UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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IN RE CONVERIUM HOLDING AG	:	
SECURITIES LITIGATION	:	
	:	**No. 04 Civ. 7897 (MBM)**
(Meyer v. Converium Holding AG, *et al.*)	:	
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This document relates to:	:	
04 Civ. 7897	:	
04 Civ. 8038	:	
04 Civ. 8060	:	
04 Civ. 8295	:	
04 Civ. 8994	:	
04 Civ. 9479	:	
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MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT ZURICH FINANCIAL SERVICES' MOTION TO DISMISS COUNTS III, V, IX, AND X OF THE CONSOLIDATED AMENDED CLASS ACTION COMPLAINT

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MEMORANDUM OF LAW

This case is about a reinsurer's estimates of uncertain amounts payable in future years on reinsurance policies it wrote. The case involves Converium Holding AG ("Converium"), a reinsurance company created in 2001 to assume a substantial portion of Zurich Financial Services' ("ZFS's") third-party reinsurance business. ZFS sold its entire interest in Converium to the public in an initial public offering (the "IPO") that initially became effective on December 11, 2001.

Before the IPO, ZFS hired an independent actuarial firm to review the adequacy of the reserves that ZFS had booked to account for losses and expenses arising from certain reinsurance policies written in prior years. The actuarial firm found a deficiency in those loss reserves, and, as a result, ZFS increased the reserves to a level that corresponded to the actuarial firm's final "best estimate" of those future losses and expenses.

Nearly three years later – in July and August 2004 – Converium announced that it would increase its loss reserves for reinsurance policies written in prior years. Converium's stock price fell, and various Converium shareholders filed these now-consolidated lawsuits alleging violations of the federal securities laws.

Plaintiffs' Consolidated Amended Class Action Complaint (the "Complaint" or "Compl.") asserts four claims against ZFS: violations of §§ 12(a)(2) and 15 of the Securities Act of 1933 (the "Securities Act") (Counts III and V), and violations of §§ 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act") (Counts IX and X). All of these claims are based on ZFS's alleged conduct preceding the December 11, 2001 IPO; the Complaint does not contend that ZFS is responsible for anything that allegedly happened after the IPO. And although the Complaint contains 328 paragraphs and is 112 pages long, plaintiffs' entire case against ZFS turns on a single allegation: that Converium's loss reserves were inadequate

because ZFS had not sufficiently increased them before the IPO to conform to the actuarial firm's best estimate. But, as shown below, that is exactly what ZFS did.

The Court should dismiss Counts III, V, IX, and X as to ZFS for failure to state a claim under Fed. R. Civ. P. 12(b)(6) and for failure to plead fraud in accordance with the requirements of Fed. R. Civ. P. 9(b) and the Private Securities Litigation Reform Act of 1995 (the "PSLRA"). The record on this motion shows that the IPO Prospectus did not misrepresent the adequacy of Converium's pre-IPO loss reserves, because those reserves corresponded to the independent actuarial firm's best estimates. Moreover, the Prospectus contained adequate warnings about the many uncertainties underlying such estimates of potential future liabilities. Plaintiffs' §§ 12(a)(2) and 10(b) claims also are deficient as to ZFS, and plaintiffs have not shown how ZFS's alleged pre-IPO conduct in 2001 somehow *caused* their purported losses nearly three years later, in late 2004. In addition, plaintiffs' Securities Act claims are time-barred, because plaintiffs were on inquiry notice of those claims more than one year before they filed suit. Finally, plaintiffs have not adequately pled control-person liability against ZFS.[1]

FACTUAL BACKGROUND

A. Reinsurance and Loss Reserves

Converium is a reinsurance company that offers property, casualty, and other non-life reinsurance products, as well as life reinsurance products. (Compl. ¶ 19.) Reinsurance is like insurance for insurance companies: the primary insurers "first underwrite risks in exchange

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[1] Regardless of whether this Court might have personal jurisdiction over ZFS (a Swiss company based in Switzerland) under United States law, ZFS respectfully protests the exercise of any such jurisdiction and reserves the right to dispute such jurisdiction in any potential foreign enforcement proceeding under foreign law. ZFS also notes that, at an appropriate time, it will file a separate motion under Fed. R. Civ. P. 12(b)(1) to dismiss, for lack of subject-matter jurisdiction, the claims of non-U.S. Converium shareholders who purchased Converium securities outside the United States. Lack of subject-matter jurisdiction can be raised at any time. *See, e.g.,* Fed. R. Civ. P. 12(h)(3).

for premiums from the insureds"; they then spread those risks by "transfer[ring] or 'ced[ing]' a portion of their risks to reinsurers, who accept the risks in exchange for premiums from the ceding companies." *Delta Holdings, Inc. v. Nat'l Distillers & Chem. Corp.*, 945 F.2d 1226, 1229 (2d Cir. 1991). The "[r]einsurers, in turn, may cede portions of their risks to secondary reinsurers or 'followers' in what are commonly referred to as retroactive cessions." *Id.*

When reinsurers prepare their financial statements, they "treat amounts of earned premiums as current income and amounts of future claims as offsets to current income." *Id.* Those offsets to current income are called "loss reserves": they are the funds the reinsurer reserves on its books to pay the reinsureds' claims – and the expenses associated with paying those claims (called "loss-adjustment expenses") – as they come due. (Compl. ¶¶ 56, 61, 64.)

Loss reserves typically consist of two components: (*i*) "case reserves," which are "sums set aside to cover estimated losses based on reported claims" received from the reinsured, and (*ii*) Incurred But Not Reported ("IBNR") reserves, which are "sums set aside to cover losses for which claims have not been reported but must be estimated so the company can pay future claims." *Delta Holdings*, 945 F.2d at 1229; *accord* Compl. ¶ 56. Total loss reserves (case reserves plus IBNR reserves) thus reflect the reinsurer's estimate of the total value of claims – whether filed or unfiled, reported or unreported – that it will have to pay in the future for reinsurance already written as of that point in time. (Compl. ¶ 56.)

A reinsurer establishes initial loss reserves when the insurer first cedes policies to the reinsurer. As claims are submitted under those policies, and as additional information about the losses becomes known over time, the reinsurer adjusts its reserves level – up or down – to reflect the newly acquired information. (*Id.* ¶ 57.)

Loss reserves, by their very nature, cannot be precisely and predictably calculated. To the contrary, the Second Circuit has recognized that the preparation of loss reserves for a casualty-risk reinsurer such as Converium "is based in large part upon *informed guesswork*." *Delta Holdings*, 945 F.2d at 1231 (emphasis added).

A reinsurer has at least some objective information to use when calculating case reserves, because the claims already have been reported. But "[e]ven case reserve decisions involving reported claims entail uncertainty as to the amount of final loss." *Id.*

IBNR reserves, however, "are far more conjectural [than are case reserves] because they must be calculated without knowing even the number of claims" – much less their severity and value. *Id.* No hard information exists, because casualty risks such as those that Converium reinsured "involve[] substantial delays or 'tails' in the discovery and reporting of claims. These delays, as lengthy as fifteen or twenty years with some policies, . . . inevitably create considerable uncertainty as to the calculation of future claims and of the reserves that must be set aside to pay those claims." *Id.* at 1229.

The delayed-reporting uncertainties are particularly acute for reinsurers (such as Converium), which do not deal with the underlying insureds and thus are several steps removed from information about claims – or even about events that could give rise to claims. Reinsurers insure the insureds' insurers; they are not directly liable to the original insureds. *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 4 F.3d 1049, 1054 (2d Cir. 1993). "Reinsurers do not examine risks, receive notice of loss from the original insured, or investigate claims." *Id.* Thus, to estimate their own loss reserves, "reinsurers are dependent on their ceding insurers for prompt and full disclosure of information concerning pertinent risks." *Id.* And the insurers themselves might not learn of claims for years, or even decades, after the underlying insurance was written.

For all of these reasons, "no actuarial method is so accurate that it eliminates conjecture in the calculation of [a reinsurer's] IBNR liabilities." *Delta Holdings*, 945 F.2d at 1231. "One cannot, therefore, expect equivalent certainty in a balance sheet's statement of loss reserves and its statement of more determinable items, such as outstanding principal and interest on debt instruments." *Id.*; *see also In re Kindred Healthcare, Inc. Sec. Litig.*, 299 F. Supp. 2d 724, 733 (W.D. Ky. 2004) ("By their very nature, reserve levels are projections of future events and results. Reserves attributable to an individual case may change as the extent of the liability becomes clearer. With the discovery of a single fact, the reserve for a case could increase many times over, or be reduced to mere nuisance value. The overall reserve level is therefore a constantly changing accumulation of numbers and processes").

Reinsurers cannot compensate for the inherent uncertainties of their loss reserves by assuming the worst and overestimating their potential future losses, because "[o]verly conservative loss estimates are no answer. Overestimated reserves are harmful because reinsurance premiums are competitive and a competitive return on investment is necessary to attract investors. Methods that cause substantial excess reserves to be set aside may cause losses to a reinsurer for lack of underwriting or investment." *Delta Holdings*, 945 F.2d at 1231. Reinsurers thus must resort to "informed guesswork" to estimate their future liabilities for reported and unreported claims. *Id.*

B. Converium's Formation and the 2001 IPO

Before 2001, ZFS had engaged in the reinsurance business under the name Zurich Reinsurance or Zurich Re. (Compl. ¶ 68.) By 2001, ZFS decided to dispose of Zurich Re's third-party reinsurance business. (*Id.* ¶ 80.)

ZFS ultimately chose to place Zurich Re's third-party reinsurance business into a wholly owned subsidiary (which became Converium) and then to sell its stock in that company

to the public through an IPO. (*Id.* ¶ 21.) The new company was incorporated under Swiss law, and its stock is primarily listed on the SWX Swiss Exchange, with American Depository Shares ("ADSs") trading in the United States. (*Id.* ¶¶ 19-20.)[2] Converium was organized into four business segments: (*i*) Converium Zurich, for the non-life reinsurance businesses in Europe and Asia, (*ii*) Converium North America, for the non-life reinsurance businesses in the United States and Canada, (*iii*) Converium Cologne, for the non-life reinsurance businesses in Germany, Africa, and the Middle East, and (*iv*) Converium Life, for the global life reinsurance business (which does not appear to be involved in this litigation). (*Id.* ¶ 20.)

In connection with the impending corporate transaction, ZFS (through a subsidiary) retained Tillinghast-Towers Perrin ("Tillinghast") – a well-known insurance industry consulting firm – to analyze Zurich Re's loss reserves (the "Tillinghast Study"). (*Id.* ¶ 81.) ZFS was not *required* to hire Tillinghast; generally accepted accounting principles do not mandate "that an actuary prepare or review loss reserve estimates." *Delta Holdings*, 945 F.2d at 1231.

Tillinghast performed separate studies of Zurich Re North America's ("ZRNA's"), Zurich Re-Cologne's ("ZRK's"), and Zurich Re-Zurich's ("ZRZ's") businesses. (Compl. ¶ 81; *see* 9/10/01 Tillinghast Summary Report, Ex. A.)[3] Plaintiffs' Complaint says nothing about Tillinghast's analyses of ZRK and ZRZ. But plaintiffs allege that, "[i]n or about April 2001," Tillinghast "determined" that the entity that would become Converium "was under-reserved by at least $350 million in North America alone." (Compl. ¶ 82.) Plaintiffs appear to

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[2] Plaintiffs have yet to sustain their burden of proving by a preponderance of the evidence that this Court has subject-matter jurisdiction over the securities-law claims asserted by or on behalf of foreign purchasers who bought this foreign issuer's stock on foreign markets. This jurisdictional issue will be the subject of ZFS's Rule 12(b)(1) motion at an appropriate time.

[3] "Ex." refers to the exhibits attached to the accompanying Declaration of Alyson L. Redman, dated December 23, 2005 (the "Redman Decl.").

base this allegation solely on the assertion of Confidential Witness No. 1 (*id.* ¶¶ 82-84, 86), who purportedly had worked as a reserving actuary at ZRNA (*id.* ¶ 51).

Plaintiffs concede, however, that Tillinghast later (on May 25) issued a *draft* analysis showing a "best estimate" deficiency of $186.386 million – not $350 million – in ZRNA's business as of December 31, 2000. (*Id.* ¶ 86; 5/25/01 Draft Tillinghast Summary Report, Ex. B.) And Tillinghast's final report, dated September 10, 2001 – which plaintiffs ignore – showed a "best estimate" deficiency of $162 million for ZRNA, as well as a $37.5 million *surplus* for ZRZ and a $31.9 million deficiency for ZRK, all as of December 31, 2000. (Ex. A at 5.)[4]

Tillinghast's official, final "best estimate" for ZRNA's reserves thus was a deficiency of $162 million, not $350 million. And its "best estimate" for the whole company was a $156.5 million deficiency on estimated total reserves of $3,300.5 million. (*Id.*) The Complaint does not allege that ZFS (or any other defendant) withheld any relevant information from Tillinghast or provided inaccurate or misleading information to Tillinghast. Nor does the Complaint charge that Tillinghast engaged in any improper actions, relied on erroneous actuarial assumptions, or performed in anything other than a fully competent manner.

Following Tillinghast's review, Converium increased its overall reserves by $112 million: it added $125 million to ZRNA's reserves and reduced ZRK/ZRZ reserves by a net amount of $13 million. (Compl. ¶ 89.) Based on Tillinghast's numbers, this reserve

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[4] Tillinghast issued a subsequent report – dated October 17, 2001 (Ex. C) – that corrected a typographical error in the September 10 report but otherwise contained the same estimates of Converium's reserves. As discussed below, the Court may consider Tillinghast's final report in ruling on this Rule 12(b)(6) motion, because plaintiffs' claims against ZFS are based on the alleged results of the Tillinghast Study, which are embodied in the final report. Moreover, the Complaint (¶ 86) expressly relies on a prior, preliminary draft of the final report. *See infra*, Part I.C.

strengthening brought Converium's total held reserves to $3,256 million – just $44.5 million (1.3%) less than Tillinghast's company-wide best estimate of $3,300.5 million. (Ex. A at 5.)

On September 6, 2001, Converium issued a press release announcing that it would be spun off from ZFS through an IPO. (Compl. ¶ 88.) The press release reported the $112 million reserve strengthening taken in response to "'an independent actuarial review'" and stated that, "'[a]s a result, Converium's loss reserves at December 31, 2000 correspond to the consulting actuaries' best estimate of provisions for net loss and loss adjustment expenses.'" (*Id.* ¶ 89 (quoting press release, Ex. D).)

The IPO was conducted on December 11, 2001 pursuant to a Registration Statement and Prospectus. (Compl. ¶¶ 91, 141; Exs. E, F.)[5] The Prospectus provided extensive financial data about Converium, including a net loss of $60.5 million for the first half of 2001 (Compl. ¶ 142; Ex. F at 13), a net loss of $29.3 million for fiscal year 2000 (Ex. F at 13), and net loss reserves of $3,333.8 million as of December 31, 2000 (*id.* at 14, 125, F-22).

The Prospectus stated that "Tillinghast has confirmed to us that our [*i.e.,* Converium's] net reserves as of December 31, 2000 plus the first half of 2001 reserve strengthening [*i.e.*, the $112 million added in response to the Tillinghast Study] correspond to Tillinghast's best estimate of our liabilities for net loss and loss adjustment expenses as of December 31, 2000" – and that "[o]ur revised estimate of reserves, based mainly on the new ceding company reported data, was in line with Tillinghast's principally top-down reserve estimate within its range of estimates." (*Id.* at 123; Compl. ¶ 144.) Tillinghast specifically consented to these disclosures in an exhibit to the Registration Statement. (Ex. E at Ex. 99.1.)

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[5] The global IPO consisted of three separate offerings: (*i*) an initial public offering of Converium shares in Switzerland, (*ii*) a public offering of shares and ADSs in the United States, and (*iii*) an offering of shares and ADSs to institutional investors elsewhere. (Ex. F at 10.)

The Prospectus also contained PricewaterhouseCoopers Ltd.'s "clean" audit opinion on Converium's financial statements, including its loss reserves. (Ex. F at F-2.)

A consortium of underwriters, led by defendants UBS AG, acting through its business group UBS Warburg, and Merrill Lynch International, purchased all of ZFS's shares of Converium stock and then sold the stock to the public in the IPO. (Compl. ¶¶ 34-35, 93-94; Ex. F at 191.) The IPO was underwritten on a firm-commitment basis, as the underwriters were "obligated to take and pay for all of the shares offered by this prospectus if any of the shares are taken." (Ex. F at 191.) By January 9, 2002, ZFS no longer owned any shares of Converium stock. (Compl. ¶ 94.)

C. <u>Post-IPO Events</u>

The Complaint does not allege that ZFS had any further involvement with Converium after the IPO. ZFS thus had nothing to do with the post-IPO allegations of additional loss-reserve increases, further actuarial studies, Converium's alleged concealment of its mounting loss-reserve deficiencies, or its decisions in 2004 to increase its reserves by $562 million (*id.* ¶ 217). In fact, the Complaint does not allege that ZFS did anything at all after December 10, 2001, the date of the final Prospectus.

Between July and September 2004, Converium announced that it would take charges against earnings to increase its loss reserves and would place its United States business into run-off (*i.e.*, it would no longer write reinsurance out of its U.S. offices). (*Id.* ¶¶ 208-18.) Converium's stock price dropped, and the first of several shareholder actions was filed in this Court on October 4, 2004. *See Meyer v. Converium Holding AG*, No. 04 Civ. 7897. On July 14, 2005, the Court consolidated the above-captioned actions and appointed co-lead plaintiffs to file their consolidated amended complaint. ZFS now moves to dismiss that Complaint under Fed. R. Civ. P. 12(b)(6) and 9(b) and the PSLRA.

I.
APPLICABLE PROCEDURAL PRINCIPLES

The following procedural principles apply to plaintiffs' substantive claims.

A. Plaintiffs Must Plead Their Claims with Particularity.

Fed. R. Civ. P. 9(b) imposes, and the PSLRA strengthens, heightened pleading requirements in securities actions such as this one. Together, these provisions require plaintiffs to plead with particularity both the allegations of fraud and the circumstances purportedly creating a "strong inference" that each defendant acted with the requisite scienter.

1. Pleading with Particularity

Rule 9(b) provides that, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated *with particularity*" (emphasis added). The Complaint must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *Rombach v. Chang*, 355 F.3d 164, 170 (2d Cir. 2004) (quotations omitted). "In cases where the alleged fraud consists of an omission and the plaintiff is unable to specify the time and place because no act occurred, the complaint must still allege: (1) what the omissions were; (2) the person responsible for the failure to disclose; (3) the context of the omissions and the manner in which they misled the plaintiff, and (4) what defendant obtained through the fraud." *Odyssey Re (London) Ltd. v. Stirling Cooke Brown Holdings Ltd.*, 85 F. Supp. 2d 282, 293 (S.D.N.Y. 2000), *aff'd*, 2 Fed. Appx. 109 (2d Cir. 2001).

Rule 9(b) also applies to allegations of loss causation, which is an essential element of a claim under § 10(b) of the Exchange Act. *See, e.g., In re Integrated Resources Real Estate Ltd. P'ships Sec. Litig.*, 850 F. Supp. 1105, 1144 (S.D.N.Y. 1993) (dismissing § 10(b)

claim for failure to plead elements, including loss causation, pursuant to Rule 9(b));[6] *cf. First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 770 (2d Cir. 1994) ("[plaintiff] must allege loss causation with sufficient particularity such that we can determine whether the factual basis for its claim, if proven, could support an inference of proximate cause").[7]

Rule 9(b) likewise requires plaintiffs to plead the elements of a control-person claim under § 20(a) of the Exchange Act with particularity, including the circumstances of the alleged control relationship and each defendant's culpability in the particular transactions underlying the primary violation. *See, e.g., In re Digital Island Sec. Litig.*, 223 F. Supp. 2d 546, 561 (D. Del. 2002) (§ 20(a) claim must "state with particularity the circumstances of *both* the defendants' control of the primary violator, as well as the defendants' culpability as controlling persons") (emphasis added), *aff'd*, 357 F. 3d 322 (3d Cir. 2004).[8]

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[6] *See also, e.g., Pfeiffer v. Goldman, Sachs & Co.*, No. 02 Civ. 6912, 2003 WL 21505876, at *4 (S.D.N.Y. June 30, 2003) ("A plaintiff . . . must allege particular facts for each of the elements of the claim, which include that . . . [defendant's] misrepresentation caused plaintiffs' loss"), *aff'd sub nom. Weinstein v. Goldman, Sachs & Co.*, 93 Fed. Appx. 326 (2d Cir. 2004); *Aduini/Messina P'ship v. Nat'l Med. Fin. Servs. Corp.*, 74 F. Supp. 2d 352, 360 (S.D.N.Y. 1999) ("plaintiffs have failed to plead the causation element of their § 10(b) claim with the degree of particularity required by Rule 9(b) and the PSLRA").

[7] In *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), the United States argued as *amicus curiae* that, "because loss causation is an element of a fraud cause of action," the allegations must be "'stated with particularity'" under Rule 9(b) and must satisfy the PSLRA's pleading requirements. Brief for the United States as Amicus Curiae Supporting Petitioners, filed jointly by the United States Department of Justice and the Securities and Exchange Commission (Ex. G at 15). The Supreme Court did not address the pleading standard; it simply "assume[d], at least for argument's sake, that neither the Rules nor the securities statutes imposed any special further pleading requirement" for loss causation other than the minimal requirement of Fed. R. Civ. P. 8(a)(2), which demands only "a short and plain statement of the claim showing that the pleader is entitled to relief." *Dura Pharm.*, 125 S. Ct. at 1634. The Court concluded that the plaintiff had not met even Rule 8(a)(2)'s minimal standard. *Id.*

[8] *See also, e.g., Howard v. Hui*, No. C 92-3742, 2001 WL 1159780, at *4 (N.D. Cal. Sept. 24, 2001) (dismissing § 20(a) claim for failure to plead "circumstances of the control relationship" with particularity); *Stamatio v. Hurco Cos., Inc.*, 885 F. Supp. 1180, 1186 (S.D. Ind. 1995) (dismissing § 20(a) claim that failed "to inform each of the defendants of the specific fraudulent acts each has allegedly performed").

2. <u>Requirement of a Strong Inference of Scienter</u>

Rule 9(b) also requires a plaintiff to "allege facts that give rise to a *strong inference* of fraudulent intent." *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (emphasis added). A plaintiff can meet this burden either by "alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness" or by establishing that "defendants had both motive and opportunity to commit fraud." *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001) (quotations omitted).[9] However, "[w]here motive is not apparent, . . . the strength of the circumstantial allegations [of conscious misbehavior or recklessness] must be correspondingly greater." *Kalnit*, 264 F.3d at 138.

To plead fraud based on conscious or reckless misconduct, plaintiffs must "*specifically* allege[] defendants' knowledge of facts or access to information contradicting their public statements." *Id.* at 142 (emphasis added; quotations omitted). Unsupported, generalized assertions about defendants' "access" to unspecified documents purportedly containing contrary facts are insufficient to survive a motion to dismiss. Instead, plaintiffs "must specifically identify the reports or statements containing this information." *Faulkner v. Verizon Commc'ns, Inc.*, 156 F. Supp. 2d 384, 396 (S.D.N.Y. 2001).[10]

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[9] Although this Court is bound by Second Circuit law, ZFS notes that the Second Circuit's position is in tension with the PSLRA, which most other Circuits have construed as requiring more than allegations of motive and opportunity to create a strong inference of scienter. *See, e.g., Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999); *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 430 (5th Cir. 2002); *In re K-tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 895 (8th Cir. 2002); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1249, 1261-62 (10th Cir. 2001).

[10] *Accord, e.g., Hart v. Internet Wire, Inc.*, 145 F. Supp. 2d 360, 368-69 (S.D.N.Y. 2001) (plaintiffs "must detail *specific contemporaneous data or information known to the defendants* that was inconsistent with the representation in question") (emphasis added; quotations omitted); *Ressler v. Liz Claiborne, Inc.*, 75 F. Supp. 2d 43, 53 (E.D.N.Y. 1999) ("A plaintiff relying on such reports instead must indicate who prepared the reports, when the reports were prepared,

To create a strong inference of fraudulent intent based on motive, plaintiffs must identify "concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *Kalnit*, 264 F.3d at 139 (quotations omitted). Motives that are "generally possessed by most [defendants] do not suffice." *Id.; see also, e.g.*, *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Glickman v. Alexander & Alexander Servs., Inc.*, No. 93 Civ. 7594, 1996 WL 88570, at *6 (S.D.N.Y. Feb. 29, 1996) (desire to raise "much needed capital" insufficient). Instead, "plaintiffs must assert a *concrete and personal* benefit *to the individual defendant* resulting from the fraud." *Kalnit*, 264 F.3d at 139 (emphasis added).

3. <u>Rule 9(b)'s Applicability to Plaintiffs' Securities Act Claims</u>

Rule 9(b)'s particularity requirements apply to Securities Act claims that sound in fraud, regardless of whether scienter is a necessary element of the alleged cause of action. *See, e.g., Rombach*, 355 F.3d at 171 ("We hold that the heightened pleading standard of Rule 9(b) applies to Section 11 and Section 12(a)(2) claims insofar as the claims are premised on allegations of fraud.").

Plaintiffs expressly predicate their Complaint in this case on allegations of fraud. The very first paragraph charges that "[t]his case is about a company's *intentional manipulation* of its loss reserves for the purpose of manufacturing profit" – and that "[d]efendants' *fraudulent conduct* began to come to light" in 2004, when Converium announced it would take a charge of at least $400 million to increase loss reserves. The second paragraph continues: "Converium and its senior management *knew and concealed* the fact that the Company's loss reserves were deficient . . . ." (Compl. ¶¶ 1-2 (emphasis added).) Similar fraud-based allegations pervade the

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what the reports said, how firm the data was, and who at the company reviewed the reports and when").

rest of the Complaint. Accordingly, Rule 9(b) applies to all of plaintiffs' claims, because all of them depend on "'averments of fraud.'" *Rombach*, 355 F.3d at 171 (quoting Rule 9(b)).

Plaintiffs cannot evade Rule 9(b) simply by asserting that their Securities Act claims "do[] not sound in fraud" and by purporting to exclude fraud allegations from those claims. (*E.g.,* Compl. ¶¶ 260, 277.) The Second Circuit rejected this precise ploy in *Rombach*, when it held that, even though "[p]laintiffs assert their Section 11 claims 'do[] not sound in fraud' . . . the wording and imputations of the complaint are classically associated with fraud: that the Registration statement was 'inaccurate *and* misleading'; that it contained '*untrue* statements of material facts'; and that 'materially *false* and *misleading* written statements were issued.'" 355 F.3d at 172; *accord, e.g., In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 635 (S.D.N.Y. 2005) ("Plaintiffs cannot evade the Rule 9(b) strictures by summarily disclaiming any reliance on a theory of fraud or recklessness."); *In re CIT Group, Inc. Sec. Litig.*, 349 F. Supp. 2d 685, 690 n.4 (S.D.N.Y. 2004) (applying Rule 9(b) even though "plaintiffs repeatedly state that their causes of action are not premised on fraud"). Rule 9(b) thus applies to plaintiffs' Securities Act claims.

4. <u>The PSLRA's Additional Pleading Requirements</u>

The PSLRA reinforced Rule 9(b)'s particularity requirement for Exchange Act cases and established "more stringent pleading requirements to curtail the filing of meritless lawsuits." H.R. Conf. Rep. No. 104-369, at 37 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 748. The statute provides that "the complaint shall *specify each statement* alleged to have been misleading, *the reason or reasons why* the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall *state with particularity* all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1) (emphasis added). In addition, the PSLRA requires that a complaint "*state with particularity* facts giving

rise to a *strong inference* that the defendant acted with the required state of mind." *Id.* § 78u-4(b)(2) (emphasis added).

The Second Circuit has held that the PSLRA did not change this Circuit's stringent Rule 9(b) standards, with two exceptions: (*i*) the PSLRA added the "with particularity" requirement for pleading facts to support allegations based on information and belief, and (*ii*) it added "with particularity" to Rule 9(b)'s requirement that plaintiffs plead facts giving rise to a strong inference of scienter. *Kalnit*, 264 F.3d at 138.

B. Standard for Motions to Dismiss Under Fed. R. Civ. P. 12(b)(6)

On Rule 12(b)(6) motions, courts generally accept as true all allegations in the complaint and draw all reasonable inferences in favor of the plaintiffs. *E.g., Rombach*, 355 F.3d at 169. The PSLRA, however, heightened the scrutiny that courts must apply when ruling on motions to dismiss Exchange Act claims. The PSLRA's requirement that a complaint "state with particularity facts giving rise to a *strong inference*" of scienter, 15 U.S.C. § 78u-4(b)(2) (emphasis added), means that plaintiffs are only entitled to the "*most plausible* of competing inferences." *Bond Opportunity Fund v. Unilab Corp.*, No. 99 Civ. 11074, 2003 WL 21058251, at *3 (S.D.N.Y. May 9, 2003) (emphasis added), *aff'd*, 87 Fed. Appx. 772 (2d Cir. 2004); *accord, e.g., Helwig v. Vencor*, 251 F.3d 541, 553 (6th Cir. 2001) (PSLRA's "strong inference requirement means that plaintiffs are entitled only to the *most plausible* of competing inferences . . . represent[ing] a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff the benefit of all reasonable inferences") (quotations omitted).[11]

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[11] *See also, e.g., Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003) (PSLRA requires courts to weigh allegations to determine whether facts support "*strong* inference" of scienter); *Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) ("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") (quotations omitted); *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002) ("when determining whether

Under Rule 12(b)(6), courts need not "accept as true the legal conclusions or unwarranted deductions of fact drawn by the non-moving party." *Scalisi v. Fund Asset Mgmt., L.P.*, 380 F.3d 133, 137 (2d Cir. 2004).

Courts also need not accept factual allegations that are contradicted by documents admissible on a motion to dismiss. *See, e.g., In re Aegon N.V. Sec. Litig.*, No. 03 Civ. 0603, 2004 WL 1415973, at *5 (S.D.N.Y. June 23, 2004) ("The truth of factual allegations that are contradicted by documents properly considered on a motion to dismiss need not be accepted."); *Rapaport v. Asia Elecs. Holding Co.*, 88 F. Supp. 2d 179, 184 (S.D.N.Y. 2000) (same); *Sazerac Co. v. Falk*, 861 F. Supp. 253, 257 (S.D.N.Y. 1994) (same).

C. <u>Documents Admissible on Rule 12(b)(6) Motions</u>

While Rule 12(b)(6) motions generally address the face of the Complaint, the Court also may consider all documents that plaintiffs mention in their Complaint and that form the bases of their claims. *See, e.g., Cortec Indus., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 47 (2d

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plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs"); *In re Rockefeller Ctr. Props., Inc. Sec. Litig.*, 311 F.3d 198, 224 (3d Cir. 2002) ("unless plaintiffs in securities fraud actions allege facts supporting their contentions of fraud with the requisite particularity mandated by Rule 9(b) and the Reform Act, they may not benefit from inferences flowing from vague or unspecific allegations – inferences that may arguably have been justified under a traditional Rule 12(b)(6) analysis"); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999) ("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, as is true when pleadings for other causes of action are tested by motion to dismiss under Rule 12(b)(6). . . . Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and '*strong*' inferences.").

The Second Circuit has not yet addressed this issue, although this Court has held that the PSLRA did not change the Rule 12(b)(6) "reasonable inference" standard. *In re Philip Servs. Corp. Sec. Litig.*, 383 F. Supp. 2d 463, 474 n.6 (S.D.N.Y. 2004) (Mukasey, J.). ZFS respectfully submits that the Court should follow the rulings in *Bond Opportunity Fund* and the appellate decisions that have analyzed this question. The Second Circuit's *Kalnit* decision – which this Court cited as declining to raise the "reasonable inference" standard, *Philip Servs. Corp.*, 383 F. Supp. 2d at 474 n.6 – did not discuss this issue at all; it simply recited the traditional standard without any analysis. *See Kalnit*, 264 F.3d at 137-38.

Cir. 1991) ("when a plaintiff chooses not to attach to the complaint or incorporate by reference a [document] upon which it solely relies and which is integral to the complaint, the defendant may produce the [document] when attacking the complaint for its failure to state a claim").

In addition, the Court "may review and consider public disclosure documents required by law to be and which actually have been filed with the SEC." *Id.* at 47; *see also Kramer v. Time Warner Inc.*, 937 F.2d 767, 774 (2d Cir. 1991) (taking judicial notice of Offer to Purchase and Joint Proxy Statement).

The Court also may take judicial notice of other public data and documents, such as stock prices, news articles, press releases, and other such matters. *E.g., Id.* at 773 (in considering Rule 12(b)(6) motion, court "may also consider matters of which judicial notice may be taken under Fed. R. Evid. 201"); *see also, e.g., In re Allied Capital Corp. Sec. Litig.*, 02 Civ. 3812, 2003 WL 1964184, at *3 (S.D.N.Y. Apr. 25, 2003) (stock prices); *Oneida Indian Nation of N.Y. v. County of Oneida*, 199 F.R.D. 61, 83 n.19 (N.D.N.Y. 2000) (newspaper articles); *In re Ashworth Inc. Sec. Litig.*, No. 99 CV 0121-L, 2000 WL 33176041, at *3 (S.D. Cal. July 18, 2000) (press releases).

II.
PLAINTIFFS HAVE NOT PLED AN ACTIONABLE MATERIAL MISREPRESENTATION OR OMISSION.

Plaintiffs' claims under § 12(a)(2) of the Securities Act and § 10(b) of the Exchange Act depend on the existence of a material misrepresentation or the omission of a material fact. *See, e.g.,* 15 U.S.C. §77l(a)(2) (requiring "an untrue statement of a material fact or [a failure] to state a material fact"); *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005) (§ 10(b) requires "a material misrepresentation (or omission)").

The alleged misrepresentations and omissions in this case involve Converium's loss reserves: plaintiffs contend that defendants were aware of Converium's purported reserve

deficiency but nevertheless misrepresented that Converium's reserves were reasonable and consistent with Tillinghast's best estimate. (The Complaint contains many other allegations about *post*-IPO misrepresentations and omissions, but none of them applies to ZFS.)

The record on this motion shows, however, that Converium's loss reserves were in fact consistent with Tillinghast's best estimate, so neither ZFS nor any other defendant made any material misrepresentation about them. Moreover, the Prospectus was full of detailed warnings about the uncertainties of loss-reserve estimation; the statements about loss reserves therefore are protected under the "bespeaks caution" doctrine. In addition, loss-reserve estimates are merely *opinions*, and plaintiffs have not pled any *facts* showing that ZFS did not actually believe, or lacked a reasonable basis for believing, those statements of opinion. Finally, the statements are protected under SEC Rule 175.

A. <u>The Loss Reserves Corresponded to Tillinghast's Best Estimate.</u>

Plaintiffs' entire case involving *pre-IPO conduct* rests on the Complaint's allegation that Tillinghast had estimated that Zurich Re North America's loss reserves were deficient by about $350 million as of December 31, 2000, but that ZFS added only $125 million to those reserves (a net increase of $112 million, after offsetting $13 million in ZRZ/ZRK reserve redundancies). (Compl. ¶¶ 82-89.) Those allegedly false statements (or omissions) about loss reserves purportedly infected Converium's other financial information, such as its net earnings, non-life combined ratio, and shareholder equity. (*Id.* ¶ 142.)

The documentary record, however, shows that Tillinghast's final "best estimate" was a North American deficiency of only $162 million – not $350 million. (Ex. A at 5.) Thus, when ZFS added $125 million to ZRNA's reserves in response to the Tillinghast Study, the "best estimate" deficiency for ZRNA shrank to only $37 million – not $225 million, as the Complaint alleges (Compl. ¶ 143). The final Tillinghast Study also shows that Converium's company-wide

held reserves (when increased by the net $112 million added in response to the study) were only $44.5 million less than Tillinghast's "best estimate" of the necessary $3,300.5 million – a difference of just 1.3% on $3.3 billion. (*Id.*)[12]

Moreover, Converium's company-wide net held reserves of $3,256 million (the $3,144.0 million cited in the Tillinghast Study plus the additional $112 million) were well within the *range* of estimates that Tillinghast provided: a "low" estimate of $3,010.5 million, a "best" estimate of $3,300.5 million, and a "high" estimate of $3,716.3 million. (Ex. A at 6.) The held reserves were $245.5 million *more* than Tillinghast's low estimate would have required.[13]

As discussed above, calculating loss reserves is not an exact science; it "is based in large part upon informed guesswork." *Delta Holdings, Inc. v. Nat'l Distillers & Chem. Corp.*, 945 F.2d 1226, 1229, 1231 (2d Cir. 1991); *accord id.* at 1238 (commenting on "the degree of guesswork that goes into estimates of loss reserves"). That Converium's reserves came so close to Tillinghast's estimates negates any claim of misrepresentation – especially in light of Tillinghast's undisputed confirmation that Converium's loss reserves (as increased in response to the Tillinghast Study) corresponded to Tillinghast's "best estimate" of those potential future losses and expenses (Ex. F at 123).

ZFS understands that, on a Rule 12(b)(6) motion, the Court might need to accept as true the allegation that, "[i]n or about April 2001," Tillinghast purportedly estimated a $350 million deficiency in Zurich Re North America's reserves. (Compl. ¶ 82.) (ZFS is not currently aware of any evidence to support that allegation.) But plaintiffs cannot build a fraud claim on an alleged preliminary estimate (even if one assumes Tillinghast ever so estimated).

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12 The final report shows a deficiency of $156.5 million. (Ex. A at 5.) If one subtracts the $112 million in new net reserves from this deficiency, the deficiency becomes $44.5 million.

13 The Prospectus reported net reserves of $3,333.8 million. (Ex. F at 14, 125, F-22.) That figure was $33.3 million *higher* than Tillinghast's best estimate.

Plaintiffs themselves concede that Tillinghast soon reduced its "best estimate" to $186 million. (*Id.* ¶ 86; Ex. B.) And even that lower estimate was only preliminary: the May 25, 2001 document containing the $186 million estimate was stamped "DRAFT" in large, capital letters, and the cover letter cautioned that the report was a "preliminary draft report," portions of which were "incomplete and have not been fully peer reviewed." (Ex. B at 1; *accord id.* at 2 ("Our preliminary results are displayed in Summary Exhibit 1. Portions of our analysis have not been fully peer reviewed and are subject to change.").)

Tillinghast's *conclusion* – the "best estimate" referred to in the Prospectus (Ex. F at 123) and Converium's September 6, 2001 press release (Ex. D at 1) – was embodied in the *final* report, not in the alleged April 2001 presentation or in the May 25, 2001 "preliminary draft report" that was "incomplete" and "subject to change." Converium's loss reserves for ZRNA and for the entire company corresponded to Tillinghast's official "best estimate." The Complaint nowhere alleges that ZFS or anyone else misled Tillinghast or provided it with incorrect information – or that Tillinghast acted unprofessionally. Tillinghast's final report thus shows that no misrepresentations about Converium's loss reserves were made before the IPO.

B. The Loss Reserve Estimates Are Not Actionable Under the "Bespeaks Caution" Doctrine.

The pre-IPO statements concerning the adequacy of Converium's loss reserves also are not actionable under the "bespeaks caution" doctrine, because the Prospectus contained detailed, specific warnings about the many uncertainties surrounding loss-reserve calculations.

The "bespeaks caution" doctrine holds that "[c]ertain alleged misrepresentations in a stock offering are *immaterial as a matter of law* because it cannot be said that any reasonable investor would consider them important in light of adequate cautionary language set out in the same offering." *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352, 357 (2d Cir. 2002)

(emphasis added); *accord, e.g., P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 96 (2d Cir. 2004) ("A defendant may not be liable under § 12(a)(2) for misrepresentations in a prospectus if the alleged misrepresentations were sufficiently balanced within the same prospectus such that no reasonable investor would be misled about the nature and risk of the offered security.").

The doctrine applies only "to forward-looking, prospective representations" "dealing with the contingent or unforeseen future." It does not apply to "[h]istorical or present fact – knowledge within the grasp of the [speaker]." *Id.* at 96-97.

The "touchstone" of the bespeaks-caution inquiry is "not whether isolated statements within a document were true, but whether defendants' representations or omissions, considered together and in context, would affect the total mix of information and thereby mislead a reasonable investor regarding the nature of the securities offered." *Halperin*, 295 F.3d at 357. This analysis requires two steps: "first we must identify the risk that plaintiffs allege was not disclosed in the IPO statements; second, we must examine the IPO statements to determine if a reasonable investor could have been misled into thinking that the risk that materialized and resulted in [the] loss did not actually exist." *Davidoff v. Farina*, No. 04 Civ. 7617, 2005 WL 2030501, at *9 (S.D.N.Y. Aug. 22, 2005) (quotations omitted).

1. <u>Statements or Omissions at Issue</u>

Plaintiffs here contend that the Prospectus misrepresented the adequacy of Converium's loss reserves and failed to disclose the risk that Converium had a reserve deficiency at the time of the IPO. Those alleged misstatements about reserves purportedly undermined the validity of Converium's other reported financial information. (Compl. ¶¶ 143-47.)

As discussed above, loss-reserving is an exercise in informed estimation and guesswork. Loss-reserve calculations and statements about the adequacy of loss reserves are classic "forward-looking, prospective representations . . . dealing with the contingent or

unforeseen future," *P. Stolz Family P'ship*, 355 F.3d at 96-97, because their accuracy depends on presently unknowable facts: whether the reinsurer has reserved sufficient funds to cover pending claims that have not yet been resolved (case reserves) and future claims that have not yet even been filed (IBNR reserves). *See, e.g., In re Aegon N.V. Sec. Litig.*, No. 03 Civ. 0603, 2004 WL 1415973, at *12 (S.D.N.Y. June 23, 2004) ("statements whose truth cannot be ascertained until some time after they are made are 'forward-looking statements'"); *see also, e.g., Harris v. Ivax Corp.*, 182 F.3d 799, 805 (11th Cir. 1999) ("a statement about the state of a company whose truth or falsity is discernible only after it is made necessarily refers only to future performance").

Courts therefore have recognized that insurers' statements about loss reserves and their adequacy are forward-looking statements. *E.g., In re Kindred Healthcare, Inc. Sec. Litig.*, 299 F. Supp. 2d 724, 738 (W.D. Ky. 2004) ("The amount [the insurer] keeps in reserves to cover liability claims is necessarily a prediction about its future claims experience based on past claims history as well as current filings. Assertions about the adequacy of [the insurer's] reserves could only be verified when liability claims were actually filed, litigated to conclusion, or settled. *It would seem rather beyond argument that such projections about the company's future economic health are forward-looking*") (emphasis added); *accord, e.g.*, *Hess v. American Physicians Capital, Inc.*, No. 5:04-CV-31, 2005 WL 459638, at *7 (W.D. Mich. Jan. 11, 2005) (holding statements "forward-looking because they are assertions about the adequacy of the [insurer's] loss reserves").[14]

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[14] *Cf., e.g., Kane v. Madge Networks N.V.*, No. C-96-20652, 2000 WL 33208116, at *5 (N.D. Cal. May 26, 2000) (accounts receivable or bad-debt reserves are forward-looking statements), *aff'd sub nom. Kane v. Zisapel*, 32 Fed. Appx. 905 (9th Cir. 2002); *Mathews v. Centex Telemanagement, Inc.*, No. C-92-1837, 1994 WL 269734, at *6 (N.D. Cal. June 8, 1994) (bad-debt reserves are forward-looking statements).

2. <u>Cautionary Language</u>

The Prospectus contained ample cautionary language warning about the many uncertainties underlying Converium's loss-reserve estimates. The Prospectus Summary at the beginning of the document contained a list of "Risk Factors Relating to Converium and the Reinsurance Industry" – one of which was the risk that "[o]ur loss reserves may not adequately cover future losses and benefits" – and it referred the reader to more detailed information under "Risk Factors." (Ex. F at 8-9.)

The "Risk Factors" section filled nine pages and included a subsection titled "***Our loss reserves may not adequately cover future losses and benefits***." (*Id.* at 14 (emphasis in original).) This subsection began by warning that "[o]ur loss reserves may prove to be inadequate to cover our actual losses and benefits experience. To the extent loss reserves are insufficient to cover actual losses, loss adjustment expenses or future policy benefits, *we would have to add to these loss reserves and incur a charge to our earnings which could have a material adverse effect* on our financial condition, results of operations and cash flows." (*Id.* (emphasis added).)

The subsection then explained the uncertainties inherent in calculating loss reserves and warned that "[l]oss reserves do not represent an exact calculation of liability, but rather are *estimates* of the expected cost of the ultimate settlement of losses."

> All of our loss reserve estimates are based on actuarial and statistical projections at a given time, of facts and circumstances known at that time and estimates in loss severity and other factors, including the concepts of liability and general economic conditions. *Changes in these trends or other variable factors would result in claims in excess of our loss reserves*.
>
> Unforeseen losses, the type and magnitude of which we cannot predict, may emerge in the future. These additional losses could arise from newly acquired lines of business, changes in the legal environment, extraordinary events affecting our clients such as reorganizations and liquidations or changes in economic conditions.

> In addition, because we, like other reinsurers, do not separately evaluate each of the individual risks assumed under reinsurance treaties, we are largely dependent on the original underwriting decisions made by ceding companies. We are subject to the risk that our ceding companies may not have adequately evaluated the risks to be reinsured and that the premiums ceded to us may not adequately compensate us for the risks we assume.

(*Id.* (emphasis added).) The Prospectus then cautioned that, if the reported net loss reserves of $3,333.8 million were underestimated by 5%, "this would have resulted in $166.7 million of incurred loss and loss adjustment expenses, before income taxes, for the year ended December 31, 2000." (*Id.*)

Following the nine pages of "Risk Factors" came a "Cautionary Note Regarding Forward-Looking Statements." This note warned that "[t]his prospectus contains forward-looking statements" and that "[n]umerous factors could cause our actual results to differ materially from those in the forward-looking statements," including "uncertainties in our reserving process." (*Id.* at 23.)

A later section – captioned "Loss and Loss Adjustment Expense Reserves" – contained even more details and warnings about the loss-reserving process and calculations. (*Id.* at 121-23.) This section explained how Converium calculated its net loss reserves (using case reserves and IBNR reserves) and again warned that, "[b]ecause estimation of loss reserves is an inherently uncertain process, quantitative techniques frequently have to be supplemented by professional and managerial judgement." The Prospectus emphasized that

> [t]he uncertainty inherent in loss estimation is particularly pronounced for long-tail lines such as umbrella, general and professional liability and motor liability, where information, such as required medical treatment and costs for bodily injury claims, will only emerge over time. . . . The uncertainty inherent in the reserving process for primary insurance companies is even greater for the reinsurer. This is because of, but not limited to, the time lag inherent in reporting information from the insurer to the reinsurer and differing reserve practices among ceding companies. *As a result, actual losses and loss adjustment expenses may deviate, perhaps materially, from expected ultimate costs reflected in our current reserves*.

(*Id.* at 122 (emphasis added).) The Prospectus expressed the belief that Converium's reserves "were reasonable estimates based on the information known at the time" but cautioned that, "since the establishment of loss reserves is an inherently uncertain process, the ultimate cost of settling claims may exceed our existing loss and loss adjustment reserves, perhaps materially." (*Id.* at 122-23.)

The Prospectus thus disclosed – in graphic detail – the precise risk that ultimately occurred and that led to plaintiffs' lawsuit: a loss-reserve deficiency that required Converium to take substantial charges against its earnings in the years following the IPO. Accordingly, the bespeaks-caution doctrine renders immaterial any alleged misstatement about Converium's loss reserves. *See, e.g., Hess*, 2005 WL 459638, at *7 (dismissing claims alleging misstatements about loss reserves because insurer issued adequate cautionary statements); *Kindred Healthcare, Inc.*, 299 F. Supp. 2d at 738-39 (same);[15] *see also, e.g., P. Stolz Family P'ship*, 355 F.3d at 97 (affirming dismissal of § 12(a)(2) claim under "bespeaks caution" doctrine where cautionary language "warn[e]d of the specific contingency that lies at the heart of the alleged misrepresentation"); *Halperin*, 295 F.3d at 360 (affirming dismissal under "bespeaks caution" where "cautionary language addresses the relevant risk directly"); *Olkey v. Hyperion 1999 Term*

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15 *Hess* and *Kindred Healthcare* relied on the PSLRA's "safe harbor" provision, which immunizes forward-looking statements accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. §§ 78u-5(c)(1)(A), 77z-2(c)(1)(A). ZFS is not invoking the PSLRA's safe-harbor provisions, because they appear to exclude statements "[m]ade in connection with an initial public offering," *id.* §§ 78u-5(b)(2)(D), 77z-2(b)(2)(D). However, the cautionary-language prong of the PSLRA's safe harbor codified the bespeaks-caution doctrine, so PSLRA cases concerning cautionary language apply here. *See, e.g., In re Copper Mtn. Sec. Litig.*, 311 F. Supp. 2d 857, 876 (N.D. Cal. 2004) ("the PSLRA created a statutory version of the [bespeaks-caution] doctrine by providing a safe harbor for forward-looking statements identified as such, which are accompanied by meaningful cautionary statements. . . . Accordingly, it is appropriate to consider the two protections simultaneously") (quotations omitted); *see also* H.R. Conf. Rep. 104-369, at 43-46 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 730, 744-45 (same).

Trust, Inc., 98 F.3d 2, 5 (2d Cir. 1996) (affirming this Court's dismissal of Securities Act and Exchange Act claims under "bespeaks caution").

C. **Plaintiffs Have Not Pled Any Facts Showing That the Loss-Reserve Estimates Were Actionable Opinions.**

Estimates of loss reserves and statements about the adequacy of those estimates also are matters of *opinion*, which cannot constitute misrepresentations except "as a misstatement of the psychological fact of the speaker's belief in what he says," *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095 (1991); *accord, e.g., Podany v. Robertson Stephens, Inc.*, 318 F. Supp. 2d 146, 153-54 (S.D.N.Y. 2004) ("The sine qua non of a securities fraud claim based on false opinion is that defendants deliberately misrepresented a truly held opinion. . . . In other words, plaintiffs must allege with particularity that defendants did not sincerely believe the opinion they purport to hold."). The Complaint, however, does not plead any facts showing that ZFS did not actually believe (or even had no basis to believe) the statements about the adequacy of Converium's estimated loss reserves. For this reason as well, the Complaint fails to plead an actionable misrepresentation.

In *In re CIT Group, Inc. Securities Litigation*, 349 F. Supp. 2d 685 (S.D.N.Y. 2004), for example, plaintiffs filed a Securities Act case against a finance company whose registration statement and prospectus purportedly had misrepresented the adequacy of the company's loan loss reserves. The Court ruled that such statements of belief could be actionable only "under the theory that defendants did not actually believe them to be true or had no reasonable basis for such a conclusion" – but "would not be actionable under the securities laws if they simply represented a failure on the part of defendants to correctly gauge the adequacy of the loan loss reserves," *id.* at 689. The Court dismissed the case because the plaintiffs had

"completely fail[ed] to plead any facts from which it could be inferred that defendants' belief in the adequacy of the reserves was beyond the pale of reason." *Id.* at 691.[16]

The same is true here. Plaintiffs do not plead any facts suggesting that ZFS *actually disbelieved* the statements about the adequacy of Converium's loss reserves or Tillinghast's final "best estimate" of those reserves. Nor have plaintiffs pled any facts suggesting that any such belief in those statements was beyond the pale of reason. Tillinghast – a respected actuarial consulting firm – conducted an independent study and allowed its name to be used in the Prospectus. (Ex. F at Ex. 99.1.) Moreover, as discussed in greater detail in Part IV.C below, Converium's financial statements – including the loss reserves – were audited by Converium's independent auditor, PricewaterhouseCoopers Ltd. Plaintiffs thus have failed to show how the opinions about loss-reserve estimates could be actionable misstatements.

D. <u>SEC Rule 175 Protects the Statements About Loss Reserves.</u>

The statements about loss-reserve estimates also are shielded by SEC Rule 175. This Rule provides that a "forward looking statement" shall "be deemed not to be a fraudulent statement" unless it "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." 17 C.F.R. § 230.175. The Rule covers statements in a registration statement filed under the Securities Act, an offering statement, or a solicitation of interest. *Id.* § 230.175(b)(1)(i). The definition of "forward looking statement" includes a "statement

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16 *Accord, e.g., Nolte v. Capital One Fin. Corp.*, 390 F.3d 311, 315-16 (4th Cir. 2004) (affirming dismissal for failure to plead facts showing that defendants did not believe statements that bank maintained sufficient capital and loan loss reserves); *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1131 (2d Cir. 1994) (affirming dismissal for failing "adequately to allege that the expression of the opinions and beliefs [about bank's loss reserves] was fraudulent"); *see also, e.g., Faulkner v. Verizon Commc'ns, Inc.*, 189 F. Supp. 2d 161, 172-73 (S.D.N.Y. 2003) ("mere opinions and predictions of future performance are not actionable under the securities laws unless . . . the speaker does not genuinely or reasonably believe them").

containing a projection of revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items." *Id.* § 230.175(c)(1).

As shown above, loss-reserve estimates are "forward looking statements" under SEC Rule 175 because they are projections of future expenses. And as discussed in Parts II.B and II.C. above and Part IV.C below, the forward-looking statements about Converium's loss reserves were made with a "reasonable basis" and in "good faith" for purposes of Rule 175, because they were based on a reserve estimate prepared by a reputable, independent actuarial consultant – Tillinghast. Accordingly, the Prospectus' statements about Converium's loss reserves are protected under SEC Rule 175.

* * * *

For all of the above reasons, the Court need not go any further to dismiss all claims pled against ZFS, because no actionable misrepresentations were made about Converium's loss reserves. Nevertheless, ZFS will provide additional reasons for the Court to grant ZFS's motion to dismiss.

III.
PLAINTIFFS HAVE NOT PLED A CLAIM UNDER SECTION 12(a)(2) OF THE SECURITIES ACT.

Section 12(a)(2) of the Securities Act imposes liability on any person who "offers or sells" newly issued securities "by means of a prospectus or oral communication" containing a material misrepresentation or omission. The statute makes the offeror or seller liable only "to the person purchasing such security from him . . . ." 15 U.S.C. § 77l(a)(2).

Plaintiffs' § 12(a)(2) claim fails as to ZFS for several reasons. First, ZFS is not an offeror or seller from which any plaintiff or putative class member purchased Converium securities. Second, § 12(a)(2) applies only to persons or entities that purchased securities *in the IPO* – and neither of the co-lead plaintiffs did so (although named plaintiff Louisiana State

Employees' Retirement System ("LASERS") did). Third, to the extent LASERS or any other putative class members purchased Converium securities in the IPO and then sold their stock at or above the IPO price, they cannot recover under § 12(a)(2).

A. ZFS Is Not an Offeror/Seller from Which Anyone Purchased Converium Securities.

The Second Circuit has construed § 12(a)(2) to impose liability only on a person or entity that either (*i*) actually passed title of the security to the plaintiff purchaser or (*ii*) successfully solicited the plaintiff's purchase, motivated at least in part by the solicitor's own financial interest or that of the securities owner. *Wilson v. Saintine Exploration & Drilling Corp.,* 872 F.2d 1124, 1125-26 (2d Cir. 1989) (adopting, for § 12(a)(2) purposes, Supreme Court's construction of § 12(a)(1) in *Pinter v. Dahl*, 486 U.S. 622, 642, 647 (1988)). Thus, "[p]ersons who are not in privity with the plaintiff" cannot be "statutory sellers" under § 12(a)(2) unless "they solicited the sales in question for a financial gain." *Wilson*, 872 F.2d at 1126. ZFS does not fall within either of these categories.

1. No Privity Between ZFS and Plaintiffs

ZFS was not in privity with any plaintiff or putative class members and did not pass title to Converium securities to them. Rather, ZFS sold its Converium stock to the underwriters, and the underwriters sold the stock to the public.

The Prospectus explained that, pursuant to an underwriting agreement among ZFS, Converium, and the underwriters, "each underwriter . . . has severally agreed to purchase and [ZFS] has agreed to sell to them, the number of shares indicated below . . . . The underwriters are obligated to take and pay for all of the shares offered by this prospectus if any of the shares are taken." (Ex. F at 191.) This type of offering is known as a "firm commitment underwriting" – the underwriters buy the stock from the seller, and "the public purchases from the underwriters." *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 871 (5th Cir. 2003).

In firm-commitment underwritings, investors cannot assert § 12(a)(2) claims against the original seller, because they did not buy their stock from that seller; they bought from the underwriters. *See, e.g., Rosenzweig,* 332 F.3d at 871 ("in the case of a typical firm commitment underwriting, the ultimate investor can recover only from the dealer who sold to him or her") (quotations omitted).[17]

Indeed, plaintiffs have conceded their lack of privity with ZFS by alleging only that the *underwriters* – not ZFS – "transferred title to Plaintiffs and other members of the Class who purchased Converium [securities]" and "transferred title of Converium [securities] to other underwriters and/or broker-dealers that sold those securities as agents for the Underwriter Defendants" (Compl. ¶ 262). The preceding paragraph (*id.* ¶ 261), which contains plaintiffs' § 12(a)(2) allegations against ZFS, does not assert any similar allegations about transfer of title.

2. <u>No Financially Motivated Solicitation by ZFS</u>

ZFS also cannot be liable under the second prong of the *Pinter*/*Wilson* analysis, because the Complaint does not plead any facts alleging that ZFS *solicited* plaintiffs' purchase of Converium securities, motivated by its own or the underwriters' financial interest.

In a firm-commitment underwriting, "the [seller] realizes all of its profits from the offering by selling its shares *to the underwriter*, leaving the underwriter with responsibility for selling its shares to investors. The [seller] therefore largely lacks the financial incentive to solicit further sales" to the public. *Cent. Laborers*, 2005 WL 2244072, at *8 (emphasis added); s*ee*

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[17] *See also, e.g., Cent. Laborers Pension Fund v. Merix Corp.*, No. CV04-826, 2005 WL 2244072, at *6 (D. Or. Sept. 15, 2005) ("Plaintiff cannot hold [seller] liable . . . because [seller] originally sold to the Underwriters the stock that Plaintiff purchased from the Underwriters."); *In re Regeneron Pharm., Inc. Sec. Litig.*, No. 7:91-CV-3352, 1992 WL 12140640, at *6 (S.D.N.Y. Apr. 17, 1992) (seller "was not, therefore, in privity with the purchasers for Section 12(2) purposes, unlike [underwriter] who purchased the shares from [seller] and then sold them to the public").

also, e.g., Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., 32 F.3d 697, 701 (2d Cir. 1994) ("the underwriter bears the risk if the offering is undersubscribed").

The absence of any factual allegations that ZFS solicited plaintiffs' purchases to promote *its own* financial interest thus is not surprising. Nor do plaintiffs allege that ZFS solicited their purchases motivated by the desire to serve the *underwriters'* financial interest.

Indeed, the Complaint does not plead any facts showing that ZFS "solicited" the sale of Converium securities at all. Plaintiffs do not allege they had any contact at all with ZFS; they contend only that "ZFS sold securities, and was a seller, offeror, and/or solicitor of sales of securities offered pursuant to the Prospectus," and that "ZFS's . . . actions and solicitations included participating in the preparation of the . . . Prospectus." (Compl. ¶ 261.)

But the Supreme Court has rejected this "substantial participation" concept of "seller," holding that § 12 liability depends on "the defendant's *relationship with the plaintiff-purchaser*," not "the defendant's degree of involvement in the securities transaction and its surrounding circumstances." *Pinter*, 486 U.S. at 651 (emphasis added). "To count as 'solicitation,' the seller must, at a minimum, *directly communicate with the buyer*." *Rosenzweig*, 332 F.3d at 871 (emphasis added); *accord, e.g., In re Craftmatic Sec. Litig.*, 890 F.2d 628, 636 (3d Cir. 1989) ("[t]he purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the [seller] liable as a § 12(2) seller").

Alleged participation in the preparation of the Prospectus thus does not constitute financially motivated "solicitation" that could subject ZFS to § 12(a)(2) liability. *See, e.g., Rosenzweig*, 332 F.3d at 871 (affirming dismissal of § 12(a)(2) claim in firm-commitment underwriting despite allegation that defendants signed the registration statement); *Cent. Laborers*, 2005 WL 2244072, at *8 ("merely signing a prospectus does not qualify as soliciting a

sale of securities" under § 12(a)(2)); *In re Gas Reclamation, Inc. Sec. Litig.*, 733 F. Supp. 713, 724 (S.D.N.Y. 1990) (absent allegations of direct contact with plaintiffs, "[s]ection 12 liability does not extend to everyone involved in the preparation of a prospectus"). (In fact, as discussed below, ZFS did not even sign the Registration Statement or Prospectus.) The Court therefore should dismiss Count III as to ZFS.

B. Non-IPO Purchasers Cannot Sue Under Section 12(a)(2).

Even if a § 12(a)(2) claim somehow could lie against ZFS despite the nature of this firm-commitment underwriting, the two co-lead plaintiffs could not assert such a claim, because they did not purchase Converium securities in the IPO.

Section 12(a)(2) applies only to sellers who make material misstatements or omissions "by means of a prospectus or oral communication." 15 U.S.C. § 77l(a)(2). The term "prospectus" "is confined to documents related to *public offerings* by an issuer or its controlling shareholders." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995) (emphasis added). The phrase "oral communication" similarly refers only to communications *about the prospectus*. *See, e.g., Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 688 (3d Cir. 1991) ("the words 'prospectus or oral communication' must be construed as related terms," applying only to "material misrepresentations made in a prospectus or in an oral communication related to a prospectus or initial offering"); *see also Gustafson*, 513 U.S. at 577 ("§ 12(2) contains language, *i.e.*, 'by means of a prospectus or oral communication,' that limits § 12(2) to public offerings").

Section 12(a)(2) thus governs only *initial public offerings* – not aftermarket transactions on a stock exchange or through other means. "Every court since *Gustafson*, including this district, has held in light of *Gustafson*, that [§] 12(2) applies only to initial public offerings." *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93 Civ. 7581, 1995 WL 406167, at *2 (S.D.N.Y. July 10, 1995) (quotations omitted); *see also, e.g., In re Cosi, Inc. Sec. Litig.*,

379 F. Supp. 2d 580, 589 (S.D.N.Y. 2005) ("[B]ecause the plaintiffs have not alleged that they purchased their shares in the IPO, they have failed to allege that they have standing to bring a claim under §12(a)(2)").[18]

The Complaint does not allege that either of the co-lead plaintiffs purchased Converium securities *in the IPO*, which went effective on December 11, 2001 (Compl. ¶ 91). To the contrary, the Complaint pleads only that the co-lead plaintiffs purchased Converium securities "during the Class Period," which lasted almost three years. (*Id.* ¶¶ 15-16.) Only LASERS is alleged to have purchased Converium securities "on the day of the IPO," although it also purportedly bought additional shares "in the week following the IPO." (*Id.* ¶ 18.)

In fact, the certifications that co-lead plaintiffs filed with the Court show that Avalon Holdings, Inc. ("Avalon") did not purchase its first shares of Converium stock until January 29, 2002 (*see* Ex. H), and Public Employees' Retirement System of Mississippi ("Mississippi") did not make its first purchase until March 18, 2002 (*see* Ex. I). Accordingly, the Court should dismiss Avalon's and Mississippi's § 12(a)(2) claims – and LASERS' § 12(a)(2) claim for its post-IPO purchases.

C. IPO Purchasers Who Sold At or Above the IPO Price Lack Standing to Sue.

The Court also should dismiss the § 12(a)(2) claim to the extent it seeks recovery on behalf of any IPO purchaser who later sold the stock at or above the IPO price. The Supreme Court held in *Randall v. Loftsgaarden,* 478 U.S. 647, 655 (1986), that § 12(a)(2) prescribes a rescission remedy "except where the plaintiff no longer owns the security." If the plaintiff has sold the stock, "a rescissory measure of damages will be employed; the plaintiff is entitled to a

[18] *See also, e.g., Dafofin Holdings S.A. v. Hotelworks.com, Inc.*, No. 00 Civ. 7861, 2001 WL 940632, at *6 (S.D.N.Y. Aug. 17, 2001); *Saslaw v. Askari*, No. 95 Civ. 7641, 1997 WL 221208, at *5 (S.D.N.Y. Apr. 25, 1997); *Komanoff v. Mabon*, *Nugent & Co.*, 884 F. Supp. 848, 857 (S.D.N.Y. 1995).

return of the consideration paid, reduced by the amount realized when he sold the security and by any 'income received' on the security." *Id.* at 655-56.

Any person who purchased Converium securities in the IPO and later sold those securities at the same or a higher price cannot show any damages under *Loftsgaarden*'s "rescissory measure of damages." Because those persons have not suffered a loss, they cannot allege an essential element of a § 12(a)(2) claim – and their claims thus should be dismissed.

IV.
PLAINTIFFS HAVE FAILED TO PLEAD A CLAIM UNDER SECTION 10(b) OF THE EXCHANGE ACT.

Section 10(b) of the Exchange Act and Rule 10b-5 prohibit material misrepresentations or omissions in connection with the purchase or sale of securities.[19] As shown above, the Complaint does not plead any material misrepresentation in the pre-IPO period – the only timeframe relevant to ZFS. The § 10(b) claim also is deficient for at least three other, independent reasons: (*i*) plaintiffs have not pled facts showing any alleged misstatement publicly attributed to ZFS; (*ii*) plaintiffs have not adequately pled reliance, and (*iii*) plaintiffs have not pled particularized facts creating a strong inference that ZFS acted with scienter.

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[19] Section 10(b) prohibits the "use or employ[ment] . . . of any . . . deceptive device" "in connection with the purchase or sale of any security," 15 U.S.C. § 78j(b). SEC Rule 10b-5 forbids, among other things, the making of any "untrue statement of material fact" or the omission of any material fact "necessary in order to make the statements made . . . not misleading." 17 C.F.R. § 240.10b-5 (2004). The elements of a § 10(b)/Rule 10b-5 claim are: "(1) a material misrepresentation (or omission); (2) scienter, *i.e.*, a wrongful state of mind; (3) a connection with the purchase or sale of a security; (4) reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as 'transaction causation'; (5) economic loss; and (6) 'loss causation,' *i.e.*, a causal connection between the material misrepresentation and the loss," *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005) (emphases and citations omitted).

A. <u>ZFS Cannot Be Held Liable for Statements Not Publicly Attributed to It.</u>

In *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 174-75 (1994), the Supreme Court abolished aiding-and-abetting liability under § 10(b), ruling that § 10(b) "does not reach those who aid and abet a § 10(b) violation . . . . [It] prohibits only the *making* of a material misstatement (or omission) or the commission of a manipulative act." *Id.* at 177 (emphasis added). One year later, Congress – in the PSLRA – expressly authorized *the SEC* to bring *enforcement actions* against persons who "knowingly provide[] *substantial assistance* to another person" in violation of the securities laws. 15 U.S.C. § 78t(f) (emphasis added). But Congress did *not* extend this authority to *private plaintiffs* seeking to bring *damages* actions against persons who knowingly provided "substantial assistance" to primary violators.

In the wake of *Central Bank* and the PSLRA, courts labored to define the line between primary liability and mere aiding/abetting. Some courts adopted a "substantial participation" test; others adopted a "bright line" test. *Wright v. Ernst & Young LLP*, 152 F.3d 169, 174-75 (2d Cir. 1998).

The Second Circuit follows the "bright line" test to distinguish primary liability from aiding/abetting: "[i]f *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.* at 175 (emphasis added; quotations omitted). Accordingly, "a secondary actor cannot incur primary liability under [§ 10(b)] for a statement *not attributed to that actor at the time of its dissemination*. . . . [T]he misrepresentation must be *attributed to that specific actor at the time of public dissemination*, that is, in advance of the investment decision." *Id.* (emphasis added).

Plaintiffs' Complaint does not allege that ZFS made any material misrepresentation that was *publicly attributed to ZFS* at the time of dissemination.

- The Complaint charges that ZFS "participat[ed] in the preparation" of the allegedly false Prospectus and is liable for the allegedly false Registration Statement and Prospectus. (Compl. ¶¶ 261, 319.) But the Complaint does not allege that ZFS *signed* the Registration Statement or Prospectus (*id.* ¶¶ 141-48) – and, in fact, ZFS did not do so (Exs. E, F). Thus, neither document was *publicly attributed* to ZFS. Indeed, ZFS's *absence* as a defendant in the Complaint's § 11 claims (Counts I and II) – alleging false statements in the Registration Statement – appears to confirm plaintiffs' understanding that ZFS did *not* sign that document, because § 11 applies to "every person who *signed* the registration statement," 15 U.S.C. § 77k(a) (emphasis added).

- The Complaint (¶ 88) alleges that "ZFS and Converium" issued a September 6, 2001 press release announcing the IPO and discussing the adequacy of Converium's loss reserves. But the press release quoted in the Complaint was *Converium's,* not ZFS's: it was on *Converium* letterhead; it did not mention ZFS as a cosignatory, and it did not attribute any statements to ZFS. (Ex. D.)[20]

- The Complaint (¶ 90) also mentions "road shows" and fliers used to promote the IPO. But the "senior managers" who allegedly participated in the road shows were *Converium's*, and the flier was "the *Company[’s]*" (*i.e.*, Converium's).

The Court thus should dismiss the § 10(b) claim against ZFS under *Wright*'s "bright line" test.

B. <u>Plaintiffs Have Not Adequately Pled Reliance.</u>

The § 10(b) claim not only is defective for failing to allege a material misrepresentation or omission publicly attributed to ZFS; it also fails adequately to plead reliance, which is an essential element of a § 10(b) claim, *see, e.g., Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005).

In securities-fraud putative class actions such as this one, plaintiffs traditionally try to satisfy the reliance requirement by invoking the *presumption* of reliance under the "fraud on the market" doctrine. This doctrine holds that, "where materially misleading statements have

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[20] ZFS did issue its own press releases about the IPO on September 6, 2001 (Exs. J, K), but ZFS's press releases did not say anything about the adequacy of Converium's loss reserves and did not contain the statements quoted in the Complaint (¶ 89).

been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed." *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988). Plaintiffs here rely on that presumption. (Compl. ¶ 45.)

The fraud-on-the-market presumption, however, applies only to efficient, well-developed markets. It "can not [*sic*] logically apply when plaintiffs allege fraud *in connection with an IPO*, because in an IPO there is no well-developed market in the offered securities." *Berwecky v. Bear, Stearns & Co.,* 197 F.R.D. 65, 69 n.5 (S.D.N.Y. 2000) (emphasis added); *accord*, *e.g.*, *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1158 (6th Cir. 1994) ("the fraud on the market presumption of reliance does not apply when securities are not traded on an efficient market, as is the case with new issues").

In an IPO, one cannot presume a security's price reflects its "real" value, because interested parties – not the "market" – have set the price. *Gruber v. Price Waterhouse*, 776 F. Supp. 1044, 1052 (E.D. Pa. 1991) ("This characteristic rules out the [fraud-on-the-market] theory in two respects. First, the initial price represents a biased view of value because the promoters are self-interested, and second, the price cannot change to reflect true value. Therefore, a buyer cannot assume the price he pays reflects all of the information in the market."); *see also*, *e.g.*, *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990) (primary market for newly issued bonds is not efficient, because "the price of newly issued securities is set primarily by the underwriter and the offeror, not by the market").

Converium's Prospectus itself made clear that the markets for Converium securities were inefficient at the time of the IPO: it stated that "[t]he initial public offering price for these securities has been determined by discussions among [ZFS], [Converium] and the underwriters, and may not be representative of the price that will prevail in the open market.

Accordingly, the actual market value of the [securities] that you receive in the global offering . . . will not be known until trading in the [securities] commences." (Ex. F at 22.) Thus, because IPO purchasers (such as LASERS) cannot rely on the fraud-on-the-market theory's presumption of reliance, and because the Complaint does not plead any other type of reliance, the Court should dismiss all IPO purchasers' § 10(b) claims.

The Court also should dismiss the post-IPO purchasers' § 10(b) claims, because the Complaint has not pled any *facts* suggesting when (if ever) and how the markets that were undeveloped and inefficient at the beginning of the putative class period ultimately became well-developed enough to warrant a presumption of reliance. The Complaint's conclusory allegation (¶ 45) that the markets for Converium securities were "efficient" "[a]t all times relevant to this Complaint" is clearly wrong at least as of the beginning of the putative class period, when the IPO commenced. Plaintiffs have not pled a single fact – much less with the particularity required by Rule 9(b) – suggesting when (if ever) and how the situation changed.

C. Plaintiffs Have Not Pled Particularized Facts Creating a Strong Inference of Scienter.

The § 10(b) claim also is deficient because the Complaint does not plead "with particularity" any facts creating the "strong inference" of scienter that the PSLRA and Rule 9(b) require. 15 U.S.C. § 78u-4(b)(2); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

Plaintiffs concede that "ZFS retained [Tillinghast] to perform an *independent* analysis of [Zurich Re's] reserves" and "to obtain an *accurate, independent and unbiased* estimate of its reinsurance business." (Compl. ¶ 81 (emphasis added).) As noted above, ZFS was not *required* by generally accepted accounting principles to hire Tillinghast – or any other actuary – to prepare or review its loss-reserve estimates. *Delta Holdings, Inc. v. Nat'l Distillers*

& Chem. Corp., 945 F.2d 1226, 1231 (2d Cir. 1991). But ZFS nevertheless chose to pay for an objective, outside analysis from this well-known consulting firm.

As discussed above, Tillinghast concluded that Zurich Re North America's reserves were $162 million lower than Tillinghast's "best estimate." (Ex. A at 5.) Plaintiffs admit that, in response to the Tillinghast Study, ZFS increased ZRNA's reserves by $125 million (Compl. ¶ 89), leaving a deficiency of only $37 million, which was well within Tillinghast's *range* of estimates (Ex. A at 6). And on a company-wide basis, Zurich Re's total net held reserves were only 1.3% lower than Tillinghast's best estimate. (*Id.* at 5.)

The Prospectus stated that "Tillinghast has confirmed" that Converium's net reserves, as strengthened by the $112 million added in response to the Tillinghast Study, "correspond to Tillinghast's best estimate of our liabilities for net loss and loss adjustment expenses as of December 31, 2000." (Ex. F at 123.) And Tillinghast expressly "consent[ed] to the references to Tillinghast-Towers Perrin in the Registration Statement." (Ex. E at Ex. 99.1.)

In light of Tillinghast's express approval of the reserve figures in the Prospectus, and in the absence of any allegation that Tillinghast's work did not conform to professional standards, ZFS did not act recklessly (or worse) in relying on Tillinghast's estimates and approval. *See, e.g., Hess v. American Physicians Capital, Inc.*, No. 5:04-CV-31, 2005 WL 459638, at *11 (W.D. Mich. Jan. 11, 2005) (finding "no accounting violation or any 'red flags' signaling accounting errors" where "the loss reserves estimate is subject to the independent reviews of an accounting firm, *actuaries*, and insurance regulators, and none of the reviews suggests that the estimate was unreasonable when made") (emphasis added).

Tillinghast was not the only outside expert to review Converium's loss reserves. PricewaterhouseCoopers Ltd. – Converium's independent accountants – audited the company's

financial statements for the IPO Prospectus and gave Converium a "clean" audit. (Ex. F at F-2.) Those financial statements included Converium's loss reserves. (*Id.* at F-22.) Courts have not hesitated to dismiss securities claims for lack of scienter in similar circumstances. *See, e.g., Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 829 (8th Cir. 2003) (affirming dismissal for lack of scienter where company's "outside auditors did not question its accounting practices and th[e] [company] received no warning letters from the SEC"); *Hess*, 2005 WL 459638, at *11 ("no accounting violation or any 'red flags' signaling accounting errors" where "the loss reserves estimate is subject to the independent reviews of an accounting firm"); *Levine v. Safeguard Health Enters., Inc.*, No. SACV991575, 2000 WL 33115907, at *6 (C.D. Cal. Sept. 12, 2000) (dismissing for failure to establish scienter where "the allegedly fraudulent financial statements were independently audited and approved and there is no allegation that information was withheld from the auditors"), *rev'd on other grounds*, 2002 WL 463366 (9th Cir. Feb. 22, 2002).

For these reasons, the Court should dismiss the § 10(b) claim as to ZFS.[21]

V. THE COURT SHOULD DISMISS THE CLAIMS AGAINST ZFS ON LOSS-CAUSATION GROUNDS.

If the Court does not dismiss plaintiffs' § 10(b) claim for the reasons discussed above, it nevertheless should dismiss the claim as to ZFS for failure to plead loss causation. Lack of loss causation also warrants a dismissal of plaintiffs' § 12(a)(2) claim as to ZFS.

A. Plaintiffs Have Not Adequately Alleged Loss Causation Under § 10(b).

Loss causation – "a causal connection between the material misrepresentation and the [alleged] loss" – is an essential element of a § 10(b) claim. *Dura Pharm.*, 125 S. Ct. at 1631.

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[21] If the Court does not dismiss the entire § 10(b) claim as to ZFS, it at least should dismiss claims based on any shares that were sold at a profit, because those shares did not suffer any "economic loss" – an essential element of a § 10(b) claim, *see Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1631 (2005).

The PSLRA imposes on plaintiffs "the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff[s] seek[] to recover damages," 15 U.S.C. § 78u-4(b)(4). As discussed above, plaintiffs must plead this element of their claim with the particularity required by Rule 9(b).

A loss-causation requirement is designed to "fix a legal limit on a person's responsibility, even for wrongful acts." *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994). The possibility that a "transaction would not have come about" "but for the defendant's misrepresentations" (*i.e.*, "transaction causation") does not necessarily mean that "the misstatements were the *reason* the transaction turned out to be a losing one" (*i.e.*, "loss causation"). *Id.* (emphasis added). Thus, the Supreme Court held in *Dura Pharmaceuticals* that "an inflated purchase price" resulting from a defendant's alleged misrepresentations "will not itself constitute or proximately cause the relevant economic loss." 125 S. Ct. at 1631.

> When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions or other events, which taken separately or together account for some or all of the lower price. . . . *Other things being equal, the longer the time between purchase and sale, the more likely that this is so, i.e., the more likely other factors caused the loss*.

Id. at 1631-32 (emphasis added); *see also, e.g.*, *First Nationwide Bank*, 27 F.3d at 771 (affirming this Court's dismissal on loss-causation grounds where five years had elapsed between defendant's alleged misstatements and plaintiff's alleged loss, and where plaintiff had "failed to adequately plead facts which, if proven, would show that its loss was caused by alleged misstatements as opposed to intervening events").

Plaintiffs bear the burden of pleading with particularity – and ultimately proving – that ZFS's alleged pre-IPO conduct *before December 11, 2001* somehow *caused* their losses nearly *three years later*, when Converium's stock price dropped after the company announced

reserve increases in July and August 2004 (Compl. ¶¶ 208-19). Plaintiffs have not met that burden. As the Complaint and the public record demonstrate, three years and a series of major intervening events individually and collectively undercut any legitimate inference of a causal connection between any alleged pre-IPO reserve deficiency in 2001 and plaintiffs' alleged losses in mid- to late 2004. The events breaking that chain of alleged causation include Converium's enormous *post-IPO* losses, its numerous *post-IPO* financial statements, its substantial *post-IPO* reserve increases, and difficult conditions throughout the insurance industry.

Post-IPO Adverse Loss Experiences. Plaintiffs' entire case against ZFS rests on Converium's alleged $225 million deficiency in North American loss reserves at the time of the IPO in December 2001. (Compl. ¶¶ 143-48.) As discussed above, this theory is based on plaintiffs' misuse of the Tillinghast Study, which ultimately showed a "best estimate" North American deficiency of only $37 million (after the $125 million reserve-strengthening) (*id.* ¶¶ 89, 145; Ex. A at 5).

But in any event, the Complaint alleges that, by mid-2003 – long after ZFS's alleged involvement with Converium had ended – Converium North America's "adverse loss development" had caused the business to be "under-reserved by at least $776.9 [million] as of June 30, 2003." (Compl. ¶ 122.) This alleged deficiency was *more than triple* the purported $225 million deficiency that supposedly existed as of December 31, 2000 – and *21 times higher* than the $37 million deficiency that the Tillinghast Study's best estimate actually had revealed.[22]

[22] This alleged post-IPO increase purportedly resulted from (*i*) an allegedly undisclosed $80 million adverse loss development 20 days *after the IPO* (Compl. ¶ 103), (*ii*) additional loss developments of up to $50 million that Converium's actuaries allegedly identified in each quarter of 2002 (*id.* ¶ 104), (*iii*) Deloitte & Touche's alleged conclusion in May 2003 that Converium North America was under-reserved by $437 million as of December 31, 2002 (*id.* ¶ 114), and (*iv*) additional adverse loss developments totaling $339.9 million during the first half of 2003 (*id.* ¶ 120). Plaintiffs added Deloitte's alleged $437 million deficiency to the

Plaintiffs further contend that Converium – not ZFS – engaged in a series of *post-IPO* actions to hide that "losses and adverse developments on Converium's North American business had continued to mount" (*id.* ¶ 158) and that Converium had a "massive reserve deficiency" of $776.9 million as of July 29, 2003 (*id.* ¶¶ 181-82) that "continued to plague the Company" as of February 17, 2004 (*id.* ¶ 193). Those alleged actions included the use of purportedly false and misleading press releases and statements during analyst calls (*id.* ¶¶ 150, 153, 165, 169, 171, 177, 182, 187, 189), undisclosed "novations" of purportedly problematic contracts (*id.* ¶¶ 128-30), "secret" additions to reserves (*id.* ¶¶ 128, 131-38), a restructured reporting format that no longer presented separate results for Converium North America (*id.* ¶¶ 124-26, 187), and a release of $31 million reserves to bolster results in 2003 (*id.* ¶ 194).

Post-IPO Statements and SEC Filings. Plaintiffs also allege that Converium made or filed with the SEC some *21 post-IPO* false and misleading statements (*id.* ¶ 292), all purportedly designed to inflate Converium's stock price (*see, e.g.*, *id*. ¶ 288). Those statements included three annual reports on Form 20-F with audited financial statements that allegedly contained false and misleading reserve information (*id.* ¶¶ 151, 173, 198) and six Forms 6-K with half-year and quarterly information that allegedly failed to disclose the severity of Converium's reserve deficiency (*id.* ¶¶ 154, 159, 180, 184, 191, 201). Plaintiffs do not allege that ZFS played any role in the preparation, making, or filing of *any* of these statements.

Post-IPO Reserve Increases. While plaintiffs accuse Converium of concealing its post-IPO reserve deficiencies, they cannot help but note that Converium announced two post-IPO reserve *increases* totaling almost $130 million: $59.6 million on October 28, 2002, and $70.3 million on November 19, 2002. (*Id.* ¶¶ 160, 165.) In fact, there were more than two: the

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$339.9 million in alleged additional loss developments experienced in the first half of 2003, to yield a total alleged deficiency of $776.9 million. (*Id.* ¶ 122.)

November 19 announcement reported that, "[s]ince the fourth quarter of 2000, Converium recorded a total of $382.2 million of additional provisions for prior years' liability lines of Converium North America written in 1997 to 2000 (2000: US$ 81.0 million; 2001: US$ 164.0 million; 1st half 2002: US$ 19.9 million; 3rd quarter 2002: US$ 47.0 million; 4th quarter 2002: US$ 70.3 million)." (Ex. L at 3.) "These additional provisions are the result of the continued emergence of increased reported losses related to prior years." (*Id.*)

Moreover, plaintiffs concede that, when Converium announced the July/August 2004 reserve increases that allegedly caused Converium's stock price to crash, those reserve increases covered "policies written for the United States in 1997-*2001*." (Compl. ¶¶ 208, 212 (emphasis added).) In contrast, the North American loss reserves on which Tillinghast opined did not go beyond policy year *2000*. (*Id.* ¶ 89; Ex. A at 1; Ex. B at 2; Ex. F at 123.) Thus, the reserve increases that were announced in 2004 and that allegedly caused plaintiffs' losses not only reflected an additional 3½ years of loss experience, they also covered an extra year's worth of policies – including those in force during the September 11, 2001 attacks – that were *not* at issue in the Tillinghast Study or in any reserving decisions based on that study.

Post-IPO Difficulties in the Industry. Converium was far from the only reinsurer that was increasing loss reserves for the policy years at issue here. Other insurers and reinsurers were experiencing similar problems with business written during the late 1990s and had collectively increased reserves by *$22 billion* in 2002.[23] Similarly, a prominent industry publication (*National Underwriter*) observed in February 2003 that the reinsurance industry

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[23] *See* Press Release, Weiss Ratings, Inc., Property and Casualty Insurers Increase Claims Reserves By $22 Billion in 2002" (July 1, 2003) ("The increase, which represents the largest reserve adjustment made by property and casualty companies since Weiss began analyzing the industry, reflects the companies' failure to adequately estimate losses [in the 1990s]." (Ex. M.)

> has experienced an unbelievable run of catastrophe losses, the worst stock market for many years, and problems with underreserving for asbestosis and environmental, [the deputy chairman of Aon Limited's U.K. reinsurance group] said. He called it the industry's "Perfect Storm." Insurers and reinsurers are sailing along in the sea, "and whichever way you look, they're being smacked by the worst possible combination of eventualities . . . .

(Ex. N.) As the Second Circuit held in affirming this Court's dismissal of another case for failure to plead loss causation: "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff's loss was caused by the fraud decreases." *First Nationwide Bank*, 27 F.3d at 772.

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In light of Converium's post-IPO losses, its post-IPO financial statements, and its post-IPO reserve increases, as well as the difficulties throughout the insurance industry, plaintiffs have failed to plead particularized facts showing how ZFS's involvement in an alleged *pre-IPO* reserve deficiency in 2001 could have *caused* the losses they purportedly suffered in late 2004. The Complaint itself makes clear that too much time and too many events intervened between ZFS's alleged misconduct and plaintiffs' purported loss.

B. <u>ZFS Did Not Cause Plaintiffs' Alleged Losses.</u>

Unlike § 10(b), § 12(a)(2) does not require plaintiffs to plead and prove loss causation. Instead, § 12 allows a defendant to raise lack of loss causation as a complete or partial defense: if the defendant can demonstrate that something other than its own actions caused all or part of the plaintiff's losses, the plaintiff may not recover those losses from that defendant. 15 U.S.C. § 77l(b).

Although lack of loss causation is a defense under § 12, a defendant may raise an affirmative defense in a Rule 12(b)(6) motion if the defense appears on the face of the Complaint. *See*, *e.g.*, *In re Merrill Lynch & Co.*, 289 F. Supp. 2d 429, 437 (S.D.N.Y. 2003)

("Where it is apparent from the face of the complaint that plaintiff cannot recover her alleged losses [from defendants under § 12(a)(2)], dismissal of the complaint pursuant to Rule 12(b)(6) is proper").

As shown in the preceding section, the face of the Complaint establishes that ZFS's alleged actions in December 2001 did not cause plaintiffs' purported losses nearly three years later, in 2004. In fact, plaintiffs spend almost all of their factual allegations contending that *Converium's post-IPO* actions – not ZFS's pre-IPO actions – caused their losses. (Compl. ¶¶ 95-140, 149-219.) The Court therefore should dismiss the § 12(a)(2) claim against ZFS, because ZFS has demonstrated that plaintiffs' losses are not recoverable from it.[24]

VI.
THE SECURITIES ACT CLAIMS ARE TIME-BARRED.

If the Court does not dismiss plaintiffs' § 12(a)(2) claim for the reasons discussed above, the Court should dismiss it (as well as the claim under § 15 of the Securities Act) as time-barred. Securities Act claims are subject to a one-year "discovery" statute of limitations. Plaintiffs were on inquiry notice of their alleged claims against ZFS more than one year before the first of these cases was filed, but they did not take any timely action to pursue their claims.

A. Claims Must Be Filed Within One Year of Inquiry Notice.

Claims under §§ 12(a)(2) and 15 are governed by the statute of limitations in § 13 of the Securities Act. *Dodds v. Cigna Sec. Inc.*, 12 F.3d 346, 349 (2d Cir. 1993). Section 13 bars actions unless "brought within one year after the discovery of the untrue statement or the

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[24] If the Court does not dismiss the entire Complaint as to ZFS on loss-causation grounds, the Court at least should dismiss claims based on any shares that were purchased and sold before the alleged fraud was revealed, because those shares did not sustain any loss *caused* by the alleged misrepresentations. The Supreme Court held in *Dura* that, if a purchaser buys stock at an allegedly inflated price and then sells the shares "before the relevant truth begins to leak out, *the misrepresentation will not have led to any loss.*" 125 S. Ct. at 1631 (emphasis added).

omission, or after such discovery should have been made by the exercise of reasonable diligence" – and in any event no later than within three years after the securities were offered to the public. 15 U.S.C. § 77m.

The first of these consolidated cases was filed on October 4, 2004 (Compl. ¶ 47), within three years after the December 11, 2001 IPO. That case, however, did not assert Securities Act claims. No such claims were pled in any of the consolidated cases until the Complaint was filed on September 23, 2005, well after § 13's three-year period had run. The Complaint (¶ 48) does not explain why the Court should allow the belatedly asserted Securities Act claims to relate back to the earlier Exchange Act lawsuits. Moreover, even if the Securities Act claims somehow could relate back to the October 4, 2004 lawsuit, they still would be time-barred under § 13's one-year discovery period.

The one-year period begins when a plaintiff "obtains [1] actual knowledge of the facts giving rise to the action *or* [2] notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge." *LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 154 (2d Cir. 2003) (emphasis added; quotations omitted).[25] The "notice" prong is "referred to as 'constructive or inquiry notice,'" which arises when "the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded . . . ." *Id.* Those circumstances are known as "storm warnings," and they trigger "a duty of inquiry." *Id.* (quotations omitted).

The existence of inquiry notice does not depend on plaintiffs' ability "to learn the *precise details* of the fraud. . . . [Plaintiffs] need only be capable of perceiving the *general*

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25 *LC Capital Partners* construed the statute of limitations for Exchange Act claims in 15 U.S.C. § 78i(e). However, the discovery rule under that section is equivalent to § 13's discovery rule, and courts cite Exchange Act discovery-rule cases when analyzing § 13's discovery rule. *See, e.g., Dodds*, 12 F.3d at 350.

fraudulent scheme based on the information available to them." *White v. H&R Block, Inc.*, No. 02 Civ. 8965, 2004 WL 1698628, at *5 (S.D.N.Y. July 28, 2004) (emphasis added; quotations omitted); *accord, e.g., Dodds*, 12 F.3d at 352 ("An investor does not have to have notice of the entire fraud being perpetrated to be on inquiry notice.").

The commencement date for the one-year period depends on how the plaintiff reacts when inquiry notice arises. "If the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose. . . . However, if the investor makes some inquiry once the duty arises, we will impute knowledge of what an investor in the exercise of reasonable diligence, should have discovered concerning the fraud . . . , and in such cases the limitations period begins to run from the date such inquiry should have revealed the fraud." *LC Capital Partners*, 318 F.3d at 154 (quotations omitted); *H&R Block*, 2004 WL 1698628, at *5.

Where the facts needed to determine when a reasonable investor would have obtained inquiry notice of storm warnings "can be gleaned from the complaint and papers such as the prospectuses and disclosure forms that are integral to the complaint, resolution of the issue on a motion to dismiss is appropriate." *Dodds*, 12 F.3d at 352 n.3; *accord, e.g., LC Capital Partners*, 318 F.3d at 156; *H&R Block*, 2004 WL 1698628, at *5 ("Dismissal is appropriate when the facts from which knowledge may be imputed are clear from the pleadings and the public disclosures themselves," including news articles, press releases, and financial statements).

As shown below, the Complaint and the documents admissible on this motion demonstrate that plaintiffs were on inquiry notice of their claims more than one year before the first of these consolidated putative class actions was filed. Plaintiffs do not allege they undertook any inquiry at that time. Accordingly, the one-year limitations period began to run as soon as inquiry notice arose, and it expired well before the first case was filed on October 4,

2004. *See, e.g., LC Capital Partners*, 318 F.3d at 154 ("Because the Plaintiffs make no claim that they undertook any inquiry in December 1998 . . . , whether the complaint is time-barred depends on whether a duty of inquiry arose at least by December 1998."); *see also H&R Block, Inc.*, 2004 WL 1698628, at *5.

B. Plaintiffs Were on Inquiry Notice More Than One Year Before They Sued.

The facts available to plaintiffs before October 4, 2003 – including four announced loss-reserve increases whose collective total of about $166 million *exceeded* the pre-IPO reserve strengthening of $112 million – constituted storm warnings of alleged under-reserving problems at Converium, but plaintiffs took no action at that time. The Securities Act claims therefore are time-barred under the one-year discovery period.

First reserve increase. On May 23, 2002 – more than five months after the IPO date, Converium reported that it had "recorded an additional $11.6 million of net adverse loss reserve development based on its year-end review of non-life reserves." (Ex. O at 47.)

Second reserve increase. Just two months later, on July 29, 2002, Converium announced another increase in its loss reserves: this time, a "$24.4 million provision for net adverse loss development." (Ex. P at 11.)

Third reserve increase. While plaintiffs ignore the first two reserve increases announced in 2002, they do mention Converium's third announced reserve increase: the Complaint alleges that, on October 28, 2002, Converium "surprised the market" by announcing that it "had increased its loss reserves by nearly $60 million" during the third quarter of 2002 "and that it anticipated increasing reserves by up to an additional $75 million during the fourth quarter." (Compl. ¶ 160.) Plaintiffs further charge that "the disclosure of the reserve increases sent the price of Converium shares and ADSs tumbling" on "heavy" trading volume: in one day, the price of the Swiss shares fell from 66.10 Swiss francs ("CHF") to CHF 59.50, and the ADSs

fell from $22 to $19.61 – " a decline of more than 10%" (*id.* ¶ 164), and an even greater decline from the IPO prices of CHF 82 and $24.59, respectively (*id.* ¶ 141).

Market reaction. While investors allegedly reacted to Converium's announcement, ratings agencies and market professionals did as well.

- The very next day (October 29), *The Wall Street Journal Europe* reported the reserve increase in an article captioned "Converium Posts Unexpected Net Loss." The article observed that "analysts were wary of the reinsurer's prospects. 'Converium's additional provisioning in the third quarter is bad news and could hurt management credibility,' said Lombard Odier analyst Roger Degen." The article also quoted Converium's Chief Financial Officer as saying: "'In the U.S. we see a sharp increase in the frequency of claims filed . . . , and the claims themselves also rising sharply'" (Ex. Q).

- That same day, Moody's downgraded its outlook for Converium's insurance financial strength rating from "stable" to "negative," attributing the downgrade to Converium's announcement. (Oct. 29, 2002 AFX News Limited, Ex. R.)

- Also on October 29, Standard & Poor's ("S&P") placed Converium on CreditWatch with negative implications. (Oct. 29, 2002 Business Wire, Ex. S; Oct. 29, 2002 AFX News Limited, Ex. T; Oct. 31, 2002 Insurance Day, Ex. U.) S&P's analyst noted that, "coming relatively soon after a full actuarial review of Converium's business as at year-end 2000, the adverse development also underlines *the continuing difficulty for insurers and reinsurers and their advisers in accurately reserving for prior year U.S. long-tail exposures*." (Ex. U (emphasis added).)

- On October 30 and November 1, respectively, Salomon Smith Barney and J.P. Morgan reduced their earnings-per-share estimates for Converium. (Oct. 30, 2002 Nelson Research Reports, Ex. V; Nov. 1, 2002 Nelson Research Reports, Ex. W.) J.P. Morgan's report was captioned: "Converium: Very disappointing Q3'02 earnings, *questionable reserving practice*." (Ex. W (emphasis added).)

- Fitch also lowered its long-term ratings of Converium from "stable" to "negative" following the release of Converium's third-quarter results. (Nov. 25, 2002 *National Underwriter Property & Casualty-Risk & Benefits Management*, Ex. X.)

All of this information was accessible to the public and helped put investors on notice that Converium's reserving issues were hurting its stock price. *See H&R Block*, 2004 WL 1698628, *5 (storm warnings may consist of public disclosures in the media about company's financial condition).

LASERS' stock sales. If the public and the market professionals took notice of the October 28 announcement and its aftermath (as plaintiffs allege), so did LASERS: it promptly decided to sell nearly one-third (32%) of its 120,400 Converium ADSs (Compl. ¶ 18). On October 30, 2002 – just two days after Converium announced its third-quarter reserve increase – LASERS sold 16,800 ADSs. Several days later, between November 1 and 8, it sold an additional 21,900 ADSs. (*See* letter from Steven B. Singer, Esq., of Bernstein Litowitz Berger & Grossmann LLP, to the Hon. Michael B. Mukasey, dated Aug. 22, 2005, at 2 n.1, Ex. Y.) Lead counsel's letter to the Court referred to the October 28 announcement as a "partial disclosure of Converium's true reserve position" and linked the disclosure to LASERS' sale: the letter noted the October 28 press release and the stock-price drop, and said in the very next sentence that "LASERS sold 16,800 ADSs on October 30, and sold an additional 21,900 ADSs between November 1 and November 8." (*Id.*)

Fourth reserve increase. On November 19, 2002, less than one month after Converium allegedly "surprised the market" with its third reserve increase, Converium announced a fourth one: a $70.3 million charge against earnings. (Compl. ¶ 165.) Even plaintiffs contend that the "Company's announcements that Converium either had or would increase its loss reserves constituted partial disclosures of the truth regarding the Company's reserve deficiency" (*id.* ¶ 236) – and they certainly constituted storm warnings sufficient to trigger a duty to inquire into whether an alleged fraud had occurred.

Subsequent events. Additional storm warnings continued to accumulate in the coming months.

- By December 16, 2002, S&P had lowered its ratings of Converium's long-term counterparty credit and insurer financial strength and long-term counterparty credit and senior unsecured debt. (Dec. 16, 2002 *Reins. Mag.*, at 9, Ex. Z.)

- On April 29, 2003, *AFX News Limited* reported that Converium "shares tumbled as first quarter [2003] results disappointed," and noted that Goldman Sachs would downgrade Converium's stock. "Sentiment is likely to remain poor in the near term, as this is the third consecutive quarter of earnings disappointment, Goldman Sachs said." (Ex. AA.)

- On July 17, 2003, *Business Wire* reported that Deutsche Bank AG – a substantial shareholder – was bailing out of Converium stock by reducing its holdings from 7.96% to 1.02% of registered shares with voting rights. (Ex. BB.)

All of these events occurred more than one year before the first of these consolidated cases was filed on October 4, 2004. And all of them placed plaintiffs on inquiry notice of the need at least to investigate their potential claims.

The circumstances of this case strongly resemble those of *Ezra Charitable Trust v. Frontier Insurance Group, Inc.*, No. 00 Civ. 5361, 2002 WL 87723 (S.D.N.Y. Jan. 23, 2002), *aff'd, LC Capital Partners*, 318 F.3d 148, which held that two loss-reserve increases within a relatively short period of time, coupled with an article in a trade publication, sufficed to put the plaintiffs on inquiry notice of their claims. In that case, as here, the plaintiffs filed securities-law claims against an insurance company, alleging that it had artificially inflated its stock price by "under-reserving for the costs of insurance claims and related expenses." 2002 WL 87723, at *1. More than one year before the plaintiffs sued, the insurer had announced two reserve increases, and an industry journal (*National Underwriter*) had published an article about the insurer's reserve increases. *Id.* at *2-*3.

The court dismissed the case on limitations grounds, holding that the two reserve increases, "coupled with the *National Underwriter* article . . . discussing [the insurer's] reserving problems, constitute sufficient storm warnings such that plaintiffs could have begun investigating the fraud and filed suit at that point." *Id.* at *5. The Second Circuit affirmed.

The same principles apply here. Converium announced four reserve increases within six months – including two significant increases within two months – and the market

allegedly reacted negatively. Those collective reserve increases substantially exceeded the $112 million reserve strengthening that had preceded the IPO. The only named plaintiff with standing to assert Securities Act claims apparently understood the alleged import of those disclosures and promptly sold one-third of its Converium holdings within days after the third of those four announcements. Industry publications and market analysts noted Converium's reserve increases and downgraded their credit ratings and opinions of the company and its securities. As in *Ezra Charitable Trust*, these circumstances constituted sufficient storm warnings to trigger plaintiffs' duty of inquiry – but plaintiffs did nothing at all. The Court therefore should dismiss the Securities Act claims as time-barred.

VII.
PLAINTIFFS HAVE FAILED TO PLEAD CONTROL-PERSON LIABILITY.

Counts X and V assert control-person liability claims against ZFS under § 20(a) of the Exchange Act and § 15 of the Securities Act, respectively. Those claims seek to hold ZFS derivatively liable for Converium's alleged violations of § 10(b) of the Exchange Act and §§ 11 and 12(a)(2) of the Securities Act during the *pre-IPO* period. (Compl. ¶¶ 324, 278.)

Section 20(a) provides that every person who "controls any person liable under [§ 10(b)] shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a). "[T]o establish a *prima facie* case of liability under § 20(a), a plaintiff must show: (1) a *primary violation* by a controlled person; (2) *control* of the primary violator by the defendant; and (3) that the controlling person was in some meaningful sense a *culpable participant* in the primary violation." *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998) (emphasis added; quotations omitted).

Section 15 likewise provides that every person who "controls any person liable under [§§ 11 or 12] shall also be liable jointly and severally with and to the same extent as such controlled person . . . , unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 15 U.S.C. § 77o. The elements of a § 15 claim are the same as those of a § 20(a) claim. *E.g.*, *Wallace v. Buttar*, 239 F. Supp. 2d 388, 395 n.1 (S.D.N.Y. 2003) (§§ 20(a) and 15 "apply the same test for control person liability" and "are interpreted the same"), *rev'd on other grounds*, 378 F.3d 182 (2d Cir. 2004).[26]

The Court should dismiss these claims because plaintiffs have failed to plead particularized facts supporting the three requisite elements for control-person liability.

A. <u>Plaintiffs Have Not Pled a Primary Violation of the Securities Laws.</u>

Control-person liability cannot exist without a primary violation of the securities laws. As explained above and in Converium's motion papers, the Complaint has not stated any such claim for the pre-IPO period. The §§ 20(a) and 15 claims thus fail for this reason alone.

B. <u>Plaintiffs' Allegations of Control Are Insufficient.</u>

The §§ 20(a) and 15 claims also fail because plaintiffs have not pled particularized facts alleging that ZFS *actually controlled* Converium during the relevant period.

To survive a motion to dismiss, plaintiffs must plead particularized facts showing that ZFS had the power – directly or indirectly – "to direct or cause the direction of the

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[26] *Accord, e.g., DeMaria v. Andersen*, 153 F. Supp. 2d 300, 314 (S.D.N.Y. 2001) (applying § 20(a) test to § 15 claims), *aff'd*, 318 F.3d 170 (2d Cir. 2003); *Silva Run Worldwide Ltd. v. Gaming Lottery Corp.*, No. 96 Civ. 3231, 1998 WL 167330, at *12 n.21 (S.D.N.Y. Apr. 8, 1998) ("[t]hese sections are substantially similar so that it is appropriate to analyze liability under these sections as though they are interchangeable"); *P. Stolz Family P'ship, L.P. v. Daum*, 166 F. Supp. 2d 871, 873 (S.D.N.Y. 2001) (requiring showing of culpable participation for § 15), *aff'd in part, rev'd in part on other grounds*, 355 F.3d 92 (2d Cir. 2004).

management and policies of [Converium], whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (defining "control" under § 20(a)); *id.* § 240.12b-2 (same for § 15). Such control must be "real, *de facto* power and not just *de jure*." *Wallace*, 239 F. Supp. 2d at 396 (rejecting argument that "control requires only the ability to direct the actions of the controlled person, and not the active exercise thereof"); *see also, e.g., Ross v. Bolton*, No. 83 Civ. 8244, 1989 WL 80428, at *3 (S.D.N.Y. Apr. 4, 1989) ("to incur controlling person liability, a defendant must possess actual control over the transactions in question") (quotations omitted), *vacated in part on other grounds*, 1989 WL 80425 (S.D.N.Y. Apr. 10, 1989), *aff'd*, 904 F.2d 819 (2d Cir. 1990).

The Complaint, however, offers only generic, conclusory allegations of control, based solely on ZFS's pre-IPO ownership of Converium's stock. Plaintiffs simply presume – without pleading any *factual* basis for their broad assertions – that ZFS (*i*) "participated" in "the operation and management" of Converium, the "preparation and dissemination of the Registration Statement," and the IPO process (Compl. ¶¶ 279, 326), (*ii*) "was able to, and did, control" "the contents of the Registration Statement" and Prospectus, "the conduct of Converium's business, the establishment of its loss reserves, . . . and public statements about its business" (*id.*), (*iii*) "had direct control and/or supervisory involvement in the operations of [Converium]" (*id.* ¶ 324), and (*iv*) "prepared or had access to [Converium's] reports, press releases, public filings and other statements" (*id.* ¶ 327).

These allegations, however, lack any *factual details* about what ZFS allegedly did to exercise its purported control over Converium and the IPO process. The allegations also ignore that Converium was incorporated as a separate entity on June 19, 2001 (Ex. F at 173) – nearly six months before the IPO – and that a "presumption of separateness [is] afforded to

related corporations," *De Jesus v. Sears, Roebuck & Co.*, 87 F.3d 65, 70 (2d Cir. 1996) (dismissing claim against parent because "[t]he Complaint does not allege facts from which it may be inferred that [parent] dominated [subsidiary's] [alleged misconduct], or that [parent's] employees themselves acted to defraud Plaintiffs") (quotations omitted).

Rule 9(b) requires plaintiffs to plead each element of their claim, including the circumstances of the alleged control relationship, with particularity. *See, e.g., In re Digital Island Sec. Litig.,* 223 F. Supp. 2d 546, 561 (D. Del. 2002). Without factual allegations showing an *actual exercise* of control, controlling-shareholder status alone will not support a control-person claim. *See, e.g., Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 85 (1st Cir. 2002) ("Although controlling shareholders own the majority of the shares in a company, they, like any other shareholders, should have the ability to be passive, leaving the management to the directors and officers. . . . [U]nless there are facts that indicate that the controlling shareholders were actively participating in the decision making processes of the corporation, no controlling person liability can be imposed.").

C. <u>Plaintiffs' Allegations of Culpability Are Insufficient.</u>

Plaintiffs also have not pled particularized facts showing that ZFS *culpably participated* in any alleged primary violation by Converium. District Courts have not definitively decided what a plaintiff must allege to show the purported control person's culpable participation. At a minimum, however, § 10(b)'s recklessness standard for scienter should apply. *See, e.g., Wallace*, 239 F. Supp. 2d at 397 ("the level of mental culpability required for control person liability under federal law is intention or recklessness"). *But see, e.g, Mishkin v. Ageloff*, No. 97 Civ. 2690, 1998 WL 651065, at *25 (S.D.N.Y. Sept. 23, 1998) ("[a]t the initial pleading stage . . . a plaintiff must allege . . . particularized facts of the controlling person's *conscious misbehavior* as a culpable participant in the fraud") (emphasis added).

For the reasons discussed above, plaintiffs have not pled particularized facts showing that ZFS engaged in any reckless misconduct (much less conscious misbehavior). Accordingly, the Court should dismiss the control-person liability claims.

CONCLUSION

For all of the foregoing reasons, the Court should dismiss Counts III, V, IX, and X of the Complaint as against ZFS.

Dated: December 23, 2005

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