BRUCE G. VANYO, State Bar No. 60134
BAHRAM SEYEDIN-NOOR, State Bar No. 203244
OLGA A. TKACHENKO, State Bar No. 228645
WILSON SONSINI GOODRICH & ROSATI
Professional Corporation
650 Page Mill Road
Palo Alto, California 94304-1050
Telephone: (650) 493-9300
Facsimile: (650) 493-6811
Email: bnoor@wsgr.com

JOHN P. STIGI III, State Bar No. 208342
WILSON SONSINI GOODRICH & ROSATI
Professional Corporation
One Market Street, Spear Tower, Suite 3300
San Francisco, CA 94105
Telephone: (415) 947-2000
Facsimile: (415) 947-2099

Attorneys for Defendants
JONATHAN MORGAN and
TRUMAN COLE

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

In re: FIRST VIRTUAL COMMUNICATIONS, INC. SECURITIES LITIGATION. This Document Relates to: ALL ACTIONS.	MASTER FILE NO: C-04-3585 MJJ **DEFENDANTS' NOTICE OF MOTION AND MOTION TO DISMISS CONSOLIDATED AMENDED CLASS ACTION COMPLAINT; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF** CLASS ACTION Date: October 11, 2005 Time: 9:30 a.m. Judge: Hon. Martin J. Jenkins

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NOTICE OF MOTION AND MOTION

PLEASE TAKE NOTICE that, on October 11, 2005, at 9:30 a.m., or as soon thereafter as the matter may be heard, in Courtroom 11 of the United States Courthouse, 450 Golden Gate Avenue, San Francisco, California, before the Honorable Martin J. Jenkins, United States District Judge, defendants Jonathan Morgan ("Morgan") and Truman Cole ("Cole"), will and hereby do move the Court pursuant to the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), 15 U.S.C. § 78u-4, *et seq.*, and Rule 12(b)(6) of the Federal Rules of Civil Procedure for an order dismissing the Consolidated Amended Class Action Complaint ("Amended Complaint" or "AC"). This Motion is based on this Notice of Motion and Motion; the Memorandum of Points of Authorities (included herein); the accompanying Request for Judicial Notice; the accompanying Declaration of Olga Tkachenko ("Tkachenko Declaration"), together with accompanying exhibits; all pleadings and papers filed herein; oral argument of counsel; and any other matter that may be submitted at the hearing.

ISSUES TO BE DECIDED (Civil Local Rule 7-4(a)(3))

1. Does plaintiff plead particularized facts giving rise to a strong inference that Messrs. Morgan and Cole knew that they caused, or were deliberately reckless in causing, First Virtual Communications, Inc. ("First Virtual" or the "Company") to issue incorrect financial statements in March 2004?

2. Does plaintiff adequately plead particularized facts (i) demonstrating the purported falsity of an April 6, 2004 press release and (ii) giving rise to a strong inference of each defendant's scienter with respect to the April 6, 2004 press release?

3. Does the Amended Complaint adequately plead loss causation as required by the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), for a claim under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder?

4. Does the Amended Complaint state a claim for "controlling person" liability under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a)?

INTRODUCTION

Defendants Morgan and Cole are the former chief executive officer and chief financial officer, respectively, of a now bankrupt technology company, First Virtual. Plaintiff asserts a securities fraud claim against them arising from just two alleged misstatements by the Company during the five-month Class Period, March 29, 2004 through August 23, 2004: (1) the Company's Form 10-K for fiscal year 2003, filed March 29, 2004, which republished the Company's annual financial results for fiscal year 2001, quarterly and annual results for fiscal year 2002 and quarterly results for the first three quarters of fiscal year 2003, and published the Company's fourth quarter and annual results for fiscal year 2003; and (2) an April 6, 2004 press release announcing that the United States Air Force had decided to buy certain of the Company's products. After the end of the Class Period, the Company restated its 2001-2003 financials to shift small amounts of revenue between and among quarters. Also after the end of the Class Period, plaintiff's counsel purportedly discovered that the Air Force did not enter into a contract with First Virtual.

The Amended Complaint fails to satisfy the heightened pleading requirements of the Reform Act. It is well settled that a restatement, standing alone, does not give rise to a strong inference that defendants issued inaccurate financials with an intent to mislead or with deliberate recklessness as to whether the financials would mislead investors. The restatement of the challenged financials here involved relatively small amounts of revenue (generally in the range of 1%–5% of total revenues for a particular period), involved many periods in which revenue originally was *under*stated, is not alleged to have included the write-off of any revenue and did not impact whether the Company would meet analysts' expectations in any period. The nature of the restatement thus leads to an equally plausible inference that the original errors were the product of an honest mistake, not fraud.

Plaintiff also does not plead with sufficient particularity facts known to the defendants at the time the financials originally were generated that would give rise to a strong inference they knew the Company's accounting was improper. Messrs. Morgan and Cole did not become officers of the Company until 2002, after many of the restated periods already were concluded.

Plaintiff pleads nothing to suggest that they should have known about accounting errors made before they became officers. Plaintiff alleges vaguely that Messrs. Morgan and Cole began to learn of suspect transactions in late February and March 2004. But plaintiff also alleges that the Company's Audit Committee began an internal investigation into these transactions immediately thereafter and that it took a team of lawyers and accountants *seven months* of investigation costing *$5 million* to conclude that the financial statements in the 2003 Form 10-K contained material, though relatively small, errors. Plaintiff fails to plead facts giving rise to a strong inference that defendants should have known in March 2004 what the Audit Committee investigation ultimately concluded in November 2004. Moreover, although plaintiff purports to identify various "improper" transactions, he fails to provide basic facts about the transactions and their impact on the Company's financials, such as the dates of the transactions or the amount of revenue recognized. Courts routinely dismiss accounting fraud claims that omit such basic details. Plaintiff also cannot identify any cognizable motive for defendants to falsify the financials. Neither defendant sold a single share of First Virtual stock during the Class Period, and many of the revenue figures that required correction had actually *under*stated revenues, which clearly is inconsistent with a "scheme" to inflate the stock price.

Plaintiff's assertion that the April 6, 2004 press release was false appears to be based upon the misguided assumption that the absence of a written contract signed by the federal government and First Virtual means that the Air Force did not agree to purchase First Virtual's products. As the April 6 press release explained, the Company agreed to provide products to the Air Force "via third-party managed service offerings," *i.e.*, not through a direct sale, a common practice described in the Company's SEC filings. In addition, plaintiff fails to plead why Mr. Cole, who is not even quoted in the press release, should be liable for any statements in it.

Finally, the Amended Complaint should be dismissed for the separate and independent reason that it fails to plead the element of loss causation under the Supreme Court's recent decision in *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005). Plaintiff here cannot allege any loss arising from the restatement because he had sold all of his stock months before the restatement occurred. He also cannot allege any loss arising from the April 6, 2004 press

release because First Virtual never issued a corrective disclosure that caused a stock price decline. For all of the foregoing reasons, the Amended Complaint should be dismissed.

BACKGROUND

A. First Virtual and the Defendants

First Virtual is a Delaware corporation formerly headquartered in Redwood City. The Company created software products that allowed users and groups to hold meetings on the Internet, complete with audio, slide presentations, white boards and video images of participants. Ex. 1 at 1.[1] In March 2004, the Company employed 140 individuals full time. *Id.* at 8. During its entire existence, First Virtual never achieved more than $50 million in revenues per year. *Id.* at 18.[2]

Jonathan Morgan joined the Company as an outside director in June 2001. Ex. 2 at 7. In October 2002, Mr. Morgan became First Virtual's president and chief executive officer, a position he retained throughout the Class Period. Truman Cole joined First Virtual as its chief financial officer and vice president in December 2002. AC ¶¶ 6, 7; Ex. 3 at 29. Mr. Cole served in that capacity throughout the Class Period.[3]

B. The Alleged Misstatements During the Class Period

The Class Period begins on March 29, 2004, when First Virtual filed its Form 10-K for fiscal year 2003 ("2003 Form 10-K"). AC ¶ 14. The 2003 Form 10-K included previously reported annual financials for 2001 and 2002 and quarterly financials for 2002 and 2003. *Id.* ¶ 15; Ex. 1 at 18, F-30. The only new financial results reported in the 2003 Form 10-K were for the fourth quarter of 2003 and aggregate results for fiscal year 2003. *Id.* The Company's stock

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[1] All exhibits referenced herein are attached to the accompanying Tkachenko Declaration.

[2] The Company initially was named as a defendant in this action. After the Company filed for Chapter 11 bankruptcy protection, and pursuant to the parties' agreement, the Court dismissed the Company from this action, without prejudice. *See* Notice of Dismissal without Prejudice of Action Solely as to Defendant First Virtual Communications, Inc., filed by the plaintiff with this Court on February 7, 2005.

[3] Mr. Cole resigned as First Virtual's chief financial officer as of November 13, 2004. AC ¶ 28; Ex. 4 at 3.

price closed at $1.48 the day the 2003 Form 10-K was filed. Ex. 6 at 13.

Just over one week into the Class Period, on April 6, 2004, First Virtual issued a press release announcing that the United States Air Force had agreed to buy First Virtual's flagship Click to Meet™ web communications product. AC ¶ 36; Ex. 7. The press release stated, among other things, that the applications sold to the Air Force were being "delivered via third-party managed service offerings." Ex. 7.

On April 30, 2004, First Virtual announced that the Audit Committee of its Board of Directors was overseeing an investigation into certain irregular sales transactions relating to the Company's China operations. AC ¶ 18; Ex. 8. The Company stated that it would not be able to release its first quarter 2004 financial results on a timely basis until the investigation was completed, and that it did not know whether a restatement of previously issued financial results would be required due to the irregular transactions. AC ¶ 18; Ex. 8.

On May 19, 2004, the Company issued another press release disclosing, *inter alia*, the continuation of the investigation into possible irregular sales transactions. *Id.* ¶ 20; Ex. 9. On August 17, 2004, First Virtual filed a Form 8-K disclosing that although the internal investigation was not completed, the part of the investigation dealing with transactions in Asia — the transactions that triggered the investigation in the first place — was "substantially complete" and that "based on the results of the investigation completed to date, no matters have arisen which would require a restatement of previously issued financial statements." AC ¶ 22; Ex. 10 at 3.

The Class Period ends on August 23, 2004. On August 24, 2004, the Company announced that its request for an extension to comply with NASDAQ's listing requirements had been denied. As a result, the Company's stock was de-listed from the Nasdaq SmallCap Market on August 25, 2004. Ex. 11.

C. The Restatement

On November 19, 2004, the Company filed a Form 8-K announcing that, as a result of the Audit Committee's investigation, it would need to restate certain of its past financials. AC ¶ 29; Ex. 5 at 3. The Audit Committee determined that as a result of errors involving the

accounting for just one of First Virtual's U.S. customers, it would be necessary to restate the Company's financial results for the period 2001 to 2003. Ex. 5 at 3. The Company also disclosed that its restatement of past financials would include corrections for errors relating to other irregular sales transactions, mostly in its Asia operations. *Id*. The Company explained further that the correction of the accounting for the Asian sales transactions, standing alone, "would *not* have required a restatement of previously issued financial statements due to their immateriality for reporting purposes." *Id*. (emphasis added).

As shown in the table below, the Company's announcement of the restatement included ranges of preliminary estimates for the restated revenue figures rather than fixed numbers, as work on the restatement was continuing at the time of the announcement. *Id*. at 4.

	Original	Restated Range	Variance from Original ($)	Variance (%)
FY 2001	$27,661,000	$27,491,000 – $27,411,000	Minus $170,000 – $250,000	Minus 0.6% – 0.9%
Q1 2002	$6,601,000	$7,751,000 – $8,001,000	*Plus* $1,150,000 – $1,400,000	*Plus* 17.4% – 21.2%
Q2 2002	$6,644,000	$6,444,000 – $6,404,000	Minus $200,000 – $240,000	Minus 3.0% – 3.6%
Q3 2002	$6,137,000	$6,057,000 – $6,047,000	Minus $80,000 – $90,000	Minus 1.3% – 1.5%
Q4 2002	$5,032,000	$5,170,000 – $5,210,000	*Plus* $170,000 – $210,000	*Plus* 3.4% – 4.2%
FY 2002	$24,414,000	$25,454,000 – $25,694,000	*Plus* $1,040,000 – $1,280,000	*Plus* 4.2% – 5.2%
Q1 2003	$5,377,000	$5,347,000 – $5,327,000	Minus $30,000 – $50,000	Minus 0.6% – 0.9%
Q2 2003	$5,894,000	$5,594,000 – $5,494,000	Minus $300,000 – $400,000	Minus 5.1% – 6.5%
Q3 2003	$5,374,000	$5,654,000 – $5,724,000	*Plus* $280,000 – $350,000	*Plus* 5.2% – 6.5%
Q4 2003	$4,678,000	$4,640,000 – $4,620,000	Minus $60,000 – $80,000	Minus 1.3% – 1.7%
FY 2003	$21,323,000	$21,213,000 – $21,143,000	Minus $110,000 – $180,000	Minus 0.5% – 0.8%

D. The Instant Lawsuits and the Company's Bankruptcy

The same day that First Virtual shares were de-listed, August 25, 2004, the first of several putative class action complaints were filed alleging violations of Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5. On December 13, 2004, the Honorable Fern Smith consolidated

the various lawsuits. On January 25, 2005, Judge Smith appointed the present lead plaintiff and counsel.

On January 20, 2005, First Virtual filed for bankruptcy protection with the United States Bankruptcy Court for the Northern District of California. On March 16, 2005, First Virtual sold substantially all of its assets to RADVision. Ex. 12. The Company currently is in liquidation.

On April 29, 2005, plaintiff filed the Amended Complaint. It asserts claims under Sections 10(b) and 20(a) of the Exchange Act, and Rule 10b-5. AC ¶¶ 1, 62-72. The claims are based upon just two alleged misstatements during the Class Period: (1) the 2003 Form 10-K, issued March 29, 2004, containing the 2001-2003 financial results that were later restated and (2) the April 6, 2004 press release regarding the contract awarded by the United States Air Force.

ARGUMENT

I. THE AMENDED COMPLAINT DOES NOT SATISFY THE REFORM ACT'S HEIGHTENED PLEADING REQUIREMENTS

Before 1995, Rule 9(b) of the Federal Rules of Civil Procedure set the standard for pleading a claim under Section 10(b) and Rule 10b-5. In December 1995, "prompted by significant evidence of abuse in private securities lawsuits" (H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730), Congress enacted the Reform Act. *See* Pub. L. No. 104-67, 109 Stat. 743 (1995). Congress intended the Reform Act to "eliminate abusive securities litigation" and "the practice of pleading 'fraud by hindsight'" (*In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084-85 (9th Cir. 2002) (citations omitted)) by "erecting procedural barriers to prevent plaintiffs from asserting baseless securities fraud claims." *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 977 (9th Cir. 1999).

The Reform Act supersedes Rule 9(b) by requiring a Section 10(b) plaintiff to "specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. § 78u-4(b)(1). This requirement is essential because a statement is not actionable under Rule 10b-5 unless it is "misleading" to investors, *i.e.*, unless it "affirmatively create[s] an impression of a state of affairs that differs in a material way from the one that actually exists." *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002).

Merely alleging that a statement is "incomplete" or omits material information is *not* sufficient, since "Rule 10b-5. . . prohibit[s] *only* misleading and untrue statements, not statements that are incomplete." *Id.*

The Reform Act also requires that "with respect to each act or omission alleged to violate this chapter" a Section 10(b) plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind [*i.e.*, scienter]." 15 U.S.C. § 78u-4(b)(2). In this Circuit, "the required state of mind" involves intentional or conscious misconduct: either "actual knowledge" that a statement is false or misleading or "deliberate recklessness" as to the truth or falsity of a statement. *Silicon Graphics*, 183 F.3d at 977, 995. In *Silicon Graphics*, the Ninth Circuit defined "deliberate recklessness" as "no less than a degree of recklessness that strongly suggests actual intent." *Id.* at 979. It constitutes conduct so "highly unreasonable" that it involves an "extreme departure from the standards of ordinary care, and which presents *a danger of misleading* buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 976 (citations omitted) (emphasis added).

The Ninth Circuit requires that a securities fraud plaintiff "plead, *in great detail*, facts that constitute *strong* circumstantial evidence of deliberately reckless or conscious misconduct." *Id.* at 974 (emphasis added). "It is not enough," the Ninth Circuit held, "for [plaintiff] to state facts giving rise to a mere speculative inference of deliberate recklessness, or even a reasonable inference of deliberate recklessness." *Id.* at 985. When determining whether the plaintiffs have pleaded facts giving rise to a strong inference of scienter, "the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *Gompper v. VISX, Inc.*, 298 F.3d 893, 897 (9th Cir. 2002). An inference of scienter is not "strong" if the court can draw an "equally if not more plausible" inference of innocence from the same set of facts. *Id.* What is more, to survive dismissal, an inference of defendants' scienter must be "the most plausible of competing inferences" from the pleaded facts. *Id.* (citation omitted). The Ninth Circuit has "established a very high threshold for the factual and logical strength of the required implication and for the level of scienter which must be strongly implied."

In re Read-Rite Corp. Sec. Litig., 115 F. Supp. 2d 1181, 1183 (N.D. Cal. 2000), *aff'd*, 335 F.3d 843 (9th Cir. 2003).

The Reform Act provides further that "if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[4] The requirement to plead "all facts" with particularity means that "a plaintiff must provide a list of all relevant circumstances in great detail." *Silicon Graphics*, 183 F.3d at 984. The Reform Act included this "all facts" requirement in order to enable courts to distinguish a meritorious claim "from the conjectures of many concerned and interested investors" and "the countless 'fishing expeditions' which the [Reform Act] was designed to deter." *Id.* at 988.

The Reform Act specifically authorizes a motion to dismiss "for failure to meet pleading requirements" and makes dismissal mandatory if those pleading requirements are not met. 15 U.S.C. § 78u-4(b)(3). As the Ninth Circuit has explained, "[t]he heightened pleading requirements of the [Reform Act] are an unusual deviation from the usually lenient requirements of federal rules pleading. In few other areas are motions to dismiss for failure to state a claim upon which relief can be granted so powerful." *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001).

As explained above, this action is about just two statements made by First Virtual during the five-month Class Period: (1) the financial statements included in the Company's 2003 Form 10-K, filed March 29, 2004; and (2) an April 6, 2004 press release announcing that the United States Air Force had decided to buy certain of the Company's products. As shown below, plaintiff fails to satisfy the Reform Act's heightened pleading requirements for a Section 10(b) claim based upon either of these alleged false statements.

[4] Allegations purportedly made upon "investigation of counsel" (*see* AC at 1) are deemed to be made upon information and belief, and thus are subject to the "all facts" requirement of the Reform Act. *See Vantive*, 283 F.3d at 1085 n.3.

A. Plaintiff Fails to Plead Specific Facts Giving Rise to a Strong Inference That Defendants Knew or Were Deliberately Reckless In Not Knowing In March 2004 That the 2003 Form 10-K Contained Materially False Financials

1. The November 2004 Restatement Does Not Support a Strong Inference of Defendants' Scienter in March 2004

It is well settled that "the mere publication of inaccurate accounting figures, or a failure to follow GAAP [(generally accepted accounting principles)], without more, does not establish scienter." *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002); *accord Blackin v. Red Brick Sys., Inc.*, No. C-98-1206 MJJ, slip op. at 5 (N.D. Cal. Apr. 30, 1999) (Jenkins, J.). As this Court has recognized, "the mere fact that [the Company] restated its financials for these years is not enough to create the necessary strong inference of scienter." *In re Network Assocs., Inc. II Sec. Litig.*, No. C-00-4849 MJJ, 2003 U.S. Dist. LEXIS 14442, at *49 (N.D. Cal. Mar. 25, 2003) (Jenkins, J.) (citations omitted). Accordingly, the November 2004 restatement of the Company's 2001-2003 financials does not give rise to a strong inference that defendants issued those financials in March 2004 with knowledge of or deliberate recklessness as to their falsity.

The relatively benign nature of the Company's restatement here actually contradicts plaintiff's theory that defendants issued false financial statements to "artificially inflate" the price of First Virtual common stock during the Class Period. AC ¶ 64; *see also* AC ¶¶ 57, 60. As discussed above, the Company's 2003 Form 10-K published (or republished) revenue figures for eleven periods that were later restated. Of these, *four* were restated to *increase* revenues. In addition, nearly all of the downward adjustments of revenues were under 2%. The largest single quarterly decrease in revenues (the second quarter of 2003) was a mere 5.1%–6.5%, and was followed *in the very next quarter* by an *increase* in revenues of 5.2%–6.5%. The restatement involved a shifting of revenues between and among quarters, and is not alleged to have involved a write-off or deletion of revenues previously recognized. Many courts have held that the most plausible inference to be drawn from similarly *de minimis* or equivocal restatements of financials is that defendants made honest errors, not fraud. *See, e.g., Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 967 (7th Cir. 1989) (most reasonable inference from defendants' restatement,

which decreased earnings by approximately 10% was that the "auditors made an honest error, of the kind endemic when firms try to release figures as soon as possible to a market ravenous for news"); *Davis v. SPSS, Inc.*, No. 04 C 3427, 2005 U.S. Dist. LEXIS 9497, at *26 (N.D. Ill. May 10, 2005) ("This understatement of revenue amounting to less than 0.3% of [defendant's] restated revenue for 2001, leads one to infer not that [defendant] purposely manipulated its financials, but that reporting errors occurred."); *see also DeMaria v. Andersen*, 318 F.3d 170, 181 (2d Cir. 2003) (understated revenues "would not have caused a reasonable investor to overestimate [the corporation's] past performance or future performance potential"); *In re Tyco Int'l, Ltd., Sec. Litig.*, 185 F. Supp. 2d 102, 112 (D.N.H. 2002) (dismissing accounting fraud allegations in part because the restatement increasing earnings per share did not support plaintiff's fraud theory). Further weakening any inference of scienter is the absence of any allegation that the Company would have missed guidance or Wall Street expectations in any restated quarter had the Company issued the restated numbers at that time.

It is also well established that a company's consultation with outside auditors, coupled with an unqualified audit opinion certifying the financial statements as presented in conformity with GAAP, negates an inference of scienter unless plaintiff pleads particularized facts indicating that defendants withheld relevant information from the auditors or knew that the audit was unreliable. *See In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1421 (9th Cir. 1994); *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1465 (N.D. Cal. 1996). Here, plaintiff cannot dispute that the Company's independent public accountants, PricewaterhouseCoopers LLP, reviewed and audited the Company's financial statements and issued unqualified audit opinions on the later restated annual financials. Ex. 1 at F-1. The willingness of defendants to open the Company's books to full and fair audits and reviews by auditors whose diligence and independence plaintiff never impugns contradicts any inference that those defendants intended to commit fraud or acted with deliberate recklessness.

2. Plaintiff Fails to Plead Particularized Facts Giving Rise to a Strong Inference That Defendants Knew or Were Deliberately Reckless In Not Knowing Contemporaneous Conditions Prior to March 29, 2004 Reflecting Material Accounting Errors

To support a strong inference of scienter in a claim for accounting fraud, plaintiffs must "allege *specific contemporaneous conditions known to the defendants* that would strongly suggest that the defendants understood" at the time the financials were first issued that the company's accounting was improper. *Vantive*, 283 F.3d at 1091 (emphasis added). Plaintiff here fails to meet this standard.

a. Plaintiff Pleads No Factual Basis From Which to Strongly Infer Defendants' Knowledge of Accounting Errors That Occurred Before They Became Officers of First Virtual

Plaintiff seeks to hold defendants liable for incorrect revenue figures for fiscal years 2001 and 2002. Yet Mr. Morgan did not even join the Company until the middle of 2001. *See* Ex. 2 at 7. Furthermore, Mr. Morgan first joined the Company as an outside director and did not become an officer until October 2002. *Id.* Plaintiff does not allege that Mr. Morgan was involved in any accounting or revenue recognition issues during his tenure as an outside director, and the law of this Circuit does not permit the Court to infer knowledge and scienter based solely upon a defendant's high-ranking position at a company. *See In re Read-Rite Corp.*, 335 F.3d 843, 848-49 (9th Cir. 2003). Similarly, Mr. Cole was not an employee of the Company before December 2002 when the 2001 and 2002 revenue figures were originally generated. *See* Ex. 3 at 29. Plaintiff offers no basis on which to infer defendants' scienter for the accounting decisions made before they became officers of the Company.

b. Plaintiff Pleads an Insufficient Factual Basis From Which to Strongly Infer Defendants' Knowledge Prior to March 29, 2004 of Material Accounting Errors Related to the Company's China Transactions

When First Virtual announced the restatement in November 2004, it disclosed that although the Audit Committee investigation had uncovered errors related to the Company's Asia operations, "these errors, standing alone, would *not* have required a restatement of previously issued financial statements *due to their immateriality* for reporting purposes." Ex. 5 at 3

(emphasis added). Plaintiff pleads nothing to indicate that those accounting errors were, in fact, material to the Company's financial condition. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988) ("[I]n order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were *misleading* as to a *material* fact."). Plaintiff's failure to do so is dispositive. *See In re Gilead Sciences Sec. Litig.*, No. C03-4999 MJJ, 2005 WL 181885, at *9 (N.D. Cal. Jan. 26, 2005) (Jenkins, J.) (dismissing plaintiff's claims regarding improper sales where plaintiff failed to allege they were "material" to the challenged financials.).

Furthermore, to plead accounting fraud, "[p]laintiff must allege 'particular transactions where revenues were improperly recorded, including the names of customers, the terms of specific transactions, when the transactions occurred, and the approximate amounts of the fraudulent transactions.'" *Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *37-38 (citation omitted); *accord, e.g.*, *In re Pac. Gateway Exch., Inc. Sec. Litig.*, 169 F. Supp. 2d 1160, 1166 (N.D. Cal. 2001); *In re Secure Computing Corp. Sec. Litig.*, 120 F. Supp. 2d 810, 820 (N.D. Cal. 2000); *Kane v. Madge Networks N.V.*, No. C-96-20652-RMW, 2000 WL 33208116, at *6 (N.D. Cal. May 26, 2000), *aff'd*, 2002 WL 506286 (9th Cir. Mar. 27, 2002); *Copperstone v. TSCI Corp.*, No. C-97-3495 SBA, 1999 WL 33295869, at *11 (N.D. Cal. Jan. 19, 1999); *Hockey v. Medhekar*, 30 F. Supp. 2d 1209, 1216 (N.D. Cal. 1998). Plaintiff fails to provide these basic details for any of the alleged "improper sales transactions" in the China operations.

The few details plaintiff does plead are incomplete and insufficient to give rise to a strong inference that defendants knew or were deliberately reckless in not knowing prior to March 29, 2004 whether the financials contained materially misleading accounting errors. For example, plaintiff challenges certain transactions that allegedly had a "right of return." AC ¶ 31(a). Under GAAP, however, the existence of a "right of return" does not, in and of itself, preclude revenue recognition. *See* Revenue Recognition When Right of Return Exists, FASB Statement of Financial Accounting Standards No. 48 (AICPA 2005) (Ex. 13) (setting forth revenue recognition criteria under GAAP for transactions involving a right of return). As this Court has observed, "even assuming all of the goods were returned, the proper inquiry, in terms of determining whether [the Company] improperly recognized revenue, is whether the Company's

reserves were sufficient to cover such returns." *Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *41. Yet plaintiff pleads nothing about the sufficiency of reserves. Similarly, the issue regarding "fictitious customers" might have raised obvious and immediate concerns only if, unlike here, payment had not been received. *See* AC ¶ 31(b). Plaintiff's allegations that Bing Liao entered into "side deals" and sold licenses to multiple customers (*see id.* ¶ 31(c), (f)) also do not, on their face, suggest improper revenue recognition in violation of accounting rules.[5] And again, plaintiff does not allege any details regarding these transactions, such as "'the names of customers, the terms of specific transactions, when the transactions occurred, and the approximate amounts of the fraudulent transactions.'" *Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *37-38 (citation omitted).

The facts pleaded in the Amended Complaint actually support an equally plausible inference that defendants acted entirely properly. Plaintiff alleges, somewhat vaguely, that Mr. Morgan first learned of potential issues regarding China transactions at the "end of February 2004." AC ¶ 31(b). Plaintiff does not allege with specificity when Mr. Cole learned of certain issues regarding the China transactions, although he seems to assert that it was sometime after March 23, 2004. *See id.*[6] Plaintiff concedes that the Company's Audit Committee began its internal investigation into the suspect China transactions immediately thereafter. *See id.* ¶ 18; *see also id.* ¶ 31(e) (alleging that collection of relevant evidence began in March 2004). The investigation was "still ongoing" in August 2004 (*see id.* ¶ 22) and was not completed until November 2004. *See id.* ¶ 29(a). It was only when the investigation concluded that the Audit Committee was able to determine that a restatement was necessary. *See id.* In other words, it

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[5] Plaintiff alleges that, in its August 17, 2004 8-K, the Company "admitted that Mr. Liao was terminated from First Virtual as a result of the Company's discovery of his improper sales conduct." AC ¶ 31(d). Mr. Liao's name, however, does not appear in the Form 8-K. *See* Ex. 10.

[6] In fact, the Amended Complaint provides no factual basis from which to infer that Mr. Cole learned of issues regarding Mr. Liao before the Company issued its 2003 Form 10-K. Although plaintiff alleges that Confidential Witness E learned about a suspect wire transfer on March 23, 2004, he does not allege when Confidential Witness E supposedly relayed this information to Mr. Cole. *See* AC ¶ 31(b). Plaintiff also does not allege when Soek Yie Phan, a First Virtual employee, came to learn of this information or whether and when she may have relayed the information to Mr. Cole. *See id.*

took a team of lawyers and accountants *working for seven months* (and costing the Company $5 million, *see id.* ¶ 24) to conclude that the financial statements reflected in the 2003 Form 10-K contained material, though relatively small, errors. Plaintiff alleges nothing from which the Court can strongly infer that Messrs. Morgan and Cole, acting on their own, reached or were deliberately reckless in not reaching that same conclusion from a handful of conversations that may have occurred during the month before the issuance of the 2003 Form 10-K.

c. Plaintiff Pleads an Insufficient Factual Basis From Which to Strongly Infer Defendants' Knowledge Prior to March 29, 2004 of Material Accounting Errors Related U.S. Transactions

Plaintiff alleges improper transactions by two of the Company's sales vice presidents in its U.S. operations. Plaintiff first alleges that these individuals made "side deals" that permitted certain customers to sign purchase orders for 100 licenses but only pay for the "number of licenses they actually needed." AC ¶ 32(a). Plaintiff does not allege that Mr. Morgan ever became aware of the "side deals." Plaintiff asserts that Mr. Cole was aware of these so-called "side deals." *See id.* Plaintiff, however, does not allege *when* Mr. Cole became aware of the alleged "side deals." Accordingly, the Court has no factual basis from which to strongly infer that defendants were aware of the alleged "side deals" before March 29, 2004.

In fact, the purported basis for plaintiff's allegations regarding Mr. Cole's knowledge of the "side deals" lacks sufficient indicia of reliability. *See Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *36-37. Plaintiff alleges that "Defendant Cole admitted to Confidential Witness E that Cole had been aware of these 'side deals,' and had stated that he (Defendant Cole) had 'a drawer full of them.'" AC ¶ 32(a). Plaintiff attributes this assertion to Confidential Witness B, an alleged former marketing consultant (*not* an employee) for First Virtual. Plaintiff did *not* attribute this assertion to the witness with alleged first-hand knowledge of Mr. Cole's purported admission, Confidential Witness E. This discrepancy leads to the inescapable inference that Confidential Witness E would not corroborate Confidential Witness B's unreliable hearsay.

In addition, as with the China transactions, plaintiff does not allege pertinent details about the alleged U.S. "side deals," such as the dollar amount of the transactions or whether the

Company recognized revenue in excess of the amount the customer actually paid. If the alleged "side deals" were immaterial and/or the Company recognized as revenue the amount the customer actually paid, then the Company committed no accounting error. The Court, therefore, has no factual basis from which to strongly infer that the Company violated GAAP with regard to these alleged "side deals," let alone whether defendants knew about or recklessly caused the Company to commit any such violation of GAAP.

Next, plaintiff alleges that one of the Company's sales vice presidents caused the Company to recognize revenue "prematurely" from sales to AT&T through the use of allegedly "backdated" documents. AC ¶ 32(b). Plaintiff does not allege that either defendant was specifically aware of the "backdating" of documents, let alone that they became aware of the alleged practice before March 29, 2004. Rather, plaintiff alleges generally that Mr. Cole "made all decisions regarding revenue recognition for sales made to AT&T (as well as all revenue recognition decisions for all products sold)" (*id.*),[7] essentially asking the Court to presume from Mr. Cole's position as the Company's chief financial officer that he must have known about the "backdating" all along. The Ninth Circuit has rejected the notion that a chief executive officer or chief financial officer can be presumed to have acted with knowledge and scienter simply by reason of his or her senior position with the company. *See Read-Rite,* 335 F.3d at 848.

In addition, as with all of the other alleged accounting errors, plaintiff does not allege key details about the errors, such as the amounts of the "premature" revenue recognition or the quarters in which the revenue alleged was and/or should have been recognized. *See* AC ¶ 32(b) (alleging that improper revenue recognition occurred in "various fiscal quarters"). Did this take place in 2001, before Mr. Morgan joined the Company? In 2002, before Mr. Cole joined the

[7] Plaintiff attributes this allegation regarding Mr. Cole's involvement in making revenue recognition decisions to Confidential Witness N. AC ¶ 32(b). Plaintiff describes Confidential Witness N as part of the Company's sales department, reporting "to the Company's Vice Presidents of Worldwide Sales." *Id.* ¶ 11(n). Confidential Witness N was not part of the Company's accounting department. What is Confidential Witness N's basis for knowing Mr. Cole's role in revenue recognition? Plaintiff does not say. Plaintiff's assertion regarding Mr. Cole's involvement in all revenue recognition decisions, therefore, lacks a sufficient factual basis under the Reform Act. *See Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *36-37.

Company? Were the amounts material in any given quarter? Plaintiff never says. Here, too, the Court has no factual basis from which to strongly infer that defendants knew about or recklessly caused the Company to recognize revenue from U.S. transactions prematurely in violation of GAAP. *Blackin*, slip op. at 5 (dismissing premature revenue recognition claim where plaintiff "fail[ed] to plead any facts showing that any sales were booked before they were completed").

Lastly, plaintiff alleges that the sales vice presidents misrepresented to AT&T the compatibility of First Virtual's products with AT&T's networks. Plaintiff alleges that as a result of the "false representations . . . concerning the attributes of the Company's products . . . , customers made many product returns, and the amount of these product returns were quantified in internal reports known as 'negative commission reports'" that were allegedly distributed to Messrs. Cole and Morgan. AC ¶ 32(c).[8] Notably, plaintiff does *not* contend that the Company accounted for the product returns improperly. This omission is dispositive. *See Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *41. Plaintiff also does not allege when the "large order from AT&T" took place. Did it take place during 2001, 2002 or 2003, or did it take place in 2004, after the Company issued the 2003 Form 10-K? Without such basic facts, the Court has no basis from which to strongly infer defendants' scienter.[9]

3. Plaintiff's Failure to Plead Any Cognizable Motive For Defendants to Commit Fraud Undermines an Inference of Scienter

Although pleading motive and opportunity is neither sufficient nor required to plead a strong inference of scienter (*see Silicon Graphics*, 183 F.3d at 985), it is recognized in this Circuit that the absence of any cognizable motive to commit fraud undercuts an inference of

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[8] In *Silicon Graphics*, the Ninth Circuit explained that "[w]e would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from these reports as well as such facts as may indicate their reliability" (183 F.3d at 985), such as "their contents, who prepared them, which officers reviewed them and from whom [plaintiff] obtained the information." *Id.* at 984. Plaintiff here does not plead sufficient details about the so-called "negative commission reports" (*see* AC ¶ 32(c)) to "indicate their reliability."

[9] Plaintiff also seems to suggest that the Company's routine renewal of its directors and officers ("D&O") insurance policy when the old policy expired in April 2004 somehow gives rise to an inference of scienter. *See* AC ¶ 23. No case in this or any other Circuit has ever held that an inference of scienter can be inferred from renewing D&O insurance.

scienter. As the court observed in *Schuster v. Symmetricom, Inc.*, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,206 (N.D. Cal. Aug. 1, 2000), *aff'd*, 2002 WL 1136064 (9th Cir. May 30, 2002), "courts do not presume that corporate officers make false statements simply out of spite or to impress others. . . . Thus, a plaintiff who makes no meaningful allegations of motive faces 'a tougher standard' for establishing scienter." *Id.* at 95,033 (citations omitted); *accord In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1269 (N.D. Cal. 2000); *Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1354 (S.D. Cal. 1998). Here, plaintiff cannot point to any cognizable motive for defendants to have engaged in fraud.

Filings with the SEC show that, as of the beginning of the Class Period, Messrs. Morgan and Cole owned $586,554 and $237,333, respectively, in vested First Virtual stock options.[10] Yet despite the opportunity to "cash in" on the supposed fraud, neither defendant sold a single share during the Class Period. To the contrary, Messrs. Morgan and Cole watched the value of these holdings dwindle by more than half during the Class Period, to $256,617 and $103,833, respectively.[11] Courts in this Circuit have held that the absence of stock sales undermines an inference of scienter. *See Allison*, 999 F. Supp. at 1352-53; *Plevy v. Haggerty*, 38 F. Supp. 2d 816, 834 (C.D. Cal. 1998); *see also In re Mego Fin. Corp. Sec. Litig.*, 213 F.3d 454, 458-59 (9th Cir. 2000); *accord Osher v. JNI Corp.*, 256 F. Supp. 2d 1144, 1164 (S.D. Cal. 2003); *In re PETsMART, Inc. Sec. Litig.*, 61 F. Supp. 2d 982, 1000 (D. Ariz. 1999); *Head v. NetManage,* [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,412, at 91,860 (N.D. Cal. Dec. 30, 1998).

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[10] Defendants' holdings were calculated by multiplying the number of vested stock options each held as of April 1, 2004 with the Company's closing stock price on that date. In evaluating the owner's trading potential, it is proper to consider the vested stock options held by Defendants because they can be converted easily to shares and sold immediately. *See Silicon Graphics*, 183 F.3d at 986-87. According to First Virtual's proxy statements and Forms 4 and 5, as of April 1, 2004, Mr. Morgan held 366,596 vested options, and Mr. Cole held 148,333 vested options. Exs. 2, 3, 14-20. The closing price of First Virtual's stock on April 1, 2004 was $1.60 per share. Ex. 6 at 14.

[11] During the Class Period, the price of First Virtual's stock fell from $1.48 on March 29, 2004 to $0.70 on August 23, 2004. *See* Ex. 6 at 13-16. Accordingly, the value of vested stock options held by Messrs. Morgan and Cole fell by a proportional amount.

Casting about for some other motive, plaintiff also alleges (falsely) that "Defendant Morgan's brother-in-law was employed at" Silicon Valley Bank. Silicon Valley Bank, plaintiff claims, sold 56,250 shares of First Virtual stock "just three days" before the Company's April 30, 2004 press release announcing the Company's internal investigation into certain irregular transactions. AC ¶ 46. Proceeds from that sale were approximately $152,000.[12] Had the Bank waited until after the April 30, 2004 press release to sell those shares, proceeds would have been approximately $90,000.[13] The extra $62,000 that Silicon Valley Bank was able to make from selling its First Virtual stock before April 30, 2004 reflects nine one-hundredths of one percent (0.09%) of the Bank's $65.4 million in net income and thirteen one-thousandths of one percent (0.0013%) of the Bank's $4.8 billion in average assets for 2004 — or about $60 for each of the Bank's 1,028 full time equivalent employees. *See* Ex. 21 at 7, 18. Even assuming *arguendo* that Mr. Morgan had a brother-in-law employed at Silicon Valley Bank (he did not), plaintiff does not explain how such a paltry benefit to the Bank or any one of its employees provides a plausible motive for Mr. Morgan to commit fraud.[14]

B. Plaintiff Fails To State a Section 10(b) Claim Based Upon the April 6, 2004 Press Release

On April 6, 2004, First Virtual issued a press release announcing a contract with the U.S. Air Force for its Click to Meet™ product. AC ¶ 36. After the Class Period, plaintiff purportedly

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[12] Silicon Valley Bank is alleged to have sold 56,250 shares of First Virtual stock on or about April 27, 2004. The Company's stock price traded that day in the range of $2.63 to $2.92, closing at $2.70. *See* Ex. 6 at 14.

[13] The Company's stock price closed on April 30, 2004 at $1.59, slightly above its low at $1.53. *See* Ex. 6 at 14.

[14] In fact, courts in this Circuit have consistently rejected profoundly more compelling allegations of non-defendant stock sales as insufficient to give rise to a strong inference of scienter. *See, e.g.*, *In re Versant Object Tech. Corp. Sec. Litig.*, No. C 98-00299 CW, 2001 U.S. Dist. LEXIS 25009, at *16 (N.D. Cal. Dec. 4, 2001), (sales by an insider non-defendant are irrelevant to alleging scienter against the named defendants), *aff'd sub nom. Wilkes v. Versant Object Tech. Corp.*, No. 01-17493, 2003 U.S. App. LEXIS 1539 (9th Cir. Jan. 23, 2003); *accord In re Splash Tech. Holdings Inc. Sec. Litig.*, 160 F. Supp. 2d 1059, 1082 n.22 (N.D. Cal. 2001); *Plevy*, 38 F. Supp. 2d at 834 n.12; *see also Campbell v. Lexmark Int'l Inc.*, 234 F. Supp. 2d 680, 685 n.6 (E.D. Ky. 2002); *In re Century Bus. Servs. Sec. Litig.*, No. 1:99CV02200, 2002 U.S. Dist. LEXIS 26964, at *26-27 n.18 (N.D. Ohio June 27, 2002).

learned that First Virtual did not have a written contract on file with the U.S. Air Force. *See* AC ¶¶ 40-41. Plaintiff deduced from the absence of a written contract between the federal government and First Virtual that the April 6, 2004 announcement must have been a lie and that defendants must have made the false statement deliberately to mislead investors. Not so.

1. Plaintiff Cannot Demonstrate That the Press Release Was Materially Misleading

Plaintiff's assumption that no contract existed is predicated upon a misinterpretation of the April 6, 2004 press release and a misunderstanding of First Virtual's sales practices. As disclosed in the press release, the Company's Click to Meet™ applications were to "be delivered [to the U.S. Air Force] *via third-party managed service offerings*." Ex. 7. (Plaintiff omitted this sentence from its excerpt of the April 6, 2004 press release in paragraph 36 of the Amended Complaint.) The press release explicitly disclosed that the Company was providing its products to the U.S. Air Force through an intermediary. In fact, the Company repeatedly disclosed to investors that it primarily sold its products to the federal government and other customers through third-party resellers and other intermediaries. For example, the Company's 2003 Form 10-K, issued *before* the April 6, 2004 press release, explained that First Virtual "distributes its products primarily through resellers, integrators and collaboration partners." Ex. 1 at 2; AC ¶ 34. The 2003 Form 10-K also disclosed that "[i]n 2003, approximately one third of the Company's revenue was through resellers to the US Federal Government, including the . . . Air Force . . . ." Ex. 1 at 12; *see also id.* at F-6 ("The Company sells its products worldwide through original equipment manufacturers ('OEM partners'), distributors and resellers."); Ex. 22 at F-6 (same); Ex. 23 at F-6 (same). Any investor reading the April 6, 2004 press release would have been well aware that the Air Force's purchase was done through a third-party intermediary.

To be actionable under Rule 10b-5, a statement or omission must be "misleading." *See Basic*, 485 U.S. at 238, 239 n.17; *Brody*, 280 F.3d at 1006. A statement is "misleading" if it "affirmatively create[s] an impression of a state of affairs that differs in a material way from the one that actually exists." *Id.* As explained above, the disclosure that the delivery of Click to Meet™ applications to the Air Force would be "via third-party managed service offerings" (Ex.

7), coupled with the myriad disclosures in the Company's SEC filings that it routinely sold products through third-party resellers, ensured that the press release's announcement of a sale to the U.S. Air Force did not mislead investors into thinking that the purchase agreement necessarily was memorialized by a written contract signed by the federal government and First Virtual. In any event, even if the press release did give the impression that the Air Force's agreement to purchase the Company's products was through a direct contract signed by the federal government and First Virtual, rather than through a contract signed by the federal government and a third-party reseller of First Virtual's products, such a "state of affairs" did not "differ[] in a material way from the one that actually exist[ed]." *Brody*, 280 F.3d at 1006.

2. Plaintiff Fails to Plead Particularized Facts Giving Rise to a Strong Inference That Defendants Knew or Recklessly Disregarded the Danger That the April 6, 2004 Press Release Would Mislead Investors

As explained above, the Reform Act requires that plaintiffs plead detailed facts giving rise to a strong inference that the defendant acted with actual knowledge and intent that a statement is misleading or "deliberate recklessness" as to the misleading nature of a statement. *See Silicon Graphics*, 183 F.3d at 977. "Deliberate recklessness" is defined as conduct so "highly unreasonable" that it involves an "extreme departure from the standards of ordinary care, and which presents *a danger of misleading* buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 976 (citations omitted) (emphasis added). Under this standard, therefore, "[k]nowledge of an omission does not itself necessarily raise a strong inference of scienter." *R2 Invs. LDC v. Phillips*, 401 F.3d 638, 644 (5th Cir. 2005) (applying same definition of "recklessness" as in *Silicon Graphics*; *see R2 Invs.*, 401 F.3d at 643). That is because allegations of knowledge of an omission support only an inference that the defendant knew a statement was incomplete, which is *not* sufficient to state a claim under Rule 10b-5. *See Brody*, 280 F.3d at 1006 ("Rule 10b-5 . . . prohibit[s] *only* misleading and untrue statements, not statements that are incomplete."). Accordingly, "'[t]he question is not merely whether the [defendants] had knowledge of the undisclosed facts; rather, it is the *danger of misleading buyers* that must be actually known or so obvious that any reasonable man would be

legally bound as knowing.'" *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1260 (10th Cir. 2001) (citation omitted) (cited with approval in *Gompper*, 298 F.3d at 896).

As shown above, plaintiff cannot demonstrate that the April 6, 2004 press release was materially misleading. It necessarily follows that plaintiff cannot plead facts giving rise to a strong inference that defendants knew or recklessly disregarded any danger that the April 6, 2004 press release was materially misleading. The Amended Complaint thus fails to plead a strong inference of scienter regarding the April 6, 2004 press release.[15]

3. Mr. Cole Cannot Be Held Liable for Any Statement In the April 6, 2004 Press Release

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the United States Supreme Court held that Section 10(b) "prohibits only the *making* of a material misstatement (or omission) or the commission of a manipulative act." *Id.* at 177 (emphasis added). Section 10(b) does not prohibit so-called "secondary violations," such as "giving aid to a person who commits a manipulative or deceptive act." *Id*. Courts routinely dismiss Section 10(b) claims where the defendant is not alleged to have either made or substantially participated in the making of the challenged statement. *See, e.g., In re Homestore.com Inc., Sec. Litig.*, 252 F. Supp. 2d 1018, 1039 (C.D. Cal. 2003); *In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1084 (N.D. Cal. 2001); *In re Harmonic, Inc. Sec. Litig.*, 163 F. Supp. 2d 1079, 1099 (N.D. Cal. 2001).

[15] Plaintiff also alleges that in March 2004, First Virtual embarked on a "re-branding" effort for the Company, called "Operation Thunder." *See* AC ¶ 41(a). To assist in this effort, the Company hired outside marketing and public relations consultants, and conducted conferences among its sales personnel. *See id.* Just one sentence in paragraph 41(a) conveys anything even remotely wrongful: plaintiff's assertion that "[u]nder the 'Operation Thunder' plan, First Virtual would, beginning in late March, 2004, issue a press release each week that would mislead the public concerning the purported success of the Company . . . ." *Id.* This conclusory assertion of wrongdoing is not only unsupported by the pleaded facts, it is highly implausible, as it would have required the illicit complicity of dozens of outside consultants and Company employees. Perhaps not surprisingly, this allegation, unlike most of paragraph 41(a), is *not* attributed to a confidential witness. The Court need not credit plaintiff's unsupported speculation that defendants planned to "mislead the public" through the alleged new marketing program.

Plaintiff here does not and cannot allege that Mr. Cole personally "made" any statement in the April 6, 2004 press release. Mr. Cole is not quoted in the press release, and plaintiff pleads nothing to suggest that Mr. Cole participated in any respect, let alone in a "significant" respect, in the drafting or editing of the press release. *See In re Software Toolworks Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994).

Nor can Mr. Cole be held liable for the April 6, 2004 press release under the "group pleading" presumption. That presumption is a judicially-created, pre-Reform Act exception to Rule 9(b)'s particularity requirement that allowed "group-published information" to be attributed presumptively for pleading purposes to corporate insiders who were involved in the preparing of such documents. Even assuming *arguendo* that the group pleading presumption survived the enactment of the Reform Act,[16] plaintiff fails to plead facts here suggesting that Mr. Cole, based upon his corporate function, was presumably involved in drafting the April 6, 2004 press release. *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 593 (9th Cir. 1995). Plaintiff pleads nothing specific about Mr. Cole's involvement in the April 6, 2004 press release, and pleads nothing to suggest that the matter at issue — the *existence* of, as opposed to the accounting for, a contract with the U.S. Air Force — was a matter within Mr. Cole's purview as the Company's chief financial officer. Plaintiff's boilerplate allegation that both "Individual Defendants participated in the drafting of, and approved the contents of, the April 6 Release" (AC ¶¶ 37, 41(b))[17] is not sufficient to invoke the group pleading presumption. *See Blackin*, slip op. at 8 (dismissing claims against non-speaking defendants where plaintiff did not "plead any *specific* information

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[16] Courts have held that the group pleading presumption did not survive the enactment of the Reform Act. *See Allison*, 999 F. Supp. at 1350; *see also In re Ashworth, Inc. Sec. Litig.*, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,243, at 95,287 (S.D. Cal. July 18, 2000); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1252 (N.D. Cal. 1998). The only Court of Appeals that has addressed the question directly has agreed. *See Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 364-65 (5th Cir. 2004).

[17] Plaintiff's attribution of the boilerplate allegation to Confidential Witnesses A and I does nothing to bolster this assertion because plaintiff does not provide any details regarding the basis for the witnesses' purported knowledge. *See Network Assocs.*, 2003 U.S. Dist. LEXIS 14442, at *36-37. Speculation by a purported confidential witness should be accorded no more weight than speculation by the plaintiff's lawyer.

regarding these defendants' duties or participation in any day-to-day activities or the preparation of any group published document.") (emphasis added).

II. PLAINTIFF FAILS TO PLEAD LOSS CAUSATION

Plaintiff's claims should be dismissed for the separate and independent reason that he fails adequately to plead the element of loss causation. In *Dura Pharmaceuticals, Inc. v. Broudo*, 125 S. Ct. 1627 (2005), the United States Supreme Court recently reaffirmed the fundamental requirement that in a securities class action the plaintiff must plead and prove that the alleged fraud caused his or her economic loss. The Court held unanimously that "at the moment the [purchase of stock] takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value." *Id*. at 1631. Under *Dura*, therefore, the only investment loss that is recoverable under the securities laws is one that follows in the wake of, and thus can be fairly said to have been caused by, a disclosure of the alleged fraud. As the Court recognized, it has long been the law that "a person who 'misrepresents the financial condition of a corporation in order to sell its stock' becomes liable to a relying purchaser 'for the loss' the purchaser sustains '*when the facts . . . become generally known' and 'as a result' share value 'depreciate*[*s*].'" *Id.* at 1633 (quoting Restatement Second of Torts § 548A, cmt. b at 107 (1977)) (alterations in the original). Accordingly, to state a claim under Section 10(b), plaintiff must plead more than that the fraud caused the price of the stock to be inflated. Plaintiff must allege "the causal connection . . . between [the] loss and the misrepresentation." *Id.* at 1634.

Here, plaintiff's allegation that "the market price of First Virtual common stock was artificially inflated throughout the Class Period" (AC ¶ 67) is the very sort of allegation the Supreme Court rejected in *Dura*. *See Dura*, 125 S. Ct. at 1634 ("'artificially inflated purchase price' is not itself a relevant economic loss"). Plaintiff's other allegation that "[t]he price of First Virtual Stock decreased upon disclosure of the true facts which had been concealed" (AC ¶ 68) is not supported by the pleaded facts. With respect to the April 6, 2004 press release, plaintiff does not and cannot allege that the supposed "truth" was ever revealed. Plaintiff's failure to identify a specific event or date on which the Company's stock price declined in response to the disclosure

of the purported falsity of the alleged misstatement means that plaintiff has failed adequately to allege "the causal connection . . . between [the] loss and the misrepresentation." *Dura*, 125 S. Ct. at 1634. Plaintiff also fails to allege a loss caused by inaccurate financial figures reported in the Company's 2003 Form 10-K. The purported "truth" — *i.e.*, need for a restatement — was disclosed on November 19, 2004. *See* AC ¶ 29. By that time, plaintiff had sold the last of his First Virtual stock. Ex. 24 at 2.[18] The Supreme Court in *Dura* held clearly that an investor who sells his stock before the "truth" is disclosed has suffered no recoverable loss under the securities laws. *See Dura*, 125 S. Ct. at 1631 ("[I]f, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."). Accordingly, the Amended Complaint should be dismissed for the separate and independent reason that it fails to plead the essential element of loss causation.[19]

CONCLUSION

For the foregoing reasons, defendants respectfully request that this Court dismiss the Amended Complaint.

Dated: July 1, 2005

WILSON SONSINI GOODRICH & ROSATI
Professional Corporation

By: /s/ John P. Stigi III
John P. Stigi III

Attorneys for Defendants JONATHAN MORGAN and TRUMAN COLE

[18] Certification of Named Plaintiff, filed as an exhibit to the Declaration of Alan R. Plutzik in Support of Motion for Appointment as Lead Plaintiff and Approval of Counsel on October 25, 2004.

[19] Plaintiff asserts a separate claim under Section 20(a) of the Exchange Act against Messrs. Morgan and Cole as "controlling persons" of First Virtual. *See* AC ¶¶ 70-72. Because the Amended Complaint does not adequately plead a primary violation under Section 10(b) and Rule 10b-5, plaintiff's claim for controlling person liability under Section 20(a) must be dismissed. *See Lipton v Pathogenesis Corp.*, 284 F.3d 1027, 1035 n.15 (9th Cir. 2002).

I, Bahram Seyedin-Noor, am the ECF User whose identification and password are being used to file this DEFENDANTS' NOTICE OF MOTION AND MOTION TO DISMISS CONSOLIDATED AMENDED CLASS ACTION COMPLAINT; MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT THEREOF. I hereby attest that John P. Stigi III has concurred in this filing.

Dated: July 1, 2005

WILSON SONSINI GOODRICH & ROSATI
Professional Corporation

By: /s/ Bahram Seyedin-Noor
Bahram Seyedin-Noor

Attorneys for Defendants JONATHAN MORGAN and TRUMAN COLE

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION

In re: FIRST VIRTUAL COMMUNICATIONS, INC. SECURITIES LITIGATION. This Document Relates to: ALL ACTIONS.	MASTER FILE NO: C-04-3585 MJJ **[PROPOSED] ORDER GRANTING DEFENDANTS' MOTION TO DISMISS THE CONSOLIDATED AMENDED CLASS ACTION COMPLAINT AND GRANTING DEFENDANTS' REQUEST FOR JUDICIAL NOTICE** CLASS ACTION Date: October 11, 2005 Time: 9:30 a.m. Judge: Hon. Martin J. Jenkins

The motion of Defendants Jonathan Morgan and Truman Cole ("Defendants") for an order dismissing plaintiff's Consolidated Amended Class Action Complaint ("Complaint") came on regularly for hearing on October 11, 2005 at 9:30 a.m. before the Honorable Martin J. Jenkins. Having considered the papers in support of and in opposition to the motion, as well as having considered the oral arguments of the parties and the papers on file in this action and good cause appearing:

IT IS HEREBY ORDERED that Defendants' motion to dismiss the Complaint is GRANTED in its entirety on the grounds that the Complaint does not state a claim upon which relief may be granted, as required by Rule 12(b)(6) of the Federal Rules of Civil Procedure and the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), 15 U.S.C. § 78u-4, *et seq.* The Court also grants Defendants' Request for Judicial Notice in its entirety.

IT IS SO ORDERED.

Dated: _____

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THE HONORABLE MARTIN J. JENKINS
UNITED STATES DISTRICT JUDGE