UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

IN RE DELPHI SECURITIES, DERIVATIVE, AND ERISA LITIGATION	)))	MDL No. 1725 Case No. 05-md-1725
This Document Relates to: *In re Delphi Corporation Securities Litigation* No. 06-10026	)))	Hon. Gerald E. Rosen ORAL ARGUMENT REQUESTED

LEAD PLAINTIFFS' OMNIBUS MEMORANDUM OF LAW IN OPPOSITION TO ALL DEFENDANTS' MOTIONS TO DISMISS THE CONSOLIDATED CLASS ACTION COMPLAINT

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PRELIMINARY STATEMENT

From the moment it became a public company in 1999 until its demise in 2005, Delphi Corporation ("Delphi" or the "Company") issued materially false and misleading financial statements. In fact, on June 30, 2005, Delphi restated all the financial statements it had issued as a stand-alone company, admitting that its previously reported results were unreliable due to accounting errors, and included material overstatements of pre-tax income among other misstated financial metrics (the "Restatement"). During this time, fraud pervaded all aspects of Delphi's business.

As set forth in Lead Plaintiffs' Consolidated Class Action Complaint (the "Complaint"), in Delphi's early years as a stand-alone company, certain of its officers, namely its former President, Chief Executive Officer and Chairman of the Board J.T. Battenberg III ("Battenberg"), its former Vice Chairman, Chief Financial Officer and member of the Board of Directors Alan Dawes ("Dawes"), its former Chief Accounting Officer and Controller Paul R. Free ("Free"), its Vice Chairman and Chief Technology Officer Donald Runkle ("Runkle"), its acting Chief Financial Officer and Chief Accounting Officer and Controller John D. Sheehan ("Sheehan"), and its former Vice President of Treasury, Mergers and Acquisitions John G. Blahnik ("Blahnik") (collectively, the "Officer Defendants"), engaged in a wide-ranging fraudulent scheme designed to artificially boost Delphi's revenues in order to make Delphi appear more profitable and successful. The scope and timing of these fraudulent transactions and accounting make it clear that Delphi's Board of Directors, including its Audit Committee[1]

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[1] The Audit Committee Defendants include Robert H. Brust, Oscar De Paula Bernardes Neto, Cynthia A. Niekamp and John D. Opie. Former Audit Committee Member Thomas H. Wyman is deceased.

(collectively, the "Director Defendants"),[2] Delphi's independent auditors Deloitte & Touche, LLP ("Deloitte") and the co-parties to these transactions were aware of the fraudulent scheme. For example:

- Delphi and the Officer Defendants improperly engaged in **$441 million** of sham, round-trip transactions at the end of key financial reporting periods with Defendants Bank One Corp. ("Bank One"),[3] BBK, Ltd. ("BBK"), and Setech, Inc. ("Setech"). ¶¶ 119-54;[4]
- Delphi and the Officer Defendants improperly accounted for more than **$240 million** in transactions with General Motors Corp. ("GM") relating to warranty expenses. ¶¶ 155-68;
- Delphi and the Officer Defendants improperly accounted for at least **$68 million** in transactions with Delphi's information technology service providers. ¶¶ 172-87; and
- Delphi and the Officer Defendants improperly understated Delphi's inventory balances by intentionally failing to record and/or delaying delivery of inventory. ¶¶ 190-99.

Even when the Officer Defendants stopped engaging in new sham transactions following the passage of the Sarbanes-Oxley Act of 2002 ("SOX"), Delphi continued to disseminate its previously reported fraudulent financial results, covered up its earlier fraud and failed to disclose that its purported success was due to phony transactions and accounting chicaneries. By any measure, the fraud at Delphi – which hid Delphi's slide into bankruptcy – is among the most egregious schemes to defraud investors in recent history.

The Complaint details each Defendant's unlawful conduct, specifically setting forth numerous violations of the Securities Act of 1933 (the "Securities Act") and the Securities

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[2] The Director Defendants include Virgis W. Colbert, David N. Farr, Dr. Bernd Gottschalk, Shoichiro Irimajiri, Susan A. McLaughlin, Roger S. Penske and Patricia Sueltz, as well as the Audit Committee Defendants.

[3] J.P. Morgan Chase & Co. is named as a Defendant as the successor-in-interest to Bank One.

[4] All references to "¶ __" refer to paragraphs of the Complaint.

Exchange Act of 1934 (the "Exchange Act"). In response, Defendants proffer blunderbuss motions full of irrelevant arguments, and improperly assert facts extraneous to the Complaint. While conceding the falsity of the Company's financial statements, Defendants contend that they cannot be held liable under the Exchange Act because they did not act with the requisite state of mind. This argument is belied by the facts adduced in Lead Plaintiffs' extensive investigation, which demonstrate that:

- The Officer Defendants ordered employees to record worthless, obsolete inventory on the books as valuable inventory. ¶ 137;
- The Officer Defendants expressly instructed employees to understate Delphi's inventory balances. ¶¶ 191-92;
- The Officer Defendants and Bank One engaged in a $200 million round-trip transaction in which Bank One purportedly "bought" precious metals from Delphi just before the close of the 2000 fiscal year-end and then purportedly "sold back" those metals to Delphi right after the close of the 2000 fiscal year-end for the very same price, even though the metals **never left Delphi's plant floor.** ¶ 152;
- Delphi employees expressly informed Setech that round-trip transactions with Delphi totaling $145 million were for the sole purpose of temporarily removing inventory from Delphi's books. ¶ 135; and
- BBK entered into round-trip inventory transactions totaling $89 million with Delphi without paying for the inventory it purportedly "bought" and knowing – according to a former BBK consultant – that the purpose of the transactions was "to move things off [of Delphi's] books for a short period of time" ¶¶ 147-48, 150.

As a result of the fraudulent scheme, Delphi appeared to achieve what otherwise would have been unattainable financial targets; consequently, the Officer Defendants received extraordinary bonuses – in many instances significantly more than 100% of their annual salary. ¶ 95. Thus, the Officer Defendants were motivated to commit and to conceal their fraud.

Delphi's fraudulent scheme, perpetrated by the Officer Defendants, Bank One, Setech and BBK, went undetected for years because the gatekeepers – the Director Defendants and

Deloitte – recklessly abandoned their duties. Deloitte opined that Delphi's financial statements complied with Generally Accepted Accounting Principles ("GAAP") and issued unqualified audit opinions certifying those statements, yet recklessly disregarded numerous red flags indicating that Delphi's financial reporting practices violated GAAP and that its financial statements were materially false and misleading. Both Deloitte and the Director Defendants failed to identify Delphi's admittedly inadequate internal controls; failed to investigate Delphi's large and unusual transactions, which occurred suspiciously at the end of important fiscal periods; failed to scrutinize management's bonus program, which was tied to achieving specific financial targets; and failed to question how management was always able to meet its ambitious financial targets despite the depressed state of the auto industry. These gatekeepers recklessly turned a blind eye to Delphi's rampant fraud.

The Underwriters[5] likewise abdicated their gatekeeping duties to the investing public in connection with Delphi's June 5, 2001 Offering (the "June 2001 Offering"); July 25, 2003 Offering (the "July 2003 Offering"); the Delphi Trust I October 21, 2003 Offering (the "Trust I Offering"); and the Delphi Trust II November 11, 2003 Offering (the "Trust II Offering"),[6] which were made pursuant to false registration statements. Prior to each of these offerings, the Underwriters were required to conduct a reasonable investigation of Delphi to ensure that the

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[5] The Underwriters include Bear, Stearns and Co. Inc. and Credit Suisse First Boston Corporation for the June 2001 Offering; Banc of America Securities LLC, Barclay's Capital Inc., and Citigroup Global Markets Inc. for the July 2003 Offering; Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Stanley & Co. Incorporated, UBS Securities LLC and Wachovia Capital Markets, LLC for the Trust I Offering; and Citigroup and Merrill Lynch for the Trust II Offering.

[6] Delphi Trust I and Delphi Trust II are referred to herein as the "Trust Defendants."

statements and representations contained in the offering materials contained no false statements. The Underwriters failed to do so.

In sum, the evidence of Defendants' scienter and negligence is overwhelming. There can be no serious dispute that the Complaint's detailed allegations are sufficient to state violations of the Securities Act and the Exchange Act. However, rather than answer the detailed allegations in the Complaint, Defendants attempt to evade responsibility by raising boilerplate challenges, contesting the allegations on a piecemeal rather than a collective basis, and asserting numerous factual arguments that are both unpersuasive and inappropriate at the pleading stage. As described more fully below, Defendants' challenges are without merit and should be rejected.

For the reasons set forth herein, Lead Plaintiffs respectfully submit that Defendants' motions to dismiss should be denied in their entirety.

FACTUAL BACKGROUND

Lead Plaintiffs refer to and incorporate by reference ¶¶ 89-226 of the Complaint, which set forth the factual background of this litigation. Lead Plaintiffs' Motion for Partial Modification of the PSLRA Discovery Stay, also incorporated by reference, sets forth facts relating to investigations being conducted by the Securities and Exchange Commission, the United States Department of Justice ("DOJ"), the Federal Bureau of Investigation ("FBI") and the United States Postal Inspection Service ("Postal Inspectors"). Detailed facts are also provided in support of each section of the Argument.

ARGUMENT

I. THE COMPLAINT STATES PRIMARY CLAIMS UNDER THE SECURITIES ACT

Section 11 of the Securities Act provides a private cause of action against issuers, underwriters, auditors and all persons signing a registration statement that "contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements made therein not misleading." 15 U.S.C. § 77k(a). Section 12(a)(2) provides a similar cause of action against anyone who sells or offers a security by means of a prospectus which "includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77l(a)(2).

The Complaint alleges Securities Act claims with respect to four note offerings: the June 2001 Offering (Count V), the July 2003 Offering (Count VIII), the Trust I Offering (Count XI), and the Trust II Offering (Count XIV).[7] Such claims are asserted against the Individual Defendants who signed the respective registration statements,[8] the Underwriters with respect to each offering (including the § 12(a)(2) claims in Counts VI, IX, XII, and XV), and Deloitte, whose audit opinions appeared in each registration statement.

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[7]On a motion to dismiss, it is axiomatic that a district court must accept all well-pleaded facts alleged in the complaint as true and must construe all allegations in the complaint in the light most favorable to the plaintiffs. *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 547 (6th Cir. 1999). "When an allegation is capable of more than one inference, it must be construed in the plaintiff's favor." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001). Dismissal of a complaint is not proper "'unless it appears beyond doubt that plaintiff can prove no set of facts in support of his claim which would entitle him to relief.'" *Comshare,* 183 F.3d at 547 (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).

[8] The Individual Defendants refers to Officer Defendants Battenberg, Runkle, Sheehan and Dawes and Director Defendants Brust, De Paula Bernardes Neto, Opie, Colbert, Farr, Gottschalk, Irimajiri, McLaughlin, Penske and Sueltz. Defendants Runkle, Sheehan, Brust, Farr, Gottschalk, Irimajiri and Sueltz are not named in connection with the June 2001 Offering, and that Defendant McLaughlin is not named in connection with the Trust II Offering.

A. <u>The Pleading Requirements for Claims Under § 11 and § 12(a)(2)</u>

Section 11 imposes a "stringent standard of liability." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983). Scienter is not an element of claims under § 11 or § 12(a)(2). *See, e.g., Rombach v. Chang*, 355 F.3d 164, 169 n.4 (2d Cir. 2004). Under the "virtually absolute liability provision" of § 11, plaintiffs need not allege that defendants acted with any particular state of mind or plead fraud for recovery. *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 269-70 (3d Cir. 2006). Neither reliance nor loss causation must be pleaded by plaintiffs asserting § 11 or § 12(a)(2) claims. *Rombach*, 355 F.3d at 169 n.4. A plaintiff "need only show a material misstatement or omission to establish his *prima facie* case," which "places a relatively minimal burden on a plaintiff." *Herman & MacLean*, 459 U.S. at 382.

Because fraud is not an element of § 11 or § 12(a)(2) claims, Fed. R. Civ. P. 8(a), which requires "a short and plain statement of the claim showing that the pleader is entitled to relief," covers such claims. *See In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 406 (S.D.N.Y. 2003), *aff'd,* 366 F.3d 70 (2d Cir. 2004).

B. <u>Plaintiffs' Non-Fraud § 11 Claims Are Not Subject to Rule 9(b)</u>

Plaintiffs' claims relating to Delphi's July 2003, Trust I and Trust II Offerings expressly disavow fraud. *See, e.g.*, ¶ 735 ("This claim does ***not*** sound in fraud and Lead Plaintiffs do not incorporate ***any*** allegation of fraud in connection with this Count") (emphasis in original). These claims (the "non-fraud § 11 claims"), therefore, are subject only to Rule 8's notice pleading requirement.[9]

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[9] Conversely, Plaintiffs' Securities Act claims relating to the June 2001 Offering (Counts V and VI) expressly incorporate allegations of fraud and hence must be pleaded with particularity pursuant to Rule 9(b).

Unable to dispute that the Complaint sufficiently alleges that the registration statements and prospectuses contained untrue statements of material fact – satisfying the "minimal" pleading burden imposed by Rule 8 on claims under § 11 – the Individual and Trust Defendants, and Deloitte contend that Plaintiffs' non-fraud § 11 claims "sound in fraud" and therefore also must comply with Fed. R. Civ. P. 9(b).[10] The Underwriters are also named in these same § 11 counts, but, tellingly, they do not join their fellow Defendants in this argument. The Court should reject the attempt by the Individual and Trust Defendants and Deloitte to evade liability on this basis because, as several district courts in this Circuit have held, proof of fraud is not required for recovery under Securities Act §§ 11 and 12(a)(2). *See, e.g., In re FirstEnergy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 602 (N.D. Ohio 2004); *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 595 (E.D. Mich. 1985).

In refusing to apply the heightened pleading standard of Rule 9(b) to § 11 and § 12 claims, these Sixth Circuit district courts found that such claims do not sound in fraud where, as here, plaintiffs expressly disclaim allegations of fraud and separate into distinct counts their § 11 claims from their § 10(b) claims. *See FirstEnergy*, 316 F. Supp. 2d at 602 n.19 (Rule 9(b) does not apply to § 11 claims when "[p]laintiffs have purposely not premised their claims on any allegations of fraud" and "explicitly exclude any allegation contained herein that could be construed to allege intentional or reckless conduct."); *In re Prison Realty Sec. Litig.*, 117 F.

[10] Memorandum of Law of Certain Individual Defendants, Delphi Trust I, and Delphi Trust II in Support of Their Motion to Dismiss the Consolidated Class Action Complaint (the "Individual Def. Br.") at 37; Defendant Deloitte & Touche's Memorandum of Law in Support of its Motion to Dismiss the Consolidated Complaint (the "Deloitte Br.") at 17; Defendant Alan Dawes' Memorandum of Law in Support of His Motion to Dismiss the Consolidated Class Action Complaint (the "Dawes Br.") at 19. Defendant Dawes incorporates the Individual and Trust Defendants' argument by reference, but does not argue the point independently.

Supp. 2d 681, 687 (M.D. Tenn. 2000) (because plaintiffs exclude any allegations of fraud from their § 11 claims, there is no need to plead those claims according to Rule 9(b)).[11]

In finding that Rule 9(b) did not apply to plaintiffs' § 11 and § 12(a)(2) claims, the court in *In re Sirrom Capital Corp. Sec. Litig*, 84 F. Supp. 2d 933 (M.D. Tenn. 1999), stated:

> Plaintiffs' Section 11 claims do not mention fraud, except to expressly exclude any allegations which might sound in fraud... Since fraud is not a necessary element of a Section 11 claim, and the Court cannot read it into the statute, it need not be pleaded pursuant to Rule 9(b) in Plaintiffs' Section 11 claim.

Id. at 938. Similarly, in *Consumers Power*, the court rejected defendants' argument that plaintiffs' § 11 claims sounded in fraud "because they incorporate by reference the prior allegations of the complaint, which include allegations of fraud." The court held:

> It is true that the recitation of facts at the beginning of the complaint contains a mixture of allegations of negligence, fraud, and the misleading nature of the offering materials. However, plaintiffs separate their claims into distinct counts at the end of the complaint. The allegations of fraud do not convert or contaminate the separate § 11 claims.

105 F.R.D. at 594. Plaintiffs' non-fraud § 11 claims here do not mention fraud, other than expressly to disclaim it. *See, e.g.*, ¶¶ 735, 753, 772.[12]

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[11] The "sounds in fraud" theory has not yet been addressed by the Sixth Circuit.

[12] Casting about for Sixth Circuit "sounds in fraud" precedent, Defendants cite inapposite cases that fail to provide any insight into this issue. *See* Individual Def. Br. at 37; Deloitte Br. at 17. *Benoay v. Decker* does not apply the sounds in fraud theory and contains no § 11 claims. 517 F. Supp. 490 (E.D. Mich. 1981). *Benoay* has a single sentence stating that Rule 9(b) applies to fraud claims brought via the 1933 and 1934 Acts, but offers no elaboration, explanation or authority for this pronouncement. *Id.* at 492. *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101 (W.D. Mich. 1996), is likewise devoid of any sounds in fraud theory application or analysis. The *Picard* court offers no explanation or authority for its one sentence statement that Rule 9(b) applies to § 11 claims save for a lone Third Circuit case, which contained only fraud allegations and which has been recently clarified by the Third Circuit in *Suprema*, and a Sixth Circuit district court case which, in fact, holds exactly the opposite – that Rule 9(b) has no application to § 11 claims whatsoever. *Id.* at 1115 (*citing Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992) and *Consumers Power*, 105 F.R.D. at 594); *but see Consumers Power*, 105 F.R.D. at 594-95 (Rule 9(b) does not apply to § 11 claims). Three other Sixth Circuit cases, relied upon by Deloitte, are also easily distinguishable, as none involve § 11 claims, and all were pleaded with express allegations of intent. Deloitte Br. at 18-19. In *Brege v. Lakes Shipping Co., Inc.*, 225 F.R.D. 546 (E.D. Mich. 2004), the court applied Rule 9(b) to a counterclaim of unjust enrichment because the claimants alleged a mental state of knowledge. Further, the *Brege*

(Cont'd)

Other circuits have rejected the sounds in fraud theory. In *In re NationsMart Corp., Sec. Litig.*, 130 F.3d 309 (8th Cir. 1997), the Eighth Circuit held that plaintiffs did not have to plead § 11 and § 12 claims with particularity because they "expressly disavow[ed] any claim of fraud in connection with the § 11 and § 12(a)(2) counts." *Id.* at 315. In the most recent appellate case to examine the sounds in fraud theory, the Third Circuit held that explicit and clear pleading defeats sounds in fraud objections. *Suprema*, 438 F.3d at 273. In *Suprema,* plaintiffs alleged both § 11 and § 10(b) claims and alleged at the outset of the complaint that the case arose out of a "massive accounting fraud." *Id.* at 271-72. Nevertheless, the Third Circuit rejected defendants' sounds in fraud arguments, holding that Rule 9(b) did not apply to plaintiffs' § 11 claims because plaintiffs "expressly disavowed" preceding allegations of fraud, and pled the negligence claims "distinctly in the complaint from the fraud-based claims." *Id.* at 273-74.[13] The Third Circuit further held that even when § 11 and § 10(b) claims are not separated, or are inartfully set forth, the § 11 claims are not subject to Rule 9(b) where they are "sufficient to give notice to defendants of the claims against them." *Id.* at 273. As in *Suprema,* Plaintiffs expressly

court clearly limited its application of Rule 9(b) to fraud allegations, saying "to require non-fraud allegations to be stated with particularity merely because they appear in a complaint alongside fraud averments, however, serves no similar reputation-preserving function, and would impose a burden on plaintiffs not contemplated by the notice pleading requirements of Rule 8(a)" (citation omitted). Similarly, in *Tramontana v. May*, Nos. 02-10012-BC, 02-10234-BC, 2004 WL 539065, at *5-6 (E.D. Mich. Mar. 16, 2004), the court applied Rule 9(b) because plaintiffs based claims of fraudulent inducement, breach of fiduciary duty, and civil conspiracy on express allegations of knowledge, intent, and reckless disregard. The *Tramontana* court was also careful to state that non-fraud allegations were not subject to Rule 9(b). In *Krieger v. Gast*, No. 4:99-CV-86, 2000 WL 288442 (W.D. Mich. Jan. 21, 2000), the court applied Rule 9(b) to claims of breach of fiduciary duty, aiding and abetting, and conspiracy because the plaintiffs expressly alleged intent to defraud. These cases are inapposite to Plaintiffs' § 11 claims, which are pled as negligence claims and which lack any allegation of culpable mental state.

[13] In making this finding, the Third Circuit specifically stated "[a] contrary result would effectively preclude plaintiffs from filing suit under § 11 and § 12(a)(2) as well as § 10(b)(5). There is no suggestion that Congress intended such an incongruous approach." *Id.* at 275.

disclaim fraud and separate the § 11 and § 10(b) claims into distinct counts. *See* ¶¶ 10, 735, 753, 772.[14]

Plaintiffs' precise wording of Counts VIII, XI, and XIV underscores that the § 11 claims sound in negligence, not fraud. First, Plaintiffs allege that offering materials for the July 2003, Trust I and Trust II Offerings "were false and misleading, contained untrue statements of material fact and omitted to state facts necessary in order to make the statements made therein not misleading," (¶¶ 737, 755, 774), tracking § 11 almost verbatim. *See* 15 U.S.C. § 77k(a).[15]

Second, Counts VIII, XI, and XIV specifically do not allege that the Individual and Trust Defendants or Deloitte knowingly or recklessly deceived, manipulated, or defrauded Plaintiffs in issuing the July 2003, Trust I and Trust II Offerings. Rather, Plaintiffs allege that the Individual Defendants were signatories to the offering materials, and that Deloitte consented to the incorporation of its unqualified audit opinions. ¶¶ 738-39, 756-57, 775-76. Because they lack the language of mental state that distinguishes securities fraud claims from negligence claims, these allegations cannot sound in fraud.

In their attempt to have the Court graft a heightened Rule 9(b) pleading standard onto Plaintiffs' non-fraud § 11 claims, the Individual and Trust Defendants and Deloitte misconstrue the principal case cited in support of their argument. Specifically, *Rombach* did not, as Defendants incorrectly suggest (Deloitte Br. at 19; Individual Def. Br. at 37), hold that a § 11

[14] The Individual and Trust Defendants cite to these paragraphs for the proposition that "the substance of [Plaintiffs'] Section 10(b) claims is incorporated wholesale into the Section 11 claims." Individual Def. Br. at 38. In fact, the opposite is true, which the Individual and Trust Defendants (and Deloitte) concede when they note that Plaintiffs disclaim allegations of fraud in their § 11 claims. Individual Def. Br. at 38; Deloitte Br. at 18.

[15] The language in Counts VIII, XI and XIV also mirrors the language used by the plaintiffs in *NationsMart,* where the Eighth Circuit rejected defendants' "sounds in fraud" argument.

claim sounds in fraud whenever plaintiffs allege a registration contained "untrue statements of material facts." Indeed, were this the case, **every** § 11 claim would sound in fraud.[16] Rather, *Rombach* holds that where plaintiffs fail to differentiate or separate their negligence and fraud claims, they "are subject to the test of Rule 9(b)." *Rombach*, 355 F.3d at 171.[17] The *Rombach* plaintiffs based both their fraud and negligence claims on the dissemination of the same registration statement and they also incorporated wholesale the allegations in their § 11 count into the allegations of their § 10(b) count. *Id.* at 175.[18] By contrast, Plaintiffs here have separately pleaded § 11 and § 12(a)(2) claims as to the July 2003, Trust I and Trust II Offerings, and did not incorporate the fraud claims into the § 11 claims. ¶¶ 10, 735, 753, 772. Defendants' reliance on *Rombach* is misplaced: Plaintiffs' non-fraud § 11 claims do not sound in fraud.[19]

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[16] The contradiction inherent in such a blanket reading of *Rombach* has been pointed out by a noted commentator: "This statement [that the wording of the *Rombach* complaint is associated with fraud] ignores that the essence of [a] Section 11 claim is 'an untrue statement of a material fact... required to be stated therein or necessary to make the statements therein not misleading'... Section 11 was structured in this manner to avoid the common law concept of fraud and deceit." Harold S. Bloomenthal & Samuel Wolff, *Second Circuit Adopts "Sound in Fraud" with a Twist*, 3C Sec. & Fed. Corp. Law § 16:119 (2d ed. 2006).

[17] Moreover, *Rombach* suggests that plaintiffs should have an opportunity to cure § 11 claims that might sound in fraud. The court notes that if not for other fatal defects in plaintiffs' negligence claims, "we might well affirm the dismissal with a direction to the district court to entertain a motion to re-plead in terms of negligence." 355 F.3d at 176. Thus, should the Court find that Plaintiffs'§ 11 claims sound in fraud, Plaintiffs respectfully request an opportunity to amend the Complaint and re-plead in clearer terms of negligence.

[18] The Individual and Trust Defendants and Deloitte also neglect to mention that the *Rombach* court found that certain of plaintiffs' § 11 counts – despite being based on allegations of "untrue statements of material fact" – sounded in negligence, and thus were not subject to the heightened pleading requirements of Rule 9(b). *Rombach*, 355 F.3d at 178. Accordingly, *Rombach* does not stand for the blanket principle that a § 11 claim automatically sounds in fraud whenever plaintiffs plead "untrue statements of material facts."

[19] The Individual and Trust Defendants rely on several other cases for the proposition that the § 11 claims sound in fraud. All are inapposite. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005), follows *Rombach* in subjecting § 11 claims to Rule 9(b). However, as was the case in *Rombach*, the *Alstom* complaint commingled its claims, "incorporating [into the negligence counts] all of their preceding allegations of fraud and fraudulent motive." *Id.* By contrast, Plaintiffs here distinguish their fraud claims from their non-fraud § 11 claims at the outset of the Complaint and then, later in the Counts section, expressly separate the preceding fraud allegations from the non-fraud § 11 claims. Defendants also rely on *In re Ultrafem Inc. Sec. Litig.*, 91 F. Supp. 2d 678 (S.D.N.Y. 2000), cited in *Rombach*. However, the allegations in *Ultrafem* differ from those supporting Plaintiffs' § 11 claims in that the *Ultrafem* plaintiffs expressly accused defendants of "intent to defraud upon which plaintiffs relied." *Id.* at 691.

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C. Plaintiffs' Non-Fraud § 11 Claims Should Be Sustained Even If They Are Found to Sound in Fraud

Even if the Court were to find that Plaintiffs' non-fraud § 11 claims are subject to Rule 9(b), the appropriate "remedy would be to strip any allegations of fraud from the claims." *Prison Realty*, 117 F. Supp. 2d at 689. Courts in this Circuit have held that, if § 11 claims sound in fraud, the fraud allegations should be read out of the § 11 claims:

> The only consequence of a holding that Rule 9(b) is violated with respect to a § 11 claim would be that any allegations of fraud would be stripped from the claim. The allegations of innocent or negligent misrepresentation, which are at the heart of a § 11 claim, would survive. The plaintiffs' case should not have been dismissed because they alleged more than was necessary to recover under § 11 of the Securities Act.

Sirrom Capital, 84 F. Supp. 2d at 938-39 (citing *NationsMart*, 130 F.3d at 315). These courts have adopted the Eighth Circuit's approach to "strip" allegations of fraud out of § 11 claims. Specifically, in *NationsMart*, the Eighth Circuit rejected the sounds in fraud theory, but held that the only consequence of alleging fraud in a § 11 claim "would be that any allegations of fraud would be stripped from the claim." *Id.* at 315.[20] This approach recognizes that § 11 claims impose liability on negligence, and it would be inappropriate to import a particularity requirement without substantively changing the relevant pleading standard.

Even assuming, *arguendo*, that the Court were to conclude that these claims sound in fraud and must satisfy Rule 9(b), the Complaint easily meets that standard. Under Rule 9(b),

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Nowhere in the non-fraud § 11 claims do Plaintiffs allege that Defendants acted with a culpable mental state. Moreover, the *Ultrafem* court declined to apply Rule 9(b) to § 11 and § 12 claims that did not allege a mental state of fraudulent intent. *Id.* Likewise, *In re American Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424 (S.D.N.Y. 2000), applied Rule 9(b) to some § 11 claims because they alleged "fraudulent intent," but declined to apply Rule 9(b) to others, because they disavowed fraud and lacked allegations of fraudulent intent. *Id.* at 439-40.

[20] The Fifth and Ninth Circuits employ the identical remedy. *See Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 368 (5th Cir. 2001); *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1104-05 (9th Cir. 2003); *see also In re Tycom Ltd.*, No. 03-CV-1352-PB, MDL 02-MDL-1335-PB, 2006 WL 39237, at *1 (D.N.H. Jan. 6, 2006).

particularity is defined as the "the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990); *see* ¶¶ 409-15 (detailing untrue statements in connection with July 2003 Offering and circumstances of Individual and Trust Defendants' and Deloitte's making of those statements); ¶¶ 424-30 (same *per* the Trust I Offering); ¶¶ 431-41 (same *per* the Trust II Offering). Thus, Defendants' arguments that Plaintiffs' § 11 claims do not meet the heightened pleading standard are baseless.

Lastly, the Court should reject Defendants' contention that if Rule 9(b) applies to Plaintiffs' non-fraud § 11 claims, then Plaintiffs must allege scienter with particularity in their § 11 claims. Individual Def. Br. at 39; Deloitte Br. at 19-20.[21] The sounds in fraud theory merely provides that § 11 claims based on allegations of fraud must be pleaded with particularity; it does not interpose new elements such as scienter that the statute itself does not require. *See In re Friedman's, Inc. Sec. Litig.*, 385 F. Supp. 2d 1345, 1367 (N.D. Ga. 2005). The Underwriters disagree with the Individual and Trust Defendants' and Deloitte's scienter argument to such an extent that they actually contradict it: "Section 11 and 12 claims, in contrast, are grounded in strict liability or negligence and do not require a showing of fraudulent intent."[22]

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[21] Inexplicably, Deloitte attempts to marshal support from several cases that, rather than address § 11 claims that sound in fraud, involve, respectively, (1) a common law claim of fraudulent misrepresentation, (2) a common law fraud claim, and (3) a claim under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. 1961 *et seq.* ("RICO"), based on mail and wire fraud. Deloitte Br. at 19-20 (citing to (1) *Coffey v. Foamex L.P.*, 2 F.3d 157, 162 (6th Cir. 1993); (2) *Yadlosky v. Grant Thornton, L.L.P.*, 120 F. Supp. 2d 622, 635 & n.1 (E.D. Mich. 2000); (3) *DeLorean v. Cork Gully*, 118 B.R. 932, 940 (E.D. Mich. 1990)). Clearly, scienter is an element of fraud claims, so these cases, which all involve fraud claims, do not prove that Plaintiffs' § 11 negligence claims, if they sound in fraud, would require allegations of scienter. For their part, Individual and Trust Defendants point to a case that misreads *Rombach* as requiring scienter. Individual Def. Br. at 39 (citing *In re JP Morgan Chase Sec. Litig.*, 363 F. Supp. 2d 595, 635 (S.D.N.Y. 2005)).

[22] *See* Memorandum of Law of Defendants Bank of America Securities, LLC, Barclay's Capital, Inc., Bear, Stearns & Co. Incorporated, Citigroup Global Markets, Credit Suisse Securities (USA) LLC (f/k/a Credit Suisse First Boston Corporation), Merrill Lynch, Pierce, Fenner & Smith Incorporated, Morgan Stanley & Co. Incorporated,
(Cont'd)

As a final matter, Plaintiffs note the Sixth Circuit's policy of reading the particularity requirement of Rule 9(b) in conjunction with the liberal notice pleading requirement of Rule 8:

> Indeed, Rule 9(b)'s particularity requirement does not mute the general principles set out in Rule 8; rather, the two rules must be read in harmony… "Thus, it is inappropriate to focus exclusively on the fact that Rule 9(b) requires particularity in pleading fraud. This is too narrow an approach and fails to take account of the general simplicity and flexibility contemplated by the rules."

Michaels Bldg. Co. v. Ameritrust Co., 848 F.2d 674, 679 (6th Cir. 1988) (citations omitted).

D. The Complaint Properly Asserts Securities <u>Act Claims with Respect to Each Offering</u>

A lead plaintiff need not have purchased every type of security at issue in order to prosecute each particular claim that a class may be able to assert. To require otherwise would ignore the very purpose of the lead plaintiff provision of the PSLRA. Nevertheless, against the clear mandate of the PSLRA, Defendants claim Lead Plaintiffs lack standing to bring their Securities Act claims because they did not purchase securities in each offering. Individual Def. Br. at 32-33; Underwriters Br. at 15-17; Dawes Br. at 19; Brief in Support of Defendant Paul R. Free's Motion to Br. ("Free Br.") at 1. The law is plainly to the contrary.[23] Nothing in the PSLRA requires a lead plaintiff to possess every claim relating to every security at issue in a case. *See In re Initial Pub. Offering Sec. Litig.,* 214 F.R.D. 117, 123 (S.D.N.Y. 2002) (*"IPO"*) (under the PSLRA "[i]t stands to reason that in many cases… the plaintiff with the largest financial interest may not have standing to sue on all causes of action."). Having been appointed

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UBS Securities LLC and Wachovia Capital Markets, LLC in Support of Their Motion to Dismiss the Consolidated Class Action Complaint (the "Underwriters Br.") at 10.

[23] Defendants' vainly attempt to bootstrap the PSLRA's certification requirement into a standing issue. This merit-less argument is also moot as Plaintiffs are filing simultaneously with this Memorandum certifications of the named plaintiffs, Norman Rosencrantz and Ronald Lee Wasserman Sr., who acquired securities in the July 2003 and Delphi Trust I Offerings. *See* Exhibit A to the Yarnoff Decl.

to lead this litigation, Lead Plaintiffs have standing to assert Securities Act claims on behalf of purchasers of all of Delphi's securities.

Courts repeatedly find that a plaintiff who purchased only one type of security has standing to represent **all** class members when, as here, the Securities Act claims arise out of a common course of conduct. *See, e.g., WorldCom,* 294 F. Supp. 2d at 422 (lead plaintiff could, by designating additional class representatives to be tested at the class certification stage, assert all claims held by the class); *IPO*, 214 F.R.D. at 123 n.8 (standing issue premature until class certification stage); *Newby v. Enron Corp.,* 206 F.R.D. 427, 445 (S.D. Tex. 2002) ("there is no requirement that the claims of all plaintiffs and class members must be identical," and "courts have repeatedly concluded that stock purchasers can represent purchasers of debt instruments and vice versa in the same action.").

Moreover, this issue is at best a class certification issue, not a standing issue and, thus, it is not ripe for decision. None of the cases on which Defendants rely holds that Plaintiffs must have purchased every security at issue to have standing at the pleading stage. In fact, two such cases specifically found this to be an issue for class certification, not the motion to dismiss. Underwriters Br. at 14-15; *Goldberger v. Bear, Stearns & Co.,* No. 98 Civ. 8677 (JSM), 2000 WL 1886605 (S.D.N.Y. Dec. 28, 2000) (at the **motion to dismiss stage**, whether plaintiffs who purchased some, but not all, of the securities at issue could represent a class of plaintiffs who purchased different securities would be resolved later, at class certification);[24] *In re Eaton Vance*

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[24] Defendants also misplace reliance on the following cases: *Lewis v. Casey*, 518 U.S. 343, 357-58 (1996) (holding, in a prisoners' rights case, that general allegations of standing by two inmates were sufficient at the pleading stage, but not at the summary judgment and trial stage); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 727, 749 (1975) (plaintiff lacked standing under 10b-5(b) where not purchaser of **only** security at issue in the case); *Mezibov v. Allen*, 411 F.3d 712, 720-21 (6th Cir. 2005) (no cognizable action for attorney's generalized claims of

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Corp. Sec. Litig., 219 F.R.D. 38, 41-42 (D. Mass. 2003) (**at class certification** plaintiffs did not meet standing requirements for some alleged claims where they had not purchased the securities at issue);

In sum, because all of the claims arise from the same common course of conduct – Delphi's long-running fraud – Plaintiffs need not have purchased securities from each of Delphi's offerings to assert claims on behalf of class members who did. Defendants' "all or nothing" standing argument would only spawn duplicative actions, an approach widely rejected, without advancing the PSLRA's purpose, or safeguarding Article III's "case or controversy" requirement. *See Weinberg v. Atlas Air Worldwide Holdings,* 216 F.R.D. 248, 254 (S.D.N.Y. 2003) ("designating multiple Lead Plaintiffs to represent each cause of action would fracture the litigation and 'obstruct any efficient and controlled process."). The same disputed issues of fact and law would be presented to multiple courts, requiring duplication of judicial effort and creating the risk of inconsistent adjudications, defeating the purpose of class action litigation.

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constitutional violations under § 1983); *In re Alcatel Sec. Litig.*, 382 F. Supp. 2d 513, 530 (S.D.N.Y. 2005) (setting forth requirement that plaintiffs must have purchased securities to have claim under § 11, but no discussion of when court must determine standing issue and no discussion of court-appointed lead plaintiffs bringing suit on behalf of all class members); *In re AOL Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 245-46 (S.D.N.Y. 2004) (finding no standing where complaint did not allege that plaintiffs suffered losses on defendant's bonds, but instead alleged that bonds purchased by plaintiffs increased in value); *In re Vivendi Universal, S.A., Sec. Litig.*, 381 F. Supp. 2d 158, 172-73 (S.D.N.Y. 2003) (finding no standing where plaintiffs asserted claims based on a non-defective registration statement); *In re Empyrean Bioscience, Inc. Sec. Litig.*, 255 F. Supp. 2d 751, 766-67 (N.D. Ohio 2003) (finding plaintiffs do not have standing to bring § 11 claim where registration statement effected change in corporate domicile, but not sale of securities); *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 205 (S.D.N.Y. 2003) ("Lead Plaintiffs have a responsibility to identify and include named plaintiffs who have standing to represent the various potential subclasses of plaintiff who may be determined at the class certification stage."); *Snaido v. Bank Austria AG*, 174 F. Supp. 2d 159 (2001) (non-PSLRA case that did not involve court-appointed Lead Plaintiff); *Sanderson, Thompson, Ratledge & Zinny v. AWACS, Inc.* 958 F.Supp. 947, 961-62 (D. Del. 1997) (analyzing and discussing diversity of citizenship jurisdiction); *Picard Chemical Inc. Profit Sharing v. Perrigo Co.*, 940 F.Supp. 1101 (W.D. Mich. 1996) (does not discuss standing issue); *Ramos v. Patrician Equities Corp.*, 765 F. Supp. 1196, 1199 (S.D.N.Y. 1991) (finding no standing where plaintiffs did not invest in all partnerships at issue and complaint did not allege partnership claims arose out of a conspiracy or common scheme to defraud). Individual Def. Br. at 32-34; Underwriters Br. at 14-15. Thus, these cases offer no support for Defendants' contention that Plaintiffs do not have standing to bring their Securities Act claims.

Moreover, the Complaint specifically alleges that named plaintiffs Norman Rosencrantz and Ronald Lee Wassermann, Sr. acquired 8.25% trust preferred securities in Delphi's Trust I Offering and 6.50% notes in Delphi's July 2003 Offering, respectively, and that the Securities Act claims relating to the Trust I and July 2003 Offerings are brought on behalf of these named plaintiffs, as well as other persons who purchased or otherwise acquired the 8.25% trust preferred securities and the 6.50% notes "pursuant or traceable to these offerings." ¶¶ 21-22, 736, 741, 743, 746, 754, 759, 761, 764. The Complaint also alleges that the registration statements, prospectus and prospectus supplements filed with the Trust I and July 2003 Offerings were materially false and misleading. ¶¶ 409, 414, 415, 424, 427, 430. Contrary to Defendants' contentions, Plaintiffs have alleged that they acquired the aforesaid securities pursuant to false registration statements, and need allege no more under § 11. *See In re Global Crossing, Ltd. Sec. Litig.,* 313 F. Supp. 2d 189, 208 (S.D.N.Y. 2003) ("the pleading requirement is not elaborate.... [G]eneral allegations that plaintiff purchased 'pursuant to' or traceable to a false registration statement have been held sufficient to state a claim."). Similarly, Plaintiffs have adequately alleged, under § 12(a)(2), that they acquired their securities pursuant to materially false and misleading prospectuses. *See In re USA Classic Sec. Litig.,* No. 93 Civ. 6667, 1995 WL 686724, at *3 (S.D.N.Y. June 19, 1995) (allegation that plaintiff purchased stock "pursuant to the Registration Statement and Prospectus" is sufficient to state a claim under § 12(a)(2), and it is unnecessary, in light of such allegation to decide "when an initial public offering ends and a secondary market transaction begin.").[25]

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[25]Accordingly, Defendants misplace reliance on *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 578 (1995). Underwriters Br. at 16-17. In *Gustafson*, the Supreme Court concluded that liability under § 12(a)(2) is limited to

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E. Counts V and VI Are Not Barred by the Statute of Limitations

Defendants have asserted statute of limitations defenses to the Securities Act claims arising out of Delphi's June 2001 Offering. Individual Def. Br. at 35-36; Underwriter Br. at 8-11; Deloitte Br. at 20; Dawes Br. at 19; Free Br. at 1.[26] These claims are timely, however, because they are governed by the limitation period enacted under SOX.

SOX § 804, entitled "Statute of Limitations for Securities Fraud," provides:

> [A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the [Exchange Act] [15 U.S.C. § 78c(a)(47)], may be brought not later than the earlier of—(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.

28 U.S.C. § 1658(b). SOX § 804 thus extends limitations for securities claims involving "fraud, deceit, manipulation, or contrivance" from one year from discovery and three years from the conduct, as provided by the Supreme Court in *Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson,* 501 U.S. 350, 364 (1991), to two years from discovery and five years from the conduct. Since Plaintiffs' claims relating to the June 2001 Offering explicitly incorporate allegations of fraud and deceit (¶¶ 718, 724), they are subject to the SOX § 804 statute of limitations. Nevertheless, Defendants argue that § 13 provides the statute of limitations for all § 11 and § 12(a)(2) claims, even those affirmatively alleging fraud.[27] As noted above, the

public offerings. Courts interpreting *Gustafson* have held that § 12(a)(2) extends to aftermarket trading of a publicly offered security, so long as that aftermarket trading occurs "by means of a prospectus." *Feiner v. SS&C Tech., Inc.*, 47 F. Supp. 2d 250, 253 (D. Conn. 1999); *see also Laser Mortg. Mgmt. v. Asset Securitization Corp.*, No. 00 Civ. 8100 (NRB), 2001 WL 1029407, *8 (S.D.N.Y. Sept. 5, 2001) ("*Feiner*... notes that *Gustafson* drew a distinction between public offerings and private ones, not between public offerings and aftermarket purchases").

[26] Deloitte, Dawes and Free incorporate by reference the arguments of Individual and Trust Defendants.

[27] Section 13 of the Securities Act requires that claims under § 11 and § 12(a)(2) be brought (a) "within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable due diligence," or (b) within three years of the offering or sale. 15 U.S.C. § 77m.

Underwriters argue that § 11 and § 12(a)(2) claims are "strict liability" claims that do not require fraudulent intent. Underwriters Br. at 10. However, while § 11 and § 12(a)(2) may not **require** pleading "deceit, manipulation, and contrivance," plaintiffs can **choose** to do so.[28]

SOX § 804 applies the two/five-year limitations period to claims of "fraud, deceit, manipulation or contrivance," infringing the "securities laws," defined in § 3(a)(47) of the Exchange Act to "mean[] the Securities Act of 1933, [and] the Securities Exchange Act of 1934." Thus, § 804's applicability turns solely on culpability of conduct.[29]

In arguing that SOX § 804 does not apply, Defendants rely on cases with clearly distinguishable facts. In those cases, however, the plaintiffs did not affirmatively plead § 11 or § 12(a)(2) claims that involved "deceit, manipulation or contrivance." Thus, the question presented is one of first impression: may a plaintiff **opt** to plead § 11 and § 12(a)(2) claims to involve "deceit, manipulation or contrivance" and plead those claims to meet a tougher pleading standard, in exchange for the benefit of the extended statute of repose provided in § 804?

Defendants sidestep this question. Instead, they direct the Court to inapposite cases in which the plaintiffs did **not** plead "deceit, manipulation or contrivance" in their complaints. Rather, in those cases, plaintiffs only argued that their § 11 or § 12(a)(2) claims involved manipulation, deceit or contrivance after defendants moved to dismiss. Those decisions rested, in part, on the fact that plaintiffs initially **expressly disavowed fraud** in connection with their

[28] Courts recognize that plaintiffs can choose to plead Securities Act claims as fraud claims if, as here, the violations did not come to light for years due to such deceit, manipulations and contrivance and, in turn, Plaintiffs meet the heightened pleading standards that are triggered by such pleading.

[29] If Congress desired that § 804 be limited to § 10(b) and Rule 10b-5 claims, then Congress could have worded the statute to reflect that intention. Instead, Congress wrote the statute to apply to Securities Act claims, provided that they involve claims of fraud, deceit, manipulation or contrivance.

§ 11 or § 12(a)(2) claims. *See Alstom*, 406 F. Supp. 2d at 410 ("after incorporating all of their preceding allegations of fraud and fraudulent motive by reference, [plaintiffs] seek to 'specifically exclude' any claims of fraud from those counts, acknowledging that scienter or fraudulent intent is not an element of a claim under Sections 11, 12(a)(2) or 15"); *Global Crossing,* 313 F. Supp. 2d at 197 n.4; *WorldCom,* 294 F. Supp. 2d at 441. In fact, the court in *WorldCom* suggested that, had the complaint there not expressly disavowed pleading § 11 claims "in fraud," the extended SOX repose provision may have applied to those claims. 294 F. Supp. 2d at 441-42.[30]

Defendants also contend that Plaintiffs have not alleged their claims relating to the June 2001 Offering with sufficient particularity. *See* Individual Def. Br. at 31, 38-39; Underwriter Br. at 12-13; Deloitte Br. at 19-20. To the contrary, the Complaint is replete with detailed facts that meet the requirements of Rule 9(b). Rule 9(b) applies to "averments of fraud or mistake," and requires that the circumstances of the fraud or mistake – "the who, what, when, where, and how" – be stated with particularity. *DiLeo*, 901 F.2d at 627. Plaintiffs satisfy that standard.[31] The Complaint sets forth the specific circumstances of numerous false and misleading statements by Individual and Trust Defendants, Underwriters, and Deloitte. Further, these allegations also

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[30] As Judge Cote wrote, "[t]here are advantages to bringing solely strict liability and negligence claims[, namely that] the pleading and proof thresholds are far lower than for claims asserting securities fraud, and the liability is 'extensive.'" *WorldCom,* 294 F. Supp. 2d at 444. The court stated that the "disadvantage[] of bringing negligence claims, however, is a more narrow window of time in which to sue." *Id.*

[31] Defendants also argue that Plaintiffs have failed to plead facts demonstrating compliance with the statute of limitations. *See* Individual Def. Br. at 35; Underwriters Br. at 9-10; Deloitte Br. at 20. Defendants are incorrect. The Complaint sufficiently alleges facts demonstrating compliance with the statute of limitations. Specifically, the Complaint clearly alleges that the untruths incorporated into the registration statement for the June 2001 Offering were not revealed until March 2005. ¶¶ 209-14. Inasmuch as that description of the fraud's revelation makes "distinct averments as to the time when the fraud, mistake, concealment, or misrepresentation was discovered," Plaintiffs have pleaded compliance with the five year statute of repose. *Armstrong v. McAlpin*, 699 F.2d 79, 89 (2d Cir. 1983) (quoting Judge Friendly in *Moviecolor Ltd. v. Eastman Kodak Co.*, 288 F.2d 80, 88 (2d Cir. 1961)).

meet the relevant standard for pleading fraud; the quantity and degree of the fraudulent disclosures connected with the June 2001 offering strongly suggest knowledge, or at a minimum, recklessness on the part of all associated Defendants.[32] *See Helwig*, 251 F.3d at 553.

For example, the Complaint alleges that the Individual and Trust Defendants signed and disseminated the June 2001 Registration Statement, which incorporated false and misleading statements, including that, for 2000, Delphi had "in excess of $29 billion" in revenue, operating income of $1.7 billion, net income of $1.1 billion and earnings per share of $1.94. ¶¶ 299, 304, 720. Further, the Complaint alleges that the Individual Defendants, as officers and directors of Delphi, orchestrated and participated directly in Delphi's fraud, including its sham transactions with Bank One, Setech and BBK, and its improper accounting for warranty payments to GM, which inflated the financial results used to sell the June 2001 Offering. ¶¶ 614-15, 625-29.

Similarly, the Complaint alleges that Deloitte knowingly consented to the incorporation of its unqualified audit opinion for Delphi's 2000 financial statements into the June 2001 Registration Statements. ¶¶ 302-03. The Complaint also alleges that Deloitte recklessly audited Delphi's 2000 financial statements, turning a blind eye to red flags indicative of Delphi's widespread fraud, including, among others, Delphi's internal control deficiencies; management compensation tied to specific financial metrics and huge annual bonuses for achieving such targets; intentional inconsistent accounting treatment by Delphi and GM of a $237 million warranty payment; and large transactions not in the ordinary course of business, such as Delphi's sham transactions with Bank One, Setech and BBK, reversed in relatively short periods of time, which inflated Delphi's quarterly and annual income. ¶¶ 303, 550-52, 554-55.

[32] Plaintiffs' fraud-based allegations are outlined in greater depth in the 10(b) portion of the brief, *infra*.

Finally, the Complaint alleges that Bear, Stearns and Credit Suisse First Boston acted as the joint bookrunners and lead underwriters of the 2001 Bond Offering. ¶¶ 300, 722, 727. As sophisticated banks vastly experienced in securities offerings, Bear, Stearns and Credit Suisse First Boston knew, or recklessly disregarded, that Delphi reported huge and increasing profits when the rest of the auto industry was faltering. ¶¶ 103-09. For these reasons, Defendants' particularity argument as to Counts V and VI must fail.

F. <u>Plaintiffs Adequately Allege Damages Pursuant to §§ 11 and 12(a)(2)</u>

The Underwriters argue that Plaintiffs fail to plead loss or damages and that this failure "is fatal to all of their claims against the Underwriter Defendants." Underwriters Br. at 19. Not so. Plaintiffs have amply satisfied the minimal pleading requirement for claims under § 11 and § 12(a)(2).

As the Underwriters concede (Underwriters Br. at 18-19), questions as to whether claims under § 11 and § 12(a)(2) adequately allege a loss are governed by the notice pleading standard of Rule 8. *Conley,* 355 U.S. at 47. With respect to the claims under § 11 and § 12(a)(2), Plaintiffs allege that the value of Delphi's securities dropped when the economic risks concealed by Delphi's wrongful conduct materialized, and Plaintiffs suffered damage as a result. This satisfies Rule 8, which, as the Underwriters admit, only requires "a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss." Underwriters Br. at 19 (citing *Dura Pharm., Inc. v. Broudo*, 125 S. Ct. 1627, 1634 (2005)).

Additionally, the Underwriters, Individual and Trust Defendants and Deloitte argue that, because Plaintiffs did not submit certifications showing that they sold bonds purchased from the July 2003 and Trust I Offerings at a loss, Plaintiffs have not sufficiently alleged that they were damaged.[33] Underwriter Def. Br. at 19-20; Individual Def. Br. at 34; Deloitte Br. at 20; Dawes Br. at 19. This argument rests on a false assumption. Indeed, while Plaintiffs do not allege that they sold their securities at a loss, this is not required at the **pleading** stage in order to sustain § 11 and § 12(a)(2) claims. As the Individual Defendants concede, "'a plaintiff has no obligation to plead damages under Section 11 of the Securities Act.'" Individual Def. Br. at 33-34 (quoting *In re AOL Time Warner, Inc. Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 246 (S.D.N.Y. 2004)); *see also In re Initial Public Offering Sec. Litig.* (*"IPO"*), 241 F. Supp. 2d 281, 347 n.76 (S.D.N.Y. 2003); *Adair v. Kaye Kotts Assoc. Inc.*, No. 97 CIV. 3375(SS), 1998 WL 142353, at *7 (S.D.N.Y. March 27, 1998).

In fact, Section 11 itself defines the measure of recoverable damages:

> The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security . . . and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought.

15 U.S.C. § 77k(e). Here, Plaintiffs plainly allege they were damaged by the diminishment in the value of their Delphi securities. ¶ 671 (Defendants' conduct "caused the price of Delphi's securities to be inflated artificially when members of the Class purchased these securities. As the truth about Delphi's actual financial condition was gradually revealed, the inflation caused by these misrepresentations was methodically eliminated by the price of Delphi's securities"); *see*

[33]Certifications for named plaintiffs, Norman Rosencrantz and Ronald Lee Wasserman Sr., are attached as Exhibit A to the Yarnoff Decl.

also ¶¶ 723, 729, 734, 741. The Complaint gives Defendants notice of the claims and damages suffered - enough for pleading damages for purposes of Plaintiffs' § 11 and § 12(a)(2) claims.[34]

Finally, it is undisputed that neither § 11 nor § 12(a)(2) requires Plaintiffs to plead loss causation. Under these provisions, loss causation is not an element of the claim; instead, the absence of loss causation is an affirmative defense, *see* 15 U.S.C. §§ 77k(e), 77l(b), which cannot be asserted on a motion to dismiss. *See In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354, 365 (D.N.J. 1999); *Adair v. Bristol Tech. Sys.*, 179 F.R.D. 126, 135 (S.D.N.Y. 1998).

II. THE COMPLAINT STATES PRIMARY CLAIMS UNDER THE SECURITIES EXCHANGE ACT

A. The Pleading Requirements for Claims Under Rule 10b-5

While the PSLRA heightened the pleading standards for fraud under Rule 10b-5, it did not eliminate the deference usually accorded to plaintiffs' allegations in deliberation of Rule 12(b)(6) motions to dismiss. Plaintiffs are not subject to some Herculean standard whereby they must plead detailed evidence and reveal confidential sources to satisfy Rule 9(b) and the PSLRA. The PSLRA does not "convert such a motion into some sort of a preliminary summary judgment motion in which the parties compare their respective collections of supporting facts and inferences." *In re Unumprovident Corp. Sec. Litig.*, 396 F. Supp. 2d 858, 878 (E.D. Tenn. 2005).

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[34] In the cases cited by the Underwriters in which a § 11 claim was dismissed under Fed. R. Civ. P. 12(b)(6), the reason for dismissal was that it was plain from the pleadings that the plaintiffs' securities had appreciated in value at the time the plaintiffs commenced suit and thus the statutory damages were unavailable. *See, e.g., In re Broderbund/Learning Co. Sec. Litig.*, 294 F.3d 1201, 1204 (9th Cir. 2002) ("Because Wolfe had disposed of his stock, it seems logical to apply § 77k(e)(2), and when we do so it becomes apparent that there was no loss whatsoever; rather, there was a tremendous gain"); *AOL Time Warner*, 381 F. Supp. 2d at 246-47 ("The AOLTW bonds issued in April 2001 and April 2002 both traded above their offering prices on April 15, 2003, the date the underwriter defendants were added to this lawsuit."); *IPO*, 241 F. Supp. 2d at 347 ("Defendants are correct, however, in arguing that all Section 11 claims brought by Plaintiffs who sold securities at prices *above* the offering price must be dismissed because these Plaintiffs have no damages"). The Underwriters do not argue – nor can they – that the Complaint establishes that the securities at issue had appreciated in value at the time this lawsuit was commenced.

Within the confines of the standard of review established by Rule 12(b)(6), the Court must determine whether Plaintiffs have pled the elements of fraud under Rule 10b-5 with the "particularity" required by Rule 9(b) and PSLRA. *See Bovee v. Coopers & Lybrand*, 272 F.3d 356, 361 (6th Cir. 2001). In addition, the Court must determine whether Plaintiffs have satisfied the PSLRA's requirement of alleging "a strong inference of scienter" in support of their Rule 10b-5 claims. *See PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 681 (6th Cir. 2004).[35]

The "particularity" required by the PSLRA and Rule 9(b) is the "who, what, when, where, when, and how" of the fraud. *New England Health Care Employees Pension Fund v. Fruit of the Loom*, No. 1:98 CV 99, 1999 WL 33295037, at *4-5 (W.D. Ky. Aug 16, 1999). None of the Defendants seriously contends that Plaintiffs' allegations want for requisite particularity.

Scienter under Rule 10b-5 is a "mental state embracing intent to deceive, manipulate, or defraud." *Helwig,* 251 F.3d at 548 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)). This standard requires a showing of intentional wrongdoing or recklessness – "highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Id.* at 550. *Helwig* suggests that courts apply the following approach to determine whether a plaintiff's allegations give rise to a "strong inference"of scienter:

> Inferences must be reasonable and strong—but not irrefutable. "Strong inferences" nonetheless involve deductive reasoning; their strength depends on how closely a conclusion of misconduct follows from a plaintiff's proposition of fact. Plaintiffs need not foreclose all other characterizations of fact, as the task of weighing contrary accounts is reserved for the fact finder. Rather, the "strong inference" requirement means that plaintiffs are entitled only to the most plausible of competing inferences.

[35] Plaintiffs' allegations of damages, reliance, and loss causation, which are not allegations of fraud, are pled in accordance with the notice pleading requirements of Rule 8. *See, e.g., Dura,* 125 S. Ct. at 1634.

Id. at 553 (citations omitted).

Seizing on language in *Helwig*, 251 F.3d at 553, Defendants ask this Court to apply a "most plausible of competing inferences" standard. Such argument overlooks, however, that, the Sixth Circuit, *sua sponte*, has called into question (but did not resolve) the constitutional validity of this standard:

> We take no position as to the constitutionality of the Reform Act's heightened scienter pleading requirements. The Seventh Amendment to the Constitution provides that "the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any Court of the United States, than according to the rules of the common law." U.S. Const. Am. VII. Traditionally, there has been a right to jury trial for securities fraud claims. *See, e.g.*, *SEC v. Infinity Group Co.*, 212 F.3d 180, 196 (3d Cir. 2000). The Reform Act compels dismissal unless the facts pleaded in the Complaint produce a "strong inference that the defendant acted" with scienter. 15 U.S.C. § 78u-4(b)(2). **One might argue that for cases where a juror could conclude that the facts pleaded showed scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented.** However, the Retirement Fund has not advanced any such argument and we decline to address the merits of this constitutional question sua sponte.

City of Monroe Employees Retirement Sys. v. Bridgestone Corp., 399 F.3d 651, 683 n.25 (6th Cir. 2005) (emphasis added). Consequently, as at least one other Circuit Court has observed, there is serious doubt about whether this aspect of *Helwig* remains "good law."[36] The Seventh Circuit recently addressed this issue in *Makor Issue & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006):

> The Sixth Circuit has said that "the strong inference requirement creates a situation in which 'plaintiffs are entitled only to the most plausible of competing inferences,' but that it does not mandate that the inference be 'irrefutable.'" *Fidel v. Farley*.... As the Sixth Circuit itself has hinted, however, this standard could potentially infringe upon plaintiffs' Seventh Amendment rights. [citing

[36] No court in the Sixth Circuit has ruled on the constitutionality of the "most plausible of competing inferences" standard subsequent to *Bridgestone*.

> *Bridgestone,* 399 F.3d at 683 n.25] ("One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented.").
>
> While we express no view on whether the Sixth Circuit's approach is in fact unconstitutional, **we think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role. Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent.** "Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the factfinder." *Pirraglia v. Novell, Inc.,* 339 F.3d 1182, 1188 (10th Cir. 2003).

Tellabs, 437 F.3d at 601-02 (emphasis added).[37]

Lead Plaintiffs believe that this Court should allow the Complaint to survive so long as it alleges facts, if true, from which a reasonable person could infer that Defendants acted with the required intent. A "most plausible inference" standard would conflict directly with the Second Circuit, the venue where this issue will presumably be tried, and the Sixth Circuit has recognized that this view may violate the Seventh Amendment.

If the Court determines that the "most plausible of competing inferences" standard should be applied, the Complaint nevertheless meets that standard. The determination of whether the plaintiffs' allegations produce a strong inference of recklessness clearly involves a fact intensive analysis – a sifting of allegations in the complaint – to be done on a case-by-case basis. *Helwig*, 251 F.3d at 550-51. In this Circuit, a scienter determination involves a "totality of the

[37] Should this Court reject *Tellabs*' approach and choose to apply the "most plausible of competing inferences" standard set forth in *Helwig*, Plaintiffs request an opportunity to brief and argue that Seventh Amendment issue raised by *Bridgestone*.

circumstances analysis whereby the facts argued collectively must give rise to a strong inference of at least recklessness." *PR Diamonds,* 364 F.3d at 683; *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1026 (N.D. Ohio 2000).

Because the Court must consider all facts argued collectively, the Court "may and, indeed, must consider allegations of motive and opportunity in conjunction with the remainder of plaintiffs' allegations to determine whether the allegations, on the whole, raise an inference of recklessness or knowing disregard." *Telxon*, 133 F. Supp. 2d at 1028 (relying on *Comshare*); *see also Helwig*, 251 F.3d at 550-51. Indeed, although conclusory labels of motive and opportunity will not alone establish the requisite scienter, "facts presenting motive and opportunity may be of enough weight to state a claim under the PSLRA…." *Helwig*, 251 F.3d at 551. Motive is demonstrated by alleging "concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *PR Diamonds*, 364 F.3d at 690. Opportunity to commit fraud "entail[s] the means and likely prospect of achieving concrete benefits by the means alleged." *Id.*

The *Helwig* court set forth a list of nine factors to aid in the scienter determination. 251 F.3d at 552. Despite the fact that the Sixth Circuit labeled this list as "not exhaustive," "usually relevant" and merely "at least helpful" to the scienter analysis, *id.*, several Defendants argue that the absence of one, more or all nine of these factors results in a failure to plead scienter with particularity. *See, e.g.,* Individual Def. Br. at 16-19; Setech Br. at 14. This is simply wrong. In fact, subsequent Sixth Circuit authority recognizes that the absence of one or more of the *Helwig* factors does not defeat an inference of scienter. *See, e.g., PR Diamonds*, 364 F.3d at 691 (rejecting contentions that (1) absence of insider trading and (2) purchase of shares by individual defendants during class period defeats or refutes inference of scienter).[38]

B. Plaintiffs Have Stated Claims Under Rule 10b-5(a) and (c)

The Complaint alleges that the Officer Defendants, the Audit Committee Defendants, Bank One, Setech and BBK violated Rule 10b-5(a) and (c) because they were primary participants in a deceptive scheme to defraud Delphi's securities holders. ¶¶ 117-54, 688-96, 702-09. The Officer Defendants and the Audit Committee Defendants, while challenging the Complaint's allegations as to scienter, do not contest the basic proposition that the Complaint states claims against them under Rule 10b-5(a) and (c). Defendants Bank One, Setech and BBK, however, do assert that the Complaint fails to state a Rule 10b-5(a) and (c) claim. The Court should reject their attempt to drastically narrow the scope of these provisions.

1. The Complaint Alleges That Defendants Were Primary Violators of Rule 10b-5(a) and (c), Not Merely Aiders and Abettors

Rule 10b-5 makes it unlawful for any person, directly or indirectly "(a) to employ any device, scheme or artifice to defraud," or "(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." "All that is required in order to state a claim for a primary violation under Rule 10b-5(a) or (c) is an allegation that the defendant (1) committed a manipulative or deceptive act (2) in furtherance of the alleged scheme to defraud, (3) scienter, and (4) reliance." *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 336 (S.D.N.Y.

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[38] *Helwig* itself relied on only three of the nine factors - divergence between public statements and internal remarks, *id.* at 557-58; suspiciously timed insider trading by the defendants, *id.* at 558; and disregard of then current factual information. *Id.* Similarly, in *Bridgestone*, the Sixth Circuit found five *Helwig* factors supported scienter for one defendant, and four for another. The number of applicable *Helwig* factors matters less than the depth and quality of the facts evidencing the defendants' scienter.

2004); *IPO,* 241 F. Supp. 2d at 385; *In re Sterling Foster & Co., Inc. Sec. Litig.*, 222 F. Supp. 2d 289, 303-04 (E.D.N.Y. 2002).[39]

Defendants do not deny that entities such as a bank can be held liable under Rule 10b-5(a) and (c), nor could they, in light of the Supreme Court's unequivocal statement in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), that

> Any person or entity, including a . . . **bank**, who employs a manipulative device . . . may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. . . . In any complex securities fraud there are likely to be multiple violators. . . .

Id. at 191 (emphasis added). Instead, Defendants assert that the Complaint does not allege that they themselves committed the primary violation of subsections (a) and (c), but that it merely alleges that they assisted Delphi in committing the primary violation. BBK Br. at 12-14; Bank One Br. at 7-8; Setech Br. at 6. Defendants are in error.

The Complaint alleges that Bank One, BBK and Setech themselves employed manipulative and deceptive devices by acting as direct participants in the fraudulent scheme designed to move worthless or obsolete inventory and/or unneeded assets off of Delphi's books through bogus "sales" to BBK, Setech and Bank One, with undisclosed obligations on their part to reverse the transactions, *see* ¶¶ 117-54, which they, in fact, did after year-end, *see, e.g.,* ¶ 152. The scheme, in part, enabled Delphi to reduce inventory levels, an indicator scrutinized by the market, while at the same time recording one-time sales that allowed the Company to meet its earnings targets. ¶¶ 618, 622.

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[39] Significantly, in pleading a deceptive scheme claim under Rule 10b-5(a) or (c), "the level of specificity required by Rule 9(b) is somewhat relaxed" in comparison to a Rule 10b-5(b) misrepresentation claim. *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 339 (S.D.N.Y. 1999); *see also IPO,* 241 F. Supp. 2d at 335 ("Congress intended that the PSLRA supersede the Federal Rules only as to those elements which the PSLRA explicitly mentions (*i.e.*, scienter and material misstatements and omissions).").

Rule 10b-5(a) and (c) liability for participation in fraudulent schemes is not a novel concept. To the contrary, in *Benzon v. Morgan Stanley Distrib., Inc.*, 420 F.3d 598 (6th Cir. 2005), the Sixth Circuit recently affirmed that defendants can be held liable under Rule 10b-5(a) and (c) in circumstances where they did not make any misleading statement or omission and therefore could not be held liable under Rule 10b-5(b). *Id.* at 610-11.

Numerous recent decisions support such liability in circumstances directly analogous to those here. For example, as Bank One concedes (Bank One Br. at 14-15), Rule 10b-5(a) and (c) claims extremely similar to those at bar were upheld in *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002) ("*Enron I*"). Among the Rule 10b-5(a) and (c) claims upheld were claims against certain banks, including Bank One's successor, JP Morgan Chase.[40] *See also In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 310 F. Supp. 2d 819, 829-30 (S.D. Tex. 2004) ("*Enron II*") (allegations of sham $12 million transaction for purchase of Nigerian barges with hidden re-purchase agreement sufficient to state claim under Rule 10b-5(a) and (c)); *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330, 342 (D. Mass. 2005) (denying bank's motion to dismiss Rule 10b-5(a) and (c) claims, where plaintiffs alleged bank "intentionally structured . . . loans artificially to inflate [the company's] revenue in a manner designed to conceal the fact that those loans were guaranteed by [the company's] principal officers").

In *Global Crossing*, Rule 10b-5(a) and (c) claims were upheld against an accounting firm for its role in transactions designed to inflate the company's revenues. The accounting firm's

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[40] Recognizing that *Enron I* directly supports Plaintiffs' claims against it, Bank One argues that the *Enron I* decision has been "resoundingly criticized." Bank One Br. at 15 n.9. In support of this assertion, Bank One cites, *inter alia*, a number of articles written by other lawyers in the defense bar whose firms currently are representing defendant financial institutions in other cases involving claims under Rule 10b-5(a) and (c). Bank One's lawyers might just as well cite articles that they themselves may have written criticizing *Enron I;* it amounts to the same thing.

motion to dismiss was denied because the complaint alleged that it "actively participated in structuring each swap" and "directly participated in the creation of the misleading 'pro forma' numbers that concealed these practices from investors." 322 F. Supp. 2d at 336. Attempting to distinguish the case, Bank One argues that *Global Crossing* involved "sham" transactions that "had no economic substance." Bank One Br. at 14 n.6. But, in fact, *Global Crossing* involved transactions whose "sham" aspects or lack of "economic substance" were directly analogous to the transactions here. Thus, the problem with the swaps in *Global Crossing* was that they were round-tripped, so that the income recognized from the sale was nullified by a corresponding purchase. 322 F. Supp. 2d at 326. The same absence of substance infected the transactions here, where the inventory was round-tripped, Delphi's revenue from the "sales" to the banks was repaid when the banks resold the inventory to Delphi, and the only substance was the fees paid Bank One, Setech and BBK for their services. *See also AOL Time Warner,* 381 F. Supp. 2d at 217 (claim stated under Rule 10b-5(a) and (c) where it was alleged that defendants "engaged in a systematic scheme . . . to inflate AOL's reported advertising revenue . . . based on various sham transactions and accounting improprieties"); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003) (claim stated under Rule 10b-5(a) and (c) where it was alleged that defendants participated in fraudulent scheme to create fictitious revenue through bogus transactions).

Defendants cite *In re Parmalat Sec. Litig.,* 376 F. Supp. 2d 472 (S.D.N.Y. 2005), for the proposition that Rule 10b-5(a) and (c) claims can be upheld against a bank only when the transaction involves fictitious or sham entities. Setech Br. at 7, 9; Bank One Br. at 11. They omit to mention, however, that the same judge who decided *Parmalat* – Hon. Lewis A. Kaplan –

later specifically rejected the very interpretation of his *Parmalat* decision that Defendants now urge. Thus, at a later stage in the *Parmalat* litigation, one of the bank defendants, Credit Suisse First Boston, urged that the claims against it were insufficient because it was not alleged to have participated in a fictitious transaction or a transaction involving sham entities. Judge Kaplan rejected this argument, the same one that Defendants argue:

> As for CSFB's suggestion that "[t]here are not allegations in the amended complaint that describe the CSFB transactions as shams or dependent on any fictions," CSFB Mem. 3, it is mistaken. The question is not, as CSFB apparently would have it, whether the plaintiffs have described the transaction using the same language that this Court ultimately used in its opinion. Rather the question is whether the complaint describes deceptive transactions.

In re Parmalat Sec. Litig., No. 04 MD 1653 (LAK), slip op. at 1 (S.D.N.Y. July 28, 2005).[41]

Another subsequent decision in the *Parmalat* litigation further underscores Defendants' misplaced reliance on *Parmalat*. In *In re Parmalat Sec. Litig.*, 383 F. Supp. 2d 616 (S.D.N.Y. 2005), claims were brought against lawyers who created and controlled certain entities that engaged in transactions with Parmalat. In one instance, Parmalat sold assets to these entities "to book as receivables obligations that it knew would not be paid." *Id.* at 625. In another instance, a loan that Parmalat purported to extend to the entity "was not a loan at all, but rather a payment to" the family of Parmalat's founder. *Id.* The court upheld the Rule 10b-5(a) and (c) claims against the lawyers because "these transactions were inventions, projects, or schemes with the tendency to deceive because they created the appearance of a conventional sale and loan when,

[41] A copy of this unreported decision is attached as Exhibit B to the Yarnoff Decl.

in fact, the reality was quite different." *Id.* at 626. The court further noted that there could be no dispute that the lawyers "used" or "employed" these devices. *Id.*[42]

Defendants' attack on Plaintiffs' Rule 10b-5(a) and (c) claims depends on their assertion that the Complaint merely alleges that Bank One, Setech and BBK were parties to legitimate business transactions that Delphi later misrepresented in its financial statements. *See* Setech Br. at 10-11; Bank One Br. at 16-17; BBK Br. at 14. But whether a transaction is legitimate or "a sham is an issue of fact," *Rice's Toyota World, Inc. v. Comm'r of Internal Revenue*, 752 F.2d 89, 92 (4th Cir. 1985); *see also U.S. v. Yellow Cab Co.*, 338 U.S. 338, 340 (1949), and "a disputed issue of fact . . . cannot be resolved on a motion to dismiss." *In re Cardizem CD Antitrust Litig.*, 332 F.3d 896, 900 (6th Cir. 2003); *accord Varljen v. Cleveland Gear Co.*, 250 F.3d 426, 431 (6th Cir. 2001).

Defendants' argument also mischaracterizes the Complaint. The Complaint alleges that these Defendants knowingly entered into transactions that had no purpose other than to

[42] The other cases relied on by Defendants are equally unhelpful to their cause. For example, in *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003) (Setech Br. at 8 n.4, 15-16; Bank One Br. at 13), the holding was the court's erroneous view that a corporation's business partners who lack a "special relationship" with the corporation cannot be held liable to purchasers of the corporation's securities, "no matter how involved they were in fraudulent transactions" with the corporation. 252 F. Supp. 2d at 1038. Everything else was dicta. Furthermore, other courts have declined to follow *Homestore.com* and criticized its approach. *See, e.g., Quaak*, 357 F. Supp. 2d at 342; *Enron II*, 310 F. Supp. 2d at 829 ("this Court has rejected the narrow construction of the statute and of primary violations employed by *Homestore.com*"). Similarly inapposite is the Second Circuit's statement in *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005), that if the "sole basis" for a Rule 10b-5 claim is misrepresentations and omissions, a claim under Rule 10b-5(a) and (c) will not be maintainable. Bank One Br. at 18; Setech Br. at 7-8. Misrepresentations and omissions are not the "sole basis" for the claim at bar. Bank One's reliance on *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804 (S.D. Tex. 2004), also is misplaced. There, the plaintiffs merely alleged that Dynegy improperly reported two loans on its financial statements and that Citigroup helped Dynegy do so by structuring, funding, and executing these loans. *Id.* at 916. Yet, unlike Bank One's precious metals transaction with Delphi – which had no economic substance and was orchestrated at year end so as to inflate Delphi's financial statements – the loans structured, funded and executed by Citigroup for Dynegy were not inherently deceptive but were made deceptive by the manner in which Dynegy misrepresented them on its balance sheet. *Id.* And *Benedict v. Cooperstock*, 23 F. Supp. 2d 754 (E.D. Mich. 1998) (Setech Br. at 10), is irrelevant because the claims there were misrepresentation claims under Rule 10b-5(b), not deceptive scheme claims under Rule 10b-5(a) and (c).

temporarily remove worthless or obsolete inventory and unneeded assets off of Delphi's books at year-end. The inventory essentially made a round trip, and ended up right where it started, with Bank One, Setech and BBK getting paid handsome fees for serving as temporary parking places for the inventory. This is a fraudulent scheme, not a series of legitimate transactions that Delphi later chose to misrepresent in its financial statements. *See Scholnick v. Schecter*, 752 F. Supp. 1317 (E.D. Mich. 1990); *Quaak*, 357 F. Supp. 2d at 342.

The fact that the transactions were misrepresented in Delphi's financial statements does not immunize Defendants from liability under Rule 10b-5(a) and (c) for their roles in the fraudulent schemes. "Common to claims of deceptive statements about the financial condition of an issuing corporation and to claims based on market manipulation through deceptive trading activity is the introduction of inaccurate information into the marketplace." *Enron I*, 235 F. Supp. 2d at 580 n.17 (citing *GFL Advantage Fund, Ltd. v. Colkitt,* 272 F.3d 189, 205 (3d Cir. 2001)). A person directly or indirectly employing a manipulative or deceptive device is liable under Rule 10b-5(a) and (c) "even if a material misstatement by another person creates the nexus between the scheme and the securities market." *Lernout & Hauspie*, 236 F. Supp. 2d at 173.

Likewise, there is no merit to Setech's argument that a defendant must be the "mastermind" of a fraudulent scheme or must participate "substantially" in order to be liable under Rule 10b-5(a) and (c). *See* Setech Br. at 8 n.4. The Second Circuit has found it "of no relevance" that another individual "masterminded" a scheme at issue. *See SEC v. U.S. Envtl.*, 155 F.3d at 112. "The Supreme Court in *Central Bank* never intended to restrict § 10(b) liability to supervisors or directors of securities fraud schemes while excluding from liability subordinates who also violated the securities law." *Id.*; *see also Enron I*, 235 F. Supp. 2d at 592.

Indeed, in *Parmalat*, on which Setech relies so heavily, Judge Kaplan specifically rejected the notion that a wrongdoer's participation in a deceptive scheme must be "substantial" in order to subject the wrongdoer to primary liability under Rule 10b-5(a) and (c). 376 F. Supp. 2d at 502-03.[43]

2. Rule 10b-5(a) and (c) Apply to More Than Just Narrow, <u>Technical Forms of Stock Market Manipulation</u>

BBK urges the Court to limit the reach of subsections (a) and (c) of Rule 10b-5 to narrow, technical forms of stock market manipulation, such as matched orders or wash sales. BBK Br. at 11. There is nothing in the text of Rule 10b-5(a) and (c) suggesting any such limitation, and as Bank One's Brief acknowledges, recent decisions have decisively rejected it. *See* Bank One Br. at 11 n.4.

This Circuit recently reiterated the Supreme Court's teaching that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly to effectuate its remedial purposes." *Benzon v. Morgan Stanley Distrib.*, 420 F.3d 598, 611 (6th Cir. 2005) (internal quotation marks omitted) (citing *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 151 (1972), and *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)). BBK's argument is an invitation to this Court to depart from this established rule.

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[43] The Court also should reject Bank One's suggestion, for which it cites no authority, that it should somehow get a pass as a matter of law because it was involved in only one fraudulent transaction somehow absolves it of Rule 10b-5(a) and (c) liability. *See* Bank One Br. at 15 n.8. Unlike a violation of, for example, RICO, a pattern of fraudulent transactions is not required for Rule 10b-5(a) and (c) liability. Participation in one fraudulent transaction is one too many and is certainly enough for liability. *See Parmalat*, 376 F. Supp. 2d at 489-90, 505 (upholding Rule 10b-5(a) and (c) claim against Credit Suisse First Boston for one transaction involving a forward sale agreement and related agreements).

BBK's argument is based on comments in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977), where the Supreme Court cited wash sales and matched orders as examples of manipulation within the scope of Rule 10b-5(a) and (c).[44] *See* BBK Br. at 11. This argument overlooks that § 10(b) prohibits the use of "any manipulative or deceptive device or contrivance," 15 U.S.C. § 78j(b); it does not prohibit merely "market manipulation." In rejecting BBK's argument, courts have held that "the *Santa Fe* list of manipulative practices is clearly not exhaustive; 10b-5(a) and (c) claims need not contain the magic words 'wash sales, matched orders, or rigged prices' to be valid." *AOL Time Warner*, 381 F. Supp. 2d at 217; *see also U.S. v. Bongiorno*, No. 05 Cr. 390 (SHS), 2006 WL 1140864, at *6 (S.D.N.Y. May 1, 2006) (defendants' assertion that Rule 10b-5(a) and (c) are limited to technical forms of market manipulation is a "crabbed interpretation [that] would narrow the reach of section 10(b) in a way inconsistent with the statute's text and purpose"); *Parmalat*, 376 F. Supp. 2d at 492 ("subsections (a) and (c) apply to at least some deceptive acts as much as to certain technical forms of market manipulation"). Indeed, *Santa Fe* itself makes this clear: "No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." *Santa Fe*, 430 U.S. at 477.

Thus, liability under Rule 10b-5(a) and (c) is not limited to the small category of cases that BBK suggests. Rather:

> subsections (a) and (c) encompass much more than illegal trading activity: they encompass the use of "any device, scheme or artifice," or "any act, practice, or course of business" used to perpetrate a fraud on investors, 17 C.F.R. § 240.10b-5(a), (c) . . . . [C]ourts including this country's highest court have held that a

[44] The holding of *Santa Fe* was merely that corporate mismanagement claims are not covered by Rule 10b-5. *Santa Fe*, 430 U.S. at 479.

> cause of action lies for claims that involve allegations of manipulative schemes used in connection with securities markets.

Global Crossing, 322 F. Supp. 2d at 336-37; *see also IPO,* 241 F. Supp. 2d at 325 n.45 ("the scope and content of a manipulative practice are only limited by new schemes which the fertility of man's invention would contrive") (quotation marks omitted).[45]

3. Rules 10b-5(a) and (c) Do Not Require That the Defendants Made a Misleading Statement

Defendants muddy the waters with arguments asserting that they did not make a fraudulent statement, *see* BBK Br. at 10, 13, and that they cannot be held liable under Rule 10b-5 for misrepresentations issued by other Defendants, *see* Bank One Br. at 19-20. These arguments are red herrings. Plaintiffs have not asserted claims against these Defendants under subsection (b) of Rule 10b-5, the subpart dealing with misrepresentations. Liability under subsections (a) and (c) of Rule 10b-5 – which are the bases for Plaintiffs' claims against Bank One, Setech and BBK – does not require that the defendant itself made any fraudulent statement.

As the Sixth Circuit stated in *Benzon*, 420 F.3d at 610 (emphasis added):

> **[W]e agree with Plaintiffs that Rules 10b-5(a) and (c) encompass conduct beyond disclosure violations.** The Supreme Court said as much in *Affiliated Ute Citizens*: "the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." 406 U.S. at 152-53, 92 S. Ct. 1456. At least one district court within this Circuit has concluded, based on that language,

[45] Plaintiffs are aware of a recent decision by the Eighth Circuit taking an extremely narrow view of the scope of Rule 10b-5(a) and (c), *In re Charter Commc'ns, Inc.*, 443 F.3d 987 (8th Cir. 2006), but that case should not be followed here. First, in adopting its narrow approach to Rule 10b-5(a) and (c), the Eighth Circuit's approach departs from the Sixth Circuit's teaching in *Benzon* that Rule 10b-5 should be read "not technically and restrictively, but flexibly to effectuate its remedial purposes." In addition, the Eighth Circuit's decision is squarely in conflict with the rulings of the District Courts in the Second Circuit. For example, the Eighth Circuit held that the word "manipulation" in Rule 10b-5(a) is limited to technical trading practices, *Charter Commc'ns*, 443 F.3d 987, whereas *Global Crossing* and *AOL Time Warner* held it is not. And the Eighth Circuit also specifically declined to follow *In re Parmalat.*

> that a defendant "not liable under rule 10b-5(b) for failure to disclose . . . may still be held liable under Rule 10b-5(a) and 10b-5(c) as a participant in [an] allegedly fraudulent scheme." *Scholnick v. Schecter*, 752 F. Supp. 1317, 1323 (E.D. Mich. 1990). A plain-language reading of the Rule supports this view.
>
> We therefore conclude that the district court's determination that Defendants complied with their disclosure obligations does not dispose of Plaintiffs' claims under Rule 10b-5(a) and (c) . . . .

Most recently, Rule 10b-5(a) and (c) claims were upheld in *SEC v. Hopper*, No. Civ.A. H-04-1054, 2006 WL 778640 (S.D. Tex. Mar. 24, 2006). At issue were certain "'round-trip' energy trades" which were "bogus trades portrayed as legitimate sales, that were improperly accounted for and reported" by the companies "to present gross overstatements of the companies' true trading volumes, revenues, and financial conditions." *Id.* at *1. In upholding the Rule 10b-5(a) and (c) claims, the court specifically rejected the argument that Defendants make here "that the alleged fraud consists solely of misstatements about the round-trip trades and is therefore not separately actionable as a fraudulent scheme under subsections (a) and (c)." *Id.* at *11. Rather, noting that the transactions had no "legitimate business purpose" but were engaged in solely "to create a false picture to the industry," the court held that the SEC had "alleged facts from which it could be inferred that the round-trip trading scheme was fraudulent apart from the manner in which the trades were characterized in the SEC filings." *Id.*

4. Plaintiffs' Claims Under Rule 10b-5(a) and (c) Satisfy the Requirements of Rule 9(b) and the PSLRA

The Complaint alleges with particularity that Bank One, BBK and Setech knew, or were reckless in not knowing, that their sham transactions with Delphi were part of a fraudulent scheme to inflate Delphi's earnings. The minimum standard necessary to establish scienter is recklessness, *Helwig*, 251 F.3d at 552; *Comshare*, 183 F.3d at 550-53, and in considering whether a complaint adequately pleads scienter, a court must view the allegations in their totality and not – as Defendants urge – in isolation. *Telxon*, 133 F. Supp. 2d at 1026. When viewing the Bank One, Setech and BBK transactions in their totality, these were obviously sham transactions that lacked economic substance, and their purpose was to remove inventory from Delphi's books and to deceive the investing public. In making these transactions, Bank One, Setech and BBK knew, or recklessly disregarded, that they were part of a massive fraud.

a. Bank One Acted With the Requisite Scienter

Bank One engaged in a $200 million round-trip transaction with Delphi that book-ended critical reporting deadlines, and lacked any economic substance. ¶¶ 152, 669. Specifically, in December 2000, just weeks before the close of Delphi's fiscal quarter and year end, Bank One agreed to "purchase" $200 million worth of precious metals from Delphi and "sell-back" those same metals to Delphi right after the close of the fiscal year for the same purchase price. ¶¶ 152, 669.[46]

This transaction was a sham. It had no legitimate purpose. It bracketed critical reporting periods and posed no risk to Bank One. And, it served only to inflate Delphi's financial results. The totality of the circumstances of the transaction – including its timing, magnitude, round-trip nature, and Bank One's failure ever to take possession of the precious metals –demonstrate that Bank One knew, or recklessly disregarded, that the transaction lacked economic substance.

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[46] Further, as recently reported by the Detroit News on March 27, 2006, Bank One agreed to the December 2000 "purchase" price and the January 2001 "sell-back" price at the outset. It also reported that Bank One never took possession of the precious metals, but rather the metals sat on Delphi plant floors. (available at http://detnews.com/apps/pbcs.dll/article?AID=/20060327/AUTO01/603270317&SearchID=73239854198128). If necessary, Lead Plaintiffs respectfully seek leave of the Court to timely file an amended complaint to allege this fact and other facts discovered following the filing of the Complaint.

Further, given the auto industry's well-known financial difficulties during the fourth quarter 2000, Bank One – an experienced and sophisticated banking institution – knew, or recklessly disregarded, that the transaction served only to make Delphi seem more profitable. The public markets, including financial professionals, were well aware that the auto industry – including Delphi – was depressed, grappling with production cuts and lay-offs. ¶¶ 103-05, 154, 276-77. Under these circumstances, Bank One's participation in a scheme to manipulate Delphi's year-end inventory numbers leaves no doubt that it acted with scienter.

Sham, round-trip transactions without legitimate purpose provide strong evidence of scienter. *See Global Crossing,* 322 F. Supp. 2d at 326, 337, 344-45; *Enron I,* 235 F. Supp. 2d at 697, 700, 702; *SEC v. U.S. Envtl.,* 155 F.3d at 112. From its inception, this was a "round-trip" whereby Bank One would – and did – "sell-back" the same metals, at the same price, shortly after the close of Delphi's fiscal year 2000. There was no risk and no revenue – a sham.

Merrill Lynch's "Nigerian barge" transaction with Enron, which supported a strong inference of scienter, parallels Bank One's conduct. Merrill Lynch "purchas[ed] Nigerian barges from Enron to create sham earnings of over $12 million in return for a secret, oral side agreement [with Enron] that Enron would repurchase them within six months so there would be no risk, only a lucrative profit for Merrill Lynch." *See Enron II,* 310 F. Supp. 2d at 829. Like Merrill Lynch, Bank One engaged in a prearranged, round-trip transaction, which posed no risk and served only to inflate Delphi's financial results.

Moreover, the fact that Bank One never took possession of the precious metals underscores its awareness of the transaction's true and only purpose – to boost Delphi's financial results. To the extent there is doubt about Bank One's part in this transaction, one need only ask:

Why did Bank One "buy" $200 million of precious metals for a few weeks? Why did Bank One even need precious metals (considering they never even took possession of them)?

The timing – conspicuously bracketing Delphi's critical year-end – supports Bank One's scienter. *See Enron I,* 235 F.Supp. 2d at 693-94 (sham transactions executed "at critical times when quarterly or year-end reports to the SEC, and by extension the public, were due, followed in many cases by the undoing of these very deals once the reports had been made" supports scienter); *In re MicroStrategy Inc. Sec. Litig.,* 115 F. Supp. 2d 620, 639 (E.D. Va. 2000) (suspicious year-end timing supports inference of scienter). In *Enron,* the court found scienter where JP Morgan provided loans to Enron, disguised as commodity trades, before period-end. *Enron I,* 235 F. Supp. 2d at 696. Here, the timing, just before a highly scrutinized financial reporting period for Delphi in light of industry problems and unwound immediately thereafter, similarly raises a clear inference of scienter. *See id.* at 693-94.[47]

The massive size of the transaction – $200 million – further supports a strong inference of scienter. *See Global Crossing*, 322 F. Supp. 2d at 347 ("the scope of the fraud alleged may appropriately be considered in determining whether scienter has been adequately pled"); *Chalverus v. Pegasystems, Inc.* 59 F. Supp. 2d 226, 234 (D. Mass. 1999) (finding scienter given

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[47] Bank One contends that Plaintiffs' allegations regarding the suspicious timing of the transaction "rest on nothing more than hindsight." Bank One Br. at 23 (relying on *Fidel*). However, the facts in *Fidel* are completely inapposite to the facts in this case. Specifically, in *Fidel,* the court rejected plaintiffs' bare allegations that the temporal proximity between the auditor's review of the company's financial statements and the company's later financial collapse supported a strong inference of scienter. *Id.* at 232. The court found that "there [wa]s no indication from the class members' allegations that Ernst & Young knew or recklessly disregarded information it had before it at the time it issued its audit report." *Id.* Here, unlike *Fidel,* Bank One **knew**, at the time it engaged in the transaction, that it was book-ending Delphi's quarter and year end reporting periods. The December 2000 "purchase" and the January 2001 "sell-back" were the actual, agreed upon circumstances of the Bank One-Delphi transaction. Thus, the suspicious timing of the transaction – which Bank One knew, or recklessly disregarded in advance of the transaction – gives rise to an inference of Bank One's scienter.

large revenue overstatement, noting "drastic overstatements of revenue are particularly suspect when the transaction occurs at a suspicious time, such as the end of a fiscal quarter or year"). This transaction almost tripled Delphi's operating cash flow for 2000. ¶ 154.

Bank One's suggestion that magnitude of its fraud in isolation does not support scienter should be rejected. Bank One Br. at 22. Bank One mistakenly relies on *Fidel,* a case in which the court found that magnitude alone cannot support scienter. Indeed, in a recent case, the court rejected this argument, holding *Fidel* "establish[es] that magnitude of accounting errors alone cannot establish scienter on the part of an *outside auditor.*" *In re Cardinal Health Inc. Sec. Litig.,* No. C2-04-575, 2006 WL 932017, at *21 (S.D. Ohio April 12, 2006) (emphasis in original). Here, unlike *Fidel,* the Complaint alleges numerous illicit characteristics that describe Bank One's transaction with Delphi, which collectively support a strong inference of scienter. Accordingly, "Defendants have not found significant support for their contention that, when combined with Plaintiffs' other allegations, the Court may not consider the magnitude" of the transaction in its scienter analysis. *Id.* at *21.[48]

Further, Bank One argues that Plaintiffs failed to allege that "Bank One knew – or was reckless in not knowing – that Delphi's intended accounting treatment for the transaction was improper." Bank One Br. at 23. Bank One's argument is unavailing. First, it is not necessary that Bank One have specific knowledge about how Delphi accounted for these transactions because, by their nature and terms, these transactions lacked economic substance and, therefore,

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[48] Bank One notes that Plaintiffs have failed to plead motive. Bank One Br. at 22. However, it is well-settled in the Sixth Circuit that motive is not necessary for a finding of scienter. *See Helwig,* 251 F.3d at 551 ("[w]hether the facts can be said to establish motive, opportunity, or neither, we are directed only to consider whether they produce a strong inference that defendant acted at least recklessly").

their impropriety was obvious. *See SEC v. Hopper*, No. CIV A. H-04-1054, 2006 WL 778640, at *11 (S.D. Tex. Mar. 24, 2006) ("Because the round-trip trades were sham transactions, and therefore had an inherent tendency to deceive, it cannot be said that the alleged fraud or deception only occurred when the trades were misreported in the companies' SEC filings"); *Enron II*, 310 F. Supp. 2d at 831 (rejecting Merrill Lynch's arguments that transactions were legitimate but later misrepresented, and stating "[s]ham business transactions with no legitimate business purpose that are actually guaranteed 'loans' employed to inflate Enron financial image are not above-board business"). Second, as discussed above, by the very terms of the transaction's contract, Bank One knew that Delphi was treating the December 2000 leg of the transaction as a "sale." To disclaim now its knowledge of Delphi's sale treatment is both disingenuous and self-serving and, at best, raises a question that cannot be resolved on a motion to dismiss. Lastly, what accounting treatment is appropriate for a sham, round-trip transaction? What purpose has such a transaction but to manipulate financial results? Nevertheless, whether this transaction was legitimate, but recorded improperly, or a sham is not proper to decide now. *See Rice's Toyota World,* 752 F.2d at 92; *Cardizem,* 332 F.3d at 900 (same); *Lernout & Hauspie,* 236 F. Supp. 2d at 175 (same).

The most plausible inference – and the only plausible one – is that Bank One knew or recklessly disregarded that it was participating in a fraud to materially inflate Delphi's earnings.

b. <u>Setech Acted With the Requisite Scienter</u>

Similarly, there is no question that Setech knew, or recklessly disregarded, that it was actively engaging in fraudulent transactions with no purpose other than to inflate Delphi's financial results. Specifically, Setech engaged in several, "back room" deals with Delphi totaling

$145 million; these deals were short-term, round-trip inventory and indirect material transactions with no economic substance. ¶¶ 124, 132, 135, 138, 663. As with Bank One, Setech agreed to "purchase" and "sell-back" the same inventory to Delphi. ¶¶ 126-27, 135. Setech's knowledge that the transactions were fraudulent is beyond question: a Delphi employee directly told Setech that the purpose of the transactions was to get inventory off of Delphi's books. ¶¶ 135, 664.

(1) <u>Setech Knowingly Engaged in Sham Transactions With Delphi</u>

Actual knowledge of fraudulent conduct establishes scienter. *Comshare* 183 F.3d at 548; *SEC v. U.S. Envtl.,* 155 F.3d at 111. Here, the Complaint expressly alleges that (1) Setech knew Delphi wanted the inventory off its books and (2) Setech knew it was buying the inventory for that very purpose. Specifically, CS 3,[49] a former Delphi senior manager who structured and negotiated several of the transactions with Setech, stated that he plainly told Setech, "you buy this stuff, get it off my books and I will buy it back from you." ¶ 135. This is corroborated by CS 1, a current Setech Manager, and CS 2, a former Setech Director, who both negotiated with Delphi and stated that the parties explicitly agreed and understood that Delphi would buy-back the inventory. ¶¶ 125-27, 663. These detailed allegations of Setech's knowledge of the true purpose and nature of the transactions show Setech acted with scienter.

Setech attempts to minimize these implications by skewing pleading standards, recasting allegations in the Complaint and advancing inappropriate factual arguments. Each tactic fails. First, Setech contends that CS 3's statements should be disregarded because they (1) only represent a "layperson's" take on an otherwise legitimate deal and (2) lack particularity because

[49] References to "CS" are to Lead Plaintiffs' confidential sources, as cited in the Complaint.

he fails to name a particular Setech employee. Setech Br. at 12. Setech cannot avoid facts: CS 3's statements are reliable, alleged with particularity and are corroborated. Specifically:

- CS 3 was a senior manager at Delphi throughout most of the Class Period. ¶ 130.
- CS 3's responsibilities included resolving Delphi's inventory problems. ¶ 130.
- CS 3 was a direct and regular participant in the Setech-Delphi transactions throughout 1999 and 2000, including during October 2000. ¶¶ 130, 132, 136, 138.
- CS 3 participated in "back room" transactions with Setech in several Delphi locations in the United States and Mexico. ¶¶ 133-36, 138.
- CS 3 participated in "back room" transactions with Setech while at Delphi's Energy & Chassis Division and Delphi's Electronics & Safety Division. ¶¶ 130, 133-35, 137.
- CS 3 participated in the "back room" transactions with Setech and Delphi purchasing people from Troy, Michigan. ¶¶ 135, 138.
- CS 3 stated that, while working for Delphi, he participated in several multi-million dollar sales of inventory to Setech. ¶¶ 130, 132.
- CS 3 stated that Setech "bought" the inventory from Delphi with the explicit agreement that Delphi would "buy-back" the inventory from Delphi. ¶ 135.
- CS 1, a current Setech Manager, corroborates CS 3's statements, stating that he was directly involved in negotiations at Delphi's Kokoma, Indiana facility. CS 1 also confirmed that Delphi was obligated to "buy-back" the inventory from Setech. ¶ 125.
- CS 2, a former Setech Director, corroborates CS 3's statements, stating that he was responsible for significant aspects of the Setech-Delphi contract, and it was known by all involved that Delphi was to "buy-back" the inventory from Setech. ¶ 127.
- CS 4, a former Delphi employee in the Electronics & Safety Division located in Reynosa, Mexico, corroborates CS 3's statements. CS 4 confirmed that Delphi sold indirect inventory to Setech during 1999 and 2000 to get the inventory off its books. Based on his experience, CS 4 stated that Delphi's Electronics & Safety Division sold Setech $30 million of indirect materials and inventory from facilities located in Kokoma, Indiana and Reynosa, Mexico. ¶¶ 141-42.

Based on the high degree of reliability, particularity and corroboration provided by three witnesses, CS 3's statements must be accepted as true. *See Comshare,* 183 F.3d at 547 (the court must take all well-pleaded allegations in complaint as true and construe those allegations in light most favorable to plaintiff).

Setech also misstates the allegations of the Complaint by arguing that its transactions with Delphi could not be deceptive because they were "explicit," "open" and "clear." Setech Br. at 12. The Complaint actually alleges that, between Setech and Delphi, the **terms** of the transactions were "explicit," "open" and "clear," insofar as Setech knew it was engaging in sham, round-trip transactions. ¶¶ 126, 662. Indeed, CS 1 stated that the terms of the "buy-back agreement" were "explicit." ¶ 126. All parties understood that Delphi had to repurchase the inventory; the terms were explicitly set forth in the contract. In discussing the transactions, CS 1, CS 2 and CS 3 state that the parties understood this was a round-trip transaction where Setech agreed to "buy" inventory from Delphi and quickly "sell-back" the inventory to Delphi. ¶¶ 126-27, 135, 138. None of this was made explicit, open or clear **to the public**. Any other interpretation is a question of fact not proper for the pleading stage. *See Rice's Toyota World,* 752 F.2d at 92; *Cardizem,* 332 F.3d at 900.

Lastly, Setech argues that Lead Plaintiffs failed to allege that Setech knew Delphi would account for these transactions improperly. Setech Br. at 12-13. This is simply wrong. Setech knew the transactions were done to relieve Delphi of inventory temporarily. Such knowledge implies that the transactions were for an improper accounting objective. Further, as with Bank One, Setech need not have had specific knowledge about how Delphi accounted for these transactions because, by their nature and terms, these transactions lacked economic substance -

their impropriety was obvious.[50] *See SEC v. Hopper*, 2006 WL 778640, at *11; *Enron II*, 310 F. Supp. 2d at 831. Again, what possible accounting treatment was appropriate for sham, round-trip transactions? Further, even if one were to ignore the specific allegations of knowledge, whether these were legitimate transactions that were recorded improperly or sham transactions is an issue of fact that is not proper at this stage of the proceedings. *See Rice's Toyota World*, 752 F.2d at 92; *Cardizem*, 332 F.3d at 900; *Lernout & Hauspie*, 236 F. Supp. 2d at 175.[51]

(2) **Setech Recklessly Engaged in Sham Transactions With Delphi**

Even setting aside the allegations of a knowledgeable witness that Setech knew that its transactions with Delphi were fraudulent, the allegations regarding the elements of those transactions themselves satisfy the PSLRA and Rule 9(b) by pleading that Setech acted recklessly. As discussed below, the totality of the circumstances – including the "back room"

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[50] Setech cites several cases for the unremarkable proposition that accounting violations **alone** do not create scienter. *See, e.g., P.R. Diamonds*, 364 F.3d at 694; *Chill v. General Electric Co.*, 101 F.3d 263, 270 (2d Cir. 1996) (parent company did not act with scienter in publishing subsidiary's improperly reported financial results where only allegations of parent company's scienter involved subsidiary's increased profits and activity and parent company "did not automatically equate record profits with misconduct cannot be said to be reckless"); *Davidoff v. Farina*, No. 04 Civ. 7617 (NRB), 2005 WL 2030501, at *17 (S.D.N.Y. Aug. 19, 2005) (defendants did not act with scienter where only allegations were violations of GAAP and defendants' positions as company's "highest officers"); *Stichting Pensioenfonds, ABP v. Qwest Commc'ns. Intern.*, 387 F. Supp. 2d 1130 (D. Colo. 2005) (defendant analyst who issued reports discussing possible accounting treatments for suspect transactions did not act with scienter where plaintiffs only alleged general access to issuer's records, general industry knowledge and general relationships with two of issuer's officers and directors). Setech's reliance on these cases is entirely misplaced. The Complaint specifically alleges that Delphi informed Setech that the purpose of the round-trip transactions between the two companies was solely to remove inventory from Delphi's books. Such a specific, corroborated allegation that the defendant **knew** it was engaged in sham transactions in furtherance of a fraudulent scheme is precisely the allegation absent from the above-cited cases, but does exist in this case.

[51] To the extent Setech argues that these transactions did not violate FAS 49, this is a factual argument, not appropriate for this stage of the proceeding. Setech Br. at 10. Indeed, in cases involving allegations of GAAP violations such as those alleged here, numerous courts have held that such accounting issues raise fact issues and are best reserved for the jury. *See, e.g., In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 147 (D. Mass. 2001) (allegations of GAAP violations are issues of fact and "therefore would be improper at the motion to dismiss phase – where the Court must take all of the plaintiff's well-pleaded allegations as true to prefer the defendants' explanation of the financial documents over that of the plaintiff") (citations omitted); *see also Digi Int'l Sec. Litig.*, 6 F. Supp. 2d 1089, 1098 (D. Minn. 1998) (whether accounting treatment was proper is subject to expert testimony which the "Court cannot resolve . . . on a motion to dismiss").

negotiations, the prearranged, short-term, round-trip nature, the contextual timing, the worthlessness of the inventory, and the financial magnitude – demonstrate that Setech recklessly disregarded that the transactions were shams, lacking economic substance.

First, Setech's participation in "back room" negotiations for these transactions supports a strong inference of scienter. *See U.S. v. Anderson,* 89 F.3d 1306, 1311 (6th Cir. 1996) (back room discussion demonstrated defendant "knew he was involved in an ongoing conspiracy of some dimension"). CS 3, a former Delphi senior manager involved in the transactions, said the transactions were "back room" deals cut with Setech in the United States and Mexico. ¶¶ 135, 138. He described how he cut a deal with Setech "and had to buy-back a little over a million bucks worth of inventory to get it off my books." ¶ 138. The only plausible inference to draw is that these "back room" deals involved illicit conduct. It is inconceivable that Setech, having engaged in repeated, multi-million dollar, back room deals with Delphi, did not fully understand the illegitimate purpose of the transactions or the scheme they advanced.

Second, when considering the nature of the transactions, Setech's scienter is apparent. Sham, round-trip transactions lack economic substance and serve no legitimate purpose, and therefore provide strong evidence of scienter. *See Global Crossing,* 322 F. Supp. 2d at 326, 337, 344-45; *Enron II,* 310 F. Supp. 2d at 829. Like the Bank One transaction, the Setech transactions were prearranged round-trips, designed to be reversed within the year.[52] ¶¶ 126, 135, 662-64.

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[52] Setech argues that the short-term nature of these transactions does not support an inference of recklessness. Setech Br. at 14 (citing *Chill*). Setech's reliance is entirely misplaced. In *Chill,* the court rejected plaintiffs' allegations that defendant parent company acted with scienter when it included its subsidiary's improperly reported financial results in its consolidated financial statements, where the only allegations of scienter involved that subsidiary's reported increased profits and activity. In rejecting plaintiffs' argument that the subsidiary's increased profits and activity should have alerted its parent company to misconduct, the court stated that scienter cannot be inferred because the parent "did not automatically equate record profits with misconduct" or because the parent

(Cont'd)

They were short-term, risk-free and generated no legitimate revenue: they had no substance. According to CS 3, the inventory itself was obsolete and worthless. ¶¶ 134-35, 137-38, 664. The only rationale for Setech to "buy" millions of dollars of worthless, obsolete "junk" was that the transactions would be quickly reversed and posed no risk. ¶ 136.

Setech contends there is no evidence it knew the value of the inventory. Setech Br. at 14. This does not withstand scrutiny. Based on the totality of the circumstances, the only plausible inference to draw – let alone the most plausible one – is that Setech knew it was round-tripping worthless, obsolete inventory. Would a sophisticated company buy $145 million worth of goods without inspecting them? Would a sophisticated company – in the business of inventory management, no less – make a $145 million loan without valuing the inventory serving as collateral? ¶ 69. The idea is far-fetched at best, preposterous at worst.

Third, the contextual timing of the transactions also supports a strong inference of scienter. These were trying times for Delphi. Indeed, these transactions began right after Delphi spun-off from GM, when Delphi needed cash and needed to prove itself as a stand-alone, profitable company. ¶¶ 128-29. As explained by CS 2, Setech was aware of the complex challenges facing Delphi in 1999. ¶ 128. In addition, the auto industry's weak state continued to deteriorate throughout 2000. ¶¶ 103, 105. Setech engaged in sham transactions with Delphi throughout this entire period. ¶ 123. Setech was undoubtedly aware of the state of the industry and of Delphi's financial situation.

"might have been more curious" about the subsidiary's increased activities. This case is inapposite because not only does the Complaint allege Setech's actual knowledge of the fraud, but it also alleges numerous other aspects of the transactions that support an inference of scienter, including the round-trip nature, the contextual timing, the worthlessness of the transacted-for inventory and the magnitude. Unlike *Chill,* the Complaint alleges numerous facts that demonstrate that Setech knew, or was reckless in not knowing, that it was participating in a massive fraud.

Finally, the combined size of the transactions – $145 million – supports a strong inference of scienter. *See Global Crossing*, 322 F. Supp. 2d at 347 ("the scope of the fraud alleged may appropriately be considered in determining whether scienter has been adequately pled.").

To minimize these allegations of scienter, Setech argues that the Complaint fails to allege that (i) Setech masterminded the scheme and (ii) Setech had motive to participate in the scheme. Setech Br. at 12, 13, 15. But, a defendant need not have masterminded or designed the scheme to have acted with scienter. *See SEC v. U.S. Envtl.,* 155 F.3d at 112 ("it is of no relevance" that defendant did not mastermind the scheme); *Enron I,* 235 F. Supp. 2d at 592 (same). Nor is motive necessary to find scienter. *See Helwig,* 251 F.3d at 551 ("Whether the facts can be said to establish motive, opportunity, or neither, we are directed only to consider whether they produce a strong inference that defendant acted at least recklessly."); *SEC v. U.S. Envtl.,* 155 F.3d at 112 (motive is irrelevant where defendant was alleged to have participated in scheme to effectuate wash sales and matched orders with scienter).[53] In addition, Setech contends that scienter has not been alleged because the allegations do not satisfy the *Helwig* factors. Setech Br. at 14. Setech is wrong. These factors are helpful guideposts for pleading scienter. *Helwig,* 251 F.3d at 552 ("we find [these factors], while not exhaustive, at least helpful in guiding securities fraud pleading"). *Helwig* holds that scienter is a "fact-sensitive," "case-by-case concept" and that the Sixth Circuit "decides[s] cases on facts, not labels." *Id.* at 550-51.

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[53] *See also MicroStrategy,* 115 F. Supp.2d at 631 ("If totality of circumstances alleged raises a 'strong inference' of the requisite state of mind, it is immaterial whether plaintiffs satisfy their burden by pleading motive, opportunity, conscious misbehavior, recklessness, or by impressing upon the Court a novel legal theory").

The totality of facts clearly demonstrates that Setech – by engaging in this illicit conduct with Delphi in 1999 and 2000 – knew or recklessly disregarded that it was involved in a scheme to inflate Delphi's earnings. The Complaint specifically alleges that Setech knowingly or, at a minimum, recklessly engaged in a pattern of illicit conduct with Delphi in 1999 and 2000.

c. **BBK Acted With the Requisite Scienter**

Like Bank One and Setech, BBK knew, or at a minimum recklessly disregarded, that it was actively involved in fraudulent transactions that had no legitimate purpose other than to temporarily remove inventory from Delphi's books and inflate Delphi's financial results. BBK engaged in three round-trip inventory transactions totaling $89 million (¶147), knowing – according to former BBK consultant CS 5 – that the end was "to move things off [of Delphi's] books for a short period of time." ¶ 150. BBK never even paid Delphi for the inventory it purportedly "bought." ¶ 148. As shown by the information provided by CS 5 and the fact that BBK never paid for the inventory – BBK knowingly engaged in this fraudulent scheme with Delphi.

(1) **BBK Knowingly Engaged in Sham Transactions With Delphi**

The Complaint specifically alleges that BBK "bought" $89 million of inventory from Delphi knowing the purpose of the transactions – that Delphi wanted the inventory temporarily off its books. CS 5, a former BBK consultant, explained that BBK knew that Delphi engaged in these deals "in order to move things off [Delphi's] books for a short period of time, and then bring them back on the books when cash flow improved." ¶ 150. CS 5 stated that the transactions were all about timing and need:

> It's always a timed deal. It's always a deal where some time is bought or some strategic negotiating time with the union or you get some number of people off

> their books of whatever they have to do to remain viable on financial terms on their books . . .

Id. BBK "bought" $89 million of inventory from Delphi knowing the true nature of the transactions – that they were round-trip transactions without any legitimate purpose. CS 5 explained that, from BBK's perspective, these transactions were primarily about "parking" inventory. *Id.* BBK's role in the inventory transactions was as follows: "you buy things, you sit on it, and then you transfer them back to them at some margins to BBK." *Id.* Accordingly, given BBK's obvious grasp of the point of these transactions, there is no question that it knew it was part of a fraudulent scheme.

BBK's knowledge is shown further in how these transactions were actually done. BBK never paid. Rather, the "purchased" inventory was paid for by "cash received through financing arranged by Delphi." ¶ 148. As Delphi admitted in its Restatement, Delphi – not BBK – came up with the money that BBK used to "buy" inventory from Delphi. *Id.* Surely, BBK knew it had not paid for $89 million of inventory it "bought" from Delphi and thus knew its "purchase" had no legitimate purpose. Under such circumstances, there can be no question that BBK knew that it was engaged in fraudulent transactions with Delphi.

Still, BBK downplays its knowledge. Specifically, it claims CS 5 offers no specific facts about the BBK- Delphi transactions or about BBK's knowledge of or involvement in Delphi's accounting for the transactions. BBK Br. at 9. BBK is wrong. First, the Complaint provides numerous, specific details of BBK's "round-trips" with Delphi, including who was involved, how much was involved, when they occurred and how they were carried out financially. ¶¶ 147-48, 151, 593, 604. Second, CS 5 explains the specific purpose and nature of these transactions, which, he clearly explained, occurred between BBK and Delphi as well as between BBK and

GM. According to CS 5, BBK's transactions with both Delphi and GM served the same purpose – to get inventory off the books. ¶ 150. Further, BBK played the very same role in its transaction with Delphi and GM – to "park" Delphi's and GM's inventory temporarily. *Id.* Describing the round-trip transactions BBK entered into with Delphi and GM, CS 5 explained that BBK bought inventory from Delphi, sat on it and then sold it back to Delphi at a margin. *Id.* BBK's attempt to negate the detailed allegations provided by CS 5 because this information also applies to GM must be rejected. BBK Br. at 9. BBK cannot evade responsibility simply because it knowingly entered into such transactions with both Delphi and another party, and not just with Delphi.

Finally, as with Bank One and Setech, BBK did not need to have specific knowledge about how Delphi accounted for these transactions because, by their nature and terms, including the fact that BBK never even paid for the inventory, the fraudulent nature of the these transactions was readily apparent. *See SEC v. Hopper*, 2006 WL 778640, at *11; *Enron II*, 310 F. Supp. 2d at 831. What possible accounting treatment would be appropriate for a sham, round-trip transaction? Further, whether these were legitimate transactions that were recorded improperly or sham transactions that lacked economic substance is an issue of fact that is not proper at this stage of the proceedings. *See Rice's Toyota World,* 752 F.2d at 92; *Cardizem,* 332 F.3d at 900; *Lernout & Hauspie* 236 F. Supp. 2d at 175.

(2) <u>BBK Recklessly Engaged in Sham Transactions With Delphi</u>

In addition to alleging BBK's knowledge of the fraudulent transactions, the Complaint also alleges facts about the transactions themselves that demonstrate BBK's recklessness. As discussed below, the totality of the circumstances of these transactions, including the round-trip nature, the contextual timing and the magnitude, undoubtedly demonstrates that BBK recklessly disregarded the fact that the transactions were shams, lacking economic substance.

First, the round-trip nature of the transactions – they were done to remove inventory temporarily from Delphi's books – clearly indicates BBK's scienter. *See Global Crossing,* 322 F. Supp. 2d at 326, 337, 344-45; *Enron II,* 310 F. Supp. 2d at 829. Like Bank One and Setech, BBK's transactions were round-trips designed to be reversed quickly. ¶¶ 150, 520. Their short-term, round-trip nature, meant they posed no risk and generated no real revenue. In short, they were devoid of substance (or risk), especially considering BBK never even reached into its own purse.

Second, the contextual timing of these transactions supports a strong inference of BBK's scienter. BBK made these transactions with Delphi when the auto industry was known to be struggling. ¶¶ 103, 105-06. An experienced consulting firm that "works closely with businesses in the automotive and manufacturing sector," "holds a dominant . . . position in the area of automotive turnaround services" and boasts Delphi as a long-standing client, BBK was undoubtedly aware of the state of the industry. ¶ 68. Moreover, BBK – having attended regular, bi-monthly meetings with Delphi throughout this period – knew, or was reckless in not knowing, Delphi's true financial condition. ¶ 151.

Finally, the size of these transactions – $89 million – further supports a strong inference of scienter. *See Global Crossing*, 322 F. Supp. 2d at 347. Thus, based on the totality of the facts alleged, there can be no question that BBK knowingly or recklessly directly participated in sham transactions with Delphi, which had no purpose other than to materially inflate Delphi's income.

C. Plaintiffs Have Stated Claims Under Rule 10b-5(b)

1. The Officer Defendants

Defendants Battenberg, Dawes, Free, Blahnik, and Sheehan (the "Officer Defendants") do not seriously contend that Plaintiffs have failed to satisfy the "particularity" requirements of the PSLRA and Rule 9(b). Rather, they attempt to evade liability by (1) suggesting that they can only be liable for false statements or omissions directly attributable to them and (2) arguing that the Complaint fails to allege sufficient facts giving rise to a "strong inference" that they acted with scienter.

a. The Group Pleading Doctrine Applies to the Officer Defendants

The Officer Defendants are liable both for their own false statements (signed public filings or oral public statements), and for all of Delphi's public statements, under the "group pleading doctrine,"[54] which provides that:

> [W]here the false and misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other "group-published information," it is reasonable to presume that these are the collective actions of the officers. Under such circumstances, a plaintiff fulfills the particularity requirement of Rule 9(b) by pleading the misrepresentations with particularity and where possible the roles of the individual defendants in the misrepresentations.

In re Smartalk Teleservices, Inc. Sec. Litig., 124 F. Supp. 2d 527, 545 (S.D. Ohio 2000).

While the Sixth Circuit has not ruled whether the group pleading doctrine is viable post-PSLRA, the overwhelming majority of district courts within the Sixth Circuit have allowed for group pleading in post-PSLRA cases. *See Bridgestone*, 399 F.3d at 690; *Cardinal Health*, 2006

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[54] Contrary to the argument of certain Officer Defendants, Plaintiffs' allegations of scienter do not rely on group pleading, but rather on specific allegations applicable to each of the Individual Defendants.

WL 932017, at *38 n.67 ("plethora of district court decisions" within this Circuit and "the vast majority of cases decided nationwide" have recognized viability of the doctrine post-PSLRA); *FirstEnergy*, 316 F. Supp. 2d at 599-600. This Court, however, found otherwise in *D.E. & J. Ltd. P'ship v. Conaway,* 284 F. Supp. 2d 719, 731 (E.D. Mich. 2003). Plaintiffs respectfully request that the Court reconsider its earlier decision and find – as the overwhelming majority of courts have – that the "group-published doctrine does not eviscerate the specificity required by the PSLRA." *Cardinal Health*, 2006 WL 932017, at *38.

In addition, the Second Circuit, whose law "merits close consideration," Individual Def. Br. at 9 n.6,[55] continues to adhere to the group pleading doctrine post-PSLRA. *See In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 308 F. Supp. 2d 249, 266 n.7 (S.D.N.Y. 2004).[56] Under Second Circuit law, plaintiffs may rely on a presumption that statements in a company's public documents and other group-published information are the work of the company's officers and directors. *See In re Livent, Inc. Sec. Litig.*, 78 F. Supp. 2d 194, 219 (S.D.N.Y. 1999); *see also Goldin Assoc., L.L.C. v. Donaldson, Lufkin & Jenrette Sec.*, No. 00 Civ. 8688 (WHP), 2003 WL 22218643, at *5 (S.D.N.Y. Sept. 25, 2003). Such statements are also presumed to be the collective work of those individuals with direct involvement in the everyday business of the company. *See In re Bayer AG Sec. Litig.*, No. 03 Civ. 1546 (WHP), 2004 WL 2190357, at *15

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[55] As Defendants note, when cases have been transferred and consolidated through the MDL procedure, "the law of the transferor court – here, that of the Southern District of New York (and the Second Circuit in which it sits) – merits close consideration." *See* Individual Def. Br. at 9 n.6 (citing *In re Air Disaster*, 819 F. Supp. 1352, 1371 (E.D. Mich. 1993)). That close consideration is heightened where, as here, the law at issue remains unanswered by this Circuit.

[56] *See also In re Philip Serv. Corp. Sec. Litig.,* 383 F. Supp. 2d 463 (S.D.N.Y. 2004); *see also In re Complete Mgmt.*, 153 F. Supp. 2d 314, 326 n. 7 (S.D.N.Y. 2001); *In re Oxford Health Plans, Inc.*, 187 F.R.D. at 142.

(S.D.N.Y. Sept. 30, 2004); *In re Solv-Ex Corp. Sec. Litig.*, 210 F. Supp. 2d 276, 283 (S.D.N.Y. 2000); *Polar Int'l Brokerage Corp. v. Reeve*, 108 F. Supp. 2d 225, 237 (S.D.N.Y. 2000).

Here, because each Officer Defendant was directly involved in and intimately familiar with all aspects of Delphi's financial reporting practices (¶¶ 581-607), the identification of the individual sources of statements is unnecessary. *See DiVittorio v. Equidyne Extractive Indus. Inc.*, 822 F.2d 1242, 1247 (S.D.N.Y. 1987) ("No specific connection between fraudulent representations in [a published company document] is necessary where ... defendants are insiders or affiliates of the company."); *see also AOL Time Warner,* 381 F. Supp. 2d 192.

In sum, Plaintiffs have sufficiently identified actionable statements and omissions made by each Officer Defendant, including the specific financial statements signed by the Officer Defendants. To the extent that the Court determines otherwise, Plaintiffs respectfully suggest that application of the group pleading doctrine is appropriate.

b. Plaintiffs Have Pled Sufficient Facts Giving Rise to a Strong Inference of the Officer Defendants' Scienter

Plaintiffs have pled specific facts that individually and collectively establish that the Officer Defendants either knew or recklessly disregarded that Delphi's financial statements were materially false and misleading. The Complaint also establishes that the Officer Defendants had the motive and opportunity to manipulate Delphi's financial statements.

(1) The Officer Defendants' Conscious Misbehavior and Recklessness

The Officer Defendants' conscious misbehavior or recklessness is evidenced by: (1) their direct participation in the fraudulent transactions; (2) the massive size and obvious nature of Delphi's Restatement; (3) the widespread acknowledgment within the Company of Delphi's accounting machinations; (4) the timing of Delphi's accounting manipulations to meet period-end financial targets; (5) the methodical concealment of prior years' manipulations to unwind the fraud; (6) the resignation of chief officers after or shortly before Delphi's fraud was disclosed; and (7) critical deficiencies in internal control and an "ineffective tone at the top." *See generally* ¶¶ 117-226. Based on the totality of these circumstances, it is clear that the Officer Defendants acted with scienter.

(a) The Officer Defendants' Knowledge of and Direct Participation in Delphi's Fraudulent Transactions and Accounting Decisions

The Complaint sets forth detailed allegations demonstrating the Officer Defendants' knowledge of and direct participation in Delphi's fraudulent transactions and improper accounting practices. Specifically:

- According to CS 10, Battenberg and Dawes together pressured their accounting executives to make the numbers work. Battenberg, along with Dawes, had a "well-known habit," when presented with financial analysis that they did not like, of saying "I don't like this picture" or "I don't like what this picture is telling me," which were known to mean, "change the numbers, go change it, rework it." ¶ 586.

- Battenberg, Dawes and Sheehan knew that Delphi improperly accounted for inventory by intentionally not recording receipt of high-dollar inventory supplies. Each received a copy of the May 2004 Audit Report, which detailed how Delphi improperly recorded inventory and determined that, in order to comply with GAAP, Delphi would have to begin to "[r]ecord receipt of material in a timely manner." ¶¶ 195-98.

- In connection with Delphi's restated transactions with EDS, Dawes and Free demanded that EDS make price concessions in the form of rebate credits. ¶¶ 175, 630. CS 9 explained that Dawes and Free "insisted that the rebates be recognized up-front as opposed to when actually earned in subsequent periods." ¶ 176, and that Delphi's finance department was "pretty clear that they wanted the upfront payments from EDS" because "the whole issue was the timing of the savings. We were a young start-up company and **[we were] looking for numbers.**" ¶¶ 176, 631. All of Delphi's accounting for its EDS rebate transactions was handled in the finance department by Dawes and Free and their staff. ¶ 181.

- Dawes and Free knew that Delphi fraudulently accounted for approximately $22 million in payments made to EDS for system implementation services rendered in 2002. According to CS 9, Dawes, Free and the finance department handled all accounting aspects of the Delphi-EDS transactions. ¶ 181.

- According to *The Wall Street Journal* and CS 6, Dawes and Blahnik arranged and handled Delphi's sham, round-trip transactions with BBK. ¶ 151, 593. Dawes met regularly with BBK's CEO B.N. Bahadur and CFO William Diehl to discuss engagements between BBK and Delphi. ¶¶ 151, 592-94.[57] These Officer Defendants thus "had direct knowledge regarding Delphi's improper accounting for the three fictitious sales involving $89 million of inventory with BBK." ¶ 593.

- According to a Delphi employee, Delphi's warranty payment to GM, improperly characterized as a payment towards pension obligations so that the expense could be amortized rather than taken immediately, was the end result of lengthy negotiations "handled at the highest financial levels involving the CFOs of both companies." ¶ 628. At the time, Dawes was CFO of the Company. *Id.*

- According to CS 10, Free threatened to fire him for establishing $1 million in environmental reserves, which "weren't part of the corporate plan" and would prevent the Company from achieving Wall Street earnings targets. ¶¶ 201-02. Free's department then reversed the environmental reserve that CS 10 established. *Id.*

- Dawes and Free ordered, knew of orders or recklessly disregarded orders given by his finance staff to division financial personnel to record Delphi's worthless, obsolete inventory on the books as valuable inventory, as explained by CS 3, a former Delphi employee. ¶¶ 137, 592.

- Blahnik knew or recklessly disregarded that Delphi entered into a $200 million sham, round-trip transaction involving precious metals with Bank One and improperly recorded this transaction as a sale in December 2000. According to CS 7, this transaction was done by the Treasury Department, of which Blahnik was Vice-President, and was "done to try to generate cash flow from off balance sheet financing." ¶ 604.

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[57] Defendant Dawes' claim that the Complaint fails to allege his participation in the BBK transactions is thus incorrect. *See* Dawes Br. at 5. Dawes also proffers an apparent alibi – that he was hospitalized when the transaction was finalized. *Id.* at 13. Even were this representation proper, which it clearly is not, it would merely show that Dawes was not physically present at the consummation of the deal. That would not foreclose his participation prior to final completion or his participation by means of telephone, fax, or some form of electronic communication. Plaintiffs' allegations of Dawes' participation in the BBK transaction are thus entirely consistent with his improper factual representation. Dawes' alibi highlights the importance of permitting a finder of fact to weigh the parties' respective evidentiary claims.

These detailed allegations of the Officer Defendants' direct participation in Delphi's improper accounting and fraudulent transactions leave no doubt that the Officer Defendants knew they were committing fraud.[58] Indeed, based on the obvious and inherently fraudulent nature of these transactions, there is no simply no way that the Officer Defendants could have been involved in these transactions without knowing that they were fraudulent.[59]

(b) The Size, Duration and Obvious Nature of Delphi's Restatement <u>Create a Strong Inference of the Officer Defendants' Scienter</u>

Delphi's Restatement describes accounting manipulations whose massive size, long duration and obvious nature strongly imply that the Officer Defendants acted with scienter. The Sixth Circuit, among others, has held that a large fraud supports a finding of scienter for those

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[58] Attempting to minimize these allegations, Dawes pleads a lack of formal training in accounting. He states: "Noticeably absent from the Complaint is any allegation that Mr. Dawes **knew** that the accounting was improper or that he was involved in the original determinations. Plaintiffs also make no allegation that Mr. Dawes was an accountant." Dawes Br. at 13. This argument is tantamount to an admission that Dawes acted recklessly, for throughout the Class Period, he made repeated public assertions regarding the contents of, integrity of and accounting treatment for Delphi's financial statements.

[59] Notwithstanding the particularity of these allegations, Defendants assert that Plaintiffs' scienter allegations rely solely on the fact that the Officer Defendants held high positions at Delphi. *See, e.g.*, Individual Def. Br. at 12; Dawes Br. at 17; Blahnik Br. at 5. Defendants are in error. The cases they rely on stand only for the proposition that a complaint must set forth particularized facts and cannot merely allege that, because of a defendant's high-level position, the defendant "must have" known of the fraud. *See, e.g., D.E. & J Ltd. P'Ship*, 284 F. Supp. 2d at 743. Here, the Complaint is replete with detailed allegations concerning how the Officer Defendants (1) directly participated in or supervised Delphi's various sham transactions and manipulative accounting practices with BBK, Bank One, Setech, GM, and EDS (¶¶ 581-607) and (2) had unfettered access to documents establishing the misleading accounting for inventory financing transactions, warranty obligations and credits, rebates, and rebate credits received from the company's suppliers, including the May 2004 Audit Report (¶ 589). *See, e.g., In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 76 (2d Cir. 2001) (scienter adequately pled where plaintiffs pled facts to demonstrate that defendant's position gave him access to confidential information and control over its dissemination); *Complete Mgmt.*, 153 F. Supp. 2d at 325 ("[i]t thoroughly strains credulity to imagine that the individual defendants, by virtue of their positions" at the company "were ignorant of the practices" alleged, in that "making all reasonable assumptions in favor of the plaintiff includes assuming that principal managers of a corporation are aware of matters central to that business's operations."). Furthermore, it is well-settled that when disclosures involve a company's core business, "the Company's CEO and CFO . . . are presumed to have had pertinent knowledge." *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 599 (D.N.J. 2001); *see also In re Atlas Air Worldwide Holdings Sec. Litig.*, 324 F. Supp. 2d 474, 490 (S.D.N.Y. 2004). The Complaint's well-detailed allegations undermine the Officer Defendants' contentions that in their positions they had no knowledge of the improprieties occurring at Delphi.

with management or control of the culprit person or firm. *See P R Diamonds,* 364 F. 3d at 685 ("'[T]he greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly. This, of course, is a matter of degree, but it cannot be gainsaid that some violations of GAAP and some restatements of financials are so significant that they, at the very least, support the inference that conscious fraud or recklessness as to the danger of misleading the investing public was present.'"); *MicroStrategy,* 115 F. Supp. 2d at 636 ("the magnitude of the restated financials and the pervasiveness and repetitiveness of [the company's] GAAP violations [and] the simplicity of the accounting principles violated in this case. . . . serves to amplify the inference of scienter").

The magnitude of Delphi's false accounting supports scienter. As admitted in its Restatement, Delphi's year-end transaction with Bank One alone inflated the Company's pre-tax income for 2000 by $100 million and its cash flow from operations for 2000 by $200 million. ¶ 154. Delphi's accounting for its transactions with Setech and BBK also inflated the Company's income by $145 and $89 million respectively ¶ 122. Similarly, Delphi's accounting for its warranty settlement payments to GM reduced Delphi's post-retirement liabilities by $202 million in 2000, while its subsequent accounting treatment for the $85 million partial rebate of that payment boosted its income by $30 million in 2001 and $20 million in 2002. ¶¶ 164-65, 505.

The duration of Delphi's false accounting also provides an inference of scienter. *See In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 507 (W.D. Pa. 2002) (the "duration of the irregularities [spanning two fiscal years] are such that it is reasonable to find them probative of scienter").[60] Delphi's fraudulent accounting practices spanned several years, from the moment it became a public company in 1999 and continuing until 2005. That the Officer Defendants were entirely ignorant of these improper accounting and fraudulent transactions that materially misstated their young company's reported bottom line for years simply beggars belief.

Lastly, the simple, obvious nature of Delphi's accounting violations further supports a finding of scienter. *See MicroStrategy*, 115 F. Supp. at 638 ("[V]iolations of simple rules are obvious, and an inference of scienter becomes more probable as the violations become more obvious."). For example, Delphi's accounting for its transactions with EDS violated GAAP in two basic areas: "matching" and "revenue recognition." ¶¶ 495-502. Specifically, Delphi failed to match expenses with the associated revenues and improperly recognized revenue before it was earned. *Id.* Delphi's misclassification of its warranty settlement payments to and rebate from GM also violated GAAP's "matching" principle. ¶¶ 503-05. Further the BBK, Setech, and Bank One transactions lacked any economic substance, and should have been recorded as a financing transaction. ¶ 120. Here, the magnitude, duration and blatancy of the Company's accounting fraud strongly supports scienter.

(c) Widespread Acknowledgement Within the <u>Company of Delphi's Accounting Machinations</u>

Widespread accounting schemes such as those at issue are probative of scienter because such breadth and pervasiveness renders them unlikely to go undetected. *See, e.g., In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 377 (D. Md. 2004) ("In this case, the

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[60] *See also P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 608 (D. N.J. 2001) (magnitude of fraud directly relevant to finding of scienter); *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 ("Strengthening the inference that [defendant] knew of the statements was the magnitude of the alleged falsity").

complaint portrays a fraud so massive and pervasive throughout Royal Ahold and USF that it strongly supports 'an inference that fraud or recklessness was afoot' and this 'serves to amplify the inference of scienter to be drawn'").[61] As expressed by Royal Ahold's interim CFO, who Judge Blake quoted in support of finding scienter:

> I find it inconceivable that such a fraud can remain undetected for so long . . . [I]t does seem to me also quite extraordinary that a business can go on so long with the creation of fraudulent receivables and they are not picked up, either, by the way, by management or by the auditors.

Id.

Here, like in *Royal Ahold*, it is inconceivable that Delphi's fraud, which pervaded so many aspects of the Company's business, went undetected by the Officer Defendants for years. Delphi's fraudulent transactions and accounting improprieties occurred in both the United States and Mexico; spanned all areas of the Company's business, and involved the Company's inventory, environmental reserves, pension obligations, warranty obligations, credit facilities and information technology systems. *See, e.g.,* ¶¶ 130, 133-43, 151, 169, 175-84, 188-90, 200-02.

Further, former employees have stated that Delphi's schemes to manipulate inventories were widely known throughout Delphi. According to CS 4, schemes to understate Delphi's inventory levels were a "constant feature" of his employment. ¶ 191. He explained that Delphi's executives ordered employees to lower inventory levels during weekly Wednesday conference calls, referred to as "cash calls." ¶¶ 192-93. CS 4 also explained how transactions with Setech

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[61] *See also, SEC v. Moskowitz*, No. 97 Civ. 7174 (HB), 1998 WL 524903, at *3 (S.D.N.Y. Aug. 20, 1998) ("magnitude of scheme and degree of oversight needed to coordinate securities activities supported district court conclusion that illegal activity could only have occurred at the direction of upper-level management, and therefore evidence was sufficient to establish that high-ranking bank executive had knowledge of the fraudulent scheme").

were orchestrated and promoted company-wide as part of a deliberate management plan to reduce inventory levels and inflate income. ¶ 144.

Delphi's inventory abuses were documented in the May 2004 Audit Report, which was distributed to Battenberg, Dawes and Sheehan. ¶¶ 195, 198. This report detailed how (i) Delphi consistently failed to record materials received as inventory in a timely fashion, and (ii) Delphi's failure to timely record inventory may render its financial statements to be misstated or not prepared in accordance with GAAP. ¶¶ 196-97. This report is a classic example of "divergence between internal reports and external statements on the same subject," which the *Helwig* court listed as a factor indicative of scienter. 251 F.3d at 552.

(d) <u>The Suspicious Timing of the Fraudulent Transactions</u>

The timing of Delphi's fraudulent transactions, frequently carried out just before the end of critical financial reporting periods, further supports an inference of scienter. *See MicroStrategy,* 115 F. Supp. 2d at 639 (inference of scienter supported where defendant's "accounting irregularities involved contracts signed at or near [year] end"); *Chalverus*, 59 F. Supp. 2d at 234 ("Drastic overstatements of revenue are particularly suspect when the transaction occurs at a suspicious time, such as the end of a fiscal quarter or year.").

Delphi's sham transaction with Bank One book-ended the end of its 2000 fiscal year. Delphi "sold" $200 million of precious metals to Bank One in December 2000 – right before the close of the 2000 year-end reporting period – and "bought-back" those same precious metals weeks later, in January 2001 – right after the close of that reporting period. ¶ 152. Of Delphi's $268 million in reported cash flow from operations in 2000, $200 million (75%) was attributable to this sham transaction. Thus, while the auto industry as a whole was suffering, Delphi was able to boast record cash flow through a strategically timed, fraudulent transaction. ¶¶ 154-55.

Delphi's transactions with BBK, handled by Dawes and Blahnik, were "done in order to move things off the books for a short period of time, and then bring them back on the books when cash flow improved." ¶¶ 150-51. This improper purpose is highlighted by the fact that two of the three admittedly sham inventory transactions with BBK to which Delphi admitted were done at year-end. ¶¶ 147-48. Delphi also engaged in sham transactions with Setech in the fourth quarter of 2000, which enabled Delphi to report additional cash flow without recording additional debt. ¶ 129.

(e) <u>The Methodical Unwinding of Previous Years' Fraud</u>

Delphi's deliberate concealment of its fraud is further evidence of the Officer Defendants' scienter. Following the passage of SOX, the Officer Defendants faced potential criminal liability for signing willfully inaccurate certifications of financial statements and, consequently, scaled back much of their earlier, fraudulent conduct. ¶¶ 355, 638, 673. Upon filing Delphi's first SOX certification in late July 2002, Battenberg deceptively told newspapers: "What Sarbanes Oxley did for me as CEO is, it validated the path we were on. We haven't had to change much of anything." ¶ 639. This was not the case.

Beginning in or about mid-2002, Delphi began to leak bad news through reports of declining earnings, reduced guidance and massive restructuring costs in order to condition the market to expect leaner quarters going forward. ¶¶ 355, 677. However, at no point during these disclosures did Delphi inform the investing public of the real reason behind its declining financial results. Even the most sophisticated analysts were unable to detect Delphi's scheme to unwind its earlier fraud. By leaking bad news and concealing the lingering effects of their earlier machinations, the Officer Defendants ensured that investors and analysts would not learn the true state of Delphi's financial condition. ¶ 355. Such opaque financial reporting supports an inference of scienter. *See Helwig*, 251 F.3d at 552 ("disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication" is indicative of scienter). Among the many facts and circumstances supporting the inference of the Officer Defendants' scienter, their collective effort to "bury the body" may be the strongest.

(f) <u>The Well-Timed Resignations and/or Demotions of Officers</u>

Upon completing its internal investigation, Delphi dismissed Free, demoted Blahnik, allowed Dawes to resign after a finding of "a loss of confidence," and accepted Battenberg's resignation. Such suspiciously timed departures are probative of scienter. *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1275 (N.D. Cal. 2000); *In re Mercator Software, Inc. Sec. Litig.*, 161 F. Supp. 2d 143, 150 (D. Conn. 2001); *In re Adaptive Broadband Sec. Litig.*, No. C 01 1092 SC, 2002 WL 989478, at *14 (N.D. Cal. Apr. 2, 2002); *Coble v. Broadvision Inc.*, No. C 01-01969-CRB, 2002 WL 31093589, at *7 (N.D. Cal. Sept. 1, 2002); *Gelfer v. Pegasystems, Inc.*, 96 F. Supp. 2d 10, 16 (D. Mass. 2000). In *McKesson*, the court found that the dismissals of certain officers, in the context of a large restatement and comments by new management regarding the performance of the former employees amounted to "strong circumstantial evidence of fraud" and constituted "sufficient allegations of scienter." 126 F. Supp. 2d at 1274-75.

Similarly, the events here involve accounting irregularities and a massive restatement followed by wide-spread resignations, demotions and dismissals, and negative characterizations of disciplined employees by new management.[62] The Complaint alleges the following factual ties between the departures of Battenberg, Dawes, Free and Blahnik and the instant fraud:

- On February 23, 2005, Battenberg announced he would retire, and Delphi did not name his successor. ¶ 208;

- On March 4, 2005, Delphi released "preliminary findings" of an internal investigation launched that pointed to "widespread accounting irregularities in Delphi's transactions dating back to 1999." ¶¶ 209, 212;

- On this same date, the Audit Committee revealed that it had met with supervisory employees and members of management who were involved with or knew about the transactions at issue "to evaluate the conduct and knowledge of these individuals, and to consider after carefully evaluating all of the findings of the investigation and the level of cooperation, what personnel changes or other steps, if any should be taken to strengthen the Company's internal controls and procedures over financial reporting and disclosure controls and procedures to prevent the future occurrences of similar errors." ¶ 213;

- Concurrent with this announcement and acknowledgment that it had met with culpable persons with knowledge or supervisory responsibility over these accounting manipulations and improper transactions, the Audit Committee announced the resignation of Dawes, Delphi's CFO and Vice-Chairman, because the Audit Committee "had expressed a loss of confidence in him." Delphi's chief accountant and controller, Free was also dismissed, and Blahnik, Vice President of Treasury, Mergers and Acquisitions, was demoted. ¶ 214; and

- On June 8, 2005, Delphi announced the resignation of Blahnik. ¶¶ 220, 603.

[62] The other cases cited by the Defendants are inapposite. In *In re Cornerstone Propane Ptnrs L.P. Sec. Litig.*, 355 F. Supp. 2d 1069, 1092-93 (N.D. Cal. 2005), the court held that departures "are not **in and of themselves** evidence of scienter." *Id.* (emphasis added). In *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003), the Fifth Circuit affirmed the district court's holding that executive resignations, part of plaintiffs' "bare allegations of motive and opportunity" would not support a strong inference of scienter. In *Kurtzman v. Compaq Computer Corp.*, No. H-99-779, 2002 WL 32442832, at *10 (S.D. Tex. Mar. 30 2002), the court held that resignations following the announcement of poor earnings could not support scienter where plaintiffs failed to plead facts "connecting the resignations in some way with fraud or malfeasance." *Id.*

Battenberg, Dawes, Free and Blahnik dispute that their resignations, demotions and/or dismissals support a strong inference that they were involved in wrongdoing. *See* Individual Def. Br. at 15-16; Blahnik Br. at 6. In support of this argument, Defendants rely on *In re Interpool Inc. Sec. Litig.*, No. Civ. 04-321 (SRC), 2005 WL 2000237 (D.N.J. Aug. 17, 2005). Such reliance is misplaced. *Interpool* holds that resignations without more cannot support a strong inference of intent to commit the fraud. Here, the Complaint provides much more. In addition to the allegations concerning the Defendants' demotions, dismissals and resignations, the Complaint sets forth numerous other allegations demonstrating the Officer Defendants' scienter including, among others, their direct participation and knowledge of the fraud, their motive to commit fraud, the massive size and duration of the fraud and the obvious nature of the accounting violations. Indeed, Plaintiffs allege an overwhelming set of circumstances that demonstrate that the Officer Defendants knew or, at a minimum, recklessly disregarded the pervasive fraud at Delphi.

(g) <u>Internal Control Deficiencies and the Ineffective "Tone" at the Top</u>

Failure to maintain sufficient internal controls to avoid fraud is indicative of scienter. *Atlas Air*, 324 F. Supp. 2d at 497-98; *In re Oxford Health Plans, Inc. Sec. Litig.*, 51 F. Supp. 2d 290, 294 (S.D.N.Y. 1999); *Zaretsky v. E.F. Hutton & Co., Inc.*, 509 F. Supp. 68, 75-76 (S.D.N.Y. 1981).[63] The Officer Defendants were, at the very least, reckless to participate in the issuance of financial statements where Delphi lacked adequate controls over financial reporting and experienced deficiencies in its disclosure controls and procedures. ¶ 223. An internal

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[63] *See also Royal Ahold,* 351 F. Supp. 2d at 378; *Crowell v. Ionics, Inc.*, 343 F. Supp. 2d 1, 16 (D. Mass. 2003); *In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 509 (W.D. Pa. 2002); *In re Lernout & Hauspie Sec. Litig.*, 208 F. Supp. 2d 74, 88-89.

investigation conducted by Delphi's Audit Committee concluded that Delphi had "[a]n ineffective 'tone' within the organization related to the discouragement, prevention or detection of management override as well as inadequate emphasis on thorough and proper analysis of accounts and financial transactions." ¶¶ 485, 633. Further, Delphi's management assessment pursuant to SOX Section 404 determined that Delphi did not maintain effective internal controls over financial reporting. ¶ 223.

The Officer Defendants were clearly reckless to participate in the preparation of financial statements when Delphi's internal controls were inadequate to prevent Delphi from, among other things: (1) inflating earnings by immediately recognizing rebates and credits received from suppliers in the periods in which these payments were received rather than over the period during which the services were performed or products purchased; (2) deferring the recording of expenses for system implementation services, materially understating expenses and overstating earnings in 2002; (3) inflating cash flow from operating activities and income through sham transactions with Bank One, Setech and BBK; (4) misclassifying warranty settlement payments to GM as an adjustment for post-retirement obligations and amortizing them over time rather than expensing them immediately; and (5) improperly failing to accrue for obligations and recording adjustments in the wrong period to inflate Delphi's earnings per share.

(2) <u>The Officer Defendants' Motive For Committing Fraud</u>

The Officer Defendants had a strong financial motive to commit fraud. Under the Company's Annual Incentive Plan, each Officer Defendant stood to be rewarded with significant cash bonuses for achieving specific financial targets, including, net income, pre-tax income, earnings per share, cash flow, inventory turnover, sales growth, and increase in customer base.

¶ 95. As the Officer Defendants' bonuses were dependent upon Delphi's apparent financial performance, they are directly relevant to the Defendants' motives for artificially inflating Delphi's performance. *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 661-63 (8th Cir. 2001).

Moreover, Delphi was a new company, and the Officer Defendants were keenly aware that any signs of its financial health – even small, incremental improvements – would buoy it in the stock market and in turn increase their bonuses. *See Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 83-84 (1st Cir. 2002). One crucial measure of improvement was Delphi's ability to wean itself off of GM as its primary customer and thus, in each of its quarterly and annual financial statements, non-GM revenue was among the primary indicators of Delphi's health. ¶¶ 98-99, 228-29, 231, 234, 236, 656. The Officer Defendants knew that the stock market would reward Delphi if it showed signs of independence from GM. *See, e.g.*, ¶ 232. Through its fraudulent transactions with BBK, Setech and Bank One, the Officer Defendants artificially boosted its non-GM revenue figures at a critical moment in Delphi's young corporate life and received substantial financial rewards for doing so. *See, e.g.* ¶¶ 229, 236, 238, 246, 248, 256.

In particular, due to their fraudulent scheme, the Officer Defendants received the following bonuses for 1999 under the Incentive Plan: Dawes received a $635,000 bonus plus a $506,000 salary; Runkle received a $650,000 bonus plus a $581,000 salary; and Battenberg received a $2.2 million bonus plus a $1.2 million salary. ¶ 95. For 2000, Dawes received a $1.1 million bonus plus a $700,000 annual salary; Runkle received $1.17 million bonus plus a $800,000 salary; and Battenberg received a $2.6 million bonus plus a salary of $1.387 million.

¶ 111. Each of these generous bonuses was based on Delphi's false claims that it met or exceeded its performance expectations. ¶ 111.

The Officer Defendants contend that the Complaint's allegations of motive and opportunity alone are insufficient to establish scienter. Individual Def. Br. at 19-20; Dawes Br. at 3, 14-16.[64] Defendants' argument badly misses the mark. Contrary to Defendants' misstatements of law, *Helwig* and *Comshare* both held that motive and opportunity alone **may** create a strong inference of recklessness or knowing conduct, so long as a complaint does not elevate labels over substantive allegations. *Helwig*, 251 F.3d at 550; *Comshare*, 183 F.3d at 551. Nevertheless, Plaintiffs have not pled motive and opportunity in isolation, but rather as part of the totality of circumstances supporting a strong inference of scienter.[65]

(3) Lead Plaintiffs' Confidential Sources Are Described in the Complaint with Sufficient Particularity

Rather than dispute the facts supplied by Plaintiffs' confidential sources, Defendants seek to undermine their credibility by demanding more information about them. Individual Def. Br. at 13-15.[66] This argument is unavailing. A confidential source should be "described in the

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[64] Similarly, the Officer Defendants contend that the absence of insider trading suggests they lacked "motive and opportunity" to commit fraud. Individual Def. Br. at 19-20; Dawes Br. at 3. This is a red herring. While insider trades may provide additional evidence of motive, their absence does not weigh against motive. *Green Tree Fin.*, 270 F.3d at 663 ("[T]he investors do not rely on allegations of inside transactions, but on other motives, such as the hope of huge bonuses, that are not directly undermined by their abstention from trading").

[65] The cases cited by Defendants emphasize this very point. *Helwig* held that "the **bare** pleading of motive and opportunity does not, standing alone, constitute the pleading of a strong inference of scienter." 251 F.3d at 550 (citing *Comshare*, 183 F.3d at 551) (emphasis added). But the court added that motive and opportunity "can be catalysts to fraud and so serve as external markers to the required state of mind." *Comshare* made this distinction by refusing to equate motive and opportunity with scienter but yet recognized that facts showing each may support a strong inference of recklessness." *Id.* The court added: "[F]acts presenting motive and opportunity **may be of enough weight to state a claim under the PSLRA**, whereas pleading conclusory labels of motive and opportunity will not suffice." *Id.* at 551 (citing *Comshare* at 551) (emphasis added).

[66] Free incorporates the Individual Defendants' argument against Plaintiffs' confidential sources. Free Br. at 4 n.1. But that argument, focusing almost exclusively on allegations by CS 10 against Battenberg (Individual Def. Br. at

(Cont'd)

complaint with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged." *Novak v. Kasaks*, 216 F.3d 300, 314 (2d Cir. 2000); *Helwig*, 251 F.3d at 557 n.4 (citing *Novak*). The Complaint more than satisfies this requirement.

For example, CS 1 is described as "a current manager at Setech [who] was involved in early discussions and initial presentations that Setech made to Delphi" regarding the indirect materials program. ¶ 125. CS 2 "worked for Setech for almost two decades [and] was responsible for significant aspects of the contract between Delphi and Setech." ¶ 127. These confidential sources provide information consistent with Delphi's 2005 Restatement. CS 3 is described as a "senior manager for Delphi through most of the Class Period and had significant responsibilities pertaining to manufacturing, materials, and asset management issues for Delphi's Energy & Chassis Division." One of his responsibilities "was to resolve the Company's inventory problems and, in particular, its indirect materials inventory problem." ¶ 130. These descriptions provide more than sufficient information to show that these confidential sources were in positions to provide reliable information about the transactions and schemes they describe.

Plaintiffs' remaining confidential sources are equally reliable. CS 4 is "a former GM and Delphi employee who was involved in logistics for Delphi's Electronics and Safety Division until 2004" who "confirmed that Delphi sold indirect materials to Setech during 1999 and 2000 in order to get the inventory off Delphi's books." ¶ 141. CS 5 is a "BBK consultant from 2001

13-15), ignores the mutually corroborating allegations of CS 3 (¶¶ 137-38, 599), CS 5 (¶¶ 150, 593, 604), CS 6 (¶ 151), and CS 9 (¶¶ 176, 181, 184, 595-96, 600-01, 631) against Free.

to 2003 who had previously worked for GM for over thirty years…." ¶ 150. CS 6 "worked in the senior executive offices of BBK during the early part of the Class Period, assisting in the preparation of reports and presentations for senior management." ¶ 151. These confidential sources were in positions to confirm and describe in detail Delphi's business dealings with BBK.

Further, Blahnik, in attacking the confidential sources' credibility, conveniently omits the following facts, which establish a strong inference of his scienter: CS 6 confirmed that Blahnik, along with Dawes and others, arranged and handled the BBK transactions for Delphi (¶¶ 151, 593); CS 5 stated that Blahnik and others knew or recklessly disregarded that Delphi's accounting for the $89 million BBK transactions was improper (¶ 604); and CS 7 stated that the Blahnik's Treasury Department used the $200 million Bank One sham transaction "to try to generate cash flow from off balance sheet financing" (¶ 604). Where, as here, the Complaint relies not merely on confidential sources, but also on ample documentary evidence of the malfeasances in question – the Restatement – information gleaned from confidential sources both corroborates and is corroborated by this other evidence.

Both separately and in the aggregate, the allegations against Defendants from Plaintiffs' confidential sources imply that they were heavily involved in the improper transactions at issue and were aware, or recklessly unaware of, the improper purpose of these transactions. The most reasonable (and obvious) inference to be drawn from these facts – one to which Defendants offer no alternative – is that Defendants intended for the Setech, BBK, Bank One, GM and EDS transactions to artificially bolster Delphi's financial performance.

2. <u>Deloitte Knew or Recklessly Disregarded Delphi's Massive Fraud</u>

Deloitte signed off on every annual financial statement at issue in this case, each time issuing unqualified opinions stating that those financial statements were prepared in accordance with GAAP. ¶ 537. Delphi and Deloitte have conceded that those opinions were indisputably incorrect. ¶¶ 210, 543. Indeed, Delphi was forced to admit in the Restatement that, contrary to Deloitte's audit opinions, (1) Delphi's financial statements had not been prepared in accordance with GAAP, and (2) as such, those financial statements were false and misleading. *Id.* Notwithstanding that there can be no dispute that its audit opinions were egregiously wrong, Deloitte claims that it cannot be held liable under Rule 10b-5 because the Complaint does not allege sufficient facts to raise a strong inference that Deloitte acted with scienter. Deloitte's argument is meritless.

This is not a case where Deloitte can claim with a straight face that it was an outside auditor with no idea of what was going on with the company it was auditing. Nor can Deloitte reasonably claim that it was duped or outsmarted by the Officer Defendants who manipulated Delphi's financial reports. Quite the contrary, this is a case where Deloitte was intimately involved with Delphi at every stage of its existence, from its conception, to its birth, to its descent into bankruptcy. ¶¶ 61, 531-34. Deloitte, perhaps better than anyone else, was positioned to know of, and put a stop to, the accounting chicanery carried out by the Officer Defendants, Bank One, Setech and BBK and involving GM, EDS and others.

As a threshold matter, Deloitte knew that Delphi was a start-up company. As such, Deloitte knew that Delphi would have growing pains as it separated from GM and would need to either create new internal control procedures or modify those used by GM to fit Delphi's needs.

Deloitte knew that it would need to pay careful attention to Delphi in its infancy to ensure not only that Delphi put adequate internal controls in place, but also, that the Officer and Audit Committee Defendants adhered to those controls.

Deloitte's role in this regard was heightened by the fact that Delphi hired Deloitte to create the very financial information systems that the Officer and Audit Committee Defendants used to carry out its fraud. ¶ 534. Deloitte knew everything there was to know about this financial information system, including where to look for accounting improprieties. Deloitte was therefore in a unique position to that of just about any other outside auditor of a public company – it designed and implemented the very financial systems through which the Officer Defendants reported their misleading accounting maneuvers. Yet, Deloitte signed off on every financial statement at issue, all of which were ultimately restated. ¶¶ 537, 543.

Deloitte's intimate awareness of Delphi's inner workings was not limited to the creation and implementation of the accounting systems used to carry out this fraud. Deloitte also served as outside auditor for GM. ¶¶ 561-62. Deloitte's audits for both companies were headed by the same office. ¶ 562. As discussed in greater detail below, the warranty payment dispute at the heart of the $237 million dollar payment to GM arose at the time of the split between GM and Delphi. ¶¶ 158-59. This payment was the subject of lengthy negotiations and a mediation between senior Delphi and GM executives. ¶ 614. Delphi and GM ultimately resolved the dispute upon which Delphi executed a written agreement to pay $237 million in cash to GM as settlement of the warranty claims. *Id.* Delphi subsequently turned around and accounted for this warranty payment to GM as payment of a pension obligation. ¶ 160.

Deloitte also signed off on this accounting treatment for these payments. ¶ 537. On the other hand, GM accounted for these payments in a wholly different manner. ¶ 562. And, as GM's outside auditor, Deloitte signed off on GM's differing accounting treatment for these same payments. *Id.* Each company's treatment of these payments is at the heart of the ongoing federal criminal and civil investigations of each company. Given Deloitte's role as outside auditor for both companies, every alarm at Deloitte's Detroit offices should have emitted an ear-splitting sound when these two high-profile clients accounted for the same transaction in a markedly different way.

Equally troubling is the fact that Deloitte again stood by and allowed the Officer and Audit Committee Defendants to manipulate the Company's financial statements within its first two years as a public company by way of Delphi's precious metals transaction with Bank One. ¶ 559. Delphi's accounting treatment for this transaction quadrupled Delphi's cash flows from operations for that quarter from $68 million to $268 million, and allowed it to meet its earnings projections in that quarter. ¶ 558-59.[67] For Deloitte to turn a blind eye to such a transaction, especially in light of the fact that a relatively new company re-opened the books within weeks of its initial accounting for this transaction at a time when such financing transactions were being called into question in accounting scandals across the country, is particularly telling.

Based upon these facts, there is only one reasonable inference that can be drawn: Deloitte either knew this fraud was occurring, or was reckless in not catching it. These facts, taken alone, are enough to establish Deloitte's scienter. However, as is discussed more fully below, these

[67] As explained above, Lead Plaintiffs' sources also reveal that, shortly after the books had been closed for the fiscal year ended December 31, 2000, Delphi re-opened the books and made additional entries regarding this fraudulent "sale" of precious metals.

facts cannot be viewed in isolation. To the contrary, Deloitte's scienter must be viewed in light of the totality of the circumstances surrounding Delphi's accounting violations. In addition to these facts—and the inescapable admission that Deloitte failed to catch **even one** of the many accounting violations that resulted in one of the most massive restatements in U.S. history – the Complaint alleges with great particularity a plethora of additional facts that create a strong inference that Deloitte acted with scienter.[68]

a. The Standard for Recklessness by Auditors

As noted above, recklessness satisfies the scienter requirement for § 10(b) liability. With respect to auditors, the Sixth Circuit has stated that recklessness involves an audit "so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *Fidel*, 392 F.3d at 227; *see also PR Diamonds*, 364 F.3d at 694 ("'to allege that an independent accountant or auditor acted with scienter, the complaint must identify specific, highly suspicious facts and circumstances available to the auditor at the time of the audit and allege that these facts were ignored, either deliberately or recklessly'") (internal quotes omitted); *Novak*, 216 F.3d at 308 (allegations that the defendants "failed to review or check information that they had a duty to

[68] Attempting to distract the Court from the Complaint's particularized allegations as to Deloitte's scienter, Deloitte harps on a statement by Plaintiffs' counsel at a hearing in the Bankruptcy Court that Plaintiffs do not "know exactly at this point where that [Deloitte's] error was. I mean, it's conceivable that it could be at any level." Deloitte Br. at 4. From this, Deloitte asks the Court to conclude that Plaintiffs' allegations as to scienter are "speculative." *Id.* This is a complete red herring. The issue at the Bankruptcy Court hearing was not whether or not Deloitte committed fraud, but only whether the fault lay with the Deloitte partners as opposed to with Deloitte's more junior audit staff. The uncertainty at issue in the Bankruptcy Court is irrelevant here, because a securities plaintiff has no obligation to identify which individuals within a defendant's corporate structure were responsible for the fraud. *See In re WorldCom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005).

monitor, or ignored obvious signs of fraud" are sufficient to allege recklessness). Therefore, although Deloitte's brief addresses Plaintiffs' allegations as to scienter in piecemeal fashion, viewing each allegation standing alone, the courts have rejected that approach and instead analyze scienter allegations in their totality. *Telxon*, 133 F. Supp. 2d at 1026.

b. The Magnitude of Delphi's Fraud Creates a Strong Inference of Deloitte's Scienter

Deloitte argues that Delphi's Restatement does not, by itself, create a strong inference of Deloitte's recklessness in issuing clean audit opinions on the Company's financial statements. Deloitte Br. at 7. Contrary to Deloitte's suggestion, however, the Restatement did not involve minor corrections or slight deviations from complicated accounting pronouncements involving the exercise of judgment. Rather, Delphi's restatements were massive both with respect to the amount of money involved – hundreds of millions of dollars in misstated income and expenses – and also in terms of the extent of the departures from longstanding and clear GAAP provisions.

Courts evaluating the sufficiency of securities fraud claims against auditors in similar circumstances consistently have found that the magnitude of a company's restatement is probative of an independent auditor's reckless misconduct. There can be no dispute that "the scope of the fraud alleged may appropriately be considered in determining whether scienter has been adequately pled." *Global Crossing,* 322 F. Supp. 2d at 347. As stated by the Sixth Circuit in *PR Diamonds* 364 F.3d at 685, "indeed, common sense and logic dictate that the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly." In words that read almost as if written for the situation at bar, *In re American Bank Note Holographics, Inc. Sec. Litig*, 93 F. Supp. 2d 424, 447 (S.D.N.Y. 2000), stated that "the admitted falsity of the statements, the extraordinary degree to which they were false, the length of time (covering several years) that the statements were false, and [the defendants'] access [to the company's] actual sales and revenue information . . . combine to raise a strong inference that [the defendants] engaged in conduct that was either conscious or reckless."[69]

As set forth above, Delphi overstated its net income for 2000 by $185 million or 22%; by $32 million or 8% in 2001; and by $24 million or 7.5% in 2002. The accounting manipulations behind these misstated financial results did not involve complex accounting rules but involved the most fundamental concepts of GAAP. Specifically, Delphi violated the concept of "matching" revenues and expenses and recognizing revenue when it is actually earned (¶¶ 495-96), and simply misclassified transactions, such as the recording of payment of a warranty expense as a payment of a pension obligation (¶¶ 503-06). With respect to the sham sales of inventory to BBK, Bank One, and Setech, Delphi's accounting for those transactions violated specific GAAP pronouncements, which demand these transactions be treated as financing transactions and not sales. ¶¶ 517-18.[70]

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[69] *See also In re Winstar Commc'ns*, No. 01 CV. 3014 (GBD), 2006 WL 473885, at *10 (S.D.N.Y. Feb. 26, 2006) ("Allegations of GAAP violations when combined with a drastic overstatement of financial results can give rise to a strong inference of scienter . . . [and] the totality and magnitude of the . . . accounting violations [may] constitute strong circumstantial evidence of reckless or conscious misbehavior") (internal quotation marks omitted); *In re Royal Dutch/Shell Transport Sec. Litig.*, 380 F. Supp. 2d 509, 570 (D.N.J. 2005) (finding that "magnitude of the reserves restatement," among other factors, created strong inference of auditor's recklessness); *MicroStrategy*, 115 F. Supp. 2d 620, 636; *In re Next Level Sys., Inc. Sec. Litig.*, No. 97-C-7362, 1999 WL 387446, at *11 (N.D. Ill. Mar. 31, 1999); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1345 (S.D. Fla.1999); *Computer Assocs. Class Action Sec. Litig.*, 75 F. Supp. 2d 68, 74 (E.D.N.Y. 1999).

[70] Unlike the blatant GAAP violations and massive restatement at bar, the cases relied upon by Deloitte in arguing that a restatement cannot give rise to an inference of recklessness simply stand for the converse proposition – a small, insignificant restatement or a large restatement without blatant GAAP violations cannot support an inference of recklessness on the part of the auditor. *See PR Diamonds*, 364 F.3d at 685-86 ("the accounting irregularities Plaintiffs allege in this case are significantly less egregious in nature and magnitude"); *Merzin v. Provident Fin. Group, Inc.*, 311 F. Supp. 2d 674, 683 (S.D. Ohio 2004) (finding that size of restatement alone, without allegations of red flags or blatant GAAP errors did not create inference of scienter); *In re SCB Computer Tech., Inc. Sec. Litig.*,

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The Court should not be misled by Deloitte's argument that one of the GAAP violations identified by Plaintiffs, involving application of FAS 49, cannot give rise to an inference of scienter because FAS 49 is a complicated provision requiring "judgment calls." Deloitte Br. at 9. This argument is nothing more than an invitation for the Court to draw inferences in Deloitte's favor and to resolve factual issues on a motion to dismiss – precisely what the Court may not do on this motion. Instructive is the Eighth Circuit's statement in *Green Tree Fin.*, 270 F.3d at 666:

> Undoubtedly, the accounting issues are complex; whether they were handled within the parameters of good faith decision-making or whether the decisions amounted to recklessness will surely be the focus of any trial of this case. We will not prejudge that issue. But neither the district court, nor we, can conduct a battle of experts on a motion to dismiss. Rather, we must assume the truth of the allegations pleaded with particularity in the complaint. The strong-inference pleading standard does not license us to resolve disputed facts at this stage of the case.

See also Global Crossing, 322 F. Supp. 2d at 339 ("Whether or not the Companies' practice of accounting for IRUs was ever acceptable under the applicable provisions of GAAP cannot be determined in advance of the development of the record. Eventual evidence on industry practice or expert testimony are likely to shed light on this question, but at the current procedural phase, the plaintiffs' assertion that they were **not** generally accepted must be taken as true.").[71]

Similarly inapposite is Deloitte's reference to an observation by Bankruptcy Judge Drain that Plaintiffs' allegations against Deloitte involve "allegations with respect to judgment calls."

149 F. Supp. 2d 334, 351 (W.D. Tenn. 2001) (noting that "the revenue associated with the PRI and Quest contracts recognized in the third and fourth quarter were nowhere near the magnitude of improperly recognized revenues in other cases.").

[71] Deloitte's reliance on *In re Bristol Meyers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 568 (S.D.N.Y. 2004), for its argument that Delphi's violation of FAS 49 cannot give rise to a strong inference of scienter, is misplaced. In that case, the company's internal investigation of its accounting had concluded that the errors "involved[] significant judgments." 312 F. Supp. 2d at 568. In contrast, here, Delphi has not stated that its internal investigation concluded that nothing more than mistaken judgment calls were involved, and the existence of the criminal investigation by the United States Attorneys' office clearly suggests otherwise.

Deloitte Br. at 11. The result on this motion is not controlled by Bankruptcy Judge Drain, and this Court need not and should not defer to the Bankruptcy Court over whether the Complaint states a Rule 10b-5 claim.[72] Moreover, in reality, the Bankruptcy Judge did not express a view on that subject.[73]

c. The Presence of Numerous Red Flags Creates a Strong Inference of Deloitte's Scienter

As the Sixth Circuit stated in *PR Diamonds*, 364 F.3d at 686, "[s]pecific factual allegations that a defendant ignored red flags, or warning signs that would have revealed the accounting errors prior to their inclusion in public statements, may support a strong inference of scienter." "Because the red flags would be clearly evident to any auditor performing its duties, one could reasonably conclude that [the auditor] must have noticed the red flags, but deliberately chose to disregard them." *Philip Servs.*, 383 F. Supp. 2d at 475 (denying motion to dismiss filed by Deloitte). Thus, an "auditor's reckless disregard of red flags, coupled with allegations of violations of GAAP and Generally Accepted Auditing Standards ("GAAS"), is sufficient to

[72] This is not the first time that Defendants have sought to have the direction of this case dictated by the Bankruptcy Judge. As the Court will recall, the Underwriters previously moved before Judge Drain for a preliminary injunction staying the prosecution of this case. After Lead Plaintiffs submitted their opposition to that motion, however, the Underwriters withdrew their meritless motion.

[73] At issue in the Bankruptcy Court was whether Deloitte could be deemed competent and disinterested for the audit of Delphi's 2005 financial statements, where Deloitte's audit team for the 2005 audit did not include top partners from the defective 2000-04 audits, but the rest of the audit team remained the same. When viewed in context, what Judge Drain said was that he viewed Deloitte's alleged wrongdoing to have occurred at the partner level, not the staff level, so that changing the audit partners made a difference. While Lead Plaintiffs contend that Judge Drain had no factual basis for that conclusion (because, *inter alia*, he denied Lead Plaintiffs the opportunity to take any discovery to prove at what level within the Deloitte audit team the wrongdoing occurred), Judge Drain's statements hardly constitute a holding binding on this Court as to whether the Complaint states a claim under Rule 10b-5.

support a strong inference of scienter." *Winstar,* 2006 WL 473885, at *11. This proposition is not subject to dispute.[74]

In an effort to diminish the significance of the red flags particularized in the Complaint, Deloitte treats each red flag in isolation. Such argument flies in the face of the settled rule that red flags should be viewed collectively. *Whalen*, 2005 WL 1799370, at *3 ("while each of the allegations standing alone would fail to satisfy the stringent requirements of the PSLRA and I have dismissed cases where more than one 'red flag' was present . . . when all the 'flags' are run up the same pole, it seems inescapable that a reasonable auditor was on notice, and acted recklessly when it disregarded all the 'flags'"); *see also Teachers' Ret. Sys. of La. v. A.C.L.N. Ltd.*, No. 01 Civ. 11814 (MP), 2003 WL 21058090, at *11 (S.D.N.Y. May 12, 2003) (same); *Complete Mgmt.*, 153 F. Supp. 2d at 334 (same). Here, much like in *Whalen*, when the red flags warning Deloitte of the potential fraud are "run up the same pole," Deloitte's recklessness is inescapable.

(1) <u>Large Transactions at the End of Reporting Periods</u>

Courts consistently hold that large and unusual transactions at the end of fiscal periods are a major red flag to auditors. *See, e.g, Winstar*, 2006 WL 473885, at *11 (allegations as to

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[74] *See also Suprema*, 438 F.3d at 279-81 ("At the pleading stage, courts have recognized that allegations of GAAS violations, coupled with allegations that significant "red flags" were ignored, can suffice to withstand a motion to dismiss"); *Whalen v. Hibernia Foods PLC,* No. 04 Civ. 3182 (HB), 2005 WL 1799370, at *3-4 (S.D.N.Y. Aug. 1, 2005) ("Plaintiffs allege . . . [PricewaterhouseCoopers] knew about and ignored a wide variety of 'red flag' incidents or events, that should have put PwC on notice that fraud was afoot, and that taken together they are sufficient for the Court to find a strong inference of recklessness"); *AOL Time Warner*, 381 F. Supp. 2d at 238 (holding that plaintiffs had pled § 10(b) claim against auditor with particularity where plaintiff alleged numerous "specific 'red flags' that were ignored by E&Y"); *FirstEnergy,* 316 F. Supp. 2d at 598 (finding plaintiff adequately pled scienter where there was a "multitude of red flags and suspicious facts," suggesting defendants should have known of the accounting errors when they were made); *Oxford Health,* 51 F. Supp. 2d at 295; *In re First Merchants Acceptance Corp. Sec. Litig.*, No. 97 C 2715, 1998 WL 781118, at *10 (N.D. Ill. Nov. 2, 1998) ("Other circumstances suggesting fraudulent intent can include the presence of 'red flags' or warning signs that the financial reports are fraudulent, as well as the magnitude of the alleged fraud").

auditor's recklessness held sufficient where plaintiffs alleged "a litany of 'red flags' concerning suspicious transactions, such as a pattern of significant end-of-quarter transactions, which [the auditor] allegedly knew, but either intentionally or recklessly ignored."); *In re Homestore, Inc.*, 252 F. Supp. 2d 1018, 1044 (C.D. Cal. 2003) (same); *In the Matter of Kenneth L. Rubin, CPA and Michael W. Lewis, CPA*, Admin. Proc. No. 3-11748, 2005 WL 2180440, at *15 (S.E.C. Sept. 8, 2005) ("[L]arge and unusual transactions require testing and special scrutiny under AU 316.20") (internal citations omitted).

Delphi's inventory and asset disposition transactions, which were not in the ordinary course of business, occurred at the end of financial reporting periods. For example, at the end of fiscal year 2000, Delphi engaged in the precious metals transaction with Bank One, which quadrupled Delphi's cash flows from operations for that quarter from $68 million to $268 million. ¶ 558. This transaction helped the Company meet its earnings projections in that quarter, and the transaction was reversed a few weeks later. *Id.*[75]

(2) <u>Delphi's Lack of Internal Controls</u>

After conducting its internal investigation, Delphi's Audit Committee concluded that "due to the pervasiveness of . . . material weakness [in Delphi's controls] many of the restatement items . . . resulted from the inappropriate selection of, misapplication, or inadequate consideration of GAAP by Delphi accounting personnel." ¶ 634. In addition, the Audit

[75] Deloitte's argument that Plaintiffs have not alleged that Deloitte failed to investigate such transactions, Deloitte Br. at 15, is inexplicable. Plaintiffs clearly allege that Deloitte failed to inquire into these conveniently timed end of quarter transactions. ¶¶ 557-58. Given the significance of these transactions in meeting Delphi's financial targets, and the fact that they were not in the ordinary course of Delphi's business, GAAS required Deloitte to examine the underlying documents supporting these transactions. ¶¶ 571-74. Deloitte was charged with collecting competent evidential matter, including contracts, checks, invoices etc., to support its audits of Delphi's transactions. ¶ 571 (citing AU §326). It is clear that Deloitte recklessly failed to undertake this task, as an examination of the arrangements would have revealed the sham nature of these supposed "sales" of inventory. ¶ 575.

Committee concluded that the Company's accounting policies were inadequate or insufficiently comprehensive to ensure proper and consistent application throughout the organization" and these failures directly resulted in the inappropriate accounting treatment for Delphi's transactions. ¶ 635. With respect to the administration and accounting for contracts, Delphi's Audit Committee concluded that the "Company does not have adequate effective controls" and "as a result, transactions related to supplier and royalty agreements were not accounted for according to GAAP." ¶ 635. Compounding these problems with internal controls, the Audit Committee also concluded that there was an "ineffective tone within the organization relating to the discouragement, prevention or detection of management override" *i.e.,* fraud being committed by management. ¶ 633(d).

During the Class Period, Deloitte was specifically charged under GAAS to test Delphi's accounting controls and policies, the methods used by Delphi to process significant accounting information, assess the level of control risk, and determine conditions that could require the extension or modification of audit tests. ¶ 569 (citing AU § 311). Either Deloitte recklessly failed to perform this function, or it did perform this function and recklessly failed to heed the warnings that such an audit test would have revealed. *See Suprema*, 438 F.3d at 279-80 (listing among the red flags missed by the auditor the Company's weak internal controls).

As discussed above, given the fact that Delphi was essentially a start up company at the beginning of the Class Period, Deloitte was required to pay especially close attention to Delphi and the Officer Defendants to ensure that they implemented and followed sufficient internal controls. As evidenced by the factual determinations made by Delphi's Audit Committee of the utter lack of internal controls at Delphi during the period when Deloitte was purportedly conducting its audit in accordance with GAAS, such was not the case. Therefore, the cases that Deloitte relies upon in asserting that red flags relating to internal controls cannot support an inference of scienter are inapposite. In none of these cases were there factual findings that during the period in which the independent auditor blessed the company's financial reporting, the company's internal controls were wholly deficient.[76]

Particularly egregious is the fact that in May 2004, Delphi's inventory abuses were documented in a memo distributed to Deloitte and several of the Officer Defendants. ¶¶ 195, 198. As explained in the Complaint, the May 2004 Audit Report raised obvious red flags regarding Delphi's inventory management practices. Deloitte can offer no reasonable explanation for its failure to catch these accounting improprieties when Deloitte received a copy of this memo. Nor can Deloitte explain why it failed to catch these problems earlier.

(3) Deloitte's Service as Auditor for GM and Delphi on Both Sides <u>of the Warranty Expense/Pension Obligation Transactions</u>

As set forth above, the difference in accounting treatment between Delphi & GM for Delphi's $202 million payment to GM was a major red flag. Attempting to diminish the importance of this red flag, Deloitte asserts that "plaintiffs do not allege that the Delphi audit team was aware of GM's accounting for the transaction." Deloitte Br. at 15. There is no merit to this argument. The same Deloitte office that audited Delphi also audited GM, ¶ 562, and given

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[76] In the cases relied upon by Deloitte, the generic allegations that the company lacked internal controls were an inference drawn from the fact of the accounting errors without the specific allegations, such as here, of an alarming absence of any controls whatsoever. *See, e.g., Reiger v. PricewaterhouseCoopers LLP,* 117 F. Supp. 2d 1003, 1009 (S.D. Cal. 2000) ("Plaintiffs also rely on boilerplate 'red flags,' present in almost every securities fraud action, that the audited company had weak internal accounting controls and needed to report strong revenues"); *Cheney v. Cyberguard Corp.*, No. 98-6879-CIV-GOLD, 2000 WL 1140306, at *12 (S.D. Fla. Jul. 31, 2000) (finding that plaintiff's allegations of weaknesses in internal controls were "simply a recitation of additional GAAP violations"). Here, Delphi's Audit Committee has made specific findings that there was a pervasive lack of internal controls within Delphi.

that GM is one of the largest and most glamorous clients of Deloitte's Detroit office, it is preposterous to think that the auditors on the Delphi account did not know that the office also audited GM. It is hard to imagine that auditors sharing the same office and auditing opposite sides of the transaction did not talk to each other about the transaction.[77]

Moreover, an audit firm's scienter is evaluated by the collective knowledge of all of its partners and employees. For example, in *WorldCom*, 352 F. Supp. 2d at 497, denying the motion for summary judgment by the auditor defendant, the court stated:

> To carry their burden of showing that a corporate defendant acted with scienter, **plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient.... [C]ase law abounds with discussions of securities fraud by accounting firms that concentrate on the firm's collective state of mind, not that of individual partners or employees**. *See, e.g., Chill*, 101 F.3d 263, 269-70; *Philip Servs.*, 383 F. Supp. 2d 463 (accounting firm); *In re Oxford Health Plans, Inc., Sec. Litig.*, 51 F. Supp. 2d 290, 295 (S.D.N.Y. 1999) (same). *See also Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529 at 538 (1999).

Here, given its unique position as auditor for both companies, for Deloitte simply to have missed the fact that Delphi accounted for this "hotly contested" (¶ 159) payment to GM as a payment for pension obligations and in a manner different from GM smacks of recklessness. And, in any event, this is a fact issue to be decided at trial.

(4) <u>Aggressive Inventory Management and Aggressive Targets</u>

Deloitte also argues that Delphi's touted "aggressive" initiatives to reduce inventories and cut costs was not a red flag since "inventory management and cost cutting are, of course,

[77] In securities fraud cases where an audit firm audits companies on both sides of a fraudulent transaction, if the audit firm learns facts auditing one client relevant to the audit of the other client, courts have made clear that the auditors cannot hide behind an auditor's duty of confidentiality and refuse to take steps necessary to prevent or disclose the fraud. *See, e.g., Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1361 (S.D.N.Y. 1982).

essential to the management of any manufacturing concern." Deloitte Br. at 14. The point, however, is not that setting aggressive targets for employees to meet is inappropriate, but that such aggressive business practices serve as "red flags" of the potential for employees to engage in desperate measures, including fraud, in trying to meet management's aggressive expectations. *See, e.g., Homestore.com*, 252 F. Supp. 2d at 1044 (noting that "another red flag occurs when management sets unduly aggressive financial targets and expectations for operating personnel"); *Enron I*, 235 F. Supp. 2d at 678-79 (enumerating as among the red flags that should have warned Enron's auditor of the company's fraud that "Enron's business and management practices were focused on highly aggressive targets").

Beginning in 2000, Delphi publicly touted its "aggressive" efforts to improve margins, reduce costs and improve operating margins. ¶ 108. The focus on these metrics is evidenced by the scrutiny placed on these initiatives by analysts, who celebrated the "seventh consecutive quarter that Delphi met or exceeded investor expectations." ¶ 109. Delphi's cost reduction, however, was the result of a slew of accounting shenanigans including failing to record expenses, improperly reducing expenses, and, with respect to inventories, fraudulently (and temporarily) disposing of inventories and also failing to write down obsolete inventories. ¶¶ 190-99, 503-30. And, based on Plaintiffs' interviews with former Delphi employees, the fact that Delphi was manipulating its inventories, and failing to write down obsolete inventories, was well known within the Company. ¶¶ 193-94. *See Alstom,* 406 F. Supp. 2d at 504 (finding recklessness of ongoing fraud where "the signs were on the wall and wall was pretty big"). Absent recklessness, Deloitte's audit should have scrutinized Delphi's aggressive measures to reduce expenses and inventories and uncovered Delphi's fraud.

(5) <u>Tying of Compensation of Senior Officers to Financial Goals</u>

Deloitte argues that the fact that Delphi tied its management incentives to the meeting of financial targets "is hardly a smoking gun." Deloitte Br. at 14. Such argument ignores Deloitte's responsibility under GAAS to inquire into the possibility of fraud and to assess the likelihood of material misstatements. ¶¶ 550-52. Under AU § 316, an auditor is required to consider and evaluate the risks that a company's audited financial statements are free of material misstatements. ¶ 554. Among the risks of fraudulent financial statements, identified by AU § 316, is financial incentives for executives directly tied to meeting earnings or other financial targets. *Id.*; *see also Enron*, 235 F. Supp. 2d at 678-79; *In the Matter of Lawrence A. Stoler, CPA*, Admin. Proc. No. 3-12179, 2006 WL 319357, at *10 (S.E.C. Feb. 9, 2006). The Complaint outlines a management incentive scheme specifically tied to Delphi's financial metrics and enormous annual bonuses received by Delphi's executives when Delphi fraudulently achieved these goals. ¶¶ 95, 556. At a minimum, the Company's ability to meet these targets in a declining economy should have alerted Deloitte to the possibility of fraud.[78]

d. Deloitte's Relationship with Delphi, Access <u>to Internal Records, and Huge Non-Audit Fees</u>

Deloitte argues that its long-standing relationship with Delphi and its intimate access to Delphi should not weigh on whether its failure to recognize Delphi's fraudulent conduct amounts to recklessness or create a strong inference of scienter. Deloitte Br. at 16. To the contrary,

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[78] Deloitte's reliance on *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 434 (5th Cir. 2002); *PR Diamonds*, 364 F. 3d at 690; and *Glickman v. Alexander & Alexander Servs. Inc.*, No. 93 Civ. 7594 (LAP), 1996 WL 88570, at *6 (S.D.N.Y. Feb. 29, 1996) (Deloitte Br. at 14), is entirely misplaced. These cases merely hold that incentive compensation does not, in and of itself, give rise to a strong inference of scienter **on the part of the Company's executives**. They say nothing of the recklessness of an auditor, like Deloitte at bar, in failing to heed red flags warning that management may be meeting aggressive targets through fraudulent practices.

courts repeatedly have held that the auditors' access to internal company information through a dual role for the client and the payment of sizeable non-audit fees to the auditor, thus creating a conflict of interest, are significant factors in weighing the sufficiency of allegations of recklessness. *See Global Crossing,* 322 F. Supp. 2d at 345 (plaintiffs' allegations against auditor for dual role as auditor and consultant were sufficient to survive motion to dismiss); *see also Complete Mgmt.,* 153 F. Supp. 2d at 334 (payment to auditor for auditing services and consulting services gave rise to allegation of motive and opportunity; these inferences coupled with other red flags established scienter); *MicroStrategy,* 115 F. Supp. 2d at 654-56 (same). Further, where the presence of sizeable non-auditing fees are coupled with allegations of GAAP and GAAS violations and red flags, the allegations of a strong profit motive to defraud becomes even more significant. *See, e.g., In re Williams Sec. Litig.*, 339 F. Supp. 2d 1242, 1265 (N.D. Okla. 2003) (holding high fees, coupled with specific allegations of GAAP and GAAS violations and allegations that Ernst & Young disregarded numerous "red flags," were enough to plead scienter).

Here, Deloitte served as Delphi's independent auditor from before the Company's inception as an independent public company. ¶ 67. Between 1999 and 2004, Delphi engaged Deloitte to provide accounting, auditing and business consulting services. ¶ 534. During the height of Delphi's fraudulent accounting practices, from 2000 through 2003, Deloitte received over $30 million in audit fees and more than $76 million in non-audit fees. ¶ 534. These circumstances support an inference of scienter.

3. The Audit Committee Acted with the Requisite Scienter

Contrary to the Audit Committee Defendants' assertions,[79] the Complaint easily satisfies the PSLRA's requirements for pleading scienter. The PSLRA does not require, as they suggest, a plaintiff to plead direct evidence of fraudulent intent, because such "direct evidence … is rare." *Hudson Venture Partners, L.P. v. Patriot Aviation Group, Inc.*, No. 98 Civ. 4132, 1999 WL 76803, at *3 (S.D.N.Y. Feb. 16, 1999). The Complaint's strong circumstantial evidence is more than sufficient to establish that each Audit Committee Defendant either engaged in conscious misbehavior or acted recklessly by abrogating his or her duties. These lapses resulted in Delphi's massive restatement.

Each named Audit Committee Defendant signed documents filed with the SEC that included fraudulent statements concerning Delphi's accounting. ¶¶ 38-44. The Audit Committee Defendants were charged with the responsibility of overseeing the internal auditing of Delphi. ¶¶ 642-47. Delphi's SEC filings represented that the Audit Committee reviewed Delphi's periodic financial statements, communicated with Delphi's independent accountant and reviewed its internal controls. To illustrate, the Company's March 27, 2000 Schedule 14A Proxy Statement filed with the SEC described the responsibilities of the Audit Committee as "Assist[ing] the Board of Directors in overseeing management's conduct of Delphi's financial reporting process." ¶ 643. Similarly, the Company's 2001 10-K states that meetings were regularly held between the Audit Committee and the independent auditors, representatives of management, and the General Auditor "to review the activities of each, to ensure that each is

[79] The Audit Committee Defendants are: Robert H. Brust, Oscar de Paula Bernardes Neto, Cynthia Niekamp, John D. Opie, Thomas H. Wyman (deceased) and Susan McLaughlin.

properly discharging its responsibilities, and to assess the effectiveness of internal control." ¶ 489. To fulfill its responsibilities, it was fundamental that the Audit Committee have a detailed understanding of Delphi's inner workings, and particularly, the adequacy and soundness of its financial systems and internal controls.

Charged with these duties, the Audit Committee served as Delphi's gatekeeper, and was required to investigate the dubious transactions with Setech, BBK, Bank One and GM. The sheer enormity of these transactions should have been a warning sign or "red flag" that an investigation was needed. Had the Audit Committee Defendants undertaken to investigate any of these sham deals or had more effective internal controls, it would have uncovered the wrongdoing that led to the massive restatement and the resignations of many senior Delphi executives. The Audit Committee Defendants' utter disregard of these "red flags" was reckless. *PR Diamonds,* 364 F.3d at 683.

a. The Audit Committee Engaged in Conscious Misbehavior or <u>Recklessly Failed to Monitor Delphi's Internal Controls</u>

The Audit Committee Defendants acted, at best, recklessly in signing the SEC filings containing Delphi's false financial and other statements. An audit committee's failure to oversee internal operations constitutes recklessness. *See e.g., In re Lernout & Hauspie Sec. Litig.,* 286 B.R. 33, 37-38 (D. Mass. 2002); *Greenfield v. Prof. Care, Inc.,* 677 F. Supp. 110 (E.D.N.Y. 1987); *In re JWP Inc. Sec. Litig*., 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996).

In *Lernout & Hausie,* the plaintiffs brought a securities class action against outside directors and members of the audit committee of the bankrupt company for their reckless failure to catch the "smorgasbord of accounting irregularities," resulting in a $377 million restatement. 208 F. Supp. 2d at 78. After the company filed for bankruptcy, the audit committee investigated the company's accounting. *Id. at* 82. Following the investigation, the audit committee filed a detailed report in which it admitted there were "numerous accounting irregularities" leading to the restatement. *Id.* The plaintiffs alleged that the audit committee defendants "continued to sign off on financial statements . . . despite the continuing lack of internal controls and various red flags . . . ." *Lernout & Hauspie,* 286 B.R. at 38. In denying the audit committee's motion to dismiss, the court found that the plaintiffs established "a strong inference of scienter based on recklessness against the members of the Audit Committee" by alleging they were "asleep at the switch" while a massive fraud was occurring. *Id.*

A similar conclusion was reached in *Greenfield*, which involved the nation's largest home healthcare provider. 677 F. Supp. at 112. There, the individual defendants and the company were alleged to have violated the Exchange Act by engaging in a pervasive scheme to defraud New York's Medicaid program by filing false claims for services. *Id.* As a result, plaintiffs alleged that certain documents were materially misleading for failing to disclose that the company's earnings included illegal payments. *Id.* The *Greenfield* plaintiffs alleged that members of the company's audit committee were charged with "monitoring [the company's] 'internal and external audit functions, control systems, financial accounting and reporting, and adherence to applicable legal, ethical and regulatory requirements.'" *Id.* at 115. In concluding that plaintiffs adequately pled recklessness, the court stated "there are sufficient facts to support an inference that the audit committee members either had actual knowledge of the ongoing fraud or recklessly disregarded its existence." *Id.*

Just as in *Lernout & Hauspie* and *Greenfield,* Plaintiffs have more than adequately alleged that the Audit Committee Defendants either engaged in conscious misbehavior or acted recklessly in their disregard for internal controls. Upon notice by the SEC that there would be an inquiry into Delphi's accounting practices, the Audit Committee announced that it was investigating Delphi's internal controls and accounting. ¶ 648. In just a few months, the Audit Committee learned that Delphi's internal controls were woefully inadequate, a fact it had disregarded for years. In admitting that Delphi's financial statements dating back to 2001 were unreliable, the Audit Committee further conceded that the Restatement was the result of:

- insufficient numbers of personnel having appropriate knowledge, experience and training in the application of GAAP;
- insufficient personnel at Delphi's headquarters to provide effective oversight and review of financial transactions;
- ineffective or inadequate accounting policies to ensure the proper and consistent application of GAAP throughout the organization;
- ineffective or inadequate controls over the administration and related accounting treatment for contracts; and
- ineffective 'tone' within the organization related to the discouragement, prevention or detection of management override, as well as inadequate emphasis on thorough and proper analysis of accounts and financial transactions.

¶ 633. The Audit Committee further concluded that the Restatement was a direct result of internal controls that were rife with "material" weaknesses:

> Due to the pervasiveness of this material weakness, many of the restatement items . . . . resulted from the inappropriate selection of, misapplication, or inadequate consideration of GAAP by Delphi accounting personnel.
>
> *   *   *   *
>
> The Company's accounting policies were inadequate or insufficiently comprehensive to ensure proper and consistent application throughout the organization.

¶¶ 634-35.

In light of these admissions, it is beyond dispute that as a direct result of the failures of the Audit Committee Defendants, Delphi's internal controls were wholly lacking, causing the massive errors in Delphi's financials. Thus, the Complaint offers strong circumstantial evidence that the Audit Committee acted with scienter.

The Audit Committee Defendants argue that the Complaint, at best, pleads negligence or lack of diligence on the part of the Audit Committee Defendants. Individual Def. Br. at 21. In support of this unfounded assertion, Defendants rely on *WorldCom,* No. 02 Civ. 3288, 2003 U.S. Dist. LEXIS 21363, at *13-14 (S.D.N.Y. Dec. 1, 2003).[80] Although the plaintiffs in *WorldCom* alleged that the audit committee defendants were reckless in failing to adhere to the committee's proscribed internal controls, there is one fundamental difference: there, the court found that plaintiffs failed to plead particularized facts concerning what information the audit committee was required to monitor and that fraud would have been disclosed had it adhered to its duties. *Id.* Here, the Audit Committee has admitted that there were "material weaknesses" in the Company's internal controls. Following an internal investigation, the Audit Committee made specific factual findings that there was a pervasive lack of internal controls and, but for those weaknesses, the fraud at Delphi would have been exposed. Thus, *WorldCom* is inapposite.[81]

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[80] A copy of this opinion is attached as Exhibit C to the Yarnoff Declaration

[81] Defendants' reliance on *In re Hayes Lemmerz Int'l, Inc. Sec. Litig.*, 271 F. Supp. 2d at 1021, and *Jacobs v. Coopers & Lybrand, LLP*, No. 97 Civ. 3374, 1999 WL 101772, *16 (S.D.N.Y. Feb. 26, 1999), is equally misplaced. Audit Def. Br. at 21. Unlike the instant case, the plaintiffs in *Hayes* alleged that the audit committee defendants' sole purpose was to hire a reputable accounting firm and the failure to do so was reckless. 271 F. Supp. 2d at 1020. Plaintiffs also argued that some of the audit committee defendants signed class period Form 10-Ks and their function was to ensure the accuracy of the financial statements. As a result, the court found the plaintiffs pleaded only negligence claims against the audit committee defendants. *Id.* at 1021. Here, Plaintiffs have pleaded concrete and demonstrable facts concerning the Audit Committee Defendants' responsibilities. Indeed, the Audit Committee Defendants admitted that the failure to follow internal controls resulted in the restatement. Similarly unavailing is the Audit Committee Defendants' reliance on *Jacobs*, 1999 WL 101772, at *16. There, in attempting to establish

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b. The Audit Committee Was Willfully Blind to or Recklessly Disregarded the Red Flags

The Audit Committee Defendants were further reckless in ignoring "red flags" in the form of Delphi's improper accounting for specific sham transactions throughout the Class Period. As discussed above, allegations that a defendant ignored "red flags" or "warning signs" that would have revealed the falsity of financial statements prior to their inclusion in public statements, support a strong inference that a defendant acted recklessly.

Delphi engaged in numerous questionable Class Period transactions with Setech, BBK, Bank One and GM, the sole purpose of which was to improperly boost Delphi's reported financial performance. ¶ 651. Although the Audit Committee Defendants were reckless not to investigate the accounting for the above transactions, it was particularly egregious for them not to take action with respect to the Bank One and GM deals. Given the size of the transaction, and its impact on Delphi's reported financial results for 2000, the Audit Committee Defendants must have been aware of the purported sale of $200 million in precious metals to Bank One, which increased Delphi's cash flows from operations for that quarter from $68 million to $268 million and also allowed Delphi to reduce inventory levels such that it was able to recognize a LIFO liquidation gain in pre-tax operating income of $100 million. ¶ 652. The Audit Committee Defendants also must have been aware of the direct repurchase of such metals only one month after the sale, yet they undertook no efforts to investigate this transaction. Also, at the very least,

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the scienter of one individual defendant, the plaintiffs relied solely on the fact that he was a director and a member of the company's audit committee. *Id.* In finding the plaintiffs' allegations deficient, the court stated, "Plaintiffs do not cite "red flags" or any specific facts of which Hirsch was aware and which he consciously disregarded." *Id.* Here, Plaintiffs have alleged that the Audit Committee Defendants were reckless in executing the very duties in which they were charged – overseeing the internal controls. As stated below, Plaintiffs further have cited specific "red flags" and other "specific facts" of which the Audit Committee was aware. Therefore, *Jacobs* is inapposite.

the Audit Committee must have been aware of the ongoing negotiations between GM and Delphi over pension benefits and the questions of warranty costs. ¶ 653. The warranty payment dispute was the subject of lengthy negotiations and a mediation between Delphi and GM, resulting in Delphi agreeing to pay GM $237 million to cover the still-contested issues. ¶ 614. With these uncontroverted facts, the Audit Committee Defendants were undoubtedly reckless in ignoring the red flags that the GM transaction was not properly recorded.

The sheer breadth and magnitude of these sham accounting transactions were red flags that put the Audit Committee on notice that a thorough investigation was warranted. *PR Diamonds*, 364 F.3d at 685, ("the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly"); *Global Crossing,* 322 F. Supp. 2d at 347 (magnitude of fraud can be indicative of scienter); *Winstar*, 2006 WL 473885, at *10 (same); *MicroStrategy*, 115 F. Supp. 2d at 636 (same); *In re Next Level Sys., Inc.*, No. 97C 7362, 1999 WL 387446, at *11 (N.D. Ill. Mar. 31, 1999) (same). Thus, the failure of the Audit Committee Defendants to question the veracity of these transactions amounts to recklessness.

D. <u>Plaintiffs Have Adequately Alleged Loss Causation</u>

Impermissibly arguing an alternative and inconsistent version of the facts well-pled in the Complaint, the Individual Defendants argue that Plaintiffs have not adequately pleaded loss causation because they failed to plead legally sufficient "corrective" disclosures that caused a loss to Plaintiffs. *See* Individual Def. Br. at 24-30; Deloitte Br. at 17). When considering **only** the well-pled facts in the Complaint, drawing all reasonable inferences in favor of Plaintiffs – as the Court is required to do on a motion to dismiss – Plaintiffs have adequately pleaded loss causation to support their § 10(b) claim, and none of the Individual Defendants' highly factual arguments can defeat the legally sufficient allegations in the Complaint at this stage of the pleadings.

There is no heightened pleading requirement for loss causation – ordinary notice pleading rules apply. *See Dura*, 125 S. Ct. at 1634 (assuming that liberal pleading standard under Rule 8 applies to pleading loss causation). As Judge Steeh recently explained, "*Dura* clearly explains that it does not modify the pleading requirements of Fed. R. Civ. P. 8(a)(2), which merely requires a plaintiff to provide 'a short and plain statement of the claim showing that the pleader is entitled to relief.'" *In re CMS Energy Sec. Litig.*, 403 F. Supp. 2d 625, 629-30 (E.D. Mich. 2005) (citations omitted). As such, courts have consistently cautioned that the requirement of pleading loss causation "ought not place unrealistic burdens on the plaintiff at the initial pleading stage." *Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 649 (7th Cir. 1997); *see also Dura*, 125 S. Ct. at 1634 ("ordinary pleading rules are not meant to impose a great burden upon a plaintiff"). Thus, all that is necessary at this early stage is that "a plaintiff who has suffered an economic loss . . . provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." *Id.*

Plaintiffs' extensive and detailed pleading of loss causation more than meets this liberal pleading standard. For example, Plaintiffs allege that beginning in June 2002, Delphi began gradually to correct earlier fraudulent statements. ¶¶ 672-77. The Complaint further alleges that this correction of earlier fraudulent statements caused a loss to Plaintiffs. *See* ¶ 674 ("Delphi's stock price fell 20% from its close of $13.75 on June 24, 2002 . . . to its close of $11 on July 16, 2002"). As the Complaint alleges:

> Delphi's announcement, and its reduced guidance for the remainder of 2002, was nothing less than corrections of the earnings inflation that it had perpetrated in prior reporting periods. Thus, as Delphi was no longer able to meet earnings guidance through earnings fabricated by manipulative transactions and fraudulent accounting, its stock price began to decline to adjust to the reality of Delphi's actual earning potential.

¶ 677. Plaintiffs also alleged further gradual corrective disclosures, each causing drops in Delphi's stock price and losses. ¶¶ 678-82. These detailed factual allegations are more than enough to satisfy the minimal notice pleading requirement of Rule 8(a)(2).

1. **Defendants' Arguments Based on Alleged Facts Outside of <u>the Complaint Are Inappropriate on a Motion to Dismiss</u>**

Unable credibly to dispute that the Complaint contains well-pled allegations of loss causation, Defendants attempt to contest loss causation essentially by pleading their own set of facts and arguing thereby that there was no loss caused by the corrective disclosures alleged by Plaintiffs; *i.e.* that any loss incurred by Plaintiffs was caused by other factors not alleged in the Complaint.

For example, instead of accepting Plaintiffs' allegations that reduced guidance in June of 2002 effectively corrected earlier puffery and fraudulent recognition of revenue, Defendants instead argue that, "[b]y no stretch of the imagination can the decline in Delphi's stock price in 2002 be linked to these earnings disclosures. **More likely**, any stock price decline is attributable to turbulent market conditions (which plaintiffs themselves acknowledge throughout the Complaint), as well as to a host of other market factors." Individual Def. Br. at 27 (citations and footnotes omitted) (emphasis added).[82]

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[82] *See also id.* at 27 n.17 (selectively choosing stock prices from different periods than those alleged in the Complaint in an attempt to show that the stock price appreciated during the relevant periods); *id.* at 27 n.18 (alleging that other auto-parts suppliers in addition to Delphi have suffered adversity in an attempt to show that market

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The Individual Defendants' fact-based arguments are entirely inappropriate on a motion to dismiss. Indeed, not surprisingly, courts have frequently found that issues of loss causation are factual matters, often requiring expert testimony, and, therefore, are generally "not proper to resolve on a motion to dismiss." *In re Sears, Roebuck & Co. ERISA Litig.*, No. 02-C-8324, 2004 WL 407007, at *7 (N.D. Ill. Mar. 3, 2004); *see also Lentell*, 396 F.3d at 174 ("Loss causation is a fact-based inquiry."). The Court should not entertain Defendants' inappropriate factual arguments at this early stage of the proceedings.

2. Plaintiffs' Allegations of Numerous Corrective <u>Disclosures Causing Loss Over Time Are Legally Sufficient</u>

Contrary to the Individual Defendants' argument that Plaintiffs' pleading of loss causation over time is somehow "novel" or "self defeating," Individual Def. Br. at 27-30, numerous courts have considered factual allegations involving multiple corrective disclosures that caused losses to plaintiffs over time – allegations similar to those here – and have found them sufficient to survive a motion to dismiss.

Courts have consistently allowed plaintiffs to plead that multiple corrective disclosures caused a gradual decline in the stock price over time.[83] *See, e.g., In re Bradley Pharm., Inc. Sec. Litig.*, No. CIV. 05-1219, 2006 WL 740793 (D.N.J. Mar. 23, 2006) (finding that the plaintiffs

conditions generally caused Delphi's loss as opposed to the disclosures correcting the fraud that are alleged in the Complaint); and *id.* at 30 n.20 (arguing that the March 2005 drop in Delphi's stock price was not caused by the Company coming clean about its fraudulent practices, but rather was caused by a downgrade of its debt rating – ironically something that was likely caused, in and of itself, by the Company's corrective disclosures, a debate that may take place at trial, but is not appropriate at this stage of the proceedings).

[83] Indeed, the Supreme Court in *Dura* implicitly recognized that corrective information and the subsequent loss may take place over time, not as the result of a single event. 125 S. Ct. at 1634 ("if, say, the purchaser sells the shares quickly before the relevant truth **begins** to **leak** out, the misrepresentations will not have led to any loss") (emphasis added).

had adequately pleaded loss causation even though "[t]he revelation of the 'truth' . . . did not take the form of a single, unitary disclosure, but occurred through a series of disclosing events").

Directly on point is *In re NTL, Inc. Sec. Litig.*, No. 02 Civ. 3013, 2006 WL 330133 (S.D.N.Y. Feb. 14, 2006), where "[t]he Complaint . . . alleges that there were several 'disclosing events' throughout the class period, which gradually alerted investors to the truth about NTL's underlying problems" and the "[p]laintiffs have linked these gradual disclosing events to a slow dissipation in the value of NTL's stock, demonstrating that throughout the Class Period, NTL's stock dropped from a high of $48.0625 on August 5, 2000 to $1.60 on November 29, 2001." *Id.* at *9. Despite, as is the case here, the more than one year period during which corrective disclosures were made and the stock price's gradual decline, the *NTL* court held that:

> [b]ecause Lead Plaintiffs have made "some showing" that these disclosing events slowly revealed the false information regarding NTL and have tied some if not all of the dissipation in value of NTL's stock to those events, they have adequately plead loss causation.

Id. at *9. Because the allegations here of multiple corrective disclosures causing a gradual loss over time mirror those in *NTL*, the same result should obtain. As a matter of law, Plaintiffs simply are not limited to pleading a single corrective event to plead loss causation for a § 10(b) claim, and this cannot serve as a basis to dismiss the Complaint.[84]

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[84] *IPO*, 399 F. Supp. 2d at 265, the case on which Defendants rely, does not even address a so-called "gradual dissipation loss causation theory," much less reject it. Indeed, to the extent that the *Liu* court considered anything akin to this, it expressly recognized that "[t]he fact of gradual price decline is not inconsistent with the theory that the price was artificially inflated, since the misrepresentations may well have buoyed a price that would otherwise have sunk much faster, raising the price at which plaintiffs purchased the stock." 399 F. Supp. 2d at 264. Similarly here, Plaintiffs have alleged that the stock price was gradually reduced by corrective information being disclosed over time, even as the Company continued to make fraudulent statements. The only reason why the *Liu* court found the complaint facially deficient was because the *Liu* plaintiffs failed to plead any corrective disclosures causing the gradual dissipation of the stock price; rather the *Liu* plaintiffs only pleaded inflation of the stock price at the time of purchase and then asked the court to presume that an alleged drop in stock price was a dissipation of the inflation caused by earlier fraudulent statements without alleging the earlier misinformation was corrected in the marketplace.

(Cont'd)

3. There Is No Requirement That a Corrective Disclosure Amount to a Corporate *Mea Culpa*

Relying primarily on their inappropriate counter-version of the facts, the Individual Defendants further argue that "Plaintiffs allege no particular corrective disclosure between June and October 2002, but merely 'bad news' regarding earnings" and that the later (2004-2005) corrective disclosures alleged in the Complaint are similarly deficient. Individual Def. Br. at 28-29. Putting aside the factual disputes manufactured by the Individual Defendants, which are addressed above, the Individual Defendants' argument is based on a fundamental misunderstanding of what is necessary for Plaintiffs to plead a corrective disclosure.

Specifically, the Individual Defendants argue that Plaintiffs' allegations "do not qualify as 'corrective' disclosures under *Dura* because they disclosed nothing about the alleged fraud." Individual Def. Br. at 28. But "*Dura* itself does not define a pleading standard for loss causation; rather, it simply rejects the Ninth Circuit's standard as overly permissive." *In re Initial Public Offering Sec. Litig.*, 399 F. Supp. 2d at 266 n.23. *Dura* simply rejected Ninth Circuit precedent that allowed a § 10(b) plaintiff to plead loss causation solely by alleging that stock was purchased at an inflated price. Plaintiffs here do not rely on this rejected pleading standard at all, but allege corrective disclosures in addition to the alleged inflation.

The law does not require a corporate defendant to engage in self-flagellation or to issue a corrective disclosure with an accompanying *mea culpa* to establish loss causation. Rather, at most, all that is necessary is that the **subject matter** of the earlier disclosure is effectively

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Id. at 266. Not surprisingly, the *Liu* court declined to make such presumptions, requiring instead that "a plaintiff . . . explicitly allege a disclosure or some other corrective event." *Id.* at 265-66. As explained above, Plaintiffs have alleged in detail numerous disclosures and corrective events that caused the gradual decline of Delphi's stock price.

corrected in the market place. *See, e.g., In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), 2005 WL 375314 (S.D.N.Y. Feb. 17, 2005) ("a misstatement or omission is the proximate cause of an investment loss if the risk that caused the loss was within the zone of risk concealed by the misrepresentations and omission alleged"); *In re Merrill Lynch Tyco Research Sec. Litig.*, No. 03 CV 4080, 2004 WL 305809 (S.D.N.Y. 2004). As explained in *Parmalat*, 375 F. Supp. 2d 278, 306 (S.D.N.Y. 2005):

> The complaint here avers that defendants, through their agents ..., misrepresented that the financial statements of Parmalat and its subsidiaries were accurate and complete when, in fact, they significantly overstated its revenue and net assets.
>
> * * * *
>
> Among the risks concealed by these reports was that Parmalat had massive undisclosed debt and was unable to service it. Defendants reasonably could have foreseen that Parmalat's inability to service its debt would lead to a financial collapse. The concealed risk materialized when Parmalat suffered a liquidity crisis on December 8, 2003, and was unable to pay bonds as they came due.

Id. In other words, when a risk or other fact is concealed or an affirmative misrepresentation is made and contrary information later enters into the marketplace – even if it is from a third-party or not presented as a correction to earlier disclosures – as long as the loss was a reasonably foreseeable result of the misrepresented or concealed fact, that is enough for pleading loss causation. *See, e.g., Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, No. 05 Civ. 1898, 2005 U.S. Dist. LEXIS 19506, at *57-58 (S.D.N.Y. Sept. 6, 2005) ("The Complaint alleges that defendants' misrepresentations regarding rigorous underwriting concealed the fact that the collateral pool contained a substantial number of high risk loans. The concealed risk materialized when the collateral pool experienced high delinquency rates and repossession on a sustained basis. Not surprisingly, BCI's earnings expectations then fell. BCI announced that it would write off the losses, rating agencies downgraded the Certificates, and the value of plaintiff's investment declined. These allegations are sufficient to plead loss causation.");[85] *see also In re Omnivision Techs., Inc.*, No. C-04-2297 SC, 2005 WL 1867717, at *5-6 (N.D. Cal. July 29, 2005).

Here, the Complaint alleges that the reduced guidance in 2002 "was nothing less than corrections of the earnings inflation that it had perpetrated in prior reporting periods" and that "as Delphi was no longer able to meet earnings guidance through earnings fabricated by manipulative transactions and fraudulent accounting, its stock price began to decline to adjust to the reality of Delphi's actual earning potential." ¶ 677. Then on September 29, 2004, Delphi announced that the SEC was investigating Delphi's accounting treatment of transactions with EDS that were fraudulently booked, further causing Delphi's stock price to drop. ¶ 678. Next, on December 8, 2004, the Audit Committee revealed that it had uncovered other problematic transactions that were previously fraudulently reported, further lowering Delphi's stock price. *Id.* Lastly, in the first week of March 2005, Delphi disclosed that the Audit Committee had uncovered massive accounting irregularities dating back to the IPO, further causing the stock's decline. ¶¶ 679-80. This series of disclosures effectively corrected Delphi's earlier misstatements and caused huge losses for Plaintiffs, all of which were foreseeable results of the alleged fraud.

Addressing a similar argument as advanced by the Individual Defendants here, in *Asher v. Baxter Int'l, Inc.*, No. 02 CV 5608, 2006 WL 299068, at *7 (N.D. Ill. Feb. 7, 2006), the court held that allegations that the Company's stock price dropped because of a "startling disconnect

[85] A copy of this opinion is attached as Exhibit D to the Yarnoff Declaration.

between Baxter's predictions and its actual second-quarter results [which] revealed to the market that the predictions had been unattainable" were adequate to plead loss causation:

> If Baxter had not lied about its internal state of affairs and its ability for growth, the disappointing second-quarter results would not have had such a negative impact on the share price. Thus, the alleged lies were responsible for the price drop following the July 18, 2002 second-quarter earnings announcement, and plaintiffs have satisfied their burden of pleading loss causation at this stage of the litigation.

Id.; *see also Stumpf v. Garvey*, No. 03-CV-1352-PB, 2005 WL 2127674, at *12 (D.N.H. Sept. 2, 2005) ("plaintiffs' economic loss was the decline in the value of their stock that was the result of TyCom's misrepresentation of the market for bandwidth . . . . plaintiffs' showing that their loss was fairly attributable to the public airing of the true state of the bandwidth market, which had been falsely misrepresented to them by defendants, provides the causal link required by *Dura*").[86] Similarly here, the precipitous drops in Delphi's share price would not have occurred had the new information Delphi put out into the market not contradicted the earlier fraudulent reports and the lofty expectations they set. Thus, Plaintiffs have adequately pleaded corrective disclosures for loss causation purposes.

E. Claims Against Setech Are Not Barred by the Statute of Limitations

Setech argues that Plaintiffs' claims relating to its 1999 conduct are time-barred. Setech Br. at 16-19. This argument fails because it is premised on an incorrect triggering point for the limitations period. Setech incorrectly argues that limitations runs from its own conduct; in fact,

[86] In stark contrast, in *Liu*, the case relied on by the Individual Defendants in making this argument, the court found that the corrective disclosures that plaintiffs alleged ended the "fraudulently induced expectation of continuing upside surprises," were not corrective because "that **expectation** . . . is not the scheme plaintiffs allege" at all. 399 F. Supp. 2d at 266.

as a result of Setech's participation in Delphi's fraudulent scheme, the correct trigger is Delphi's last public statement that was false because of Setech's wrongful conduct.

Under § 10(b), limitations begins to run after the Rule 10b-5 violation occurs. *See* 28 U.S.C. § 1658(B).[87] As a primary participant in Delphi's scheme to deceive investors, Setech's 10b-5 violation was not complete until Delphi publicly disclosed false financial statements reflecting the Setech-Delphi sham transactions. Delphi released false financial statements for fiscal years 1999 and 2000, on February 9, 2000 and February 8, 2001, respectively, that overstated Delphi's net income and operating income, among other financial metrics. Here, because the last financial statement that was false due to Setech's participation in the scheme was Delphi's Form 10-K for fiscal year 2000, limitations began to run for claims against Setech on February 8, 2001, the date of that filing.[88] Thus, pursuant to the five-year period of repose under SOX, Plaintiffs' claims against Setech are timely.[89]

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[87] "A cause of action "may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."

[88] Setech argues that Plaintiffs do not allege when the fraud occurred with particularity. Setech Br. at 17-18. Not so. The Complaint alleges Setech's participation in the fraudulent scheme with particularity, including who was involved; when the conduct occurred; and how the conduct was fraudulent. ¶¶ 123, 130, 132-42. Further, Plaintiffs allege that Setech's fraudulent conduct, which occurred throughout 1999 and 2000, resulted in misrepresentations in Delphi's financial statements that were filed on February 9, 2000 and February 8, 2001. Thus, Plaintiffs' allegations fully comply with the standard set forth in *Krear v. Malek,* 961 F. Supp. 1065, 1070 & n.5 (E.D. Mich. 1997), the case Setech cites in support of its argument. Here, rather than allege that the false misrepresentations occurred in the "[s]ummer of 1994" as the plaintiffs did in *Krear,* Plaintiffs have "plead[ed] the time and place of the misrepresentations with sufficient specificity." *Id.* at 1070. Accordingly, Setech's argument should be rejected.

[89] Setech contends that Plaintiffs allege that Delphi issued "storm warnings" in mid-2002 sufficient to put the public on notice of Setech's fraudulent conduct. Setech Br. at 17. This is simply not true. Plaintiffs allege that in mid-2002, knowing that it could not sustain its prior levels of accounting fraud, Delphi started conditioning the market to expect leaner quarters going forward, but continued to deceive investors by disseminating false financial results throughout the remainder of the Class Period. ¶ 355. Rather than alleging suspicious facts that should have put investors on notice of Setech's fraudulent conduct in mid-2002, Plaintiffs specifically allege that Delphi continued to intentionally and knowingly perpetuate the fraud and conceal the truth from the investing public. Setech's suggestion that such guidance was a storm warning sufficient to trigger limitations is wholly without merit.

Quaak is directly on point. In *Quaak*, plaintiffs alleged that Dexia, a non-issuer defendant, engaged in a fraudulent scheme to inflate issuer Lernout & Hauspie's ("L&H's") financial results by funding sham entities that ostensibly generated revenues for L&H over the course of several years in violation of § 10(b). 357 F. Supp. 2d at 332-34. Dexia argued that plaintiffs' claims were time-barred because the trigger of the repose period was the non-issuer defendant's conduct, all of which occurred outside the period of repose. *Id.* at 337. The court rejected this argument, holding that, under § 10(b), limitations starts to run when the last fraudulent misrepresentation is made by the issuer:

> Plaintiffs have alleged a primary violation of Rule 10b-5 by defendant through its participation in a manipulative or deceptive scheme intended to mislead investors. Integral to the violation of Rule 10b-5 through this fraudulent scheme is the fraudulent misrepresentation by L & H, improperly recognizing revenue. Under Section 10(b), the statute of repose runs from the date of the last fraudulent misrepresentation, and the unique role of the defendant in this particular scheme does not affect this rule. Thus, the period of repose in this case was triggered on June 30, 2000, the date of L & H's last allegedly false financial statement.

Id. at 338. Here, the last false financial statement due to Setech's participation in the scheme was Delphi's 2000 10-K, filed on February 8, 2001. Plaintiffs' claims against Setech are timely.

Further, the *Quaak* court held that plaintiffs' claims against Dexia were not time-barred where the alleged fraudulent scheme impacted financial statements outside of the repose period, because the impacted earlier financial results were reflected in the issuer's later financial statements. In rejecting Dexia's argument that plaintiffs' claims relating to L&H's financial statements outside the repose period were time-barred, the court stated:

> All of plaintiffs' claims involve allegations of improper revenue recognition by L & H in 1998 or 1999. Plaintiffs state that L & H's June 30, 2000 public filing necessarily reflected L & H's financial results for both 1998 and 1999. At the motion to dismiss stage, this provides a sufficient nexus between the alleged

> actions of Dexia and L & H's June 2000 financial statement. Accordingly, the statute of repose does not bar this action.

Id. at 338. Application of *Quaak* demonstrates that Plaintiffs' claims against Setech are timely. First, all of Plaintiffs' claims against Setech involve allegations of sham transactions designed to reduce Delphi's reported inventory and increase Delphi's net income. Second, Delphi's 2000 10-K – Delphi's last false financial statement due to Setech's direct participation in the scheme – necessarily and actually reflected Delphi's financial results for 1999. ¶ 269. Thus, Plaintiffs have alleged a "sufficient nexus" between Setech's actions and Delphi's 2000 10-K and, therefore, the statute of repose does not bar any of the alleged claims.

Assuming *arguendo* that Plaintiffs' claims relating to Setech's 1999 conduct are somehow outside the limitations period, those claims are timely under the continuing violation doctrine. This doctrine applies when a violation occurring outside the limitations period is so closely related to other violations which are not time-barred that it should be viewed as part of the continuing practice or scheme for which recovery should be had. *SEC v. Ogle*, No. 99 C 609, 2000 WL 45260, at *4-5 (N.D. Ill. Jan. 11, 2000). Setech claims this doctrine is inapplicable to securities fraud cases. Setech Br. at 17. Setech is mistaken. While the doctrine developed in other contexts, courts have extended the doctrine to the securities fraud context.

In *Ogle*, for example, the court held that the continuing violation doctrine applied to securities fraud cases. 2000 WL 45260, at *4-5. The court determined that the rationale for the doctrine in other areas also existed in the securities fraud context. In particular, the court stated that: "[t]he SEC suffered from a similar inability to detect discrete violations until the alleged scheme was well underway and had created suspicious variations" in the issuer's market. *Id.* at *4. "[B]ecause [d]efendants' alleged manipulation would not be clear until many of the isolated incidents had already occurred" and the SEC would not be able to determine the applicable violations of the securities law until "a more detailed picture of a long-term market manipulation scheme emerged," the court applied the continuing violation doctrine to the SEC's securities fraud action, and held that the securities fraud claims were not time-barred. *Id.* at *4-5. Like *Ogle*, Setech engaged in an ongoing, repeated course of conduct designed to serve a single purpose – to inflate Delphi's financial results – and Plaintiffs, because of the fraudulent nature of the scheme, were unable to immediately recognize Setech's misconduct.[90] Accordingly, under the continuing violation doctrine, Plaintiffs' claims against Setech are also timely.

F. The Impact of Setech's Fraudulent Conduct on Delphi's 2000 <u>Financial Results Is Not Immaterial as a Matter of Law</u>

Plaintiffs' claims against Setech are material. Tellingly, Setech does not challenge the materiality of its 1999 conduct. Rather, Setech only challenges the materiality of its 2000 conduct, which resulted in a $16 million, or 1.9%, overstatement of Delphi's net income and a $17 million, or 1.0%, understatement of Delphi's inventories.[91] ¶ 144. Setech contends that these misstatements are immaterial as a matter of law. Setech is in error.

[90] In support of its incorrect blanket statement that the continuing violation doctrine does not apply to securities fraud, Setech relies on two cases, both of which actually indicate that the doctrine could apply to securities fraud actions. *See Pro Bono Invs., Inc. v. Gerry*, No. 03 Civ. 4347, 2005 U.S. Dist. LEXIS 22348, at *29 (S.D.N.Y. Sept. 30, 2005) (doctrine has been applied to securities cases involving SEC enforcement actions, and expressly finding that doctrine did not apply to case before the court because plaintiffs did not meet doctrine's requirements, namely they failed to allege any connection between transactions that occurred outside the statue of limitations period and pledge transaction that occurred within statute of limitations period); *SEC v. Caserta*, 75 F. Supp. 2d 79, 89 (E.D.N.Y. 1999) (it is unclear whether continuing violation doctrine applies to securities fraud and declining to address that issue at pleading stage because it would be a purely academic exercise). Here, Plaintiffs specifically allege that all of Setech's transactions were closely connected as they were part of the same, continuing fraudulent scheme. Thus, the doctrine is applicable to the claims against Setech, and Plaintiffs' claims should be deemed timely.

[91] Delphi's liabilities were also understated by $33 million in 2000. ¶ 144.

A false statement is "considered material under Section 10(b) if its disclosure would alter the 'total mix' of facts available to an investor and 'if there is a substantial likelihood that a reasonable shareholder would consider it important' to the investment decision." *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1305 (C.D. Cal. 1996) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 236, 240 (1988)); *see also Helwig*, 251 F.3d at 555. "Courts generally reserve questions [of materiality] for the trier of fact." *Helwig*, 251 F.3d at 563. The Supreme Court has held that materiality is a fact-specific inquiry, which is generally appropriate for jury determination. *See Basic*, 485 U.S. at 236, 240; *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976).[92] This Circuit has stated that, at the motion to dismiss stage, "a complaint may not properly be dismissed on the ground that the alleged misstatements or omissions are not material **unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their unimportance.**" *Helwig*, 251 F.3d at 563 (emphasis added).

The SEC has rejected the position that materiality can be judged on the basis of a mathematical formula. In Staff Accounting Bulletin 99, 1999 SEC LEXIS 1599 (Aug. 12, 1999), the SEC's Division of Corporate Finance and Office of the Chief Accountant noted that determining materiality by exclusive reference to a "percentage or numerical threshold has no basis in the accounting literature or the law." *Id.* at *4. SAB 99 further states that "quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations." *Id.* at *5. It further states that one "should not assume that even small

[92] *See also In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 409 (S.D.N.Y. 1998).

intentional misstatements in financial statements, for example those pursuant to actions to 'manage' earnings, are immaterial." *Id.* at *15; *see also In the Matter of Richard P. Scalzo, CPA,* File No. 3-11212, 2003 SEC LEXIS 1915, at *43 n.32 (SEC Aug. 13, 2003).[93]

Here, because Delphi's misstatements due to Setech's 2000 conduct are not "**so obviously unimportant**" that reasonable minds could not differ on the question of their unimportance, the Court should reserve this question for the trier of fact. A reasonable investor would have undoubtedly considered the falsity of Delphi's financial statements that resulted from Setech's conduct during 2000 important to an investment decision because of (1) the nature of the misstatements; (2) the depressed state of the auto industry and the economy during 2000; and (3) the impact on the perception of Delphi's management.

First, the misstatements consisted of overstatements of net income. ¶ 144. Overstatements of net income and revenues are considered particularly material to the reasonable investor. *See Ganino v. Citizens Utils. Co.,* No. 99-7904, 2000 WL 1262550, at *164 (2d Cir. 2000); *Kidder Peabody,* 10 F. Supp. 2d at 409-10; *Marksman Partners,* 927 F. Supp. at 1306; *SEC v. Benson*, 657 F. Supp. 1122, 1131 (S.D.N.Y 1987).

Second, considering the state of the auto industry in 2000, Delphi's 1.9% overstatement of net income and 1% understatement of inventory attributable to Setech would have been important to the reasonable investor in making an investment decision. In 2000, the auto industry was "plagued with declining vehicle production" and was "suffering from production cuts and lay-offs." ¶¶ 154, 276. Investors believed that the auto industry had collapsed and that there was fundamental long-term deterioration in return on capital. ¶ 104. There was also a

[93] A copy of this opinion is attached as Exhibit E to the Yarnoff Declaration.

general downturn in the overall economy at this time. ¶ 103. Under these weak conditions, a reasonable investor would have viewed **any** overstatement of net income as significant. Further, with production declines threatening increased inventories, a reasonable investor would have also considered **any** understatement of inventories to be important. ¶ 105. *See Ganino,* 2000 WL 1262550, at *163, 166 (declining to hold immaterial as matter of law misrepresentation of 1.7% of defendant's revenues and stating that "[q]ualitative factors may cause misstatements of qualitatively small amounts to be material"); *In re Home Health Corp. of America, Inc. Sec. Litig.*, No. Civ. A. 98-834, 1999 WL 79057, at *6-7 (E.D. Pa. Jan. 29, 1999) (declining to hold immaterial as matter of law failure to report loss of de minimis percentage of total revenue where qualitative factor rendered the loss significant). Due to the depressed state of the auto industry and economy, such misstatements, regardless of the percentages, would have greatly impacted a reasonable investor.

Third, Setech's fraudulent conduct and its impact on Delphi's 2000 financial results would have been significant to a reasonable investor because of its relevance to evaluating management's integrity and fitness to run the Company. *See Kidder Peabody,* 10 F. Supp. 2d at 409 (overstatements and false profits could be material to extent they raise concerns about parent company's "internal controls, efficiency, and integrity, all of which would have been relevant to a reasonable investor"); *Ross v. Warner,* No. 77 Civ. 243, 1980 WL 1474, at *8 (S.D.N.Y. Dec. 11, 1980) (company's practice of not disclosing its questionable payments could be material to extent they were pertinent to management's integrity); *SEC v. Jos. Schlitz Brewing Co.,* 452 F. Supp. 2d 824, 830 (D. Wisc. 1978) ("the question of the integrity of management gives materiality to the matters" not disclosed). Allegations regarding Setech's direct participation in

Delphi's fraudulent scheme in 2000 would have inculpated Delphi's management and, consequently, been important to a reasonable investor in making an investment decision.

Despite the fact that its conduct directly enabled Delphi to overstate its income, Setech contends that the specific numbers – 1.9% and 1.0% – are immaterial as a matter of law because of their size. Setech Br. at 19. Setech ignores the Supreme Court's clear guidance against adoption of a bright-line rule to determine what an investor would consider significant. In *Basic v. Levinson*, the Supreme Court advised courts to heed the following advice:

> After much study, the Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula, [stating:]
>
> [I]t would be desirable to have absolute certainty in the application of the materiality concept, . . . [but] such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula.

485 U.S. at 236.

Setech's reliance on *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997), is entirely misplaced. Rather than standing for the proposition that "as a matter of law no reasonable investor would put any substantial weight on whether the issuer's assets were or were not 2% inflated," *Parnes* stands for the proposition that materiality is a fact-specific inquiry, not subject to a bright-line rule. *Parnes* specifically limited its decision to overstatements of assets in connection with a "high-risk/high-yield investment opportunity in a company with a history of very rapid growth," which had prominently disclosed pertinent risk in the prospectus. *Id.* at 547. The court held: "While there may be many cases where this amount of money [2% misstatement] would be material and would dramatically affect the total mix of information relied on by a reasonable investor, this simply is not the situation in this case."[94] Here, however, due to the specific facts of this case, including the depressed auto industry, the overstatement of net income, not "assets," the failure to disclose the pertinent risks and the fact that Delphi is not a "high-risk/high-yield investment," a reasonable investor would consider 1.9% significant, and Setech's fraudulent conduct would dramatically affect the total mix of information relied on by a reasonable investor.

In sum, the Court should reject Setech's materiality argument because it is clear that a reasonable investor would consider the impact Setech's conduct had on Delphi's 2000 financial statements important in making an investment decision and, consequently, this issue is best suited for the trier of fact. *Helwig,* 251 F.3d at 563.

III. PLAINTIFFS HAVE STATED CONTROL PERSON CLAIMS UNDER § 15 OF THE SECURITIES ACT AND § 20(a) OF THE EXCHANGE ACT

The Officer Defendants and Director Defendants are liable under § 15 of the Securities Act and § 20(a) of the Exchange Act for Delphi's violations of the securities laws.[95]

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[94] Similarly, Setech also misplaces reliance on *In re Burlington Coat Factory,* 114 F.3d 1410, 1427 (3d Cir. 1997), and *In re Goodyear Tire & Rubber Co. Sec. Litig,* No. 88-8633, 1993 U.S. Dist. LEXIS 5333, at *64 (E.D. Pa. Apr. 21, 1993) (a copy of which is attached as Ex. F to the Yarnoff Declaration). In *Burlington Coat Factory*, the court determined that defendant's failure to disclose a lower discount rate from its supplier was not material because the 0.2% impact on total costs was not discernable or singularly identifiable. 114 F.3d at 1427. In *Goodyear,* the court found that a memo from one manager pushing his other managers was not, standing alone, evidence of fraud because it included forward looking language; plaintiffs had not provided any contradictory evidence calling the subject matter of the memo into question; and, lastly, it referred to only "one of Goodyear's 87 manufacturing plants which represents probably less than two percent of the corporation's plants." 1993 U.S. Dist. LEXIS 5333, at *64. Here, unlike *Burlington Coat Factory* and *Goodyear,* Setech's 2000 conduct is an identifiable, appreciable overstatement of income in a declining market and economy that directly implicates management's integrity.

[95] The Director Defendants and Officer Defendants do not contest Delphi's primary liability under either § 10(b) or § 11 or that that they may be liable for Delphi's violations of the securities laws as control-persons even though this action is stayed against Delphi. *See In re Hayes Lemmerz Int'l, Inc. Equity Sec. Litig.*, 271 F. Supp. 2d at 1021 n. 11 ("if the complaint states a primary violation by the Company, even if the Company is not named in the complaint as a defendant, then a § 20 claim can stand if the individuals were controlling persons."); *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1077 (S.D.N.Y. 1988) (denying dismissal of § 20(a) claim where plaintiffs failed to sue primary violator; holding "liability of the primary violator is simply an element of proof of a § 20(a) claim, and that

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For claims under both § 15 and § 20(a), Plaintiffs must allege that (1) the "controlled person" committed an underlying violation of the securities laws or the rules and regulations promulgated thereunder, and (2) the "controlling person" defendant directly or indirectly controlled the person liable for the securities law violation. *See PR Diamonds,* 364 F.3d at 696; *Hayes Lemmerz*, 271 F. Supp. 2d at 1029 (noting that "the standard for control liability under § 15 is the same as § 20(a).")[96] Control person allegations need only satisfy Rule 8 notice pleading requirements. *See Fezzani v. Bear Stearns & Co*., No. 99 Civ. 0793 (RCC), 2004 WL 744594, at *23 (S.D.N.Y. April 6, 2004) ("The Rule 9(b) heightened pleading standard does not apply to averments of control person liability"); *WorldCom*, 294 F. Supp. 2d at 415-16 (a "short, plain statement that gives the defendant fair notice of the claim that the defendant was a control person and the ground on which it rests its assertion . . . is all that is required"); *In re Vivendi Universal S.A. Sec. Litig.*, No. 02 Civ. 5571 (RJH), 2004 WL 876050, at *1 (S.D.N.Y. April 22, 2004).

A. <u>Plaintiffs Have Adequately Alleged Control</u>

Plaintiffs have adequately alleged the Officer Defendants' and Director Defendants' control over Delphi for control-person liability under §§ 15 and 20(a). "Control" is defined as

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liability need not be actually visited upon the primary violator before a controlling person may be held liable"); *Elliott Graphics, Inc. v. Stein*, 660 F. Supp. 378 (N.D. Ill. 1987); *Briggs v. Sterner*, 529 F. Supp. 1155, 1770-71 (S.D. Iowa 1981) (holding officers and directors of non-defendant bankrupt corporation may be liable as controlling persons under § 20(a) and § 15).

[96] Section 15 imposes liability on "[e]very person who, by or through stock ownership, agency, or otherwise . . . controls any person liable under [§ 11 or § 12 of the Securities Act] . . . unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which liability of the control person is alleged to exist. 15 U.S.C. § 77o; *Pacholder v. Cruz*, 271 F. Supp. 2d 1007, 1029 (E.D. Mich. 2003) Likewise, § 20(a) imposes liability on "every person who, directly or indirectly, controls any person liable under any provision of [the Exchange Act] or any rule or regulation thereunder . . . 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); *Sennott Et Ux. v. Rodman & Renshaw*, 414 U.S. 926, 929 n.3 (1973).

'the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through ownership of voting securities, by contract, or otherwise.'" *Bridgestone*, 399 F.3d at 667 (quoting 17 C.F.R. § 230.405). The question of control person liability "is necessarily fact intensive and cannot be resolved on these motions" to dismiss. *In re Executive Telecard, Ltd. Sec. Litig.*, 913 F. Supp. 280, 286 (S.D.N.Y. 1996); *see In re Nat'l Century Fin. Enters., Inc., Inv. Litig.*, No. 2:03-MD-1565, 2006 WL 469468, at *22 (S.D. Ohio Feb. 27, 2006) ("Whether Ayers in fact controlled NPF XII is a matter for discovery to resolve"); *In re Nord Res. Corp. Sec. Litig.*, Nos. C-3-90-380, C-3-90-391, C-3-90-409, C-3-90-410, 1992 WL 1258516, at *3 (S.D. Ohio Dec. 16, 1992) (denying motion to dismiss where "it is possible for [p]laintiffs to develop facts which will prove this [d]efendant's controlling person liability").[97]

Here, the Complaint alleges that the Officer Defendants and Director Defendants possessed, directly or indirectly, the requisite power to direct and/or control Delphi's management and policies, including Delphi's management of and policies surrounding its financial reporting, and by virtue of their operational and management control of Delphi's business, had the ability to prevent the issuance of the statements alleged to be false and misleading or cause such statements to be corrected. ¶¶ 27-54, 730-34, 748-52, 766-71, 785-90.

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[97] *See also No. 84 Employer-Teamster Joint Council Pension Trust v. Am. W. Holding Corp.*, 320 F.3d 920, 945 (9th Cir. 2003) ("intensely factual question"; reversing order granting motion to dismiss); *Hayes Lemmerz*, 271 F. Supp. 2d at 1022-23 ("whether one is a control person is a factual question"; denying motion to dismiss); *In re Oxford Health Plans, Inc. Sec. Litig.*, 187 F.R.D. 133, 143 (S.D.N.Y. 1999) ("fact intensive" question for a jury); *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1023 (S.D.N.Y. 1984) (determination of whether there is control "must be made at trial"); *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395, 400 (S.D.N.Y. 1957) ("The question of control is a factual question"). Thus, the issue of control person liability "is not ordinarily subject to resolution on a motion to dismiss" and "dismissal is appropriate only when a plaintiff does not plead any facts from which it can reasonably be inferred the defendant was a control person." *MicroStrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d at 661.

Thus, Plaintiffs have satisfied the pleading requirements of Rule 8 and have adequately alleged the Defendants' control for purposes of § 15 and § 20(a).[98]

B. Claims Under §§ 15 and 20(a) Need Not Plead "Culpable Participation"

Aware that the Complaint easily satisfies the requirements for pleading control, the Defendants urge the claims under both §§ 15 and 20(a) must allege "culpable participation." Individual Def. Br. at 40 (citing *Pacholder*, 271 F. Supp. 2d at 1029); Blahnik Br. at 7; Dawes Br. at 18. There is no such pleading requirement.

First, with respect to Plaintiffs' § 15 claim, Defendants' reliance on *Pacholder* is misplaced. In reciting the elements required to establish control person liability under § 15, the *Pacholder* court did not mention "culpable participation." *See Pacholder*, 271 F. Supp. 2d at 1021. The court merely indicated that § 15 and § 20(a) of the Exchange Act are interpreted the same. Moreover, reading a "culpable participation" requirement into § 15 makes no sense. The minority of courts outside this Circuit that have required "culpable participation" for a § 20(a) claim have done so because § 20 liability depends on § 10(b) liability, which requires scienter. Hence, those courts have reasoned, § 20(a) liability also should not be imposed absent some degree of culpability. In contrast, there can be strict liability under § 11 and § 12 of the Securities Act. Therefore, the rationale for requiring culpable participation for a § 20(a) claim is not present with respect to § 15. "Because the underlying violation pursuant to § 15 is a

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[98] Courts usually find that officers and directors, particularly those serving on committees or signing the company financials, are control persons. *See In re Hayes Lemmerz Int'l, Inc.*, 271 F. Supp. 2d 1007, 1021-23 (E.D. Mich. 2003) (audit committee members); *State of New Jersey v. Sprint Corp.*, 314 F. Supp. 2d 1119, 1143 (D. Kan. 2004); *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 419-20 (S.D.N.Y. 2003) (directors who signed SEC filings); *In re CINAIR Corp. Sec. Litig.*, 186 F. Supp. 2d 279, 309-10 (E.D.N.Y. 2002); *Lernout & Hauspie*, 286 B.R. at 39-40 (audit committee members); *In re Reliance Sec. Litig.*, 91 F. Supp. 2d 708, 731 (D. Del. 2000).

violation of §§ 11 and 12(a)(2) in which strict liability is imposed," culpable participation is not required "to establish a *prima facie* case of control person liability pursuant to § 15." *In re Deutsche Telekom AG Sec. Litig.*, 2002 WL 244597, at *6 (S.D.N.Y. Feb. 20, 2002). For this, among other reasons, most courts reject the notion that a § 15 claim must plead culpable participation. *See, e.g., In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 188 (S.D.N.Y. 2003) ("the apparent majority of judges in the Southern District [of New York] . . . have determined that culpable participation is not an element of § 15"); *Dorchestor Investors v. Peak Trends Trust*, No. 99 Civ. 4696 (LMM), 2003 WL 223466, at *3 (S.D.N.Y. Feb. 3, 2003) (collecting cases).

Likewise, the Sixth Circuit also holds that culpable participation is not an element of a § 20(a) claim. In *PR Diamonds,* the Sixth Circuit stated the elements of a § 20(a) claim with no mention of "culpable participation." 364 F.3d at 696 (stating two requirements: an underlying violation and control of the violator); *see also Nat'l Century*, 2006 WL 469468, at *24 (finding plaintiffs properly alleged that defendant was a controlling person and declining to require culpable participation, stating, "[a]nd while the statutory language of § 20(a) exempts those control persons who act in good faith from liability, it does not otherwise contain a requirement of culpable participation."); *CMS Energy*, 403 F. Supp. 2d. 625 ("As plaintiffs contend, the *PR Diamonds* case did not hold that 'culpable participation' was an element of a 20(a) claim."); *but see Burkett*, 2005 WL 3556202 (citing *D.E. & J. Ltd. P'ship*, 284 F. Supp. at 750 (requiring culpable participation in the underlying violation to establish a claim under § 20(a)).

In support of their assertion that Plaintiffs must allege culpable participation, Defendants cite only to this Court's opinion in *D.E. & J. Ltd. P'ship* – a decision superseded by the Sixth

Circuit's decision in *PR Diamonds*, 364 F.3d 671 (6th Cir. 2004). Allegations of "culpable participation" are simply not required in the Sixth Circuit.[99] Indeed, most courts addressing the issue have expressly rejected a requirement to allege "culpable participation" in order to establish a claim of controlling person liability under § 20(a).[100]

[99] Notwithstanding *PR Diamond*'s exclusion of a requirement to allege culpable participation, Plaintiffs' allegations as set forth in the Complaint, *see, e.g.*, ¶¶ 581-611, 621-26, 628, 630-50 are sufficient to show the culpable participation of all Defendants alleged to be liable as control persons. *See Burkett v. Hyman Lippitt, P.C.*, No. 05-72110, 2005 WL 3556202, at *21 (finding plaintiffs sufficiently alleged culpable participation by a controlling person who was alleged to have had actual knowledge of facts surrounding the underlying violation).

[100] A requirement to plead "culpable participation" in the underlying violation to establish a claim under § 20(a) has been expressly rejected by the Courts of Appeals for the Fifth, Seventh, Eighth, Ninth, Tenth and Eleventh Circuits. *See Abbott v. The Equity Group, Inc.*, 2 F.3d 613, 619-20 (5th Cir. 1993); *Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d. 609, 614 (7th Cir. 1996); *Martin v. Shearson Lehman Hutton, Inc.*, 986 F.2d 242, 245 (8th Cir. 1993); *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000); *Kinder Morgan,* 340 F.3d at 1109; *Brown v. The Enstar Group, Inc.*, 84 F.3d 393, 397 (11th Cir. 1996). Although not addressed by the Courts of Appeals for the Second, Fourth and D.C. Circuits, culpable participation has been expressly rejected by District Courts in those circuits. *See Parmalat*, 414 F. Supp. 2d 428, 439; *Royal Ahold*, 351 F. Supp. 2d at 408; *In re Baan Co. Sec. Litig.* 103 F. Supp. 2d 1, 23-24 (D.D.C. 2000). The First Circuit has yet to take a position on whether a plaintiff must allege culpable participation. *See In re Stone & Webster, Inc. Sec. Litig.*, 424 F.3d 24, 26 (1st Cir. 2005). Only the Third Circuit has held that plaintiffs must plead that the controlling person was a culpable participant in the underlying securities violation to state a claim under § 20(a). *See Suprema*, 438 F.3d at 285 n.16.

CONCLUSION

For the reasons set forth herein, Defendants' motions to dismiss should be denied in their entirety.

Dated: May 12, 2006

Respectfully submitted,

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By ________________

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UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

IN RE DELPHI SECURITIES, DERIVATIVE, AND ERISA LITIGATION	)))	MDL No. 1725 Case NO. 05-md-1725
This Document Related to: In re Delphi Corporation Securities Litigation, No. 06-10026	)))	Hon. Gerald E. Rosen

LEAD PLAINTIFFS' OMNIBUS RESPONSE TO MOTIONS TO DISMISS THE CONSOLIDATED CLASS ACTION COMPLAINT

Lead Plaintiffs object to the Motions to Dismiss the Consolidated Class Action Complaint for the reasons more particularly set forth in the LEAD PLAINTIFFS' OMNIBUS MEMORANDUM OF LAW IN OPPOSITION TO ALL DEFENDANTS' MOTIONS TO DISMISS THE CONSOLIDATED CLASS ACTION COMPLAINT, submitted to the Court simultaneously herewith.

Respectfully submitted,

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