UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

NORMAN J. HESS, INDIVIDUALLY AND ON BEHALF OF A PUTATIVE CLASS OF INVESTORS,

Plaintiffs,

v.

Case No. 5:04-CV-31

AMERICAN PHYSICIANS CAPITAL INC., WILLIAM B. CHEESEMAN, AND FRANK H. FREUND,

HON. GORDON J. QUIST

Defendants.
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OPINION

Plaintiffs in this securities fraud case are a class of investors who purchased or acquired the stock of American Physicians Capital, Inc. ("APC" or the "Company") between February 13, 2003 and November 6, 2003 ("Class Period"). Defendants are APC and its two officers, William B. Cheeseman and Frank H. Freund (the "Individual Defendants"). The consolidated class action complaint (the "Complaint") alleges that APC and the Individual Defendants committed securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated by the Securities and Exchange Commission (the "SEC"), 17 C.F.R. § 240.10b-5. In addition, the Complaint alleges that the Individual Defendants are liable as "controlling persons" under Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). Now before the Court is Defendants' motion to dismiss.

I. Facts

APC is a Michigan corporation with its principal place of business in East Lansing, Michigan. APC operates as a holding company through various subsidiaries and provides medical professional liability insurance in 18 states, including Michigan, Illinois, Ohio, Kentucky, and Florida. A publicly-held company, APC was registered with the SEC and its stock was traded on the NASDAQ National Market System.

The two Individual Defendants were APC officers and directors. Cheeseman was the President and Chief Executive Officer during the Class Period. Freund was the Executive Vice President, Chief Financial Officer and Treasurer during the Class Period.

The focal point of this litigation concerns the adequacy of the Company's loss reserves to cover malpractice claims plus a deferred tax asset which the Company could not utilize without taxable income. On February 13, 2003, the Company issued a press release reporting financial results for the fourth quarter and the year ending 2002. Between February 13 and November 5, 2003, APC issued additional financial statements and press releases stating that the Company was satisfied with the adequacy of the reserves and it was positioned to profit in the near future. Standard & Poor's and A.M. Best Company both reaffirmed their positive ratings of APC. However, on November 6, 2003, the Company issued a press release announcing that the Company expected a substantial loss for the third quarter due to adjustments in loss reserves and the deferred tax asset. Specifically, the Company was forced to increase its loss reserves by approximately $43 million. As a result, the Company had to reserve the entire deferred tax asset on the balance sheet and incur a non-cash charge of $50 million to establish a valuation allowance in order to eliminate the tax asset. The Company explained that the adjustment in the loss reserves was due to an over 20%

increase in the severity of claims reported in the professional liability markets in Ohio, Kentucky, and Florida. Upon the news, the stock price of the Company fell 37%.

Plaintiffs are a class of investors who purchased APC common stock during the Class Period and suffered losses when the stock lost value as a result of the November 6, 2003, press release. Plaintiffs allege that the Company's financial statements and press releases issued during the Class Period contained material misrepresentations masking the Company's true financial condition and, as a result, the Company's stock price was inflated. With respect to the Individual Defendants, Plaintiffs allege that as top-level officers, the Individual Defendants had control over the dissemination of the alleged statements and were aware of, or recklessly disregarded, the misleading nature of these statements.

II. <u>Discussion</u>

A. Parties' Arguments

Plaintiffs have asserted two claims: a Section 10(b) violation against the Company and the Individual Defendants, and a Section 20(a) "controlling persons" liability claim against the Individual Defendants. Plaintiffs allege that the Company and the Individual Defendants violated Section 10(b) by failing to disclose the inadequacy of the loss reserves in all of Defendants' statements discussed in the Complaint. Plaintiffs allege that Defendants systematically understated the Company's loss reserves, and thus overstated the net operating income. In addition, Plaintiffs allege that Defendants improperly carried the deferred tax asset when it was clear that the Company was unable to generate any income in the foreseeable years to offset the tax asset. Plaintiffs argue that the misleading statements do not fall within the statutory safe harbor for forward-looking statements, because many of the statements were not identified as forward-looking, and to the extent that they were so identified, they were not accompanied by meaningful cautionary statements. Plaintiffs argue that Defendants' cautionary statements cannot shield them from liability because the risks of which these statements warned were already affecting the Company.

With respect to the scienter allegation, Plaintiffs claim that the Complaint sufficiently pleads scienter with particularity, and thus meets the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). Plaintiffs allege that the Individual Defendants knew or should have known of the adverse information by virtue of their top positions in the Company. Particularly, Plaintiffs claim that even Cheeseman himself admitted on November 13, 2003, that the huge loss the Company suffered was not a new problem, but a problem that Defendants identified two years ago. Plaintiffs claim that Cheeseman's statement suggests that Defendants were aware of the company-specific issues (i.e., poor underwriting and inadequate price), yet they continued to assure investors that the loss reserves were adequate. Moreover, Plaintiffs allege that the magnitude of the adjustments of the loss reserves and deferred tax asset suggests that Defendants must have known that the loss reserves were understated and the deferred tax asset was overstated. In addition, Plaintiffs allege that Defendants had the motive and opportunity to paint a rosy picture of the Company's operation because they wanted to save their jobs and facilitate the Company's financing efforts.

Furthermore, Plaintiffs assert a Section 20(a) claim against the Individual Defendants. Plaintiffs allege that the Individual Defendants were controlling persons of the Company within the meaning of Section 20(a) because they had the power to control the dissemination of the alleged misleading statements.

On the other hand, Defendants classify the claim as a classic "fraud-by-hindsight" suit. Defendants argue that Plaintiffs fail to plead the basic elements of a misrepresentation because the estimation of loss reserves is an inherently uncertain process due to the volatility of professional liability claims. Defendants claim that they provided sufficient warnings to investors regarding the uncertain nature of loss reserves, and specifically, the volatility of the markets in Kentucky, Ohio, and Florida. In addition, Defendants claim that the estimate of the loss reserves was independently reviewed by actuaries, accountants, and insurance regulators, and none of these reviews suggested any "red flags." Defendants further claim that the Company closely monitored the level of estimate and increased the reserves over 40% from December 31, 2000, to September 30, 2003. Moreover, Defendants argue that the alleged statements are puffery or forward-looking statements accompanied by meaningful cautionary statements. Specifically, Defendants argue that statements regarding loss reserves are deemed to be forward-looking because they are projections of future litigation losses.

With respect to the scienter allegation, Defendants argue that the Complaint fails to plead facts that give rise to a strong inference of scienter because the Complaint never alleges when and how Defendants in fact learned of the reserves' inadequacy and its magnitude. In addition, Defendants claim that Plaintiffs quoted Cheeseman's November 13, 2003, statement out of context. Defendants claim that the "problem" that Cheeseman was referring to was the fact that the Company often had to adjust reserves due to bad claims, and in fact the Company has disclosed such risk to investors in the 2002 Form 10-K. Defendants argue that Plaintiffs' allegations about Defendants' motive and opportunity and their senior positions in the Company cannot establish a strong inference of scienter.

With respect to the Section 20(a) claim, Defendants argue that the claim should be dismissed because Plaintiffs fail to establish an underlying Section 10(b) claim.

B. Governing Law - Pleading Standards

Section 10(b)[1] of the Exchange Act and Rule 10b-5[2] prohibit "fraudulent, material misstatements or omissions in connection with the sale or purchase of a security." *Morse v. McWhorter*, 290 F.3d 795, 798 (6th Cir. 2002). In order to state a claim under Section 10(b) and Rule 10b-5, "a plaintiff must allege, in connection with the purchase or sale of securities, the misstatement or omission of a material fact, made with scienter, upon which the plaintiff justifiably relied and which proximately caused the plaintiff's injury." *In re Comshare, Inc. Sec. Litig.*, 183

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[1] Section 10(b) provides as follows:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. §78j.

[2] Rule 10b-5, prescribed by the SEC under Section 10(b), provides as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

F.3d 542, 548 (6th Cir. 1999). In the instant case, the parties do not dispute the purchase of securities, justifiable reliance, causation, and damages. Therefore, the analysis centers on whether the Complaint sufficiently pleads the scienter element. The Supreme Court has defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12, 96 S. Ct. 1375, 1381 n.12 (1976). The Sixth Circuit has held that scienter "is recklessness for statements of present or historical fact and actual knowledge in the case of forward-looking statements." *Helwig v. Vencor, Inc.*, 251 F.3d 540, 552 (6th Cir. 2001)(en banc). Recklessness is defined as "highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979).

In order to allege scienter, the PSLRA mandates that "the complaint shall, with respect to each act or omission alleged to violate this Act, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). "The 'strong inference' requirement means that a plaintiff is entitled to only the most plausible of competing inferences." *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 682 (6th Cir. 2004). Thus, if this requirement is not met, "the court shall, on the motion of any defendant, dismiss the complaint . . . ." 15 U.S.C. § 78u-4(b)(3)(A).

In addition, the PSLRA created a "safe harbor" for forward-looking statements and excuses liability for defendants' projections, statements of plans and objectives, and estimates of future economic performance. 15 U.S.C. § 78u-5(i)(1). The following is the different scienter requirement applied to forward-looking statements and statements of historical and present facts:

> There are three distinct scienter requirements for securities fraud actions, each of which depends on the type of statement that is being made, and, in the case of "forward-looking statements," whether that statement was material and accompanied by meaningful cautionary statements. First, for "forward-looking statements" that are accompanied by meaningful cautionary language, the first prong of the safe harbor provided for in the PSLRA makes the state of mind irrelevant. In other words, if the statement qualifies as "forward-looking" and is accompanied by sufficient cautionary language, a defendant's statement is protected regardless of the actual state of mind. Second, under the second prong of the safe harbor provision of the PSLRA, in the case of "forward-looking statements" that are not accompanied by meaningful cautionary language, actual knowledge of their false or misleading nature is required. Finally, for statements of present or historical fact, the state of mind required is recklessness.

Miller v. Champion Enters., Inc., 346 F.3d 660, 672 (6th Cir. 2003) (citations and footnotes omitted).

Accordingly, the Court will first analyze each alleged statement and decide whether it is forward-looking or puffery and whether Defendants can claim the safe harbor protection. For those statements that are not forward-looking or do not fit within the safe harbor, the Court will determine whether the facts alleged in the Complaint give rise to a strong inference that the Defendants acted recklessly.

C. The Alleged Statements

Plaintiffs allege that each statement set forth below and all of the Company's financial filings during the Class Period were false and misleading:

(1) The press release on February 13, 2003, with Cheeseman's comment about the Company's financial results:

> We accomplished our major objectives – higher rates, better risks and lower limits – in 2002 and are now positioned to return to profitability in 2003. Our focus on our current business has resulted in outstanding persistency at higher rates and will enable us to deliver positive returns for our shareholders in 2003.
>
> . . . .

> We have positioned the Company for success and profit in 2003. I believe we will continue to see a pattern of improving results with each passing quarter.

(Compl. ¶ 30 (quoting APC Press Release Dated February 13, 2003, at 1, 4, Def.'s Br. Supp. Mot. Ex. 14).)

(2) The press release on May 8, 2003, with Cheeseman's comment about the Company's first quarter results:

> Our operating results continued to improve as our loss ratio dropped to 95.8%. We had hoped to be profitable for the quarter, but the extremely low interest rate environment has reduced our investment returns. However, we are reporting improved operating results in all lines, and continue to obtain rate increases in all markets.
>
> . . . .
>
> I remain positive about the future. Our higher rate structure and improved book of business will result in continued declines in our loss ratios; and I remain confident that we will achieve profitability in 2003.

(Compl. ¶ 32 (quoting APC Press Release Dated May 8, 2003, at 1, 3, Def.'s Br. Supp. Mot. Ex. 15).)

(3) The statements regarding the Company's loss reserves in the Form 10-Q filed with the SEC on May 15 and August 14, 2003:

> Although considerable variability is inherent in these estimates, management believes that the current estimates are reasonable in all material respects. The estimates are reviewed regularly and adjusted as necessary. Such adjustments are reflected in current operations.

(Compl. ¶¶ 33, 40.)

(4) Cheeseman's comments regarding the positive ratings respectively on June 25, July 31, and August 25, 2003: "The excellent rating from Best once again reflects our strong financial foundation. This rating further indicates that we are on the right track in improving our operating results." (Compl. ¶ 36 (quoting APC Press Release Dated June 25, 2003, Def.'s

Br. Supp. Mot. Ex. 16).) "The reaffirmation of our 'A-' rating from S & P reflects our commitment to maintain a strong financial base while continuing to improve our operating results." (Compl. ¶ 37.)

(5) The press release on August 7, 2003, with Cheeseman's comment about the Company's second quarter results:

> The aggressive actions we have implemented over the last two years have resulted in the Company reporting a profitable second quarter. Our medical professional liability and workers' compensation loss ratios have improved as a direct result of rate increases and stricter underwriting standards.
> . . . .
> We are pleased with the progress we are making, but we must remain focused on pricing and the underwriting discipline. I am encouraged by the improvements we have achieved to date and optimistic about the future.

(Compl. ¶ 38 (quoting APC Press Release Dated August 7, 2003, at 1, 4, Def.'s Br. Supp. Mot. Ex. 17).)

(6) Cheeseman's conference call on August 8, 2003, when he answered an investor's inquiry regarding the volatility of the markets in Ohio and Florida:

> They [the Ohio and Florida markets] just are more volatile. Anytime you pull out of a market or out of a particular book of business, as we've experienced with personal and commercial lines, it just becomes more difficult to predict how those claims will settle. I stand by my comment. We're confident with our reserves as they are presented.

(Compl. ¶ 39.)

(7) The press releases regarding the three trust preferred pooled transactions respectively on May 16, May 23, and October 30, 2003, stating that the Company had issued long-term debt to raise funds with a description of the allocation of the funds raised.

(Compl. ¶¶ 34, 35, 43.)

(8) The press release regarding the stock repurchase on September 22, 2003, with Cheeseman's comment:

> We continue to view the market conditions within the medical professional liability sector as very favorable, which we believe will positively impact our results going forward. This repurchase program reflects our continued confidence in the value of our Company.

(Compl. ¶ 42 (quoting APC Press Release Dated September 22, 2003, Def.'s Br. Supp. Mot. Ex. 18).)

1) Statements That Are Protected by the PSLRA Safe Harbor

a) Identified As Forward-Looking Statements

Statements (1), (3), (6), and the second paragraph of Statement (2) are protected under the PSLRA safe harbor because they are forward-looking statements accompanied by meaningful cautionary language. *Miller*, 346 F.3d at 672.

Statement (1) says that the Company is "now positioned to return to profitability in 2003," that the Company's focus "will enable us to deliver positive returns" in 2003, and that Cheeseman "believe[s]" that the Company will have improving results. These statements imply projections or objectives, and thus fall within the definition of forward-looking statements under 15 U.S.C. § 78u-5(i)(1). Although the phrases such as "[w]e accomplished our major objectives . . . in 2002" and "our focus on our current business has resulted in outstanding persistency . . ." imply some present facts, these phrases are the basis for the later forward-looking statements, and thus qualify as assumptions underlying the forward-looking statements. 15 U.S.C. § 78u-5(i)(1)(D) (a forward-looking statement includes a statement of the assumptions underlying or relating to any forward-looking statements). Similarly, the second paragraph of Statement (2) is forward-looking because it expresses Cheeseman's confidence in the Company's profitability in 2003.

In *In re Kindred Health Care, Inc. Sec. Litig.*, 299 F. Supp. 2d 724 (W.D.Ky. 2004), investors brought a securities fraud claim against Kindred, a long-term health care provider, for failure to maintain adequate loss reserves. The court held that statements about the adequacy of loss reserves for future litigation are forward-looking statements:

> The remaining statements . . . do contain assertions about present facts, namely that management believed at the time the statements were made that Kindred's current reserves and liability coverage were adequate. These statements, however, were predicated on projections of future events. The amount Kindred keeps in reserves to cover liability claims is necessarily a prediction about its future claims experience based on past claims history as well as current filings. Assertions about the adequacy of Kindred's reserves could only be verified when liability claims were actually filed, litigated to conclusion, or settled. It would seem rather beyond argument that such projections about the company's future economic health are forward-looking within the meaning of the PSLRA. *See Harris v. Ivax Corp.,* 182 F.3d 799, 805 (11th Cir.1999) ("[A] statement about the state of a company whose truth or falsity is discernible only after it is made necessarily refers only to future performance.... While it is true that the *state* of [a company's] 'fundamental business' and 'underlying strategies' is a question of present condition, whether they are intact is a fact only verifiable by seeing how they hold up in the future.").

Id. at 738. In the instant case, Statements (3) and (6) are forward-looking because they are assertions about the adequacy of the Company's loss reserves.

Furthermore, the Company has identified the alleged statements as forward-looking statements. In its 2002 Form 10-K, the Company devoted one section to forward-looking statements: "Our forward-looking statements are subject to risks and uncertainties and include information about our expectations and possible or assumed future results of our operations. When we use any of the words 'believes,' 'expects,' 'anticipates,' 'estimates' or similar expressions, we are making forward-looking statements." (APC 2002 Form 10-K at 11, Def.'s Br. Supp. Mot. Ex. 1.) In addition, the Company has incorporated the above language into subsequent filings, press releases and conference calls. Statements (1), (3), (6), and the second paragraph of Statement (2) all have similar expressions as the forward-looking statement language indicated above, and thus have been identified as forward-looking statements.

b) Accompanied by Meaningful Cautionary Language

Statements (1), (3), (6), and the second paragraph of Statement (2) are accompanied by meaningful cautionary language. "The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statements, such as, for example, information about the issuer's business." *Helwig*, 251 F.3d at 558-559.

In its 2002 Form 10-K, the Company provided cautionary statements regarding its loss reserves in particular, and incorporated these statements into subsequent press releases and conference calls.

> There can be no assurance that ultimate losses will not exceed our actuarially determined best estimate of loss reserves at December 31, 2002. While management does not explicitly calculate an acceptable "range" of probable reserves, historical results have shown ultimate losses can vary from our initial estimates in a range of plus or minus 7%.

(2002 Form 10-K at 7, Def.'s Br. Supp. Mot. Ex. 1.)

> In the second half of 2001, we encountered a large increase in reported losses, primarily in our Florida, Ohio and Kentucky professional liability markets. This increase in reported losses was the result of an over 20% increase in an average severity of claims reported in 2001. The 2001 adjustment was also unusually large because Ohio and Florida markets were relatively new for the Company, making our initial reserve estimates very difficult to predict. These higher than expected loss trends continued into 2002, but at a much lower level. As a result, we also added to prior year reserves in 2002, primarily in our Ohio and Florida markets.

(2002 Form 10-K at 50-51, Def.'s Br. Supp. Mot. Ex. 1.)

In addition to the above cautionary statements, the Company provided cautionary statements with respect to press releases. The Company listed a dozen risk factors that were inherent in the professional liability industry and beyond the Company's control. These risk factors include "the potential inadequacy of our loss and loss adjustment expense reserves . . . an unanticipated increase in claims or other unforeseen costs due to our exit from the state of Florida." (Press Release Dated February 13, 2003, at 5, Def.'s Br. Supp. Mot. Ex. 14.) The Company's cautionary statements are meaningful because they provide investors company-specific risks and describe the impact on the Company's financial results.

Plaintiffs argue that the cautionary statements above cannot shield Defendants from liability because the risks that the statements warned investors of were existing risks. Plaintiffs allege that at the time the Company issued these cautionary statements, the Company was well aware that the loss reserves were understated, and thus, the cautionary statements were fraudulent. Plaintiffs claim that even Cheeseman admitted on November 13, 2003, that he knew of the loss reserves inadequacy back in 2001. However, as the discussion below indicates, Plaintiffs have not pleaded with particularity that Defendants had actual knowledge of the inadequacy, or recklessly disregarded the inadequacy. Therefore, Plaintiffs fail to establish that the risk of inadequate loss reserves was a known circumstance during the Class Period.

2) Puffery Statements

Statements (4), (8), and the second paragraph of Statement (5) are puffery because they lack concrete information upon which investors may rely in making investment decisions. The Sixth Circuit defines puffery statements as "loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor could find them important to the total mix of information available." *In re Ford Motor Co. Sec. Litig.*, 381 F.3d 563, 571 (6th Cir. 2004). "Statements that are 'mere puffing' or 'corporate optimism' may be forward-looking or 'generalized statements of optimism that are not capable of objective verification.'" *Id.* at 570 (quoting *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119 (10th Cir. 1997)). Puffery statements are not actionable because they are immaterial.

In Statement (4), Cheeseman commented after the Company received positive ratings from S&P and A.M. Best Company. The phrases such as "[t]his rating further indicates that we are on the right track in improving our operating results" and "[the] rating from S & P reflects our commitment to maintain a strong financial base . . ." are vague self-praises that a reasonable investor would not seriously consider. Similarly, the phrases in Statement (8) (e.g., "[w]e continue to view the market . . . as very favorable" and "[the] program reflects our continued confidence") and the second paragraph of Statement (5) (e.g., "I am encouraged by the improvements . . . and optimistic about the future") are generalized statements of corporate optimism.

3) Statements That Contain No Misrepresentations

Statement (7) contains no misrepresentations and is thus inactionable. There, the Company announced three financing activities (i.e., the trust preferred pooled transactions) and described the terms of the debt services and the allocation of the fund raised. The Court is unable to discern, and Plaintiffs have not indicated, any misrepresentation in these press releases.

4) The SEC Filings During the Class Period

Plaintiffs allege that the financial filings during the Class Period are misleading because they did not reveal the fact that the loss reserves were understated. Plaintiffs' allegations fail because they lack particularity. Pursuant to Fed. R. Civ. P. 9(b) and the PSLRA, Plaintiffs may not allege generally that all the SEC filings during the Class Period are fraudulent. Rather, Plaintiffs must pinpoint specific misrepresentations. In addition, some of the alleged misstatements in the SEC filings originated from the earlier press releases or conference calls. Because the Court has addressed the alleged misstatements in the press releases and conference calls, the Court will not analyze separately the alleged misstatements in the SEC filings.

5) Statements of Present or Historical Facts

The first paragraph of Statement (2) and the first paragraph of Statement (5) are statements of present or historical facts, and thus recklessness is the required state of mind. For the reasons stated below, the Court holds that Plaintiffs fail to state a claim regarding these statements because the Complaint has not alleged particular facts giving rise to a strong inference of recklessness.

D. The Scienter Allegations

When examining a pleading of scienter, the Sixth Circuit "employs a totality of the circumstances analysis whereby the facts argued collectively must give rise to a strong inference of at least reckless." *PR Diamonds,* 364 F.3d at 683. The court examines "whether Plaintiffs have met their burden of pleading specific facts which, when viewed together, persuade us [i.e., the court] that the most plausible conclusion to draw is that the Individual Defendants must or should have known about the problems and nevertheless knowingly or recklessly made the allegedly misleading public statements." *Id.* at 683-684.

Plaintiffs argue that the Complaint has established a strong inference that throughout the Class Period, Defendants knew, or were reckless in not knowing, that the loss reserves were significantly understated. Despite this awareness, Plaintiffs argue, Defendants continued to make misleading statements to assure investors that the loss reserves were adequate. Specifically, Plaintiffs argue that a strong inference of scienter arises when viewing in totality the following allegations: 1) Cheeseman's two admissions on November 13, 2003, that: a) the Company "did not do as good a job of underwriting in that period [1999 to 2001] as we should have;"(Compl. ¶ 54); and b) "the loss we suffered during this quarter was not a new problem. It was a problem that we identified two years ago . . . " (Compl. ¶ 55); 2) the sheer magnitude of the loss reserves adjustment; 3) the Individual Defendants' access to the Company's financial information by virtue of their senior positions in the Company; and 4) the Individual Defendants' motive and opportunity to commit fraud.

An examination of each of these allegations suggests that, even viewed collectively, Plaintiffs fail to adequately plead scienter on the part of the Individual Defendants. It is possible that some of the allegations draw some inference of scienter. However, the possibility that Defendants may know or should have known is not enough to establish a strong inference that Defendants acted recklessly. *PR Diamonds*, 367 F.3d at 684.

1) Cheeseman's Two Admissions

Neither of Cheeseman's statements is sufficient to establish a strong inference of scienter. With respect to the first statement, Plaintiffs have not provided a source of the quote, and the Court is unable to locate the quote in any exhibits dated November 13, 2003. Moreover, the gist of Plaintiffs' claim was that the Company knew the loss reserves were understated, but failed to reveal it to investors. Cheeseman's statement about the poor underwriting between 1999 and 2001 is merely a review of the past. The statement does not establish that Cheeseman knew between 1999 and 2001 that the loss reserves were significantly understated. In fact, the statement suggests the opposite. The acknowledgment that the Company failed to do as good a job in underwriting as it should have suggests that Cheeseman was not aware of the poor underwriting.

With respect to the second statement, Defendants argue that Plaintiffs quoted Cheeseman's statement out of context. According to Defendants, the complete version of the statement is as follows:

> Thank you, Frank. I think my role is to try and provide the proper perspective. *The loss that we suffered this quarter was not due to a new problem. It was a problem that we identified two years ago* and at the time felt we had adequately resolved. Now two years later we are facing the same problem.
>
> The inadequate pricing and poor underwriting that occurred on business in '99, '00 and '01 coupled with increasing severity in the markets that you've heard mentioned time and time again – Florida, Ohio and Kentucky – and our occurrence book of business where we write occurrence excluding the states of Michigan and New Mexico.
>
> We have addressed the problem again and even after a large reserve adjustment, AP Capital is a strong company financially . . . .

(Conference Call Dated November 13, 2003, at 17, Def. Reply Br. Supp. Mot. Ex. 2 (emphasis added).) Furthermore, Defendants claim that the Company's public filings have warned investors about the "problem" Cheeseman mentioned, namely, the uncertainty of the markets in Florida, Ohio, and Kentucky, and possible loss reserve adjustments.

The Court agrees with Defendants that Plaintiffs quoted Cheeseman's statement out of context. In 2001, the Company encountered a similar problem on loss reserves. Because of the increase of claims filed in Florida, Ohio, and Kentucky, the Company was forced to substantially increase its loss reserves in 2001. The "problem" that Cheeseman referred to was the uncertainty of the three markets and the difficulty in making a close estimate of loss reserves. Therefore, Cheeseman's statement does not suggest that he knew of the inadequacy of the loss reserves during the Class Period. In fact, the statement suggests the opposite: the statement underscores Cheeseman's belief that the Company had adequate reserves. In addition, the problem of inadequate reserves should not be shocking news to investors, as the Company has warned them that the adjustment in loss reserves may go as high as 7%.

2) The Magnitude of the Adjustments

Plaintiffs argue that the sheer magnitude of the reserves increase and the charge to eliminate the deferred tax asset suggests that Defendants must have known that the Company had inadequate loss reserves, or, at the very least, Defendants were reckless in not knowing. Plaintiffs argue that the loss reserves adjustment caused the Company to go from reporting a profit to an immense loss, and such change cannot possibly arise overnight. Plaintiffs further argue that accounting violations that are so basic and pervasive should have been obvious to Defendants.

Courts are more likely to examine the argument of magnitude adjustment in the context of accounting errors.

> [S]ome courts have recognized that an inference of knowledge or recklessness may be drawn from allegations of accounting violations that are so simple, basic, and pervasive in nature, and so great in magnitude, that they should have been obvious to a defendant.

PR Diamonds, 364 F.3d at 684. However, in the instant case, the Complaint has not alleged any accounting violation or any "red flags" signaling accounting errors. In fact, the loss reserves estimate is subject to the independent reviews of an accounting firm, actuaries, and insurance regulators, and none of the reviews suggests that the estimate was unreasonable when made.

Moreover, the adjustment in the loss reserves is not egregious in nature and magnitude. The focus of the litigation is the 7.2% increase of the loss reserves in the third quarter of 2003.[3] Such increase is not especially dramatic when compared to a 17.9% increase in loss reserves in the third quarter of 2001,[4] when the Company was forced to increase the loss reserves due to the significant claims filed in Florida, Ohio, and Kentucky. In addition, the estimate of loss reserves is an inherently uncertain process with many risk factors. In its 2002 Form 10-K, the Company informed investors about the adjustment in 2001, and specifically warned that due to the uncertainty of the Florida, Ohio, and Kentucky markets, the loss reserves may be ripe for adjustment as high as 7%. Such warning renders the 7.2% increase in the third quarter of 2003 immaterial.

3) Access to Information

Plaintiffs argue that being top officers, Defendants have access to the Company's financial data, and thus must have known of the inadequate loss reserves. Specifically, Plaintiffs argue that by virtue of the senior positions, financial information regarding the Company's core business (i.e., malpractice insurance) is imputed to Defendants, which gives rise to an inference of knowledge.

It is well established that "fraudulent intent cannot be inferred merely from the Individual Defendants' positions in the Company and alleged access to information." *PR Diamonds*, 364 F.3d at 688. Rather, "the Complaint must allege specific facts or circumstances suggestive of their knowledge. Without more, Plaintiffs fail to meet the PSLRA requirement to state with particularity facts giving rise to a strong inference of scienter." *Id.* at 688.

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[3] $\frac{(678,136,000 - 632,488,000)}{632,488,000} \times 100\% = 7.2\%$

[4] $\frac{(572,425,000 - 485,399,000)}{485,399,000} \times 100\% = 17.9\%$

In *Ruskin v. TIG Holdings, Inc.*, No. 98 Civ. 1068, 1999 U.S. Dist. Lexis 14860 (S.D.N.Y. Sept. 24, 1999), the court pointed out a fatal flaw of a complaint that alleged the defendants fraudulently concealed the inadequacy of loss reserves:

> [T]he complaint never alleges when and how, if at all, before January 30, 1998, the defendants in fact learned of the reserves' inadequacy, and its magnitude – without which allegations there remains no sufficient basis for the claim their statements, or omissions, were false when made.

Id. at 9. In the instant case, the Complaint does not plead with particularity to show "how," "when," and "where" Defendants learned of the inadequacy of the loss reserves. In the absence of such detail, it is impossible to draw the necessary strong inference of recklessness. *In re Copper Mountain Sec. Litig.*, 311 F. Supp. 2d 857, 871 (N.D.Cal. 2004). In addition, the Complaint does not allege that the loss reserves number was misstated when initially made. Neither does the Complaint suggest any "red flags" demonstrating any discrepancy in the loss reserves estimate. In fact, the estimate was closely monitored and subject to multiple levels of independent review by auditors, actuaries, and regulators, and none of the reviews signaled any "red flags." Therefore, while Defendants may have some knowledge regarding the loss reserves, such knowledge is insufficient to give rise to recklessness.

4) Motives and Opportunities

Plaintiffs next argue that the Individual Defendants had motives and opportunities to defraud investors. The Complaint's motive allegations include: (1) the Individual Defendants desired to retain their jobs and save their skins; and (2) Defendants tried to paint a rosy picture of the Company to facilitate financing efforts.

The Sixth Circuit has held that motive and opportunity alone do not establish a strong inference of scienter, though they may be relevant in scienter pleading:

> [E]vidence of a defendant's motive and opportunity to commit securities fraud does not constitute "scienter" for the purposes of § 10b or Rule 10b-5 liability . . . While facts regarding motive and opportunity may be "relevant to pleading circumstances from which a strong inference of fraudulent scienter may be inferred," and may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct, the bare pleading of motive and opportunity does not, standing alone, constitute the pleading of a strong inference of scienter.

In re Comshare, 183 F.3d at 551 (citations omitted)(quoting *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997)). Therefore, the Court must assess whether the allegation of motives and opportunities, in totality with the remainder of allegations, raises an inference of recklessness. *PR Diamonds*, 364 F.3d at 689-690.

Furthermore, the Sixth Circuit distinguishes motives common to corporations and executives from motives to commit fraud.

> The more important question in this case is whether the Complaint alleges motives on the part of the Individual Defendants from which the Court could infer a knowing or reckless state of mind. In order to demonstrate motive, a plaintiff must show concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged. *Phillips v. LCI Int'l, Inc.,* 190 F.3d 609, 621 (4th Cir.1999). Our review of the cases cited by the parties shows that courts distinguish motives common to corporations and executives generally from motives to commit fraud. All corporate managers share a desire for their companies to appear successful. That desire does not comprise a motive for fraud. *See Chill v. Gen. Elec. Co.,* 101 F.3d 263, 268 (2d Cir.1996) ("such a generalized motive, one which could be imputed to any publicly-owned, for-profit endeavor, is not sufficiently concrete for purposes of inferring scienter"). Neither does an executive's desire to protect his position within a company or increase his compensation. *See Kalnit v. Eichler,* 264 F.3d 131, 140 (2d Cir.2001) ("an allegation that defendants were motivated by a desire to maintain or increase executive compensation is insufficient because such a desire can be imputed to all corporate officers"); *Criimi Mae,* 94 F. Supp. 2d at 660 (allegations that defendants sought to "protect their executive positions," standing alone, are inadequate to plead motive).

Id. at 690. In the instant case, one of Plaintiffs' motive allegations is about Defendants' desire to retain their jobs and skins. However, such motive is common to executives, and thus the allegation is insufficient to give rise to a strong inference of scienter.

On the other hand, the allegation about Defendants' motive to facilitate financing activities warrants closer scrutiny. Plaintiffs claim that during the Class Period, the Company could not have survived without an infusion of capital. Plaintiffs allege that Defendants understated the loss reserves in order to generate proceeds from the three financing efforts.

In *PR Diamonds*, the plaintiffs alleged that the defendants were motivated to engage in fraud because they wanted to forestall the company's default of its loan agreement and to preserve the company's creditability. The court considered that the complaint had alleged particularized facts.

> We view the motive allegations concerning the bank loan and credit facility as suggestive of scienter, although standing alone they do not establish a strong inference. Accordingly, we will consider these allegations, along with all others, in the totality of the circumstances analysis.

PR Diamonds, 364 F.3d at 690. In the instant case, the Court considers the allegation of the motive to facilitate financing activities as pleading particularized facts. However, this allegation, standing alone, is insufficient to plead scienter. Therefore, the Court will consider the allegation in totality within the circumstances.

5) Summary of Scienter Allegations

Plaintiffs have accumulated numerous allegations to establish that the facts give rise to a strong inference of recklessness. However, other than the allegation about Defendants' motive to facilitate financing efforts, Plaintiffs do not plead with particularized facts the other allegations such as the magnitude of the adjustments, Defendants' access to the information and their desire to keep their jobs. As a result, the totality of the allegations does not give rise to a strong inference of scienter.

E. The Controlling Persons Liability under Section 20(a)

Plaintiffs allege that the Individual Defendants are liable under Section 20(a) as controlling persons because they had control and influence over the Company's financial operation and the dissemination of the alleged misleading statements.

In order to plead that someone is a "controlling person" within the meaning of Section 20(a), the complaint must allege an underlying violation. *PR Diamonds*, 364 F.3d at 698. In the instant case, because the Complaint fails to sufficiently allege an underlying Section 10(b) violation, the Court will dismiss the Section 20(a) claim.

F. The Deferred Tax Asset Allegation

Plaintiffs further allege that Defendants improperly carried the deferred tax asset when it was clear that the Company was unable to generate any income in the foreseeable years to offset the tax asset.

The Court does not consider the statements regarding the deferred tax asset independent misstatements because the deferred tax asset adjustment is derivative of the loss reserves adjustment. The adjustment in the loss reserves caused a substantial loss in the third quarter of 2003, and as a result, the Company determined that it would not be able to utilize the deferred tax asset in the foreseeable future. To properly report the balance sheet, the Company was forced to establish an allowance account to eliminate the deferred tax asset. Therefore, the deferred tax asset adjustment is not a misstatement by itself. Rather, it is merely a balance sheet effect caused by the loss reserves adjustment.

Even Plaintiffs acknowledge that the adjustment of the deferred tax asset is a "side effect" of the adjustment of the loss reserves:

> The Company further stated that it expected to announce a "substantial net loss" for the quarter due to significant adjustments in reserves for policy losses . . . *As a result*, management was forced to reserve the entire balance of the deferred tax asset on its balance sheet, resulting in a material addition to the current period loss of $35 million.
>
> In addition, *as a result of the net loss*, the Company expected that, for the then foreseeable future, it would not be able to report the deferred tax asset that had resulted from its accumulated net operating losses.

(Compl. ¶¶ 26, 27 (emphasis added).)

G. Leave to Amend

Finally, Plaintiffs argue that in the event that the Court grants Defendants' motion to dismiss, the Court should grant Plaintiffs leave to amend the Complaint.

Generally, leave to amend is "freely given when justice so requires." Fed. R. Civ. P. 15(a). In the instant case, Plaintiffs have amended the complaint once. Lead plaintiff Hess filed the first complaint on February 20, 2004. New lead plaintiff Fuller & Thaler Asset Management filed an amended complaint on May 7, 2004. Furthermore, Plaintiffs have not submitted any facts "to aid the court in deciding whether justice require[s] the court to grant leave to amend." *Roskam Baking Co., Inc. v. Lanham Mach. Co., Inc.*, 288 F.3d 895, 906 (6th Cir. 2002). Plaintiffs have not filed a motion requesting leave to amend the Complaint. Nor have Plaintiffs submitted a proposed amendment for the court to review, or indicated what additional facts the amended complaint will contain to plead scienter. At oral argument the Court asked Plaintiffs' counsel what any proposed amendment would say. Plaintiffs' counsel said, in effect, she did not know. She asked for more time. If there were meritorious proposed amendments, it seems that they would be known to

Plaintiffs by the time of oral argument on a motion to dismiss. Finally, the Sixth Circuit has held that "allowing repeated filing of amended complaints would frustrate the purpose of the PSLRA." *Miller*, 346 F.3d at 690.

Therefore, the Court will deny Plaintiffs leave to amend.

III. Conclusion

For the foregoing reasons, the Court will grant Defendants' motion to dismiss because the Complaint fails to allege particular facts that give rise to a strong inference of scienter. The Court will deny Plaintiffs leave to amend.

An Order consistent with this Opinion will be entered.

Dated: January 11, 2005

/s/ Gordon J. Quist
GORDON J. QUIST
UNITED STATES DISTRICT JUDGE