UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MINNESOTA

THE CORNELIA I. CROWELL GST TRUST, On Behalf of Itself and All Others Similarly Situated, Plaintiff, vs. PEMSTAR, INC., ALLEN BERNING, ROY BAUER and GREGORY LEA Defendants.	**Case No. 05--CV-01182-JMR-FLN** **PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS CONSOLIDATED COMPLAINT**

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Lead Plaintiff Dr. Brian Cromwell (“”Plaintiff”) hereby submits this Memorandum of Law in Opposition to the Motion to Dismiss Consolidated Complaint and Memorandum of Law in Support Thereof (the “Motion”) filed by Defendant Pemstar, Inc. (“Pemstar” or the “Company”), and Defendants Allen J. Berning (“Berning”), Greg S. Lea (“Lea”), and Roy Bauer (“Bauer”) (the “Individual Defendants” and, together with Pemstar, “Defendants”).

I. INTRODUCTION

Plaintiff’s Consolidated Complaint (the “Complaint”) vividly describes in extraordinary factual detail how Defendants carried out a blatant securities fraud between January 30, 2003 and January 12, 2005 (the “Class Period”). As confirmed by the recent restatement of Pemstar’s financial results and the resignation of Pemstar’s auditors, Defendants materially overstated Pemstar’s financial results by more than $6 million, by reporting phony revenue, invalid accounts receivables, and defective inventory during the Class Period. Through interviews with four former senior officers of Pemstar, the Complaint contains specific and detailed facts demonstrating that the Defendants knew that Pemstar’s financial results were false and misleading both prior to, and during, the Class Period. The Complaint also specifically alleges that Defendants’ misrepresentations artificially inflated the price of Pemstar’s stock during the Class Period, and explains how Defendants’ misrepresentations caused the losses suffered by Plaintiff and the Class.

As discussed below, none of the Defendants’ desperate attempts to avoid liability for their securities fraud have any merit. First, contrary to Defendants’ arguments, the factual

allegations underlying Plaintiff's claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 easily satisfy the pleading standards of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), as the Complaint expressly identifies which statements by Defendants were false or misleading, and alleges numerous facts which – individually or collectively – give rise to strong inference that Defendants' misrepresentations were made knowingly or recklessly.

Second, Defendants' argument that the Complaint's specific allegations do not satisfy the "loss causation" pleading standard is also without merit. Defendants' argument blatantly misrepresents the standard for properly alleging "loss causation" (evaluated under F.R.C.P. 8) articulated under *Dura Pharmaceuticals, Inc., v. Broudo*, 125 S.Ct. 1627, 1634 (2005) and its progeny, and ignores the Complaint's allegations detailing significant drops in the price of Pemstar stock in response to the disclosure that Pemstar's auditors had resigned, that there were "accounting discrepancies" with respect to Pemstar's financial results, and in response to Defendants' admission that Pemstar's earnings were overstated by more than $6 million.

Third, Defendants' attacks on Plaintiff's claims under Section 11 of the Securities Act of 1933 are also without merit. Contrary to Defendants' argument, the "bespeaks caution" doctrine does not immunize Defendants from liability for Pemstar's false financial results in Pemstar's Secondary Public Offering Prospectus, because the doctrine does not apply to false statements of *past or present facts* or "boilerplate" warnings of problems that had ***already*** occurred.

Finally, Defendants' argument that the Class Members in this litigation (investors who purchased Pemstar stock between January 30, 2003 and January 12, 2005) are somehow barred from recovery under the doctrine of *res judicata* because Defendants previously settled securities fraud claims brought by an *entirely different class* of Pemstar stock purchasers (investors who purchased Pemstar stock between June 8, 2001 and May 3, 2002) and is also without merit.

II. THE FACTUAL ALLEGATIONS OF THE COMPLAINT

A. Defendants' Misrepresentations About The Financial Results of Pemstar Mexico

Pemstar designed and manufactured products for use in the communications, data storage, industrial equipment and medical industries. ¶13.[1] Pemstar misrepresented its financial results throughout the Class Period with respect to the financial results of Pemstar's operations in Guadalajara, Mexico (the "Mexico facility" or "Pemstar Mexico"). Pemstar originally acquired the Mexico facility in 1997, and Pemstar Mexico served as Pemstar's primary order fulfillment center. ¶69(b).

Even before the Class Period, Defendants learned in 2002 of significant accounting errors at Pemstar Mexico. In April, 2002, Pemstar's International Program Management Director (the "IPMD") (Confidential Witness "C") conducted an extensive analysis of

[1] All references to "¶__" and "¶¶__" herein are to the Complaint.

Pemstar Mexico's operations.[2] By May 2002, the IPMD concluded that approximately $1 million of Pemstar Mexico's inventory was defective and had to be written off. ¶51. Defendant Berning (Pemstar's CEO and Chairman) stated during a phone conference with Pemstar Mexico management that he did not believe the financial results of Pemstar Mexico were true. ¶50. During another phone conference, Defendant Berning (along with other Pemstar management) discussed a "huge" variance between Pemstar Mexico's general ledger and its perpetual records and permanent data records with Pemstar Mexico management. ¶25. And, at a July 2002 meeting in Pemstar's headquarters in Minnesota, Defendant Lea discussed Pemstar Mexico's financial problems with Marcio Pavageua, Pemstar Mexico's General Manager. ¶53.

The accounting errors at Pemstar Mexico continued into the Class Period. In November 2002, Pavageua demanded that Luz Maria Gonzalez ("Gonzalez"), the Controller of Pemstar Mexico, sign financial statements that contained false and inaccurate information. ¶14. Gonzalez refused, and resigned instead. *Id.* Regardless, the false financial results were reported by Defendants as part of Pemstar's financial results in the Class Period. ¶¶14-16. In 2003, Pavageua similarly demanded that auditors at Ernst & Young ("E&Y") sign documentation confirming that Pemstar Mexico's financial results satisfied GAAP. ¶32.

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[2] Based upon his review, the IPMD prepared a "Breakeven Report" which was provided to Pemstar's senior officers, including Defendant Lea. ¶48. The "Breakeven Report" stated that Pemstar Mexico would run at an operating loss of at least $1.2 million per year through June 2003 and would never show a profit. ¶¶12(c), 47, 49.

When E&Y refused to do so, Pavageua fired E&Y and replaced them with other accountants. *Id.*

Pemstar then decided to hire a former Pemstar Mexico controller as a consultant (the "Consultant") (Confidential Witness "A") to provide a detailed review Pemstar Mexico's finances and accounting. ¶31. In December 2003, the Consultant issued a report (the "December 2003 Report") which detailed that Pemstar Mexico's reported assets were overstated by at least $3.5 million. ¶31. The December 2003 Report further stated that Pemstar Mexico had reported revenue from fabricated invoices for the sale of products that were never ordered, which also were used to inflate Pemstar Mexico's accounts receivable and revenue without a corresponding increase in cost of goods sold (¶31(a)); that Pemstar Mexico was carrying approximate $1 million of non-existent inventory on its books (¶31(b)) along with another $1 million of worthless scrap (¶31(c)) and obsolete material (¶31(d)); and that Pemstar Mexico's reported inventory was overstated due to the refusal to account for shipping costs (¶31(e)). The Consultant met several times with Defendant Lea in Mexico from November 2003 to April 2004 (*i.e.,* while preparing the December 2003 Report and thereafter) concerning Pemstar Mexico's finances. ¶36. Shortly after issuing the December 2003 Report, the Consultant began reporting directly to Kevin Larson ("Larson"), Pemstar's controller in Minnesota (¶33), and the Consultant regularly discussed action items contained in the December 2003 Report with Larson (¶34). The Consultant also prepared monthly reports for Larson about the status of Pemstar Mexico's finances that Larson passed on to

Defendant Lea. ¶33.

After issuing the December 2003 Report, the Consultant continued to communicate with Pemstar's senior officers in Minnesota about other financial errors at Pemstar Mexico. For example, in early 2004, the Consultant reported on a $500,000 Pemstar invoice from 2003 for which no Pemstar shipments had ever been made, but for which Pemstar had reported revenue and accounts receivable. ¶31(a). Significantly, the invoice was dated immediately prior to the end of one of Pemstar's fiscal quarters. *Id.* The Consultant also found several other phony notices, each of which was also dated immediately prior to the end of a Pemstar fiscal quarter. *Id.* The Consultant provided the $500,000 phony invoice to Larson, who in turn provided it to Defendant Bauer. *Id.*

In April 2004, Doug Titus ("Titus"), Pemstar's Vice President of Operations, traveled from Minnesota to Pemstar Mexico. ¶39. After meeting with the Consultant, Titus concluded that Pemstar Mexico's reported financial results were overstated by at least $3 million. *Id*. Pemstar then fired several members of Pemstar Mexico's management team, and rehired E&Y to audit the financial results of Pemstar Mexico. *Id.* However, by May 2004, E&Y Mexico again refused to certify the accuracy of Pemstar Mexico's financial results (¶38), and, in June 2004, E&Y resigned as Pemstar's auditor. ¶59. Defendant Lea explained to Confidential Witness "D" (Pemstar's International Financial Controller) that Ernst & Young resigned rather than risk the significant exposure it faced in connection with

the financial errors at Pemstar Mexico. *Id.*[3]

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[3] Not only has Plaintiff pled evidence that each of the Individual Defendants had specific knowledge of Pemstar Mexico's accounting errors, but the Individual Defendants also had access to extensive reports detailing Pemstar Mexico's finances. According to Pemstar's International Financial Controller (the "IFC") (Confidential Witness "D") Pemstar Mexico was required to provide a "Monthly Financial Report." ¶54. The IFC, Defendant Lea (Pemstar's CFO) and Pemstar's controller regularly reviewed the Monthly Financial Report and often requested additional follow-up information from Pemstar Mexico. ¶55-56. Similarly, Defendant Bauer (Pemstar's COO) required Pemstar Mexico to prepare and submit a "Monthly Operational Report," providing detailed information on important areas of Pemstar Mexico's business and financial results, known within Pemstar as "Dashboards," including Material/Inventory, Finance, Operations, and Quality. ¶57. The Material/Inventory Dashboard included data on scrap rate, obsolete inventory, work in progress, finished goods, out of stock, and other data; the Finance Dashboard included gross margin trends, aging of accounts receivable, sales trends, and other data; the Operations Dashboard included manufacturing yield, utilization of equipment, re-work levels, rejects, customer returns, and other data; and the Quality Dashboard included on-time delivery, red flags (indicating a problem area that needs to be addressed), green flags (indicating a problem area that has been fixed), and other data. After reviewing the Monthly Operational Report, Defendant Bauer regularly discussed the contents of the report each month with senior Pemstar Mexico management in detail. ¶58. In addition to the regular and special reports, Defendants also had access to all information about inventory (including Mexico) through the Company's enterprise resource planning ("ERP") systems. ¶68. Defendants routinely held both telephone conferences (*see, e.g.*, ¶¶25, 50) and in-person meetings (*see, e.g.*, ¶53) with Pemstar Mexico employees. In mid-2003, responsibility for Pemstar Mexico's accounts receivable and payable was even moved to Pemstar's Minnesota headquarters (where the Individual Defendants were located). ¶31(a).

The financial and accounting problems at Pemstar Mexico were regularly discussed at the weekly meetings of Pemstar's management in Minnesota. ¶41. However, the Individual Defendants routinely tabled the discussion until their "Super Honcho" meetings, which were limited to the Individual Defendants and other high-level executives. *Id.* The Individual Defendants held "Super Honcho" meetings two weeks before each quarter's financial results were released, and the results released to the public were always materially better than the results discussed at the meeting. ¶43.

B. The Fraud Begins To Unravel

Defendants' fraudulent scheme began to unravel in mid-2004. First, on June 24, 2004, Pemstar was forced to announce the resignation of E&Y (discussed above), which caused Pemstar's stock to drop by more than 12% on extremely heavy volume. ¶71. Then, on November 3, 2004, after the market closed, Pemstar issued a press release announcing an investigation of accounting errors related to Pemstar Mexico. On November 4, 2004, the trading day after the announcement, Pemstar stock plummeted more than 21% from the previous day's closing price, on nearly five times the previous day's trading volume.

On January 13, 2005, Defendants finally admitted that Pemstar's Financial Reports reported during the Class Period were false and misleading:

> [D]ue to certain accounting discrepancies at its Mexico facility, its previously filed financial statements for the year ended March 31, 2004, should no longer be relied upon. As previously disclosed, PEMSTAR has been conducting an investigation of accounting discrepancies at its Mexico facility since late October 2004 and has now turned over the results of its inquiry to Grant Thornton LLP and Ernst & Young LLP, its current and former independent audit firms, respectively, for their review and consultation with management in determining the impact on the company's financial results. Management's conclusion regarding continued reliance upon these previously filed financial statements was also discussed with and confirmed by the Audit Committee of the company's Board of Directors. The Company continues to estimate the amount involved as approximately $6.0 million and currently believes that the majority of that amount will impact the operating results included in its previously filed financial statements for the year ended March 31, 2004. The Company is still considering whether its previously reported financial results for fiscal year 2003 and for the quarter ended June 30, 2004 will be impacted

> by the results of the Mexico investigation and may need to be restated as well.

¶73. Once the market opened, Pemstar stock fell more than 13% from the previous day's closing price, on more than three times the previous day's trading volume. ¶74.

On February 14, 2005, Pemstar announced that it was restating its previously issued financial statements for the year ended March 31, 2004, and the quarter ended June 30, 2004. According to Defendants, the restatement was necessary because Pemstar's previous financial statements had overstated Pemstar's earnings by more than $6 million, which were primarily attributable to overstated inventory and accounts receivable at Pemstar Mexico. As Defendants admitted in Pemstar's restated annual report on Form 10-K for the year ended March 31, 2004 (the "Restated 2004 Form 10-K"):

> The Company has restated its Consolidated Balance Sheet, Consolidated Statement of Operations, Consolidated Statement of Shareholders' Equity and Consolidated Statement of Cash Flows as of and for the year ended March 31, 2004 to reflect corrections for errors identified as a result of its investigation of certain accounting discrepancies related to its Guadalajara, Mexico operation. Findings of this investigation resulted in increased charges in costs of goods sold and selling, general and administrative expenses related to fully recording materials costs and expenses, certain taxes, and asset valuations. ***Accounts payable and inventory were the primary balance sheet accounts affected,*** with various other accounts being less significantly affected.

¶77 (emphasis added). The Restated 2004 Form 10-K wiped out nearly $5.5 million in fiscal 2004 earnings (¶77), impacting each and every quarter in that year (¶¶17, 19-21). In addition, Defendants restated Pemstar's results for the first fiscal quarter for 2005 (ended

June 30, 2004), wiping out a further $709,000 in previously reported earnings. ¶22. Defendants also admitted in the Restated 2004 Form 10-K that "there were significant deficiencies" its internal controls with regard to Pemstar Mexico. ¶27.

Incredibly, none of the severe and pervasive accounting errors and internal control problems were disclosed in the press releases and SEC filings that Pemstar issued at the end of each and every fiscal quarter and year throughout the Class Period (collectively, the "Financial Reports").[4] Instead, throughout the Class Period Defendants reported materially misleading financial results, including inflating Pemstar's earnings by over $6 million. ¶¶15-17, 19-22; *see* ¶¶23-24.

C. Defendants' Misrepresentations About Pemstar's Vendors

Throughout the Class Period, Pemstar was frequently unable to generate enough cash to pay its bills from vendors for component parts, which caused Pemstar's vendors to repeatedly refuse to ship necessary components to the Company. Indeed, according to Pemstar's Vice President of Worldwide Supply Chain (the "VP WSC") (Plaintiff's Confidential Witness "B"), from February 2003 through January 2005 Pemstar was forced to close its production lines ***every month*** because vendors repeatedly refused to send parts to Pemstar due to Pemstar's non-payment. ¶45. For example, between February 2003 and February 2004, Pemstar owed one supplier ("Arrow") as much as $60 million, which

[4] Defendant Lea was consistently listed as a contact person for these press releases, and Defendants Berning and Lea signed each of the false SEC filings. *Id.*

frequently caused Arrow to stop component shipments. ¶46. Confidential Witness "B" devoted over half of his time between February 2003 and February 2004 to attempting to convince vendors to keep open Pemstar's credit lines. ¶44. Defendant Lea worked side-by-side with Confidential Witness "B" in making these calls (handling the larger accounts himself), and took over full responsibility for this task in February 2004. *Id.* Nonetheless, Defendants concealed these critical disputes with Pemstar's vendors. Indeed, Defendants affirmatively (and falsely) claimed in Pemstar's Form 10-K for the fiscal year ended March 31, 2003 (the "2003 Form 10-K"), that Pemstar had "strong relationships with a broad range of materials and component suppliers." ¶28

D. Pemstar's Need For Operating Funds

Defendants' cash flow crisis gave them a powerful motive for fraud. As a result of Pemstar's need for operating funds, Pemstar was forced to borrow funds from lenders and raise funds from investors. On April 25, 2003, Pemstar entered into a Loan and Security Agreement with various lenders which provided Pemstar with a revolving line of credit of up to $90 million (the "Loan Agreement"). ¶¶62, 64. However, the terms of the Loan Agreement limited Pemstar's ability to borrow to an amount based upon Pemstar's "eligible collateral." "Eligible collateral" was primarily determined by the amount of Pemstar's inventory and accounts receivable (*i.e.*, the very items falsified in Pemstar Mexico's financial results). *Id.* Accordingly, Pemstar had to report significant levels of inventory and accounts receivable in order to obtain funds under the Loan Agreement.

Defendants also obtained operating funds by selling Pemstar stock to the public through a Secondary Public Offering. In August 2003, Pemstar raised approximately $20.1 million from a Secondary Offering of approximately 7.5 million shares of Company stock. ¶¶18, 67. As discussed below, the financial results of Pemstar contained in the Secondary Public Offering Prospectus (the "SPO Prospectus") used to raise the $20.1 million were materially false and misleading.

III. THE APPLICABLE STANDARD OF REVIEW ON A MOTION TO DISMISS

A. The Standard Of Review On A Motion To Dismiss

It is well settled that, as with any complaint, a securities fraud complaint may be dismissed "***only*** if the plaintiffs can prove ***no set of facts*** that would entitle them to the relief requested." *Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 829 (8th Cir. 2003) (emphasis added); *In re NovaStar Fin. Sec. Litig.*, No. 04-0330-CV-W-ODS, 2005 WL 1279033, at *2 (W.D. Mo. May 12, 2005) (same). The factual allegations of a complaint must be taken as true and the complaint, as a whole, must be considered in the light most favorable to plaintiffs; all reasonable inferences must be drawn in favor of the plaintiffs and against defendants. *Gebhardt*, 335 F.3d at 829. The Private Securities Litigation Reform Act of 1995 ("PSLRA") did not alter these pleading standards. *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 666 (8th Cir. 2001) (PSLRA "does not license [the Court] to resolve disputed facts at this stage of the case"); *In re Stellent, Inc. Sec. Litig.*, 326 F. Supp. 2d 970, 979 (D. Minn. 2004) ("[o]n a motion to dismiss an action covered by the

[PSLRA], the Court still views factual allegations in the light most favorable to the plaintiff and assumes the truth of particularly pleaded allegations").

B. The Standard Under The PSLRA For Alleging Claims Under Section 10(b)

The PSLRA affected only two pleading requirements for claims asserted under Section 10(b) of the Exchange Act – specificity and scienter.[5]

1. The PSLRA's Specificity Requirement

Under the PSLRA, a complaint must identify each statement alleged to have been misleading and set forth the reason or reasons why the statement is misleading. 15 U.S.C. §78u-4(b)(1). The "purpose" of the PSLRA's specificity requirement is simply to "ensure the defendants are given sufficient notice of the allegations against them." *In re Engineering Animation Sec. Litig.*, 110 F. Supp. 2d 1183, 1190 n.10 (S.D. Iowa 2000).

2. The PSLRA's Scienter Pleading Standard

Under the PSLRA, a complaint also must allege facts giving rise to a strong inference of scienter. 15 U.S.C. §78u-4(b)(2). A defendant acts with scienter when the alleged misrepresentation is made knowingly or recklessly. *Green Tree*, 270 F.3d at 653 and n.7 (scienter may be pled by allegations of either reckless or knowing misrepresentation); *In re Xcel Energy, Inc.*, 286 F. Supp. 2d 1047, 1057 (D. Minn. 2003) (same). A plaintiff properly

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[5] Even after enactment of the PSLRA, plaintiffs need only satisfy the notice pleading standard of Fed. R. Civ. P. 8 with respect to pleading "materiality and loss causation." *Dura Pharmaceuticals, Inc., v. Broudo*, 125 S.Ct. 1627, 1634 (2005); *Gebhardt*, 335 F.3d at 830 n.3.

alleges that a defendant acted knowingly or recklessly under the PSLRA by specifically alleging that that defendant had knowledge of facts or access to information contradicting their public statements. *Green Tree*, 270 F.3d at 665 ("[o]ne of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate") (collecting cases); *In re McLeodUSA Inc. Sec. Litig.*, No C02-001-MWB, 2004 WL 1070570, at *5. In determining whether plaintiffs have pleaded a "strong inference" of scienter, the Court should examine the totality of the allegations. *McLeodUSA*, 2004 WL 1070570 at * 5. A strong inference of scienter may be properly alleged through circumstantial evidence. *Green Tree*, 270 F.3d at 660; *In re PeopleSoft, Inc. Sec. Litig.*, No. C 99-00472 WHA, 2000 WL 1737936, at *3 (N.D. Cal. May 25, 2000) (unless circumstantial evidence could be used to infer scienter, defrauded investors could never recover their losses as "it is rare that perpetrators of fraud would confess outright").

IV. DEFENDANTS' MOTION TO DISMISS MUST BE DENIED

A. The Complaint Adequately Pleads Primary Violations Under Section 10(b)

1. The Complaint Satisfies The PSLRA With Respect To Defendants' Misrepresentations Concerning Pemstar Mexico

The detailed allegations in the Complaint satisfy the specificity and scienter pleading requirements of the PSLRA with respect to Defendants' issuance of the Financial Reports.

a. Plaintiff Has Properly Alleged That Pemstar's Financial Results Were False And Misleading

The Complaint satisfies the PSLRA (15 U.S.C. § 78u-4(b)(1)(B)) because it both alleges specific statements in the Financial Reports that were false and explains in precise detail why they were false. As set forth in the Complaint, Defendants ***restated*** Pemstar's financial results for every quarter in fiscal 2004 and the first quarter of fiscal 2005 to eliminate over $6 million in earnings. ¶¶76-77. As Defendants ***admit*** in their Motion (at 18), "restatements are corrections of errors." Indeed, it is well-established that the "mere fact" that a company restated its financial results is by itself sufficient to plead that the original financial results were false when made and therefore to defeat a motion to dismiss.[6]

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[6] *See In re Enron Corp. Sec. Deriv. and ERISA Litig.*, No. MDL-1446, Civ. A. H-01-3624, H-04-0088, 2005 WL 3704688, at *17 (S.D. Tex. Dec. 5, 2005) (agreeing with plaintiff that Enron's "restatement of its previously issued financial reports . . . establishes that they were false"); *In re Atlas Air Worldwide Holdings, Inc. Sec. Litig.*, 324 F. Supp. 2d 474, 486-87 (S.D.N.Y. 2004) ("the mere fact that financial results were restated at all is sufficient" basis for pleading that those statements were false when made); *In re Bisys Sec. Litig.*, 397 F. Supp. 2d 430, 437 (S.D.N.Y. 2005) (citing *Atlas*); *In re First Energy Corp. Sec. Litig.*, 316 F. Supp. 2d 581, 594-95 (N.D. Ohio 2004) (agreeing with plaintiff that defendant's restatements "establish the falsity of its earlier financial statements" and finding "unpersuasive" defendants' argument to the contrary, because "the purpose of a restatement is to correct an error in a previously-issued financial statement. By definition then, a restatement says that the prior financial statement was false"); *In re National Golf Properties Inc. Sec. Litig.*, No. CV 02-1383GHK(RZX), 2003 WL 23018761 at *5 (C.D. Cal. March 19, 2003) ("By restating these financials after the [initial SEC filing], Defendants essentially admit that the statements included in the [SEC filing] were false"); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1084 (N.D.Cal 2001) ("mere fact" that financial results restated sufficient to establish falsity at pleading stage). Tellingly, the ***only*** case relied upon by Defendants (Motion at 13-17) in attacking the sufficiency of Plaintiff's allegations of falsity (for the general principle that fraud must be pled with specificity) does ***not*** involve a restatement. *See In re Navarre Corp. Sec. Litig.*, 299 F.3d

Moreover, even if the existence of the restatement was not itself enough to establish the falsity of Pemstar's financial results (which it is), Defendants explicitly ***admitted*** in their restatement that Pemstar Mexico had falsely inflated, *inter alia*, its accounts receivable and inventory, and acknowledged that "there were significant deficiencies in the design or operation of its internal control." ¶27. In addition, as set forth above, Plaintiff has provided extraordinary detail, from high-level confidential witnesses, concerning the facts underlying the financial statement misrepresentations in Pemstar Mexico's and Pemstar's financial results. ¶¶14, 30-59.[7]

Similarly, Plaintiff has sufficiently pled that Pemstar's financial results for the quarters ended December 31, 2002, and March 31, 2003 (and for the year ended March 31, 2003 as a whole) were false and misleading. As detailed in the Complaint, Pemstar Mexico's Controller specifically refused to sign Pemstar Mexico's financial results for the quarter ended September 30, 2002, because they were false and inaccurate, and instead resigned from the Company. ¶14. However, these false financial results were nonetheless reported by Defendants during the Class Period.[8]

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735 (8th Cir. 2002).

[7] Defendants do not dispute Plaintiff's allegation that the size of the $6 million (or 34%) overstatement of Pemstar's financial results was material to Class Members.

[8] Defendants' argument that "plaintiff fails to inform the Court" that Pemstar's fiscal year 2003 financials were not restated (Motion at 14) is simply wrong. The Complaint makes clear which financial statements were and were not restated. *Compare* ¶¶15-16 *with* ¶¶17, 19-22. Moreover, Defendants' implicit argument – that the fiscal year 2003 financials therefore were not false when made because there was no restatement – is

Given the overwhelming specificity and detail underlying the allegations of falsity in the Complaint, Defendants are incorrect (Motion at 13-17) that Plaintiffs have not provided sufficient detail concerning the falsity of Defendants' financial reports. As discussed above, there is no real dispute concerning the falsity of Defendants' statements, as Defendants restated Pemstar's financial results. Moreover, contrary to Defendants' argument, it is well-settled that a plaintiff is not required to plead the level of ***evidentiary*** detail demanded by Defendants in order to satisfy the specificity requirements of 15 U.S.C. §78u-4(b)(1). Every Court of Appeals to consider the issue has wisely recognized that it is unreasonable to require a plaintiff to allege – prior to the institution of discovery – such minor details that are in the sole possession of defendants. *See, e.g., Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 n.8 (4th Cir. 2003) ("[i]t is inappropriate at the pleading stage, before any discovery, to require [plaintiff] to cite specific transactions"); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 32-33 (1st Cir. 2002) (plaintiff need not allege precise details underlying misconduct, especially where there has been no discovery); *In re Scholastic Corp. Sec. Litig.*,

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also incorrect. While the existence of a restatement establishes falsity, the absence of a restatement does ***not*** establish the accuracy of the initial financial statements. Defendants cite no cases supporting – and themselves do not seriously advance – such an absurd proposition. Here, not only has Plaintiff alleged specific facts demonstrating that Pemstar's 2003 financials were inflated (as discussed above), but Defendants acknowledged in the January 13 Form 8-K that Pemstar Mexico's fraud may extend back that far. ¶73. Although Defendants have yet to actually restate for fiscal 2003, that failure in no way signifies that Pemstar's 2003 financial were true and accurate. Notably, Defendants have never rescinded the concerns expressed in the January 13 Form 8-K or represented that, notwithstanding Pemstar's warnings, the 2003 financial results in fact were correct.

252 F.3d 63, 72 (2d Cir. 2001) (plaintiff not required to plead evidence to satisfy specificity requirement of PSLRA).[9]

b. Plaintiff Has Properly Alleged That Defendants Acted With Scienter In Misrepresenting Pemstar's Financial Results

The Complaint also satisfies the PSLRA's scienter pleading standard as the detailed allegations, taken together, give rise to a "strong inference" that Defendants acted knowingly or recklessly in issuing the false Financial Reports. 15 U.S.C. §78u-4(b)(2). The PLSRA's

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[9] *See In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 584 (D.N.J. 2001) (because requiring plaintiffs to plead evidentiary detail "prior to discovery . . . may permit sophisticated defrauders to successfully conceal the details of their fraud," plaintiff need not plead detailed "factual information [that] is peculiarly within defendant's knowledge or control") (internal citations and quotation marks omitted); *In re World Access, Inc. Sec. Litig.*, 119 F. Supp.2d 1348, 1355 (N.D. Ga. 2000) (court rejected defendants' argument that PSLRA complaint had to "describe in detail each single specific transaction in which Defendant transgressed, by customer, amount, and precise method"); *In re First Merch. Acceptance Corp. Sec. Litig.*, No. 97 C 2715, 1998 WL 781118, at *8 (N.D. Ill. Nov. 4, 1998) (plaintiffs not required to allege precise amount of overstatement of earnings "given that most of this information is in the hands of the defendants"); *Chu v. Sabratek Corp.*, 100 F. Supp.2d 815, 821 (N.D. Ill. 2000) ("Although we agree with [defendants] that the plaintiffs have failed to allege several details regarding [defendants'] allegedly improper revenue recognition practices, such as the dollar amounts by which [defendants' results] have been misstated as a result of these transactions, the plaintiffs have alleged sufficient facts to meet their burden at this stage in litigation."); *Danis v. USN Communications, Inc.*, 73 F. Supp.2d 923, 935 & n.6 (N.D. Ill. 1999) ("Plaintiffs need not state the amount by which [defendants'] financial statements were in error."); *In re Computer Assocs. Class Action Sec. Litig.*, 75 F. Supp.2d 68, 73 (E.D.N.Y. 1999) ("Unknown specifics, such as the exact amount the earnings have been overstated are not fatal in this case."); *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp.2d 1, 26-27 (D. Mass. 1999) (holding pleading of misstatement on inventory valuation is sufficiently specific to survive motion to dismiss where it relies on industry trade publications to support overvaluation); *Carley Cap. Group v. Deloitte & Touche*, LLP, 27 F. Supp.2d 1324, 1335 (N.D. Ga. 1998) ("complaint need not specify the exact dollar amount of each accounting error").

scienter pleading standard is satisfied where the complaint specifically alleges that the defendant knew or recklessly ignored facts that were contrary to his public statements. *Green Tree*, 270 F.3d at 665 ("[o]ne of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate") (collecting cases). As detailed above, the Complaint includes specific allegations show that each of the Defendants were aware of facts indicating that the financial statements were false. For example, Defendant Berning specifically discussed the fraudulent inflation of the financial results with Pemstar Mexico managers. ¶¶25, 50. Defendant Lea likewise confronted Pavageua about Pemstar Mexico's fraud (¶53), worked closely with the Consultant analyzing the specific details of that fraud (¶36), and told Confidential Witness D that E&Y resigned as Pemstar's auditor in order to escape the risk of liability for that fraud (¶59). Defendant Bauer was given specific evidence of Pemstar Mexico's falsification of its invoices (¶31(a)), and regularly discussed Pemstar Mexico's finances and operations with the General Manager of Pemstar Mexico (¶58). ***All*** of the Individual Defendants discussed Pemstar Mexico's financial results at their "Super Honcho" meetings (and, as discussed above, would table any discussion of Pemstar Mexico at their regular weekly executive meetings that included other managers). ¶¶41-43. In addition, the "sheer size" of Pemstar's

restatement strongly infers scienter. *Green Tree*, 270 F.3d at 666.[10] Pemstar's knowledge of the fraud as a corporate entity is strongly inferred not only from the knowledge of each of the Individual Defendants, but from the extensively pled knowledge of several other high-level Company officers (*see* ¶¶31, 33-35, 37, 39, 40-43, 48, 52, 55-56) as well. *See In re Campbell Soup Co. Sec. Litig.*, 145 F. Supp. 2d 574, 597 (D.N.J. 2001) ("scienter sufficiently pled as to a company's agents may be imputed to the company itself").[11] Despite each Defendant's knowledge that Pemstar Mexico had inflated its financial results, Defendants included Pemstar Mexico's false financial results as part of Pemstar's financial results. ¶¶15-17, 19-23, 24. These specific allegations easily satisfy the standard for properly alleging scienter under the PSLRA. *See Green Tree*, 270 F.3d at 665 (allegations "that defendants published statements with knowledge of facts indicating crucial information in the statements was based on discredited" numbers gives rise "to a strong inference of scienter").

Moreover, Plaintiff's allegations that defendants had an "unusual or heightened

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[10] Although Plaintiff is not relying principally upon GAAP violations to establish scienter, significant GAAP violations of the type alleged by Plaintiff (¶¶15-17, 19-24) can, contrary to Defendants' argument (Motion at 18-19), contribute to a strong inference of scienter. *See In re Daou Sys., Inc.*, 411 F.3d 1006, 1016 (9th Cir. 2005); *Stellent*, 326 F. Supp. 2d at 982; *Engineering Animation*, 110 F. Supp. 2d at 1192; *In re Ancor Comm., Inc. Sec. Litig.*, 22 F. Supp. 2d 999, 1006 (D. Minn. 1998).

[11] The scienter of Pemstar as a corporate entity does not hinge upon the scienter of all – or, indeed, ***any*** – of the Individual Defendants. *See In re Envoy Corp. Sec. Litig.*, 133 F. Supp. 2d 647, 660-664 (M.D. Tenn. 2001) (finding scienter for § 10(b) claim as to corporate defendant based upon misstatements in public filings which were not attributed to any particular defendant or individual, and then ***separately*** analyzing whether plaintiff had adequately alleged scienter as against individual defendants for purposes of individual liability under § 10(b)).

motive" for fraud that led to a "concrete" benefit contributes to a strong inference of scienter. *Green Tree*, 270 F.3d at 659-60. Here, Pemstar's cash situation was dire, leading to monthly production line shutdowns when Pemstar was unable to pay its vendors – an "unusual or heightened" motive for fraud. ¶¶29, 44-46. By misrepresenting Pemstar's financial results, Defendants were able to obtain from lenders and investors the funds necessary to continue operations – a "concrete" benefit. Specifically, Defendants' inflation of Pemstar's financial results enabled Pemstar to raise desperately needed funds in the August 2003 Secondary Offering. ¶¶66-67. *NovaStar,* 2005 WL 1279033, at *6 (defendant's motive to inflate financial results in advance of two stock offerings needed to raise funds sufficiently "concrete" to contribute to strong inference of scienter); *In re Pemstar, Inc. Sec. Litig. ("Pemstar I"),* No. Civ. 02-1821 DWFSRN, 2003 WL 21975563 (D. Minn. Aug. 15, 2003) (plaintiff adequately pled scienter where, *inter alia*, plaintiff alleged that defendants misstated inventory and accounts receivable issues is order to bolster financial results in advance of a secondary public offering).[12] Similarly, by inflating Pemstar's inventory and accounts receivable (*i.e.,* the components of "eligible collateral" under Pemstar's Loan

[12] Defendants' reliance on Second Circuit authority (*Johnson v. NYFIX*, 399 F. Supp. 2d 105, 114 (D. Conn. 2005)) for the proposition that their need to raise money in the Secondary Offering does not contribute to a strong inference of scienter (Motion at 26) is misplaced. In *Johnson*, the court merely held that such allegations, when combined only with a generic allegation that defendants would receive incentive pay based on stock performance, was insufficient to strongly infer scienter. *Id. Johnson* is consistent with the precedent from this Circuit that holds that allegations concerning a secondary offering ***does*** contribute to an inference of scienter when combined, as here, with other particularized allegations concerning Defendants' knowledge and motive.

Agreement), Pemstar obtained money from its lenders under the $90 million Loan Agreement. ¶¶61-65.[13] *In re MicroStrategy, Inc.*, 115 F. Supp. 2d 620, 648 (E.D. Va. 2000) (allegations that defendant misrepresented its financial results in order "to comply with the specific terms of its credit agreement with" its lenders and thus guarantee continuing availability of funds "are sufficiently particularized so as to be probative of scienter"); *In re American Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 445 (S.D.N.Y. 2000) (defendants' alleged motive "to enhance its ability to raise cash under [a] $30 million credit facility agreement" was "a sufficient motive to raise an inference of fraudulent intent").

Defendants' attempt to evade liability on the ground that a "subsidiary's wrongdoing cannot be ***automatically*** imputed to its corporate parent" or its senior officers (Motion at 19; emphasis added) borders on the frivolous. Defendants' argument completely ignores the

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[13] Contrary to Defendants' argument (Motion at 26-27), the fact that the Individual Defendants did sell their own shares of Pemstar stock does not undermine Plaintiff's detailed allegations of scienter. *See, e.g., No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 944 (9th Cir. 2003) ("[s]cienter can be established even if the officers who made the misleading statements did not sell stock during the class period"); *In re CIENA Corp. Sec. Litig.*, 99 F. Supp. 2d 650, 663 (D. Md. 2000) ("[t]he fact that [an individual defendant] was not acting out of personal greed (as demonstrated by his non-sale of his own stock during the class period) is irrelevant under this theory since, even if [he] was acting out of a sense of duty to the corporation, his reason to dissimulate would be equally strong. Under the securities laws, purity of intent cannot alone excuse deceptive conduct"); *In re McKesson HBOC, Inc. Sec. Litig.*,126 F. Supp. 2d 1248,1269 (N.D. Cal. 2000) (because "personal gain [] is not a required element of scienter or of fraud in general . . . benefit [to] the speaker . . . is of no importance") (citation omitted); *In re Nuko Information Sys. Inc. Sec. Litig.*, 199 F.R.D. 338, 344-45 (N.D. Cal. 2000) ("the absence of Defendants' selling or trading has little bearing on determining whether Plaintiffs have adequately pleaded scienter").

factual allegations in the Complaint (discussed above) specifically showing that each Individual Defendant knew that Pemstar Mexico's financial results were false and overstated, and that they nonetheless included those false results in Pemstar's reported Financial Reports.[14] Thus, contrary to Defendants' argument, Plaintiff does ***not*** seek to "automatically" impute knowledge of the financial errors to anyone, but has shown a strong inference of knowing or reckless misrepresentations based on specific allegations of intentional wrongdoing.[15]

Defendants' argument that the Complaint does not allege scienter because it fails to provide ***enough*** detail about the Company's misrepresentations (Motion at 20-25) is also hopelessly without merit. As set forth above, the Complaint includes extensive detail

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[14] As a result of the inclusion of these specific factual allegations of knowledge, Defendants' reliance on *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999), *Chill v. Gen. Elec.* Co., 101 F.3d 263 (2d Cir. 1996), and *Svezzese v. Duratek*, 67 Fed. Appx. 169 (4th Cir. 2003) (Motion at 19-20) is wholly without merit. In each case, the plaintiff failed to allege ***any*** facts indicating that a corporate parent or its officers had any knowledge of its subsidiary's misconduct. *Comshare*, 183 F.3d at 553-54 (plaintiff's allegations of corporate parent's knowledge based purely on "speculation"); *Chill*, 101 F.3d at 270 ("[f]raud cannot be inferred simply because GE might have been more curious or concerned about the activity at" its subsidiary); *Svezzese*, 67 Fed. Appx. at 173 ("plaintiffs fail to point to ***any*** evidence" of fraudulent intent) (emphasis added).

[15] Moreover, Plaintiff has alleged extensive facts demonstrating that Pemstar and the Individual Defendants were control persons of Pemstar Mexico. *See* ¶¶8-10, 31, 33-39, 47-59, 68-69. Plaintiffs have also alleged extensive facts demonstrating that Pemstar Mexico was aware of its own misrepresentations. *See* ¶¶14, 25, 31-33, 38, 47-53. Accordingly, as control person of Pemstar Mexico, Pemstar and the Individual Defendants may be held liable under §20 of the Exchange Act for Pemstar Mexico's misrepresentations. If necessary, Plaintiff would amend the Complaint to specifically allege Defendants' control person liability for Pemstar Mexico's misrepresentations.

demonstrating that Defendants "knew of the scheme at the time they made their statements" (Motion at 20). ¶¶25, 31, 33-37, 39, 40-43, 48, 50, 52-53, 55-56, 58-59. Although Defendants discuss several ***additional*** facts that Plaintiff ostensibly should have alleged, Defendants provide ***no*** support for the proposition that Plaintiff was ***required*** to plead such facts (especially at the motion to dismiss stage, before any discovery has occurred). *See Kushner v. Beverly Enterprises, Inc.*, 317 F.3d 820, 827 (8th Cir. 2003) (there is no "particular method[] of satisfying [the PSLRA's scienter] requirement"); *McLeodUSA*, 2004 WL 1070570, at *6 (rejecting defendants' argument that scienter not pled with sufficient specificity where complaint alleged, based on confidential informant, that defendants had "direct knowledge" that problems existed with integration of new acquisition and that an unspecified "significant percentage" of the revenue from the acquisition was from false orders).

2. The Complaint Satisfies The PSLRA With Respect To Defendants' Misrepresentations Concerning Pemstar's Vendor Relationships

The detailed allegations in the Complaint also satisfy the specificity and scienter pleading requirements of the PSLRA with respect to Defendants' misrepresentations concerning the status of Pemstar's business relationships with its suppliers.

a. Plaintiff Has Properly Alleged That Pemstar's Misrepresentations Concerning Pemstar's Vendor Relationships Were Materially False And Misleading

The Complaint satisfies the PSLRA's specificity requirement with respect to Plaintiff's claim that Defendants misrepresented the status of its business relationships with

Pemstar's suppliers. In accordance with 15 U.S.C. § 78u-4(b)(1)(B), the Complaint alleges the specific statement that was false (Defendants' statement in the 2003 Form 10-K that "[w]e have strong relationships with a broad range of materials and component suppliers and distributors") (¶28), and explains in precise detail why that statement was false – because Pemstar's suppliers routinely refused to ship materials to the Company due to Pemstar's non-payment of bills, which, as discussed above, caused Pemstar's production lines to shut down at the end of ***every month*** between February 2003 and January 2005 (¶¶44-46).

b. Plaintiff Has Properly Alleged That Defendants Acted With Scienter In Misrepresenting Pemstar's Supplier Relationships

The Complaint also satisfies the PSLRA's scienter requirement. Plaintiff specifically alleges Defendant Lea's direct knowledge of, and involvement in, Pemstar's disputes with its suppliers caused by Pemstar's refusal to pay its bills. ¶44. Moreover, given the indisputable significance of the refusal of suppliers to ship Pemstar component parts and the resultant regular production shut-downs, the Court may strongly infer that Defendants Berning And Bauer knew these adverse facts. *See McLeodUSA*, 2004 WL 1070570, at *6 ("when considering a motion to dismiss, making all reasonable assumptions in favor of the plaintiff includes assuming that individuals in top management of a corporation are aware of matters central to that business's operation"); *In re Ancor Comm., Inc. Sec. Litig.*, 22 F. Supp. 2d 999, 1005 (D. Minn. 1998) ("facts critical ***to a business's core operations*** or an important transaction generally are so apparent that their knowledge may be attributed to the

company and its key officers") (emphasis shifted).[16] Pemstar's regular need to halt production due to vendor refusal to deliver supplies is plainly a fact "central to [Pemstar's] operation."

3. The Complaint Properly Alleges "Loss Causation"

Plaintiff has adequately pled that Defendants' misrepresentations caused the losses suffered by Plaintiff and the Class. In order to properly allege "loss causation" under *Dura Pharmaceuticals, Inc., v. Broudo*, 125 S.Ct. 1627 (2005), a complaint merely has to provide "some indication of the loss and the causal connection that the plaintiff has in mind." *Id.* at 1634. As the Supreme Court explained, and as Defendants admit (Motion at 12-13), even under *Dura* the sufficiency of "loss causation" allegations continue to be governed by Fed.

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[16] *See In re Turbodyne Tech., Inc. Sec. Litig.*, No. CV9900697MMMBQRX, 2000 WL 33961193, at *20 (C.D. Cal. Mar. 15, 2000) ("[g]iven the significance of [a certain product] to the company's operations, a strong inference can be drawn that" the president, the COO, and the CFO "knew the true facts respecting the company's manufacturing capacity"); *MicroStrategy*, 115 F. Supp. 2d at 639 (significance of transactions "makes less credible the inference that the Defendants were not aware of or did not recklessly disregard" accounting irregularities regarding underlying transaction); *In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 953-54 (E.D. Pa. 1999) (strong inference that defendants/officers had conscious knowledge of misrepresentations and omissions concerning financial impact and success of integration with acquired company due to their high level executive positions and the significance and importance of the acquisition); *In re Tel-Save Sec. Litig.*, No. 98CV3145, 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"); *Angres v. Smallworldwide PLC*, 94 F. Supp. 2d 1167, 1175-76 (D. Colo. 2000); *accord America West*, 320 F.3d at 941-42 (plaintiff sufficiently pled strong inference of scienter by pleading evidence that airline's aircraft maintenance problems were "severe enough that Defendants must have been aware of it").

R. Civ. P. 8(a). *Id.* at 1634 (further noting that plaintiff need only provide defendants "with notice of what the relevant economic loss might be or of what the causal connection might be between that loss and the misrepresentation"). Thus, even after *Dura*, loss causation is a question of fact not ordinarily amenable to resolution on a motion to dismiss. *See, e.g.*, *Zelman v. JDS Uniphase Corp.*, 376 F. Supp. 2d 956, 973 (N.D. Cal. 2005).

Contrary to Defendants' arguments, in order to properly allege "loss causation," there is no requirement that a stock drop follow an ***express admission or disclosure*** that Defendants' prior statements were ***false***. *See Montalvo v. Triops*, No. 4:03CV995SNL, 2005 WL 2453964, at *9-10 (E.D. Mo. Sept. 30, 2005) (agreeing that "plaintiffs have sufficiently alleged a causal connection between the purported fraud and the inflated stock price" where stock dropped after company admitted had missed contract milestone with important client, even though company did not admit that it had improperly accelerated revenue as charged in the complaint); *In re Retek, Inc. Securities Litig.*, No. Civ. 02-4209 (JRT/SRN) 2005 WL 3059566, at *3-4 (D. Minn. Oct 21, 2005) (loss causation sufficiently alleged where stock price dropped when defendants "revealed figures disclos[ing] the company's *true* financial condition" which "were at odds with the defendants' previous alleged misrepresentations concerning its financial condition," even absent admission of misconduct in defendants' disclosures, where plaintiff alleged that inflation caused by accounting misconduct alleged in the complaint); *In re Daou Sys., Inc., Sec. Litig.*, 411 F.3d 1006, 1026 (9th Cir. 2005), *reh'g en banc denied*, (9th Cir. Aug. 12, 2005) (rejecting the district court's requirement of

express "negative public statements, announcements or disclosures at the time the stock dropped that Defendants were engaged in improper accounting practices" to allege loss causation and holding that it was sufficient under *Dura* to allege that stock drop was caused by reporting negative financial results which were the "direct result of prematurely recognizing revenue") (emphasis removed).[17] Rather, loss causation is sufficiently alleged whenever inflation is removed from a stock's price due to the materialization of the previously misrepresented facts. *See Daou*, 411 F.3d at 1026; *Retek*, 2005 WL 3059566, at *3-4.

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[17] *See Plumbers & Pipefitters Local 572 Pension Fund v. Cisco Systems, Inc.*, No. C 01-20418 JW, 2005 WL 3723202, at *6 (N.D. Cal. Oct. 27, 2005) (denying defendants' *Dura* motion and finding loss causation adequately pled where stock price dropped after defendants disclosed that future results would deteriorate and plaintiff alleged that in fact past results had been inflated by undisclosed misconduct); *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc.*, No. 05 Civ. 1898 (SAS), 2005 WL 2148919, at **12-13, n. 15 (S.D.N.Y. Sept. 6, 2005) (holding that drop in value of securities that occurred when company reported decreased earnings expectations were sufficient to allege "loss causation" where plaintiff alleged that the decreased earnings expectations were caused by the materialization of the concealed adverse facts; court rejected defendants' argument that a complaint must allege that a "corrective disclosure was revealed to the market"); *In re The Loewen Group Inc. Sec. Litig.*, 395 F. Supp. 2d 211, 215, 218 (E.D. Pa. 2005) (denying defendants' motion for summary judgment on loss causation where stock dropped after company announced that earnings would be below consensus analyst forecasts, even though announcement did not admit to accounting improprieties, where plaintiff "offered enough evidence" to demonstrate that the failure to meet estimates was because of the inflated estimates caused by earlier accounting improprieties alleged by plaintiff); *Greater Penn. Carpenters Pension Fund v. Whitehall Jewellers, Inc.*, No. 04 C 1107, 2005 WL 61480, at *4-5 (N.D. Ill. Jan. 10, 2005) (no requirement that the complaint allege a specific direct disclosure or admission that prior financial statements were false to establish loss causation where stock fell after defendant issued lower guidance), *aff'd on reconsideration*, 2005 WL 1563206, at *5-6 (N.D. Ill. June 30, 2005) (foregoing analysis unchanged by *Dura*).

Plaintiff's allegations more than adequately plead loss causation under *Dura*. On June 24, 2004, Defendants announced that E&Y was resigning as Pemstar's auditors. ¶71. E&Y's resignation served to alert investors of potential problems with Pemstar's reported financial results, leading Pemstar's shares to plummet 12%. *Id.* Plaintiffs allege that those problems were the materialization of Pemstar's reporting of Pemstar Mexico's misstated financial results in its own Financial Reports. ¶¶32, 38, 59. Indeed, as Defendant Lea admitted to Confidential Witness "D," E&Y resigned due to, *inter alia*, the potential exposure it faced from the accounting issues at Pemstar Mexico. ¶59. Defendants' November 3, 2004 announcement that "accounting discrepancies" had arisen at Pemstar Mexico again served to alert investors that Pemstar's accounting was problematic, and Pemstar's shares fell 21% as a result. ¶72. Likewise, Defendants' January 13, 2005 admission that the accounting discrepancies at Pemstar Mexico would require Pemstar to reduce its earnings by approximately $6 million caused Pemstar's stock to fall a further 13%. ¶¶73-74. Thus, contrary to Defendants' argument (Motion at 29-30), Plaintiff's loss causation allegations easily meet the requirements of Rule 8 and more than satisfy *Dura*'s requirement that Plaintiff provide "some indication of the loss and the causal connection that the plaintiff has in mind." *See In re Enron Corp. Sec. Deriv. and ERISA Litig.*, No. MDL-1446, Civ. A. H-01-3624, H-04-0087, 2005 WL 3504860, at *16 (S.D. Tex. Dec. 22, 2005) (for purposes of establishing loss causation under *Dura*, "the market may learn of possible fraud [from] a number of sources [including] resignations of . . .auditors" or "announcements

by the company of changes in accounting treatment going forward").[18]

B. The Complaint Adequately Pleads Primary Liability Under Section 11

1. The Securities Act Provides A Broad Remedy To Investors Who Purchased In The Secondary Offering

Section 11 of the Securities Act of 1933 ("Section 11") enforces the important proposition that if an issuer has taken investors' money pursuant to a registration statement (including a prospectus) any part of which contains material misrepresentations or omissions, the people responsible for the registration statement – rather than the investors – should

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[18] The cases cited by Defendants are easily distinguishable. For example, the court in *In re Acterna Corp. Sec. Litig.*, 378 F. Supp. 2d 561 (D. Md. 2005) (Motion at 28-29, 30) held that the plaintiff did not adequately allege loss causation because the stock had already dropped ***94%*** prior to ***any*** alleged disclosure, and, once the alleged "truth" was revealed, the stock only dropped a further ***$0.01***, from $0.34 to $0.33. Moreover, the court found significant the fact that within a week the company's stock was trading at $0.37, or $0.04 ***higher*** than it had before the corrective disclosure. *Id.* at 588-89. Even assuming such an analysis is proper, *Acterna* is readily distinguishable. Here, Pemstar's shares had several drops exceeding 10%. ¶¶71-74. For example, the announcement of E&Y's resignation caused Pemstar's shares to immediately drop ***12%*** (¶71), the announcement on November 3, 2004, that the Company was launching a public investigation of Pemstar Mexico's accounting discrepancies caused the stock to fall ***21.4%*** (¶72), and when Pemstar announced its need to restate $6 million of earnings, Pemstar's shares fell another ***13%*** (¶74). Accordingly, unlike in *Acterna*, a tremendous amount of the decline in the value of Pemstar's shares during the Class Period is directly attributable to disclosures concerning Pemstar's misrepresentations. Moreover, unlike in *Acterna*, Pemstar's shares did not soon recover (and, indeed, have ***never*** recovered) the value from their final drop. *In re Tellium, Inc. Sec. Litig.*, No, 02CV5878FLW, 2005 WL 1677467 (D.N.J. June 30, 2005) (Motion at 28), is similarly distinguishable. There, the plaintiffs had not alleged that the stock drops were anything other than a reflection on an industry-wide stock decline in the telecommunications sector. *Id.* at *27.

suffer the consequences of ***any*** material misrepresentation.[19] Thus, as Defendants admit, Plaintiff need only plead that the SPO Prospectus contained a material misstatement or omission. Motion at 30. Because "Section 11 imposes a stringent standard of liability to ensure that registration statements are prepared in compliance with the disclosure provisions of the Act[, t]he issuer's liability is virtually absolute, even for innocent misstatements." *Romine v. Acxiom Corp.*, 296 F.3d 701, 704 (8th Cir. 2002) (internal quotation marks and citations omitted). Indeed, Section 11 imposes liability ***without proof of fraud or intent*** on anyone involved in the issuance of these new securities, including the issuer (Pemstar) and all directors or other signatories to the registration statement (such as Defendants Berning and Lea). *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309, 315 (8th Cir. 1997).

Moreover, Section 11 imposes liability ***not only*** for false statements and for failure to disclose facts necessary to make statements actually made not misleading (which Section 10(b) of the Exchange Act does as well) ***but also*** for the omission of any facts "required to be stated [in a registration statement]." Therefore, Section 11, unlike Section 10(b) of the Exchange Act, permits liability for a pure omission of a material fact. *NationsMart*, 130 F.3d at 314-15. The type of information "required to be stated" in a registration statement includes the information required under Item 303 of SEC Regulation S-K, 17 C.F.R. §229.303 ("Item 303"). *Oxford Asset Management, Ltd v. Jaharis*, 297 F.3d 1182, 1191-92

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[19] As Defendants admit (Motion at 30 n. 7), the PSLRA's pleading standards do not apply to a claim under Section 11.

(11th Cir. 2002); *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1296 (9th Cir. 1998); *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1204-05 (1st Cir. 1996); *In re Gander Mountain Co. Sec. Litig.*, No. Civ. 05-183DWFAJB, 2006 WL 140670, at *15 (D. Minn. Jan. 17, 2006). Item 303 requires, in part, disclosure of:

> any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations . . .

17 C.F.R. §229.303(a)(3)(ii). Item 303 "essentially says to a registrant: If there has been an ***important change in*** your company's business or ***environment*** that ***significantly or materially decreases the predictive value of your reported results***, explain this change in the prospectus." *Oxford*, 297 F.3d at 1191-92. Therefore, Section 11 required disclosure of known adverse trends or uncertainties that existed as of August 7, 2003, the date Pemstar issued the SPO Prospectus. *See Shaw*, 82 F.3d at 1205 n.9, 1208; *Milman v. Box Hill Sys. Corp.*, 72 F. Supp. 2d 220, 230-31 (S.D.N.Y. 1999); *NationsMart*, 130 F.3d at 314 (sustaining Section 11 claim that alleged, *inter alia*, that prospectus failed to disclose trends or uncertainties).

2. The SPO Prospectus Contains Untrue Statements And Omits Material Facts In Violation Of Section 11

The Complaint adequately alleges that the SPO Prospectus contains material misstatements and omissions in violation of Section 11. Defendants do not – and cannot – dispute that SPO Prospectus was false and misleading. The SPO Prospectus included

financial results for portions of fiscal 2004 that Defendants subsequently ***restated***. ¶¶17-18, 77. As discussed above, Defendants ***admitted*** that the restatement was to correct for falsely inflated inventory and accounts receivable (¶77) (and, in any event, the fact of the restatement itself sufficiently demonstrates falsity at this stage of the litigation). Moreover, Plaintiff has alleged in detail that the fiscal year 2003 financial results incorporated in the SPO Prospects were also false and misleading. *See* ¶¶14-16; *see* ¶¶31, 47-52. Indeed, Pemstar Mexico's controller resigned rather than signing-off on those false financial results. ¶14.

Not only did the SPO Prospectus contain financial results that were affirmatively false and misleading, but Defendants failed to disclose material information necessary to make the SPO Prospectus not misleading in violation of Section 11. Specifically, the SPO Prospectus failed to disclose the material fact that Defendants knew that Pemstar Mexico was falsifying its financial results, and that Pemstar's failure to pay its vendors was leading to monthly production shut-downs. ¶¶44-45.

Finally, Defendants violated Item 303 (and thus Section 11) by failing to disclose "known trends and uncertainties" that were "reasonably" likely to have an adverse impact on the Company. In the 2003 Form 10-K, Defendants had touted the strength of Pemstar's relationships with its vendors. Although Defendants omitted this representation from the SPO Prospectus, Item 303 required them – and Defendants failed – to affirmatively disclose the "known trend" that Pemstar's vendors were refusing to supply Pemstar, leading to

monthly production shut-downs. ¶¶44-45.

3. Defendants' Sole Argument For Dismissing Plaintiff's Section 11Claim Is Without Merit

Defendants' ***only*** argument for dismissal of Plaintiff's Section 11 claims – that the misrepresentations in the SPO Prospectus are immaterial as a matter of law because the SPO Prospectus somehow warned investors that Pemstar Mexico's financial results were false and misleading (Motion at 30-33) – is entirely without merit. All of the purported "caution[ary]" statements relied upon by Defendants (*see* Motion at 3-5, 32-33) merely refer to problems that ***could*** occur ***in the future***. It is well-settled that "cautionary statements" or risk warnings do not immunize Defendants for misrepresenting past or present facts or for concealing problems had ***already*** occurred at Pemstar.[20] *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273, 1280 (D. Minn. 1997) (cautionary statements in offering materials do not render immaterial misrepresentations of "presently known facts" about defendant's business performance: "[b]y omitting any reference to that which allegedly had occurred already, defendants' disclosures could be materially misleading even though these disclosures

[20] As Defendants acknowledge, the "warnings" in the SPO Prospectus simply state that "[w]e face risks associated with coordinating multinational operations;" that "[w]e have limited experience in managing geographically dispersed operations and in operating in foreign countries;" that "***if*** we fail to manage our inventory effectively, we may bear [certain] risks [that may] decrease our profit margins;" and that Pemstar had made inventory adjustments in the past and "***may be*** required to recognize similar charges in future periods." Motion at 32-33.

contained specific, forward-looking warnings regarding certain risks").[21] Moreover, even if Defendants' statements were forward-looking (which they were not), none of the "boilerplate" warnings from the SPO Prospectus specifically warn investors – or even remotely disclose – that Pemstar Mexico's financial results were false and inflated or that Pemstar was experiencing severe supply problems. "Cautionary statements, however, cannot be general risk warnings or mere boilerplate; they must be detailed and specific." *NationsMart*, 130 F.3d 317.

Indeed, the court in *Pemstar I* summarily rejected Defendants' identical arguments with regard to plaintiff's Section 11 claims in that litigation. *Pemstar I*, 2003 WL 21975563,

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[21] *See Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 947 (9th Cir. 2005) (reversing district court for improperly "extend[ing] the bespeaks caution doctrine to statements of fact, despite the lack of approval from this circuit for such application of the doctrine as well as the explicit rejection of such an extension" by several other Courts of Appeal); *EP Medsystems, Inc. v. EchoCath, Inc.*, 235 F.3d 865, 874 (3rd Cir. 2000) ("bespeaks caution" doctrine limited to forward-looking statements); *Ruskin v. TIG Holdings, Inc.*, No. 98 Civ. 1068 (LLS), 2000 WL 1154278, at * 7 (S.D.N.Y. Aug. 14, 2000); *Danis v. USN Communications, Inc.*, 73 F. Supp. 2d 923, 935 (N.D. Ill. 1999) ("warnings of future risk cannot adequately caution against a misstatement of historical, present facts"); *Shaw*, 82 F.3d at 1213 (holding cautionary language cannot render a false statement of present fact immaterial); *Gray v. First Winthrop Corp.*, 82 F.3d 877, 883 (9th Cir.1996) (indicating the bespeaks caution doctrine is not applicable to misrepresentations of historical fact) *In re Prudential Secs. Inc. P'ships Litig.*, 930 F.Supp. 68, 72 (S.D.N.Y.1996) (safe harbor offers "no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away"); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981), aff'd in relevant part and rev'd in part on other grounds, 459 U.S. 375 (1983) ("To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit.").

at *8-9 (misstatements in offering prospectus not rendered immaterial by purported cautionary language because "Defendants were aware that some of the information contained in the financial portion of the Registration Statement was [already] false based on events [already] taking place at [various] facilities over the prior 6 months").[22]

C. The Complaint Adequately Pleads Control Person Liability Under Section 20

Plaintiff has adequately pled the Individual Defendants' control person liability under Section 20 of the Securities Exchange Act of 1934 ("Exchange Act") . The Individual Defendants do ***not*** dispute that they are control persons of Pemstar. Their sole argument for dismissal of the control person claims – that Plaintiff has failed adequately to allege that Pemstar committed a primary violation – is without merit, as discussed above. Accordingly, Defendants' motion to dismiss the Section 20 claims should be denied.

D. Plaintiff's Claims Are Not Barred By *Res Judicata*

Defendants' argument (Motion at 34-35) that the Class Members in ***this*** litigation cannot recover against Defendants because ***an entirely different*** class settled its claims

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[22] As the *Pemstar I* court expressly concluded, both of the cases cited by Defendants (at Motion at 31-32 as well as in *Pemstar I*) are inapposite. Defendants' reliance on *Parnes v. Gateway 2000 Inc.*, 122 F.3d 539 (8th Cir. 1997), is misplaced because "the court in *Parnes* dealt with disclosures of future risk. Here, the Plaintiffs allege that those risks had already become reality by the time the Registration Statement had been filed." *Pemstar I,* 2003 WL 21975563, at *9. In *Oxford*, 297 F.3d 1192 defendants failed to disclose a trend that had only begun six weeks earlier in preliminary sales reports, whereas here (as in *Pemstar I*) "Plaintiffs allege Pemstar executives were aware of some of the problems at the facilities a full six months [or more] prior to the filing of the Registration Statement." *Pemstar I*, 2003 WL 21975563, at *9.

against Defendants in ***an entirely different litigation*** is utterly frivolous. Plaintiff brought the present litigation on behalf of a class of investors who purchased Pemstar shares from January 30, 2003 through and including January 12, 2005. The class in the prior litigation against Pemstar (*Pemstar I*) involved shareholders who purchased Pemstar shares between June 8, 2001 and May 3, 2002. Defendants do not dispute – nor could they – that investors who purchased Pemstar shares during the Class Period of ***this*** litigation and who are ***not*** members of the *Pemstar I* class (and thus are not bound by the *Pemstar I* settlement agreement) may recover in this litigation. However, Defendants erroneously argue that Class members in this case who also purchased Pemstar shares during the class period in *Pemstar I* may not maintain their present claims.

Defendants' argument completely ignores the express language of the "Final Judgment and Order of Dismissal" in *Pemstar I* ("*Pemstar I* Final Order"). *See* Declaration of Seth R. Klein, Ex. A. The *Pemstar I* Final Order ***only*** bars further claims related to "***both (1) the purchase or sale of PEMSTAR common stock during the [Pemstar I] Class Period, and*** (2) the allegations set forth or that could have been set forth in the [*Pemstar I* litigation]." *Pemstar I Final Order*, at ¶8(b) (emphasis added). Clearly, the claims in the present litigation do ***not*** seek recovery for any shares purchased or sold during the *Pemstar I* class period. Accordingly, the *Pemstar I* Final Order does ***not*** bar investors who purchased Pemstar shares during both class periods and who participated in the settlement of *Pemstar I* from participating in the present litigation.

V. CONCLUSION

For the foregoing reasons, Defendants' motion to dismiss should be denied in its entirety. In the event that the Court determines that any of the allegations in the complaint are insufficient, Plaintiffs respectfully request leave to amend the Complaint to remedy any such insufficient allegations.

Dated February 15, 2006

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