sufficient particularity (Rabouin v. Metropolitan Life Ins. Co., 307 A.D.2d 843 [1st Dept 2003]; Zaref v. Berk & Michaels, P.C., 192 A.D.2d 346 [1st Dept 1993]).

Here, plaintiffs have identified no material misstatements on which they reasonably relied. Plaintiffs allege that TPI, TGH, and the Tremont Individuals fraudulently induced them to invest and to remain invested in the Funds by "falsely claim[ing] ... that they were actively managing and controlling the Funds and the assets of the Funds, and g[iving] no reason for Plaintiffs to believe that anything was amiss" (Complaint, ¶ 121). Likewise, plaintiffs allege that the Prime Fund and the XL Fund "falsely claimed and led Plaintiffs to believe that their investments were legitimate investments, and gave no reason for plaintiffs to believe that anything was amiss" (*id.,* ¶ 47). However, plaintiffs fail to identify any specific misstatements on which they reasonably relied, who made them, or when the statements were allegedly made. This lack of specificity warrants dismissal of the fraud claim (*see* Cohen v. Houseconnect Realty Corp., 289 A.D.2d at 278 [dismissing fraud claim where the "complaint does not contain any allegations setting forth the alleged material misrepresentations"]; *Mountain Lion Baseball v. Gaiman,* 263 A.D.2d 636, 638 [3d Dept 1999] [finding that "plaintiff's complaint, which fails to set forth the substance of, the dates upon which or the persons to whom the alleged misrepresentations purportedly were made, falls far short of satisfying the pleading requirement imposed by CPLR 3016(b)"]; *Chrysler Credit Corp. v. Dioguardi Jeep Eagle,* 192 A.D.2d 1066, 1068 [4th Dept 1993] [finding claim "based upon fraud ... insufficient on its face because defendants have failed to set forth in detail the alleged fraudulent representations"]).

***10** Plaintiffs also fail to allege facts sufficient to show that any representation made by TPI, TGH, the Tremont Individuals or the Funds concerning TPI's management of the Funds or the legitimacy of the investments was false. Rather, plaintiffs merely conclusorily allege that "the representations made by Tremont and the Tremont Principals concerning the management and control of the Funds and the assets of the Funds were false at the time such representations were made" (Complaint, ¶ 122), and that the "representations made by the Funds ... were false at the time such representations were made" (*id.,* ¶ 148). This is insufficient to state a cause of action for fraud (*see In re Health Mgt. Sys., Inc. Sec. Litig.,* 1998 WL 283286, * 5 [SD N.Y.1998] ["the conclusory allegation that the opposite of (an alleged misrepresentation) is true, without further factual elaboration, is insufficient"]; *accord Greschler v. Greschler,* 51 N.Y.2d at 375 ["Plaintiff's conclusory allegations as to the defendant's misrepresentations concerning his financial status fail to meet the statutory requirement that a cause of action based upon fraud must be pleaded in detail' "]).

In opposition, plaintiffs contend that the Prime PPM contains three specific misrepresentations: (1) TPI would be responsible for "the day-to-day administration of the Partnership [and have] primary responsibility [for] monitoring the ongoing activities of the Investment Advisor"; (2) TPI would have the "sole responsibility of contacting the Investment Advisor"; and (3) in selecting the Funds' Investment Advisor, TPI would consider the "Investment Advisor's ... reputation" and "favorable outlook for the strategy" employed by him (Pl Opp., at 27–28).

However, even if alleged in the complaint, the foregoing alleged misrepresentations would still be insufficient to state a cause of action for fraud because plaintiffs have alleged no facts sufficient to demonstrate that any of the statements was false when made. There is no dispute that TPI was responsible for administering the Funds, monitoring the Investment Advisor (BLMIS), and communicating with BLMIS. Indeed, plaintiffs do not allege to the contrary in the complaint. Moreover, while plaintiffs allege that a few individuals criticized or questioned Madoff's investment strategy (Pl Opp., at 29), plaintiffs do not allege any fact demonstrating that the Tremont defendants selected Madoff—the former chairman of NASDAQ—without genuinely believing that he generally had a good reputation within the investment community. Thus, the subsequent revelation of Madoff's fraud does not establish, for pleading purposes, that any of TPI's prior representations regarding Madoff or the Funds was false when made. Indeed, courts have repeatedly "rejected the legitimacy of alleging fraud by hindsight (citation omitted)' " (*see e.g.* Shields v. Citytrust Bancorp., Inc., 25 F3d 1124, 1129 [2d Cir1994] [earlier representation that loan loss reserve was adequate not false or misleading merely because it subsequently proved inadequate]).

***11** Plaintiff's fraud claims are also defective because they do not satisfy the scienter requirement. Allegations of scienter are essential to a cause of action for fraud (*Wallace v. Crisman,* 173 A.D.2d 322 [1st Dept 1991]). Scienter means an actual intent "to deceive, manipulate, or defraud (citation omitted)' " (*Matter of People v. Condor Pontiac, Cadillac, Buick & GMC Trucks, Inc.,* 2003 WL 21649689, 2003 N.Y. Slip Op 51082[U], *5 [Sup Ct, Greene County 2003]; *see also Friedman v. Anderson,* 23 AD3d 163, 167 [1st Dept 2005] ["A fraud claim is not actionable without evidence that the misrepresentations were made with the intent to deceive"]). "[O]ne who conducts normal business activities while ignorant that those activities are furthering a fraud is not liable for securities fraud" (*Securities & Exch. Commn. v. Cohmad Sec. Corp.,* 2010 WL 363844, *1 [SD N.Y.2010] [dismissing fraud claims against party that referred clients to Madoff]).

With respect to the Funds, plaintiffs merely conclusorily assert, with no supporting factual allegations, that "[a]t the time of making these misrepresentations, the Funds knew such representations were false or made them recklessly without knowing whether they were true or false" (Complaint, ¶ 149]). Such boilerplate allegation is insufficient to plead scienter (*see* Zanett Lombardier, Ltd. v. Maslow, 29 AD3d 495 [1st Dept 2006] [finding conclusory statements of defendant's intent did not adequately plead sufficient details of scienter]; *Giant Group, Ltd. v. Arthur Andersen LLP,* 2 AD3d 189 [1st Dept 2003] [fraud claim dismissed for failure to set forth facts sufficient to establish inference of scienter]).

With respect to TPI, TGH, and the Tremont Individuals, in addition to the conclusory allegation that they "knew such representations were false or made them recklessly without knowing whether they were true or false" (Complaint, ¶ 123), plaintiffs also suggest that these defendants had a motive to defraud plaintiffs—a pecuniary interest in "causing unearned fees, commissions and bonuses to inure [to] the benefit of Tremont and the Tremont Principals" (Complaint, ¶¶ 115, 119). However, this allegation is legally insufficient to establish scienter because the "desire for higher compensation ... is found in virtually all commercial transactions, making it an ill-suited motive from which to draw an inference of intent to defraud" (*Technical Support Servs., Inc. v. International Bus. Machs. Corp.,* 18 Misc.3d 1106[A], *30, 2007 N.Y. Slip Op 52428[U], *25 [Sup Ct, Westchester County 2007]; *see also Jana Master Fund, Ltd. v. JPMorgan Chase & Co.,* 19 Misc.3d 1106[A], 2008 N.Y. Slip Op 50571[U] [Sup Ct, N.Y. County 2008]; *Stephenson v. Citco Group Ltd.,* 700 F Supp 2d 599, 621 [SD N.Y.2010] [dismissing fraud claims against administrator of a fund looted by Madoff and stating "it is economically irrational to risk your professional reputation, license, and the possibility of legal liability simply in return for a professional services fee"])

***12** Plaintiffs also allege that TPI, TGH, and the Tremont Individuals "ignored red flags raised by others in the industry with respect to Madoff and BLMIS" (Complaint, ¶ 112). The complaint fails, however to specify any such "red flags," an omission that is fatal to plaintiffs' fraud claim (*see e.g.* *Goldstein v. CIBC World Mkts. Corp.,* 6 AD3d at 296 [dismissing fraud claim where plaintiff "failed to allege facts with sufficient specificity from which ... intent ... might be inferred"]).

For instance, in *Credit Alliance Corp. v. Arthur Andersen & Co.* (65 N.Y.2d 536, *order amended* 66 N.Y.2d 812 [1985]), a fraud claim was brought against an auditor who allegedly issued reports containing false information. The plaintiffs attempted to plead scienter through the conclusory allegation that the auditor recklessly disregarded unidentified "facts which would have apprised it that its reports were misleading" (*id.* at 554). In finding these allegations legally defective, the Court explained that "[t]his single allegation of scienter, without additional detail concerning the facts constituting the alleged fraud, is insufficient under the special pleading standards required under CPLR 3016(b), and, consequently, the cause of action should have been dismissed" (*id.*).

Likewise here, dismissal of the fraud claim is warranted because plaintiffs have failed to specify any "red flags" or other facts that the Tremont defendants allegedly disregarded.

Moreover, even if the complaint had actually identified particular "red flags," that would also be insufficient to establish scienter for pleading purposes (*In re J.P. Jeanneret Assoc., Inc.,* 769 F Supp 2d 340, 2011 WL 335594, *32 [SD N.Y.2011] ["(m)erely alleging that (accountant defendant) would' or could' or even should' have known of Madoff's fraud if only it had paid attention to the red flags' is insufficient to make out a (federal fraud) claim"]). To be sufficient, allegations of scienter based on red flags must include facts showing both that the defendant was actually aware of the alleged flags (*see* *South Cherry St., LLC v. Hennessee Group LLC,* 573 F3d 98 [2d Cir2009]; *Stephenson v. Citco Group Ltd.,* 700 F Supp 2d at 622) and that the flags were "so obvious[ly]" indicative of misconduct "that the defendant must have been aware of [the wrongdoing]" and desirous of furthering it (*South Cherry St., LLC v. Hennessee Group LLC,* 574 F3d at 109, 112; *see also* *MLSMK Inv. Co. v. JP Morgan Chase & Co.,* 737 F Supp 2d 137, 144 [SD N.Y.2010] [finding allegations of scienter insufficient because "(w)hile it may be true that Defendants could have connected the dots to determine that Madoff was committing fraud, Plaintiff offers no facts to support the claim that they actually reached such a conclusion"]).

Here, the complaint contains no allegations that the TPI, TGH or the Tremont Individuals actually knew of any "red flags" (*see* *South Cherry St., LLC v.*

Hennessee Group LLC, 573 F3d 98, *supra; Stephenson v. Citco Group Ltd.,* 700 F Supp 2d 599, *supra* [each dismissing fraud claims]). Moreover, even if the complaint did contain such allegations, it would still be defective because it also fails to explain how one or more alleged red flags made it so obvious that Madoff was running a Ponzi scheme that defendants must have known about the scheme and wanted to further it (*see e.g. Laikin v. Vaid,* 2001 WL 1682873, *1 [Sup Ct, N.Y. County 2001] [dismissing fraud claim where "the complaint does not allege specific facts as to how and when (the defendant) learned that the offering plan allegedly contained misleading information"]).

***13** Accordingly, the complaint fails to allege facts creating a plausible inference that the moving defendants intended to defraud plaintiffs (*see Zaref v. Berk & Michaels, P.C.,* 192 A.D.2d 346, *supra*). As such, the fraud claims against them must be dismissed.

Massachusetts Mutual Life and OAC's Motions to Dismiss (Motion Sequence Nos. 006 and 012)

Plaintiffs allege one count of fraud against MassMutual and OAC. Plaintiffs do not base their fraud claims against MassMutual and OAC on any alleged act or omission, but rather, solely on their corporate status as owners of TPI (*see* Complaint, ¶ 157). MassMutual is the corporate parent of OAC. OAC is the parent of TGH, which is the parent of TPI, the general partner of the Prime Fund and the XL Fund, the entities in which plaintiffs invested and which, in turn, invested their assets with Bernard Madoff.

Plaintiffs do not contend that OAC or MassMutual made any misrepresentation of fact to them, or communicated with them at all. Indeed, the complaint contains no allegations that the moving defendants had any dealings or contact with, or made any representations to plaintiffs regarding the Funds. Plaintiffs do not allege that the moving defendants had any involvement with the management of the Funds or their choice of investment managers. Rather, plaintiffs contend that, merely by "associating" themselves with the Tremont defendants, the moving defendants made false representations to plaintiffs, and are guilty of fraud.

Specifically, plaintiffs allege that "MassMutual was and is an insurance company domiciled in the Commonwealth of Massachusetts and licensed to do business in the State of New York" (Complaint, ¶ 9), and that OAC "was and is a Delaware business corporation authorized to do business in the State of New York and is a subsidiary of MassMutual Holding LLC, which is a subsidiary of [MassMutual]" (*id.,* ¶ 8).

Plaintiffs allege that, as the "owners of [TPI], the general partner of the Funds," MassMutual and OAC "had a duty to supervise the operations of its subsidiaries, including [TPI's] involvement and activities as general partner of the Funds and to assure that such activities were running properly" (*id.,* ¶¶ 157–158), and that MassMutual and OAC breached this duty (*id.,* ¶ 159). Plaintiffs assert that, by virtue of their ownership of TPI, MassMutual and OAC associated themselves with TPI (*id.,* ¶ 160), and "lent their names and credibility to [TPI] and its involvement as general partner of the Funds and its management, control and supervision of the Funds, including the investments made by Plaintiffs" (*id.,* ¶ 161), such that they "caused themselves to be identified with [TPI]" (*id.,* ¶ 162).

These allegations are insufficient to sustain a cause of action for fraud. First, plaintiffs fail to allege the most rudimentary element of a fraud claim—that MassMutual or OAC ever made a representation to them. Where a claimant has "failed to articulate a misrepresentation of a material existing fact," a fraud claim is "properly dismissed" (*WorldCom, Inc. v. Segway Mktg. Ltd,* 262 A.D.2d 164, 164 [1st Dept], *lv dismissed in part, denied in part* 93 N.Y.2d 1036 [1999]). Plaintiffs fail to identify a single statement by either MassMutual or OAC regarding the Funds. They do not identify any dealings with MassMutual or OAC, or any wrongful conduct by the moving defendants. They do not allege that either MassMutual or OAC had anything to do with the management of the Funds. To the contrary, plaintiffs allege that TPI had "ultimate authority" over the Funds, was in charge of "day-to-day management" of the Funds, and had "complete" or "sole" "discretion" to select the manager (Complaint, ¶¶ 51, 32, 57, 66). As such, plaintiffs' fraud claim must be dismissed (*see National Westminster Bank USA v. Weksel,* 124 A.D.2d 144, 147 [1st Dept], *lv denied* 70 N.Y.2d 604 [1987] [overturning denial of motion to dismiss fraud claim where "(t)here is no allegation anywhere in the complaint that (defendant) made any representation, fraudulent or otherwise, to plaintiff"]; *Mountain Lion Baseball Inc. v. Gaiman,* 263 A.D.2d at 638 ["In our view plaintiff's complaint, which fails to set forth the substance of, the dates upon which or the persons to whom the alleged misrepresentations purportedly were made, falls far short of satisfying the pleading requirement imposed by CPLR 3016(b)"]).

***14** Plaintiffs' essential argument is that MassMutual and OAC's ownership of TPI represented an endorsement of its statements to its investors, and its management of its funds. They contend that the moving defendants "lent their name and credibility to TPI," and that this led plaintiffs "to believe that their investments were legitimate investments" (Complaint, ¶¶ 161, 164). The alleged misrepresentation is that MassMutual and OAC, by virtue of being corporate parents that were "associated themselves with [TPI]," "lent their names and credibility to [TPI]" and "as a result of this association ... caused themselves to be identified with [TPI] and such identification was used to mislead limited partners and prospective limited partners, including plaintiffs, as to the safety, security, and legitimacy of any investments made with the Funds" and "led Plaintiffs to believe that their investments were legitimate investments" (*id.,* ¶¶ 60, 161, 164).

The inference that plaintiffs seek to draw is that, by virtue of their ownership of TPI, MassMutual and OAC represented that investments made through TPI were secure and legitimate. However, plaintiffs cannot demonstrate that, simply by virtue of ownership, MassMutual and OAC represented anything to plaintiffs, or committed fraud. "It is beyond dispute that a corporation may not be held liable for the actions of another company merely because it has an ownership interest in it" (*Maung Ng We v. Merrill Lynch & Co., Inc.,* 2000 WL 1159835, *3 [SD N.Y.2000]; *see also* *United States v.. Bestfoods,* 524 U.S. 51, 61 [1998] ["(i)t is a general principle of corporate law deeply' ingrained in our economic and legal systems' that a parent corporation ... is not liable for the acts of its subsidiaries (citation omitted)]").

Plaintiffs' fraud claim against OAC and MassMutual must also be dismissed on the ground that plaintiffs fail to allege the falsity of any representation. Plaintiffs' assertion that "these representations made by MassMutual and [OAC] were false at the time such representations were made" (Complaint, ¶ 165), merely restate the legal requirement of alleging falsity. This is insufficient to support a fraud claim (*see e.g.* *Caldwell v. Gumley–Haft L.L.C.,* 55 AD3d 408, 408 [1st Dept 2008] [conclusory allegations of falsity absent factual support fail to satisfy the particularity requirement of CPLR 3016(b)]).

Plaintiffs also fail to sufficiently plead scienter. Although plaintiffs make no factual allegation of any representation made to them by the moving defendants, they nonetheless conclusorily conclude that MassMutual and OAC "knew or should have known that such representations were false" (Complaint, ¶ 166). Where, as here, a "complaint is devoid of any but the most conclusory allegations ... that defendant ... knew or should have known" about the alleged fraudulent conduct, that complaint fails "to support the scienter element of its claim" (*National Westminster Bank v. Weksel,* 124 A.D.2d at 148; *accord* *Zanett Lombardier, Ltd. v. Maslow,* 29 AD3d at 496–496 [finding "conclusory statement of (defendant's) intent did not adequately plead sufficient details of scienter"]). Accordingly, a fraud claim must be dismissed where, as here, "[t]he complaint does not allege any facts to suggest who at [the defendant] possessed such knowledge, when and how they obtained the knowledge, or even why anyone at [the defendant] should have known that the views expressed [as another's were not true]" (*Devaney v. Chester,* 813 F.2d 566, 568 [2d Cir1987]; *see also* *Laikin v. Vaid,* 2001 WL 1682873 at *2 [fraud claim should be dismissed where it "does not allege specific facts as to how and when (the adverse party) learned that the offering plan allegedly contained misleading information"]). Plaintiffs' failure to offer any facts in support of an allegation that MassMutual and OAC knowingly made a false representation is fatal to its fraud claim.

***15** In opposition to the motion, plaintiffs contend that the fraud claim should survive because "the allegations made in the Complaint are sufficient to put [MassMutual and OAC] on notice as to the claims against them" (Pl Opp., at 34). However, notice pleading does not apply to fraud claims (*see e.g.* *Block v. Landegger,* 44 A.D.2d 671, 671 [1st Dept 1974] [dismissing fraud claim where allegations did "not sufficiently plead the circumstances constituting the wrong,' " and stating that a fraud claim must be "stated in detail, as distinguished from the notice pleading required by CPLR 3013"]).

Plaintiffs further contend that the complaint adequately pleads causes of action for aiding and abetting fraud and piercing the corporate veil. However, the complaint contains no such causes of action. It is well settled that claims asserted for the first time in opposition papers should not be considered by the court (*see e.g. MediaXposure Ltd. (Cayman) v. Omnireliant Holdings, Inc.*, 29 Misc.3d 1215(A), *6 [Sup Ct, N.Y. County 2010] [denying plaintiff's attempt to "amend the complaint through an opposition brief, which is not permissible"]; Rubin v. Nine West Group, Inc., 1999 WL 1425364, *4 [Sup Ct, Westchester County 1999] ["A claim for relief may not be amended by the briefs in opposition to a motion to dismiss (citation omitted)' "]).

Accordingly, the complaint is dismissed as against MassMutual and OAC.

BNY Mellon's Motion to Dismiss (Motion Sequence No. 010)

Plaintiffs allege two causes of action against BNY Mellon—conspiracy to commit fraud (tenth cause of action) and unjust enrichment (eleventh cause of action).

Plaintiffs allege that BNY Mellon entered into a service agreement with the XL Fund, pursuant to which BNY Mellon would serve as administrator of the XL Fund (Complaint, ¶ 58). According to the complaint, BNY Mellon's duties under its contract to provide administrative services, which were set forth in an administrative services agreement (the ASA), were simply to provide purely administrative services, not investment advice or due diligence (*see* Complaint, ¶ 60 [setting forth list of administrative services, such as maintaining books and records, opening and closing accounts, preparing statements, performing annual audits and reconciling general ledger accounts]).

Rather, as the general partner in the XL Fund, TPI had the responsibility to conduct due diligence, select investments, monitor investment performance, and consider the appropriate balance of portfolio risks (*see* Complaint, ¶ 109 ["Tremont and the Tremont Principals had the sole power to manage the funds"]). BNY Mellon is not alleged to have had any interest, direct or indirect, in any of the Tremont defendants, or any Tremont-affiliated entity.

According to the XL PPM, BNY Mellon also provided custodial services to the XL Fund, pursuant to the ASA, and also served as the fund's secretary to the extent necessary (*id.*, ¶ 61).

***16** In performing its services, BNY Mellon was specifically entitled to rely on information it received:

> In the event BNY–AIS's computations hereunder rely, in whole or in part, upon information, including ... prices or values supplied by a Fund or by brokers, dealers, market makers, or specialists described in the Offering Materials, BNY–AIS shall not be responsible for, under any duty to inquire into, or deemed to make any assurances with respect to, the accuracy or completeness or such information

(ASA, § 5[g] [Aff. of Steven J. Kaiser, Exh A]). Thus, BNY Mellon had no obligation to independently verify information it received was correct.

As an initial matter, plaintiffs' claims against BNY Mellon are derivative of the XL Fund, and may not go forward as direct claims. Plaintiffs simply allege that losses that the XL Fund sustained in turn caused the value of their investments in the XL Fund to diminish, which is quintessentially a derivative claim.

As previously discussed, courts routinely dismiss purportedly direct claims based on injuries that are derivative of their investments (*see e.g.* Stephenson v. Citco Group Ltd., 700 F Supp 2d 599, *supra* [dismissing claims by investors in a fund that suffered Madoff-related losses, holding claims were derivative]; *Ernst & Young Ltd. v. Quinn*, 2009 WL 3571573 at *1, *8 [holding that claims by limited partners against an investment fund's auditor for failing to reveal that the fund was invested in "a massive Ponzi scheme" were derivative, not direct, because "(u)nder Delaware law, injuries sustained on account of having investment or ownership stake in a corporation that diminishes in value are not individually suffered harms"]).

Likewise here, claims against BNY Mellon are dependent on plaintiffs' investment in the XL Fund, and may not be brought as direct claims. As plaintiffs allege, BNY Mellon "entered into a service agreement with the Rye Select XL Fund" (Complaint, ¶ 58), and BNY Mellon performed "various day-to-day tasks on behalf of the Rye Select XL Fund" (*id.*, ¶ 60). Alleging that they were investors in the XL Fund (*id.*, ¶¶ 28–41), plaintiffs claim that BNY Mellon caused their injury—a decline in the value of their investment—by not properly performing services it owed to the XL Fund set forth in its agreement with the XL Fund (*id.,* ¶¶ 225–226, 236–238). Plaintiffs argue that, "[b]y virtue of the foregoing" (*id.,* ¶¶ 230–231, 244–245), their investments in the XL Fund "have been rendered worthless" (*id.,* ¶ 227).

Thus, plaintiffs' alleged loss is not distinct from the losses that were allegedly suffered by the other limited partners. As such, the claims they seek to bring against BNY Mellon are derivative, and must be dismissed.

Plaintiffs' claims for conspiracy to commit fraud (tenth cause of action) and unjust enrichment (eleventh cause of action) must also be dismissed on substantive grounds.

***17** With respect to the conspiracy claim, this claim must be dismissed because there is no such tort under New York law. A "claim of conspiracy to commit fraud is not viable because the State of New York does not recognize an independent cause of action in tort for conspiracy" (*Waggoner v. Caruso,* 68 AD3d 1, 6 [1st Dept 2009], *affd* 14 NY3d 874 [2010]; *see e.g. Roche v. Claverack Coop. Ins. Co.,* 59 AD3d 914, 918 [3d Dept 2009] ["As New York does not recognize an independent cause of action for civil conspiracy to commit a tort, that claim was properly dismissed"]).

Plaintiffs' unjust enrichment claim also fails because, as previously discussed, a claim for unjust enrichment cannot be maintained where a contract exists between the parties covering the same subject matter (*Clark–Fitzpatrick, Inc. v. Long Is. R.R. Co.,* 70 N.Y.2d 382, *supra; Goldstein v. CIBC World Mkts. Corp.,* 6 AD3d 295, *supra*). Here, plaintiffs allege that "BNY entered into a service agreement with the Rye Select XL Fund" (Complaint, ¶ 58), and that "BNY neglected its duties as administrator to the Rye Select XL Fund" (*id.,* ¶ 236). BNY Mellon's compensation for those services is expressly addressed by the ASA. Therefore, the unjust enrichment cause of action must be dismissed.

Accordingly, the complaint is dismissed as against BNY Mellon.

KPMG's Motion to Dismiss (Motion Sequence No. 008)

Pursuant to an engagement agreement dated October 6, 2006, and amended on October 15, 2007 (the Engagement Agreement), KPMG was engaged to audit the year-end financial statements of the XL Fund (Complaint, ¶¶ 63–63, 198, 211). Plaintiffs assert two claims against KPMG arising out of its audits of the XL Fund's financial statements—professional malpractice and breach of contract. KPMG moves to dismiss the complaint as against it on the ground that plaintiffs' claims against it are subject to mandatory arbitration because there is a valid and binding arbitration agreement to which plaintiffs are bound.

Pursuant to the Engagement Agreement, the XL Fund is required to arbitrate any claims arising out of KPMG's audits of the XL Fund's financial statements. Specifically, the Engagement Agreement provides for mediation and arbitration as the "sole methodologies" for resolving "[a]ny dispute or claim arising out of or relating to the engagement letter between the parties or the services provided thereunder" (Engagement Agreement, at 5, Appendix 2 [9/20/10 Aff. of Laya R. Kaigh, Exh A]).

Plaintiffs concede that their action against KPMG should be stayed in favor of arbitration. In their omnibus memorandum of law in opposition to defendants' motions to dismiss, plaintiffs do not oppose KPMG's motion to dismiss or compel arbitration. Indeed, in the affirmation supporting the omnibus memorandum, plaintiffs expressly "consent to a stay of the action against KPMG LLP pending arbitration" (10/26/10 Aff. of Seth A. Presser, ¶ 3). Because plaintiffs do not oppose KPMG's motion, it must be granted (*see e.g. Cippitelli v. County of Schenectady,* 307 A.D.2d 658 [3d Dept 2003]).

***18** Although plaintiffs contend that they only consent to a stay of the action pending arbitration "on the condition that KPMG LLP remain in this action for the purposes of discovery only" (Presser Aff., ¶ 3), the court rejects this contention.

The purported condition is directly contrary to the terms of the Engagement Agreement, which sets forth the discovery principles applicable in arbitration. The Engagement Agreement states that "[d]iscovery shall be permitted in connection with the arbitration only to the extent, if any, expressly authorized by the arbitration panel upon a showing of substantial need by the party seeking discovery" (Engagement Agreement, App II, at 2). Thus, the Engagement Agreement makes clear that the arbitrators—not the court—are to decide how much discovery the parties are entitled to, if plaintiffs make a showing of "substantial need." Thus, plaintiff's proposal that KPMG remain in the action so that the court may supervise discovery must be rejected because it is inconsistent with the engagement agreement.

Consequently, KPMG's motion to compel arbitration and stay this action pending arbitration is granted.

The court has considered the remaining claims, and finds them to be without merit.

Accordingly, it is

ORDERED that the motion of defendant Massachusetts Mutual Life Insurance Company to dismiss the complaint herein (Motion Sequence No. 006) is granted, and the complaint is dismissed in its entirety as against said defendant with costs and disbursements to said defendant as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendant; and it is further

ORDERED that the motion of defendants Tremont Partners, Inc., Tremont Group Holdings, Inc., Robert I. Schulman, Stephen T. Clayton, Stuart Pologe, Patrick Kelly, Harry Hodges, Rupert A. Allan, Cynthia J. Nicoll, Ileana Lopez–Balboa, Robert I. Rosenbaum, Stephen Jupp, Lynn Keeshan and James McCormick to dismiss the complaint herein (Motion Sequence No. 007) is granted, and the complaint is dismissed in its entirety as against said defendants with costs and disbursements to said defendants as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendants; and it is further

ORDERED that the motion of defendant KPMG LLP to compel arbitration and to stay this action (Motion Sequence No. 008) is granted; and it is further

ORDERED that plaintiffs shall arbitrate their claims against defendant KPMG LLP in accordance with the Engagement Agreement dated October 6, 2006; and it is further

ORDERED that all proceedings in this action are hereby stayed as against defendant KPMG LLP, except for an application to vacate or modify said stay; and it is further

ORDERED that either party may make an application by order to show cause to vacate or modify this stay upon the final determination of the arbitration; and it is further

***19** ORDERED that the motion of defendants Sandra L. Manzke and Suzanne S. Hammond to dismiss the complaint herein (Motion Sequence No. 009) is granted, and the complaint is dismissed in its entirety as against said defendants with costs and disbursements to said defendants as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendants; and it is further

ORDERED that the motion of defendant the Bank of New York Mellon Corporation on behalf of itself and dissolved entity BNY Alternative Investment Services, Inc. to dismiss the complaint herein (Motion Sequence No. 010) is granted, and the complaint is dismissed in its entirety as against said defendant with costs and disbursements to said defendant as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendant; and it is further

ORDERED that the motion of defendants Rye Select Broad Market Prime Fund, L.P. and Rye Select Broad Market XL Fund, L.P. to dismiss the complaint herein (Motion Sequence No. 011) is granted, and the complaint is dismissed in its entirety as against said defendants with costs and disbursements to said defendants as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendants; and it is further

ORDERED that the motion of defendant Oppenheimer Acquisition Corp. to dismiss the complaint herein (Motion Sequence No. 012) is granted, and the complaint is dismissed in its entirety as against said defendant with costs and disbursements to said defendant as taxed by the Clerk of the Court, and the Clerk is directed to enter judgment accordingly in favor of said defendant; and it is further

ORDERED that the action is severed and continued as against the remaining defendant.

N.Y.Sup.,2011.
Zutty v. Rye Select Broad Market Prime Fund, L.P.
33 Misc.3d 1226(A), 939 N.Y.S.2d 745, 2011 WL 5962804 (N.Y.Sup.), 2011 N.Y. Slip Op. 52121(U)

END OF DOCUMENT

No. 68130-3-1

COURT OF APPEALS, DIVISION ONE
OF THE STATE OF WASHINGTON

FUTURESELECT PORTFOLIO MANAGEMENT, INC., et al., Appellants, v. TREMONT GROUP HOLDINGS, INC., et al., Respondents.	CERTIFICATE OF SERVICE

NANCY LYGREN certifies and states: On May 16, 2012, I caused to be served a true and correct copy of the following document on the following counsel of record at their address as stated by the method of service indicated.

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I declare under penalty of perjury under the laws of the United States of America and of the State of Washington that the foregoing is true and correct.

EXECUTED at Seattle, Washington on May 16, 2012

Nancy Lygren
Nancy Lygren