UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE WORLDCOM, INC. SECURITIES LITIGATION	:	MASTER FILE 02 Civ. 3288 (DLC)
This Document Relates to:	:	OPINION AND ORDER
ALL ACTIONS	:	

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DENISE COTE, District Judge:

In the summer of 2002, WorldCom, Inc. ("WorldCom") disclosed that it had improperly reported and would have to restate its publicly-reported financial results from 1999 through the first quarter of 2002. Plaintiffs in this litigation contend that defendants associated with WorldCom violated provisions of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") by publishing false information about WorldCom's financial condition in analyst reports, press releases, public statements, and filings with the Securities and Exchange Commission ("SEC").

Arthur Andersen LLP, who was WorldCom's outside accountant, two Andersen partners, Arthur Andersen's affiliate in Great Britain, and the Swiss umbrella organization for all Andersen firms, are alleged to have committed securities fraud in connection with publicly-disseminated audit opinions that materially misrepresented WorldCom's financial state. Each of the Andersen defendants is alleged to have violated Section 10(b) of the Exchange Act. In addition, Arthur Andersen LLP is alleged to have violated Section 11 of the Securities Act. This Opinion addresses the Andersen defendants' motions to dismiss the consolidated class action complaint filed in the multi-district securities litigation ("Complaint").

The descriptions that follow summarize the allegations in the Complaint relevant to the motions to dismiss addressed in this Opinion. In addition to the allegations addressed in this Opinion, the Complaint pleads claims against WorldCom officers, directors, underwriters, the outside analyst Jack Grubman, Solomon Smith Barney, and Citigroup, Inc. The allegations pertaining to those defendants and their motions to dismiss were addressed in a recent Opinion. See In re WorldCom, Inc. Sec. Litig., No. 02 Civ. 3288 (DLC), 2003 WL 21219049 (S.D.N.Y. May 19, 2003) ("May 19 Opinion"). Familiarity with the May 19 Opinion is assumed.[1]

I. Background

A. Parties

Plaintiffs

New York State Common Retirement Fund ("NYSCRF"), the lead plaintiff, invests the assets of the New York State and Local

[1] Portions of this Opinion draw heavily from the May 19 Opinion, including the Complaint's description of the accounting fraud at WorldCom, the law regarding pleading standards generally and in particular for the alleged securities fraud claim. A description of the procedural history of this litigation is included in the May 19 Opinion. See In re WorldCom, Inc. Sec. Litig., 2003 WL 21219049, at *1.

Employees' Retirement System and the New York State and Local Police and Fire Retirement System and is the second largest public pension fund in the United States. Three entities have joined the action as named plaintiffs: the Fresno County Employees Retirement Association ("FCERA"), the County of Fresno, California ("Fresno"), and HGK Asset Management ("HGK"), a registered investment advisor.

Defendants

Arthur Andersen LLP

Arthur Andersen LLP ("Andersen") was once one of the "Big 5" firms of certified public accountants. During the class period, Andersen provided accounting services for WorldCom, audited WorldCom's year-end financial statements, and reviewed its quarterly statements. Andersen issued unqualified audit reports regarding WorldCom's financial statements for inclusion in (1) WorldCom's Form 10-K annual reports for each year from 1999 through 2001; (2) the registration statements for WorldCom acquisitions between 1999 and 2002; and (3) the registration statements filed in connection with WorldCom's massive 2000 and 2001 bond offerings. Andersen's statements contained in each of the Forms 10-K from 1999 through 2001 falsely represented that Andersen had conducted its audits in accordance with generally accepted accounting standards ("GAAS") and that WorldCom's financial statements were in conformity with generally accepted accounting principles ("GAAP") and as such were materially misleading. Andersen also performed reviews of the WorldCom quarterly statements issued with respect to the first three quarters of each year from 1999 through 2001 and the first quarter of 2002. In May 2002, WorldCom replaced Andersen with KPMG LLP.

Mark Schoppet

Mark Schoppet ("Schoppet"), a certified public accountant, was the senior partner at Andersen with responsibility for audits of WorldCom financial statements. Schoppet was the engagement partner for Andersen's audits of WorldCom financial statements up to and including 2000.

Melvin Dick

Melvin Dick ("Dick"), a certified public accountant, was also a senior partner at Andersen with responsibility for the audits of WorldCom financial statements. Dick was the engagement partner for Andersen's audit of WorldCom's financial statements for 2001. Dick testified before Congress that neither he nor any member of the Andersen audit team had any idea prior to June 2002 that WorldCom (as explained below) had fraudulently transferred "line costs."

Arthur Andersen (United Kingdom)

Arthur Andersen ("Andersen UK"), a British public accounting firm, is a member of Andersen Worldwide SC. During the class period, Andersen UK audited WorldCom financial statements with Andersen.

Andersen Worldwide SC

Andersen Worldwide SC ("AWSC") is a Swiss Societe Cooperative and serves as an "umbrella organization" for its member firms throughout the world. Andersen and Andersen UK are member firms of AWSC. "Through Andersen and Andersen UK," AWSC was "involved" in WorldCom audits.

B. Accounting Irregularities

WorldCom manipulated its books in two main areas: (1) its charges to income and classification of assets in connection with acquisitions, and (2) its accounting for "line" costs. In each of these areas, WorldCom failed to follow GAAP, and instead freely reworked its numbers in order to meet marketplace earnings projections.

1. Acquisitions

Part of the acquisition process involves identifying costs incurred in connection with each merger and taking corresponding charges to income. WorldCom improperly recorded expenses at the time of the acquisition that should not have been included. The effect was to inflate earnings in later periods when the expenses were actually incurred and should have been recorded.

In addition, at the time of acquisitions, WorldCom took overly large and unjustified charges to income, creating inflated merger reserves that it would later tap into when it needed to do so to boost reported earnings. Enormous charges were typical of the mergers and acquisitions in the 1990s and "WorldCom and its senior officers knew that Wall Street would not be concerned with the size of the charges."

WorldCom used the acquisition of MCI in September 1998 in particular to manipulate its earnings statements by improperly classifying the assets it obtained. WorldCom understated the book value of MCI's property, plant and equipment assets and overstated the value of the goodwill acquired. By classifying MCI's value in terms of a slowly depreciating asset like goodwill rather than hard assets, which depreciate in one-tenth of the time, WorldCom improperly inflated its earnings during the years immediately following the MCI acquisition.

2. Line Costs

With a decline in its revenue, and further prompted by the failure in early 2000 of its attempt to acquire Sprint, WorldCom began a new accounting fraud in connection with its single largest operating expense: line costs. WorldCom had entered into long-term lease agreements with other telecommunications companies for the use of their networks. Pursuant to these leases, WorldCom was obligated to make fixed monthly payments for the use of the networks, or lines, regardless of whether WorldCom or its customers in fact used the leased lines. When demand did not grow as WorldCom had hoped, the company found itself with substantial fixed line costs for networks that were not generating any income.

Under GAAP, line costs must be reported as an expense. In October 2000, and without any justification in fact or under GAAP, Scott D. Sullivan ("Sullivan"), WorldCom's Chief Financial Officer, instructed Buford Yates, Jr., WorldCom's Director of General Accounting, David F. Myers ("Myers"), WorldCom's Controller and a Senior Vice President, and others in WorldCom's accounting department to make journal entries crediting WorldCom's line cost expense accounts, and instructed Myers and others to make corresponding reductions in various reserve accounts so that the general ledger would balance.

In 2001, WorldCom changed its method for disguising the impact of line costs on its revenues. Sullivan directed that line costs simply be reclassified as capital expenditures that could be depreciated over time. The effect of the reclassification was to inflate WorldCom's reported earnings.

3. Discovery of the Accounting Fraud

In May 2002, WorldCom's Vice President of Internal Audit initiated an investigation of WorldCom's capital expenditures and capital accounts. Within a month, the investigation determined that WorldCom had made large, dubious transfers with respect to line costs. By mid-June, the internal audit team had determined that there was no documentary or other support for the transfers. Those responsible for the accounting entries admitted to the internal audit team that they had no documents to support the treatment of line costs.

On June 25, 2002, WorldCom announced that it had improperly treated more than $3.8 billion in ordinary costs as capital expenditures in violation of GAAP and would have to restate its publicly-reported financial results for 2001 and the first quarter of 2002. WorldCom later announced that its reported earnings for 1999 through the first quarter of 2002 had been affected by manipulation of various reserves and had overstated earnings by $3.3 billion. WorldCom also announced that it would likely write off goodwill of $50 billion. The impact of those disclosures on the price of WorldCom shares and the value of its notes was catastrophic.

C. The Audits

As WorldCom's auditor, Andersen had unlimited access to WorldCom's books and records. Independent auditors are charged with obtaining and evaluating evidence concerning the assertions made in their client's financial statements. Auditors are not entitled to allow representations from a company's management to substitute for the auditing procedures that are necessary to provide a reasonable basis for forming an opinion regarding the financial statements that are the subject of the audit. In auditing the financial statements, an auditor may consider as evidence all books of original entry, the general and subsidiary ledgers, related accounting manuals, and records such as work sheets and spreadsheets supporting cost allocations, computations and reconciliations. The underlying accounting data should be considered when forming an opinion as to the financial statements.

Professional auditors are required to act diligently and in good faith, and to apply a professional skepticism to their evaluation of evidence. An auditor should conduct the audit objectively, thoroughly and carefully. Before certifying financial statements, an auditor should have an understanding of the factors that may have a significant effect on the financial statements.

Andersen did not obtain direct evidence regarding WorldCom's treatment of merger reserves or its treatment of line costs.

Instead, it relied on management's representations. Had Andersen sought supporting documentation for various adjustments and journal entries or reviewed WorldCom's general ledgers, it would have discovered that WorldCom had no documentation to support many significant adjustments or the results reported in its financial statements.

Andersen failed to obtain sufficient knowledge of WorldCom's accounting systems to understand the significance of the adjustments through which the fraud was effected. Andersen did not adequately investigate the nature and use of WorldCom's merger reserves, WorldCom's internal controls or lack thereof, or the propriety and consistency of WorldCom's application of accounting principles. If Andersen had performed a sufficient review, and sought the necessary supporting documentation, it would, or should have, discovered the on-going fraud. Instead, Andersen failed to recognize the warning signs of fraud, and to consider the obvious risk that WorldCom would engage in fraud to meet its aggressive financial targets and to protect the personal fortune of its CEO.

At one point, Andersen was even notified that WorldCom had made entries after the books had closed. In March 2000, Steven Brabbs ("Brabbs"), WorldCom's Director for International Finance & Control, noticed that a journal entry reducing line cost expenses by $33.6 million had been made after the International Division had closed its books and reported its results for the first quarter of 2000. Brabbs eventually was told that the entry had been made at Sullivan's direction, but was not given any support or explanation for the entry. In April 2000, Brabbs reviewed the International Division's first quarter results with Andersen's "audit partner in the United Kingdom." Brabbs asked the auditors at Andersen UK to ask auditors in the United States to ensure that appropriate accounting was being used at the global consolidated level. Andersen UK's report on the matter was sent to Andersen and to WorldCom executives.

When Sullivan insisted that the entry be made, Brabbs established a fictitious entity and placed the entry on its books. This kept the books of the International Division "clean," but allowed WorldCom management to maintain its reported figures. The entry was labeled "late adj[ustment] as instructed by Scott Sullivan."

Andersen was well paid for its WorldCom work. WorldCom was the most valuable client for Andersen's branch office in Jackson, Mississippi. During 2001, for example, WorldCom paid Andersen $16.8 million.

II. Legal Standards

Federal Rules of Civil Procedure

The defendants move to dismiss the Complaint pursuant to Rules 9(b) and 12(b)(6), Fed. R. Civ. P., and the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u4-b.

Rule 12(b)(6)

To dismiss an action pursuant to Rule 12(b)(6), a court must determine that "it appears beyond doubt, even when the complaint is liberally construed, that the plaintiff can prove no set of facts which would entitle him to relief." Jaghory v. New York State Dep't of Educ., 131 F.3d 326, 329 (2d Cir. 1997) (citation omitted). In construing the complaint, the court must "accept all factual allegations in the complaint as true and draw inferences from those allegations in the light most favorable to the plaintiff." Id. "Given the Federal Rules' simplified standard for pleading, a court may dismiss a complaint only if it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations." Swierkiewicz v. Sorema, N.A., 534 U.S. 506, 514 (2002) (citation omitted).

Although the court's focus should be on the pleadings, it may also consider

> any written instrument attached to [the complaint] as an exhibit or any statements or documents incorporated in it by reference, as well as public disclosure documents required by law to be, and that have been, filed with the SEC, and documents that the plaintiffs either possessed or knew about and upon which they relied in bringing the suit.

Rothman v. Gregor, 220 F.3d 81, 88 (2d Cir. 2000) (citation omitted); Cortec Indus., Inc. v. Sum Holding L.P., 949 F.2d 42, 47-48 (2d Cir. 1991). The court need not credit general conclusory allegations that "are belied by more specific allegations of the complaint." Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1092 (2d Cir. 1995), and may not rely on factual allegations contained only in legal briefs. Friedl v. City of New York, 210 F.3d 79, 83 (2d Cir. 2000).

Rule 9(b)

Rule 9(b) requires allegations of fraud, including securities fraud, to be stated with particularity. Ganino v. Citizens Utils. Co., 228 F.3d 154, 168 (2d Cir. 2000). Under Rule 9(b), "[m]alice, intent, knowledge and other conditions of mind of a person may be averred generally." Rule 9(b), Fed. R. Civ. P.; Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001). To comply with the requirements of Rule 9(b), an allegation of fraud must specify: "(1) those statements the plaintiff thinks were fraudulent, (2) the speaker, (3) where and when they were made, and (4) why plaintiff believes the statements fraudulent." Koehler v. Bank of Bermuda (New York) Ltd., 209 F.3d 130, 136 (2d Cir. 2000).

Section 10(b) and Rule 10b-5

To state a cause of action under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, a plaintiff must allege that "the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff's reliance on defendant's action caused injury to the plaintiff." Lawrence v. Cohn, 325 F.3d 141, 147 (2d Cir. 2003) (quoting Ganino, 228 F.3d at 161); see also Kalnit, 264 F.3d at 138. Section 10(b) claims sound in fraud, and must satisfy the pleading requirements of Rule 9(b) and the PSLRA. See In re Scholastic Corp., 252 F.3d 63, 69-70 (2d Cir. 2001). "Any person or entity, including [an] accountant . . . who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming <u>all</u> of the requirements for primary liability under Rule 10b-5 are met." <u>Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.</u>, 511 U.S. 164, 191 (1994) (emphasis in original).

1. Scienter

"The requisite state of mind, or scienter, in an action under section 10(b) and Rule 10b-5, that the plaintiff must allege is an intent to deceive, manipulate or defraud." <u>Kalnit</u>, 264 F.3d at 138 (citation omitted). In the Second Circuit, plaintiffs alleging securities fraud have long been required to state with particularity "facts that give rise to a strong inference of fraudulent intent." <u>Acito v. IMCERA Group, Inc.</u>, 47 F.3d 47, 52 (2d Cir. 1995); <u>see also</u> <u>San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.</u>, 75 F.3d 801, 812 (2d Cir. 1996).

When Congress passed the PSLRA it required that

> [i]n any private action arising under this chapter in which the plaintiff may recover money damages <u>only on proof that the defendant acted with a particular state of mind</u>, the complaint shall, with respect to each act or omission alleged to violate this chapter, <u>state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind</u>.

15 U.S.C. § 78u-4(b)(2) (emphasis supplied). The PSLRA raised the nationwide pleading standard for securities fraud but did not alter the level of pleading previously required by the Second Circuit. <u>Kalnit</u>, 264 F.3d at 138; <u>Ganino</u>, 228 F.3d at 170; <u>Novak v. Kasaks</u>, 216 F.3d 300, 310 (2d Cir. 2000).

"The requisite 'strong inference' of fraud may be established either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." Acito, 47 F.3d at 52 (citation omitted); see also Kalnit, 264 F.3d at 138; Rothman, 220 F.3d at 90. The Second Circuit has identified four types of allegations that may support a strong inference of scienter:

> [W]here the complaint sufficiently alleges that the defendants: (1) benefitted in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor.

Novak, 216 F.3d at 311 (citation omitted).

(a) Motive and opportunity

"Motive would entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged." Novak, 216 F.3d at 307 (citation omitted).

(b) Conscious misbehavior or recklessness

The pleading standard also will be satisfied if plaintiffs allege facts showing that the defendant's conduct was "highly unreasonable, representing an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." Rothman, 220 F.3d at 90 (citation omitted); Kalnit, 264 F.3d at 142. Pleadings have been found sufficient when they have "specifically alleged defendants' knowledge of facts or access to information contradicting their public statements. Under such circumstances, defendants knew or, more importantly, should have known that they were misrepresenting material facts related to the corporation." Kalnit, 264 F.3d at 142 (citation omitted). If plaintiffs rely on allegations that the defendants had access to facts contradicting their public statements, plaintiffs must "specifically identify the reports or statements containing this information." Novak, 216 F.3d at 309 (citation omitted). Allegations of recklessness have also been sufficient where the allegations demonstrate that defendants "failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud." Id. at 308. A violation of GAAP, however, standing alone, is insufficient. Id. at 309.

2. Causation

Another element of a Section 10(b) claim is that "plaintiff's reliance on defendant's action caused plaintiff injury." Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 534 (2d Cir. 1999) (citation omitted). "It is settled that causation under federal securities laws is two-pronged: a plaintiff must allege both transaction causation, i.e. that but for the fraudulent statement or omission, the plaintiff would not have entered into the transaction; and loss causation, i.e., that the subject of the fraudulent statement or omission was the cause of the actual loss suffered." Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001). To show reliance on a defendant's statement, "the misrepresentation must be attributed" to the defendant at the time of public dissemination and "in advance of the investment decision." Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (1998).

III. Discussion

Andersen[2]

Taken as a whole, the allegations against Andersen adequately plead scienter. The Complaint alleges that Andersen had unlimited access to WorldCom's books and records and had, as WorldCom's independent auditor, an obligation to review and evaluate those records in order to form an opinion regarding WorldCom's financial statements. The Complaint alleges that WorldCom's books and records contained no support for or documentation of the accounting treatment of significant merger reserves and line costs. Had Andersen reviewed WorldCom's accounting systems and data, as it was obligated to do, it would have discovered the lack of documentation and the fraudulent accounting treatment.

The allegations identifying the steps Andersen should have taken and failed to take, and the fraud it would have discovered if it had taken those steps, create a strong inference that Andersen acted recklessly in conducting the WorldCom audits. See

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[2] Andersen also moves to dismiss the Section 11 claim against it. In moving, it relies wholly on the arguments made by the underwriter defendants in their motion to dismiss. The motions to dismiss the Section 11 claims were denied in the May 19 Opinion. In re WorldCom, Inc. Sec. Litig., 2003 WL 21219049, at *25-27. For the reasons stated therein, Andersen's motion to dismiss the Section 11 claim is denied.

Novak, 216 F.3d at 308 (allegations that defendants "failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud" are sufficient to allege recklessness). Although the size of the fraud alone does not create an inference of scienter, the enormous amounts at stake coupled with the detailed allegations regarding the nature and extent of WorldCom's fraudulent accounting and Andersen's failure to conduct a thorough and objective audit create a strong inference that Andersen was reckless in not knowing that its audit opinions materially misrepresented WorldCom's financial state. See In re Scholastic Corp., 252 F.3d at 73 (size of post-class period special charge supports inference of knowledge); Rothman, 220 F.3d at 92 (size of write-off supports claim of fraudulent intent).

In moving to dismiss, Andersen emphasizes that the guilty plea allocutions of certain former WorldCom executives, the Indictment filed by the United States Attorney in this District against Sullivan, and the SEC's complaint against former WorldCom officers all assert that WorldCom's senior management had lied to WorldCom's auditors and concealed the falsification of the WorldCom books from the auditors. The issue presented by this motion is whether the Complaint states a claim against Andersen. It does. It alleges with sufficient particularity that Andersen would have uncovered the fraud perpetrated by WorldCom's management if it had conducted the review it was required to do before issuing its audit opinions in connection with the WorldCom annual financial statements, and that the Andersen audit opinions included in WorldCom's year-end financial statements materially misrepresented WorldCom's financial state.

Dick & Schoppet

The allegations in the Complaint are insufficient to state a Section 10(b) claim against either Schoppet or Dick. First, the Complaint fails to allege that Schoppet or Dick made a misstatement or omission on which plaintiffs relied. A defendant is not liable under Section 10(b) "for a statement not attributed to that actor at the time of its dissemination." Wright, 152 F.3d at 175. The Complaint alleges only that Andersen authored statements, not that any of the statements were attributed to the individual Andersen partners.

Plaintiffs' reliance on SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996), for the proposition that those who participate in a fraud may be liable is misplaced. As explained in Wright, First Jersey was an SEC enforcement action, brought under a provision of the securities laws that allows liability to attach to those who knowingly provide "substantial assistance" to a violator. Wright, 152 F.3d at 176 (citation omitted). Congress, however, has not created a private right of action under that provision. Id. The Second Circuit has explicitly declined to adopt a "substantial participation" test for liability for misrepresentations under Section 10(b). Id.

Second, the Complaint does not sufficiently allege scienter against either Schoppet or Dick.[3] The lengthy and detailed

[3] The additional facts in the plaintiffs' memorandum of law regarding Dick's review of workpapers and Schoppet's role in the audits may not be used to cure this defect. See Friedl, 210 F.3d

allegations regarding Andersen's conduct of the WorldCom audits and knowledge or recklessness with regard to the fraud are all pleaded only against Andersen itself: none of the paragraphs setting out specific details even mentions Schoppet or Dick.[4] At most, the Complaint implies that because Andersen either knew of the fraud or was reckless in not knowing, the engagement partners must also have known or been reckless. The Section 10(b) claim against these individual defendants is dismissed.

Andersen UK

Plaintiffs' limited allegations against Andersen UK are insufficient to state a claim for violation of Section 10(b). There are no allegations identifying any work performed by Andersen UK that resulted in any false statement. There are also no allegations that Andersen UK ever failed to do work, which if performed, would have unmasked the fraud. There are no allegations that Andersen UK ever made any statement on which plaintiffs relied.

The only allegation that even remotely connects Andersen UK to WorldCom's securities fraud is the allegation that Brabbs asked Andersen UK to ask Andersen to make sure that "appropriate accounting treatment was in place at the global consolidated

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at 83.

[4] In their memorandum in opposition to this motion, plaintiffs direct attention to paragraphs 432, 433 and 434 for allegations sufficient to plead scienter with respect to Schoppet and Dick. None of these paragraphs even mentions either of the defendants by name. The Complaint contains no allegations of motive or knowledge that are specific to either Schoppet or Dick.

level" because an improper journal entry had been "made by persons in the US at the consolidated level." The relevant portion of the 2002 Brabbs e-mail recounting the conversation with Andersen UK from two years earlier reads as follows[5]:

> During April 2000, I reviewed at a high level the International Q1 results with the UK audit partner and senior manager. The increase in our margin trend due to the above entry was obvious and I explained that this was an entry made in the US, and that the auditors should request follow through in the US to ensure appropriate accounting treatment was in place at the global consolidated level. A relevant paragraph was included in their report that was sent to both Andersens [sic] and senior WorldCom finance management in the US.

The e-mail further reflects that the entry Brabbs questioned had been made by people at WorldCom in the United States after the European and Asian entities had closed their books and reported their quarterly figures to the United States.

Even viewed in the light most favorable to the plaintiffs, the Brabbs e-mail does not support their argument that Andersen UK knew or should have known of the securities fraud from either its conversation with Brabbs or its audit of any international WorldCom branch. Instead, the e-mail suggests that adjustments to the books were being made in the United States, after the foreign entities' books had closed and quarterly results had been posted. The Complaint alleges that Andersen failed to investigate WorldCom's accounting practices after Brabbs notified it of his concerns; it does not, however, allege that Andersen UK

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[5] The Brabbs e-mail may be considered in deciding defendants' motion to dismiss because it was incorporated into the Complaint by reference and was relied upon by plaintiffs. Rothman, 220 F.3d at 88.

failed to do as Brabbs requested, that is, request that Andersen confirm that appropriate accounting treatment was being given to the consolidated financials.[6]

Apart from the Brabbs e-mail, the Complaint does not identify any "red flags" that Andersen UK should have or would have encountered in its audits of WorldCom's Asian and European entities, or plead any other indicia of recklessness. It does not even identify the WorldCom entities that were audited by Andersen UK.[7] In sum, in addition to the other deficiencies in its pleading of a Section 10(b) claim against Andersen UK, the Complaint contains insufficient allegations to give rise to an inference -- much less a strong inference -- that Andersen UK acted with fraudulent intent.[8]

AWSC

The Complaint contains no allegations that AWSC was the source of or an identified speaker with respect to any of the misrepresentations described in the Complaint, and contains no allegations of AWSC's scienter. Instead, plaintiffs contend that

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[6] In their brief, plaintiffs also argue that Andersen UK's "failure to investigate" creates a strong inference of fraudulent intent. The Complaint itself, however, is silent with respect to Andersen UK's investigation. Plaintiffs refer to paragraph 317 of the Complaint as alleging that Andersen UK abdicated its responsibility to investigate: that paragraph, and the related allegations, allege only that Andersen, not Andersen UK, failed to investigate. Plaintiffs' argument cannot cure the pleading defects. See Friedl, 210 F.3d at 83 (2d Cir. 2000).

[7] WorldCom's public filings reflect that it had over 160 subsidiaries in more than fifty countries.

[8] Because the Section 10(b) claim is dismissed, Andersen UK's arguments regarding personal jurisdiction are not addressed.

AWSC is responsible for Andersen's statements and omissions and that Andersen's knowledge is attributable to AWSC under the law governing partnerships and general principles of agency law.

In 1994, the Supreme Court held that there was no private cause of action under Section 10(b) for aiding and abetting liability. Central Bank, 511 U.S. at 177. It did not, however, eliminate the use of principles of agency law to hold principals responsible for the misrepresentations of their agents. See Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87, 100-01 (2d Cir. 2001); Cromer Fin. Ltd. v. Berger, Nos. 00 Civ. 2284 & 00 Civ. 2498 (DLC), 2002 WL 826847, at *7 (S.D.N.Y. May 2, 2002). As the Second Circuit noted in Suez Equity, "[a] corporation can only act through its employees and agents." Suez Equity, 250 F.3d at 101. Under agency law, "[t]he principal is held liable not because it committed some wrongdoing outside the purview of the statute which assisted the wrongdoing prohibited by the statute, but because its status merits responsibility for the tortious actions of its agent." American Tel. & Tel. Co. v. Winback & Conserve Program, Inc., 42 F.3d 1421, 1431 (3d Cir. 1994); see also Cromer, 2002 WL 826847, at *7-8; Vento & Co. LLC v. Metromedia Fiber Network, Inc., No. 97 Civ. 7751 (JGK), 1999 WL 147732, at *12 (S.D.N.Y. Mar. 18, 1999); Pollack v. Laidlaw Holdings, Inc., No. 90 Civ. 5788 (DLC), 1995 WL 261518, at *17 (S.D.N.Y. May 3, 1995); In re Rickel & Assoc., Inc., 272 B.R. 74, 94 & n.13 (S.D.N.Y. 2002).

While an agency theory may be used to assert liability for a Section 10(b) claim, the Complaint does not allege that Andersen was an agent of AWSC or that AWSC and Andersen are partners. It alleges only that AWSC is a Swiss Societe Cooperative and an "umbrella organization for its member firms worldwide." These bare allegations are insufficient to plead that Andersen acted as an agent of AWSC when it conducted the WorldCom audits, or to impute Andersen's knowledge or recklessness to AWSC.

Plaintiffs' reliance on Suez Equity, 250 F.3d 87, is misplaced. In that case, there were allegations that an individual defendant knowingly conveyed a false report to the plaintiffs. Id. at 100. It was alleged that he had acted as the agent for three related corporate entities in doing so: specifically, that he was the employee of one and acting on behalf of all three in managing their relationship with the plaintiffs. Id. Each of the three corporate defendants was alleged to have had a motive to commit the fraud. Id. Similarly, this Court's decision in Cromer, 2002 WL 826947, on which plaintiffs also rely, permitted plaintiffs to proceed on the theory that Deloitte Touche (Bermuda) had acted as the agent of Deloitte Touche Tohmatsu, and that the scienter of the member firm could be imputed to the international umbrella firm, where the complaint included specific allegations of a conveyance of actual authority. Id. at *3-8. The Cromer plaintiffs also alleged that the name and logo of the international umbrella organization appeared on the audits prepared by Deloitte Touche (Bermuda). Id. at *3.

In sum, plaintiffs' allegations are not sufficient to invoke an agency or partnership theory. As a consequence, the Section 10(b) claim against AWSC must be dismissed.[9]

Fraudulent Scheme

As noted above, with the exception of Andersen, none of the defendants is alleged to have made a statement on which the plaintiffs relied. In an effort to salvage its claims against three of these defendants -- Schoppet, Andersen UK and AWSC -- the plaintiffs argue that these defendants are liable even if they did not make any untrue statements or omissions because Rule 10b-5 also creates a private cause of action against those who "employ any device, scheme or artifice to defraud." 17 C.F.R. § 240.10b-5(a). This argument suffers from two principle deficiencies. While the Complaint is replete with allegations of misrepresentations contained in the WorldCom financial statements and registrations statements, it does not allege the existence of any scheme or artifice in which these defendants participated. It does not identify any false information that these defendants contributed to a scheme or actions they took to facilitate a scheme. Moreover, to state a claim for use of a fraudulent scheme, plaintiffs must allege that defendants acted with scienter. SEC v. Zandford, 535 U.S. 813, 819-20 (2002); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-14 (1976). As already

[9] Having dismissed the Section 10(b) claim, AWSC's arguments that as a societe cooperative formed under the Swiss Code it is not susceptible to arguments based on a partnership or agency theory are not addressed. In addition, it is unnecessary to address its motion based on a lack of personal jurisdiction.

explained, plaintiffs' claims against Schoppet, Andersen UK, and AWSC have been dismissed for failure, inter alia, to plead scienter.

Conclusion

For the reasons stated above, Arthur Andersen LLP's motion to dismiss is denied. The motions to dismiss brought by Arthur Andersen (United Kingdom), Mark Schoppet, Melvin Dick and Andersen Worldwide SC are granted.[10]

SO ORDERED:

Dated: New York, New York
June 24, 2003

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DENISE COTE
United States District Judge

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[10] The plaintiffs have asked for leave to amend. Because of the numerous legal barriers to pleading a Section 10(b) claim against any of the dismissed defendants, leave to amend is denied. Should the plaintiffs seek to amend to replead claims against any of the four dismissed defendants, they must do so through a motion filed by August 1, 2003.