No. 05-2580

IN THE

United States Court of Appeals

FOR THE FIRST CIRCUIT

HANS A. QUAAK, ATTILIO PO and KARL LEIBINGER,
on behalf of themselves and those similarly situated

Plaintiffs-Appellees

v.

DEXIA, S.A.

Defendant

DEXIA BANK BELGIUM, f/k/a ARTESIA BANKING CORP., S.A.

Defendant-Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS (D.C. No. CV-03-11566-PBS)

BRIEF OF THE BOND MARKET ASSOCIATION, THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, THE CLEARING HOUSE ASSOCIATION L.L.C. AND THE SECURITIES INDUSTRY ASSOCIATION, AS *AMICI CURIAE*, IN SUPPORT OF DEFENDANT-APPELLANT AND REVERSAL

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29, the undersigned counsel for The Bond Market Association, the Chamber of Commerce of the United States of America, The Clearing House Association L.L.C. and the Securities Industry Association hereby certifies that these organizations are not subsidiaries of any other corporation, and that no publicly held corporation owns 10% or more of the stock of these organizations.

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Pursuant to Federal Rule of Appellate Procedure 29, The Bond Market Association ("The BMA"), the Chamber of Commerce of the United States of America (the "Chamber"), The Clearing House Association L.L.C. ("The Clearing House") and the Securities Industry Association ("SIA") (collectively, the "*Amici*") respectfully submit this brief as *amici curiae* in support of Defendant-Appellant Dexia Bank Belgium ("Appellant" or "Dexia") to urge that the Court reverse the judgment below and to address the proper scope of primary liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Appellant and Plaintiffs-Appellees ("Plaintiffs") have consented to the filing of this *amicus curiae* brief.

INTEREST OF THE *AMICI CURIAE*

The BMA represents approximately 200 securities firms and banks that underwrite, trade and sell fixed-income securities in the United States and in international markets. The BMA's membership comprises a diverse mix of securities firms and banks, including large, multi-product firms and companies with special market niches. Its members include all primary dealers in U.S. government securities and all major dealers in federal agency securities, mortgage-backed and asset-backed securities,

corporate bonds, money market instruments and funding instruments such as repurchase and securities lending agreements. The BMA files *amicus curiae* briefs in cases raising issues of importance to fixed-income securities markets.

The Chamber is the world's largest business federation. The Chamber represents an underlying membership of more than three million businesses and organizations of every size, in every industry sector, and from every region of the country. The Chamber regularly advocates the interests of its members, including as *amicus curiae*, in cases involving issues of national concern to the American business community.

The Clearing House was founded over 150 years ago and is an association of leading commercial banks that provides payment, clearing and settlement services to its member banks and to other financial institutions. The Clearing House regularly appears as *amicus curiae* in cases that present issues of importance to the commercial banking industry.

SIA brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers and mutual fund companies) are

active in U.S. and foreign markets and in all phases of corporate and public finance. SIA routinely files *amicus curiae* briefs addressing issues of importance to the securities industry.

The *Amici* submit this brief because one of the issues presented by this appeal — namely, what conduct may give rise to primary liability under Section 10(b) and Rule 10b-5 after the Supreme Court's decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) — is of great importance to the members of the *Amici*.[1] The members of the *Amici* collectively have countless business relations and engage in many thousands of securities and other commercial transactions each year involving publicly traded companies. As a result, it is critically important to the *Amici* that their members are not exposed to expansive primary liability under Section 10(b) and Rule 10b-5 where they have engaged in commercial transactions involving an issuer (or its affiliates) and it is alleged that the issuer has misreported or misrepresented such matters in its financial statements. And, more generally, it is essential that there be the

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[1] Although the *Amici* believe that the District Court incorrectly decided all three issues certified for appeal, this brief addresses only the *Central Bank* issue because the District Court's determination on that issue could subject members of the *Amici* to private litigation that has been barred by the Supreme Court and Congress.

clear, distinct guidelines concerning primary liability that the Supreme Court has repeatedly held are essential for Section 10(b) and Rule 10b-5. *See, e.g.*, *Central Bank*, 511 U.S. at 188-89; *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 755 (1975).

Any analysis of Section 10(b) liability for a secondary actor in securities markets begins with the Supreme Court's dichotomy in *Central Bank*, which was subsequently endorsed by Congress, between a primary violator and an aider and abettor. In the latter case, there is no private right of action, but the SEC retains the authority to bring proceedings.

Central Bank draws a clear distinction between a primary violator of Section 10(b) and a person alleged to have aided and abetted a primary violator. A secondary actor itself "may be liable as a primary violator" of Section 10(b) only where "*all* of the requirements for primary liability . . . are met." 511 U.S. at 191 (emphasis in original). Thus, in the absence of statements or actions by a secondary actor that are relied upon by investors in connection with transactions in an issuer's securities, there cannot be a primary violation of Section 10(b) because at least two required elements of such a violation are absent: (1) the secondary actor's conduct (*i.e.*, a transaction with the issuer or, even one step further removed (as

here), with an entity that later transacts with the issuer) is not "in connection with" any securities transaction, and (2) *a fortiori*, investors have not relied on the secondary actor's conduct.

Claims under Section 10(b) by private plaintiffs against secondary actors where all of the requirements of primary liability are not met are, at the most, aiding and abetting claims barred by *Central Bank*. *See, e.g., In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1039 (C.D. Cal. 2003) [hereinafter *In re Homestore*] (dismissing "scheme" claims against business counterparties of an issuer and observing that a contrary conclusion "would broaden the scope of [Section 10(b)] so as to haul into court anyone doing business with a publicly traded company"), *appeal docketed*, No. 04-55665 (9th Cir. Apr. 16, 2004);[2] *see also Stoneridge Inv. Partners LLC* v. *Charter Commc'ns, Inc. (In re Charter Commc'ns., Inc. Sec. Litig.)*, No. 4:02-CV-1186 CAS, slip op. at 10-14 (E.D. Mo. Oct. 12, 2004) [hereinafter *In re Charter*] (following *In re Homestore*) (copy appended), *appeal docketed*, No. 05-1974 (8th Cir. Apr. 8, 2005) (argued Dec. 12, 2005).

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[2] The *Amici* submitted a brief as *amici curiae* in the *Homestore* appeal in support of affirmance. That appeal is still pending.

The standard for primary liability adopted by the District Court here — requiring only "substantial[] participat[ion]" in an alleged scheme, *Quaak* v. *Dexia, S.A.*, 357 F. Supp. 2d 330, 341 (D. Mass. 2005) (quoting *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) [hereinafter *In re Lernout*]) — would largely eliminate the lines carefully drawn by *Central Bank* by directly contravening its mandate that "*all* of the requirements for primary liability [be] met" with respect to each Section 10(b) defendant, 511 U.S. at 191. The District Court's "substantial participation" standard explicitly allows liability to attach to the conduct of a secondary actor where "'the nexus between the scheme and the securities market'" is only "'a material misstatement by *another person*.'" *Quaak*, 357 F. Supp. 2d at 341 (quoting *In re Lernout*, 236 F. Supp. 2d at 173) (emphasis added). This standard incorrectly ignores the requirements that a secondary actor's *own conduct* must be "in connection with" securities transactions and relied on by investors. It also incorrectly ignores the requirement that that conduct must rise to the level of "use" or "employ[ment]" of a "manipulative or deceptive device or contrivance," 15 U.S.C. § 78j(b), which is necessarily more than "substantial participation" in a scheme whereby investors are misled by someone else's public misrepresentations.

Thus, applying this erroneous standard, the District Court held that Plaintiffs had stated a claim against Dexia for a primary violation of Section 10(b) even though Plaintiffs did not (and could not) allege that Dexia's conduct — engaging in transactions with affiliates of an issuer (*i.e.*, Lernout & Hauspie Speech Products, N.V. ("L&H")), which *L&H* later misrepresented in *its own* financial statements — coincided with any securities transactions by Plaintiffs or was relied upon by Plaintiffs or the market as a whole. By dispensing with these essential elements, the District Court's standard eliminates the distinction between primary liability under Section 10(b), which *Central Bank* allows private plaintiffs to pursue, and aiding and abetting liability under Section 10(b), which it does not.

The *Amici* also have an important interest in ensuring that Congress's decisions concerning the application of Section 10(b) are faithfully observed. Following *Central Bank*, Congress was confronted with two basic issues. First, Congress was urged by the Securities and Exchange Commission (the "SEC") and others to overturn *Central Bank*. Second, there was uncertainty as to whether the *Central Bank* dichotomy between primary conduct and aiding and abetting applied to enforcement actions by the SEC as well as to private litigation.

Congress dealt directly with both issues in the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). Congress reaffirmed the SEC's authority to bring actions against persons who knowingly aid and abet primary violations of Section 10(b). *See* 15 U.S.C. § 78t(e). Responding, however, to the explosion of meritless private litigation and its adverse effect on individual companies and the economy as a whole, Congress specifically declined to give private plaintiffs similar authority, because "private aiding and abetting liability actions under Section 10(b) would be contrary to S. 240's goal of reducing meritless securities litigation." S. REP. NO. 104-98, at 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698.[3] The *Amici* urge this Court to respect that Congressional determination, as well as the strict scope of primary Section 10(b) liability enunciated in *Central Bank*, by reversing the decision below.

ARGUMENT

It is essential at the outset to set forth both what this case is about and what it is not about. This case is not about the SEC's ability to

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[3] Congress decided not to give private plaintiffs this authority even though the SEC argued that Congress should "fully restore the aiding and abetting liability eliminated in the Supreme Court's *Central Bank of Denver* opinion." S. REP. NO. 104-98, at 48, *reprinted in* 1995 U.S.C.C.A.N. 679, 727.

enforce Section 10(b) and Rule 10b-5. Congress made clear in the PSLRA that *Central Bank* does not limit the SEC's enforcement authority based on the distinction between primary violators and aiders and abettors. The SEC is authorized to take enforcement action against both, and, therefore, reversal of the decision below will not in any way immunize alleged aiders and abettors from action by the SEC.[4]

This case is about the boundary between a primary violator, against whom a private right of action exists, and an aider and abettor, against whom it does not. The words of Section 10(b) and Rule 10b-5, as reinforced by the Supreme Court in *Central Bank* and by Congress in the PSLRA, make clear that only the company that publishes inaccurate or misleading financial statements or that commits a manipulative act in connection with a securities transaction is a primary violator. Any other

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[4] As the Supreme Court noted in *Central Bank*, "[t]o be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute." 511 U.S. at 177 (citation omitted); *see also In re Homestore*, 252 F. Supp. 2d at 1041 ("This decision does not mean that the wrongs of these aiders and abettors will necessarily go unchecked; the PSLRA expressly granted the SEC the authority to bring civil actions against aiders and abettors of securities fraud, and it is this Court's understanding that some investigation is ongoing.").

conclusion will inevitably result in the explosion of meritless securities litigation that Congress sought to prevent.

I. THE SUPREME COURT AND CONGRESS HAVE MANDATED THAT COURTS MAINTAIN THE DISTINCTION BETWEEN PRIMARY LIABILITY AND AIDING AND ABETTING LIABILITY UNDER SECTION 10(b) AND RULE 10b-5.

The Supreme Court's decision in *Central Bank* and Congress's enactment of the PSLRA were both premised on the principle that primary liability under Section 10(b) and aiding and abetting liability under Section 10(b) are distinct spheres of legal responsibility. Courts must preserve the important distinction between these two spheres to implement and adhere to the decision of the Supreme Court and the intent of Congress.

In *Central Bank*, the Supreme Court unequivocally held that no private right of action for aiding and abetting exists under Section 10(b). *See* 511 U.S. at 191. Perhaps anticipating the efforts of private litigants to erode *Central Bank* by seeking to expand the concept of "primary violator," the Supreme Court also established boundaries for a determination of primary liability. The Supreme Court held that it could exist in private litigation under Section 10(b) and Rule 10b-5 only if "*all* of the requirements for primary liability under Rule 10b-5 are met." *Id.* (emphasis

in original). In other words, the Supreme Court held that, to state an actionable claim under those provisions, private plaintiffs must plead and prove *each element* of a primary violation of Section 10(b) and Rule 10b-5 *as to each defendant* based on each defendant's conduct.

The Supreme Court also provided clear guidance for making these determinations based upon its prior decisions addressing Section 10(b) and Rule 10b-5. It established three key guidelines.

First, there must be "adherence to the statutory language." *Central Bank*, 511 U.S. at 173 (citing *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring); *Chiarella* v. *United States*, 445 U.S. 222, 226 (1980); *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 472 (1977)). The Supreme Court declined to "amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." *Central Bank*, 511 U.S. at 177-78; *see also id.* at 173 (text of Section 10(b) controls scope of conduct actionable under Rule 10b-5).

Second, this is "'an area that demands certainty and predictability.'" *Id.* at 188 (quoting *Pinter* v. *Dahl*, 486 U.S. 622, 652 (1988)). Unclear rules "lead[] to the undesirable result of decisions 'made

on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Central Bank*, 511 U.S. at 188 (quoting *Pinter*, 486 U.S. at 652). "'[S]uch a shifting and highly fact-oriented disposition of the issue of who may [be liable for] a damages claim for violation of Rule 10b-5' is not a 'satisfactory basis for a rule of liability imposed on the conduct of business transactions.'" *Central Bank*, 511 U.S. at 188 (quoting *Blue Chip Stamps*, 421 U.S. at 755) (alterations in original).

Third, there should be recognition that "'litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'" *Central Bank*, 511 U.S. at 189 (quoting *Blue Chip Stamps*, 421 U.S. at 739). The Supreme Court noted the "ripple effects" of "excessive litigation" under Rule 10b-5 on newer and smaller companies, professionals and ultimately investors. *Central Bank*, 511 U.S. at 189.

This third guideline is not merely reinforced, but explicitly imposed, by Congress in the PSLRA. Congress determined that the interests of our capital markets are best served by preventing the meritless litigation burdens that inevitably accompany aiding and abetting as a basis for private liability under Section 10(b) and Rule 10b-5. As set forth in the House

Report, the PSLRA was designed "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." H.R. REP. NO. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 731. Thus, Congress decided to limit private liability under Section 10(b) and Rule 10b-5 while at the same time reaffirming the SEC's authority to bring actions for aiding and abetting. *See* 15 U.S.C. § 78t(e) ("For purposes of any action brought by the [SEC] . . . , any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter . . . shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.")

The positions advanced by Plaintiffs in the case at bar, and in the District Court's decision below, are contrary to each of these guidelines.

Despite *Central Bank*'s clear ruling and Congress's unambiguous choice, Plaintiffs here and plaintiffs in numerous other actions have attempted to resurrect aiding and abetting liability by asserting that financial institutions and other business entities may be liable for primary violations of Section 10(b) and Rule 10b-5 when they have engaged in

commercial transactions with companies that have allegedly published inaccurate or misleading financial statements.[5]

What the plaintiffs ignore in each of these cases is that the issuer can (1) account for and represent the transactions in a way that is in accordance with generally accepted accounting principles and the issuer's other disclosure obligations, or (2) account for the transactions improperly or otherwise misrepresent them. It is the issuer's decision — and its alone — as to which course to take. If it elects the first, there is no harm to investors. If it elects the second, *the issuer* is the primary violator who has caused harm to the investors and therefore is directly responsible to them. In this second scenario, the counterparty or lender to the issuer (or to an entity affiliated with the issuer) *may* have aiding and abetting liability in an SEC enforcement action (assuming that the elements of that violation are established). But it is the issuer alone that is the primary violator of Section 10(b) and Rule 10b-5 as a result of its decision to publish inaccurate or misleading financial statements.

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[5] One of the most prominent examples of such a case is the Enron Corp. securities litigation pending in the United States District Court for the Southern District of Texas (the "*Enron* Litigation"). *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, MDL No. 1446, Civ. A. No. H-01-3624 (S.D. Tex.). Some of the members of one or more of the *Amici* have been named as defendants in the *Enron* Litigation.

Seeking to circumvent *Central Bank* and its Congressional reaffirmation, plaintiffs in many recently filed cases attempt to characterize the claims against these secondary actors as primary violations of Section 10(b) by contending that the transactions themselves are "manipulative or deceptive devices" in furtherance of a "scheme to defraud" under Rule 10b-5(a) or (c). In other words, plaintiffs seek to recast aiding and abetting claims as primary violations of Section 10(b) by alleging that various secondary actor defendants "participated" in a "scheme to defraud" with the issuer. But allegations of "participation" — or even "substantial participation" — in a scheme do not state a claim for primary liability. Instead, as the Supreme Court observed in *Central Bank*, to establish primary liability under Section 10(b) against a particular defendant, a plaintiff must plead and prove *each* element of primary liability as to that specific defendant based on that defendant's own conduct.

The conclusory invocation of "scheme" liability by Plaintiffs here — and its acceptance by the District Court — ignores the Supreme Court's three guidelines for determining the scope of primary liability under Section 10(b) and thus eliminates the critical distinction between primary liability under Section 10(b) and private aiding and abetting liability barred

by *Central Bank*. Consistent with Supreme Court's guidelines of "adherence to the statutory language," "certainty and predictability" and "danger of vexatiousness," primary liability under Section 10(b) attaches only where the defendant's alleged conduct is (among other things) (i) in connection with the purchase or sale of a security, and (ii) relied upon by the investor engaging in the securities transaction (either directly or by proper application of the fraud-on-the-market presumption). Where a defendant's alleged conduct is one or more steps removed from the pertinent securities transactions by the allegedly defrauded investors, a plaintiff is unable to plead and prove each element of a primary Section 10(b) and Rule 10b-5 violation with respect to that defendant.

As shown below, in this case there was no connection between Dexia's alleged conduct and the pertinent securities transactions by investors in the issuer's securities after the issuer, L&H, published allegedly false financial statements. Regardless of how Plaintiffs characterize their claim against Dexia, they cannot plead and prove a primary violation because Dexia's lending and other commercial transactions with persons and entities affiliated with L&H were not "in connection with" the allegedly defrauded investors' purchases of L&H securities. The District Court's view that

L&H's materially misleading financial statements somehow *created* "a nexus" between Dexia's conduct and the "securities market" is not an adequate substitute for the statute's requirement that Dexia's own conduct *must have been* "in connection with" the purchase or sale of securities for primary liability to attach. Indeed, by eliminating this essential statutory requirement (as well as the reliance requirement), the District Court's standard for *committing* a primary violation of Section 10(b) is indistinguishable from this Court's standard for aiding and abetting one. *See Cleary* v. *Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983) (elements of an aiding and abetting violation are: "(1) the commission of a violation of § 10(b) or rule 10b-5 by the primary party; (2) the defendant's general awareness that his role was part of an overall activity that is improper; and (3) knowing and substantial assistance of the primary violation by the defendant"); *SEC* v. *Druffner*, 353 F. Supp. 2d 141, 150 (D. Mass. 2005).

This impermissible congruity is particularly striking given the District Court's repeated holding that "substantial participation" in a scheme to defraud is sufficient to establish primary liability. "Substantial participation" — a phrase essentially indistinguishable from "substantial assistance" — appears nowhere in the text of Section 10(b). The language

of the statute addresses only the "use" or "employ[ment]" of a "manipulative or deceptive device or contrivance," 15 U.S.C. § 78j(b), and, by its terms, does not proscribe "participation" in a device that is "used" by another.

Private litigants cannot evade the fundamental distinction between primary liability and aiding and abetting liability by alleging the very same conduct that constitutes "aiding and abetting" also constitutes a "primary violation." There must be something that is more than "knowing and substantial assistance," and the "more" is lacking in this case.[6]

In short, after *Central Bank*, a defendant can be liable as a primary violator only if a private plaintiff establishes *each* element of Section 10(b) and Rule 10b-5 as to that defendant, *without regard to the*

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[6] *See Wright* v. *Ernst & Young LLP*, 152 F.3d 169, 176 (2d Cir. 1998) (allegations of "mere knowledge and assistance in the fraud" are insufficient to state a Section 10(b) and Rule 10b-5 claim); *Shapiro* v. *Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("[a]llegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms . . . all fall within the prohibitive bar of *Central Bank*"); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) ("The Court's rationale [in *Central Bank*] precludes a private right of action for 'conspiracy' liability."); *Stack* v. *Lobo*, 903 F. Supp. 1361, 1374 (N.D. Cal. 1995) (dismissing Section 10(b) claims because plaintiffs' "scheme allegations [are] no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision"); *In re Valence Tech. Sec. Litig.*, No. C 95-20459 JW, 1996 WL 37788, at *10-11 (N.D. Cal. Jan. 23, 1996) ("Courts have dismissed claims alleged as 'schemes' on the grounds that they were merely non-actionable conspiracy claims that had been recharacterized.").

conduct of other defendants. *See Central Bank*, 511 U.S. at 191; *see also In re Homestore*, 252 F. Supp. 2d at 1040 ("What is clear, however, is that *Central Bank* requires a plaintiff to allege that each and every defendant committed its own independent primary violation of securities laws in order to state a claim.").

II. PRIMARY LIABILITY UNDER SECTION 10(b) AND RULE 10b-5 ATTACHES ONLY IF A PLAINTIFF PLEADS AND PROVES EACH ELEMENT OF THOSE VIOLATIONS AS TO EACH DEFENDANT.

Regardless of whether Dexia is characterized as a primary or secondary actor, or whether Plaintiffs' claim is labeled a Rule 10b-5(b) claim or a Rule 10b-5(a) or (c) claim, the District Court erred in denying Dexia's motion to dismiss. Plaintiffs failed to plead adequately each element of a Section 10(b) and Rule 10b-5 violation as to Dexia. Specifically, Plaintiffs failed to allege that Dexia's conduct was "in connection with" the purchase of any L&H security. Likewise, Plaintiffs failed to allege reliance by investors on the conduct of Dexia in deciding to purchase L&H securities. Under *Central Bank*'s dictates, these failures are dispositive.

A. A Defendant Cannot Be Liable for a Primary Violation of Section 10(b) and Rule 10b-5 Unless Its Statements or Actions Occurred in Connection with the Purchase or Sale of Securities.

Section 10(b) liability attaches only to those who "use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). Under Rule 10b-5(a) and (c), it is unlawful to employ any device, scheme or artifice to defraud *in connection with* the purchase or sale of any security, or to engage in any act that would operate as a fraud in connection with the purchase or sale of any security. *See* 17 C.F.R. § 240.10b-5(a) & (c).

Although the Supreme Court in *Central Bank* observed that "secondary actors in securities markets . . . including a lawyer, accountant, or bank . . . may be liable as a primary violator under Rule 10b-5," it also made clear that such liability may attach only if a plaintiff pleads and proves that the conduct of such secondary actors independently satisfies *each* element of a violation of Section 10(b) and Rule 10b-5.[7] *Central Bank*, 511 U.S. at 191. In order to state a claim under these sections, a plaintiff must

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[7] The *Central Bank* standard applies equally to material misrepresentations and omissions prohibited by Rule 10b-5(b) and to "manipulative" or "deceptive" acts prohibited by Rule 10b-5(a) and (c). *See Central Bank*, 511 U.S. at 171-72, 180.

plead that a defendant "(1) . . . made a materially false or misleading statement [or committed a fraudulent act]; (2) in connection with the purchase or sale of a security; (3) with the intent to deceive, manipulate, or defraud; and that (4) [the plaintiff] was injured by his reasonable reliance on [the defendant's] misrepresentations [or fraudulent conduct]." *Wortley* v. *Camplin*, 333 F.3d 284, 294 (1st Cir. 2003). The standard adopted by the District Court here effectively eliminates, among other things, the critical "in connection with" element of the cause of action and allows a plaintiff to substitute "a material misstatement by *another person* [as the] nexus [to] the securities market." *Quaak*, 357 F. Supp. 2d at 341 (emphasis added). This departure is barred by the language of Section 10(b) and *Central Bank*.

The Supreme Court addressed the "in connection with" requirement in *SEC* v. *Zandford*, 535 U.S. 813 (2002). In holding that this requirement had been satisfied there, the Supreme Court explained:

> The securities sales and respondent's fraudulent practices were not independent events. This is not a case in which, after a lawful transaction had been consummated, a broker decided to steal the proceeds and did so. . . . Rather, *respondent's fraud coincided with the sales themselves*.

Id. at 820 (emphasis supplied); *see also United States* v. *O'Hagan*, 521 U.S. 642, 656 (1997) (holding trading on misappropriated information met the "in

connection with" requirement because "[t]he securities transaction and the breach of duty thus coincide[d]").

Dexia's alleged fraudulent conduct did not similarly coincide with the purchase or sale of any security. Plaintiffs allege that: (1) Dexia provided loans to companies allegedly affiliated with L&H (the "Companies") in anticipation of the Companies paying "licensing fees" to L&H pursuant to allegedly fraudulent licensing agreements; (2) Dexia entered into credit default swaps with L&H officers with respect to certain of those loans, instead of obtaining personal guarantees, because Dexia allegedly knew that L&H would have to disclose guarantees but not credit default swaps; (3) only later, when L&H publicly issued its financial statements, L&H misrepresented the "licensing fees" received from the Companies as legitimate revenue; and (4) Dexia knew of L&H's misrepresentations. Thus, Dexia's transactions with L&H officers and the Companies — as distinguished from L&H's alleged misreporting of those transactions in its financial statements — were independent transactions that in and of themselves did not deceive any L&H investors and were not "in connection with" any purchase of L&H securities. Rather, it was the alleged, *subsequent* public misrepresentations in L&H's financial statements

— and only those misrepresentations — that deceived investors who bought L&H securities after the financial statements were published. Indeed, the District Court explicitly stated that it was the alleged misstatements of "another person" (*i.e.*, L&H) — and not any statements or conduct by Dexia — that established the "nexus" (*i.e.*, connection) with the "securities market." *Quaak*, 357 F. Supp. 2d at 341.

This is precisely the type of situation that the Supreme Court was distinguishing in *Zandford* when it indicated that the "in connection with" requirement would not have been met if the fraud had occurred "after a lawful transaction had been consummated." 535 U.S. at 820. Here, certain transactions were consummated between Dexia and the Companies and Dexia and L&H officers. Then, similar to the hypothetical broker contemplated in the Supreme Court's example, L&H alone misrepresented these transactions to the public. It was only the alleged subsequent misrepresentations by L&H, and not the underlying transactions, that "coincided" with the sale of L&H securities; thus, L&H is the only entity against which a private Section 10(b) claim may properly lie.

A recent decision from the United States District Court for the Southern District of Texas, *In re Dynegy, Inc. Securities Litigation*, 339 F.

Supp. 2d 804 (S.D. Tex. 2004), illustrates this distinction. The plaintiff in that action alleged that Citigroup had structured and funded transactions that concealed debt from Dynegy's balance sheet, with the result that Dynegy's reported income and cash flows were inflated. Applying the holding of *Zandford*, and focusing directly on the "in connection with" requirement, the court concluded that "[b]ecause plaintiffs in this case do not allege any facts showing that Citigroup's allegedly manipulative and deceptive acts *coincided* with sales of Dynegy securities, . . . the facts of this case are distinguishable from those in which courts have found defendants' acts to constitute a manipulative or deceptive device or fraud that is actionable under § 10(b)." *Id.* at 916 (emphasis added). The court also found that "the aid that Citigroup provided Dynegy is not actionable under § 10(b), and plaintiffs cannot invoke subsections (a) and (c) of Rule 10b-5 to circumvent *Central Bank*'s limitations on liability for a secondary actor's involvement in the preparation of false and misleading statements." *Id.*

Just as in *Dynegy*, here Dexia's alleged acts did not coincide with purchases of L&H securities by the putative class members. As the court in *Dynegy* understood, private plaintiffs' claims must be dismissed where they assert only that secondary actors have engaged in conduct one or

more steps removed from the relevant securities transactions, because such claims do not satisfy Section 10(b)'s "in connection with" requirement.

B. A Defendant Cannot Be Liable for a Primary Violation of Section 10(b) and Rule 10b-5 Unless the Plaintiff Pleads and Proves Reliance as to That Defendant.

The Supreme Court in *Central Bank* reasoned that aiding and abetting liability would eviscerate the reliance element under Section 10(b) and Rule 10b-5 because "the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions." 511 U.S. at 180. The Court observed that "[a]llowing plaintiffs to circumvent the reliance requirement would disregard the careful limits on 10b-5 recovery mandated by our earlier cases." *Id.*

Applying *Central Bank*, district courts in both California and Missouri have correctly dismissed purported Section 10(b) "scheme" claims against issuers' business counterparties because the plaintiffs in those cases did not adequately plead that investors relied on any statements or actions by those counterparties. *See In re Charter*, slip op. at 14; *In re Homestore*, 252 F. Supp. 2d at 1038. In those cases there was no allegation, nor could there be, that any investor relied on the underlying transactions themselves — in contrast to how the issuer, and the issuer alone, accounted for and reported

them. In fact, had the issuers in those cases properly accounted for or disclosed the transactions, there would have been no alleged securities fraud at all. *See O'Hagan*, 521 U.S. at 655. Similar to the participation of the business counterparty defendants there, Dexia's participation in underlying transactions with L&H officers and the Companies — without any subsequent affirmative act or statement whatsoever by Dexia with respect to L&H's investors — is not actionable by private litigants under Section 10(b) and Rule 10b-5.

The District Court allowed Plaintiffs to circumvent the reliance requirement by holding that reliance was satisfied by Plaintiffs' "alleging facts sufficient to show (1) that defendants substantially participated in a fraudulent scheme; and (2) when the scheme is viewed as a whole, the plaintiffs relied on it." *Quaak*, 357 F. Supp. 2d at 341-42 (quoting *In re Lernout*, 236 F. Supp. 2d at 174). This new "substantial-participation-plus-scheme-viewed-as-a-whole" test — in the absence of a single specific allegation that shows actual reliance by investors on any statements or conduct by Dexia — is wholly insufficient and effectively resurrects the very same private "aiding and abetting" liability that was foreclosed by *Central Bank* and by Congress in the 1995 PSLRA. As is clear from

Plaintiffs' allegations, the alleged "scheme" in this case manifested itself to L&H's investors only through alleged misstatements by L&H, and not through any statements or conduct by Dexia. Because it is only L&H's public statements to the marketplace that connect investors to the alleged "scheme," Plaintiffs cannot plead or prove that investors relied on Dexia at all. The Court should reject Plaintiffs' attempt to use "scheme" allegations to bootstrap their reliance allegations against Dexia.

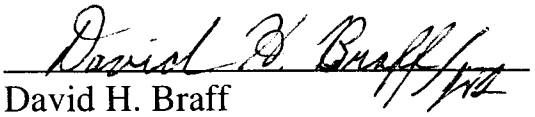
Likewise, the "fraud-on-the-market" doctrine — which affords plaintiffs a rebuttable presumption that investors relied on alleged misrepresentations or omissions because they were reflected in L&H's stock price, *see Basic Inc.* v. *Levinson*, 485 U.S. 224, 245-47 (1988) — does not excuse Plaintiffs from pleading that they relied on statements or conduct by Dexia *itself*. The only alleged fraud presented to the market here was in L&H's statements, not the underlying transactions executed by Dexia. Thus, although the fraud-on-the-market presumption may arguably serve as a proxy for investors' reliance upon L&H's statements to the market, it does not allow a presumption that investors or the market relied upon any conduct by Dexia.

CONCLUSION

For the foregoing reasons, the judgment of the District Court below should be reversed.

Dated: January 11, 2006
New York, New York

Respectfully submitted,



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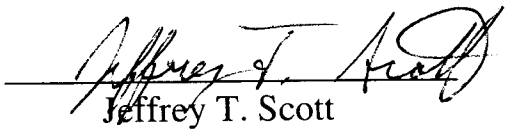
CERTIFICATE OF COMPLIANCE WITH TYPEFACE AND LENGTH LIMITATIONS

I, Jeffrey T. Scott, hereby certify that the foregoing Brief of The Bond Market Association, the Chamber of Commerce of the United States of America, The Clearing House Association L.L.C. and the Securities Industry Association, as *Amici Curiae*, in Support of Defendants-Appellants and Reversal complies with the type-volume limitations of Federal Rule of Appellate Procedure 32 by using 14-point Times New Roman font, a proportionally spaced, serif typeface. According to the word count of the word processing program that was used to prepare it, this brief contains 5,912 words, exclusive of the Corporate Disclosure Statement, Table of Contents, Table of Authorities, and Certificates of Compliance and Service.

Dated: New York, New York
January 11, 2006



Jeffrey T. Scott

ADDENDUM
PURSUANT TO LOCAL RULE 32.3(b)

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

IN RE CHARTER COMMUNICATIONS, INC., SECURITIES LITIGATION	MDL DOCKET NO. 1506 ALL CASES
STONERIDGE INVESTMENT PARTNERS LLC, Individually and On Behalf of All Others Similarly Situated, Plaintiffs, v. CHARTER COMMUNICATIONS, INC., et al., Defendants.	Consolidated Case No. 4:02-CV-1186 CAS

MEMORANDUM AND ORDER

This matter is before the Court on several motions to dismiss for failure to state a claim. Plaintiffs oppose the motions and the matter is now fully briefed. The Court will grant the motion as to Scientific-Atlanta and Motorola, and deny the motion as to Arthur Andersen for the reasons set forth below. The Court will also enter the protective order submitted by the parties.

I. BACKGROUND

Charter Communications, Inc. ("Charter") is a cable operator that provides video, data, interactive and private business network services to customers in forty states through the company's broadband network of coaxial and fiber optic cable. The company offers traditional analog cable as well as digital television services, along with an array of advanced products and services such as high-speed Internet access, interactive video programming and video-on-demand.

This is a putative securities class action filed on behalf of investors who purchased Charter securities during the period from November 8, 1999 through July 17, 2002 (the "Class Period"). In addition to Charter, plaintiffs named as defendants current and former senior executives, Arthur Andersen LLP, an accounting firm headquartered in Chicago, Illinois, which served as Charter's independent auditor during the Class Period; and Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola"), two of Charter's vendors that manufacture electronic equipment, including digital set-top boxes used in the cable industry.

Upon motion of several of the parties, the Court temporarily stayed the proceedings so that the parties could pursue mediation. The parties who participated in the mediation reached a tentative agreement that is subject to the Court's approval. Prior to the stay, Scientific-Atlanta, Motorola,[1] and Arthur Andersen--who are not parties to the tentative settlement-- moved to dismiss the amended complaint for failure to state a claim upon which relief can be granted under Federal Rules 12(b)(6) and 9(b), and the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act"), 15 U.S.C. § 78u-4(b). These motions are now before the Court.

In their Amended Consolidated Class Action Complaint ("Amended Complaint"), plaintiffs allege, *inter alia,* defendants (1) engaged in a fraudulent scheme to artificially boost the company's customer base and reported financial results; (2) inflated Charter's internal customer growth rate by deliberately delaying "disconnects" for over 100,000 customers who were no longer paying their bills or who had advised the company they wished to terminate their service; and (3) materially inflated

[1]The plaintiffs' allegations as to Motorola and Scientific-Atlanta are pled collectively as to both defendants. While Scientific-Atlanta and Motorola filed separate motions to dismiss, Motorola adopts Scientific-Atlanta's arguments to the extent they are applicable to Motorola.

Charter's operating cash flow by improperly capitalizing labor-related and other costs that should have been expensed.

II. DISCUSSION

A. Pleading Standard under PSLRA

A motion to dismiss will not be granted 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." Conley v. Gibson, 355 U.S. 41, 45 (1957). In considering a motion to dismiss for failure to state a claim upon which relief can be granted under Federal Rules of Civil Procedure 12(b)(6) and 9(b), this Court must view the factual allegations in the light most favorable to the plaintiff. Parnes v. Gateway 2000, Inc., 122 F.3d 539, 546 (8th Cir.1997). The facts alleged in the complaint are assumed to be true. In re Navarre Corp. Sec. Litig., 299 F.3d 735, 738 (8th Cir. 2002).

"Complaints brought under Rule 10b-5 and section 10(b) are governed by special pleading standards adopted by Congress in the [Reform Act]. These pleading standards are unique to securities and were adopted in an attempt to curb abuses of securities fraud litigation." Navarre Corp., 299 F.3d at 741. Congress enacted two heightened pleading requirements in the Reform Act. First, the Reform Act requires the plaintiff's complaint to specify each misleading statement or omission and specify why the statement or omission was misleading. 15 U.S.C. § 78u-4(b)(1) (Supp. IV 1998). If the allegation "is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." Id. Similarly, Rule 9(b) of the Federal Rules of Civil Procedure has long required that "in all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The text of the Reform Act was designed "to embody in

the Act itself at least the standards of Rule 9(b)." Greebel v. FTP Software, Inc., 194 F.3d 185, 193 (1st Cir. 1999).

Second, Congress stated in the Reform Act that a plaintiff's 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); Florida State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir.2001). The Reform Act requires the court to dismiss the complaint if these requirements are not met. 15 U.S.C. § 78u-4(b)(3). In the securities fraud context, this Court must "disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the [Reform Act]." Green Tree, 270 F.3d at 660. "[U]nder the Reform Act, a securities fraud case cannot survive unless its allegations collectively add up to a strong inference of the required state of mind." Green Tree, 270 F.3d at 660. "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable .... Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences." Id. (quoting Greebel, 194 F.3d at 195-96) (alterations in original).

Plaintiffs brought causes of action under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5(b) promulgated thereunder. Section 10(b) of the Exchange Act states in relevant part:

> It shall be unlawful for any person, directly or indirectly ... (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 implements this statute, stating:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

B. Scientific-Atlanta and Motorola

According to the Amended Complaint, Scientific-Atlanta is headquartered in Lawrenceville, Georgia and is a leading manufacturer of products for the cable television industry. It designs, develops, and manufactures innovative products which it sells to several cable system operators, also known as "Multiple System Operators" ("MSOs"), one of which is Charter. Motorola is based in Schaumberg, Illinois, and is also one of the country's leading manufacturers of electronic equipment, including products for the cable television industry.

The MSOs use products from Scientific-Atlanta and Motorola, who are primary competitors, as well as other vendors, to distribute video and other services to their consumer cable subscribers. One of the products that Scientific-Atlanta and Motorola manufacture and distribute to the MSOs is a "digital set-top," a unit that is typically placed on top of a television set to enable the customer to access digital cable television and other digital services. Charter purchases this equipment and supplies it to its customers so they can view Charter's cable television programs. In 2000, the digital

set-top was a relatively new product, and cable operators such as Charter marketed its new features to prospective and existing cable customers.

Plaintiffs assert that Charter entered into sham arrangements with Motorola and Scientific-Atlanta intended to boost Charter's revenues and operating cash flow. In order to provide digital cable television service, it was necessary for Charter to purchase digital cable converter boxes for installation in customers' homes. The purchases of these digital cable converter boxes became a large capital expense for Charter and made Charter an important customer of Scientific-Atlanta and Motorola, the two largest manufacturers of such converter boxes and other equipment used by cable companies. (Am. Compl. at ¶ 75.)

In August 2000, defendants Kent D. Kalkwarf, former Executive Vice President and Chief Financial Officer, and David G. Barford, former Executive Vice President and Chief Operating Officer, realized that Charter was facing a year-end shortfall in operating cash flow relative to amounts projected by Charter and those analysts who covered the company. In order to cover that shortfall, Charter entered into sham agreements for "advertising" from Scientific-Atlanta and Motorola to inflate Charter's operating cash flow for the fourth quarter of 2000. (Id. at ¶ 76.) As part of the sham transactions, Charter agreed to pay Scientific-Atlanta and Motorola an additional $20 for each digital converter so long as suppliers repaid that same amount to Charter in the form of "advertising." (Emphasis in Amended Complaint). Thus, the price increases paid by Charter and "advertising" payments made by the vendors constituted "wash" transactions with no economic substance. (Id. at ¶ 77.)

Although these sham agreements could have no legitimate effect on Charter's operating cash flow, defendants exploited such transactions by fraudulently accounting for them in such a way as to

significantly and artificially inflate Charter's operating cash flow during the Class Period, by treating the "payments" from Scientific-Atlanta and Motorola as "revenues" when in fact they were simply the return of Charter's own monies. (Id. at ¶ 78.)

On the other hand, Charter avoided any adverse effect or decrease on its operating cash flow by capitalizing the payments made to Scientific-Atlanta and Motorola, under the pretext that they were related to the purchase of equipment. Thus, although the advertising payments had no economic effect whatsoever on Charter, through their misleading and fraudulent accounting for the transactions, the defendants used them to artificially increase Charter's publicly disclosed operating cash flow by at least 17 million dollars during the fourth quarter of 2000. But for this scheme, Charter's reported revenues and operating cash flow would have fallen short of analyst expectations. (Id. at ¶ 79.)

Plaintiffs assert Scientific-Atlanta and Motorola agreed to such sham transactions knowing or recklessly disregarding that Charter intended to inflate its reported results by recording the monies it received as revenues, while recording monies it paid to them as capital expenses. Plaintiffs assert Scientific-Atlanta and Motorola also knew that analysts would be relying upon such reported amounts in making their recommendations on Charter's stocks. (Id. at ¶ 196.) They further allege that by virtue of such conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading, in violation of § 10 (b) and Rule 10b-5(b). (Id. at ¶ 197.) Alternatively, plaintiffs claim that these sham transactions constituted a "device, scheme, or artifice to defraud" and "an act, practice or course of business which operate[d] . . . as a fraud or deceit" upon Charter investors in violation of Rule 10b-5(a) and (c). (Id. at ¶ 198.)

In support of their motions, Scientific Atlanta and Motorola argue that plaintiffs' claims amount to aiding and abetting liability under § 10(b) and Rule 10b-5, and are therefore barred by the Supreme Court's decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). They further maintain plaintiffs have failed to plead the required elements to state a claim for primary liability under any subpart of § 10(b) or Rule 10b-5. They also contend the Amended Complaint fails to satisfy the pleading requirements of the PSLRA because it fails to specify each statement attributed to them that is alleged to be misleading and the reason or reasons why the statement is misleading. Finally, they argue plaintiffs have failed to plead the strong inference of scienter to "deceive, manipulate or defraud" Charter's investors as required under the Reform Act.

The Court concludes that plaintiff's claims against Scientific-Atlanta and Motorola amount to claims for aiding and abetting liability under § 10(b) and Rule 10b-5. Under any subsection of those provisions, plaintiffs' claims against these defendants are barred by the Supreme Court's decision in Central Bank. Central Bank held that "there is no private aiding and abetting liability under § 10(b)" of the Exchange Act. Id. at 191. The Supreme Court examined the text of the Exchange Act and concluded that Congress did not intend to impose secondary liability under section 10(b). Id. at 184. The Court also observed that allowing recovery for aiding and abetting would permit plaintiffs to circumvent the reliance element of a Rule 10b-5 claim -- a requirement that places "careful limits" on recovery under Rule 10b-5. Id. at 180.

Although aiding and abetting liability was a frequently used basis for derivative liability prior to Central Bank, since then, consistent with Central Bank, courts have declined to imply aiding and abetting liability or other forms of derivative liability. Central Bank left open the possibility of aiding and abetting liability to individuals who had been held liable before, such as accountants and

attorneys, as primary violators of § 10(b). In Anixter v. Home-Stake Production Co., the Tenth Circuit similarly held that Central Bank precludes liability for secondary actors under Section 10(b) unless they "themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors." 77 F.3d 1215, 1226 (10th Cir. 1996). "The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or by omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by another cannot itself form the basis of liability. Id. at 1225, citing Central Bank. Moreover, in Wright v. Ernst & Young, 152 F.3d 169, 175 (2d Cir. 1998), the Second Circuit stated that "if Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." Id. (internal citations omitted).

The Court concludes plaintiffs' claims against Scientific-Atlanta and Motorola are claims for aiding and abetting. Plaintiffs do not assert that Scientific-Atlanta and Motorola made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do not allege that Scientific-Atlanta or Motorola were responsible for, or were involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by Scientific-Atlanta or Motorola. Instead, plaintiffs contend that Scientific-Atlanta and Motorola are

liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.

Nor can these defendants be held liable for any purported omissions as plaintiffs have not alleged that Scientific-Atlanta or Motorola had any duty to Charter's investors. See Chiarella v. United States, 445 U.S. 222, 235 (1980) (there can be no liability for fraud under Section 10(b) absent a duty to speak). Plaintiffs allege that by virtue of their conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading. The Court can find no precedent for the conclusion that business partners, such as Motorola and Scientific-Atlanta, made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

In re Homestore.com Inc. Sec. Litig., 252 F.Supp.2d 1018, 1038 (C.D. Cal. 2003), is instructive. In Homestore the district court dismissed the complaint, holding that third-party vendors and other business partners were not liable under § 10(b) where plaintiffs failed to allege that they relied on any statements made by those defendants or on the purported "scheme" in which the defendants were alleged to have participated. The Homestore court gave three reasons for rejecting plaintiff's theory of liability as to the outside defendants. First, the parties did not cite, nor was the court aware of any case that had ever held a simple business partner to a corporation liable to the shareholders of that corporation for securities fraud. Id. at 1037. Second, regardless of how "scheme" is defined, Central Bank permits liability only for actors who commit "primary violations" of the securities laws, not "those who merely facilitate or participate." Id. at 1038. Third, Homestore shareholders were damaged by reliance on statements and material omissions made by

Homestore, not by the "scheme" itself. Id. Finally, the court noted that in the cases cited to it following CentralBank where an "outsider" had been held liable as a primary violator, the outsider had a special relationship with the corporation, such as accountant or auditor. Thus, these were the kinds of "secondary actors" the Supreme Court in Central Bank foresaw as primary violators. Id. at 1039. Homestore further stated:

> [T]he language of the Supreme Court does not suggest, and the subsequent case law does not support, the notion that a business partner with no special relationship with a corporation, let alone its shareholders, can be held liable for the material misstatements or omissions of that corporation or its officers, no matter how much it assisted or participated in transactions that led to that statement or omission. Such a holding would broaden the securities acts as to haul into court anyone doing business with a publicly traded company.

Id. at 1039.

Courts have also rejected attempts to characterize such claims as a "scheme to defraud." The Homestore court defined a scheme within the meaning of the Exchange Act and the PSLRA as involving "one or more participants acting together to violate securities laws" all of whom "may have varying degrees of culpability depending on their role in the scheme." Id. at 1040. Nonetheless Homestore held that in light of Central Bank, only participants who are primary violators of § 10(b) may be held liable in a private action for securities fraud. Id.

Plaintiffs maintain Homestore is distinguishable because it involved the actual exchange of services that had real value for the parties regardless of how Homestore treated the transactions, unlike here where the added price to the transaction had no economic benefit for any of the parties. They further maintain the fact that these defendants did not directly "make" any of the earnings statements issued by Charter does not protect them from liability. Plaintiffs argue that both Scientific-Atlanta and Motorola knowingly or recklessly participated in a fraudulent kickback scheme, the sole

purpose of which was to enable Charter, as a valued customer, to inflate its publicly reported revenues and stock price. Therefore, they argue liability for such misconduct falls within Rule 10(b)-(5).

Plaintiffs principally rely on In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F.Supp.2d 549, 577 (S.D. Tex. 2002). In Enron, plaintiffs claimed Enron's lawyers, accountants and underwriters participated with the company in a "Ponzi" scheme for their own enrichment which, in an essential part of the plan, resulted in defrauding third-party investors in order to keep funds flowing into the company. The complaint specifically claimed that secondary actors caused Enron to violate SEC rules and Generally Accepted Accounting Principles in order to inflate corporate assets, shareholder equity and net income, while at the same time understating company debt.

The Enron court found that primary securities fraud allegations were sufficiently stated against several secondary actors, including the company's outside law firm, its auditor and commercial and investment banks. The court adopted the SEC's proposal for primary liability of a secondary party under Rule 10b-5. Id. at 590. The SEC proposed, "when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter." "Moreover, it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." Also, "a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the

document and thus had the requisite scienter, he or she would not have created those misrepresentations." The plaintiff, must of course, plead and prove the elements of scienter and reliance. Enron, 235 F.Supp.2d at 583-91 (internal citations omitted.)

Here plaintiffs allege that it was foreseeable to defendants that these transactions would have the intended effect of inflating Charter's revenues and stock price, and as such, defendants knowingly or recklessly engaged in a scheme or artifice designed to defraud Charter investors. Plaintiffs argue this situation is like Enron because defendants' alleged kickbacks with Charter had no purpose other than to deceive investors about Charter's true financial condition. The arrangements were meaningful only insofar as they advanced illegitimate ends of an important customer of those defendants.

Scientific-Atlanta and Motorola counter that under Enron defendants must have created a misrepresentation upon which investors relied. They argue that they did not create or participate in the creation of Charter's accounting, financial statements, public filings or public statements. They contend that plaintiffs have not alleged that they directed, or even knew of, Charter's accounting treatment. They note that in Enron the bank JP Morgan was alleged to have possessed non-public financial information about Enron that would have demonstrated that the transactions in which it was involved were fraudulent. They further note that here plaintiffs have not alleged, nor can they allege that these defendants possessed any non-public information about Charter's financials or its accounting practices, and that these defendants had the ability to verify the accuracy of Charter's public statements. Scientific-Atlanta and Motorola also contend they made no public representations about Charter and that no Charter investor relied on anything they said. Finally, they note that other third parties who transacted business with Enron, such as the law firm of Kirkland & Ellis, as well as Lehman Brothers and Bank of America, were dismissed for failure to state a claim.

This Court does not find Enron on point. To reiterate, Enron held that § 10(b) liability may only be imposed for secondary actors who have created a document containing a misrepresentation upon which investors relied. The Amended Complaint does not allege that Scientific-Atlanta or Motorola created or participated in the creation of any of Charter's accounting, financial statements, public filings or public statements, nor does it allege that they directed, or even knew of, Charter's accounting treatment. The plaintiffs also do not allege Scientific-Atlanta and Motorola made public representations about Charter or that any Charter investor relied on anything Scientific-Atlanta and Motorola said. The Court concludes that plaintiffs' claim fails as neither Scientific-Atlanta nor Motorola made a representation to Charter's investors nor participated in the drafting of statements Charter made to its investors.

The Court concludes for the above reasons that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.. The parties have not provided, nor has the Court found, any precedent holding a business partner to a corporation, such as Scientific-Atlanta and Motorola here, liable to the investors of that corporation for securities fraud. As the Court finds that plaintiffs' claims are precluded as to Scientific-Atlanta and Motorola as a matter of law, the Court need not address the sufficiency of the Amended Complaint as to these defendants.

C. Arthur Andersen, LLP

Arthur Andersen, LLP ("Andersen"), Charter's outside auditor during the Class Period, moves to dismiss Count IV of the Amended Complaint for failure to state a claim. The PSLRA's pleading requirements do not distinguish between corporate defendants and accountants. Therefore, although the factual allegations against Andersen in the Amended Complaint must be separately

considered, the pleading principles set forth above apply equally to the allegations against an accounting firm such as Andersen. In re MicroStrategy, Inc. Sec. Litig., 115 F.Supp.2d 620, 650 (E.D. Va. 2000). After reviewing the Amended Complaint and drawing all inferences in favor of plaintiffs as the Court must do in reviewing a motion to dismiss, the Court finds that the plaintiffs have satisfied the heightened pleading standards of the PSLRA.

"Scienter means the intent to deceive, manipulate, or defraud." Green Tree, 270 F.3d at 653 (internal quotations omitted). Although the Reform Act's heightened pleading rules require a showing of a "strong inference" of scienter, Congress did not codify any particular methods of satisfying that requirement. Kushner v Beverly Enters, 317 F.3d 820, 827 (8th Cir. 2003). The Eighth Circuit holds that the Reform Act was not intended to alter the substantive nature of the scienter requirement, and therefore its prior case law on the issue remains instructive for this Court. Green Tree, 270 F.3d at 653 & n.7.

As a general rule, inferences of scienter tested under the Reform Act will not survive a motion to dismiss if they are only reasonable inferences-the inferences must be " 'both reasonable and strong.' " Helwig v. Vencor, Inc., 251 F.3d 540, 551 (6th Cir. 2001) (en banc) (quoting Greebel, 194 F.3d at 195-96), cert. dismissed, 536 U.S. 935 (2002). Other circuit case law suggests that a strong inference of the required scienter may arise where the complaint sufficiently alleges that the defendants (1) benefitted in a concrete and personal way from the purported fraud, (2) engaged in deliberately illegal behavior, (3) knew facts or had access to information suggesting that their public statements were not accurate, or (4) failed to check information they had a duty to monitor. See Kushner, 317 F.3d at 827, citing Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir.), cert. denied, 531 U.S. 1012 (2000). The Eighth Circuit considers how other circuits have interpreted the

strong-inference-of-scienter language as valuable guidance about what factors help to establish such an inference, but takes care to use subsidiary formulae as an aid to interpreting the strong-inference standard and not as a substitute for it. Navarre, 299 F.3d at 746 (internal quotations omitted).

Scienter may also be demonstrated by recklessness. Kushner, 317 F.3d at 828; Green Tree, 270 F.3d at 653. Scienter may be established by severe recklessness involving "highly unreasonable omissions or misrepresentations" amounting to "an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." K & S P'ship v. Cont'l Bank, N.A., 952 F.2d 971, 978 (8th Cir.1991) (internal quotations omitted), cert. denied, 505 U.S. 1205 (1992). Recklessness, then, may be shown where unreasonable statements are made and the danger of misleading plaintiffs is so obvious that the defendant must have been aware of it. Id. "[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements." Novak, 216 F.3d at 308. Also, recklessness is shown where alleged facts demonstrate that the defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. Id.

According to the Amended Complaint, Andersen served as Charter's independent auditors throughout the Class Period. In that capacity, Andersen performed audits of Charter's books, records, and financial statements for the years 1999, 2000, and 2001. Plaintiffs allege that Andersen violated §10(b) and Rule 10b-5 in auditing the financial statements prepared by Charter.

Plaintiffs allege that as Charter's auditor, Andersen had full access to its books, records and personnel, and knew, or recklessly disregarded, that (a) Charter's capitalization rate was the highest

in the industry, and resulted from Charter's improper capitalization of costs that should have been expensed; (b) Charter had a pattern of holding disconnects, which contributed to a significant rise in account receivables that should have been promptly written off; (c) Charter improperly accounted for other matters, such as including all launch fees paid by program providers at the initial rate of a contract, rather than over the entire term of the contract; and (d) though aware that Charter was seeking to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transactions by confirming them with the vendors. (Amended Complaint at ¶ 193.)

Plaintiffs specifically allege that following such audits, Andersen issued opinion letters stating that its audits of Charter's financial statements had been conducted in conformance with Generally Accepted Auditing Standards ("GAAS"),[2] and that the statements conformed with Generally Accepted Accounting Principles ("GAAP").[3] (Id. at ¶ 191.) Andersen issued a "Report of Independent Public Accountants" with respect to Charter's financial statements for the years 1999, 2000, and 2001 in which Andersen stated that it had conducted its audits in accordance with GAAS and that Charter's financial statements were fairly presented in conformity with GAAP. (Id. at ¶¶ 100, 113, 138, 191.) Plaintiffs asserts that Andersen's statements about GAAP and GAAS were false

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[2]GAAS are the standards prescribed by the Auditing Standards Board of the American Institute of Certified Public Accountants for the conduct of auditors in the performance of an examination. See In re Ikon Office Solutions, Inc., 277 F.3d 658, 663 (8th Cir. 2002), cited in SEC v. Arthur Young & Co., 590 F.2d 785, 788 n.2 (9th Cir. 1979).

[3]GAAP is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time." See American Institute of Certified Public Accounts ("AICPA"), Statement of Auditing Standards No. 69, ¶ 69.02 (1992), quoted in Sanders v. Jackson, 209 F.3d 998, 1001 n.3 (7th Cir. 2000).

and misleading (Id. at ¶¶ 95, 192), resulting in major financial restatements for 2000 and 2001. (Id. at ¶¶ 154-55.)

On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow," otherwise known as earnings before interest, taxes, depreciation and amortization ("EBITDA"), had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (Id. at ¶ 15.)

Given the significance assigned operating cash flow, it was critically important whether a company expensed certain costs, or capitalized them over a period of time (in which case they were excluded from operating cash flow). (Id. at ¶ 43.) GAAP governs the accounting for such costs and the determination of whether they are expensed or capitalized.

Plaintiffs assert Andersen knew or recklessly ignored Charter's significant GAAP violations. They allege that while Charter's stated policy[4] conformed to GAAP, in actual practice, Charter

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[4]Charter's *stated* accounting policy for expenses conformed to GAAP. The *stated* policy was:

> Costs capitalized as part of new *customer installations* include materials, subcontractors costs, internal direct labor costs, including service technicians and customer care representatives and internal overhead costs incurred to connect the customer to the plant from the time of installation scheduling through the time service is activated and functioning. We capitalize incremental and direct contract acquisition costs to the extent realizable from future revenues. The overhead rates established are based on a combination of internal company-wide overhead analysis and internal time and motion studies of specific activities. These studies are updated to adjust for changes in facts and circumstances. ... The *costs of disconnecting and reconnecting* a customer are charged to expense in the period

consistently violated its own policy and GAAP by arbitrarily capitalizing material portions of certain labor related expenses in order to artificially enhance its operating cash flow results to be in line with Wall Street's expectations. This dovetailed with Charter's fraudulent inflation of its internal customer growth rate previously described. (Id. at ¶ 46.)

Plaintiffs assert the favorable, though fraudulent, results that Charter disseminated during the Class Period were intended to enable Charter to meet analysts' forecasts and thereby bolster the price of Charter stock. In turn, this enabled Charter to continue to use its stock as valuable currency on its acquisition spree, completing sixteen acquisitions in the years 1999 and 2000 alone. (Id. at ¶ 47.)

Plaintiffs assert senior Charter executives orchestrated a scheme to artificially inflate the number of Charter cable TV subscribers and misstate Charter's earnings by inflating Charter's operating cash flow. (Id. at ¶¶ 3-9, 48-59, 62, 72-73, 83-94.) On the directives of corporate officers, Charter capitalized numerous labor costs that should have been expensed. (Id. at ¶ 62.) This widespread practice not only violated GAAP, Financial Accounting Standard 51,[5] ("FAS") but was

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> incurred. *Expenditures for repairs and maintenance* are charged to operating expense as incurred, while equipment replacements and betterments, including the replacement of drops, are capitalized. (Emphasis in Amended Complaint.)

(Id. at ¶ 45.)

[5]Financial Accounting Standard ("FAS") 51 governs the standards for accounting on specific issues related to the cable industry. Among other things, FAS 51 states:

a. Labor costs associated with installing new services on the *first visit* to an address can be capitalized, and then depreciated over a period no longer than the period used to depreciate the cable television plant.

b. A portion of associated "indirect" costs, that are associated with installation or upgrade labor costs may likewise be capitalized.

c. The costs of subsequently disconnecting or reconnecting a subscriber (or an address) must be expensed. Thus, the second time a service is enabled at an address (even if it is a new subscriber), it must be expensed in the period incurred.

inconsistent with Charter's own policy as set forth in its public filings, particularly with respect to repair and disconnection related expenses. (Id. at ¶ 63.) Charter also routinely capitalized significant portions of "reconnect" costs (costs to reconnect subscribers who had requested that their cable be disconnected or whose service had been terminated for failure to pay their bills). (Id. at ¶ 64(d).) As a result, plaintiffs assert Charter improperly capitalized costs totaling $93 million in 2001, and $52 million in 2000. (Id. at ¶ 64 (e).)

Plaintiffs further assert Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred. (Id. at ¶ 64(h).) This practice was in direct violation of Statement of Position 93-7[6] ("SOP" 93-7),

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d. "Subscriber related costs" and general administration expenses must be expensed in the period incurred. These costs include:

> Cost of billing and collection, bad debts, mailings, repairs and maintenance of taps and connections, general and administrative systems costs such as salary of the system manager and office rent, programming costs for additional channels used in the marketing effort or costs related to revenues from per channel or per program service, and direct selling costs.

(Id. at ¶ 44.)

[6]SOP 93-7 states the following:

> The costs of advertising should be expensed either as incurred or the first time advertising takes place except for :
>
> a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.
>
> b. Expenditures for advertising costs that are made subsequent

Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, during 2001, $59 million in marketing campaign expenses were improperly deferred rather than expensed. (Id.)

Referring to the alleged sham arrangements with vendors Scientific-Atlanta and Motorola intended to artificially boost Charter's revenues and operating cash flow, the plaintiffs allege that indicative of the deliberately fraudulent nature of these transactions, Kent Kalkwarf "discussed the concept" with Arthur Andersen in August 2000, prior to any payments being exchanged. At the time Andersen stated that "Charter could not recognize the advertising payments as revenue because they appeared integrally related to the cost increases being paid by Charter." (Id. at ¶ 80.) Andersen advised Charter that it could recognize the advertising fees as revenues if the additional payments for the converter boxes and the advertising were (1) at fair market value; (2) unrelated to one another; and (3) negotiated at least one month apart.

In late August 2000, Kalkwarf advised Andersen that it would fulfill those conditions. In September 2000, Kalkwarf falsely told Andersen that the advertising and supply contracts with Scientific-Atlanta and Motorola had been negotiated by two separate departments at Charter, one month apart from each other. Plaintiffs allege that to lend further credibility to these claims, even though the set-top box price increases were not finalized with either vendor until late September 2000, the contracts were backdated to August 2000 on the instructions of Kalkwarf and David Barford, to give the false appearance that the set-top box price agreements were negotiated a month before the advertising contracts which were dated in late September. (Id. at ¶ 80.)

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to recognizing revenues related to those costs.

Despite being aware that Charter was seeking to generate additional revenue through a series of questionable transactions with these two vendors, Andersen accepted the explanations provided by Kalkwarf and Barford, and failed to perform further audit checks, for example, requesting additional verification from the vendors as required under GAAS. (Id. at ¶ 81.)

In support of its motion, Andersen argues the Amended Complaint fails to allege facts sufficient to establish the required strong inference of scienter necessary to state a claim of securities fraud. Specifically, Andersen argues the Amended Complaint contains few allegations about Andersen and fails to establish Andersen acted with fraudulent intent. Andersen argues that the Amended Complaint largely addresses Charter's alleged conduct in calculating the number of its cable TV subscribers. Andersen notes that there is no allegation it approved or "certified" the subscriber count number in any way, nor could there be, because Andersen merely audited Charter's financial statements, which did not reference the subscriber count. Andersen argues the Amended Complaint fails to allege specific facts to support the conclusion that Andersen--at the time of the audits--knew of or recklessly disregarded GAAP and GAAS violations, or to suggest Andersen acted fraudulently or recklessly at the time it audited the financial statements. Andersen contends the allegation that it had "full access" to Charter's books, records and personnel, as well as plaintiffs' allegations as to GAAP and GAAS, are insufficient to establish the requisite strong inference of scienter under §10(b).

Plaintiffs oppose the motion, asserting the Amended Complaint pleads numerous facts that, taken together, give rise to the requisite strong inference of scienter. They note that the magnitude of the fraud, involving improper accounting for $487 million of Charter's revenues and expenses, and inflation of Charter's growth rate for operating cash flow by 100%, strongly suggests that Andersen was either a knowing or severely reckless participant in the fraud. They argue that Andersen

disregarded numerous "red flags" which should have alerted it to Charter's fraud, including Charter's unusually high capitalization rate; its practice of including all new program launch fees paid by program providers at the initial date of a contract period, rather than amortizing these fees over the entire term of a contract; and its ignoring the series of sham transactions that Charter conducted with its two main digital converter-box providers in an effort to boost operating cash flow. Plaintiffs claim Andersen knew of Charter's deceptive purpose for these transactions, but did nothing to investigate them further as required by GAAS, noting that a Charter official discussed the propriety of booking revenues on the wash transactions with Andersen, who advised that Charter's plan would violate GAAP unless certain specific conditions were met. Despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional verification from the vendors when Charter represented that Andersen's conditions had been met.

Plaintiffs contend the magnitude of the GAAP violations, and the inference of scienter to be drawn therefrom, is confirmed by Charter's restatement after Andersen was replaced as auditor. Given the severity of the GAAP violations, Charter was forced to restate its 2000 and 2001 financials. For 2000, this resulted in reduced revenues of $108 million and increased expenses of $87 million. For 2001, this resulted in reduced revenues of $146 million and increased expenses by $146 million. Plaintiffs note that as a result, Charter's reported growth rate for 2001 was reduced by one half. The plaintiffs argue that these sums are not reasonable differences over interpretation and application of GAAP, but speak of a massive and concerted fraud that only the most callous auditor could fail to detect. (Id. at ¶¶ 43-44, 60-71, 75-82.)

The plaintiffs assert the combination of GAAP violations, red flags, and the financial restatement satisfy the scienter requirement. The Court agrees. Allegations of GAAP violations, alone, are insufficient to state a claim for securities fraud. Navarre, 299 F.3d at 745. However, GAAP violations coupled with evidence of corresponding fraudulent intent may state a securities fraud claim. In re K-Tel Int'l, Inc. 300 F.3d 881, 894 (8th Cir. 2002); see also In re McKesson HBOC, Inc. Sec. Litig., 126 F.Supp.2d 1248, 1272 (N.D. Cal. 2000) ("when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter").

Plaintiffs allege Andersen knew or recklessly ignored Charter's significant GAAP violations, particularly noting Charter's operating cash flow rate growth rate, which was reported to be twice the actual operating cash flow growth rate. They allege the inflated results were achieved by accounting ploys such as the capitalization of labor costs that should have been expensed, as well as the recognition of non-existent revenues from sham transactions with Scientific-Atlanta and Motorola. They allege this practice not only violated GAAP and FAS 51, but was inconsistent with Charter's own policy as set forth in its public filings, particularly the portion related to repair and disconnection related expenses. The plaintiffs allege Charter routinely but improperly capitalized significant portions of "reconnect costs," resulting in improperly capitalized costs totaling $93 million in 2001 and $52 million in 2000. Plaintiffs further argue Andersen knew or recklessly ignored Charter's significant GAAP violations, citing Charter's inflated operating cash flow as the linchpin of Charter's fraud. They note that whereas Charter reported that operating cash flow grew at 12-14% during the Class Period, its actual operating cash flow growth rate was only 6%.

Plaintiffs also allege Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred, in violation of SOP 93-7, Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, the plaintiffs allege $59 million in marketing campaign expenses were improperly deferred rather then expensed in 2001.

Plaintiffs assert Andersen either knowingly or recklessly ignored several "red flags" in acquiescing to these violations. Courts have held allegations an auditor ignored "red flags" is probative of fraudulent intent or recklessness. See e.g., In re Health Mgmt. Inc. Sec. Litig., 970 F.Supp.192, 203 (E.D.N.Y. 1997); In re Oxford Health Plans, Inc. Sec. Litig., 51 F.Supp.2d 290, 295-96 (S.D.N.Y. 1999). This is a matter of degree, however, the probative value of allegations that an auditor ignored "red flags" is a function of the nature and number of such flags. In re MicroStrategy, 115 F.Supp.2d at 653-54. Thus, as one court stated, "while [defendant's] ignorance of warning signs in one sense demonstrate[s] that it was merely negligent, allegations that, with gross recklessness, [defendant] ignored multiple 'red flags' could reasonably support an inference that [defendant] acted with intent." In re Leslie Fay Cos., Inc., 871 F. Supp. 686, 699 (S.D.N.Y.1995) (holding that an accountant's ignoring multiple "red flags" could reasonably support an inference that the accountant defendant acted with intent).

The first red flag plaintiffs note was Charter's "extraordinary" capitalization rate, which plaintiffs allege was by far the highest in the industry. They note that Charter's aggressive capitalization policy was one of the factors Merrill Lynch cited in deciding to downgrade its investment rating from "strong" to "neutral." The plaintiffs note that Merrill Lynch's ability to ascertain this indicator of Charter's troubles--without the benefit of the extensive access to Charter's

books that Andersen enjoyed--is additional evidence of Andersen's recklessness. Plaintiffs maintain another red flag was Charter's practice of including all new program "launch fees" paid by program providers at the initial date of a contract period rather than amortizing them over the entire term of the contract.

Plaintiffs assert a third red flag was Charter's ignoring a series of sham transactions that Charter conducted with two vendors, Scientific-Atlanta and Motorola, in an attempt to boost operating cash flow. The plaintiffs allege that despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional verification from vendors, when Charter represented that Andersen's conditions had been satisfied.

As previously stated, plaintiffs maintain Charter's significant financial restatement after Andersen was re-placed as auditor provides further inference of scienter. On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow" had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (Id. at ¶ 15.) The plaintiffs allege these large figures suggest a massive and concerted fraud, not merely reasonable differences over interpretation and application of GAAP.

"The mere *fact* that there was a restatement or a violation of GAAP, by itself, cannot give rise to a strong inference of scienter; the *nature* of such a restatement or violation, however, may

ultimately do so." In re MicroStrategy, 115 F.Supp.2d at 635. "Common sense and logic dictate that the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly." Id. at 636. The Court agrees that the size of the restatement here is probative of a strong inference of scienter on the part of Andersen.

The plaintiffs finally argue that Andersen's knowledge of Charter's operations also supports a strong inference of scienter. They note that throughout the relevant time period, Andersen had full access to Charter's books and revenues. The allegations that Andersen had knowledge of Charter's operations in and of itself is not probative of scienter. It does not necessarily follow that because Andersen had access to Charter's operations it was aware of the alleged fraud at Charter, but it is also true that the greater access Andersen's access to Charter operations, the greater the possibility of an inference of scienter. See In re MicroStrategy, 115 F.Supp.2d at 653.

This Court finds plaintiffs' allegations concerning Andersen's failure to detect Charter's purported fraud amount to an "egregious refusal to see the obvious, or to investigate the doubtful," thus creating a strong inference of scienter. See Homestore, 252 F.Supp.2d 1043. The Court finds these allegations, considered alone, would not be sufficient to raise a strong inference of scienter. However, the allegations do not exist in isolation. Taken together, the allegations provide important information on the context in which Andersen may have conducted its audits of Charter's financials, and therefore, this information is relevant to weighing the strength of any scienter inference.

Considering the Amended Complaint and drawing all inferences in favor of plaintiffs as is required in reviewing a motion to dismiss, the Court finds that the plaintiffs have established the heightened pleading requirements of the PSLRA. The Court concludes the Amended Complaint's allegations as to Andersen's GAAS violations, Charter's GAAP violations and subsequent financial

restatements, Andersen's level of access to Charter and necessary knowledge of its operations and most important contracts, and the existence of circumstances suggesting that Andersen was or should have been aware of Charter's accounting practices, taken in context and in light of the totality of the circumstances, raise a strong inference that Andersen acted with scienter. Cf. Danis v. USN Communications, Inc., 73 F.Supp.2d 923 (N.D. Ill. 1999) (plaintiffs satisfied pleading requirements under PSLRA where complaint alleged auditor/consultant violated GAAS, had sufficient contact with the company to become aware of fraudulent abuses, as well as pervasive and fundamental internal control problems at company; court noted auditor was hired to consult, and did not simply allege auditor had access to information); In re Cendant Corp. Sec. Litig., 60 F.Supp.2d 354, 372-73 (D.N.J. 1999) (denied accounting firm's motion to dismiss where plaintiffs alleged operating income was overstated, earnings per share were overstated, audits were not performed in accordance with GAAS, and quarterly financial statements were materially false and misleading). Accordingly, Andersen's motion to dismiss should be denied.

D. Settling Parties' Joint Motion for a Protective Order

Finally, also before the Court is a joint motion for a protective order filed by Charter and plaintiffs. As previously stated, plaintiffs, Charter, and the individual defendants state that they have reached a tentative settlement. They also state that they have entered into a Memorandum of Understanding ("MOU"). The MOU contemplates Charter's voluntary commitment to make a limited number of mutually agreed-upon witnesses under its control available for interviews or meetings with plaintiffs, and to provide plaintiffs with requested documents as necessary to facilitate due diligence concerning the fairness of the proposed settlement. The Proposed Protective Order ("PPO") applies only to these voluntary disclosures made by Charter. The PPO further provides that,

after the plaintiff's due diligence is completed, plaintiffs "shall retain the right to utilize the documents produced [by Charter] in accordance with this Order solely to litigate its existing claims against the non-settling defendants in this action." ¶ 18.

Anderson, the remaining defendant which is not a party to the tentative settlement, objects to provisions of the PPO.[7] Andersen argues that due to the pendency of its motion to dismiss, a stay of discovery already exists pursuant to the Reform Act, and thus, plaintiffs are not permitted any discovery relevant to the claims against it unless and until plaintiffs demonstrate they have sufficiently stated a claim under the Reform Act. Thus, Andersen seeks to prohibit the use of documents received by plaintiffs that would interfere with or undercut the protections afforded to it under the Reform Act. Andersen argues plaintiffs' claims against it be based on the allegations in the Amended Complaint and that any documents obtained by plaintiffs not be used for purposes of responding to the pending motions to dismiss and for drafting a second amended complaint in response to a ruling sustaining the motions to dismiss.

Andersen further argues that the Federal Rules do not authorize its exclusion from discovery conducted under the auspices of the Court. Andersen argues alternatively that even if the Federal Rules do not obligate the Court to reject their PPO, fundamental fairness and efficiency require that they be given simultaneous access to the information Charter provides. Andersen also seeks the opportunity to monitor the ongoing discovery between the settling parties, including being provided access to whatever documents are made available to plaintiffs, as well as notice and an opportunity to attend the interviews at its expense.

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[7]Scientific-Atlanta and Motorola also opposed the PPO. Their arguments are moot in light of the Court's ruling on their motions to dismiss.

Charter responds that Andersen has failed to demonstrate it has a right to participate in this informal exchange of information. As an accommodation, Charter states it will provide Andersen with access to the documents given, but will not permit it to attend the informal interviews contemplated by the MOU. Charter asserts that the contemplated interviews are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process, and thus are outside the ambit of formal discovery governed by the Federal Rules and the Reform Act. Charter further maintains Andersen will suffer no prejudice as a result of being denied access to the interviews given that the interviews constitute inadmissible out of court statements that cannot be used by any other party not in attendance.

The purpose of the Reform Act was "to restrict abuses in securities class-action litigation, including: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants' culpability; (2) the targeting of "deep pocket" defendants; (3) the abuse of the discovery process to coerce settlement; and (4) manipulation of clients by class action attorneys." SG Cowed Sec. Corp. v. United States District Court for the Northern District of California, 189 F.3d 909, 911 (9th Cir.1999) (quoting In re Advanta Corp. Sec. Litig., 180 F.3d 525, 530-31 (3d Cir.1999)). The Reform Act "mandated a stay of discovery during the pendency of a summary judgment or dismissal motion." Id. Under the Reform Act, "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. § 78u-4(b)(3)(B). The stay provision was "intended to prevent unnecessary imposition of discovery costs on defendants." SG Cowed, 189 F.3d

at 911 (citing H.R. Conf. Rep. No. 104-369, 104th Cong. 1st Sess. at 32 (1995), reprinted in 1995 U.S.C.C.A.N. Sess. 731).

The Court concludes Andersen has been afforded the protections of the Reform Act's stay provision. The Court further concludes Andersen's concern regarding the protections of stay provision is moot based on the Court's ruling that plaintiffs have sufficiently stated a claim under the Reform Act.

The Court further concludes Andersen has not demonstrated it has a right to participate in the exchange of information between the settling parties. The contemplated interviews or informal discovery are with individuals under Charter's control, not Andersen representatives, and are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process.

The parties have not provided any case authority that is factually analogous to the situation at hand, nor is the Court aware of any. In JDS Uniphase Corp. Sec. Litig., 238 F.Supp2d 1127 (N.D. Cal. 2002), the plaintiffs sought a court order allowing defendant's former employees to speak voluntarily to plaintiffs' lead counsel about certain topics without fear of breaching their former employer's confidentiality agreements. No motion to dismiss was pending. The court held that it was not discovery under the Federal Rules, because the plaintiffs were not using court process to require these third parties to provide information about the lawsuit, but were merely seeking an order that would allow former employees to speak voluntarily if they wished to do so. The court held that unlike discovery and initial disclosures, the interviews were not compelled by the Federal Rules. Neither the former employees nor the defendants were required to participate in these interviews in any way. Id. at 1134. The court reiterated that "the Reform Act was not intended to provide

defendants with immunity from suit, but, rather, was intended to protect defendants from the burdens of defending against frivolous litigation." Id. at 1134. Cf. In re Tyco Int'l Ltd. Sec. Litig., 2001 U.S. Dist. Lexis 819 (D.N.H.2001) (district court declined to prohibit voluntary discussions between plaintiffs and third party witnesses, stating "[n]either logic, tradition, the constitution nor the PSLRA prohibit interviewing prospective witnesses"); Maley v. Del Global Techs. Corp., 186 F.Supp.2d 358, 363-64 (S.D.N.Y. 2002) (securities fraud class action submitted proposed settlement for approval to district court; settlement was fair despite lack of formal discovery based in part on "confirmatory" discovery, including production of documents, interviews with senior officials, and inspection of company's facilities); Connecticut Gen. Life Ins. Co. v. Connecticut Gen. Life Ins. Co., M.D.L. 1156, No. CV 95-3566, 1997 WL 910387 (C.D. Cal. Feb. 13, 1997) (parties sought certification of the settlement class and final judgment approving the settlement; permitting informal confirmatory discovery to verify certain facts provided during settlement negotiations.)

The Court believes Andersen will suffer no prejudice by not being permitted to attend the informal interviews contemplated by the MOU in light of the fact that it will be provided access to the documents that will be provided to plaintiffs. Therefore, the Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Charter and plaintiffs will provide Andersen access to the documents provided by Charter as long as Andersen agrees to be bound to the terms of the Protective Order.

III. CONCLUSION

For the above reasons, the Court concludes that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994), and accordingly, the Court will grant their motions to

dismiss the Amended Complaint. The Court also concludes plaintiffs have satisfied their pleading burden under the PSLRA to maintain their claims against Arthur Andersen. Therefore, the Court will deny Andersen's motion to dismiss. The Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Accordingly,

IT IS HEREBY ORDERED that the stay in this action is lifted.

IT IS FURTHER ORDERED that Scientific-Atlanta, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 133)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 150)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion for a hearing on its motion to dismiss is **DENIED**. (Doc. 212)

IT IS FURTHER ORDERED that Arthur Andersen's motion to dismiss Count IV of the amended consolidated class action complaint is **DENIED**. (Doc. 138.)

IT IS FURTHER ORDERED that the Joint Motion for a Protective Order is **GRANTED**. (Doc. 242.)

IT IS FURTHER ORDERED that Arthur Andersen's Motion for Leave to File a Surreply Regarding the Joint Motion for a Protective Order is **DENIED.** (Doc. 250.)

IT IS FURTHER ORDERED that Scientific-Atlanta's Motion for leave to Submit a

Supplemental Memorandum Regarding the Joint Motion for a Protective Order is **DENIED.** (Doc. 251.)

CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

Dated this 12th day of October, 2004.

CERTIFICATE OF SERVICE

I, Jeffrey T. Scott, hereby certify that on this 11th day of January, 2006, I caused an original, nine paper copies and one electronic copy of the foregoing Brief of The Bond Market Association, the Chamber of Commerce of the United States of America, The Clearing House Association L.L.C. and the Securities Industry Association, as *Amici Curiae*, in Support of Defendants-Appellants and Reversal (the "Brief") to be sent by Federal Express for delivery on January 12, 2006 to:

Richard Cushing Donovan
Clerk of Court
United States Court of Appeals for the First Circuit
John Joseph Moakley U.S. Courthouse
1 Courthouse Way, Suite 2500
Boston, MA 02210

I further certify that on this 11th day of January, 2006, I caused two true and correct paper copies of the Brief to be served by Federal Express for delivery on January 12, 2006, to each of the following:

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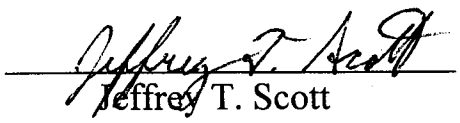

Jeffrey T. Scott