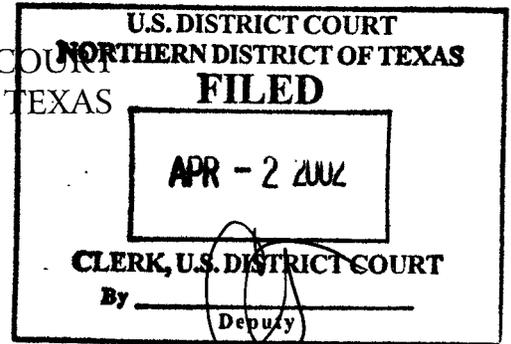


IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF TEXAS  
DALLAS DIVISION



DOUGLAS HAACK, on behalf of himself )  
and all other similarly situated, ET AL., )  
 )  
Plaintiffs, )  
 )  
VS. )  
 )  
MAX INTERNET )  
COMMUNICATIONS, INC., ET AL., )  
 )  
Defendants. )

CIVIL ACTION NO.  
3:00-CV-1662-G  
CONSOLIDATED WITH  
3:00-CV-1719; 1724; 1741;  
1747; 1785; 1814; 1853;  
2016 and 2127-G



MEMORANDUM ORDER

Before the court are the motions of the defendants Max Internet Communications, Inc. ("Max Internet"), Lawrence R. Biggs, Jr., Harold L. Clark, Leslie D. Crone and Donald G. McLellan (collectively, "the individual defendants") to dismiss this case.<sup>1</sup> Also before the court is Max Internet's motion to strike. For

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<sup>1</sup> On July 17, 2001, Max Internet filed a motion to dismiss the plaintiff's Douglas Haack and all others similarly situated (collectively, "Haack") First Consolidated Amended Complaint ("complaint") under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b)(3), and FED. R. CIV. P. 12(b)(6) and 9(b). See Brief in Support of Defendant Max Internet Communications, Inc.'s Motion to Dismiss ("Max Internet's Motion to Dismiss") at (continued...)

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the reasons discussed below, the motions to dismiss by Max Internet and the individual defendants are denied and Max Internet's motion to strike is denied as moot.

## I. BACKGROUND

Max Internet, a corporation with its principal place of business in Dallas, Texas, manufactures and markets Max i.c. Live, a personal computer Internet media processor card ("the live card"). Complaint ¶¶ 1, 10. The live card was designed to enhance a computer's video and audio functions by delivering "the power to conduct true-motion, synchronized video and audio communications, as well as video and audio streaming and browsing over a broadband Internet connection . . . ." *Id.* ¶ 1. Following the decline in Max Internet's stock price, Haack, a Max Internet shareholder, brought this securities fraud action on behalf of all purchasers of Max Internet's publicly-traded securities. *Id.* The central allegation in the complaint is that from November 12, 1999 until May 12, 2000 (the "class period"),<sup>2</sup> Max

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<sup>1</sup>(...continued)

Communications, Inc.'s Motion to Dismiss ("Max Internet's Motion to Dismiss") at 1. On that same day, the individual defendants filed a similar motion to dismiss. *See* Defendant Lawrence Biggs', Harold Clark's, Leslie Crone's, and Donald McLellan's Motion to Dismiss and Memorandum Brief in Support Thereof ("Individual Defendants' Motion to Dismiss") at 1. On September 17, 2001, Haack responded to the motions to dismiss. *See* Plaintiffs' Joint Memorandum of Points and Authorities in Opposition to Defendants' Motions to Dismiss ("Response") at 1.

<sup>2</sup> Max Internet reported its first quarter fiscal 2000 results ("F00") on November 12, 1999. Complaint ¶ 2. On May 12, 2000, Max Internet restated its  
(continued...)

Internet issued a series of false and misleading statements and omissions of material fact regarding the live card and the company's near term earnings potential. *Id.* ¶¶ 2-8.

According to the complaint, beginning on November 12, 1999, the defendants represented to the investing community that Max Internet successfully launched the live card and that the product was "positioned to become the industry's standard for video processing over the Internet." *Id.* ¶ 2. Allegedly, Max Internet further represented that improving sales of the live card would result in strong earnings per share growth for the company during the first half of F00. *Id.* Less than two months later, in January of 2000, Max Internet reported that Access 1 Financial initiated coverage of the company's common stock and issued a "buy" recommendation. *Id.* Haack contends that Access 1 repeated Max Internet's representations about the company's prospects for future growth and that Max Internet reported better than expected sales for the live card during the first half of F00. *Id.*

Haack further asserts that the defendants' forecasts artificially inflated Max Internet's stock price by over 600% from November 1999 to February 2000. *Id.* Shortly thereafter, on May 12, 2000, Max Internet revealed that its financial results for the first half of F00 had been overstated, with 98% of its revenues during that

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<sup>2</sup>(...continued)  
earnings for the first half of F00. *Id.* ¶ 3.

period being falsely reported. *Id.* ¶¶ 3, 7. Max Internet subsequently restated its financial results and disclosed that

The Company previously reported sales for the six and three months ended December 31, 1999 in the amount of \$10,770,240 and \$8,133,086 respectively, and net earnings of \$715,433 or \$.04 per share and \$1,072,788 or \$.06 per share for the same periods. The majority of these sales were from Brazil and were booked in reliance upon documentation that was later found to be falsified. As a result, the prior financial statements have been restated by \$10,513,691 for the six months ending December 31, 1999. For the nine months ended March 31, 2000, adjusted revenues were \$397,402 resulting in a loss of \$(.46) per share based on 16,248,188 weighted average shares outstanding.

*Id.* ¶ 3.

As a result of this disclosure, Haack claims, Max Internet's stock price plummeted 69% from \$28 per share on February 9, 2000 to a low of \$4-13/16 on May 12, 2000. *Id.* ¶¶ 2-3. Haack contends that Max Internet's statements during the class period "were false and misleading when issued because Max's financial results were presented in violation of Generally Accepted Accounting Principles ("GAAP")." *Id.* ¶ 4. In particular, Haack maintains that Max Internet falsified its financial earnings by recognizing revenues on the sale of live cards, which did not occur. *Id.* ¶ 4(a). These falsified earnings were achieved in violation of GAAP, he says, by improperly recording non-existent sales to Max Internet Communications do Brasil Ltda, a Brazilian subsidiary of Max Internet, and by shipping the live cards to

wholesalers wherein payment was contingent on resale. *Id.* Haack further claims that the live cards did not work on many of the major manufacturer's platforms and that despite Max Internet's awareness of this defect, the company never attempted to address the problem. *Id.* ¶ 4(i).

Haack filed this case on August 1, 2000 against Max Internet and the individual defendants,<sup>3</sup> alleging that they committed securities fraud in violation of § 10(b) and Rule 10(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), (first claim for relief), and that the individual defendants are individually liable as controlling persons pursuant to § 20(a) of the Exchange Act (second claim for relief). Complaint ¶¶ 91-107. Haack further asserted derivative claims for relief against the individual defendants for intentional and negligent breach of fiduciary duties. Verified Derivative Complaint for Breach of Fiduciary Duty, ¶¶ 1-71, located in Complaint.<sup>4</sup>

In response to the complaint, Max Internet and the individual defendants filed separate motions to dismiss under FED. R. CIV. P. 12(b)(6) and 9(b). Max Internet's

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<sup>3</sup> Defendant Lawrence R. Biggs, Jr., was Max Internet's founder, as well as chairman of the board and chief executive officer of the company during the class period. Complaint ¶ 14(a). Defendant Harold L. Clark was Max Internet's chairman of the board from March 28, 2000 through October 25, 2000. *Id.* ¶ 14(b). Defendant Leslie D. Crone was Max Internet's chief financial officer during the class period. *Id.* ¶ 14(c). Defendant Donald G. McLellan was Max Internet's president and a director of the company during the class period. *Id.* ¶ 14(d).

<sup>4</sup> The derivative complaint was consolidated into this action on October 25, 2000. Complaint at 32, n.3.

Motion to Dismiss at 1; Individual Defendants' Motion to Dismiss at 2-3. On October 17, 2001, Max Internet filed a motion to strike Exhibits 1 through 10 of the Appendix in Support of Plaintiffs' Joint Memorandum of Points and Authorities in Opposition to Defendants' Motion to Dismiss ("Haack's Appendix"), *see* Defendant Max Internet Communications, Inc.'s Motion to Strike ("Motion to Strike") at 1, which Haack opposed. Plaintiffs' Opposition to Defendant Max Internet Communications, Inc.'s Motion to Strike ("Response to Strike") at 1.<sup>5</sup>

On October 23, 2001, the court held a status conference in this case and subsequently ordered the parties to proceed to mediation. *See* Docket Sheet. Apparently, mediation efforts since that time have been to no avail.

## II. ANALYSIS

### A. Legal Standard

To establish a violation of § 10(b) of the Exchange Act and Rule 10b-5, the plaintiffs must allege, in connection with the purchase of the sale of securities, "(1) a misstatement or an omission (2) of material fact (3) made with scienter (4) on which the plaintiff relied (5) that proximately caused [the plaintiff's] injury." *Tuchman v.*

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<sup>5</sup> In the motion to strike, Max Internet requested that the court strike Exhibits 1 through 10 of the appendix in support of Haack's response to Max Internet's motion to dismiss. Motion to Strike at 1. The documents pertain to settlement proceedings between the Securities and Exchange Commission and Max Internet. Because none of the challenged material played a dispositive role in the court's decision to deny the motions to dismiss, Max Internet's motion to strike is denied as moot.

*DSC Communications Corporation*, 14 F.3d 1061, 1067 (5th Cir. 1994). A plaintiff's claims for a violation of § 10(b) of the Exchange Act must satisfy the strict pleading requirements for fraud set out in FED. R. CIV. P. 9(b) and the PSLRA, 15 U.S.C. § 78u-4(b)(3).

1. *Standard for Dismissal Under Rule 12(b)(6)*

Federal Rule of Civil Procedure 12(b)(6) authorizes dismissal of a complaint for "failure to state a claim upon which relief can be granted." However, a motion under Rule 12(b)(6) should be granted only if it appears beyond doubt that the plaintiff could prove no set of facts in support of his claims that would entitle him to relief. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957); *Leffall v. Dallas Independent School District*, 28 F.3d 521, 524 (5th Cir. 1994); see also *Kaiser Aluminum & Chemical Sales, Inc. v. Avondale Shipyards, Inc.*, 677 F.2d 1045, 1050 (5th Cir. 1982) (citing WRIGHT & MILLER, *Federal Practice and Procedure: Civil* § 1357 at 598 (1969), for the proposition that "the motion to dismiss for failure to state a claim is viewed with disfavor and is rarely granted"), *cert. denied*, 459 U.S. 1105 (1983). In determining whether dismissal should be granted, the court must accept all well-pleaded facts as true and view them in the light most favorable to the plaintiff. See *Capital Parks, Inc. v. Southeastern Advertising and Sales System, Inc.*, 30 F.3d 627, 629 (5th Cir. 1994); *Norman v. Apache Corporation*, 19 F.3d 1017, 1021 (5th Cir. 1994); *Chrissy F. by Medley v. Mississippi Department of Public Welfare*, 925 F.2d 844, 846 (5th Cir. 1991).

In the securities context, Rule 12(b)(6) dismissals are difficult to obtain because the cause of action deals primarily with fact-specific inquiries. See *Basic Incorporated v. Levinson*, 485 U.S. 224, 240 (1988).

## 2. *Standard for Dismissal Under Rule 9(b)*

A complaint need only recite a short and plain statement of the claim showing that the pleader is entitled to relief. FED. R. CIV. P. 8(a)(2). When, however, the defendant is charged with fraudulent activity, the plaintiff must state with particularity the circumstances constituting fraud. FED. R. CIV. P. 9(b). Rule 9(b) provides that “[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.” *Id.*

Rule 9(b) permits a plaintiff to allege generally the defendant’s intent to commit fraud. A mere allegation that the defendant had the requisite intent, however, will not satisfy Rule 9(b). *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994); *Tuchman*, 14 F.3d at 1068. To adequately plead fraudulent intent, the plaintiff must set forth specific facts that support an inference of fraud. *Tuchman*, 14 F.3d at 1068. The pleading must include specific details of the time, place, contents, and nature of the activities which form the basis of the allegedly fraudulent conduct, as well as identifying what was obtained through the fraud. *Tel-Phonic Services, Inc. v. TBS International, Inc.*, 975 F.2d 1134, 1139 (5th Cir. 1992) (quoting 5 CHARLES A.

WRIGHT & ARTHUR MILLER, FEDERAL PRACTICE AND PROCEDURE § 1297). Dismissal of a fraud claim for failure to plead the claim with particularity under Rule 9(b) is treated as a dismissal for failure to state a claim under Rule 12(b)(6). See *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015, 1017 (5th Cir. 1996).

## B. Grounds for Dismissal

Max Internet move to dismiss Haack's claims for relief under § 10(b) of Exchange Act on the basis that the company's alleged misstatements are not actionable as a matter of law and that Haack failed to adequately plead scienter. Max Internet's Motion to Dismiss at 8-19. The individual defendants move to dismiss Haack's claims for relief under § 10(b) of the Exchange Act on those grounds as well as for Haack's failure to plead reliance. Individual Defendants' Motion to Dismiss at 10-24. The individual defendants also move to dismiss Haack's claims against them under § 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), on the basis that Haack failed to establish control person liability. *Id.* at 24-25. Each of these arguments will be examined separately to determine whether Haack's complaint meets the stringent pleading requirements of FED. R. CIV. P. 9(b) and the PSLRA.

### 1. *Materiality*

Max Internet and the individual defendants present the same arguments as to why Max Internet's alleged misstatements are not actionable as a matter of law. First, they all maintain that Max Internet's statements regarding its products and

position in the market are not actionable because they amount to mere puffing. Max Internet's Motion to Dismiss at 8-9; Individual Defendants' Motion to Dismiss at 10-11. Second, all defendants assert that Haack cannot base a security fraud claim upon the allegedly misleading nature of the Access 1 Financial report because Access 1 publicly disclosed that it had not issued an independent report. Max Internet's Motion to Dismiss at 9-10; Individual Defendants' Motion to Dismiss at 11-12. In response, Haack contends that he adequately pled the false and misleading nature of Max Internet's statements about the live card and the company's near term earnings potential. Response at 7-19.

To satisfy the first element of a Rule 10b-5 claim, a plaintiff must allege facts showing that the defendant made an untrue statement of material fact, or failed to state a material fact necessary to make the statements that were made not misleading. See *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119-20 (10th Cir. 1997) (citing 17 C.F.R. § 240.10b-5). A statement or omission is only material if a reasonable investor would consider it important in determining whether to buy or sell stock. See *Basic Incorporated*, 485 U.S. at 231-32.

The defendants first seek dismissal of this case by selectively picking out a few statements in Haack's complaint that they contend are not actionable because they amount to puffing. Max Internet's Motion to Dismiss at 8-9; Individual Defendants' Motion to Dismiss at 10-11. While some courts have held that statements classified

as “corporate optimism” are not actionable, see *e.g.*, *Grossman*, 120 F.3d at 1119-20 (collecting cases), the court finds, after a careful review of the complaint, that Haack’s fraud claims satisfy the materiality element of a Rule 10b-5 claim.

First, as Haack notes in his response, the complaint sets forth a series of detailed allegations, which rebut the claim that the company was making merely optimistic statements about its products. Response at 16-19. For example, the complaint alleges defects with the live card, including compatibility problems, which are material to the fraud claims at issue here. Complaint ¶¶ 4(f)-(g), 50, 75.

Further, Haack’s complaint makes specific allegations about Max Internet’s financial affairs and internal operations, which buttress the claim that the defendants were aware or should have been aware that they were making fraudulent statements regarding the live card and the company’s position in the market. *See* Complaint ¶¶ 91-93 (alleging that the defendants claimed extraordinary sales growth and increased revenues during the class period based on sales of the live card in Brazil, which the defendants knew or should have known were in fact grossly overstated); Response at 11-14.

Alternatively, even if the court were to find that these select “puffing” allegations (in total only a few sentences from five different paragraphs of a 52 page

complaint) were not actionable,<sup>6</sup> the defendants fail to address Haack's other detailed allegations of fraud. *See* Response at 8 (“[A]lthough plaintiffs set forth defendants’ statements about Max’s (1) sales to Brazil; (2) sales to ICG and GTI; (3) NASDAQ listing; and (4) Live Card, and detail why each statement was materially false and misleading, defendants, again, ignore the majority of these allegations.”).

Consequently, dismissal on this basis is not warranted. *See STI Classic Fund v. Bollinger Industries, Inc.*, NO. 3-96-CV-823-R, 1996 WL 885802 at \* 1 (N.D. Tex. Oct. 25, 1996) (Sanderson, M.J.) (“The flaw in Defendants’ argument is that it seeks to isolate an element of the circumstances alleged . . . rather than to consider them in their totality.”), *adopted by* 1996 WL 866699 (N.D. Tex. November 12, 1996); *In re Southern Pacific Funding Corporation Securities Litigation*, 83 F.Supp.2d 1172, 1178 (D. Or. 1999) (sustaining complaint because “overall presentation” alleged securities fraud).

The defendants next seek to dismiss this case on the ground that Haack is unable to state a securities fraud claim based upon the Access 1 Report. *See* Max Internet’s Motion to Dismiss at 9-10; Individual Defendants’ Motion to Dismiss at

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<sup>6</sup> Haack cites several cases, *see* Response at 17-19, for the proposition that predictive statements of optimism *may be* actionable where they concern particular factual assertions, *see Zuckerman v. Foxmeyer Health Corp.*, 4 F.Supp.2d 618, 624 (N.D. Tex. 1998) (Maloney, J.) (citing *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994)), or pertain to a company’s core product. *See Hanon v. Dataproducts Corporation*, 976 F.2d 497, 501 (9th Cir. 1992) (“general expressions of optimism may be actionable under the federal securities laws”).

11-12. According to the complaint, “[o]n January 21, 2000, Access 1 issued a report on Max [Internet] with a ‘buy’ recommendation and a 12-month target stock price of \$40 per share . . . .” Complaint ¶ 44. The report allegedly stated that Max Internet’s future growth would be driven by domestic and foreign market penetration with high revenues for the coming fiscal years. *Id.* The information in the report, which was published in its entirety on Max Internet’s web site, apparently came from individual defendant McLellan and other company executives. *Id.* ¶¶ 44-45. Following publication of the Access 1 report, Max Internet’s stock rose 152% from January 19, 2000 to January 26, 2000. *Id.* ¶ 46. Haack alleges that Max Internet failed to disclose that it had paid Access 1 \$25,000 and 30,000 shares of its stock to issue this report. *Id.* ¶ 47(a). The defendants argue that Haack cannot sustain a fraud claim on the basis of the Access 1 report because it was never represented as an independent report. Individual Defendants’ Motion to Dismiss at 11-12; Max Internet’s Motion to Dismiss at 9-10. Haack disputes this contention, asserting that the report was in fact represented as an independent report. Response at 31 (“Defendants’ argument [that the report was never represented as an independent report] is belied by defendant McLellan’s very own admission in the *Wall Street Journal* that he did not disclose this information at the time the report was issued because he did not think it was ‘relevant.’”) (citing Complaint ¶ 63). Because of the legal standard applicable to a Rule 12(b)(6) motion, the court finds that Haack’s

allegations related to Max Internet's publication of the Access 1 report support the securities fraud claims. Stated differently, the court cannot say -- at this stage of the case -- that Haack would be unable to prove any set of facts in support of his claims that would entitle him to relief.

## 2. *Scienter*

Both Max Internet and the individual defendants argue that Haack's suit must be dismissed because the complaint fails to plead particularized facts, which support a strong inference that the defendants acted with scienter. Max Internet's Motion to Dismiss at 10-19; Individual Defendants' Motion to Dismiss at 12-22. The PSLRA provides in part:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, 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).

A plaintiff may meet his scienter pleading obligation based on conscious behavior, severe recklessness, or motive and opportunity. See *Mortensen v. Americredit Corp.*, 123 F.Supp.2d 1018, 1023 (N.D. Tex.) (Fitzwater, J.), *aff'd*, 240 F.3d 1073 (5th Cir. 2000) (table); *Krogman v. Sterritt*, No. 3:98-CV-2895-T, 1999 WL 1455757, at \*3 (N.D. Tex. July 21, 1999) (Maloney, J.) ("A plaintiff may meet the heightened

pleading requirements of Rule 9 and Section 10(b) by alleging either (1) motive and opportunity to commit fraud or by (2) pleading facts which identify circumstances indicating the defendant's conscious or reckless behavior, so long as the totality of the allegations raises a strong inference of fraudulent intent."); cf. *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 410-11 (5th Cir. 2001) (adopting the view of other circuits that scienter can be alleged by pleading facts giving rise to a strong inference of recklessness or conscious misconduct, but that allegations of motive and opportunity standing alone fail to meet the pleading requirement). If a plaintiff fails to meet this pleading requirement of scienter, the court shall, on the motion of the defendant, dismiss the complaint. 15 U.S.C. § 78u-4(b)(3)(A).

The defendants argue that the complaint fails to allege scienter because Haack has not plead a viable motive for fraud, conscious misbehavior, or severe recklessness. Max Internet's Motion to Dismiss at 10-19; Individual Defendants' Motion to Dismiss at 12-22. In response, Haack asserts that the complaint "plead particularized facts demonstrating defendants' knowledge or reckless misconduct on two bases: (1) defendants' GAAP violations and (2) defendants' intimate knowledge of adverse, contemporaneous facts while making false and misleading public representations." Response at 20.

After a careful review of the complaint and the parties' submissions, the court finds that Haack has sufficiently pleaded fraudulent intent. In particular, Haack's

complaint alleges a viable theory of severe recklessness. As noted previously, scienter can be alleged by pleading facts giving rise to a strong inference of severe recklessness. See, e.g., *Nathenson*, 267 F.3d at 409 (“‘severe recklessness’ . . . constitutes scienter for purposes of claims brought under section 10(b) and Rule 10b-5”). The Fifth Circuit has defined “severe recklessness” as being “limited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.” *Id.* at 408 (citing and quoting *Broad v. Rockwell*, 642 F.2d 929, 961-62 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981)).

The court agrees with Haack that the complaint supports the strong inference that the defendants acted with fraudulent intent. Here, Haack makes specific and detailed allegations about the defendants’ violations of GAAP, as well as other alleged misstatements regarding the company’s earnings and technical problems with the live card, which -- when viewed in their entirety -- support Haack’s securities fraud claim. See, e.g., Complaint ¶¶ 71, 88 (alleging that the defendants restated the company’s financial earnings by \$10 million, amounting to a 98% decrease of Max Internet’s revenues during the first half of F00); Response at 24. The overstatement of significant revenues, as is allegedly the case here, supports the claim that the

defendants acted in a severely reckless manner. See *In re MicroStrategy, Inc. Securities Litigation*, 115 F.Supp.2d 620, 637 (E.D. Va. 2000) (“the alleged GAAP violations and the subsequent restatements are of such a great magnitude -- amounting to a night-and-day difference with regards to [defendant’s] representations of profitability -- as to compel an inference that fraud or recklessness was afoot.”); *In Re McKesson HBOC, Inc. Securities Litigation*, 126 F.Supp.2d 1248, 1273 (N.D. Cal. 2000) (“[W]hen significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter. After all, books do not cook themselves.”).

The defendants argue that the alleged GAAP violations and subsequent restatement of Max Internet’s earnings do not support a theory of recklessness on their part. Defendant Max Internet Communications, Inc.’s Reply Brief in Support of its Motion to Dismiss (“Max Internet’s Reply”) at 8-10; Reply in Support of Defendants Lawrence Biggs’, Harold Clark’s, Leslie Crone’s, and Donald McLellan’s Motion to Dismiss, and Brief in Support Thereof (“Individual Defendants’ Reply”) at 9-11. To buttress their claim, the defendants advance two arguments. First, they argue that a restatement of earnings does not automatically support a strong inference of intent to defraud. See Max Internet’s Reply at 8-9; Individual Defendants’ Reply at 9-10. While the court agrees with this general proposition, as previously indicated, the overstatement of significant revenues can support the claim

that the defendants acted in a severely reckless manner. See *In re Micro Strategy*, 115 F.Supp.2d at 637; *Rehm v. Eagle Finance Corp.*, 954 F.Supp. 1246, 1256 (N.D. Ill. 1997) (“While it is true that the mere fact that a company’s financial reporting was inaccurate does not establish scienter, . . . the magnitude of reporting errors may lend weight to allegations of recklessness where defendants were in a position to detect the errors.”). Second, the defendants contend that size of the restatement actually suggests the lack of intentional or reckless conduct on their part. Max Internet’s Reply at 9-10; Individual Defendants’ Reply at 10-11. At present, the court will not entertain this argument because it concerns a factual dispute about motive. See *In re MicroStrategy*, 115 F.Supp.2d at 631 (the court, on a motion to dismiss a securities fraud claim, “must take the factual allegations in the complaint as true, draw whatever inferences regarding the defendant’s state of mind are supported by these allegations, and determine whether these inferences individually or cumulatively provide a strong -- or ‘persuasive’ and ‘cogent’ inference that the defendant possessed the requisite state of mind.”). Accordingly, the court denies the defendants’ motions to dismiss based on Haack’s alleged failure to plead scienter.<sup>7</sup>

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<sup>7</sup> In light of this ruling, the court will not address the defendants’ other argument that Haack has failed to plead scienter on the basis of a viable motive for fraud. See *Nathenson*, 267 F.3d at 412 (“What must be alleged is not motive and opportunity as such but particularized facts giving rise to a strong inference of scienter...”); *McKesson*, 126 F.Supp.2d at 1269 (“[M]otive for fraud, such as personal gain, is not a required element of scienter or of fraud in general.”).

### 3. *Reliance*

The individual defendants seek dismissal of Haack's § 10(b) allegations on the basis that the complaint fails to allege reliance with particularity. Individual Defendants' Motion to Dismiss at 22-24. As Haack notes, the individual defendants appear to concede that the complaint pleads reliance with particularity as to Haack's Rule 10b-5(a) and (c) allegations by relying on the fraud-on-the-market theory.<sup>8</sup> Response at 32. The individual defendants, however, argue that Haack's reliance on fraud-on-the-market theory cannot be claimed for the Rule 10(b)-5(b)<sup>9</sup> allegations.

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<sup>8</sup> The fraud-on-the-market theory allows a plaintiff to satisfy the reliance element of securities fraud without proving direct reliance on false representations. See *Basic Inc.*, 485 U.S. at 241 ("The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . .") (internal citation and quotation omitted). Under this theory, the plaintiff may meet his pleading burden by alleging that he indirectly relied on the misstatements by relying on the integrity of the market. *Id.* at 247.

<sup>9</sup> In relevant part, Rule 10b-5(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

\* \* \*

(b) To make any untrue statement of a material fact necessary in order to make the statements made, in the light of the

(continued...)

Individual Defendants' Motion to Dismiss at 23-24 (citing *Finkel v. Docutel/Olivetti Corporation*, 817 F.2d 356, 362 (5th Cir. 1987)), *cert. denied*, 485 U.S. 959 (1988). In response, Haack argues that any pleading distinction between Rule 10b-5(b) misstatements and other Rule 10b-5 allegations was eliminated by the Supreme Court in its decision in *Basic Inc.* Response at 32. The court agrees with Haack's reading of *Basic Inc.* and concludes that Haack may assert reliance based on the fraud-on-the-market theory in connection with his cause of action under Rule 10b-5(b). See *Basic Inc.*, 485 U.S. at 245-249 (holding presumption of reliance upon misstatements made by corporation, supported by fraud-on-the-market theory, may be applied in Rule 10b-5 cases and that presumption may be rebutted by showing that the stock price was not affected by the misrepresentation or that purchasers or sellers did not trade in reliance on the integrity of the market price.).<sup>10</sup>

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<sup>9</sup>(...continued)

circumstances under which they were made,  
not misleading . . . ,

in connection with the purchase or sale of any  
security.

17 C.F.R. § 240.10b-5.

<sup>10</sup> The court notes that the individual defendants did not reply to Haack's argument on this point. *See generally* Individual Defendants' Reply.

#### 4. *Control Person Liability*

Finally, the individual defendants move to dismiss Haack's claims against them under § 20(a) of the Exchange Act on the basis that Haack failed to establish a basis for control person liability. Individual Defendants' Motion to Dismiss at 24-25. Section 20(a) of the 1934 Act provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a).

Here, the individual defendants argue that Haack's cause of action under § 20(a) fails because the complaint did not allege a primary securities violation. Individual Defendants' Motion to Dismiss at 24. A § 20(a) claim is derivative of a § 10(b) claim. Because the court has previously denied the individual defendants' motion to dismiss Haack's § 10(b) claims, the court denies dismissal under § 20(a) as moot. See, *e.g.*, *Zuckerman*, 4 F.Supp.2d at 627-28.

### III. CONCLUSION

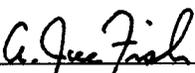
The complaint in this case complies with the requirements of Rules 12 and 9(b) of the Federal Rules of Civil Procedure and the PSLRA. Accordingly, the

motions to dismiss by Max Internet and the individual defendants are **DENIED**.

The motion to strike by Max Internet is **DENIED** as moot.<sup>11</sup>

**SO ORDERED.**

April 2, 2002.

  
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A. JOE FISH  
Chief Judge

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<sup>11</sup> In Haack's response to the individual defendants' motion to dismiss, Haack asserts that the individual defendants waived all defenses to the shareholder derivative action alleged in the complaint by failing to address those allegations in their motion to dismiss. Response at 35 (citing FED. R. CIV. P. 8(c) (requiring all affirmative defenses to be pleaded in a responsive pleading)). The court agrees with the individual defendants, Individual Defendants' Reply at 13-14, that because they only moved to dismiss Haack's securities fraud claims under Rules 12(b)(6) and 9(b), they were not required to file a responsive pleading at this time to Haack's derivative allegations of negligent and intentional breach of fiduciary duties.