CHU v. SABRATEK CORP.

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MEMORANDUM OPINION AND ORDER

Plaintiff Dennis Chu, on behalf of himself and all purchasersof the publicly traded securities of Sabratek Corporation("Sabratek") between the period of February 25, 1997 and October6, 1999, seeks remedies under § 10(b) of the Securities ExchangeAct of 1934 ("Exchange Act") and Rule 10b-5.[1] The plaintiffscontend that Defendant KPMG, LLP ("KPMG") knowingly or recklesslymisrepresented material facts in connection with the purchase ofSabratek securities by certifying that Sabratek's 1997 and 1998financial reports had been prepared in conformity with GenerallyAccepted Accounting Principles ("GAAP") and that it had auditedSabratek's financial statements in accordancewith Generally Accepted Accounting Standards ("GAAS"). KPMG fileda motion to dismiss the plaintiffs' Third Amended Complaint("complaint"), (R. 42-1), arguing that the plaintiffs have failedto comply with the heightened pleading requirements of Rule 9(b)of the Federal Rules of Civil Procedures and the PrivateSecurities Litigation Reform Act of 1995 ("PSLRA"),15 U.S.C. § 78u-4(b). We agree with KPMG that the plaintiffs have failed toallege facts which give rise to a strong inference that KPMGeither knew or recklessly disregarded Sabratek's improper revenuerecognition practices. The plaintiffs have, however, allegedsufficient facts to show that KPMG either knowingly or recklesslymade a material misstatement when it certified approximately $39million of Sabratek's expenses as intangible assets in violationof GAAP and GAAS. Therefore, we grant in part and deny in partKPMG's motion to dismiss.

FACTS

For purposes of a motion to dismiss, this Court accepts as trueall well-pleaded allegations in the complaint and draws allreasonable inferences in favor of the plaintiffs. See Travel AllOver the World, Inc. v. Kingdom of Saudi Arabia, 73 F.3d 1423,1429 (7th Cir. 1996). In accordance with this standard, we recitethe facts relevant to KPMG's motion.

Sabratek Corporation ("Sabratek") incorporated in 1990 with thestrategic goal of becoming a comprehensive solution provider tothe alternative healthcare market. In particular, Sabratek soughtto create a so-called "virtual hospital room" that would enablehealthcare providers to treat and monitor patients in alternatecare facilities. Sabratek's products, which include infusionpumps for the delivery of therapeutic agents and diagnostic andinformation systems for patient monitoring, allow healthcareproviders to treat high-acuity patients in such places aslong-term care facilities, outpatient centers, and patients'homes. With Sabratek's products, healthcare providers can reduceoperating costs while improving the delivery and quality of care.(Compl. at ¶¶ 1, 24, 43.) Since going public in June 1996,Sabratek common stock experienced dramatic increases in price. Atits highest point during the putative class period, Sabratekcommon stock reached the price of $38.75 per share. (Compl. at ¶¶2, 45.)

In the meantime, the plaintiffs contend that Sabratek'sbusiness was experiencing a number of material adverse problems.Although Sabratek repeatedly touted the benefits of its productline, Sabratek experienced significant safety and complianceproblems. At all material times prior to and during the putativeclass period, Sabratek manufactured its line of Rocap flushsyringes without Food and Drug Administration ("FDA") approvals.(Compl. at ¶ 46.) Sabratek also began to lose its customer baseand experienced a growing level of customer complaints about thequality of its products. (Id.) The net effect of these problemswas that Sabratek's supply of unsold products, specifically itsinfusion pumps, increased to "damagingly high levels." (Compl. at¶ 5.) In light of these and other problems, Sabratek began tolose market share to its competitors.

The plaintiffs allege that starting no later than February 25,1997, the defendants, including KPMG, engaged in an elaborateaccounting scheme to conceal Sabratek's declining sales and otherprofit-related problems. KPMG was the consultant and auditor whocertified Sabratek's 1997 and 1998 annual financial statements,which were filed with the SEC and disseminated to the public. Theplaintiffs allege, inter alia, that Sabratek engaged (and KPMGacquiesced) in numerous improper revenue-inflating andexpense-deflating practices in violation of GAAP. Sabratek'simproper practices included: (1) recognizing revenue on "phonysales" of products to entities that had not ordered Sabratekproducts; (2) recognizing revenue on "inventory parkingarrangements"; (3) booking revenue on "consignment sales" whereno bona fide purchase had been made; (4) backdating invoices forpremature revenue recognition; (5) concealing substantialcredits, discounts, and/or rebates offered to distributors; and(6) paying itself "consulting fees" for fictitious consultingservices where no money ever exchanged hands and no invoices wereever generated. (Compl. at ¶¶ 6, 48-51.)

In addition, the plaintiffs allege that Sabratek, with theapproval of KPMG, structured various fraudulent transactions withfour entities: Unitron Medical Communications, Inc. ("Unitron"),GDS Technology, Inc. ("GDS"), Healthmagic, Inc. ("Magic"), andCollaborations in Healthcare, LLC ("Healthcare"). Through theirtransactions with Unitron, GDS, Magic, and Healthcare(collectively "R & D Satellite Entities"), Sabratek reportedapproximately $39 million of cash disbursements and researchexpenses as licensing deals, loans, and other "intangibleassets."[2] (Compl. at ¶ 53.)

Sabratek's improper accounting practices artificially depressedSabratek's expenses and inflated its reported revenues, income,and earnings per share. Sabratek reported its inflated figures onits quarterly and annual financial forms, which received positivemarket feedback. But on October 7, 1999, after delaying itssecond quarter financial statements by two months, Sabratekannounced that its previously reported earnings, as reflected inits 1997 and 1998 financial statements, had been overstated byapproximately $39 million. Sabratek also announced that its boardwas considering certain unspecified "other accounting issues"that had been raised by Sabratek's CFO. Sabratek's closing stockprice of $1.03 per share on October 7, 1999 represented adramatic decline of more than 97% from its class period high of$38.75 per share in September 1997. (Compl. at ¶¶ 13, 164.) OnNovember 17, 1999 the plaintiffs filed this complaint, (R. 42).

STANDARD OF REVIEW

KPMG's motion to dismiss the plaintiffs' securities fraudcomplaint implicates the Federal Rules of Civil Procedure12(b)(6) and 9(b) as well as the PSLRA. Under Rule 12(b)(6), wewill dismiss a complaint for failure to state a claim only if "itappears beyond doubt that the plaintiff can prove no set of factsin support of his claim which would entitle him to relief." SeeMaple Lanes, Inc. v. Messer, 186 F.3d 823, 824-25 (7th Cir.1999) (quoting Conley v. Gibson, 355 U.S. 41, 45-46, 78 S.Ct.99, 2 L.Ed.2d 80 (1957)). On a motion to dismiss, this Courtdraws all inferences and resolves all ambiguities in favor of theplaintiffs and assumes that all well-pleaded facts are true. SeeLong v. Shorebank Dev. Corp., 182 F.3d 548, 554 (7th Cir. 1999)(citation omitted).

Rule 9(b) requires plaintiffs to plead "the circumstancesconstituting fraud . . . with particularity." In re HealthCareCompare Corp. Sec. Litig., 75 F.3d 276, 281 (7th Cir. 1996)."This means the who, what, when, where, and how: the firstparagraph of any newspaper story." DiLeo v. Ernst & Young,901 F.2d 624, 627 (7th Cir. 1990). As a policy matter, the heightenedpleading requirements under Rule 9(b) serves three main purposes:"to protect defendants' reputations, to prevent fishingexpeditions, and to provide adequate notice to defendants of theclaims against them." Fugman v. Aprogenex, 961 F. Supp. 1190,1194 (N.D.Ill. 1997) (citing Vicom, Inc. v. Harbridge MerchantServs., Inc., 20 F.3d 771, 777 (7th Cir. 1994)).

In addition to the Rule 9(b) requirement, the PSLRA amendmentsto the Exchange Act raise the pleading standards in securitiesfraud cases, requiring the plaintiffs to "state withparticularity facts giving rise to a strong inference that thedefendant acted with the required state ofmind." 15 U.S.C. § 78u-4(b)(2). The PSLRA also requires theplaintiffs to "specify each statement alleged to have beenmisleading, [and] the reason or reasons why the statement ismisleading." 15 U.S.C. § 78u-4(b)(1).

With these standards in mind, this Courts takes as true allwell-pleaded facts of the complaint, but we will dismiss theclaim if it fails to satisfy the heightened pleading requirementsof Rule 9(b) or the PSLRA.

ANALYSIS

KPMG moves to dismiss the plaintiffs' complaint for a failureto state a securities fraud claim under the heightened pleadingrequirements of Rule 9(b) and the PSLRA. (Mot. to Dismiss at 2.)The Seventh Circuit has explained that in order to state a claimunder § 10(b) of the Exchange Act, a plaintiff must allege that"the defendant (1) made a misstatement or omission, (2) ofmaterial fact, (3) with scienter, (4) in connection with thepurchase or sale of securities, (5) upon which plaintiff hasrelied and (6) that reliance proximately caused plaintiff'sinjuries." In re HealthCare Compare, 75 F.3d at 280. KPMGargues that the plaintiffs have failed to plead withparticularity that KPMG made a misstatement of materialfact.[3] KPMG also asserts that the plaintiffs have failed toallege facts which give rise to a strong inference that it actedwith the requisite state of mind.

I. KPMG's Misleading Statements of Material Fact

KPMG first contends that the plaintiffs' allegations concerningSabratek's allegedly improper financial statements do notestablish that KPMG made a misstatement of material fact. Inparticular, KPMG argues that the plaintiffs have failed to pleadwith particularity "what" was materially misstated in thefinancial statements, "why" its audit reports were misleading,and "how" the financial statements and KPMG's audit of thosestatements violated GAAP and GAAS. See DiLeo, 901 F.2d at 627.As a threshold matter, under § 10(b) the plaintiffs mustsufficiently allege that KPMG either made a false statement ofmaterial fact or omitted a material fact that rendered anaffirmative statement misleading. See Searls v. Glasser,64 F.3d 1061, 1065 (7th Cir. 1995). A misstatement or omission ismaterial if there was a "substantial likelihood that disclosureof the omitted fact would have been viewed by a reasonableinvestor as having significantly altered the `total mix' ofinformation available." TSC Indus., Inc. v. Northway, Inc.,426 U.S. 438, 449, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). Financialstatements filed with the SEC that do not conform to therequirements of GAAP are presumptively misleading and inaccuratepursuant to SEC regulation. See 17 C.F.R. § 210.4-01(a)(1).Without a "misstatement of material fact," we will dismiss a §10(b) complaint.

After examining the plaintiffs' allegations, we findunpersuasive KPMG's arguments that the plaintiffs have failed toplead with particularity "what," "why," or "how" KPMG'scertifications of Sabratek's financial statements were materialmisstatements. Under the Rule 9(b) and PSLRA pleadingrequirements, the plaintiffs must with particularity "specifyeach statement alleged to have been misleading" and "the reasonor reasons why the statement is misleading." The complaintspecifies that each of KPMG's 1997 and 1998 audit reports wasfalse in that KPMG stated that it had conducted Sabratek's auditsin conformity with GAAS and that, in its opinion, Sabratek's 1997and 1998 financial statements were fairlypresented, in all material aspects, in accordance with GAAP. Thecomplaint also sufficiently states the reasons the financialstatements contained materially misleading statements: thefinancial statements misrepresented Sabratek's true earnings byrecognizing revenue on "phony sales" and erroneously classifying$39 million in expenses as intangible assets.

A. KPMG's Certifications Regarding Sabratek's Inflated Earnings

We first note, but reject, KPMG's argument that the plaintiffshave failed to specify how its certified financial statements andaudit reports violated GAAP and GAAS. KPMG contends, for example,that there is nothing inherently wrong about Sabratek's so-called"revenue inflating" practices. (Mot. to Dismiss at 5). KPMGcorrectly notes that "there is nothing inherently improper inpressing for sales to be made earlier than in the normal course[of business]," even if doing so is "likely to the detriment ofearnings in later quarters." Greebel v. FTP Software, Inc.,194 F.3d 185, 202 (1st Cir. 1999). We agree with KPMG that GAAP doesprovide for some flexibility in the timing of revenuerecognition.

However, drawing all reasonable inferences in favor of theplaintiffs, we believe that they have sufficiently alleged thatSabratek's revenue recognition practices violated GAAP. In thecomplaint, the plaintiffs point to several instances whenSabratek, in violation of GAAP, recognized revenue ontransactions even though collection was not reasonably assured.(Compl. at ¶ 183.) In December 1997, Sabratek induced MedicalSpecialties, Inc. to receive $1.2 million worth of Sabratek pumpsby promising that it could return the pumps at the end of 1998for full credit. In March 1998, Sabratek shipped almost $1million worth of inventory to Tacy Medical of Fernandina Beach,Florida, even though Tacy Medical had never ordered or previouslydistributed the products. (Compl. at ¶ 48.) Also in 1998,Sabratek induced Coram to receive $1 to $1.5 million worth ofexcess inventory for which Coram had no current demand. (Id.)Another such company, Amtec, received "so many [unordered] excessSabratek pumps that they used them as impromptu workspacedividers." (Id.) These allegations, if true, would show thatSabratek materially inflated reported revenues in violation ofGAAP.[4]

As the complaint stands, the plaintiffs have specified "eachstatement alleged to have been misleading" (that Sabratek's 1997and 1998 financial statements were in accordance with GAAP) and"the reason or reasons why the statement is misleading" (Sabratekrecognized false revenue in violation of GAAP). Although we agreewith KPMG that the plaintiffs have failed to allege severaldetails regarding Sabratek's allegedly improper revenuerecognition practices, such as the dollar amounts by whichSabratek's financial statements have been misstated as a resultof these transactions, the plaintiffs have alleged sufficientfacts to meet their burden at this stage in the litigation. See,e.g., Danis, 73 F. Supp.2d at 935, n. 6 ("Plaintiffs need notstate the amount by which USN's financial statements were inerror."); In re First Merchants Acceptance Corp. Sec. Litig.,No. 97 C 2715, 1998 WL 781118, at *8-9 (N.D.Ill. Nov.4, 1998)(agreeing that Rule 9(b) does not require the plaintiffs todescribe the precise amount of overstatement). Having satisfiedthe Rule 9(b) and the PSLRA's pleading requirements, theplaintiffs need not allege such additional details to survive amotion to dismiss.

B. KPMG's Certifications Regarding Sabratek's Transactions with the Research and Development Satellite Entities

Similarly, the plaintiffs adequately allege that KPMG made a"misstatement of material fact" in that KPMG erroneouslycertified that Sabratek "fairly presented" approximately $39million dollars in expenses as intangible assets. GAAP requiresresearch and development costs to be treated as "expenses" andprecludes capitalizing the value of a purported "asset" unless ithas a probable future economic benefit. (Compl. at ¶¶ 176-83.)Although the plaintiffs have not specified the exact manner bywhich Sabratek structured its deals, the lack of that detail isnot fatal to meet the "material misstatement" element of the §10(b) claim. As it stands, the plaintiffs have specified thatSabratek either never acquired any licensing rights for the moneyit paid or that the licensing rights it did receive were forproducts that were still in development. Under either scenario,the plaintiffs have alleged which portions of Sabratek'sfinancial statements were overstated (the intangible assets) andwhich portions were understated (the research and developmentrelated expenses) in violation of GAAP. See, e.g., Danis, 73F. Supp.2d at 935. "This is sufficient to permit defendants toprepare a defense to the allegation." Id. The plaintiffs notonly identify each of the R & D Satellite Entities and the natureof each suspected transaction, but also plead the dollar amountsof each cash disbursement, the aggregate dollar amount by whichSabratek's assets were correspondingly misstated, and the datesof each of the alleged "loans" and "licensing" transactions.(Compl. at ¶ 55.)

Having concluded that the plaintiffs have adequately allegedthat KPMG "made a misstatement of material fact," we inquire asto whether the plaintiffs have alleged "facts which give rise toa strong inference" that KPMG acted with the requisite intent.

II. KPMG's Scienter

KPMG contends that the plaintiffs' claim must fail because thefacts alleged do not support a finding of "a strong inference" ofscienter. Scienter, as applied to securities fraud claims, refersto a mental state embracing the intent to deceive, manipulate ordefraud. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). The Seventh Circuit haslong since interpreted Hochfelder as establishing that"reckless disregard for the truth counts as intent" for thepurpose of the § 10(b) scienter requirement. SEC v. Jakubowski,150 F.3d 675, 681 (7th Cir. 1998) (citing Sundstrand Corp. v.Sun Chem. Corp., 553 F.2d 1033, 1044-45(1977)).

The PSLRA amendments did not change the substantive provisionof the Exchange Act's scienter requirement.[5] Every court inthis district that has construed the scienter requirement afterthe PSLRA has concluded that allegations of recklessness continueto be sufficient to state a claim under § 10(b). See, e.g., Inre System Software Assocs., Inc., No. 97 C 177, 2000 WL 283099,*14 (N.D.Ill. Mar.8, 2000); Danis, 73 F. Supp.2d at 937-38; Inre Spyglass Inc. Sec. Litig., No. 99 C 512,1999 WL 543197, at *7 (N.D.Ill. July 21, 1999). At a minimum,recklessness requires "conduct which is highly unreasonable andwhich represents an extreme departure from the standards ofordinary care . . . to the extent that the danger was eitherknown to the defendant or so obvious that the defendant must havebeen aware of it." Rehm v. Eagle Fin. Corp., 954 F. Supp. 1246,1255 (N.D.Ill. 1997). As applied to outside auditors,recklessness means that "the accounting firm practices amountedto no audit at all, or to an egregious refusal to see theobvious, or to investigate the doubtful, or that the accountingjudgments which were made were such that no reasonable accountantwould have made the same decisions if confronted with the samefacts." In re First Merchants, 1998 WL 781118, at *10 (N.D.Ill.Nov.4, 1998) (citing SEC v. Price Waterhouse, 797 F. Supp. 1217,1240 (S.D.N.Y. 1992)); see also Rehm, 954 F. Supp. at 1255.

While not changing the substantive requirements, the PSLRA didheighten the pleading requirements of the Exchange Act's scienterrequirement. A post-PSLRA securities fraud plaintiff must "statewith particularity facts giving rise to a strong inference thatthe defendant acted with the required state of mind."15 U.S.C. § 78u-4(b)(2). The PSLRA does not elaborate on what facts orfactual situations will give rise to "a strong inference" ofintent, and the Seventh Circuit has not yet addressed the PSLRApleading standard. As a threshold matter, this Court notes thatthe language of the PSLRA imposes a stricter pleading standardthan that imposed by Rule 9(b). The Rule 9(b) standard requiredsecurities fraud plaintiffs to allege facts and circumstanceswhich gave rise to "a basis for believing that plaintiffs couldprove scienter." DiLeo, 901 F.2d at 628-29. Under the PSLRA,securities fraud plaintiffs must allege facts that afford "astrong inference" for believing that plaintiffs could provescienter.

As to the particular contours of the factual pleadingrequirements, there is remarkable discord among the CircuitCourts.[6] Several courts in this district have characterizedthe PSLRA as effectively codifying the standard employed by theSecond Circuit. Danis, 73 F. Supp.2d at 936-37 (N.D.Ill. 1999)(quoting O'Brien v. Nat'l Property Analysts Partners,936 F.2d 674, 676 (2d Cir. 1991)); In re First Merchants, 1998 WL781118, at *9. Under the Second Circuit's pleading requirements,a plaintiff may allege scienter by either (1) showing that thedefendants had both the motive and opportunity to commit fraud or(2) establishing strong circumstantial evidence of consciousbehavior or recklessness. See, e.g., Press v. Chemical Inv.Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999).

Although this Court finds the Second Circuit's standardinstructive, we note that the PSLRA's only requirement is thatthe facts alleged must give rise to a "strong inference" of thedefendant's scienter. The types of facts with which a plaintiffpleads scienter factor little into our analysis, as long theoverall facts give rise to a "a strong inference" of scienter.Thus, a plaintiff may use "motive and opportunity" or"circumstantial evidence" to establish scienter under the PSLRA,as long as those facts support a strong inference "that thedefendant acted recklessly or knowingly." See Danis, 73F. Supp.2d at 927 (quoting In re Comshare, Inc. Sec. Litig., 183F.3d at 551).

A. KPMG's Scienter Regarding Sabratek's Inflated Earnings

KPMG correctly points out what is not enough to raise a stronginference of scienter. A company's overstatement of earnings,revenues, or assets in violation of GAAP does not itselfestablish scienter. See, e.g., Lovelace v. Software SpectrumInc., 78 F.3d 1015, 1020-21 (5th Cir. 1996); In re SoftwareToolworks, 50 F.3d 615, 627-28 (9th Cir. 1994); Malone v.Microdyne Corp., 26 F.3d 471, 479 (4th Cir. 1994); HealthManagement, 970 F. Supp. at 203; Rehm, 954 F. Supp. at 1256. Insecurities fraud cases, a plaintiff may not simply allege "fraudby hindsight" or point to the "before" and the "after" to showthat the defendants must have intended to defraud them. SeeDiLeo, 901 F.2d at 628 (citation omitted). Thus, althoughplaintiffs have sufficiently alleged that KPMG made materialmisrepresentations, the plaintiffs still face a much tougherburden of alleging facts that give rise to a strong inferencethat KPMG made those misrepresentations with knowledge orreckless disregard of the truth.

As to KPMG's misstatements about Sabratek's inflated earnings,we conclude that the plaintiffs have not met their pleadingrequirements. In fact, the plaintiffs do not allege any factsbeyond the simple fact of Sabratek's GAAP violations to show thatKPMG certified Sabratek's financial statements with the requisiteintent. Thus, Sabratek's allegedly improper revenue recognitionpractices cannot give rise to a strong inference that, inrendering its opinion on Sabratek's financial statements, KPMGacted with fraudulent intent.

B. KPMG's Scienter Regarding Sabratek's Transactions with the R & D Satellite Entities

The plaintiffs have, however, alleged specific facts which giverise to a strong inference that KPMG either participated in, knewabout, or deliberately ignored numerous warning signs ofSabratek's financial misstatements with the R & D SatelliteCompanies. Although violations of GAAP generally are notsufficient standing alone to establish scienter, "when combinedwith other circumstances suggesting fraudulent intent,allegations of improper accounting may support a strong inferenceof scienter." Marksman Partners, L.P. v. Chantal Pharm. Corp.,927 F. Supp. 1297, 1313 (C.D.Cal. 1996); Danis, 73 F. Supp.2d at941-42. Allegations of obvious "red flags" or warning signs thatfinancial reports are misstated, as well as the magnitude of thefraud alleged, can give rise to a strong inference of fraudulentintent. Miller, 9 F. Supp.2d at 928 (deliberately ignoring "redflags" such as the rapid and unexplained increase in the cost perpound of carried inventory "can constitute the sort ofrecklessness necessary to support § 10(b) liability"); Rehm,954 F. Supp. at 1256 ("[t]he more serious the error, the lessbelievable are defendants' protests that they were completelyunaware of [the Company's] true financial status and the strongerthe inference that defendants must have known about thediscrepancy"); In re Health Management, 970 F. Supp. at 203(finding that allegations of accounting firm's ignorance of redflags presented evidence of fraudulent intent).

The plaintiffs have stated sufficient facts to raise a stronginference that KPMG either knew about or recklessly disregardedinformation about Sabratek's material misstatements with regardto research and development expenditures. In March 1999, K. ShanPadda ("Padda"), Sabratek's CEO and Chairman of the Board duringthe class period, told one of Sabratek's shareholders thatSabratek and KPMG had developed a "brilliant strategy" to fundSabratek's research and development costs "off the balance sheet"by transferring its expenses to Unitron, GDS, and Magic aslicensing or loan agreements. Padda explained to the shareholderthat Sabratek and KPMG had structured these deals so that thelater impact of eliminating any false assets from its books wouldbe offset by the benefits of earnings from the finished products.(Compl. at ¶ 188(a).) Similarly, Padda represented to otherSabratek shareholders that KPMG worked as a paid consultant onthe Unitron and GDS licensing agreements and that KPMG'sconsulting advice in connection with those transactions was thecause of the $39 million in accounting restatement announced onOctober 7, 1999.

Moreover, according to a former Unitron employee familiar withthe events that led up to the signing of the "licensingagreement" between Unitron and Sabratek, Sabratek informedUnitron during the negotiations that it would not do the deal"until its auditors [KPMG] signed off on it." Steven

Holden,Sabratek's CFO at the time, told Unitron management duringnegotiations that any agreement would be submitted to KPMG forits review, and that Sabratek "couldn't do the deal as alicensing agreement until its auditors said it was kosher."Holden thereafter informed Unitron that KPMG had in fact "signedoff" on the deal. (Compl. at ¶ 188(c).)

The plaintiffs also point to other factors that would havecaused all but the most reckless auditor to subject thesetransactions to heightened scrutiny. When Sabratek signed thelicensing agreements with Unitron and GDS, the $7 million Unitrondeal and the $4 million GDS deal represented an overall 242%increase in Sabratek's reported intangible assets. The decisionnot to expense these deals as research and development expenseseffectively saved Sabratek's reported net income of $7.2 millionfor 1997. (Compl. at ¶ 189(a).) Yet, Unitron was a developmentalstage company with no marketable products and virtually nocustomers. Unitron's only major product, the MOON network system,was only just entering the testing phase and was at least 18months away from entering the market. (Compl. at ¶ 189(b).)

The magnitude of the fraud alleged combined with the allegationthat KPMG participated in structuring the suspect deals suggestsa deliberate ignorance or perhaps even knowledge on the part ofKPMG. In so concluding, we emphasize that this is still thepleading stage of the case. Our decision today expresses noopinion as to the truth of the allegations or the plaintiffs'ability to produce evidence establishing the facts as alleged.But, with respect to the plaintiffs' claim that KPMG fraudulentlycertified Sabratek's financial statements about its intangibleassets, the allegations are sufficient to withstand KPMG's motionto dismiss.

III. Reliance of Sabratek Convertible Note Holders

KPMG finally argues that claims by the Sabratek convertiblenote purchasers should be dismissed for failure to allege theessential element of reliance. As KPMG contends, some form ofreliance or causal nexus is an essential element of a § 10(b)cause of action. See Basic v. Levinson, 485 U.S. at 243, 108S.Ct. at 489; Rowe v. Maremont Corp., 850 F.2d 1226, 1233 (7thCir. 1988). Without allegations of some causal connection betweenthe defendant's material misstatement and the plaintiff's injury,the plaintiffs cannot survive a motion to dismiss. In the absenceof actual reliance, however, "an alternative method ofestablishing causation — an effect on the market price" maysupport recovery by plaintiffs who never actually read or reliedon the defendant's alleged misstatements. See Eckstein v. BalcorFilm Investors, 8 F.3d 1121, 1129 (7th Cir. 1993).

In addressing KPMG's arguments, we first conclude that theplaintiffs have sufficiently pleaded actual reliance on KPMG'smisstatements. (Reply at 3.) Although the plaintiffs do notexplicitly state that they "received or read KPMG's auditreports," (Reply at 7), the plaintiffs do specify that theyrelied "directly or indirectly on the false and misleadingstatements made by [KPMG]" and that because of KPMG'smisstatements, the plaintiffs"acquired Sabratek's securities . . . at artificially high pricesand were damaged thereby." (Compl. at ¶ 212.) The plaintiffsallege that they were ignorant of the falsity of KPMG'sstatements and that they had erroneously believed them to betrue. (Compl. at ¶ 213.) Had the plaintiffs known Sabratek's truefinancial conditions, which KPMG misstated, they "would not havepurchased or otherwise acquired their Sabratek securities."(Id.) These allegations are sufficient to withstand KPMG'smotion to dismiss.

Further, contrary to KPMG's contentions, the plaintiffs havepleaded sufficient facts to establish a rebuttable presumption ofreliance based on the fraud-on-the-market theory. KPMG contendsthat because the plaintiffs have not pleaded that an efficientmarket exists for Sabratek convertible notes, the plaintiffs arenot entitled to a presumption of reliance under thefraud-on-the-market theory. (Mot. to Dismiss at 18). As explainedby the Supreme Court,

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 on the purchasers do not directly rely on the misstatements. . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Basic Inc. v. Levinson, 485 U.S. 224, 241-42, 108 S.Ct. 978, 99L.Ed.2d 194 (1988) (citation omitted).

The plaintiffs argue, and KPMG concedes, that "the question ona motion to dismiss is not whether [the] plaintiff has proved anefficient market, but whether he has pleaded one." Hayes v.Gross, 982 F.2d 104, 107 (3d Cir. 1992) (emphasis added). KPMGcorrectly notes that the complaint does not specifically allegethat Sabratek convertible notes were traded in an "efficientmarket." (Mot. to Dismiss at 19.) The complaint does state,however, that the notes were convertible into Sabratek commonstock, presumably at the will of the note holder, at a specifieddollar amount. (Compl. at ¶ 100.) The plaintiffs also explicitlydetail the existence of an efficient market for Sabratek commonstock. (Compl. at ¶¶ 201-02.) From these allegations, the Courtmay infer the existence of an efficient market for Sabratek'sconvertible notes. Millions of shares of Sabratek common stockwere traded on the Nasdaq National Exchange, and Sabratek wasfollowed by several securities analysts employed by majorbrokerage firms. Inasmuch as there existed an efficient marketfor Sabratek common stock, this Court also concludes that anefficient market existed for Sabratek convertible notes, whichwere convertible to Sabratek common stock.

Therefore, we conclude that Sabratek convertible notepurchasers have sufficiently alleged reliance and deny KPMG'smotion to dismiss their claim.

CONCLUSION

KPMG's motion to dismiss the plaintiffs' complaint, (R. 96-1),is granted in part and denied in part as indicated herein. Asexplained in Chu II, an amended complaint that conforms to thisopinion will be due on or before August 4, 2000.

A status hearing will be held in open court on August 9, 2000at 9:45 a.m.

1. Today, we issue two opinions resolving numerous motions todismiss. Here we decide KMPG's motion to dismiss, ("Chu I"); inthe second opinion we decide the individual defendants' motionsto dismiss ("Chu II"). Additionally, the plaintiffs have fileda motion for class certification, which has yet to be fullybriefed. We refer to the putative plaintiff class as "theplaintiffs" throughout this opinion without expressing anyconclusion about the propriety of certifying that putativeclass.

2. Sabratek paid Unitron $18.5 million, GDS $10.4 million,Magic $10 million, and CIH $2.7 million throughout the putativeclass period.

3. Although the plaintiffs devote much of the complaint toSabratek's FDA regulatory problems regarding its Rocap division,the plaintiffs do not allege that Sabratek's financial statementswere materially affected by these problems. Thus, for thepurposes of KPMG's motion to dismiss, we limit our inquiry to theplaintiffs' allegations regarding Sabratek's improper revenuerecognition practices and transactions with the R & D SatelliteEntities.

4. See Cooper v. Pickett, 137 F.3d 616, 626-27 (9th Cir.1997) (a company that "overstates its revenues by reportingconsignment transactions as sales . . . make[s] false ormisleading statements of material facts"); Malone v. MicrodyneCorp., 26 F.3d 471, 478 (4th Cir. 1994) ("We cannot find asingle precedent . . . holding that a company may . . .substantially overstate its revenue by reporting consignmenttransactions as sales without running afoul of Rule 10b-5");Sirota v. Solitron Devices, Inc., 673 F.2d 566, 572-76 (2d Cir.1982) (reporting consignment transactions as sales violates GAAPand § 10(b)); Danis v. USN Communications, Inc., 73 F. Supp.2d 923,935 (N.D.Ill. 1999) (holding that recognition of revenue onfictitious sales violates GAAP and § 10(b)); Bell v. Fore Sys.,Inc., 17 F. Supp.2d 433, 440 (W.D.Pa. 1998) (concluding thatclaims that defendant engaged in "inventory parking" arrangementsadequately alleged violation of both GAAP and § 10(b)).

5. See Greebel, 194 F.3d at 199-200; Phillips v. LCI Int'l,Inc., 190 F.3d 609 (4th Cir. 1999); Bryant v. Avado Brands,Inc., 187 F.3d 1271 (11th Cir. 1999); In re Comshare, Inc. Sec.Litig., 183 F.3d 542, 552-53 (6th Cir. 1999); In re AdvantaCorp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999); Press v.Chemical Inv. Servs. Corp., 166 F.3d 529, 537-38 (2d Cir.1999).

6. Circuit Courts have interpreted the pleading standard underthe PSLRA to varying degrees of stringency. Compare In reAdvanta Corp. Sec. Litig., 180 F.3d at 533 (3rd Cir.) (PSLRA"establishes a pleading standard approximately equal instringency to that of the Second Circuit"), with Bryant, 187F.3d at 1282 (11th Cir.) (PSLRA does not codify the "motive andopportunity" test formulated by the Second Circuit for pleadingscienter), and with In re Silicon Graphics Inc. Sec. Litig.,183 F.3d 970, 974 (9th Cir. 1999) ("mere motive and opportunity"is never enough to establish scienter).