United States Court of Appeals
for the
Third Circuit

Case No. 04-3716

IN RE: SUPREMA SPECIALTIES, INC. SECURITIES LITIGATION

TEACHERS' RETIREMENT SYSTEM OF LOUISIANA,

Appellant.

Case No. 04-3755

IN RE: SUPREMA SPECIALTIES, INC. SECURITIES LITIGATION

SPECIAL SITUATIONS FUND, III, L.P.; SPECIAL SITUATIONS CAYMAN FUND, L.P.,

Appellants.

ON APPEAL FROM THE ORDER ENTERED AUGUST 26, 2004 IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY

BRIEF OF APPELLANT TEACHERS' RETIREMENT SYSTEM OF LOUISIANA AND JOINT APPENDIX
Volume I of IV (Pages A1–A40)

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United States Court of Appeals for the Third Circuit

Corporate Disclosure Statement and Statement of Financial Interest

No. 04-3716

Smith

v.

Cocchiola

Instructions

Pursuant to Rule 26.1, Federal Rules of Appellate Procedure any nongovernmental corporate party to a proceeding before this Court must file a statement identifying all of its parent corporations and listing any publicly held company that owns 10% or more of the party's stock.

Third Circuit LAR 26.1(b) requires that every party to an appeal must identify on the Corporate Disclosure Statement required by Rule 26.1, Federal Rules of Appellate Procedure, every publicly owned corporation not a party to the appeal, if any, that has a financial interest in the outcome of the litigation and the nature of that interest. This information need be provided only if a party has something to report under that section of the LAR.

In all bankruptcy appeals counsel for the debtor or trustee of the bankruptcy estate shall provide a list identifying: 1) the debtor if not named in the caption; 2) the members of the creditors' committee or the top 20 unsecured creditors; and, 3) any entity not named in the caption which is an active participant in the bankruptcy proceedings. If the debtor or the bankruptcy estate is not a party to the proceedings before this Court, the appellant must file this list. LAR 26.1(c).

The purpose of collecting the information in the Corporate Disclosure and Financial Interest Statements is to provide the judges with information about any conflicts of interest which would prevent them from hearing the case.

The completed Corporate Disclosure Statement and Statement of Financial Interest Form must, if required, must be filed upon the filing of a motion, response, petition or answer in this Court, or upon the filing of the party's principal brief, whichever occurs first. An original and three copies must be filed. A copy of the statement must also be included in the party's principal brief before the table of contents regardless of whether the statement has previously been filed. Rule 26.1(b) and (c), Federal Rules of Appellate Procedure.

If additional space is needed, please attach a new page.

Pursuant to Rule 26.1 and Third Circuit LAR 26.1, Teachers' Retirement System of Louisiana makes the following disclosure: (Name of Party)

1) For non-governmental corporate parties please list all parent corporations:

N/A

2) For non-governmental corporate parties please list all publicly held companies that hold 10% or more of the party's stock:

N/A

3) If there is a publicly held corporation which is not a party to the proceeding before this Court but which has as a financial interest in the outcome of the proceeding, please identify all such parties and specify the nature of the financial interest or interests:

N/A

4) In all bankruptcy appeals counsel for the debtor or trustee of the bankruptcy estate must list: 1) the debtor, if not identified in the case caption; 2) the members of the creditors' committee or the top 20 unsecured creditors; and, 3) any entity not named in the caption which is active participant in the bankruptcy proceeding. If the debtor or trustee is not participating in the appeal, this information must be provided by appellant.

N/A

(Signature of Counsel or Party) Dated: 9-29-04

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I. STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

The district court had jurisdiction over this Action pursuant to 15 U.S.C. §78aa, 15 U.S.C. §77v and 28 U.S.C. §1331. The District Court entered a final judgment dismissing the Complaint on August 26, 2004. (A1.)[1] This Court has jurisdiction over this appeal pursuant to 28 U.S.C. §1291. Appellant's Notice of Appeal was timely filed on September 15, 2004. (A38.)

II. STATEMENT OF RELATED CASES

The appeal of plaintiffs in *Special Situations Fund, III, L.P., et al. v. Cocchiola, et al*, District Court No. 2:02 Civ. 03099 (WHW), Court of Appeals No. 04-3755, is currently pending before this Court. Counsel is not aware of any other related cases or proceedings currently pending.

III. STATEMENT OF THE ISSUES

A. Whether the District Court Erred in its Application of the "Sounds in Fraud" Doctrine to Securities Act Claims that Expressly Rest on Negligent Conduct and Contain no Allegation that Defendants' Acted with Fraudulent Intent? (Raised, Opposed and Ruled Upon: A9-A18)

B. Whether the District Court Erred in Dismissing Exchange Act Claims Against a Company's Officers and Auditors Where the Complaint Alleges, With Great Specificity, How The Officers Orchestrated a Massive Scheme to Defraud Investors, and the Auditor's So-Called "Audit" Was So Deficient as to Constitute No Audit at All? (Raised, Opposed and Ruled Upon: A19-A31)

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[1] All references to "A__" refer to the Joint Appendix submitted herewith.

C. Whether the District Court Erred in Dismissing Control Person Claims Against a Company's Senior Officers Where the Complaint Sets Forth a Primary Violation on the Part of the Company and Detailed Facts Demonstrating How Those Officers Controlled Every Aspect of the Company's Affairs? (Raised, Opposed and Ruled Upon: A34-A36)

IV. STATEMENT OF THE CASE

A. Nature of the Action

This is not your run-of-the-mill appeal. In dismissing the instant Complaint, the District Court rewrote the Securities Act of 1933 (the "Securities Act") to require plaintiffs to plead scienter, even though intent is not an element of a §11 or §12(a)(2) claim. It also completely ignored the Complaint's detailed allegations, choosing instead to accept the defendants' version of events as true and drawing all inferences in their favor, in direct contravention of the law governing motions to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure ("Rule 12(b)(6)"). Any fair reading of the Complaint and the relevant statutes and case law compels the conclusion that each of Lead Plaintiff's claims should be allowed to proceed against all of the named defendants.

Between September 27, 2000 and December 21, 2001 (the "Class Period"), Suprema Specialties, Inc. ("Suprema" or the "Company") publicly represented itself as a rapidly growing manufacturer and importer of gourmet Italian cheeses. In fact, the vast majority of Suprema's business consisted of fabricated or "round-trip" transactions undertaken for the sole purpose of artificially inflating the Company's reported revenues and accounts receivable. There is no bona fide

dispute that approximately two-thirds of Suprema's business was a sham. Indeed, four individuals have pleaded guilty to criminal charges of, among other things, securities fraud based on the exact conduct that is detailed in the Complaint.

Just weeks before this fraud came to light, Suprema conducted a secondary offering of common stock (the "Offering"), raising over $40 million pursuant to a Registration Statement filed with the Securities & Exchange Commission (the "SEC") in November 2001 (the "Registration Statement"). As alleged in the Complaint, the Registration Statement contained untruths and omissions of material facts relating to Suprema's business and financial results. Specifically, the Registration Statement included Suprema's financial statements for fiscal years 2000 and 2001, which were materially misstated, and numerous statements regarding the nature of Suprema's business and operations that were materially false and misleading.

On December 21, 2001 – a mere ***six weeks*** after the Offering – Suprema announced that its Chief Financial Officer, defendant Steven Venechanos ("Venechanos"), and its Controller, Art Christiansen, had resigned; that the NASDAQ had halted trading of Suprema common stock; and that the SEC had initiated a formal investigation. Shortly thereafter, federal criminal authorities executed search warrants at the Company, which promptly went into bankruptcy and then liquidation. Today, there is nothing left of Suprema except for a

Liquidation Trustee who is dissolving the Company's assets and prosecuting claims on behalf of Suprema's creditor banks.

The Complaint alleges claims under the Securities Act based on the admitted untruths and material omissions in the Registration Statement against Suprema's Chief Executive Officer, Mark Cocchiola ("Cocchiola") and its Chief Financial Officer, Venechanos (together, the "Officers"); its outside directors, Marco Cocchiola, Rudolph Acosta, Jr., Paul Desocio, and Barry S. Rutcofsky ("collectively, the "Directors"); its underwriters, Janney Montgomery Scott LLC, Pacific Growth Equities, Inc., and Roth Capital Partners, LLC (collectively, the "Underwriters"); and its auditor, BDO Seidman LLP ("BDO"). The Complaint also alleges claims under the Securities Exchange Act of 1934 (the "Exchange Act") against the Officers and BDO based on their materially false and misleading statements throughout the Class Period. The District Court dismissed all of these claims on August 26, 2004.

First, with respect to Lead Plaintiff's Securities Act claims, the District Court held that the Complaint adequately alleges all of the elements of §§11 and 12(a)(2). Furthermore, it specifically found that these counts were devoid of ***any*** allegation of fraudulent intent as to ***any*** of the named defendants. (A16, A19.) Nevertheless, the District Court somehow concluded that these claims "sounded in fraud," and then dismissed them ***precisely because they contained no allegations***

of fraudulent intent. (*Id.*) This decision was obviously in error. (*See* Section VIII.A.)

Second, with respect to Lead Plaintiff's Exchange Act claims, the District Court recognized that the only element of Rule 10b-5 at issue was scienter. (A23.) It then went on to hold that, notwithstanding Lead Plaintiff's detailed description of the central role of Cocchiola and Venechanos in orchestrating the fraud at Suprema, as well as their motive for doing so, Lead Plaintiff failed to plead a strong inference of scienter as to these defendants. (A24-A25.) Similarly, the Court held that despite the existence of numerous glaring red flags and its apparent failure to make even the most rudimentary investigation into those red flags during its "audit," Lead Plaintiff had not pleaded sufficient facts to raise "a strong inference of recklessness" as to BDO. (A32.) In making these findings, however, the District Court failed to credit the allegations of the Complaint, or draw any inferences in Lead Plaintiff's favor. Lead Plaintiff respectfully submits that under any fair reading of the Complaint, these claims should have been sustained. (*See* Sections VIII.B-C.)

Finally, with respect to Lead Plaintiff's control person claims against Cocchiola and Venechanos, the District Court held that these claims must be dismissed because the Complaint failed to set forth a primary violation on the part of these individuals. (*See* A35-36.) However, these claims do ***not*** rest on primary

violations by Cocchiola and Venechanos, but rather on primary violations by ***Suprema***. Thus, it appears that the District Court simply misunderstood these control person counts, which are easily satisfied in view of the admitted nature of this fraud. (*See* Section VIII.D.)

B. Procedural History

Following Suprema's December 21, 2001 announcement, numerous class action complaints were filed. On July 1, 2002, the District Court consolidated these actions and appointed the Teachers' Retirement System of Louisiana as the Lead Plaintiff for the consolidated action. *See Smith v. Suprema Specialties, Inc.*, 206 F. Supp. 2d 627 (D.N.J. 2002).

On September 11, 2002, Lead Plaintiff filed an Amended Consolidated Class Action Complaint. (*See* A1086.) Motions to dismiss under Rule 12(b)(6) were filed, and the initial complaint was dismissed in an unpublished decision on June 25, 2003. (*See* A435-A474.) The Court granted Lead Plaintiff 60 days "to formally move for leave to amend [its] complaint by the submission of a proposed amended complaint." (A476.)

Lead Plaintiff timely made such a motion on August 25, 2003, and attached a proposed amended complaint. Defendants filed opposition to the motion for leave to amend, and the Court scheduled oral argument for January 8, 2004. However, that morning, Lead Plaintiff provided the District Court with four

criminal Informations that had been entered the previous afternoon. (*See* A1799.) The Informations and accompanying plea allocutions mirrored the allegations that were contained in the proposed amended complaint. In view of this new information, the parties agreed that Lead Plaintiffs' motion for leave to amend should be granted, and that Lead Plaintiff would file a revised amended complaint incorporating the facts from the Informations and plea allocutions, subject, of course, to any renewed motions to dismiss.

On January 30, 2004, Lead Plaintiff filed the Second Amended Consolidated Class Action Complaint (the "Complaint"), which is the operative pleading at issue on this Appeal.[2] Defendants once again moved to dismiss the Complaint under Rule 12(b)(6), and the District Court heard oral argument on May 4, 2004. On August 26, 2004, the District Court issued a published opinion dismissing the Complaint in its entirety. (A2-A37.)

For all of the reasons set forth below, the District Court's decision is incorrect as a matter of law and should be reversed.

V. STATEMENT OF FACTS

Throughout the Class Period, Suprema was a relatively small company headquartered in Paterson, New Jersey. (A85 ¶11.) According to its public filings, Suprema's "management" consisted of only four individuals: defendant

[2] The Complaint appears at A77-A258. Hereinafter, references to "¶_" are references to the paragraphs of the Complaint.

Cocchiola, the CEO; defendant Venechanos, the CFO; Thomas Egan, Suprema's Senior Vice President; and Anthony Distinti, Suprema's Vice President for Human Resources. (A530.) Its purported business was manufacturing and importing gourmet all-natural Italian cheese. (A96-97 ¶¶56-57.)

In 2000 and 2001, Suprema reported astronomical growth in sales, which it attributed to increased sales of cheese that it had manufactured. (A98 ¶59.) Concomitant with these increased sales, Suprema reported dramatic increases in accounts receivables, which grew from $36.0 million at the end of fiscal 1999 to over $101.8 million by the end of fiscal 2001. (A95 ¶53.) Suprema attributed the vast majority of its business, and nearly all of its Class Period growth, to sales to five customers: A&J Foods ("A&J"); Noble J.G. Cheese ("Noble"); California Goldfield Cheese Traders ("California Goldfield"); Tricon Commodities International ("Tricon"); and Battaglia and Company ("Battaglia"). (A95 ¶54.)[3]

Unbeknownst to investors, Suprema's financial results throughout the Class Period were bogus and its reported success was a complete sham. As detailed in the Complaint, and admitted by the four individuals who pleaded guilty, the vast

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[3] The concentration of Suprema's business in these five customers was disclosed in the Notes to the financial statements included in the Registration Statement. (A120-A121 ¶133, A228 ¶405.) However, the Company did not disclose that A&J, Noble and California Goldfield were all controlled by a single individual, Jack Gaglio, that its hard cheese suppliers were similarly concentrated, or that these customers and suppliers were related to each other. (A228-A229 ¶¶405-06.)

majority of Suprema's business consisted of nothing more than fictitious "round-trip" transactions with Suprema's major customers. The Complaint identifies these customers as Jack Gaglio of A&J, Noble and California Goldfield (A136-A154 ¶¶175-221); Paul Zambas of Tricon (A154-A157 ¶¶222-33); Robert Quattrone of Battaglia (A158-A160 ¶¶234-38); George Vieira of California Milk Market (A160 ¶¶239-41); and Lawrence Fransen of LNN (A161-A162 ¶¶242-45.)[4]

As detailed in Count Four of the Complaint, the fraud was fairly simple. Defendants Cocchiola and Venechanos wrote checks from Suprema to their alleged "customers," and then those "customers" turned around and wrote checks back to Suprema. (A134-A135 ¶172; *see also* A136-A166 ¶¶174-250.) No cheese – or very little cheese – ever actually changed hands. (A134 ¶172(i).) Furthermore, to the extent that any "cheese" was shipped or stored by Suprema, that "cheese" was misbranded, adulterated and generally not fit for human consumption. (A104 ¶79; A118-A119 ¶¶123-25; A166-A168 ¶¶ 251-56.) As a result of this fraud, Suprema was able to report sky-rocketing sales and accounts receivable, none of which had any basis in reality. (A94-A95 ¶¶51-53; A106 ¶86.)

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[4] Quattrone, Vieira and Fransen were among the individuals who pleaded guilty to *inter alia*, securities fraud, as did John Van Sickle, the former operations manager and Assistant to the Executive Vice President of Suprema. (*See* A105 ¶83; A132-A135 ¶¶170-73.)

The Complaint sets forth numerous facts demonstrating that it Cocchiola and Venechanos were responsible for orchestrating the fraud. For example:

- The individuals who pleaded guilty testified that they perpetrated the fraud "at the direction and with the participation of ***Suprema's management***," (A132-A134 ¶¶170-71 (emphasis added));

- According to a sworn affidavit of Thomas Egan, one of the four members of Suprema's senior management, Cocchiola and Venechanos dealt directly with the individuals and entities involved in this fraud, including Gaglio, who controlled A&J, Noble and California Goldfield, (A137 ¶179); Zambas, the principal of Tricon (A156-A157 ¶232); and Quattrone, the principal of Battaglia who pleaded guilty (A158 ¶235.) (*See also* A430-A431.)

- Cocchiola and Venechanos wrote many of the checks through which this fraud was perpetrated (*see* A145-A146 ¶202; A149-A151 ¶212; A153 ¶218; A157 ¶233; A158 ¶235; A161-A162 ¶244);

- Former employees stated that Cocchiola and Venechanos were responsible for the portion of the business that was the locus of the fraud (A162-A166 ¶¶246-50);

- The resignation letter provided by Christiansen (Suprema's controller) resigned – the event that triggered the revelation of the fraud and the demise of the Company – unmistakably suggests that his unwillingness to participate in the fraud forced his resignation: "Mark [Cocchiola] and Steve [Venechanos], as we discussed, I am not willing to participate in the tasks that have been assigned to me since Paul's death." A transcript of the Liquidation Trustee's deposition of Cocchiola makes clear that these "tasks" were related to the fraudulent scheme (A168-A169 ¶¶257-61); and

- When asked about this fraudulent scheme at their depositions, both Cocchiola and Venechanos invoked their Fifth Amendment privilege against self-incrimination. (*See* A169 ¶¶260-61.)

Suprema capitalized on the fraud in two ways. First, it used its fraudulently inflated accounts receivable to increase its borrowing under its credit facility:

Suprema borrowed $83.3 million based on its phony 1999 and 2000 financial statements. (A99-A100 ¶¶63-65.) Second, it sold $41.5 million of stock to public investors in the Offering. (A100-A102 ¶¶66-70.) In addition, Cocchiola and Venechanos personally capitalized on their fraud, selling $4.1 million and $628,000 worth of stock, respectively, in the Offering. (A192-A193 ¶314(i)(c), (ii)(b).)

On December 21, 2001, just six weeks after the Offering, Suprema announced that Venechanos and Christiansen had resigned and that it had initiated an internal investigation into its prior reported financial results. (A102 ¶72.) In response to this announcement, the NASDAQ halted trading in Suprema stock, and trading never resumed. (*Id.* ¶73.)

On February 4, 2002, federal authorities executed a search warrant at Suprema and seized certain financial and manufacturing records. (A103 ¶78.) Thereafter, the Company revealed that it was being criminally investigated by the FBI, FDA, SEC and New Jersey Department of Agriculture. (*Id.*) On February 18, 2002, BDO resigned as Suprema's auditors, stating, among other things, that it was suddenly unable to determine whether the Company had adequate internal controls; whether the Company's prior financial statements; or whether it could rely on management's representations. (A104 ¶80.)

On February 24, 2002, Suprema filed for bankruptcy protection under Chapter 11 and, at the same time, announced that Cocchiola had stepped down as CEO and that its stock had been delisted by NASDAQ. (*Id.* ¶81.) On March 20, 2002, Suprema's bankruptcy was converted to a Chapter 7 liquidation and the Court appointed a Liquidation Trustee. (A104-A105 ¶82.) Since that time, the Liquidation Trustee has been dissolving Suprema's assets. (*Id.)*

On January 7, 2004, the four guilty pleas described above were entered. (A105 ¶83; A132-A133 ¶¶170-71); and the SEC has filed a civil complaint. (A105-A106 ¶84; A134 ¶172.)

VI. THE STANDARD OF REVIEW

This Court's review of the District Court's dismissal of the Complaint is plenary. *See Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 279 (3d Cir. 1992). The Court "must accept the allegations of the Complaint as true and draw all reasonable inferences in the light most favorable to plaintiffs." *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997). "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). Thus, this Court should reverse unless "it appears certain that plaintiffs could prove no set of facts supporting their claim ...." *Weiner*, 129 F.3d at 315.

VII. SUMMARY OF THE ARGUMENT

The District Court erred in dismissing the Complaint for several reasons. First, it concluded that Lead Plaintiff's §11 and §12(a)(2) claims "sounded in fraud," and then dismissed those claims because they do not contain a single allegation that any of the defendants acted with fraudulent intent. However, where, as here, a claim is premised solely on misstatements and omissions in a Registration Statement and does not contain any allegation that a defendant acted knowingly or recklessly, then the claim cannot be said to "sound in fraud" so as to implicate the particularity requirements of Rule 9(b). The gravamen of a fraud claim is the "intent to deceive." In the absence of any such allegation, a plaintiff need only allege a material misstatement or omission in order to state a prima facie claim under §11 of the Securities Act.

This is the case even if a complaint also charges a defendant with fraud in a later count. It is axiomatic that a Court must consider each claim separately as to each defendant in order to determine if there are any allegations that the particular defendant acted with fraudulent intent. A court may not conclude that simply because a fraud may have existed at a company, every claim against every defendant who signed a registration statement on behalf of that company must satisfy the requirements of Rule 9(b). If that were the case, then plaintiffs would be forced to file two complaints in every single securities fraud case involving an

offering of securities, one alleging fraud claims under Rule 10b-5 and another alleging negligence claims under §§11 and 12(a)(2).

Second, even if the "sounds in fraud" doctrine applies to this case, the instant Complaint easily satisfies the standard. Despite the District Court's assertions to the contrary, the application of Rule 9(b) through the "sounds in fraud" doctrine does ***not*** graft the element of scienter – or any other element of Rule 10b-5 – onto §11 or §12(a)(2). Rather, in this context, Rule 9(b) requires only that the Complaint sets forth the necessary elements of a Securities Act claim with particularity – i.e, that it detail the "who, what, when, where and how" of the material misstatement itself. The District Court here acknowledged that the Complaint satisfied these requirements and, accordingly, its decision dismissing Counts One and Two must be reversed.

Third, the District Court held the Complaint to an unreasonably high standard in dismissing the Rule 10b-5 claims against the Officers and BDO. Indeed, accepting the Complaint's allegations against the Officers as true (as is required), it is inescapable that Cocchiola and Venechanos were responsible for the massive fraud at Suprema. In entering guilty pleas to securities fraud, the four criminal defendants testified that it was Suprema's "management" who orchestrated that fraud. Suprema's management consisted of only four people, one of whom provided Lead Plaintiff with a sworn affidavit that it was Cocchiola and

Venechanos who dealt exclusively with the portion of the business that was the locus of the fraud. Further, Cocchiola and Venechanos signed the checks through which the fraud was perpetrated, and they invoked the Fifth Amendment in refusing to answer questions relating to the fraud. These facts, along with the numerous other facts and circumstances detailed in the Complaint and discussed below, are more than sufficient to raise a strong inference of scienter.

Similarly, with the sweep of a hand, the District Court disregarded 41 pages of particularized allegations of BDO's scienter, including thirty separate red flags that put BDO on notice of serious deficiencies in Suprema's 2000 and 2001 financial statements. The Complaint makes clear that had BDO complied with even its most basic obligations as auditors, it would have uncovered this fraud. Thus, the Complaint adequately alleges that BDO's conduct was so deficient as to constitute no audit at all. Yet the District Court concluded that "given the information available to BDO at the time of the audit it cannot be said that BDO did not have an honest belief that the statements made by it were true." (A32.) "What BDO believed" is a fact question that is not appropriately resolved on a motion to dismiss. For these reasons and others, Lead Plaintiff's Rule 10b-5 claims against BDO should be sustained.

Finally, the District Court misunderstood Lead Plaintiff's control person claims. It mistakenly believed that these claims were premised on a primary

violation by the control persons themselves. (A36.) However, even a cursory reading of the Complaint makes clear that these claims are premised on a primary violation by Suprema, which violation is clearly established in as much as the fraud is admitted. Accordingly, these claims should also be permitted to go forward.

VIII. LEGAL ARGUMENT

A. The District Court Erroneously Applied the "Sounds in Fraud" Doctrine in Dismissing Lead Plaintiff's Securities Act Claims

"Although limited in scope, §11 places a relatively minimal burden on a plaintiff." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). "If a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his *prima facie* case." *Id.*; 15 U.S.C. §77k(a). The District Court here specifically ruled that the Registration Statement contained material misstatements. (A15.) This should have ended the analysis. However, the District Court went on to apply the so-called "sounds in fraud" doctrine to the Securities Act claims and then dismissed those claims for failing to allege scienter. As detailed below, both the decision to apply the sounds in fraud doctrine to the allegations underlying these claims and the manner in which it was applied constitute reversible error.

1. None of Lead Plaintiff's Securities Act Claims are Based on or Sound in Fraud

a) The Underwriters and Directors are not Accused of Fraud Anywhere in the Complaint

The District Court concluded that because the Complaint alleges that Suprema perpetrated a fraud against investors, Rule 9(b) should apply to ***every*** Securities Act claim against ***every defendant*** in this case, regardless of whether any particular defendant is itself accused of fraud. (A13-A14.) This conclusion was wrong. Whether Rule 9(b) applies turns on a defendant-by-defendant and claim-by-claim analysis. That one defendant might be accused of acting knowingly or recklessly does ***not*** mean that claims against other defendants brought ***solely*** under §§11 and 12(a)(2) sound in fraud. Here, Lead Plaintiff has not accused the Underwriters or Directors of ***any*** fraudulent or reckless misconduct. Thus, it was reversible error for the District Court to dismiss these claims based on the sounds in fraud doctrine.

In dismissing Lead Plaintiff's Securities Act claims, the District Court completely misconstrued this Court's decision in *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 287 (3d Cir. 1992). In *Shapiro*, this Court determined that a plaintiff's §11 claims sounded in fraud because the plaintiff had alleged that "***Each*** of the defendants... [made material misstatements in a registration statement] knowingly or in such a reckless manner as to constitute a willful deceit...." *Id.*

(emphasis added). The Court specifically highlighted that it was "not presented with a 'mixture of allegations of negligence, fraud, and the misleading nature of, certain communications." *Id.* at 288. Rather, the complaint in *Shapiro* was "devoid of allegations that defendant acted negligently in violating §11 and 12(2)." *Id.* Thus, "[t]he ***only reasonable conclusion*** that [could] be drawn [was] that plaintiffs charge[d] defendants with fraud. There [was] ***not a hint*** in the allegations that defendants were negligent in violating §§11 and 12(2)." 964 F.2d at 287-88 (emphases added).

In stark contrast with the allegations in *Shapiro*, the instant Complaint does not accuse the Underwriters or Directors of engaging in ***any*** fraudulent conduct. The Complaint contains no Exchange Act claims against these defendants; they were sued only for violating the Securities Act. Indeed, the Complaint does not include a single allegation relating to these defendants' state of mind. It alleges only that they were ***negligent*** in failing to conduct a reasonable investigation into the truth and accuracy of the Registration Statement. (A82 ¶2; A123 ¶141.) On these allegations, it is impossible to conclude that the claims against the Underwriters and Directors "sound in fraud." *See In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 502 (S.D.N.Y. 2004) (Rule 9(b) does not apply to §11 claims against an underwriter where "[t]he Complaint contains no allegations of fraudulent conduct on the part of Morgan Stanley and

plaintiffs have not asserted any Exchange Act claims against the underwriter."); *see also Shapiro*, 964 F.2 at 287-88.

The recent decision in *Rombach v. Chang* is instructive. There, the Second Circuit affirmed a decision of the district court that specifically distinguished "the plaintiffs' claims against the individual defendants [that] sound in fraud and [] the claims against the underwriters [that] sound in negligence." 355 F.3d 164, 171-72 (2d Cir. 2004). There, the district court had evaluated the §11 claims against each defendant ***separately*** to assess whether the plaintiffs had alleged that any particular defendant had or had not acted with fraudulent intent. *Id.* Accordingly, the Second Circuit only considered whether the Securities Act claims against the defendants who were accused of fraud sounded in fraud. *Id.* At 172-76; *see also In re Prison Realty Sec. Litig.*, 117 F. Supp. 2d 681, 688 (M.D. Tenn. 2000) ("Only a defendant facing the particular threat posed by an accusation of fraud may invoke the protections of Rule 9(b).").

Such a defendant-by-defendant analysis comports with the purpose of the "sounds in fraud" doctrine. The *sine qua non* of applying this doctrine is that the plaintiff has accused a particular defendant of acting with the intent to defraud, thereby implicating the reputational concerns animating Rule 9(b). *See Rombach,* 355 F.3d at 171 ("The particularity requirement of Rule 9(b) serves to 'provide a defendant with fair notice of a plaintiff's claim, ***to safeguard a defendant's***

reputation from improvident charges of wrongdoing, and to protect a defendant against the institution of a strike suit.") (quotation omitted) (emphasis added); *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1105 (9th Cir. 2003); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 325 (S.D.N.Y. 2003); *Giarraputo v. UNUMProvident Corp.*, 2000 WL 1701294, *10 (D. Me. 2000) (declining to apply Rule 9(b) where "the [§11] complaint can proceed without a risk that the defendants' reputations would be exposed publicly to meritless fraud claims").

Where, as here, a plaintiff rests a §11 claim on simple negligence and does not accuse a defendant of any knowing or reckless misconduct, the "sounds in fraud" doctrine simply does not apply. This is precisely the holding of the Courts of Appeals that have considered this issue. *See Rombach*, 355 F.3d at 171-72; *Lone Star Ladies Inv. Club v. Schlotzsky's Inc.*, 238 F.3d 363, 369 (5th Cir. 2001) (where a complaint "expressly do[es] not assert that defendants are liable for fraudulent or intentional conduct and disavow[s] and disclaim[s] any allegation of fraud" under Section 11, "[t]hose claims do not 'sound in fraud' and cannot be dismissed for failure to satisfy Rule 9(b)") (alteration in original); *In re NationsMart Corp. Sec. Litig.*, 130 F.3d at 309, 315 (8th Cir. 1997) (Rule 9(b) inapplicable where the complaint expressly disavows any claim of fraud in connection with the §11 and §12(a)(2) counts); *see also In re Westinghouse Sec. Litig.*, 90 F.3d 696, 717 n.20 (3d Cir. 1996) ("It seems to us that the district court

... implicitly required plaintiffs to plead their section 12(2) claims with the particularity required by Rule 9(b). Absent a determination that plaintiffs' claims sounded in fraud, or some analysis explaining why Rule 9(b) should apply when a section 12(2) claim does not sound in fraud, this constitutes legal error.")

Thus, the District Court wrongly applied the "sounds in fraud" doctrine to the Securities Act claims asserted against the Underwriters and Directors.

b) The Securities Act Claims Against the Officers and BDO, Consistent with this Court's Decision in Westinghouse, Do not "Sound in Fraud"

The District Court's determination that the Securities Act counts against the Officers and BDO "sound in fraud" was inconsistent with this Court's prior teachings. In pleading its Securities Act claims against these defendants in Counts One and Two, Lead Plaintiff carefully avoided making any allegation relating to the defendants' "intent to deceive." (*See* A16, A19 (acknowledging that Lead Plaintiff made no allegation relating to these defendants' fraudulent intent in its §11 or §12(a)(2) claims).) Every allegation that the Officers acted with fraudulent intent is set forth in Count Four and every allegation that BDO was severely reckless in its purported audit of Suprema is set forth in Count Five. Consequently, under this Court's precedent, Counts One and Two do ***not*** "sound in fraud" as to these defendants and the District Court's application of Rule 9(b) to these claims was error.

As noted above, in *Shapiro*, the case upon which the District Court relied, the plaintiffs incorporated all of the allegations from their Rule10b-5 claim into their §11 and §12(a)(2) claims, ***including allegations delineating the defendants' fraudulent intent.*** 964 F.2d at 287. Thus, the Securities Act counts there "sounded in fraud," and the Court saw "no way to construct a negligence cause of action" out of that complaint's allegations. *Id.* at 288.

In *Westinghouse*, this Court shed further light on the "sounds in fraud" doctrine, holding that a plaintiff can avoid the particularity requirements of Rule 9(b) by not including scienter allegations in a Securities Act claim:

> Unlike the complaint in [*Shapiro*] – where the section 12(2) count sounded in fraud essentially because it incorporated all prior factual allegations, including those alleging intentional, knowing, and reckless conduct – count III of the first amended complaint in this case incorporates only paragraphs 1-28 (jurisdiction/venue, parties, and class action allegations) and paragraphs 423-38 (section 11 allegations).

90 F.3d at 717, n.21 (citations omitted).

Indeed, the District Court's failure to acknowledge the pleading convention specifically endorsed in *Westinghouse*, or to draw any distinction between *Shapiro* and the present case, flies in the face of its own prior ruling in *In re Cendant Corp. Litig.*, 60 F. Supp. 2d 354 (D.N.J. 1999). There, Judge Walls sustained §11 claims against Cendant's officers and auditors, holding that the claims did not "sound in

fraud," despite the fact that many of the defendants were also charged with fraud in later counts. *Id.* at 361. Judge Walls specifically distinguished *Shapiro*, stating:

> Unlike the complaint in *Shapiro*, this complaint does not incorporate allegations of scienter and fraud into the §11 claim. Rather, here the §11 claim is plead before any of the other claims. ***Although the plaintiffs have plead that the defendants acted fraudulently in violation of §10(b), the §11 claim is limited to negligence.***

Id. at 364 (emphasis added).

Other cases in this circuit have reached similar results. For example, in *In re Ravisent Tech., Inc. Sec. Litig.*, 2004 WL 1563024, *13-14 (E.D. Pa. July 13, 2004), the district court noted that the plaintiffs had avoided the problems that warranted dismissal in *Shapiro* because "[t]he Complaint [did] not use language like 'intentional' or 'reckless' in connection with the Section 11 claim," and because the phrases used to describe the misstatements at issue were "at the very least ambiguous as to whether Plaintiffs' claim [was] based on fraud or negligence." Accordingly, the court denied the motion to dismiss, recognizing that "[t]his case is similar to *In re Cendant*, where the court determined that despite the fact that plaintiff claimed violations of Section 11 and 10(b), the allegations were separate such that the '§11 is limited to negligence.'" *Id.* (quotation omitted); *see also In re Adams Golf, Inc. Sec. Litig.*, 381 F.3d 267, 273 n.5 (3d Cir. 2004) ("claims under the 1933 Act that do not sound in fraud are not held to the heightened pleading requirements of" Rule 9(b)); *Resolution Trust Corp. v. del Re*

Castellett, 1993 WL 719764, at *2 (D.N.J. 1993) (refusing to apply Rule 9(b) to claim based on negligence though identical events supported parallel fraud count, because "plaintiff is entitled to proceed on alternate grounds of liability").

2. Even if the "Sounds in Fraud" Doctrine Applies to Lead Plaintiffs' Securities Act Claim, the Doctrine Does Not Graft a Scienter Requirement onto Sections 11 and 12(a)(2)

Even if the "sounds in fraud" doctrine does apply to the instant Securities Act claims, the manner in which the District Court applied Rule 9(b) was erroneous. Despite the fact that scienter is not an element of §11 or §12(a)(2), the District Court incorrectly held that Rule 9(b) grafts the element of scienter onto Lead Plaintiff's Securities Act claims, and then dismissed those claims because they did not contain any allegation of knowing or reckless misconduct on the part of any of the defendants. (A16, A19.) ***In other words, Judge Walls dismissed Lead Plaintiff's §§11 and 12(a)(2) claims based on the "sounds in fraud" doctrine precisely because those claims do not sound in fraud.***

When this Court adopted the "sounds in fraud" doctrine in the context of §§11 and 12(a)(2) claims, it surely did not intend (and in any event was not empowered) to create new elements for these statutory causes of action. Nevertheless, in rejecting Lead Plaintiff's Securities Act claims, the District Court held that in order to plead a Section 11 claim under the "sounds in fraud" doctrine,

a plaintiff must allege all of the elements of a Rule 10b-5 claim:

> Rule 9(b) requires that a plaintiff plead: (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that should be acted upon; and (5) that the plaintiff acted upon it to his or her damage.

(A14-A15 (citing *Shapiro*, 964 F.2d at 284) (emphasis added).)

This holding was in error. The passage from *Shapiro* cited by the District Court relates to an analysis of a Rule 10b-5 fraud claim, and not a claim based in negligence. *See Shapiro*, 964 F.2d at 280, 284. In fact, this Court recently confirmed that the elements cited above need only be satisfied when applying Rule 9(b) in the context of Rule 10b-5. *In re Alpharma Sec. Litig.*, 372 F.3d 137, 147 (3d Cir. 2004) ("***As applied to Rule 10b-5 claims***, 'Rule 9(b) requires a plaintiff to plead'" the five elements cited above) (emphasis added) (quotation omitted).

As this Court recognized several months ago, neither Rule 9(b) nor the "sounds in fraud" doctrine grafts the element of scienter onto a Section 11 claim. *See Adams*, 381 F.3d at 273 n.5 ("The requirements under section 11 stand in ***stark contrast*** to those of the [Exchange Act], which include a showing of reasonable reliance and scienter.") (emphasis added); *Rombach*, 355 F.3d at 171 ("fraud is not an element or a requisite to a claim under Section 11 or Section 12(c)(2)"); *see also Ravisent*, 2004 WL 1563024 at *12; *In re IPO Sec. Litig.*, 241 F. Supp. 2d at 342.

Rather, in the context of §11 or §12(a)(2) claims, Rule 9(b) requires only that Lead Plaintiff plead "the who, what, when, where, and how" ***of the alleged misrepresentations***. *Alpharma*, 372 F.3d at 148; *Rombach*, 355 F.3d at 170 (in the context of §11 or §12(a)(2) claims, Rule 9(b) requires only that a complaint "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent"); *Cendant*, 60 F. Supp. 2d at 368.

Properly applying the requirements of Rule 9(b) to the instant Securities Act claims, there can be little doubt that Lead Plaintiff has properly stated a claim against each of the named defendants. Indeed, the District Court itself identified the particularized allegations of the "who, what, where, when and how" of the misstatements in the Registration Statement:

> Lead Plaintiff identifies several statements that were allegedly fraudulent (*See* ¶¶83-147.) These statements are alleged to have been made in the 2001 Registration Statement and Prospectus (*See, e.g.*, ¶¶66, 68, 85-102) and in the financial statements for the fiscal years 200 and 2001. (*See e.g.*, ¶¶67, 103-140.) Explanations for why these statements were fraudulent were also included. (*See* ¶¶85-102, 108, 111, 119, 126, 129, 134-137, 139.) Ignorance of the falsity of these statements is alleged in ¶147. The alleged fraudulent statements involved material facts ... [and] Suprema is identified as the speaker as well as those who signed the Registration Statement.

(A15-A16; *see also* A19 (discussing §12(a)(2) claims).)

As noted above, the District Court's only problem with Counts One and Two was that "[k]nowledge of falsity" and "intent" to induce reliance were not alleged. (A16; A19.) However, because scienter is ***not*** an element of these claims, the decision below must be reversed.

3. Even if the Complaint did not Satisfy Rule 9(b) as to Any of the Defendants, Lead Plaintiff's Securities Act Claims Should not Have Been Dismissed

Courts that have applied the "sounds in fraud" doctrine to §11 or §12(a)(2) claims have made clear that the remedy for failure to meet Rule 9(b) is ***not*** automatic dismissal of the Complaint. Rather, a court should strip the allegations of fraud from the Complaint and then determine whether the remaining allegations state a claim. As the Eighth Circuit explained in *NationsMart*:

> [E]ven if the plaintiffs were alleging fraudulent conduct under §11…any such allegation would be ***mere surplusage***. 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.

130 F.3d at 315 (emphases added). The Second and Fifth Circuits concur: *Rombach*, 355 F.3d at 176 ("But for the fact that such a negligence claim, if properly pleaded, would be defeated in any event by the bespeaks caution doctrine, we might well affirm the dismissal with a direction to the district court to entertain

a motion to re-plead in terms of negligence.); *Schlotzsky's*, 238 F.3d at 368 ("Where averments of fraud are made in a claim in which fraud is not an element, an inadequate averment of fraud does not mean that no claim has been stated. The proper route is to disregard averments of fraud not meeting Rule 9(b)'s standard and then ask whether a claim has been stated.").

Indeed, when this Court dismissed claims brought under §§11 and 12(a)(2) in *Shapiro*, it strongly suggested that it would not have done so had the complaint properly alleged negligence: "[W]e are not presented with a 'mixture of allegations of negligence, fraud, and the misleading nature of, certain communications. ***We see no way to construct a negligence cause of action here.***" 964 F.2d at 288 (emphasis added) (citation omitted).

Stripped of every allegation that could possibly be construed as fraud, there can be no *bona fide* dispute that the instant Complaint still states claims under §§11 and 12(a)(2). (*See* A15-A16; A18-A19 (acknowledging that the elements of these claims are adequately alleged).) For this reason also, the decision below should be reversed.[5]

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[5] If stripping the fraud allegations is the proper remedy under the "sounds in fraud" doctrine for a complaint's failure to satisfy Rule 9(b), this Court should consider narrowing or doing away with the doctrine altogether. As the Eighth Circuit held in *NationsMart*, "[A] pleading standard which requires a party to plead particular facts to support a cause of action that does not include fraud or mistake as an element comports neither with Supreme Court precedent nor with the liberal system of 'notice pleading' embodied in the Federal Rules of Procedure...."

B. The District Court Erred in Dismissing Lead Plaintiff's Exchange Act Claims Against Cocchiola and Venechanos

To establish a claim under §10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, a plaintiff must plead that (1) the defendant made a misrepresentation or omission of material fact; (2) with scienter; (3) in connection with the purchase or sale of securities; (4) upon which the plaintiff relied; and (5) the plaintiff's reliance was the proximate cause of its injury. *Pinker v. Roche Holdings Ltd.*, 292 F.3d 361, 373 (3d Cir. 2002). The PSLRA requires that plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with" scienter. 15 U.S.C. §78u-4(b)(2). In interpreting this "strong inference" requirement, this Court requires plaintiffs to "either (1) identify circumstances indicating conscious or reckless behavior by defendants or (2) allege facts showing both a motive and clear opportunity for committing the fraud." *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1422 (3d Cir. 1997).

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130 F.3d at 315 (citing *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 168 (1993)); *see also IPO Sec. Litig.*, 241 F. Supp. 2d at 339 ("Because a plaintiff cannot be required to plead something it need not prove," Rule 9(b) should not apply to §11 claims); *Prison Realty*, 117 F. Supp. 2d at 688-89 ("Since fraud is not a necessary element of a §11 or §12 claim, and the Court cannot read it into the statute, it need not be pled pursuant to Rule 9(b) in Plaintiffs' §11 or §12 claims."); Wright & Miller, Fed. Prac. and Proc., Civil 2d §1297, 615 (1990) ("Since Rule 9(b) is a special pleading requirement and contrary to the general approach of simplified pleading adopted by the federal rules, its scope of application should be construed narrowly and not extended to other legal theories or defenses.").

The District Court erred in finding that the Complaint failed to allege scienter as to the Officers (Cocchiola and Venechanos) with the requisite specificity. (A24-A28.) As described below, the District Court disregarded the tidal wave of specific allegations tying both of the Officers directly to Suprema's fraud.

1. The Complaint Pleads Particularized Facts Constituting Strong Evidence That Cocchiola and Venechanos Acted With Scienter

The District Court dismissed the Complaint based on its view that Lead Plaintiff had not alleged "specific circumstances" where Cocchiola and Venechanos had "access to and received information about" the fraudulent transactions at issue here. (A25.) In so doing, the District Court contrasted this case with *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 599 (D.N.J. 2001). As detailed below, however, the Complaint contains allegations of scienter that are at least as detailed as – and arguably far more detailed than – those in *Campbell Soup*. Indeed, any fair reading of the Complaint compels the conclusion that the instant Rule 10b-5 claims should be allowed to proceed.

First, the Complaint alleges that the individuals who have already pleaded guilty with respect to the financial fraud at Suprema admitted that it took place "with the direction of and participation of Suprema management." (A132-A134 ¶¶170-71.) John Van Sickle, the only Suprema employee who pleaded guilty, also testified that the scheme to mislabel and adulterate cheese occurred "at the

direction and with the participation of Suprema's management." (*Id.*; A167 ¶254.) There can be no serious dispute that Cocchiola and Venechanos, the Company's CEO and CFO, respectively, were Suprema's "management" and these admissions raise a strong inference that Cocchiola and Venechanos acted with scienter. (*See* A86-A87 ¶¶14-17; A128-A130 ¶163.)

Suprema was not a multinational conglomerate; rather, it was a small New Jersey based company with only four officers. (A530.) Indeed, the Registration Statement contained a specific section entitled "Management" that listed only ***four*** people: Cocchiola (CEO and President); Venechanos (CFO and Secretary); Thomas Egan (Senior Vice President); and Anthony Disinti (Vice President for Human Resources). (*Id.*; *see also* A656-A662.) Similarly, the Company's 2001 Form 10-K, which was incorporated into the Registration Statement, contained a section entitled "***Management's*** Discussion and Analysis of Financial Condition and Results of Operations" (A646-A655 (emphasis added).) The "management" that signed the 10-K and was, therefore, responsible for this "Discussion and Analysis" consisted of two people: Cocchiola and Venechanos. (A692.)

In addition, Thomas Egan, Suprema's Senior Vice President, was unquestionably in a position to know who from "management" was involved with and responsible for dealing with the customers and suppliers who participated in this fraudulent scheme. He has stated, under oath, that it was Cocchiola and

Venechanos who dealt directly with Gaglio, Quattrone, Zambas and their related entities (which the Complaint alleges were on the other end of the majority of Suprema's fraudulent transactions). (A430-A431; *see also* A137 ¶179; A145-A146 ¶ 202; A149-A151 ¶212; A153 ¶218; A157 ¶232; A158 ¶235.) Egan's testimony is corroborated by the fact (pleaded in the Complaint) that Cocchiola and Venechanos each signed millions of dollars worth of fraudulent checks to Suprema's sham suppliers. (*See, e.g.*, A145-A146 ¶202; A149-A151 ¶212.) Further, Venechanos specifically instructed Suprema's accounts receivable supervisor not to deal with the sham hard cheese accounts, even though they were delinquent by tens of millions of dollars. (A162-A163 ¶247.) Venechanos, Christenson and Lauriero dealt with these accounts personally. (*Id.*)

Moreover, in their plea allocutions, the criminal defendants admitted that their unnamed co-conspirators made false statements to the SEC and the investing public in connection with Suprema's purported operations, its financial condition and performance, and its business practices. (A132-A134 ¶171(viii).) Cocchiola and Venechanos were the ***only*** members of Suprema's management who made statements to the SEC and the investing public, and did so by signing the Company's quarterly and year-end SEC filings, (A172-A173 ¶271; A177 ¶283; A178-A179 ¶287), and by touting the Company's astronomical success in the Company's press releases and other public statements. (*See* A178 ¶286; A184-

A185 ¶308) Again, the strong, if not inescapable, inference is that Cocchiola and Venechanos were the co-conspirators.

Similarly, the criminal defendants admitted that one purpose of the scheme was to inflate the amount of money that Suprema could borrow against its credit facility, which was backed by the fraudulent accounts receivable and inventories. (A133-A134 ¶171(ix).) Approximately 81% of Suprema's accounts receivable, or $101 million as of June 30, 2001, was attributable to bogus sales to entities owned by Gaglio, Zambas and Quattrone alone. (A100 ¶65.) Cocchiola and Venechanos were responsible for Suprema's bank borrowings and they requested bank approval for the massive increase in the Company's line of credit, thereby increasing Suprema's debt from $30.4 million on June 30, 1999 to $113.7 million by September 30, 2001. (A99-A100 ¶¶63-65.) Suprema drew down the credit facility to the maximum amount allowed under the terms of the credit agreement with the banks. (*Id.*; A188 ¶313(i)(o).) That Cocchiola and Venechanos drastically increased the credit facility and Suprema's borrowing under it – one of the stated purposes of the fraud – raises a strong inference of their scienter.

The criminal defendants also admitted that their co-conspirators recorded the bogus transactions in Suprema's books and records. (A133 ¶171(ii).) Venechanos was the person who personally reconciled Suprema's accounts. (A162-A163 ¶247.) As alleged in the Complaint, Suprema received large round-numbered

checks from the sham cheese customers and then falsified journal entries to add up to the exact amounts of the checks received. (A164-A166 ¶¶249-50.) The fact that Venechanos was responsible for these fraudulent entries creates a strong inference of his scienter. Relatedly, that the Officers did not allow Suprema's employees, including the accounts receivable supervisor, to deal directly with the Company's auditors also raises a strong inference of their scienter. (A162-A163 ¶247; A189 ¶313(i)(q).)

The Officers' central role in the fraud is further evidenced by the December 17, 2001 resignation letter of Suprema's controller, Art Christiansen, which states: "Mark and Steve, as we discussed, I am not willing to participate in the tasks that have been assigned to me since Paul's death." (A168-A169 ¶259.) The only fair inference that can be drawn from this fact is that Mark Cocchiola and Steve Venechanos had assigned Christiansen to assist in their fraudulent scheme. Indeed, when asked at their depositions before the Liquidation Trustee whether these "tasks" related to the transactions with the various parties involved in this fraud, Cocchiola and Venechanos each asserted his Fifth Amendment right not to answer. (A169 ¶¶260-61.)

In addition, the Company touted that the Officers had a hands-on relationship with the entities involved in the fraud. The Company stated that its success was "largely dependent on the personal efforts of Mark Cocchiola ... his

expertise and knowledge ... are critical factors in our continued growth and succcss." (A128 ¶163(i)(b).) It also stated that "senior management is responsible for planning and coordinating our marketing programs and maintains a hands-on relationship with select key accounts." (A168 ¶¶313(i)(b)); A189 ¶313(ii)(b).) The Company's "key accounts" included the companies operated by Gaglio, Zambas and Quattrone all of which were at the other end of Suprema's fraudulent transactions. (A136-A162 ¶¶175-245.)

In fact, Cocchiola and Venechanos personally signed millions of dollars in checks that were sent with suspicious frequency to Suprema's sham cheese suppliers. (A145-A146 ¶202 (over $14.3 million paid to Whitehall); A149-A151 ¶212 (over $9.2 million paid to Commodities and Cal Fed); A153 ¶218 (over $4.7 million paid to St. Charles Trading); A157 ¶233 (over $6.4 million paid to Noram); A158 ¶235 (over $9.1 million paid to Packing Products); A161-A162 ¶244 (over $3.2 million paid to WSC).) The fact that Cocchiola and Venechanos each repeatedly signed checks for millions of dollars to these entities, which admittedly provided no goods or services to Suprema, (*see, e.g.*, A147 ¶203; A151 ¶213), raises a strong inference of their scienter. These payments that Cocchiola and Venechanos authorized included "kick backs" to the sham suppliers as payment for their participation in the fraud. (A133 ¶170(v); A134 ¶172(iii).) For example, Robert Quattrone, who sent invoices to Suprema as "Packing Products" and then

made payments back to Suprema as "Battaglia," was paid approximately $1.3 million in kick-backs. (A134 ¶172(iv).) These facts raise a strong inference of scienter – indeed, the idea that anyone at Suprema other than Cocchiola and Venechanos, who, by all accounts, controlled every aspect of Suprema's business – could have authorized these kickbacks defies logic.

Further, for three of Suprema's top five customers, accounting for 37% of Suprema's sales in fiscal 2001 (Noble, California Goldfield and Tricon) the "ship to" addresses on Suprema's invoices, where it supposedly sent the cheese it sold, were single family homes and a downtown office building that did not have the ability to receive ***any*** cheese, much less the millions of pounds of cheese that Suprema purportedly shipped. (A140-A141 ¶¶187-88; A156 ¶230.) A fourth customer, A&J, which accounted for 15% of Suprema's fiscal 2001 sales, was located in a small warehouse that could receive only approximately 20% of the cheese that Suprema purportedly shipped. (A140 ¶186.) That approximately 50% of Suprema's sales were to facilities that could not receive shipments of cheese and that Cocchiola and Venechanos dealt with these entities directly (according to Egan and others), raises a strong inference that they knew that no cheese was actually being shipped to these "customers."

Also telling is that while nearly all of Suprema's revenues and growth stemmed from the alleged purchase and resale of domestic bulk hard cheeses, there

is no reference to this business activity anywhere in the Company's Class Period statements, all of which were prepared and signed by Cocchiola and Venechanos. (A96 ¶56; A172-A173 ¶271; A178 ¶287; A179 ¶289; A181 ¶296.) So, too, is the simple fact that much of the cheese that was actually stored and shipped by Suprema was adulterated – the only people who could possibly have ordered this adulteration, which consisted of mixing the cheese with fillers such as soy, were Cocchiola and Venechanos. (*See* A167 ¶254.)

All of these facts rest on top of a plethora of the more classic indicators of scienter, which have been repeatedly affirmed in securities fraud case such as this. For example, the fraud here involved the Company's core business and in such circumstances, "the Company's CEO and CFO ... are presumed to have had pertinent knowledge." *Campbell Soup*, 145 F. Supp. 2d at 599.[6] Similarly, the magnitude and scope of the fraud, which involved approximately two-thirds of the Company's total revenue and nearly all of its reported growth (A180-A181 ¶¶293-94; A186-A187 ¶313(i)(e)), give rise to a strong inference of scienter.[7] In view of

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[6] *See also In re Tel-Save Sec. Litig.*, No. 98-cv-3145, 1999 WL 999427, at *5 (E.D. Pa. Oct. 19, 1999)) ("knowledge concerning a company's key businesses or transactions may be attributable to the company, its officers and directors).

[7] *See In re Rent-Way Sec. Litig.*, 209 F. Supp. 2d 493, 507 (W.D.Pa. 2002) ("magnitude of the fraud [net loss underreported by $4 million in one year and over $15 million in another] and duration of the irregularities (spanning two fiscal years) are such that it is reasonable to find them probative of scienter.") (collecting authority). *See also Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003) (magnitude of alleged falsity – $6 million recognition of revenue which

these basic principles, knowledge of the true state of affairs of Suprema's business, and the accuracy of the Company's financial results and accounting policies related to this business, can be properly imputed to Cocchiola (the founder of Suprema and its CEO since 1991) and Venechanos (the CFO since 1995). (A128 ¶163(i)(a)); A129 ¶163(ii)(a).) This is particularly the case here because Suprema's core business was supposedly limited to the sale of a handful of Italian cheeses, with five major "customers" accounting for 64% of Suprema's sales in fiscal 2001. (A180 ¶293.) That over 60% of Suprema's total sales were fabricated, and that all of its business with the five major customers (A&J, Tricon, Noble, Battaglia and

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accounted for over one-quarter of company's net income for the quarter – supported strong inference of scienter); *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000) ($73.8 million write-off was "remarkable" and "support[ed] a strong inference of recklessness"); *In re Hamilton Bancorp., Inc. Sec. Litig.*, 194 F. Supp. 2d 1353, 1358-59 (S.D. Fla. 2002) (magnitude of accounting fraud involving supported strong inference of scienter against both outside auditor and company insiders); *In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 148 (D. Mass. 2001) ("magnitude of [$200 million] accounting overstatement resulting from the combination of these alleged GAAP violations is also quite significant" and supported strong inference of scienter); *Kinney v. Metro Global Media, Inc.*, 170 F. Supp. 2d 173, 180 (D.R.I. 2001) (overstatement of net income by 240% one year and 203% another led to strong inference that accountant acted with scienter) (collecting authority); *In re MicroStrategy, Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 636 (E.D.Va. 2000) (accounting misstatements were "breathtaking" and supported strong inference of scienter) (collecting authority); *In re Telxon Corp. Sec. Litig.*, 133 F. Supp. 2d 1010, 1030-31 (N.D. Ohio 2000); *In re Computer Assocs. Class Action Sec. Litig.*, 75 F. Supp. 2d 68, 74 (E.D.N.Y. 1999) ("the enormous scope and scale of this alleged fraud" supports strong inference of scienter); *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1255-56 (N.D.Ill. 1997) ("the more serious the error, the less believable are [management] defendants' protests that they were completely unaware of [the corporation's] true financial status and the stronger is the inference that defendants must have known about the discrepancy.").

California Goldfield) was pure fiction, involving a fraud that dates back to at least 1996, gives rise to a strong inference that Cocchiola and Venechanos knew about the fraud or, at the very least, were reckless in not knowing.

Finally, the fact that Cocchiola and Venechanos invoked their Fifth Amendment rights not to testify about Suprema's fictitious sales before the Liquidation Trustee supports a strong inference of their scienter. (A169 ¶260-61.) It is well settled that "reliance on the Fifth Amendment in civil cases may give rise to an adverse inference against the party claiming its benefits." *In re Grand Jury*, 286 F.3d 153, 160 (3d Cir. 2002). Nevertheless, the District Court refused to draw a negative inference here, holding that to do so "could unduly penalize Cocchiola and Venechanos." (A26 n.5.) In so doing, the District Court flouted its obligations on a motion to dismiss – *i.e.*, the Court was ***required*** to draw all reasonable and strong inferences of scienter in Lead Plaintiff's favor. *See In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 150 (3d Cir. 2004). In view of this fundamental principle, ***the Officers' invocation of the Fifth Amendment, coupled with the plethora of additional detail in the Complaint, surely provides sufficient evidence to raise a strong inference of scienter.***

2. The Complaint Adequately Pleads That Cocchiola and Venechanos Had Motive and Opportunity to Commit Fraud

The Complaint also alleges that Cocchiola and Venechanos had the motive and opportunity to commit the fraud. The District Court held that neither

Cocchiola's sale of 31% of his stock (coupled with his pledging an additional 20% as collateral for a personal loan), nor Venechanos's sale of 38% of his stock was sufficient to demonstrate a motive to commit fraud. (A27.) Instead, relying on this Court's holding in *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 540-41 (3d Cir. 1999), the Court held that because "both Cocchiola and Venechanos retained large stock holdings after the sales, 49% and 62%, respectively," the Complaint did not adequately plead scienter. (A27-A28.)

In *Advanta,* the plaintiffs based their motive allegations on sales of "only 5 percent and 7 percent, respectively" of the total holdings of the defendant officers. 180 F.3d at 540-41 (citing *In re Burlington Coat Factory*, 114 F.3d at 1423-24 (an officer's sale of 0.5% of his total holdings did not suffice to show motive to commit fraud)). These facts stand in stark contrast to those presented here. In fact, the District Court provided no justification for the remarkable conclusion that the Officers' sales of 51% and 38% of their holdings failed to establish motive.

There is no bright-line test as to what percentage of a defendants' stock holdings needs to be sold before an inference of improper motive exists. Nevertheless, courts have consistently concluded that sales of the magnitude that existed here are sufficient to establish motive. *See Stevelman v. Alias Research Inc.*, 174 F.3d 79, 82, 85 (2d Cir. 1999) (insider's sale of 40% of his holdings "supports the inference that [he] withheld disclosures that would depress his stock

until he had profitably sold his shares"); *In re Complete Mgmt. Inc. Sec. Litig.*, 153 F. Supp. 2d 314, 328 (S.D.N.Y. 2001) (defendants' sales of 90% and 33%, respectively, of total stockholdings supported strong inference of scienter); *In re SmarTalk Teleservices, Inc. Sec. Litig.*, 124 F. Supp. 2d 527, 542 (S.D. Ohio 2000) (defendants' sale of 40%, 40%, 27%, 11% and 37% of their shares contributed to finding a strong inference of scienter).

Further, the Complaint alleges that Cocchiola pledged an additional 20% of his Suprema stock as collateral against a personal loan on September 19, 2001. (A192 ¶314(i)(b-c).) It is well settled that pledging shares as collateral for personal loans can suffice to establish motive. *See Tel-Save,* 1999 WL 999427, at *6 (motive sufficiently pleaded where plaintiffs alleged that defendant CEO "had a motive to inflate the stock price because by doing so he was able to secure a $30 million loan ... by using ... stock as collateral"); *see also In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392, 416-17 (S.D.N.Y. 2003) (finding motive to falsely inflate stock price where CEO pledged significant amount of his personal holdings as collateral for massive personal loans).

In sum, the Complaint alleges that Cocchiola and Venechanos orchestrated the Offering at a time when the Company's stock was artificially inflated and then sold-off or pledged huge portions of their holdings for their own benefit. All of this happened a mere ***six weeks*** before trading was halted and Suprema's stock

became worthless. (A192-A193 ¶¶314-15.) Thus, the Officers' trades "were made at times and in quantities that were suspicious enough to support the necessary strong inference of scienter." *Burlington*, 114 F.3d at 1424.

C. The District Court Erred in Dismissing Lead Plaintiff's Exchange Act Claims Against BDO

In dismissing Lead Plaintiff's claims against BDO, the District Court rested its analysis on the following points:

> "[T]here has been no restatement of Suprema's financial statements or other acknowledgement that the financial results were misstated"; "BDO also ***claims*** that it was the victim of Suprema's fraud ...."; "BDO notes that Suprema did manufacture and ship ***some*** hard cheese"; "The levels of reserves against receivables set up by management is a matter of professional judgment"; and "BDO also ***asserts*** that the adulterated inventory was worth far less than superior grade cheese ... but that it was not as expert in cheese ... so short of performing laboratory tests for quality it did all it was required to do."

(A30-A31 (emphases added).)[8]

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[8] Although Lead Plaintiff's argument turns on the District Court's fundamental misreading of the Complaint, the above quotes show that the District Court plainly erred in affirmatively accepting BDO's factual contentions in response to Lead Plaintiff's allegations as true. *See Burlington*, 114 F.3d at 1421 ("since the claim at issue was dismissed at the pleading stage, we are required to credit plaintiffs' allegations ***rather than defendants' responses.***" (emphasis added)); *see also In re Philip Servs. Corp. Sec. Litig.*, No. 98 Civ. 0835 (MBM), 2004 WL 1152501, *9 (S.D.N.Y. May 24, 2004) ("[the auditor's] characterizations either contradict the plain meaning of the allegations in the Complaint or rely on convoluted inferences favoring [the auditor]. Granting plaintiffs the reasonable inferences to which they are entitled at the pleading stage, the allegations are sufficient to establish [the auditor's] conscious misbehavior.").

The District Court's (and BDO's) focus on semantics ignores the salient reality of the situation: the problem at Suprema was not one of subtle judgment or attention to detail; ***more than two-thirds of Suprema's business was literally a fiction that existed only on paper***. The combination of GAAP and GAAS violations, the massive and blatant nature of Suprema's fraud, and the numerous "red flags" of wrongdoing are compelling facts from which a court can draw only one conclusion regarding BDO's so-called "audits": BDO recklessly ignored its most basic obligations as an auditor and thereby avoided learning the particulars of Suprema's fraud.

As demonstrated below, the District Court erred in refusing, at the pleading stage, to draw the simple and reasonable (and strongly supported) inferences that BDO acted with extreme recklessness.

1. The Standard for Alleging Scienter Premised On Auditor Recklessness

The recklessness prong of this Court's scienter test may be met by alleging "[h]ighly unreasonable (conduct), involving not merely simple, or even excusable negligence, but an extreme departure from the standards of ordinary care ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000) (citing *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979)). "A showing of shoddy accounting practices

amounting at best to a 'pretended audit,' or of grounds supporting a representation 'so flimsy as to lead to the conclusion that there was no genuine belief' [in the audit] have traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue to do so." *McLean*, 599 F.2d at 1198 (citations omitted).

This Court's decision to uphold securities fraud claims based on a law firm's tax opinions that were allegedly made recklessly in *Eisenberg v. Gagnon*, applies to BDO's opinion letters here with full force:

> When a representation is made by professionals or "those with greater access to information or having a special relationship to investors making use of the information," there is an obligation to disclose data indicating that the opinion or forecast may be doubtful. When the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate further may "support an inference that when the defendant expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion."

766 F.2d 770, 776 (3d Cir. 1985) (quotations omitted).

Thus, "[a] good faith belief is not a 'get out of jail free card.' It will not insulate the defendants from liability if it is the result of reckless conduct." *Infinity Group*, 212 F.3d at 193. As shown below, BDO's ***claim*** that it was a mere victim of Suprema's fraud is specious, for the recklessness that permeated BDO's so-called "audits" of Suprema belies any claim that "it did all it was required to do." (A31.)

Other courts within this circuit have delineated the types of allegations that are sufficient to state a claim against an auditor. For example, auditor recklessness was adequately alleged where:

> (1) the ***magnitude and duration*** of the fraud was significant; (2) [the auditor] committed ***serial violations*** of GAAP and GAAS; (3) [the auditor] knew that Rent-Way's internal accounting structure and ***controls were inadequate***; and (4) [the auditor] ***disregarded a number of 'red flags,'*** including reports of declining expense ratios made during periods of substantial growth, a lack of adequate documentation, and Rent-Way personnel's practice of manually altering entries on the company's general ledger.

In re Rent-Way Sec. Litig., 209 F.Supp. 2d 493, 506 (W.D. Pa. 2002) (emphasis added); *see also In re IKON Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622, 629 (E.D. Pa. 1999) ("Numerous specific violations of GAAP and/or GAAS, along with other 'red flags' may also, depending on the allegations, suffice to show scienter under this standard.").

Similarly, in *P. Schoenfeld Asset Mgmt. LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 606-09 (D.N.J. 2001), the district court sustained claims against an auditor where the complaint alleged that the auditor "failed to obtain sufficient competent evidential matter to form a basis for its unqualified reports ... failed to obtain direct evidence" of various matters, relying instead "largely on management's representation" and where the plaintiff "pleads specific and detailed facts showing the magnitude either enhanced the suspiciousness of specifically identified transactions, or made the overall fraud glaringly conspicuous." *See also In re*

Cendant Corp. Litig., 60 F. Supp. 2d 354, 372-73(D.N.J. 1999) (plaintiff alleged "recklessness if not conscious misbehavior" by the auditor based on, *inter alia*: failure to discover the massive fraud; failure to comply with GAAS; disclosure to investors of unqualified audit reports that were false; and a failure to obtain sufficient evidential matter to form a basis for an unqualified audit opinion instead of simply relying on management's representations); *In re Health Mgmt., Inc. Sec. Litig.*, 970 F. Supp. 192, 202-03 (E.D.N.Y. 1997) (complaint adequately alleged that BDO acted with scienter based on "sheer size and variety" of GAAP violations and "BDO's clear violation of GAAS with respect to ... accounts receivable.").[9]

Moreover, Rule 10b-5 claims against an auditor were recently upheld in light of the relative ease with which a properly motivated investigator could have uncovered the fraud. Specifically, in *Argent Classic Convertible Arbitrage Fund L.P. v. Rite Aid Corp, et al.*, the plaintiff alleged that when the auditor assigned a

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[9] *See also In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288, 2003 WL 21488087 at *7 (June 25, 2003) ("[t]he allegations identifying the steps Andersen should have taken and failed to take, and the fraud it would have discovered if it had taken those steps, create a strong inference that Andersen acted recklessly in conducting the WorldCom audits."); *In re First Merchants Acceptance Corp. Sec. Litig.*, No. 97 CV 2715, 1998 WL 781118 at *11 (N.D. Ill. Nov. 2, 1998) ("the magnitude of the misstatements, the specific GAAP and GAAS violations and the 'red flags' together support an inference that Deloitte's audit, amounted to no audit at all or an egregious refusal to see the obvious or investigate the doubtful,") (quotations omitted); *In re Lernout & Hauspie Sec. Litig.*, 230 F. Supp. 2d 152, 168 (D. Mass 2002) ("[t]he panoply of 'red flags,' taken together, is more than sufficient to strongly support an inference that KPMG U.S. acted with recklessness or actual knowledge....")

new partner to replace Rite Aid's long-standing audit partner, the new partner "soon discovered" the deficiencies in prior audits, and that the auditor continued to issue unqualified audit opinions after it realized that "Rite Aid's accounting practices were seriously flawed." 315 F. Supp. 2d 666, 684-85 (E.D.Pa. 2004). Indeed, "[t]hese flaws were so obvious that an outside consultant identified some of them "[i]n a matter of days." *Id.* at 686; *see also In re MicroStrategy Inc. Sec. Litig.*, 115 F. Supp. 2d 620, 638 (E.D.Va. 2000) ("[T]he alleged simplicity of the GAAP rules violated here are relevant and contribute probative weight to an inference of scienter.").

2. The Fraud At Suprema Was So Egregious And Widespread That BDO Cannot Avoid A Finding of Scienter By Simply Claiming Ignorance

As described in Section VIII.B above, Lead Plaintiff alleged in great detail how Suprema literally fabricated approximately ***two-thirds*** of its reported revenues, approximately ***80%*** of its accounts receivable as of June 30, 2001, and ***virtually all*** of its Class Period growth. Critically, this fraud did not involve such complexity that it would take an especially keen or skeptical eye from BDO to learn the truth. On the contrary, anyone with access to Suprema's financial records, employees and physical facilities could (and would) recognize the falsity of Suprema's public financial statements.

In this regard, the Complaint identifies ***thirty*** specific "red flags" that BDO completely ignored (A197-A199 ¶328(i)-(xxx)), as well as the specific audit procedures BDO was required to undertake (A200-A210 ¶¶330-36; A224-A234 ¶¶396-418), and the facts it would have discovered had it complied with these obligations. (A210-A224 ¶¶357-95.) Among these are the following facts that BDO ***knew***:

- Despite its enormous reported earnings growth, Suprema was unable to generate cash flows from operations (A210-A212 ¶¶357-62);
- The Company reported tremendous sales growth that far exceeded the growth of its competitors and the Italian cheese industry as a whole (A212-A213 ¶363-65);
- Suprema said it was in the business of manufacturing cheese. Yet, despite Suprema's statement that its 58% and 50.9% increases in sales in 2000 and 2001, respectively, were "***primarily in sales volume for food service products manufactured by us***" (A98 ¶59), neither Suprema's labor force nor its utilization of its plant capacity increased, *i.e.*, it was impossible for Suprema to have manufactured the cheese it said it was manufacturing (A213-A214 ¶¶366-67);
- Accounts receivables skyrocketed to over $100 million, or approximately one-quarter of its total net sales, and were concentrated in a very small number of Suprema's "customers" (A214 ¶¶368-70);
- Suprema did not record ***any*** charge to its accounts receivable reserve and did not increase its allowance for bad debt, despite its skyrocketing accounts receivables (A215-A216 ¶¶371-74);
- There were significant discrepancies in the accounting records and unsupported or unauthorized balance transactions, such as large checks written to "suppliers" without corresponding invoices (A218-A219 ¶¶378-80);

- Suprema's management was dominated by a small number of individuals, and key accounting personnel were not permitted to have any involvement in approximately two-thirds of Company's business (A162-A163 ¶247; A217 ¶376);

- Management had motive to engage in fraud through significant stock options, making their financial success and net worth dependent on the Company's stock price (A217-A218 ¶377);

- There were unexplained items, missing documents and implausible responses from management with respect to, among other things, Suprema's increased sales volume, its seriously past due accounts and growth of accounts receivable, and missing invoices (A219-A223 ¶¶381-91);

- The auditors were denied access to critical accounting personnel and relevant information and there were unusual delays in providing requested information (A223-A224 ¶¶392-95.)

In response to these and other "red flags," at a minimum, BDO was required under GAAS to: conduct a *bona fide* investigation of the very limited number of suppliers and customers that constituted the vast majority of Suprema's reported business; corroborate the representations of management through a review of Suprema's books and records; interview those employees responsible for the Company's internal accounting; interview Suprema's major customers and suppliers; and investigate the possibility of related party transactions and the sources of financial resources supporting the Company's transactions, accounts receivable and the like. (A209-A210 ¶355 (citing AU §§316.25-.29).)

Had BDO taken even those most basic steps, it would have discovered that the entirety of Suprema's hard cheese business was a fiction concocted by the

Officers and their co-conspirators for the purpose of artificially inflating the Company's revenues and accounts receivable. (A210 ¶356.) It is well settled that "when tidal waves of accounting fraud are alleged, it may be determined that the accountant's failure to discover his client's fraud raises an inference of scienter ...." *In re Leslie Fay Cos., Inc. Sec. Litig.*, 835 F. Supp. 167, 175 (S.D.N.Y. 1993). Furthermore, "ignorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant." *S.E.C. v. Infinity Group*, 212 F.3d at 193. Essentially, faced with the myriad of red flags specified in the Complaint, it is clear that BDO's "audits" constituted no audits at all. *See, e.g., In re Rent-Way*, 209 F. Supp. 2d at 508 (finding scienter where plaintiffs "allege that in spite of its knowledge of the specific deficiencies in Rent-Way's accounting systems, [auditor] failed to expand its audit procedures in violation of GAAS.").[10]

For example, Suprema repeatedly represented that it was a manufacturer and importer of gourmet Italian cheeses. (A109 ¶94; A172-A173 ¶271; A179 ¶289;

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[10] The District Court ignored the overwhelming magnitude of this fraud based primarily on the fact that Suprema never issued a restatement of its financial results. (A30.) This decision is bizarre. The Company did not restate its financial results for one reason, and one reason only: it went out of business and was liquidated. (A104-A105 ¶82.) Moreover, as the Complaint alleges, BDO specifically announced to investors that they should no longer rely on its previously filed audit opinions, because, among other things, it could not determine whether those financial statements contained material inaccuracies. (A104 ¶80.)

A204-A207 ¶342-50.) Similarly, Suprema repeatedly assured investors that its Class Period growth was the result of increased sales of cheese "***manufactured*** by us." (A98 ¶59; A106 ¶86; A175 ¶278; A182-A183 ¶301; A184-A185 ¶308 (emphasis added).) Assuming, for the sake of argument, that BDO was unaware that the invoices and shipping records from the sham cheese suppliers were bogus, had BDO conducted any reasonable investigation, these documents would have alerted them to the fact that the vast majority of Suprema's reported business had nothing at all to do with manufacturing or importing cheese, as the Company represented. Rather, these documents demonstrate that, at best, the vast majority of Suprema's business consisted of buying and reselling domestic bulk cheese – a material fact that was ***never*** disclosed to investors during the Class Period. (*See* A98 ¶59 (asserting that sales growth came from cheese "manufactured by us"); A106 ¶86; A175 ¶278; A182-A183 ¶301; A184-A185 ¶308.) Not surprisingly, this undisclosed – and apparently unaudited – portion of the business is exactly where the fraud prospered.

Similarly, had BDO made even a cursory investigation into related party transactions, as it was required to do under GAAS, it would have discovered that Suprema's major customers were interrelated with Suprema's major suppliers – a circumstance at the heart of this fraud. (A136-A162 ¶¶174-245; A226 ¶400.) As alleged in the Complaint, simple reviews of D&B reports, incorporation records, or

direct contact with these various entities would have revealed that the vast majority of Suprema's business was nothing more than a sham. (*Id.*) Indeed, a simple drive-by of the physical locations of Suprema's principal customers would have alerted BDO to the simple fact that Suprema's reported sales could not possibly be real – as noted in Section VIII.B, above, three of these customers (accounting for 37% of total sales in 2001) were single family homes, and a fourth could never have taken on the quantities of cheese that were purportedly shipped. (*See* A140-A141 ¶¶186-88; A155 ¶224; A156 ¶229-30; A243-A258.)

In its Opinion, the District Court accepted BDO's contention that "given the information that was available to BDO at the time of the audit it cannot be said that BDO did not have an honest belief that the statements made by it were true." (A32.) However, the problem with this holding is that "what information BDO had" and "what BDO believed" are both fact questions that simply ***cannot*** be resolved on a motion to dismiss. Indeed, the answers to these questions are exclusively within BDO's knowledge and control and, under such circumstances, the particularity requirements of Rule 9(b) should be relaxed. *See, e.g., In re Philip Servs.*, 2004 WL 1152501, *10 (facts such as the audit procedures accountant used, why those procedures did or did not uncover fraud, or what audit procedures should or could have been used in response to red flags were particularly within defendant's knowledge and not required at the pleading stage).

For all of these reasons, the Complaint more than adequately pleads recklessness on the part of BDO and, accordingly, Lead Plaintiff's Rule 10b-5 claim against BDO should be allowed to proceed.

D. The District Court Erred in Dismissing Lead Plaintiff's Control Person Claims Against Cocchiola and Venechanos

The District Court simply misunderstood Lead Plaintiff's control person claims, asserted against Cocchiola and Venechanos. Specifically, the Court dismissed these claims because it decided that Lead Plaintiff failed to set forth a primary violation of the securities laws against ***Defendants Cocchiola and Venechanos***. (A36.) However, the control person claims are not premised on a primary violation by these individuals. Rather, the "primary violator" in Counts Three and Six is ***Suprema***, the controlled entity. *Compare Cendant*, 60 F. Supp. 2d at 379 (first element met where plaintiffs plead underlying violations "by Cendant, the controlled entity"). It is indisputable in this case that Suprema, though not named, violated the securities laws. The only issue is whether Cocchiola and Venechanos can face liability as control persons of Suprema.

"Controlling person liability exists where the defendant has direct or indirect power over the management or policies of a person.... In the determination... 'heavy consideration' should be given 'to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.'" *Cendant*, 60 F. Supp. 2d at 367. While the District Court alludes to an

additional requirement of "culpable participation," courts in this circuit have generally held that a plaintiff need not plead "culpable participation" as an element of a control person claim. *See, e.g., In re Rent-Way Inc. Sec. Litig.*, 209 F. Supp. 2d 493, 523 (E.D.Pa. 2002) ("'culpable participation' need not be pled in a Section 20(a) action"); *In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 600 (D.N.J. 2001); *In re MobileMedia Sec. Litig.*, 28 F. Supp. 2d 901, 940-41 (D.N.J. 1998); *Derensis v. Coopers & Lybrand Chartered Accountants*, 930 F. Supp. 1003, 1013 (D.N.J. 1996).

Indeed, the absence of "culpable participation" is more akin to an affirmative defense that can only be established through discovery. *See* ABA Section on Litigation, *Model Jury Instructions: Securities Litigation* § 4.03[2], at 111 ("Section 20(a) expressly provides a defense if the controlling person acted in good faith...."); *Derensis*, 930 F. Supp. at 1013 ("the facts establishing culpable participation can only be expected to emerge after discovery"). Even in *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, (3d Cir. 1975), the case upon which Judge Walls relies, the court only considered the issue of "control" following a motion for summary judgment – after discovery was complete and the record was fully developed. *Id.* at 883.

Here, the Complaint clearly alleges that Cocchiola and Venechanos dominated every aspect of Suprema's business and operations. (*See, e.g.*, A185-

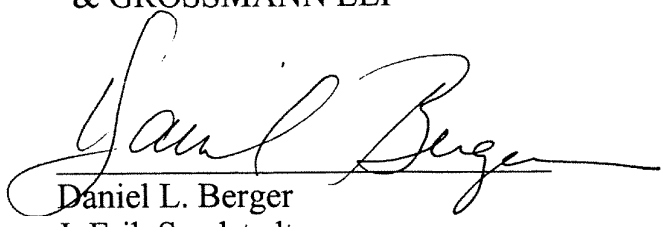
A192 ¶¶309-13; A217 ¶376.) The Complaint also makes clear that it was these defendants who controlled the specific portion of Suprema's business that was the locus of the fraud and, in fact, orchestrated the fraud for their own benefit. (A185-A192 ¶¶309-13; A133-135 ¶¶170-73; A192-A193 ¶314.) Thus, under any formulation, Lead Plaintiff has adequately pleaded its control person claims.

IX. CONCLUSION

For all of the foregoing reasons, the District Court's Dismissal of the Complaint should be REVERSED and the matter should be REMANDED to the District Court for further proceedings.

Dated: November 29, 2004

BERNSTEIN LITOWITZ BERGER & GROSSMANN LLP



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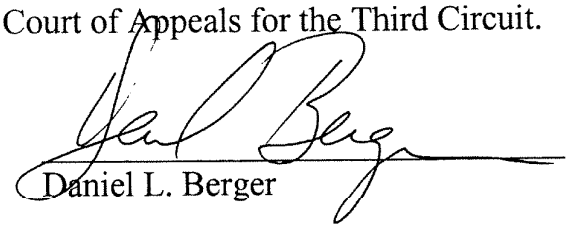

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APPENDIX

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FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

In re SUPREMA SPECIALTIES, INC. SECURITIES LITIGATION	ORDER Civil Action No. 02-3099
SPECIAL SITUATIONS FUND, III, L.P., et al., Plaintiffs v. MARK COCCIOLA, et al., Defendants.	

Walls, District Judge

Defendants having moved to dismiss the Second Amended Complaints of lead plaintiff Teachers' Retirement System of Louisiana ("Lead Plaintiff") in civil action number 02-766 and of plaintiffs Special Situations Fund III, L.P. and Special Situations Cayman Fund LLP (the "SSF Plaintiffs") in civil action number 02-3099, and the Court having considered the submissions of the parties and heard the arguments of counsel,

IT IS on this 26th date of August, 2004,

ORDERED that Defendants' respective motions are GRANTED and both complaints are DISMISSED.

s/ William H. Walls, U.S.D.J.

FOR PUBLICATION

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

In re SUPREMA SPECIALTIES, INC. SECURITIES LITIGATION	**OPINION**
	Civil Action No. 02-0168
	Civil Action No. 02-3099
SPECIAL SITUATIONS FUND, III, L.P., et al.,	
Plaintiffs	
v.	
MARK COCCIOLA, et al.,	
Defendants.	

Walls, District Judge

This matter is before the Court on Defendants' Motions to Dismiss the Complaint in two securities fraud cases that were consolidated before this Court as In re Suprema Specialties, Inc. Securities Litig. The first case, Civ. No. 02-168 (the "Class Action"), is a class action prosecuted by lead plaintiff Teachers' Retirement System of Louisiana (the "Lead Plaintiff"). The second, Civ. No. 02-3099, is prosecuted by plaintiffs Special Situations Fund III, L.P. and Special Situations Cayman Fund LLP (collectively, "SSF Plaintiffs" or "SSF").

FACTS

The factual and procedural history of this case are in this Court's Opinion of June 25, 2003 ("June 25, 2003 Opinion"). Since the issuance of that Opinion, Lead Plaintiff for the class

and the SSF Plaintiffs filed motions for leave to amend the complaints. On January 8, 2004, the morning of the oral argument of the motions for leave to amend the complaints, Plaintiffs brought four criminal Informations to the Court's and the Defendants' attention. The criminal Informations were submitted with the guilty pleas of JohnVan Sickell, a former Suprema employee, and Robert Quattrone, Lawrence Fransen, and George Vieira, former Suprema customers. These four men plead guilty to conspiracy to commit, *inter alia*, securities fraud, to make false statements to auditors and to introduce, or cause the introduction of, adulterated and misbranded food into interstate commerce. In light of this new information, the parties agreed to file the Second Amended Complaints ("Class Complaint" and "SSF Complaint," respectively) subject to renewed Motions to Dismiss which are presently before the Court.

Both Plaintiffs included new facts that purportedly satisfied the Rule 9(b) and PSLRA requirements and showed that Suprema's business was a sham. These new facts are based on Plaintiffs' extensive access to sources including, *inter alia*, Suprema's business records received by Lead Plaintiff from counsel to the Liquidation trustee; discussions with counsel to the Liquidation Trustee, discussions with representatives of the A&J receiver and a review of filings made in connection with the A&J receivership proceedings; interviews of customers and suppliers of Suprema; physical inspections and photographs of the 'ship to' addresses indicated on Suprema's hard cheese invoices; and the criminal Informations submitted with the guilty pleas of Van Sickell, Quattrone, Fransen, and Vieira. The criminal Informations set forth specific details about what, where, when, and how the fraud took place. The "who" was merely identified as "Suprema's management" or "Suprema's senior management." (See, e.g., Class Complaint ("CC") ¶¶ 175-245, SSF Complaint ("SSF") ¶¶ 59, 94, 95.)

THE PARTIES

A. *Lead Plaintiff* (in the Class Action). Lead Plaintiff, Teachers' Retirement System of Louisiana, is a public pension fund organized for the benefit of the current and retired public school teachers of the State of Louisiana. It is located in Baton Rouge, Louisiana, and has total assets of approximately $10 billion. Lead Plaintiff represents a class of investors who purchased shares of Suprema stock pursuant to the company's Secondary Offering. Lead Plaintiff purchased 47,200 shares.

B. *SSF Plaintiffs* (in the SSF Litigation). The SSF Plaintiffs are investment partnerships that purchased almost 400,000 shares of Suprema stock at various times between August 25, 2000 and November 14, 2001. Certain of these shares were purchased in conjunction with the company's Secondary Offering and 2000 Offering.

C. *Suprema* (unnamed defendant in both cases). As noted, Suprema was a manufacturer, processor and marketer of gourmet Italian cheeses with principal place of business in Paterson, New Jersey. Other company facilities were located in New York, California and Idaho. Suprema is not named as a defendant. Pursuant to its bankruptcy filing, it is subject to the protection of a bankruptcy stay.

D. *The Inside Individual Defendants.*

1. *Mark Cocchiola* (defendant in both cases). Defendant Mark Cocchiola ("Cocchiola") is the co-founder of Suprema and, at all times relevant to these actions, was the company's CEO and Chairman of the Board of Directors (the "Board"). As of June 30, 2001, Cocchiola was the largest shareholder of the

company, owning or controlling 1.1 million shares or 17.4% of the company's common stock issued and outstanding.

2. *Steven Venechanos* (defendant in both cases). Until his resignation on December 21, 2001, Venechanos was Suprema's CFO, Secretary and member of the Board. As of June 30, 2001, Venechanos owned or controlled over 138,000 shares of Suprema stock, approximately 2.4% of shares issued and outstanding. Pursuant to the Secondary Offering, Venechanos sold approximately 53,000 shares, realizing profits of almost $628,000.

E. *Outside Director Defendants* (defendants in both cases). Defendants Rudolf Acosta, Jr. ("Acosta"), Marco Cocchiola, Paul DeSocio ("DeSocio"), and Barry Rutcofsky ("Rutcofsky") were each members of Suprema's Board who signed the registration statement and prospectus of the Secondary Offering.

F. *The Underwriter Defendants* (defendants in both cases). Defendants Janney Montgomery Scott LLP, Roth Capital Partners LLC, and Pacific Growth Equities (collectively the "Underwriter Defendants") are investment banking firms who underwrote the Secondary Offering.

G. *BDO Seidman LLP* (defendant in both cases) ("BDO"). Defendant BDO is a Chicago-based accounting firm which provided auditing services to Suprema at all times relevant to these cases.

H. *The 2000 Underwriter Defendants* (defendants in the SSF Litigation only). The SSF Plaintiffs also assert claims against investment banks who underwrote Suprema's 2000 Offering. They are Paulson Investment Company, Inc., Westport Resources Investment Services, Inc.,

Westminster Securities Corp., and Oberweis.net, or collectively, the "2000 Underwriter Defendants."

THE CLAIMS

The Class Complaint alleges the following claims:

Count 1: Against all defendants for violations of Section 11 of the Securities Act
Count 2: Violations of Section 12(a)(2) of the Securities Act Against Cocchiola, Venechanos and the Underwriter Defendants
Count 3: Violations of Section 15 of the Securities Act Against Cocchiola and Venechanos
Count 4: Against Cocchiola, Venechanos for Violations of Section 10(b) of the Exchange Act
Count 5: Against BDO for Violations of Section 10(b) of the Exchange Act and Rule 10b-5
Count 6: Against Cocchiola and Venechanos for Violations of Section 20 of Exchange Act

The SSF Complaint alleges the following claims:

Count 1: Violations of Section 11 of Securities Act against all defendants
Count 2: Violations of Section 12(a)(2) of the Securities Act against Cocchiola, Venechanos and one of the 2000 Underwriter Defendants
Count 3: Violations of Section 15 of the Securities Act against Cocchiola, Venechanos and the Outside Director Defendants
Count 4: Violations of Section 18 of the Exchange Act against Cocchiola, Venechanos, the Outside Director Defendants, and BDO
Count 5: Against Cocchiola, Venechanos, the Outside Director Defendants and the Underwriter Defendants for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder
Count 6: Against BDO for Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Promulgated Thereunder
Count 7: Violations of Section 20 of the Exchange Act against Cocchiola, Venechanos and the Outside Director Defendants
Count 8: Common Law Fraud/ Fraudulent Misrepresentation against all defendants
Count 9: Negligent Misrepresentation against all defendants

STANDARD OF REVIEW

On a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), the court is required to accept as true all allegations in the complaint and all reasonable inferences that can be drawn

therefrom, and to view them in the light most favorable to the non-moving party. See Oshiver v. Levin, Fishbein, Sedran & Berman, 38 F.3d 1380, 1384 (3d Cir. 1994). The question is whether the claimant can prove any set of facts consistent with his or her allegations that will entitle him or her to relief, not whether that person will ultimately prevail. Hishon v. King & Spalding, 467 U.S. 69, 73 (1984).

While a court will accept well-plead allegations as true for the purposes of the motion, it will not accept unsupported conclusions, unwarranted inferences, or sweeping legal conclusions cast in the form of factual allegation. See Miree v. DeKalb County, Ga., 433 U.S. 25, 27 n. 2 (1977). Moreover, the claimant must set forth sufficient information to outline the elements of his claims or to permit inferences to be drawn that these elements exist. See Fed. R. Civ. P. 8(a)(2); Conley v. Gibson, 355 U.S. 41, 45-46 (1957). The Court may consider the allegations of the complaint, as well as documents attached to or specifically referenced in the complaint, and matters of public record. See Pittsburgh v. West Penn Power Co., 147 F.3d 256, 259 (3d Cir. 1998); see also 5A Wright & Miller, Federal Practice & Procedure § 1357 at 299 (2d ed. 1990).

"A 'document integral to or explicitly relied on in the complaint' may be considered 'without converting the motion [to dismiss] into one for summary judgment.'" In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1426 (3d Cir. 1997) (citation omitted). "Plaintiffs cannot prevent a court from looking at the texts of the documents on which its claim is based by failing to attach or explicitly cite them." Id.

DISCUSSION

I. Material Misrepresentations Common to §§ 11, 12, 18, and 10(b) Claims

As stated in this Court's Opinion of June 25, 2003, "a common requirement of all of plaintiffs' claims is an allegation of a material misstatement or omission. Sections 11 and 12 of the Securities Act and sections 10(b) and 18 of the Exchange Act all require an allegation of a material misstatement. In re Westinghouse Sec. Litig., 90 F.3d 696, 707 (3d Cir. 1996) (citation omitted). The control person claims under section 15 of the Securities Act and section 20 of the Exchange Act each require an underlying violation of the respective statute, and thereby incorporate the requirement. To be actionable, a statement or omission must be misleading at the time it was made; liability cannot be imposed on the basis of later events. In re Mobile Media Sec. Litig., 28 F.Supp.2d 901, 925 (D.N.J. 1998) (citing Zucker v. Quasha, 891 F.Supp. 1010, 1014-17 (D.N.J. 1995), aff'd 92 F.3d 408 (3d Cir. 1996)) (filing for bankruptcy four months after offering could not be used to support claim that corporation was in a precarious financial position at time of offering). "At a minimum, each of the securities fraud provisions" allegedly violated by the Defendants "requires proof that the defendants made untrue or misleading statements or omissions of material fact." In Re Donald J. Trump Casino Securities Litigation, 7 F.3d 357, 368 (3d Cir. 1993); Zucker v. Quasha, 891 F. Supp. 1010, 1014 (D.N.J. 1995). Allegations that a company's later financial difficulties imply that earlier financial statements were untrue or misleading are "fraud by hindsight" and do not state a claim. In re Mobile Media, 28 F. Supp. 2d at 925 (citation omitted).

The misrepresentations alleged by Plaintiffs can be summarized as follows:

1) the statements in the 2001 Annual Report and other SEC filings regarding hard cheese sales, compliance with loan covenants, and accounts receivable, which plaintiffs claim were inflated because the hard cheese business, in reality, was a sham, based on round trip sales and fictitious transactions;

2) Suprema's fundamental misstatements of the nature of its business because it was "brokering" or "invoicing" business instead of a manufacturer; the cheese was not "all natural" but "adulturated and not fit for human consumption";

3) the failure of the 2001 Annual Report to declare that several of Suprema's largest customers were "interrelated"; and

4) the representations that Suprema's financial statements were prepared in accordance with GAAS and GAAP.

The guilty pleas and criminal Informations of Van Sickell, Quattrone, Vieira and Fransen confirm that there were in fact misstatements in the 2000 and 2001 Registration Statements and Prospectuses and the financial statements audited by BDO. (See SSF ¶¶ 190-220; CC ¶¶ 83-147.)

II. Securities Act

Section 11

Section 11 establishes a private right of action for any person who acquires a security, the registration statement for which contained a material misrepresentation or omission. If the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not

misleading," then "any person acquiring such security" may sue a number of enumerated individuals and entities. 15 U.S.C. § 77k(a).

> Those subject to liability under § 11 are:
>
> (1) every person who signed the registration statement;
> (2) every person who was a director of (or person performing similar function) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; and
> (5) every underwriter with respect to such security.

15 U.S.C. § 77k(a)(1-5). Section 11 generally does not require a showing of intent or scienter. In re Cendant Corp. Litig., 60 F.Supp.2d 354, 363 (D.N.J. 1999). If a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case. Id. (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983)).

Where a plaintiff seeks to hold § 11 defendants liable for a negligent misrepresentation or omission, his or her claim is not subject to the pleading requirements of Fed. R. Civ. P. 9(b). Id. (citing Shapiro v. UJB Financial Corp., 964 F.2d 272, 288 (3d Cir. 1992)). However, where a § 11 claim is based on allegations of fraud, the heightened pleading requirements of Rule 9(b) apply. Id. Rule 9(b) requires that a plaintiff plead: (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the

plaintiff acted upon it to his or her damage. Castlerock Mngmt., Ltd., et al. v. Utralife Batteries, Inc., et al., 68 F.Supp.2d 480, 485 (D.N.J. 1999) (citing Shapiro, 964 F.2d at 284). Because in the securities context the "factual information is peculiarly within the defendant's knowledge or control," the Third Circuit has stated that "the normally rigorous particularity rule has been relaxed somewhat.... But even under a relaxed application of Rule 9(b), boilerplate and conclusory allegations will not suffice. Plaintiffs must accompany their legal theory with factual allegations that make their theoretically viable claim plausible." Castelrock Mngmnt., 68 F.Supp. at 485 (citing In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1418 (3d Cir. 1997)). Plaintiffs must identify with specificity "who, what, when, where and how." In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999).

Section 12

Under § 12(a)(2) any defendant who "offers or sells a security... by means of a prospectus or oral communication" containing a materially false statement 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 public, not misleading," shall be liable to any "person purchasing such security from him." Castlerock Mngmnt., 68 F.Supp.2d at 484-85 (quoting 15 U.S.C. § 77*l*(a)(2)). To state a claim under § 12(a)(2), a complaint must allege that (1) defendant sold or offered the sale or securities; (2) by the use of any means of communication in interstate commerce; (3) through a prospectus or oral communication; (4) by making a false or misleading statement of a material fact or by omitting to state a material fact necessary to make the statements not misleading; (5) plaintiff did not know of the untruth or omission; and (6) defendants knew, or in the exercise of reasonable care, could have known of the untruth or the omission. In re MobilMedia Sec. Litig.,

28 F.Supp.2d at 924 (citing Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682, 687-88 (3d Cir. 1991)). As is the case under § 11, claims brought under § 12 need be plead with particularity in compliance with Rule 9(b) only if they sound in fraud. Id.

Section 11 and 12(a) Standing

"At the pleading stage, the court may "presume that the general allegations in the complaint [as to standing] encompass the specific facts necessary to support those allegations.. . . Alternatively, however, it is "proper," and "'within the trial court's power,'" even on a motion to dismiss, 'to require the [plaintiff] to go beyond ... general allegations in the complaint and allege particularized facts supportive of its standing.'" Clark v. McDonald's Corp., 213 F.R.D. 198, 206 (D.N.J. 2003) (citations omitted). With respect to plaintiffs' claims under § 12(2), the issue is clear-cut: unless a plaintiff has purchased his shares in the Initial Public Offering, he cannot assert a claim. Gustafson v. Alloyd Co., 513 U.S. 561, 566 (1995); Warden v. Crown American Realty Trust, 1998 WL 725976 (W.D.Pa. 1998) (unpublished), aff'd 229 F.3d 1140 (3d Cir. 2000).

"To state a claim under Section 11, a plaintiff must allege: 1) The plaintiffs purchased securities traceable to an effective registration statement; 2) The defendants fall within the statutorily enumerated categories; and 3) the registration statement, at the time it became effective, contained a material misstatement or omission." In re MobileMedia Secs. Litig., 28 F. Supp. 2d at 923 (D.N.J. 1998). The parties debate the acceptance of using tracing to determine standing. The cases relied on by Defendants misinterpret Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991). The Ballay court decided that purchasers of shares in the secondary market can not bring a cause of action under section 12 of the Securities Act. No

section 11 claim was alleged in Ballay. Plaintiffs rely on In re Adams Golf, Sec. Litig., 176 F. Supp. 2d 216, 226-227 (D.Del. 2001) which discusses the state of the law on tracing and concludes "this court will adopt the view that aftermarket purchasers may proceed under § 11 so long as they can trace the purchase of their shares to a public offering that is covered by the offending registration statement." See Shapiro v. UJB Fin. Corp., 964 F.2d 272 (3d Cir. 1992) ("We agree that traceability must be alleged. . ."); Copland v. Grumet, No. Civ. A 96-3351, 1998 WL 256654, at *4 (D.N.J. Jan. 9, 1998). But see Warden v. Crown American Realty Trust, 1998 WL 725946 at *3 (W.D.Pa. October 15, 1998), aff'd 229 F.3d 1140 (3d Cir. 2000) (holding that the Ballay and Shapiro decisions are clear that the Securities Act exists to protect investors in initial offerings, not those who purchase on the secondary market).

Defendants argue that Plaintiffs do not have standing because they cannot show that securities were purchased "in or traceable to" the 2000 or 2001 Secondary offerings or both. Plaintiffs contend that they have standing to bring their Section 11 and 12(a)(2) claims because the Class Complaint alleges in ¶ 8 that they purchased "in" the 2001 secondary offering and in ¶11 of the SSF Complaint, plaintiffs allege that they purchased shares "in" the 2000 secondary offering and shares "traceable to" the 2001 secondary offering. Because Plaintiffs have alleged that they have purchased "in" or "traceable to" the 2000 and 2001 secondary offerings, Plaintiffs have plead standing sufficiently at this motion to dismiss stage.

A. Section 11

Class Complaint

Although Lead Plaintiff states in ¶ 45 that "This claim is not based on and does not sound in fraud," a review of the allegations in Count 1 asserting the section 11 claim shows that the

allegations of that claim alone "sound in fraud." As example, the Class Complaint states that this case arises from a "massive fraud" that resulted in "materially false and misleading" Registration Statements under the Securities Act (¶¶ 1, 2), four "individuals admitted that certain of Suprema's public statements relating to its financial results and the nature of its business were untrue" (¶83) because they were based on "transactions that never actually took place" (¶87). Also, Suprema's total aggregate sales for fiscal years 1999, 2000, 2001 were "overstated by including sales of cheese that never actually occurred." (¶¶89, 90, 92, 93, 101.) Accord Rombach v. Chang, 355 F.3d 164, 172 (2d Cir. 2004) ("Plaintiffs assert that their Section 11 claims 'do[] not sound in fraud' but the wording and imputations of the complaint are classically associated with fraud: that the Registration statement was 'inaccurate and misleading;' that it contained 'untrue statements of material facts;' and that 'materially false and misleading written statements' were issued.").

Because the § 11 claim "sounds in fraud," the heightened pleading requirements must be satisfied. Lead Plaintiff argues that it satisfies the Rule 9(b) requirements for a section 11 claim as set forth in Rombach, 355 F.3d at 170. According to Rombach, Rule 9(b) requires that the Complaint must "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." Id. Unfortunately for Plaintiffs, the Third Circuit applies a more demanding test for Rule 9(b). In the Third Circuit, Rule 9(b) requires that a plaintiff plead: (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity by the person to whom it was made; (4) the intention that it

should be acted upon; and (5) that the plaintiff acted upon it to his or her damage. Shapiro, 964 F.2d at 284; Castlerock Mngmt., 68 F.Supp.2d at 485.

A statement or omission is material if there is "a substantial likelihood that, under the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." Zucker v. Quasha, 891 F. Supp. at 1014 (citing Renz v. Shreiber, 832 F. Supp. 766, 775 (D.N.J. 1993); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). See also Donald J. Trump, 7 F.3d at 368 n.10 (noting that materiality analysis for claims under §§ 10 and 10(b) of the Securities and Exchange Act of 1934 applies equally to claims under §§ 11 and 12 of the Securities Act of 1933). A fact is material if its disclosure would have "significantly altered the 'total mix' of information available." Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628, 641 (3d Cir. 1989).

In Count 1 of the Class Complaint, Lead Plaintiff identifies several statements that were allegedly fraudulent. (See ¶¶ 83-147.) The statements are alleged to have been made in the 2001 Registration Statement and Prospectus (See, e.g., ¶¶ 66, 68, 85-102.) and in the financial statements for the fiscal years 2000 and 2001 (See, e.g., ¶¶ 67, 103-140.) Explanations for why these statements were fraudulent were also included. (See ¶¶ 85-102, 108, 111, 119, 126, 129, 134-137, 139.) Ignorance of the falsity of these statements is alleged in ¶ 144 and damage is alleged in ¶ 147. The alleged fraudulent statements involve material facts because if investors knew that the transactions with customers such as Quattrone, Fransen or Vieira were fictitious and that cheese was adulterated, such facts would have been significant in the deliberations of the reasonable shareholder.

Suprema is identified as the "speaker" as well as those who signed the Registration Statement: Cocchiola, Venechanos and the director defendants (¶46), the underwriters and the auditor. Although the Class Complaint fails to specifically link such misstatements to the named defendants, once a misstatement is alleged section 11 liability attaches to these defendants by virtue of 15 U.S.C. § 77k(a)(1-5). Knowledge of falsity by the person who made it and intention that it should be acted upon was not alleged in Count 1. In fact, Lead Plaintiff specifically states in ¶ 2 that their "Securities Act claims are not based on any knowing or reckless misconduct on the part of the defendants – i.e., they do not allege, and do not sound in fraud." Lead Plaintiff's Section 11 claim under the Securities Act fails against all defendants under this Rule 9(b) standard of Shapiro. At oral argument, Lead Plaintiff clarified that it was suing under a negligence theory as to the Underwriter Defendants and the individual Outside Director Defendants (Marco Cocchiola, Acosta, DeSocio and Rutcofsky) and under a fraud theory as to Mark Cocchiola, Venechanos and BDO and argued that the Rule 9(b) particularity requirements only applied to the latter group of defendants.[1] This Court is not persuaded by Lead Plaintiff's argument. In paragraph 1 of the Second Amended Complaint, Lead Plaintiff alleges "[t]his case

[1] Plaintiffs argue that even though they incorporate all the factual averments, they are permitted to argue negligence in the alternative and because their negligence claims are plead before the fraud claims they are not required to plead with particularity under Rule 9(b). See In re CINAR Corp. Secs. Litig., 186 F. Supp. 2d 279, 308 (E.D.N.Y. 2002) ("A Section 11 claim does not sound in fraud simply because it is based on acts that also support a claim for securities fraud under Section 10(b)."); In re Cendant Corp. Litig., 60 F. Supp. 2d at 364 ("[T]his complaint does not incorporate allegations of scienter and fraud into the § 11 claim. Rather, here the § 11 claim is plead before any of the other claims. Although the plaintiffs have plead that certain defendants acted fraudulently in violation of § 10(b), the § 11 claim is limited to negligence."); Resolution Trust Corp. v. del Re Castellett, 1993 WL 719764, *2 (D.N.J. 1993) ("At the outset the Court notes that Rule 9(b) does not reach claims grounded in negligence.. . . While the events underlying both counts are exact, plaintiff is entitled to proceed on alternate grounds of liability.").

arises out of the massive fraud that was perpetrated at Suprema, and the resulting demise of the Company...." This allegation is incorporated into Plaintiff's § 11 claim in Count 1. (CC ¶ 45.) In Count 1, Lead Plaintiff also refers to, *inter alia*, the cheese sale "transactions that never actually took place," "overstated aggregated sales," overstated inventory, mislabeled and adulterated cheese inventory, and the "failure to disclose the truth about the nature of Suprema's business and the associated risks." (CC ¶¶ 51, 87, 89, 102, 123, 124, 129.) Lead Plaintiff's boilerplate language in paragraph 2 stating that the section 11 claim in Count 1 is based in negligence and "do[es] not sound in fraud" is insufficient to limit the claim to negligence where "the wording and imputations of the complaint are classically associated with fraud." See Rombach, 355 F.3d at 172 .

SSF Complaint

The SSF Complaint expressly disclaims any allegations that could be construed as alleging fraud which further supports the limitation of their §11 claim to negligence. (SSF ¶ 277.) See In re AnnTaylor Stores Sec. Litig., 807 F. Supp. 990, 1003 (S.D.N.Y. 1992) ("Since plaintiffs disavow any claim of fraud or mismanagement in Count I, it need not comply with Rule 9(b)."); see also Westinghouse, 90 F.3d at 717 n.21 (noting that in their brief, "plaintiffs expressly disavowed any reliance on the allegations supporting the fraud claims in an effort to avoid having Rule 9(b) apply to [their Section 11 claims]"). But such disclaimers are not always sufficient. See In re Stac Elec. Secs. Litig., 89 F.3d 1399, 1404 n.2 (9th Cir. 1996) (plaintiff's argument that it "specifically disclaimed any allegations of fraud with respect to its section 11 claims" was "unconvincing where the gravamen of the complaint is plainly fraud"), cert. denied,

520 U.S. 1103 (1997). "[T]he court is not required to put on a blindfold when ruling on a motion to dismiss." Castlerock Mgmt, 68 F.Supp.2d at 487 (applying Rule 9(b)).

In its section 11 claim, the SSF Plaintiffs identify several specific false representations of material fact and explain why they are material. (See ¶¶ 190-220.) These facts are material because such facts would have significantly altered the total mix of information available to a reasonable investor. They were allegedly made in the 2000 and 2001 Registration Statements. (¶187.) In ¶¶ 223-224, SSF Plaintiffs allege that they acted upon the false information to its damage and, in ¶ 226, that plaintiffs were ignorant of the falsity of the statements.

The SSF Complaint also sounds in fraud despite the disclaimer in paragraph 185 because the misstatements or omissions are based on the alleged fraudulent activity of Suprema and at least one of its employees and some of its purported customers and suppliers. Thus, Rule 9(b)'s more stringent pleading requirements apply. Plaintiffs failed to allege knowledge of the falsity by the person who made it and intention that it be relied upon. SSF Plaintiffs do make these allegations in the general facts section of the Complaint (See, e.g., ¶¶ 52, 54, 60, 105, 114), however, they "expressly disclaim and exclude any allegation that could be construed as alleging fraud or intentional or reckless misconduct" in ¶ 185. Under the Shapiro Rule 9(b) standard, SSF Plaintiffs' section 11 claim fails along with that of Lead Plaintiff.

B. Section 12

Class Complaint

In Count 2 of the Class Complaint, Lead Plaintiff alleges that the defendants "offered and sold Suprema common stock to the class in the Secondary Offering by means of the prospectus." (¶¶ 148, 151.) This satisfies the first and third elements of a § 12 Securities Act claim. Paragraph

5 of the Complaint asserts the use of "the means and instrumentalities of interstate commerce including the United States mail" which satisfies the second element. The class alleges a material misstatement or omission in ¶152, referencing ¶¶ 85-102. In paragraph 153, Lead Plaintiff alleges that it did not know of the untruth or omission. And, in paragraph 154, Lead Plaintiff alleges that the underwriter and officer defendants failed to make a reasonable investigation nor possessed reasonable grounds for the belief that the statement contained in the Prospectus were accurate or complete in all respects.[2] Lead Plaintiff appears to have adequately plead a Section 12 Securities Act claim. However, as in Count 1, Lead Plaintiff fails to plead knowledge of falsity by the person who made it and intention that it should be acted upon which is required by Rule 9(b). See Shapiro, 964 F2d at 288. In fact, Lead Plaintiff specifically states in ¶ 2 that their "Securities Act claims are not based on any knowing or reckless misconduct on the part of the defendants – i.e., they do not allege, and do not sound in fraud." Saying it does not make it so. Lead Plaintiff's Section 12 claims against the Officer and Underwriter Defendants are dismissed.

SSF Complaint

Similarly, in Count 2 of the SSF complaint, Plaintiffs allege the sale or offer of securities (¶¶ 235, 236), by the use of communications in interstate commerce (¶ 235), through a prospectus (¶ 235), by making a false statement of material fact or omitting a fact necessary to make the statements not misleading (¶ 239), plaintiffs did not know of the untruth or omission (¶ 240). They state that defendants could have known of the material misstatements and omissions

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[2] Lead Plaintiff asserts that the officer defendants participated in the drafting of the prospectus which is a stronger basis for the argument that this claim "sounds in fraud" and is subject to the particularity requirements of Rule 9(b). (¶¶ 150, 151.)

alleged had they conducted a reasonable investigation . (¶ 241.) But again SSF Plaintiffs' section 12 claim fails because the Complaint fails to allege knowledge of the falsity by the person who made the misstatement and intention that it be relied upon. See Shapiro, 964 F2d at 288. SSF Plaintiffs do make these allegations (see, e.g., ¶¶ 52, 54, 60, 105, 114), however, they "expressly disclaim and exclude any allegation that could be construed as alleging fraud or intentional or reckless misconduct" in ¶ 234. The SSF Plaintiffs' section 12 claims against the Officer and Underwriter Defendants are dismissed.

III. Exchange Act

Section 10(b) and Rule 10b-5

Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), prohibits the use of fraudulent schemes or devices in connection with the purchase or sale of securities. Under § 10(b), it is unlawful to "employ, in connection with the purchase or sale of any security... any manipulative or deceptive device or contrivance in contravention" of any rule promulgated by the SEC designed to protect the investing public. 15 U.S.C. §78j(b). To implement the statute, the SEC enacted Rule 10b-5, violation of which gives rise to a private cause of action. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). That Rule makes it unlawful: (1) "to employ any device, scheme, or artifice to defraud," (2) "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading," or (3) "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. The Supreme Court has held that standing to bring a private

cause of action under Rule 10b-5 is limited to actual purchasers or sellers of securities. Blue Chip Stamps, 421 U.S. 723, 95 S.Ct. 1917, 44 L.Ed.2d 539.

To make a 10b-5 claim, a plaintiff must allege that the defendant made: (1) a misstatement or omission (2) of a material fact (3) with scienter (4) in connection with the purchase or sale of a security (5) upon which plaintiff reasonably relied and (6) that reliance proximately caused the injury to the plaintiff. Kline v. First Western Gov't Sec., Inc., 24 F.3d 480, 487 (3d Cir. 1999), cert denied sub nom., Arvey, Hodes, Costello & Burman v. Kline, 513 U.S. 1032 (1994); In re Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989). Claims asserted under Rule 10b-5 are subject to the enhanced pleading requirements of Rule 9(b). The Private Securities Litigation Reform Act ("PSLRA"), 15 U.S.C. § 78u-4(b)(2), specifically addressed the scienter requirement of a §10(b) claim. It requires that a complaint which asserts a §10(b) claim must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2); see In re NAHC, Inc. Secs. Litigation, 306 F.3d at 1328, Nappier v. Pricewaterhouse Coopers LLP, 227 F. Supp. 2d 263, 273 (D.N.J. 2002) (emphasizing the word "strong"); P. Schoenfeld Asset Management LLC v. Cendant Corp,142 F Supp 2d 589, 604 (D.N.J. 2001); June 25, 2003 Opinion. "Plaintiffs must accompany their legal theory with factual allegations that make their theoretically viable claim plausible." In re Rockefeller Center Properties, Inc. Secs. Litig., 311 F.3d 198, 216 (3d Cir. 2002) (emphasis deleted); Advanta, 180 F.3d at 533.

Scienter is a culpable state of mind. As the Supreme Court observed in Ernst & Ernst, 425 U.S. at 193 n.12, "'[S]cienter refers to a mental state embracing intent to deceive, manipulate, or defraud." To satisfy this pleading requirement, plaintiffs must state with

particularity facts which show that defendants had both motive and opportunity to commit fraud or facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. Id. Recklessness, in turn, involves "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Id. Conscious behavior in this sense refers to "intentional fraud or other deliberate illegal behavior." Id.

Recklessness suffices where there exists "a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception." McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979) (internal quotations omitted); see June 25, 2003 Opinion at 34. See also Nappier, 227 F. Supp. 2d at 275 ("must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company") (internal quotation omitted); P. Schoenfeld, 142 F. Supp. 2d at 607.

Section 18

As noted in the June 25, 2003 Opinion, section 18 grants a right of action to any person who purchases or sells a security in reliance on a false or misleading statement of a material fact included in any application, report or document filed with the SEC pursuant to the Exchange Act. 15 U.S.C. §78r(a).[3] Proof of scienter is not needed, but allegations of actual (as opposed to

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[3] 15 U.S.C. § 78r(a) provides, in relevant part:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . ., which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was

presumed) reliance are required to state a § 18 claim. 15 U.S.C. §78r; Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir. 1968), cert. denied 395 U.S. 903 (1969); Ross v. A.H. Robins Co., 607 F.2d 545, 552. Constructive reliance is not sufficient. Heit v. Weitzen, 402 F.2d at 916. A plaintiff must specifically allege that he actually read a copy of the document filed with the SEC, or relevant parts of the document reported in some other source, and was induced to act upon specific misrepresentations in the document. In re American Continental Corp./Lincoln Sav. & Loan Sec. Litig., 794 F.Supp. 1424, 1438 (D.Ariz.1992); Jacobson v. Peat, Marwick, Mitchell & Co., 445 F.Supp. 518, 525 (S.D.N.Y. 1977); Lindner Dividend Fund, Inc. v. Ernst & Young, 880 F.Supp. 49, 56 (D.Mass. 1995).

A. Section 10(b) and Rule 10b-5

Misstatement or Omission of a Material Fact

As discussed, Plaintiffs identify misstatements or omissions of material facts which are attributed to the Defendants Cocchiola and Venechanos by virtue of their signatures on the Registration Statements and other Exchange Act documents filed with the SEC (CC ¶¶ 271, 283, 287; SSF ¶ 330), and to BDO for authorizing the use of such statements in financial statements audited by BDO. (CC ¶¶ 281, 282, 304; SSF ¶¶ 398, 399.) SSF Plaintiffs attribute the misstatements to the Director and Underwriter Defendants by virtue of their signatures on the Registration Statements.

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false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

Scienter

Cocchiola and Venechanos

One's position in company is not enough to show knowledge or recklessness. See Advanta, 180 F.3d at 539; In re Cendant Corp. Sec. Litig., 76 F.Supp.2d 539, 547; June 25, 2003 Opinion at 32, 38. "Absent specific factual allegations linking specific defendants with the preparation of . . . allegedly false financial statements . . ., defendants cannot be said to have necessarily participated in such activities simply because they were in positions of authority." In re Tyco Int'l, Ltd. Sec. Litig., 185 F. Supp. 2d 102, 115 (D.N.H. 2002).

Plaintiffs rely on In re Campbell Soup Co Sec. Litig., 145 F.Supp.2d 574, 599 (D.N.J. 2001), for the proposition that when the fraud involves the Company's core business, "the Company's CEO and CFO . . . are presumed to have had pertinent knowledge." Thus, Plaintiffs conclude that they have sufficiently plead facts giving rise to a strong inference of scienter. But, as Defendant Cocchiola points out, the Campbell Soup plaintiffs set forth "a detailed picture of the improper practices in which Defendants knowingly engaged" in their complaint. The Campbell court also noted that "[m]ore importantly [than the presumed knowledge that the CEO and CFO had], Plaintiffs identify specific circumstances under which Defendants [CEO and CFO] had access to and received information about the sales efforts and the related accounting practices." Id.[4]

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[4] The Campbell Soup court relied on the following specific allegations: "In this case, Plaintiffs have specifically alleged that Defendants Morrison and Anderson were involved in discussions regarding the Company's sales and shipping practices and that, in these discussions, reservations were expressed about the propriety of these practices. On one occasion, Plaintiffs claim, Defendant Morrison rejected recommendations that the practices stop. On another occasion, he allegedly said that he did not want the 'L' word - 'loading' - used because it was hurting morale. Plaintiffs also allege that Defendant Morrison gave William Toler revenue

Here Plaintiffs have not alleged such "specific circumstances" where Cocchiola and Venechanos had "access to and received information about" the fraudulent transactions. Rather, Plaintiffs ask the Court to infer scienter from, *inter alia*, Cocchiola and Venechanos' positions as CEO and CFO, admissions of former Suprema employees, suppliers and customers in criminal Informations including that the criminal actions were known and authorized by "Suprema management," "senior management," defendants' signing of hundreds of thousands of dollars in checks to entities who admitted that they did not provide goods or services to Suprema, ship to addresses on Suprema's invoices, the adulteration of cheese as admitted by Van Sickell, and that Suprema's controller, Art Christiansen, resigned his position because he was unwilling to participate in the tasks assigned to him. (CC ¶¶ 313(i)(d), 170-171, 196-221, 202, 212, 218, 233, 235, 244.; SSF ¶ 341.) Cocchiola and Venechanos are not specifically named in the criminal Informations, nor were they named in the SEC enforcement action against 10 individuals for their participation in the fraud. That "senior management" was identified in the criminal Informations as involved in or authorizing the fraud by those who plead guilty does not, without

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targets, which then guided the levels of 'loading' that occurred. Defendant Morrison allegedly also received memoranda regarding the status of the Company's sales efforts. Plaintiffs further claim that both Defendant Morrison and Defendant Anderson were involved in preparing the statements that the Company released to the public and filed with the SEC." Campbell Soup, 145 F. Supp. 2d at 599.

more, raise a strong inference of scienter as to Cocchiola and Venechanos.[5] (See, e.g., CC ¶¶ 175-245; SSF ¶¶ 110, 114.)

Plaintiffs' motive and opportunity scienter allegations include Cocchiola's stock sales, timing and volume, and position as Director and Chief Executive Officer which this Court previously found to be insufficient. June 25, 2003 Opinion at 37, 39. (CC ¶¶ 314(i), 315; SSF ¶¶ 23, 352-345(sic), 371-373.) Plaintiffs ask the Court to make similar scienter inferences against Venechanos on the basis of stock activity, his position as CFO of Suprema, and responsibilities

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[5] Plaintiffs also argue that Cocchiola and Venechanos asserted their Fifth Amendment right and refused to answer any questions relating to Suprema's business or their dealings with the individuals and entities identified in the Second Amended Complaint, thereby raising a negative inference in favor of Lead Plaintiff. (CC ¶¶ 313(i)(k), (ii)(j); SSF ¶¶ 119, 120.) As recently noted by the First Circuit, "in a civil proceeding, the drawing of a negative inference is a permissible, but not an ineluctable, concomitant of a party's invocation of the Fifth Amendment. While the law does not forbid adverse inferences against civil litigants, it does not mandate such inferences." In re Carp, 340 F.3d 15, 23 (1st Cir. 2003) (internal citations omitted). Moreover, despite the permissibility of a negative inference, an analysis of all proffered evidence is required and "[s]ilence is a relevant factor to be considered in light of the proffered evidence, but the direct inference of guilt from silence is forbidden" and therefore exceeds constitutional bounds. LaSalle BankLake View v. Seguban,54 F.3d 387, 390, 391 (7th Cir. 1995). See also In re Bartlett, 154 B.R. 827, 829-30 (Bankr. D.N.H. 1993).

Lead Plaintiff argues that "the Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them, at least where refusal to waive the privilege does not lead automatically and without more to [the] imposition of sanctions." Mitchell v. U.S., 526 U.S. 314, 328 (1999) (internal quotations and citations omitted); see also In re Grand Jury, 286 F.3d 153, 160 (3rd Cir. 2002) ("We have held that reliance on the Fifth Amendment in civil cases may give rise to an adverse inference against the party claiming its benefits."). Drawing a negative inference in this case could unduly penalize Cocchiola and Venechanos for his invocation of the Fifth Amendment, particularly considering that the Fifth Amendment was invoked in the bankruptcy proceeding and not in this case. See SEC v. Greystone Nash, Inc., 25 F.3d 187,192 (3d Cir. 1994) ("A trial court must carefully balance the interests of the party claiming protection against self-incrimination and the adversary's entitlement to equitable treatment. Because the privilege is constitutionally based, the detriment to the party asserting it should be no more than is necessary to prevent unfair and unnecessary prejudice to the other side"). No party cites authority for the use of a party's invocation of the Fifth Amendment to create a negative inference when such privilege was invoked in an unrelated case.

attendant thereto, the Christianson resignation letter and Venechanos' alleged invocation of his Fifth Amendment right at a bankruptcy proceeding, and references to "Suprema's management" in the criminal Informations of the four individuals who plead guilty for participating in the Suprema fraud. (CC ¶¶ 314(ii), 315; SSF ¶¶ 24, 371-373.) The Third Circuit has made it clear that insider stock sales can only raise an inference of fraud where they are "unusual," and a plaintiff bears the burden of pleading a factual basis to demonstrate that they were unusual or suspicious. See, e.g., Oran v. Stafford, 226 F.3d 275, 290 (3d Cir. 2000) ("While we will not infer fraudulent intent from the mere fact that some officers sold stock, 'if the stock sales were unusual in scope or timing, they may support an inference of scienter.'"); Advanta, 180 F.3d at 540; Burlington Coat Factory, 114 F.3d at 1423; Wilson v. Bernstock, 195 F.Supp.2d 619, 634-35 (D.N.J. 2002). See also June 25, 2003 Opinion at 37-38.

This Court previously rejected the allegations regarding the stock sales of both Cocchiola and Venechanos because Plaintiffs failed to plead that the sales were unusual in timing and scope. Here Plaintiffs allege that the timing of Cocchiola's stock sales is unusual and suspicious because before the class period, Cocchiola only sold 50,000 shares but then weeks before NASDAQ suspended trading, Cocchiola sold 347,809 (31%) in a secondary stock offering and pledged 200,000 (20%). Venechanos sold no stock before the secondary offering in which he sold 52,937 shares (38%). This Court finds that the pleadings still do not sufficiently allege that the stock sales were unusual for the same reasons expressed in the June 25, 2003 Opinion. Both Cocchiola and Venechanos sold their respective shares as part of the Secondary Offering, a natural time for such sales. The sales were fully disclosed as part of the Secondary Offfering. Even with the 20% stock pledge by Cocchiola, both Cocchiola and Venechanos retained large

stock holdings after the sales, 49% and 62%, respectively. See Advanta, 180 F.3d at 540-541 (where defendant kept a sizeable percentage of Advanta's outstanding stock even after his sales, "[f]ar from supporting a 'strong inference' that defendants had a motive to capitalize on artificially inflated stock prices, these facts suggest that they had every incentive to keep Advanta profitable.").

BDO

Both Lead Plaintiff and the SSF Plaintiffs focus on circumstantial evidence of BDO's reckless or conscious behavior to show BDO's scienter. The thrust of the Complaints against BDO is that it had issued a "clean" audit opinion which ultimately proved to be erroneous, that there were audit steps that BDO might have taken but did not, and there were numerous "red flags" that BDO did not investigate.

In securities fraud claims against an auditor – claims which generally are based on the fraud of others – "the failure... to identify problems with the defendant-company's internal controls and accounting practices does not constitute reckless conduct sufficient for § 10(b) liability." Nappier, 227 F. Supp. 2d at 275 (quoting Novak v. Kasaks, 216 F.3d 300, 309 (2d Cir. 2000)). Rather, plaintiffs must allege that the auditor's conduct was "highly unreasonable, representing an extreme departure from the standards of ordinary care [and] must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." Id. (quoting Rothman v. Gregor, 220 F.3d 81, 98 (2d Cir. 2000)). Moreover, "allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.... [O]nly where such allegations are coupled with evidence of corresponding fraudulent intent, might they suffice." Id. at 276, (quoting Novak, 216 F.3d at 309). Similarly, allegations

that an auditor "must have known," by virtue of its role as auditor, of the defendant company's role is insufficient by themselves to permit an inference of recklessness. See id. at 276-77 (citing Rothman, 220 F.3d at 98).

As the Third Circuit explained in McLean:

> A showing of shoddy accounting practices amounting to at best a "pretended audit" or of grounds supporting a representation "so flimsy as to lead to the conclusion that there was no genuine belief back of it" have traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue to do so. In such cases, the fact finder may justifiably conclude that despite those assertions the "danger of misleading... [was] so obvious that the actor must have been aware of it."

599 F.2d at 1198 (citations and quotations omitted). See also In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288, 2003 WL 21488087 (June 25, 2003) ("[t]he allegations identifying the steps Andersen should have taken and failed to take, and the fraud it would have discovered if it had taken those steps, create a strong inference the Andersen acted recklessly in conducting the WorldCom audits."). See also In re First Merchants Acceptance Corp. Sec. Litig., No. 97 CV 2715, 1998 U.S. Dist. Lexis 17760 at *32, 33 (N.D. Ill. Nov. 2, 1998) (Court denied the accountant's motion to dismiss, finding that "the magnitude of the misstatements, the specific GAAP and GAAS violations and the 'red flags' together support an inference that Deloitte's audit amounted to no audit at all or an egregious refusal to see the obvious or investigate the doubtful.") (quotations omitted).

"The issue is whether the defendants had an honest belief that the statements made by them were true. If they did have that honest belief, whether reasonably or unreasonably, they are not liable." McLean, 599 F.2d at 1198. This information is tested against the knowledge that the auditor had, not what it would have had if the audit were conducted differently. See McLean, 599 F2d at 1199. If the magnitude of the fraud "either enhanced the suspiciousness of

specifically identified transactions, or made the overall fraud glaringly conspicuous," P. Schoenfeld, 142 F.Supp.2d at 609, then an auditor may have "reckless[ly] disregard[ed] of numerous – even hundreds – of unsupported entries." "Where a transaction derives its suspiciousness from specific details associated with the audited company's business, the plaintiff must plead facts suggesting the accountant's awareness of those details." Nappier, 227 F.Supp.2d at 276.

The complaints claim that the audit was erroneous because Suprema's sales were overstated; it overstated the accounts receivable; that, accordingly, its reserves against receivables proved too low; and that the value of its inventory was too high. Plaintiffs' theory is because the alleged fraud was so massive, BDO must have known or should have known of it when it performed its audits and therefore acted recklessly in certifying Suprema's financial statements. Even if some courts have accepted the "must have known" reasoning rejected by the Nappier court, most if not all of those cases advanced by the plaintiffs involved an acknowledgment of misstated financial statements. See, e.g., P. Schoenfeld, 142 F. Supp. 2d at 610. Here, there has been no restatement of Suprema's financial statements or other acknowledgment that the financial results were misstated. The absence of such acknowledgment undermines plaintiffs' attempt to infer knowledge based on the magnitude of the alleged fraud.

Plaintiffs argue that had BDO conducted a bona fide investigation of the very limited number of suppliers and customers that constituted the vast majority of Suprema's reported business; corroborated the representations of management through a review of Suprema's books and records; conducted interviews with those employees responsible for the Company's internal accounting, and interviews of Suprema's major customers and suppliers; or investigated the

possibility of related party transactions and the sources of financial resources supporting the Company's transactions, accounts receivable and the like– BDO would have discovered the fraud. According to Plaintiffs, BDO's failure to take these steps – which were required by GAAS– was severely reckless.

BDO argues that an auditor does not guarantee the correctness of its opinion and that an auditor is not required to take every possible auditing step. But that the auditor must have a reasonable basis for its opinion. BDO also claims that it was the victim of Suprema's fraud because Suprema's employees and individuals outside the audited company made misstatements and sent false communications to BDO. BDO notes that Suprema did manufacture and ship some hard cheese. The supporting documentation, including invoices and bills of lading that looked genuine, and fund transfers by check and otherwise, was created to reflect sales that proved to be inflated. To all appearances, the sales had occurred and payment was forthcoming. BDO confirmed the receivable balances with those purportedly owing the money and the false explanation given for the growth of such balances was they had extended credit terms. The level of reserves against receivables set up by management is a matter of professional judgment. See Shapiro, 964 F.2d at 281. BDO also asserts that the adulterated inventory was worth far less than superior grade cheese would be but that it was not an expert in cheese and the labels were changed to mask the adulteration so short of performing laboratory tests for quality it did all it was required to do.

Finally, BDO contends that the red flags "must be closer to smoking guns than mere warning signs." BDO Br. at 16 (citing Nappier, 227 F. Supp.2d at 278). Even with the admissions of guilt by Van Sickell, Quattrone, Fransen and Vieira and the criminal Informations

detailing the fraud, the complaints do not show that BDO knew: the sales were fictitious, that there was a relationship among or greater concentration of buyers and sellers of hard cheese than was reported, that shipments were fictitious, or that various warehouses and facilities of Suprema were not as expected. The purported 'red flags' were normal aspects of a healthy business: the fact that management played an important role in the business and had stock in the company and were paid bonuses based on performance, cash flow problems due to extended payment terms for the largest purchasers, faster growth than other companies in the cheese industry.

Unlike the accounting firms in Cendant and P. Schoenfeld, here the accounting firm was in effect a victim of the fraud. Not only were all those involved in the hard cheese business at Suprema part of the fraudulent scheme, according to the complaints at issue, but a substantial number of persons and entities outside Suprema were also involved in the scheme. An object of all of the conspirators was to deceive, among others, Fleet and Sovereign Banks (Suprema's lenders), the Securities and Exchange Commission, and the investing public, and the auditors. The criminal Informations cited in the complaints explicitly state that Suprema's employees made misstatements and sent false confirmations to BDO to effectuate their fraudulent scheme. See, e.g., Information in United States v. Van Sickell, Docket No. CR 04-12, ¶43 (D.N.J. 2004). What under different circumstances may be an indicator of fraudulent intent– the magnitude of the fraud, violations of GAAP, and the presence of "red flags"– do not rise to a "strong inference" of recklessness here. Rather, given the information available to BDO at the time of the audit it can not be said that BDO did not have an honest belief that the statements made by it were true.

Outside Director Defendants (the Audit Committee)

In its scienter allegations, the SSF Complaint merely states that the outside director defendants had the responsibility to review the company's financial reporting, external audits, internal controls and compliance. (¶ 378.) The Complaint then states that the audit committee "had access to" business records, BDO and BDO's audit procedures, Suprema's personnel, all phases of Suprema's manufacturing business operations. (¶ 380-383.) According to the SSF Complaint, "[t]he fact that Suprema recognized significant and material amounts of revenue in violation of the Company's own internal revenue recognition policies – the very policies that these defendants were responsible for monitoring – supports a strong inference of recklessness." (¶ 384.) But the SSF Plaintiffs did not specifically state in this count that the outside directors failed to carry out their monitoring duties. "Plaintiffs may not impute knowledge of a company's financial infirmities to defendants solely by nature of the positions they held." In re Milestone Scientific SEC Litig., 103 F.Supp 2d 425, 470 (D.N.J. 2000). Here the Complaint merely concludes that the outside director defendants were reckless without providing specific facts from which the Court can infer motive, opportunity, or recklessness. Such is legally defective.

Underwriter Defendants

The SSF Complaint alleges that the Underwriter Defendants had statutory obligations to conduct due diligence and that they abdicated such obligations. (SSF ¶¶ 385-390.) Specifically, the complaint avers that they failed to adequately review Suprema's internal financial forecasts, contracts and other documents; failed to make a physical inspection of the major facilities; failed to employ analysts with expertise in the cheese business; failed to interview senior and middle management and major customers. (¶ 389.) Had they done so, the complaint avers, they would

have discovered the fraud. (¶ 388.) The complaint offers no allegations of motive or opportunity except that they earned "significant fees" for their services. (¶ 385.) Allegations that proper due diligence would have uncovered the "truth . . . constitute negligence at best, and these types of allegations against an underwriter have always been insufficient to establish scienter under the federal securities laws." In re WRT Energy Sec. Litig, 1999 WL 178749, *10 (S.D.N.Y March 31, 2999); Advanta, 180 F.3d at 525 (negligence is insufficient for scienter).

B. Section 18

The parties disagree whether the heightened pleading requirements of Rule 9(b) apply to a Section 18 claim. This issue need not be determined at this time because the claim fails on the "actual reliance" prong. Here the SSF Plaintiffs identify misrepresentations in documents filed with the SEC under the Exchange Act. Paragraphs 279, 283, 296, 300, and 320 refer to Suprema's 10Q and 10K documents which were Exchange Act documents filed with the SEC between May 2000 and November 2001 and signed by the Officer Defendants or audited by BDO (See, e.g., SSF ¶¶ 293, 294, 317, 318.) The SSF Plaintiffs identify the misrepresentations and explain why they were misleading. (See, e.g., SSF ¶¶ 280, 281, 283-294.) SSF Plaintiffs go on to state for each document that they "received, reviewed, actually read, and relied upon Suprema's [Exchange Act filing]. Plaintiff obtained this document at or about the time it was publicly filed with the SEC, and actually read and relied upon it in making their decisions to invest in Suprema common stock. . . ." (SSF ¶¶ 282, 295, 299, 319, 321.) The Lindner court noted that the plaintiffs in that case alleged that they "'specifically relied upon the various statements contained in said reports'" and ruled that plaintiffs satisfied their burden of alleging that "they saw and relied upon the alleged misstatements contained in the documents." Lindner,

880 F.Supp. at 56. Here the SSF Plaintiffs identify the fraudulent or misleading statements but merely allege that they relied the on documents that contained misstatements. They did not allege actual reliance on the specific misrepresentations themselves. Plaintiff's section 18 claim is dismissed as to all defendants.

IV. Section 15 of the Securities Act and Section 20 of the Exchange Act

The elements of controlling persons claims under Section 20 of the Exchange Act and Section 15 of the Securities Act are identical. See In re Mobile Media Sec. Litig., 28 F. Supp. 2d at 940. To state a claim for control person liability, the plaintiff must allege (1) a primary violation of the federal securities laws by a controlled person; (2) control of the primary violator by the defendant; and (3) that the controlling person was in some meaningful way a culpable participant in the primary violation. Tracinda Corp. v. DaimlerChrysler AG, 197 F. Supp. 2d 42, 55 (D.Del. 2002). Section 15 of the Securities Act provides liability for "controlling persons" for violations of §§ 11 and 12. Under § 15:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency or otherwise, controls any person liable under sections 77k or 77*l*(a)(2) of this title [that is, §§ 11 and 12] shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o. "Controlling person liability exists where the defendant has direct or indirect power over the management or policies of a person...." In re Cendant, 60 F.Supp.2d at 367 (quoting Wiley v. Hughes Capital Corp., 746 F.Supp. 1264, 1281 (D.N.J. 1990)) (citation omitted). In the determination of whether a person is a "controlling person" within the meaning

of § 15, "heavy consideration" should be given "to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof." In re Cendant, 60 F.Supp.2d at 367 (quoting Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975)).

Section 20(a) of the Exchange Act creates liability for "controlling persons" in a corporation, and imposes joint and several liability upon anyone who "controls a person liable under any provision of" the Exchange Act. 15 U.S.C. § 78t(a). To maintain a claim under § 20(a), the plaintiffs must establish (1) an underlying violation by a controlled person or entity, (2) that the defendants are controlling persons. Campbell Soup, 145 F. Supp. 2d at 599. But see Cendant, 60 F. Supp. 2d at 379 (citing Rochez Bros., 527 F.2d at 885) (holding that plaintiff must also allege that control persons are "in some meaningful sense culpable participants in the fraud perpetuated by controlled persons.").

Here where the underlying securities violations are inadequately plead against Defendants Cocchiola and Venechanos, the §§15 and 20 control person claims fail on the first element. Because both Lead Plaintiff and the SSF Plaintiffs failed to state a claim under section 11 or 12 of the Securities Act, and section 10(b) of the Exchange Act, their sections 15 and 20 claims fail also.

V. SSF Common Law: Fraud and Negligent Misrepresentation

The SSF Plaintiffs assert claims against all defendants for common law fraud and fraudulent misrepresentation, and negligent misrepresentation. The basis for this Court's subject matter jurisdiction over these claims appears to be supplemental jurisdiction to the Court's original jurisdiction over the federal securities law claims. Because the federal claims have been

dismissed, the Court, in its discretion, will not maintain jurisdiction over the state law claims. They too are dismissed, under 28 U.S.C. § 1367(c)(3).

CONCLUSION

Defendants' motions are granted and both the Second Amended Class Action Complaint and the Second Amended SSF Complaint are dismissed.

s/ William H. Walls, U.S.

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UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

IN RE SUPREMA SPECIALTIES, INC. SECURITIES LITIGATION	Master File No. 02-168 (WHW)

Notice is hereby given that Teachers' Retirement System of Louisiana, Lead Plaintiff in the above-captioned class action, hereby appeals to the United States Court of Appeals for the Third Circuit from the opinion and order entered in this Action on August 31, 2004 ("Opinion and Order"), which granted defendants' motions to dismiss the Second Amended Class Action Complaint ("Amended Complaint"). Lead Plaintiff hereby declares its intention to stand on the Amended Complaint. Thus, the Court of Appeals has jurisdiction pursuant to 28 U.S.C. § 1291. *See Borelli v. City of Reading*, 532 F.2d 950, 951-52 (3d Cir. 1976).

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Dated: September 15, 2004

Respectfully submitted,

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