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UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

THE CORNELIA I. CROWELL GST TRUST, On Behalf of Itself and All Others Similarly Situated,

Plaintiff,

v.

PEMSTAR INC., ALLEN BERNING, ROY BAUER and GREGORY LEA,

Defendants.

Civil File No. 05-CV-01182(JMR/FLN)

REPLY MEMORANDUM IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS CONSOLIDATED CLASS ACTION COMPLAINT

INTRODUCTION

Plaintiff embellishes the Complaint. Instead of showing how the actual allegations give rise to a strong inference that defendants knew the financial statements were false when they were issued, plaintiff's response memorandum exaggerates the allegations in the Complaint. What remains unanswered is how defendants specifically knew about the need to restate Mexico at the beginning of the class period or why the individual defendants would delay a restatement.

I. PLAINTIFF HAS MISSTATED THE MOTION TO DISMISS STANDARD IN SECURITIES LITIGATION CASES.

As an initial matter, plaintiff attempts to persuade the Court that the motion to dismiss standard for a securities fraud complaint is the same as for any other complaint, citing to Gebhardt v. Conagra Foods, Inc., 335 F.3d 824, 830 n.3 (8th Cir. 2003). Gebhardt, however, is inapposite because it dealt only with materiality and loss

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causation, and the PSLRA's "heightened pleading scienter requirement [was] not involved in [that] appeal." Id.

Instead, as the Eighth Circuit has consistently held, "the special pleading standards adopted by Congress in the PSLRA . . . are unique to securities." In re Navarre Corp. Sec. Litig., 299 F.3d 735, 741 (8th Cir. 2002). This is because the PSLRA "requires that both falsity and scienter be pleaded ***with particularity***." Id. at 742 (emphasis added). Furthermore, the Court must "disregard catch-all or blanket assertions that do not live up to the particularity requirements of the statute." See Florida State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.2d 645, 660 (8th Cir. 2001).

II. PLAINTIFF HAS FAILED TO PLEAD THAT DEFENDANTS KNEW THEIR STATEMENTS WERE FALSE WHEN MADE.

A. PEMSTAR's Restatement Does Not, by Itself, Establish Fraud or Scienter.

Plaintiff argues that because PEMSTAR restated its financials, it has, *ipso facto*, committed securities fraud. But contrary to plaintiff's assertions the mere fact that PEMSTAR had to restate its financial statements does not mean that defendants have committed securities fraud. Because a complaint must allege with particularity facts that defendants knew that the statements were false when made, courts routinely hold that a restatement does not by itself give rise to securities fraud or scienter. See, e.g., In re Comshare, Inc. Sec. Litig., 183 F.3d 542, 553 (6th Cir. 1999); Greebel v. FTP Software, Inc., 194 F.3d 185, 204 (1st Cir. 1999).

Plaintiff's citations to the contrary are incorrect. For instance, the cited section of In re Enron Corp. Sec., Deriv. & ERISA Litig., No. MDL-1446, 2005 WL 3704688, at

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*17 (S.D.Tex. Dec. 5, 2005), did not even concern a Section 10 claim—it concerned a Section 11 claim. The remainder of cases cited by plaintiff, such as In re Atlas Air Worldwide Holdings, Inc. Sec. Litig., 324 F. Supp. 2d 474, 486-88 (S.D.N.Y. 2004), merely stand for the proposition that a restatement means that the previously issued financial statements were in error, but not for the proposition that a defendant automatically knows the restated statements were false when made.

B. Plaintiff Fails to Show that Defendants Knew the Statements Were False When Made.

Plaintiff embellished many of the Complaint's factual allegations in an effort to create the impression of a stronger connection between defendants and the alleged fraud at the Mexico facility. For example, plaintiff argues that the CEO "specifically discussed the fraudulent inflation of financial results," Pl.'s Mem. at 19, even though the paragraphs from the Complaint cited having nothing to do with "fraudulent inflation" but relate instead to the general ledger and the CEO's frustration that certain information had been kept from him. See Compl. ¶¶25, 50. The allegations in the Complaint that the CFO confronted a Mexico General Manager about "financial issues," Compl. ¶ 53, is represented by plaintiff to be a confrontation about "Mexico's fraud" in his responsive memorandum. Pl.'s Mem. at 19.

Plaintiff also asserts that "Defendant Bauer was given specific evidence of Pemstar Mexico's falsification of its invoices," see id., even though the Complaint makes clear that Jorge Ramirez, the subsequently fired general manager of the Mexico facility, merely told Confidential Witness "A" that Controller Larson showed an invoice to Bauer.

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Compl. ¶ 31(a). Plaintiff also does not allege, as required by the PSLRA, ***when*** Bauer or any of the other individual defendants had knowledge of the accounting practices in Mexico. Obviously, defendants eventually learned about the need for a restatement, but they cannot be held liable for knowledge gained due to an investigation after the financial statements had been issued.

Plaintiff has also failed to "connect the dots" between reports that defendants received and knowledge of problems at the Mexico facility. Instead, plaintiff conflates general knowledge of issues at the Mexico facility with specific knowledge that a $6 million restatement was needed. Tellingly, plaintiff has failed to identify any "red flags" that might have put defendants on notice of issues at a time when they could have changed PEMSTAR's reported financial results. Without specific allegations that the defendants should have known that the Mexico facility was overstating its books, defendants' citations to In re Comshare, Inc. Sec. Litig., 183 F.3d 542 (6th Cir. 1999) (stating that a "Court should not presume recklessness or intentional misconduct from a parent corporation's reliance on its subsidiary's internal controls") and Chill v. General Elec. Co., 101 F.3d 263 (2d Cir. 1996), remain directly on point.

In addition, allegations that defendants merely attended meetings or received reports about their operations "is neither surprising nor indicative of fraud." In re Nash Finch Co. Sec. Litig., 323 F. Supp. 2d 956, 962 (D. Minn. 2004). Plaintiff has not explained what in the reports would have put the defendants on notice that the financial statements generated from the Mexico facility were misstated at the time.

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Moreover, as Judge Frank in the Gander Mountain case recently observed, "information from confidential sources must be evaluated under the heightened pleading standard" and "vague" allegations by "unreliable" witnesses (due to their lack of personal knowledge) are subject to "little weight." In re Gander Mountain Co. Sec. Litig., No. Civ. 05-183, 2006 WL 140670, at * 10 (D. Minn. Jan. 17, 2006), appeal docketed No. 16-1545 (8th Cir. Feb. 22, 2006). Here, not one of the witnesses are identified by name. Their tenure with the Company is not identified and many of the allegations reflect conversations about conversations or what was seen through a window into a conference room. See Compl. ¶¶ 31(a), 33, 35, 42, 52-53, 58.

III. PLAINTIFF HAS NOT PLED MOTIVE AND OPPORTUNITY.

Plaintiff has also failed to plead sufficient allegations of motive and opportunity that support a strong inference of scienter on behalf of any of defendants.[1] Simply put, plaintiff has not shown what "concrete and personal benefit" accrued to the individual defendants due to alleged misstatements. See K'Tel Int'l, Inc. Sec. Litig., 300 F.3d 881, 894 (8th Cir. 2002). Instead, plaintiff asserts allegations of motive and opportunity that are generic to all corporate executives. For instance, plaintiff says that PEMSTAR inflated its financial results in order to obtain funds from lenders and investors to continue its operations. This Court, however, has discounted these "motives" as being

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[1] Plaintiff makes the rather extraordinary claim that he does not have to plead scienter on behalf of any defendant. But because the corporation acts through individuals, the scienter of the individual defendants must be pled. See, e.g., In re Royal Ahold N.V. Sec. & ERISA Litig., 351 F. Supp. 2d 334, 369 (D. Md. 2004) ("to survive the defendants' motions to dismiss the plaintiffs must successfully plead with particularity facts specific to each individual").

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"commonplace . . . shared by legions of corporate officers," and thus "insufficient to support a claim of scienter." Nash Finch, 323 F. Supp.2d at 963; see also In re K-Tel, 300 F.3d at 894.

Plaintiff completely fails to address the ***negative*** inference that arises due a lack of stock sales. See In re Acterna Corp. Sec. Litig., 378 F. Supp. 2d 561, 576-77 (D. Md. 2005); see also In re K'Tel, 300 F.3d at 894. Though plaintiff cites several cases in other circuits, the law in Minnesota and the Eighth Circuit is clear that "where none of the Defendants sold any of their stock during the Class Period" and where defendants lost millions of dollars in collective stock value during the Class Period, "Plaintiffs have failed to establish motive." Gander Mountain, 2006 WL 140670, at *11. The defendants' retention of stock during the class period likewise nullifies plaintiff's allegation that they misrepresented PEMSTAR's financial results in order to raise funds for their secondary offering. Id. (rejecting claim that defendant's IPO "conferred an economic benefit . . . when none of the Defendants sold their stock during the IPO").[2]

Finally, plaintiff's reliance on Green Tree for the proposition that the "sheer size" of PEMSTAR's restatement shows motive and opportunity and gives rise to a strong inference of scienter is also misplaced. The restatement at issue in the instant case (approximately $6 million) does not rise to the level of that in Green Tree, where plaintiffs alleged a $390 million write down of earnings. Green Tree, 270 F.3d at 661.

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2 The fact that the individual defendants did not sell stock during the class period also distinguishes this case from the first PEMSTAR securities case. See In re PEMSTAR Inc. Sec. Litig., No. Civ. 02-1821, 2003 WL 21975563 (D. Minn. Aug. 15, 2003). In PEMSTAR I, the Company launched its secondary offering in 2001 and the individual defendants each sold between 3% and 22% of their shares. Id. at *2.

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Plaintiff also argues that it has met the scienter standard because of allegations that PEMSTAR needed to shut down certain production lines after not receiving supplies. What is missing in the Complaint are any specifics as to how the closure of the lines or the inability to obtain parts meant that PEMSTAR did not have a "strong relationship" with its suppliers. Comp. ¶¶ 28, 44-46. In addition, specific facts describing the shortage of supplies and its impact on financial statements is completely missing. Indeed, the closure of a production line and the ability to slow delivery of parts may actually have been a good thing for PEMSTAR and an indication of the strength of PEMSTAR's relationship with its suppliers.

IV. PLAINTIFF FAILED TO PLEAD LOSS CAUSATION.

Despite plaintiff's assertion otherwise, whether plaintiff has adequately alleged loss causation can be resolved on a motion to dismiss because it is a question of whether the plaintiff has adequately ***pled*** facts that, if true, would show that plaintiff's economic loss was caused by the alleged misstatements of the defendants. See In re Aceterna, 378 F. Supp. 2d at 588. Plaintiff has not met this basic pleading requirement because it has not pled a direct, causal nexus between the misrepresentation of any defendant and the drop in PEMSTAR's stock price. See In re Tellium, Inc. Sec. Litig., No. Civ.A. 02CV5878FLW, 2005 WL 1677467, *26-*27 (D.N.J. June 30, 2005). Without such a causal nexus, the court cannot meaningfully distinguish between price fluctuations due to defendants' statements and other, fluctuations, factors, or unrelated market events. See Dura Pharm., Inc. v. Broudo, 125 S. Ct. 1627, 1632 (2005). Indeed, the Complaint helps

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to show that the stock price was affected by other factors, including Ernst & Young's resignation, rather than defendants' misstatements. Compl. ¶ 71.

V. PLAINTIFF FAILED TO ADEQUATELY PLEAD SECTION 11 LIABILITY.

While a Section 11 claim is analyzed under Federal Rule of Civil Procedure 8(a), that does not mean that plaintiff's claim automatically survives a motion to dismiss. In fact, "while notice pleading does not demand that a complaint expound the facts, a plaintiff who does so is bound by such exposition." Romine v. Acxiom Corp., 296 F.3d 701, 706 (8th Cir. 2002). Here, the allegations plaintiff expounds necessarily call for dismissal.

Plaintiff argues that the registration statement contains omissions of material fact by the mere fact that there was a restatement. But even under Rule 8(a), plaintiff has failed to connect the dots and allege that any of the information was available before the issuance of the registration statement. Quite to the contrary, plaintiff actually alleges that some of the problems at the Mexico facility were secret. See Compl. ¶ 31(a). Such allegations are fatal to his claim; as the Eighth Circuit recently stated in In re Acceptance Ins. Cos. Secs. Litig.:

> [R]etrospective analysis of awareness cannot be the basis for a claim. Under . . . Section 11, information is required to be included only if it is available prior to the issuance of a financial statement. The Appellants' complaint alleges no such facts to support prior knowledge by the Appellees.

423 F.3d 899, 903 (8th Cir. 2005). The Gander Mountain court made a similar observation, stating that "the Court finds that Plaintiffs have failed to allege in the

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Complaint that Defendants knew, at the time the registration statement was issued, that it contained false information . . . ." 2006 WL 140670, at *12; see also Oxford Asset Mgt., Ltd., 297 F.3d 1182, 1189 (11th Cir. 2002) (providing that an element of a Section 11 claim is that "such information existed at the time the prospectus became effective.").

In addition, plaintiff's Section 11 claim does not sufficiently allege material omissions when compared to disclosures in the registration statement. See, e.g., Parnes v. Gateway 2000, Inc., 122 F.3d 539, 546 (8th Cir. 1997). Plaintiff, however, argues that PEMSTAR's registration statement only addressed future events, and that they therefore were not part of the "total mix" available to investors. But such is not the case – the PEMSTAR registration statement addressed both current and future events, and therefore could be considered part of the mix of total information. See In re Grand Casinos, Inc. Sec. Litig., 988 F. Supp. 1273, 1280 & n.7 (D. Minn. 1997) (concluding that cautionary statements could cover statements of current as well as future events), see also Gander Mountain, 2006 WL 140670 at *12. For instance, PEMSTAR specifically stated that it had "limited experience in . . . operating in foreign countries." Ex. 25 at S-7. Moreover, to the extent that any issues were not addressed in the registration statement, this is because defendants were unaware of them – and as discussed above, plaintiff has been unable to allege otherwise. See Acceptance Ins. Cos., 423 F.3d at 903.

Plaintiff's contention that defendants violated Item 303 of SEC Regulation S-K, 17 C.F.R. § 229.303, is similarly unfounded. A Section 11 claim based on a "trend" will only be successful where there is a disclosure duty, and this duty only exists where a trend is (1) presently known to management, and (2) reasonably likely to have material

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effects on the registrant's financial condition or results of operation. Gander Mountain, 2006 WL 140670, at *15 (citing Steckman v. Hart Brewing, Inc., 143 F.3d 1293, 1296 (9th Cir. 1998)). Here, plaintiff alleges that it was a "trend" that PEMSTAR was forced to close its production lines because vendors were refusing to send parts. Compl. ¶ 45-46. But plaintiff fails to allege how this had any material effect on PEMSTAR's financial condition, which is fatal to the Section 11 claim. Compl. ¶ 109; see also Gander Mountain, 2006 WL 140670, at * 15 (dismissing Section 11 claim where "Plaintiffs have failed to plead facts showing that the credit card promotion was a 'trend' . . . that Defendants knew was reasonably likely to have material effects on Gander Mountain's financial condition.").

CONCLUSION

For the reasons stated above and in defendants' opening memorandum of law, defendants respectfully request the Court dismiss plaintiff's complaint with prejudice.

Dated: March 1, 2006

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