UPREME COURT
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IN THE SUPREME COURT

OF THE STATE OF CALIFORNIA

OVERSTOCK.COM, INC., et al.,
Plaintiffs and Respondents,

v.

GRADIENT ANALYTICS, INC., et al.
Defendants and Appellants.

PETITION NO. S154213
(Superior Court No. CV-053693)
(Court of Appeal No. A113397)

Service on the California Attorney General's Consumer Law Section and on the Marin County District Attorney required by Cal. Bus & Prof. Code §§ 17209 and 17536.5 and by Cal. Rules of Court 8.212(c)(3) and 8.29

Petition for Review of Decision of Court of Appeal, First Appellate District, Division Four, Affirming the Orders of the Superior Court of California for the County of Marin, The Honorable Vernon F. Smith Presiding

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RESPONDENTS' ANSWER TO DEFENDANTS' PETITIONS FOR REVIEW

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I. INTRODUCTION

On August 11, 2005, plaintiffs Overstock.com, Inc. ("Overstock"), Hugh D. Barron and Mary Helburn filed suit in Marin Superior Court. For two years, defendants have successfully delayed the progress of this litigation by filing an anti-SLAPP motion which was rejected by the trial court and again rejected by a unanimous decision of the Court of Appeal. In affirming the trial court, the Court of Appeal applied well-settled law governing the burden of proof on a plaintiff in responding to an anti-SLAPP motion. The opinion made no mention of any disagreement with the holding of any other court and did not claim to resolve any novel issue of law. Nor is there any longstanding split in authority that has yet to be resolved.

Nonetheless, in the apparent hope of delaying this litigation for a third year, defendants Gradient Analytics, Inc., James Carr Bettis, Donn Vickrey and Matthew Kliber (collectively, "Gradient") and Rocker Partners, LP, Rocker Management, LLC, Rocker Offshore Management Company, Inc., David Rocker, and Marc Cohodes (collectively "Rocker") have filed two petitions for review totaling 65 pages of argument in the hope that the Supreme Court might find a reviewable issue somewhere in this morass. In order to distill these arguments down to a coherent set of issues, respondents will submit one answer to these two petitions.

Because the petitioners cannot cite to any disagreement among the courts of appeal, petitioners resort to misrepresenting a holding of the *Overstock* Court of Appeal in an attempt to invent a purported split. Specifically, petitioners contend that the "court below held that a plaintiff need only show that it will probably be able to produce evidence to support its position, rather than actually submitting evidence that demonstrates a

likelihood of success." Rocker Br., at 2; *accord,* Gradient Br., at 2-3 (claiming that one standard "requires the plaintiff to submit evidence" whereas the *Overstock* court decided to "wait and see" if evidence would be developed during discovery). Starting with this false premise, petitioners then proceed to hysterical rhetoric about the imminent downfall of the First Amendment. *See, e.g.,* Gradient Br., at 25 (referring to the "dangerous ruling" that will inflict "untold damage" and will "wreak[] havoc").

In reality, the Court of Appeal carefully followed precedent, including the requirement that "a plaintiff opposing an anti-SLAPP motion cannot rely on allegations in the complaint, but must set forth evidence that would be admissible at trial." Opinion ("Op."), at 9. Thus, petitioners' claim that the Court of Appeal held that a plaintiff need not submit actual evidence is patently false. The Court of Appeal thoroughly reviewed the evidence actually submitted and found that the evidence, if credited, would sustain a judgment in plaintiffs' favor.

After inventing this split in the courts to purportedly comply with California Rule of Court 8.500, petitioners proceed to reargue the facts at length. This factual rehash is not the stuff of Supreme Court appeals. Four judges have examined the facts, and four judges have rejected petitioners' highly misleading and self-serving characterizations of the facts. It is also ironic that petitioners insist that the Court of Appeal did not require actual evidence at the same time petitioners argue the evidence at such length with countless references to the record below.

What the evidence shows is that Gradient and Rocker conspired to publish a flurry of defamatory reports about Overstock at the same time Rocker was building a short position in Overstock. Rocker intended to profit by driving down the price of the stock and paid Gradient

substantial fees for these reports which Gradient allowed Rocker to take part in writing and editing. Gradient distributed these reports to institutional investors and the financial media under the guise of being Gradient's unbiased and objective assessment of Overstock.

Four former employees of Gradient signed declarations swearing that it was the regular practice of Gradient to allow customers like Rocker to request, edit and control the timing of publications of negative reports on a company that would be coordinated with the customer taking a short position in the company's stock. One of the four employees even sat in on specific telephone calls between the principals of Rocker and Gradient during which Rocker specifically requested delaying publication of negative reports on Overstock so that Rocker could build up a bigger short position before the release of the reports. Gradient advertised its ability to "blow up" stocks via these reports as a reason why customers should pay to purchase them. To further profit, Gradient secretly invested in companies that were the subject of Gradient's reports through a related, but undisclosed, investment company known as Pinnacle Investments.

While petitioners try to stick to a mantra that the reports were "detailed, critical analysis of an inherently judgmental, technical subject," the truth is that the reports unequivocally accuse Overstock of intentionally falsifying its financial reporting in multiple concrete ways and call for an SEC investigation of Overstock based on Overstock's alleged financial fraud. When Overstock submitted a declaration from its Senior Vice President of Finance demonstrating the falsity of petitioners' accusations, petitioners were forced to admit that some of the statements were provably false (and the declaration proves the other statements are false whether or not petitioners wish to concede the fact at this time). As for its "detailed,

critical analysis," Gradient used unqualified recent college graduates, not certified professional accountants, to write its hatchet jobs.

When the facts are understood, petitioners' effort to wrap themselves in the First Amendment is unavailing. Market manipulation is not a value enshrined in the First Amendment. And it requires extraordinary audacity for petitioners to claim that allowing discovery to proceed on their market manipulation scheme will prevent nonprofits from testing consumer products, investigative journalists from reviewing government budgets, medical researchers from stopping cancer, and business journalists from detecting fraud. *See, e.g.,* Gradient Br., at 4-5. This case should proceed without further delay.

II. FACTS

Contrary to Gradient's assertion that the case is based on a "single declaration" of a "disgruntled former employee," Gradient Br., at 2, Overstock submitted seven declarations in support of its case and attached extensive exhibits, including over 50 Gradient reports on Overstock. Four of the declarations were from former Gradient employees, all of whom testified to Gradient's practice of working with its clients to manipulate stock prices.[1] The declaration of Mr. Antifantis, who has a master's degree in economics from Fordham, was particularly devastating because he was present for many calls between Mr. Vickrey and Mr. Rocker—the editor-in-chief of Gradient and the principal of Rocker, respectively—as they coordinated their attack on Overstock.

The Superior Court and Court of Appeal carefully reviewed

[1] See the declarations of Demetrios Antifantis, Robert Ballash, Danette Dehnicke and Daryl Smith. (4A 1004-13; 6A 1654-60; 4A 1000-03; 6A 1650-53). Two of them—Mr. Ballash and Mr. Smith—were terminated by Gradient when they questioned Gradient's business practices.

the thousands of pages in the record, and there is no reason for this Court to grant review simply to pore over all of the facts in the record for a third time. While the Court of Appeal's opinion ably outlines the facts, Overstock will review some of the facts here to provide context in later considering petitioners' claim that Overstock is putting a microscope to "some minor error or debatable statement" in the petitioners' "serious and detailed analyses." Gradient Br., at 5.

A. Gradient's Business

Gradient, formerly Camelback Analytics, Inc., publishes reports, alerts and bulletins that it advertises are "unbiased, independent and objective analysis of a company's earning quality." Op., at 17. One product is an "earnings quality analytics (EQA) report" in which it rates public companies on an "A" (highest grade) through "F" scale (lowest grade). Op., at 2. Despite advertising the reports as having been prepared by Certified Public Accountants and Chartered Financial Analysts, Gradient in fact relied on recent college graduates to draft the reports who had no such accounting or financial analysis qualifications. Op., at 5.

While Gradient was publishing research reports it advertised as "unbiased, independent and objective," the founders of Gradient, James Carr Bettis and Donn Vickrey ran a hedge fund known as Pinnacle Investments Advisors, LLC ("Pinnacle"). Op., at 5. To cover up the conflict of interest,[2] Mr. Vickrey instructed employees not to disclose that Gradient managed money via Pinnacle, and one Gradient employee in fact answered one phone on his desk on behalf of Gradient and another on

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[2] Gradient employees were provided a financial bonus that was tied in part to the performance of Pinnacle. (4A:1002 ¶4). Pinnacle's investments included most, if not all, of the companies about which Gradient prepared "research" reports. (6A:1659 ¶25).

behalf of Pinnacle. Op., at 5-6.

B. Gradient's "Unbiased," "Independent" and "Objective" Reports

Gradient charged customers an annual base subscription rate of $25,000 to $40,000 per year to subscribe to Gradient. Op., a 2. Gradient subscribers receive research reports prepared by Gradient, and are also entitled to have Gradient prepare two "custom reports" on a specific company, at any time. Op., at 2. Beyond that, subscribers can pay for additional reports. Op., at 2-3.

The Gradient customer would choose whether the report on the company would be positive or negative. Op., at 4. Gradient and the customer would discuss the report's contents in detail, and Gradient would commonly lower the company's grade or otherwise alter the report upon the customer's request. Op., at 4. Typically a subscriber requesting a report would supply Gradient with negative information on the company subject to the request and instruct Gradient to include the information. Op., at 3-4.

It was common knowledge at Gradient that customers who requested negative reports and supplied negative information on a company either had short positions in the securities of these companies or intended to take short positions before publication of the reports. Op., at 4. Gradient's negative reports were a key component in the efforts of Gradient customers to profit from the anticipated depression of the trading price of these companies' stocks. Op., at 4. Customers would ask Gradient not to disseminate the report to the public for a specified time period during which the customer would establish a short position. Op., at 4. Many hedge funds asked Mr. Vickrey specifically to delay public release of reports for three to

seven days while the funds built up short positions. Op., at 4-5.

Gradient marketed its report service by use of a "Top Ten" list of stocks that were the subjects of its reports, and that had moved in price according to the rankings Gradient gave the stocks in its reports. Op., at 5. The purpose of the list was to provide potential and current customers the tracking results to demonstrate Gradient's ability to affect stock performance. Op., at 5. Gradient also tracked what it called "Blow ups by Grade." Op., at 5. "Blow ups" were companies which suffered a one-day price decline of 20% or more, or a price decline of more than 25% over the course of a week, within 12 months after the publication of a Gradient report. Op., at 5. The "Blow up" report was a successful part of Gradient's marketing efforts to short-selling hedge fund clients. Op., at 5.

C. Gradient's Publication of the "Independent" Reports

Once the subscriber established its short position in the targeted company's stock, Gradient's "unbiased, independent and objective" report was distributed to its customers, knowing that the customers intended to republish the reports to third parties who held positions in the stock and to government regulatory agencies. Op., at 5. Gradient also permitted financial journalists to review the reports, knowing that this exposure would provide wider circulation of the content of the reports. Op., at 5.

Gradient did not disclose (1) that its reports were ordered by subscribers, (2) that subscribers had advance copies prior to publication, or (3) that subscribers exerted influence over the content of these custom reports, including influence over the negative assessment of the company. Op., at 5. Rocker knew that the reports were being advertised as

independent and objective when in fact Rocker was editing them to make them more negative. Op., at 26.

D. Rocker and Gradient's Assault on Overstock

In 2003, Rocker approached Gradient and began requesting reports about Overstock. Op., at 6. Gradient's first report on Overstock issued in June 2003, and three reports followed that year. Op., at 7 n.9. Rocker began establishing short positions in Overstock in February of 2004. Op., at 6. In July 2004, Rocker became a Gradient subscriber.[3] Op., at 6. After July 2004, Gradient issued seven reports on Overstock in the remainder of that year. Op., at 7 n. 9. In the first half of 2005, Gradient increased its reporting with a flurry of over 20 negative reports and ultimately published over 50 negative reports on Overstock, which Gradient made available to the media at no cost. Op., at 7 n.9.

Mr. Rocker, Rocker's principal, was in frequent contact with Mr. Vickrey concerning Rocker's requests for negative reports on Overstock. Op., at 6. Gradient knew that Rocker had a short position in the shares of Overstock. Op., at 6. At Mr. Rocker's request Gradient wrote several reports on Overstock that graded the company either "D" or "F." Op., at 6.

Rocker and Gradient discussed the reports on Overstock in advance of their publication. Op., at 6. Gradient would send drafts to Rocker, to which Rocker would respond with suggested changes, including additional negative information, a more negative perspective or

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[3] Although Rocker states it did not become a Gradient subscriber until July 2004, Rocker was requesting negative reports on Overstock beginning in 2003, before Rocker began establishing short positions in Overstock in 2004. (4A:1009 ¶28). This was consistent with Gradient's practice of offering services to hedge funds for a period of up to several months before they actually became paying customers. (6A:1652 ¶9).

underscoring more negative aspects of the report. Op., at 6. Gradient thus accommodated Rocker's requests to publish negative information on Overstock for the purpose of negatively influencing the price of Overstock shares so that Rocker could profit from its existing or intended short positions. Op., at 6.

Not only did Rocker edit the Gradient reports, Rocker also controlled the timing of the reports. Several times Rocker requested that Gradient delay the publication of the reports so that Rocker could establish a short position. Op., at 6.

E. The Defamatory Statements

In addition to being falsely disguised as "objective and independent" analyses prepared by experts, the reports contained both express and implied false statements regarding Overstock, some of which petitioners have already been forced to concede the falsity.

In support of its claims that the Gradient reports contained false statements regarding Overstock, Overstock submitted the declaration of its senior vice-president of finance, David Chidester. Op., at 7. Mr. Chidester reviewed over fifty Gradient reports on Overstock, from June 2003 through December 2005. Op., at 7. He identified multiple false statements of fact about Overstock's accounting practices and related matters. Op., at 7-8.

As the Court of Appeal reviewed in great detail, Gradient's reports accused Overstock of, among other things, (1) intentionally inflating its revenue to drive up its share price by using accounting methods that substantively violated generally accepted accounting principles ("GAAP"), as well as severely overstating its cash flow, (2) hiding losses connected to a purchase of bulk diamonds, and (3) subjecting shareholders

to millions in losses via a stock buy-back program. Op., at 12-22. Mr. Chidester demonstrated that these allegations were provably false, and Gradient admitted the falsity of its statements regarding the stock buy-back program to the Court of Appeal. Op., at 20 (observing that Gradient eventually admitted that its assertion that Overstock would have to pay out $13.9 million for a stock buy-back program was false).

Each of these three categories of false statements is discussed below. The consistent theme of the Gradient reports was that Overstock was intentionally falsifying its accounting in order to drive up its share price, i.e., committing accounting fraud and securities fraud. These explosive accusations lacked any foundation.

1. Overstock's Revenue Recognition Model

Effective July 1, 2003, Overstock began accounting for revenue received in fulfillment partner transactions on a gross basis as opposed to a net basis. Op., at 12. Overstock made this change from net to gross because it had assumed an inventory risk, and Overstock's outside auditor determined that the change was proper and complied with the criteria specified by the Financial Accounting Standards Board ("FASB"). Op., at 12.

Gradient relentlessly attacked Overstock's revenue recognition accounting, alleging that:

- Overstock is "misstating revenues through a substantive violation of GAAP"; Op., at 12
- "the amount of [inventory] risk borne by OSTK[4] is virtually nil"; Op., at 12
- Overstock has therefore "materially overstated its sales since July 1, 2003"; Op., at 13

[4] OSTK is Overstock's stock symbol.

- "the company changed its revenue policy in order to drive its share price higher"; Op., at 13
- "this is the type of accounting policy choice that we believe the SEC would be very interested in looking at"; Op., at 13
- Gradient's "professional opinion" is that any argument that gross revenue recognition is appropriate is "complete balderdash"; Op., at 13
- the contemporaneous resignation of the CFO "was (and still is) a significant concern"; Op., at 13-14
- in addition to revenue inflation, Overstock's cash flow was also artificially and "severely" overstated by float cash; Op., at 14

In sum, Gradient accused Overstock of intentionally inflating its revenues by changing its revenue recognition policy so that Overstock could "drive its share price higher." To hide its wrongdoing, Gradient continued, Overstock falsely stated to investors that the change was required because of inventory risk (which was "complete balderdash"), and, on top of all that, Gradient accused Overstock of also severely inflating its cash flow numbers. In Mr. Chidester's declaration, however, Overstock showed that its accounting practices were correct and motivated by GAAP, not any desire to defraud investors. Op., at 15-16, 18-19 & n.15. Nonetheless, petitioners casually dismiss their statements as too "minor" and "debatable" to be actionable—apparently believing that false allegations of deliberate accounting fraud is free speech and the right of all market manipulators. Gradient Br., at 5.

2. Overstock's Purchase of Bulk Diamonds

In late 2004, a variable interest entity ("VIE") purchased diamonds on behalf of Overstock. Op., at 19. Per accounting rules, the financial statements of the VIE were consolidated with Overstock's financial statements. Op., at 19.

In a series of reports, Gradient attacked Overstock's accounting, claiming that Overstock was misusing the VIE to report the benefits of the jewelry business while hiding half of its losses. Op., at 19. Gradient's report further asserted that the use of the VIE was motivated by "cosmetic earnings management." Op. at 19-20.

Overstock demonstrated that, in reality, all of the components of the VIE's financial statements (including all losses) would be incorporated within Overstock's financial statements, that the use of the VIE was proper and required under accounting rules, and considerations of cosmetic earnings management had nothing to do with the VIE's accounting treatment. Op., at 20.

3. Overstock's Stock Buy-Back Program

Gradient also assailed Overstock's stock buy-back program and asserted that Overstock was "on the hook to pay out an additional $13.9 million" as a consequence of the program. Op., at 20.

Overstock again showed that Gradient's report was false because the amount that Overstock could pay out was fixed from inception and there was no possible additional payout obligation. Op., at 20. Gradient admits in a footnote that its statement was false, but tries to dismiss its statement as an "isolated error." Gradient Br., at 13 n.17. Of course, it is not isolated, as Gradient's reports also made false accusations regarding Overstock's inflated revenue recognition, overstated cash flow, and improper use of the VIE, as shown above.

F. The Damage to Overstock

Gradient published at least 20 negative reports on Overstock in the first half of 2005. *See supra*, at 8. By July 2005, Overstock's share price had dropped by more than half during that same time span. (3A:

0822). Rocker thus profited from short-selling Overstock while Gradient achieved its goal of earning more fees and having another successful "blow-up" to add to its future marketing.

While Overstock's price drop was cause for celebration at Gradient and Rocker, it was no laughing matter for Overstock. The performance of Overstock's stock is a major factor in its relationships with its lenders, suppliers, banks, investors, customers and the media. Op., at 8. As a result of the stock drop, Overstock had its line of credit halved, which forced it to draw down on another, more expensive line of credit. Op., at 8. The halving of its credit line also delayed its receipt of inventory and increased the amount charged to Overstock's vendors. Op., at 8. Overstock was also hampered in its ability to use stock to acquire companies and raise additional capital. Op., at 8.

III. THERE IS NO GROUND FOR SUPREME COURT REVIEW

A. There is no split in authority as to the burden of proof in responding to an anti-SLAPP motion.

The burden on a plaintiff in responding to an anti-SLAPP motion is well settled. Cal. Code Civ. Proc. § 425.16(b)(1) provides that a court should strike a cause of action within the scope of the statute "unless the court determines that the plaintiff has established that there is a probability that the plaintiff will prevail on its claim." *Accord*, Op., at 9 (citing the statute). Cal. Code Civ. Proc. § 425.16(b)(2) instructs the court to "consider the pleadings, and supporting and opposing affidavits." The Court of Appeal enforced this subsection, requiring Overstock to "set forth evidence that would be admissible at trial." Op., at 9. Overstock's libel claim required evidence of defamatory statements made with knowledge of

their falsity or with reckless disregard of their truth or falsity. Op., at 10-11.[5]

In order to establish a probability of prevailing, a plaintiff need only state and substantiate a legally sufficient claim. *Navellier v. Sletten*, 29 Cal.4th 82, 88 (2002); *Wilson v. Parker, Covert & Chidester*, 28 Cal. 4th 811, 821 (2002). "Put another way, the plaintiff must demonstrate that the complaint is both legally sufficient and supported by a sufficient prima facie showing of facts to sustain a favorable judgment if the evidence submitted by the plaintiff is credited." *Navellier*, 29 Cal. 4th at 88-89; *Wilson*, 28 Cal. 4th at 821; *accord*, Op., at 9. In deciding the question of potential merit, the court "does not *weigh* the credibility or comparative probative strength of competing evidence." *Wilson*, 28 Cal. 4th at 821 (emphasis in original); *accord*, Op., at 10. The anti-SLAPP statute is thus designed to weed out those cases that lack even "minimal merit." *Navellier*, 29 Cal. 4th at 89; *accord*, Op., at 10.

Every statement in the Court of Appeal's discussion is thus backed up by Supreme Court authority and the statute itself. Indeed, every aspect of the Court of Appeal's legal summary was recently restated in *Taus v. Loftus*, 40 Cal. 4th 683 (2007). There, the Supreme Court reaffirmed that a plaintiff need only make out a "prima facie showing of facts," that the court should not weigh the credibility or comparative

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[5] Rocker bizarrely claims that the defamation claim must be dismissed because Overstock did not offer a statistical regression analysis in support of a non-existent damages element. Rocker Br., at 19-20 & n.8. Damages are not an element of libel per se, where the defamatory meaning is evident from the statement itself. *Palm Springs Tennis Club v. Rangel*, 73 Cal. App. 4th 1, 5 (1999). As Gradient acknowledges, Overstock has claims for libel per se. Gradient Br., at 12. Moreover, Rocker cites no California law holding that damages for defamation can only be proved by a statistical regression analysis or that such an analysis should be submitted before expert disclosures even begin.

probative strength of competing evidence, and that the "Legislature did not intend that a court, in ruling on a motion to strike under this statute, would weigh conflicting evidence to determine whether it is more probable than not that plaintiff will prevail on the claim, but rather intended to establish a summary-judgment-like procedure... ." *Id.* at 713-14. Thus, the bottom line is that a legally sufficient claim supported by a prima facie showing of supporting facts is all that is needed "at the earliest stages of litigation."[6] *Id.* at 714.

Faced with the need to contrive some purported split in legal authority, Gradient claims that the Court of Appeal revolutionized anti-SLAPP law by holding that Overstock needed only to show "a probability that it <u>will</u> be able to produce at trial" the evidence necessary to oppose the anti-SLAPP motion, which was a "'wait-and-see' standard" in conflict with the normal summary-judgment style approach. Gradient Br., at 2, 17 (emphasis in original). Rocker parrots this argument, stating that "[t]he court below held the plaintiff only had to demonstrate that it 'can produce' evidence of actual malice at trial as opposed to actually producing such evidence in response to the motion to strike." Rocker Br., at 17, 20. It is telling that petitioners feel compelled to resort to such intellectual dishonesty to create a purported split in authority.

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[6] Gradient selectively quotes the Court of Appeal in order to argue that the court ignored the proper evidentiary standard in favor of "an especially forgiving burden." Gradient Br., at 20. Correctly quoted, the Court of Appeal stated that "[the burden] is not high: We do not weigh credibility, nor do we evaluate the weight of the evidence." Op., at 10. That is straight from multiple Supreme Court opinions, as shown above. Gradient omits part of the quote and tacks on another: "[the burden] is not high...Only a cause of action that lacks 'even minimal merit' constitutes SLAPP." Gradient Br., at 21. By manipulating legal authority in this manner, Gradient tries to make it appear that the Court of Appeal did not follow precedent.

Nowhere did the Court of Appeal hold that Overstock could merely show a probability that it would discover evidence in the future rather than present evidence in response to the anti-SLAPP motion. As clearly stated in the opinion, the Court of Appeal required Overstock to "set forth evidence that would be admissible at trial."[7] Op., at 9. Indeed, the Court of Appeal examined in depth Overstock's evidence—the evidence actually submitted—to see if it satisfied the actual malice standard. *See, e.g.*, Op., at 23 (reviewing what "[t]he evidence showed" regarding the malice of Gradient), Op., at 26-27 (reviewing the evidence of malice as to Rocker). Gradient and Rocker argue the significance of that evidence at length, ignoring the contradiction in their efforts to reargue the evidence and concurrently claim that the Court of Appeal did not require evidence. In sum, there is no doubt that the *Overstock* court in fact based its decision on admissible evidence that was submitted in the form of declarations, as required by statute.

Petitioners try to denigrate the Court's review of the evidence, but such attacks have nothing to do with whether there is a split in authority. For example, Gradient contends that the Court of Appeal "speculated," based on "atmospherics," that Overstock "may be able to prove malice if allowed to conduct costly, speech-chilling discovery." Gradient Br., at 2. Gradient may wish to dismiss demonstrably false

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7 Of course, in ruling on anti-SLAPP or summary judgment motions courts regularly discuss what a plaintiff "will," "would," "can," or "could" show at trial because the whole point of such motions is to determine whether there will be an issue of fact for the jury if a trial is held. *See, e.g.*, *Live Oak Publishing Co. v. Cohagan*, 234 Cal. App. 3d 1277, 1291 (1991) (stating that the issue on summary judgment was whether plaintiff "can produce clear and convincing evidence of actual malice at trial"). Petitioners absurdly argue that this use of the future tense means that courts are not requiring the submission of evidence in response to the motion.

statements (as proven by Mr. Chidester's declaration) made in support of a short-selling scheme (as proven by four declarations of former employees) as "atmospherics," but that is simply Gradient's own self-serving effort to ignore, mischaracterize, misstate and otherwise distort the facts. It has nothing to do with legal standards.

Finally, petitioners argue that there is a split between *Overstock* and *Christian Research Institute v. Alnor*, 148 Cal. App. 4th 71 (2007), but the *Overstock* opinion expresses no disagreement with the *Christian Research* opinion published three months earlier. Petitioners assert that *Christian Research* follows the prevailing evidentiary standard whereas the *Overstock* court "adopted" the "other standard" set forth in *Ampex Corp. v. Cargle*, 128 Cal. App. 4th 1569 (2005). Gradient Br., at 2. The *Overstock* court cited *Ampex* as the source of the proposition that a plaintiff must establish a probability that it "can produce" at trial clear and convincing evidence of malice, which is the basis for petitioners' semantic argument that actual evidence was not required. Rocker Br., at 17; *accord*, Gradient Br., at 2. Yet in *Ampex*, after purportedly opening the door to speculation about what evidence plaintiffs "can produce" in discovery, the court held that plaintiffs "have not produced any evidence or inferences from evidence" showing malice and granted the anti-SLAPP motion. *Ampex*, 128 Cal. App. 4th at 1578. Thus, the *Ampex* court in fact considered the evidence actually submitted, just as the *Overstock* court did, and no "other standard" exists.

As for *Christian Research*, petitioners assert that it reaffirms that a plaintiff must submit actual evidence in response to an anti-SLAPP motion rather than speculate about what evidence might be revealed in discovery. Gradient Br., at 17; Rocker Br., at 3. Accordingly, petitioners

do not contend that *Christian Research* broke new ground, nor does that the opinion make any such claim. The question in *Christian Research* that prompted a dissent in that case was the "application of the law to the facts in this case."[8] *Christian Research*, 148 Cal. App. 4th at 93 (J. Rylaarsdam, dissenting). Likewise, the application of law to fact is the basis for petitioners' disagreement with the *Overstock* decision. No court has stated that two conflicting legal standards have emerged, nor have they.

B. There is no split in authority regarding who may be liable for taking a responsible part in the publication of defamatory material.

One who takes a responsible part in a publication of defamatory material may be held liable for the publication. *Shively v. Bozanich*, 31 Cal. 4th 1230, 1245 (2003). Participating in the editing of a publication constitutes taking a responsible part. *Jones v. Calder*, 138 Cal. App. 3d 128, 134 (1982). There is no requirement that a person who takes a responsible part must have specifically drafted the defamatory language in question; of course, if that were the case, only authors could be liable. *See id.* at 130 (both author and editor sued as responsible parties).

Rocker did more than just take a responsible part in the publication of the defamatory material; in fact, Rocker was the very reason that the defamatory material was published. As testified to by Mr. Anifantis, at Rocker's request Gradient wrote reports on Overstock that graded the company a "D" or "F." Mr. Rocker, the fund's principal, was frequently in contact by telephone with Mr. Vickrey, Gradient's editor-in-

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8 The majority similarly noted that the plaintiffs might have met their burden if they had simply submitted a declaration from a third party supporting their claim. *Id.* at 93. Here, Overstock did not merely allege malice based on Overstock's own beliefs; instead, Overstock submitted evidence from third parties with inside knowledge of petitioners' activities.

chief, concerning Rocker's requests for negative reports. Rocker edited the reports and supplied negative information to make them more negative. Rocker controlled the timing of the reports so that Rocker could build up a short position. There never would have been a flurry of 50 defamatory reports if Rocker had not requested this flood of negative reporting in support of its short-selling.

Rocker claims that there is a "split in authority" regarding who can be held liable as a responsible party, Rocker Br., at 25, but no court has referred to any split in authority or any disagreement at all. Rocker's imagined split in authority is between the Court of Appeal's factual finding that Rocker took a responsible part in the publication of the material, *see* Op., at 26, and Rocker's own self-serving view of the facts that it had no reason to know of or investigate the falsity of the statements (apparently including its own false statement that it insisted Gradient add, i.e., that no subscriber had requested a report on Overstock).

Rocker relies heavily on cases regarding the liability of distributors of defamatory statements, such as bookstore owners and magazine stands. *See* Rocker Br., at 23. Rocker also cites to Section 581 of the Restatement (Second) of Torts concerning the liability of distributors. Rocker Br., at 23. This law, to the extent it could apply, does not aid Rocker's cause. Rocker asserts that a distributor cannot be liable unless it "knows," "has reason to know," or "knows facts that would impose a duty to investigate" whether the material was defamatory. Rocker Br., at 23-24. Rocker certainly had reason to know of and investigate the accuracy of reports which Rocker was commissioning, editing and manipulating the timing of expressly to aid in its short-selling—as testified to by former employees. This case is nothing like the cases cited by

Rocker, which involve innocent booksellers, authors whose work was altered without their knowledge, and the like. *See also* Restatement (Second) of Torts, § 581 cmt. c (contrasting the liability of persons involved in preparing a false publication and who would be expected to know or find out the accuracy of the publication with those persons who merely distribute a publication which they had no involvement whatsoever in preparing).

Rocker also tries to invent a new legal requirement that the plaintiff show that the defendant had control over the content of the publication. Rocker Br., at 25. If control over the content of a publication were a requirement for liability, then there could be no liability based on taking a responsible part in the publication of defamatory material because only one defendant—the one with control—could be liable. In addition to being another legal invention of the petitioners, Rocker obviously had substantial control as the reports were being published in response to Rocker's solicitations and their content was altered by Rocker.

Nowhere has Rocker shown that there is any split in authority or other uncertainty among the courts of appeal about when liability may be imposed on a defendant who takes a responsible part in the publication of defamatory material.

C. The scope of the UCL has nothing to do with freedom of speech and does not warrant review.

Rocker asks the Court to grant review of the denial of its demurrer to Overstock's UCL claim that petitioners engaged in unfair business practices and false advertising by intentionally disseminating negative and false reports on Overstock that were represented to be independent and objective. *See* Op., at 28 (outlining Overstock's claim).

Rocker contends that California's unfair competition law ("UCL"), as set forth in Sections 17200 and 17500 of the Business & Professions Code, excludes securities transactions. Rocker relies on *Bowen v. Ziasun Tech., Inc.*, 116 Cal. App. 4th 777, 788 (2004), which held that transactions involving the purchase or sale of securities fall outside the scope of the UCL.

Rocker's assertion has nothing to do with freedom of speech, the First Amendment, or anti-SLAPP motions. Demurrers are not reviewable on interlocutory review, and the Court should reject Rocker's effort to obtain review of a nonappealable issue.

In addition to lacking any right to interlocutory review, the issue raised in *Bowen* was not raised here. As the Court of Appeal observed, Overstock's claims do not arise from stock transactions. Op., at 29. *Bowen* and the cases on which it rests all concern fraud in the sale of securities, and *Bowen* does not encompass all situations where securities are somehow implicated, but not purchased or sold. *Strigliabotti v. Franklin Resources, Inc.*, 2005 WL 645529, at *9 (N.D. Cal. Mar. 7, 2005) (finding *Bowen* inapplicable to scheme to overcharge investors in the management of securities). The regular dissemination of the defamatory reports was not a purchase or sale of securities, or a securities transaction at all.

The question of whether *Bowen* correctly found that the purchase or sale of securities falls outside the scope of the UCL is not presented here. Overstock's UCL claim raises no issue regarding the purchase or sale of securities, and the Court should not grant review to consider the holding of another case that is not squarely on point.

IV. DEFENDANTS' FACTUAL ARGUMENTS HAVE NO MERIT

Petitioners argue that there is no evidence of falsity because accusations of accounting fraud are just a matter of opinion. Petitioners further contend that there is insufficient evidence of malice. Neither contention is accurate or warrants review.

A. There is sufficient evidence of falsity.

Expressions of "opinion" may often imply an assertion of objective fact, such as an assertion that someone is a liar. Op., at 11 (citing *Milkovich v. Lorain Journal Co.*, 497 U.S. 1, 17 (1990)). Even if the speaker discloses the basis for his opinion, if the disclosed facts are either incorrect or incomplete, or if his assessment of them is erroneous, the statement will still constitute a false statement of fact.[9] Op., at 11.

In determining whether a statement is actionable, courts examine the totality of the circumstances, starting with the language of the statements at issue. *Ruiz v. Harbor View Community Assoc.*, 134 Cal. App. 4th 1456, 1471 (2005). Here, Gradient made numerous false statements that generally accused Overstock of (1) intentionally inflating its revenue to drive up its share price by using accounting methods that substantively violated GAAP, and also overstating its cash flow, (2) hiding losses as part of a purchase of bulk diamonds, and (3) subjecting shareholders to millions

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[9] The CFA Institute, whose amicus brief was considered by the Court of Appeal, submits an amicus letter claiming that Gradient lost its anti-SLAPP motion because its reports were not "written in the form of loose, figurative, or hyperbolic language." Letter of CFA Institute, at 3. This is as disingenuous as petitioners' legal arguments. Gradient lost its anti-SLAPP motion because the Court of Appeal found it made false accusations of accounting fraud with actual malice in support of a market manipulation scheme. The CFA Institute concludes that Overstock's remedy should be limited to speaking out in its defense, i.e., de facto immunity for CFA members. The Supreme Court has rejected immunity even for a newspaper's coverage of political campaigns. *Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657, 687-88 (1989).

in losses via a stock buy-back program. Op., at 12-22. Gradient never cites the actual language used in making these accusations because the language belies Gradient's claim that the statements were mere opinion.

Gradient generically and expediently characterizes its statements as "detailed reports on controversial, technical subjects" and then concludes that such reports are automatically protected opinion. Gradient Br., at 25. When one examines the actual language of the statements, however, there is nothing difficult to grasp about factual assertions that Overstock was "misstating revenues through a substantive violation of GAAP," Op., at 12, or that "the amount of [inventory] risk borne by OSTK is virtually nil," Op., at 12, or that Overstock has therefore "materially overstated its sales since July 1, 2003," Op., at 13, or that "the company changed its revenue policy in order to drive its share price higher," Op., at 13. There is no law that would exempt these sorts of defamatory statements as mere opinion, and there exist no accurate, disclosed facts that would justify the statements. The same is true for Gradient's statements that Overstock was hiding losses via variable interest entities or subjecting shareholders to millions in losses via stock buy-back program. These are false statements of fact, plain and simple.

Because it cannot defend the text of the defamatory statements it actually made, Gradient creates an abstract and convoluted fiction about how the Court of Appeal differentiated statements of fact from statements of opinion. Specifically, Gradient tries to mislead this Court into believing that the Court of Appeal held that there were "four nonactionable categories of speech" and further held that the four categories did not survive *Milkovich*: "the *Overstock* decision enumerates and specifically identifies each of the four nonactionable categories—and

then gives them the back of the hand, implying that they somehow have been superseded by the *Milkovich* 'implied assertion of fact' doctrine." Gradient Br., at 26. In truth, the Court of Appeal never adopted any set of four nonactionable categories of speech, nor did it give them "the back of the hand" or hold that they were superseded by *Milkovich*. Gradient offers no supporting citations for the false holding it attributes to the Court of Appeal (just as it failed to cite any authority for the false holding that the Court of Appeal did not require actual evidence in response to the motion).

Gradient claims that "[t]he four nonactionable categories are—to quote the *Overstock* decision—'(1) "opinions based on fully disclosed fact"; (2) "rational interpretations of ambiguous sources"; (3) "statements embodying complex and debatable technical judgments"; [and] (4) "statements too inexact or subjective to be proved true or false."'" Gradient Br., at 25-26. However, Gradient is not quoting the *Overstock* court; rather, it is quoting the *Overstock* court's quotation of Gradient's own contentions in its briefing. *See* Op., at 14 (reciting that Gradient asserted four categories of nonactionable speech). There is no law holding that every statement must be held up against each one of Gradient's four mythical categories.

After devoting so much space to inventing its "four categories of nonactionable speech," Gradient fails to show how any of the categories would be relevant here. Nowhere does Gradient show that it disclosed accurate facts evidencing that Overstock had inflated its revenue numbers, or severely overstated its cash flow, or misused a variable interest entity to hide losses, or actually put its shareholders on the hook for millions in losses because of the stock buy-back program. Nor does Gradient show how it was merely interpreting ambiguous sources or making statements

that cannot be shown to be true or false (and Gradient has already admitted the falsity of the accusations regarding the stock buy-back program).

Gradient finally gets to its point when it contends that statements attacking a company's accounting practices can never be actionable because there is no "right or wrong answer" to any accounting question—ever.[10] Gradient Br., at 30. To devise this astonishing assertion, which will certainly come as news to the SEC, Gradient attempts to import and distort federal securities cases where courts have sometimes held—under highly specific facts and circumstances—that a plaintiff had failed to state a Rule 10b-5 claim. While revenue recognition and other accounting issues may *sometimes* be a question of judgment in the arcane interstices of accounting and federal securities law, it does not follow that straightforward accounting issues are *always* a question of judgment in a securities case or otherwise.[11] *See, e.g., Nursing Home Pension Fund v.*

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[10] An associate accounting professor, J. Edward Ketz of Penn State University, disagrees and states that there is a "set of right answers, a set of wrong answers and a set of debatable answers." Amicus Letter of J. Edward Ketz, at 3. Professor Ketz seems to have no trouble discerning an accounting fraud—the wrong answer—when asserting that there were several thousand accounting frauds in the past decade. *Id.*, at 1-2. His apparent objection is that the Court of Appeals denied the anti-SLAPP motion in spite of Overstock's alleged "flimsy evidence." *Id.*, at 1. Professor Ketz does not identify what judicial qualifications he has to distinguish what evidence is sufficient to satisfy California's anti-SLAPP law, or why the Supreme Court should grant review to reconsider which statements in the reports were right, wrong or merely debatable.

[11] A University of San Diego accounting professor, Thomas Dalton, posits that there are "millions of variables" in accounting and that there can never be a correct opinion. Amicus Letter of Thomas Dalton, at 2. Ironically, Professor Dalton cites the Enron debacle, where the Enron defendants would have been only to happy to agree that there are never right and wrong answers in accounting. Professor Dalton further objects to the Court of Appeal's purported decision that a defamation suit can proceed "*without providing evidence of malice.*" *Id.* (emphasis in original). Professor Dalton shows the same lack of concern for supporting citations as Gradient does. Coincidentally, Gradient's website discloses that Mr. Vickrey was an accounting professor at University of San Diego.

Oracle Corp., 380 F.3d 1226, 1228, 1233 (9th Cir. 2004) (inflated revenue was basis for securities fraud claim); *Cooper v. Pickett*, 137 F.3d 616, 626 (9th Cir. 1997) (a company that overstates its revenues makes false or misleading statements of fact actionable under the federal securities laws). Here, Gradient boldly and unequivocally asserted that Overstock was cooking its books in multiple ways in order to inflate its share price. While Gradient now talks about there being no "right or wrong answer" as to how Overstock recorded its revenue and says that "reasonable persons might disagree," back at the time Gradient did not use such mushy language—which is why Gradient so conscientiously avoids citing the language from its own reports.

Because Gradient cannot cite any case—whether within Gradient's four purported categories or otherwise—that finds comparable statements to be nonactionable opinion, Gradient vaguely concludes that its false accusations of accounting fraud are "immunized" by all four "doctrines."[12] Gradient Br., at 29. Gradient thus seeks an open invitation to reargue to the Supreme Court whether the false statements constitute protected opinion, an issue that was amply considered and disposed of by the Court of Appeal and that is generic to any defamation case.

B. There is sufficient evidence of malice.

A defamatory statement is made with "actual malice" when it is made with knowledge of falsity or reckless disregard as to its truth or falsity. *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964); *Khawar v. Globe International, Inc.*, 19 Cal. 4th 254, 275 (1998).

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[12] If short sellers are immunized from liability in making allegations of accounting fraud, it will be open season on companies, and honest investors will be confused by a flood of false information.

Although the concept of reckless disregard for the truth "cannot be fully encompassed in one infallible definition," it includes a defendant who makes a false publication with "a high degree of awareness of . . . probable falsity" or who must have entertained "serious doubts as to the truth of his publication." *Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657, 667 (1989); *accord*, *St. Amant v. Thompson*, 390 U.S. 727, 731 (1968). When inaction is likely a product of a deliberate decision not to acquire knowledge of facts that might confirm probable falsity, actual malice exists. *Harte-Hanks*, 491 U.S. at 692.

The defendant's reckless disregard for truth or falsity may be shown by circumstantial evidence. *Reader's Digest Association, Inc. v. Superior Court*, 37 Cal. 3d 244, 257 (1984); *see also Harte-Hanks*, 491 U.S. at 686 (actual malice can be defined only on a case-by-case basis). "Evidence of negligence, of motive and of intent may be adduced for the purpose of establishing, by cumulation and by appropriate inferences, the fact of a defendant's recklessness or of his knowledge of falsity." *Reader's Digest*, 37 Cal. 3d at 257. There are many factors that can show a defendant "had serious doubts regarding the truth of his publication," including the following: the defendant's failure to adequately investigate, anger and hostility toward the plaintiff, and reliance upon sources known to be unreliable or biased against the plaintiff. *Id.* Financial motive is also a relevant factor in the actual malice inquiry. *Kaelin v. Globe Communications, Inc.* 162 F.3d 1036, 1042 (9th Cir. 1998) (considering a tabloid's financial motive as part of the totality of circumstances evidencing actual malice). An inference of actual malice can also be drawn when a defendant's analysis was designed to arrive at a predetermined conclusion. *Suzuki Motor Corp. v. Consumers Union of United States, Inc.*, 330 F.3d

1110, 1135 (9th Cir. 2003) (evidence that the defendant's test was designed to support its conclusion that plaintiff's vehicle rolled over too easily was sufficient to prove actual malice); *see also Harte-Hanks*, 491 U.S. at 684 (newspaper decided to publish unsubstantiated allegations against political candidate to support its overall attack on candidate in spite of lacking credible source for the allegations).

The totality of the circumstances show, clearly and convincingly, a predetermined plan to drive down the price of Overstock through a deluge of negative reports that were recklessly prepared with no regard for their truth or falsity. As both petitioners took a responsible part in their production, they cannot try to pass the buck to their respective co-defendant. The reports unequivocally and harshly accuse Overstock of using phony accounting schemes to overstate its financials in order drive up its stock price. These allegations of accounting fraud were false, as petitioners are being forced to admit grudgingly. Gradient and Rocker coordinated the timing of the reports to support Rocker's short-selling schemes. In order to maintain the appearance of independence and objectivity, Rocker insisted that Gradient falsely state that the reports—which were being prepared at Rocker's request—were not prepared at the request of a subscriber. Gradient and Rocker were thus fully attuned to the need to preserve the appearance that the report was independent and fair, not subject to manipulation at the request of a hedge fund.[13] In sum, when the very purpose of Gradient and Rocker's 50-report attack was to drive down the stock price of Overstock, and when the two parties assist each

[13] The CFA Institute's amicus letter cites the obligations of independence, objectivity and professionalism, yet turns a blind eye toward the obvious failure of Gradient to maintain that independence.

other in piling on negative and false information in support of that attack, the question as to whether they had malice answers itself.

Petitioners' effort to reargue the facts is not compelling. Rather than consider the cumulation of inferences and totality of the circumstances as the law provides, Gradient argues that it can be held liable only if Rocker specifically drafted the false and defamatory statements in the reports. Op., at 24; Gradient Br., at 21. That is a non sequitur, as Gradient can certainly be liable for publishing defamatory reports that it participated in drafting and published in furtherance of Rocker's short-selling scheme (and Gradient's solicitations of a new subscriber and more fees). Rocker, for its part, claims that Rocker's "reasons to doubt" and "serious doubt" about the veracity of the reports cannot support an inference of actual malice, *see* Rocker Br., at 26, 28, ignoring the holding in *Harte-Hanks* that reckless disregard includes situations where the defendant entertains "serious doubts" about the truth of the publications or deliberately avoids asking questions of those persons in a position to provide accurate information.

Petitioners had substantial reason to doubt the truthfulness of their accusations of accounting fraud. For example, petitioners have been forced to admit the falsity of the statement that Overstock was putting shareholders on the hook for millions because of its stock buy-back program. As stated in paragraph 13 of Mr. Chidester's declaration, petitioners never contacted Overstock to inquire into the veracity of their accusation. (5A:1159 ¶ 13). Instead, petitioners disseminated their report into the financial media knowing that this attack would support Rocker's short-selling efforts. This deliberate decision not to acquire knowledge of facts that might confirm probable falsity fits squarely within the definition

of actual malice. *See Harte-Hanks*, 491 U.S. at 692-93 (failure to question persons with access to the facts evidences inference of "intent to avoid the truth" and satisfies actual malice standard). Another example is the change in revenue recognition for inventory accounting. Overstock had explained in conference calls and public filings the basis for its accounting change, namely the assumption of inventory risk. *See* Chidester Decl., ¶ 5 (5A:1155-56 ¶ 5). Aware of the true facts, petitioners nonetheless issued their report declaring that Overstock had no inventory risk, that Overstock's explanation was "complete balderdash," that Overstock's change was designed to inflate its share price and that the SEC should investigate. Thus, petitioners had been informed by Overstock of the falsity of their claim that Overstock was fraudulently inflating its share price via a revenue recognition change, yet made the charge without foundation and even called for an SEC investigation. These circumstances show that petitioners' comparison of themselves to medical researchers, environmental advocates or honest reporters is absurd and offensive.

Petitioners never cite any case that bears any similarity to the factual circumstances here. In essence, petitioners have accused Overstock of committing securities fraud by intentionally inflating its share price via various accounting deceptions, hence the call for an SEC investigation. Securities fraud creates both criminal and civil liability and is obviously considered highly dishonest. There are no First Amendment protections for such accusations of criminal conduct or personal dishonesty. *Fisher v. Larsen*, 138 Cal. App. 3d 627, 640 (1982). Where the information is from a source known to be hostile to the subject against whom the material is to be used, failure to investigate may support an inference of actual malice. *Id.* The issue is ultimately for the trier of fact. *Id.* As Gradient and Rocker

were colluding to "blow up" Overstock, each was hostile to Overstock, and neither bothered to investigate the truthfulness of the statements in the reports because the whole point was to attack Overstock.

This Court should not grant review to give petitioners a third bite at the apple to argue the facts supporting an inference of malice. The fact-sensitive inquiry will not set any new principle of law or resolve any split in authority. It will only force Overstock to respond to more tedious mischaracterizations of the evidence. While petitioners like to claim that Overstock has been "artful" in arguing the facts, it is petitioners that are slippery.[14] For example, they repeatedly argue their innocence by stating that Gradient was publishing reports with a "D" or "F" grade before Rocker became a subscriber in July 2004. Gradient Br. at 15; Rocker Br., at 9. However, Rocker had been soliciting the reports back in 2003 (and Rocker specifically requested the negative reports), so their focus on when Rocker formally became a subscriber is irrelevant. Indeed, Gradient's practice was to solicit potential subscribers by showing them how they could blow up a target company. Another review of the evidence will only result in more misleading arguments about what the evidence purportedly shows.

V. CONCLUSION

Two years is enough delay. Petition for review should be denied.

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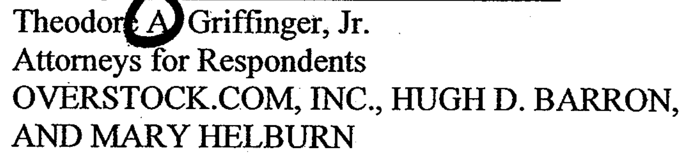
[14] Rocker and Gradient cannot get their facts straight on such basic points as whether Gradient's reports are designed primarily for short sellers. Compare Rocker Br., at 9 ("[T]he focus of Gradient's research is to identify companies that are overvalued, and to explain why their valuations are suspect.") *with* Gradient Br., at 6 (asserting that the "vast majority" of Gradient's investors are "long" investors).

Dated: July 26, 2007

STEIN & LUBIN LLP

By: 

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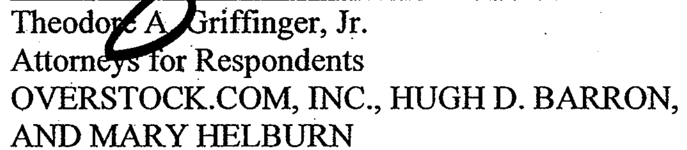
CERTIFICATE OF COMPLIANCE

In accordance with California Rule of Court 8.504(d)(1), counsel for Respondents hereby certifies that Respondents' Answer to Defendants' Petitions for Review (including footnotes) contains 9,240 words, as determined by the computer program used to prepare the brief.

Dated: July 26, 2007

STEIN & LUBIN LLP

By: 

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N.D.Cal.,2005.
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v.
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Defendants.
No. C 04-00883 SI.

March 7, 2005.

Ronald Lovitt, Henry I. Bornstein, J. Thomas Hannan, Lovitt & Hannan, Inc., San Francisco, CA, Gary A. Gotto, Phoenix, AZ, Gretchen Freeman Cappio, Lynn Lincoln Sarko, Michael Dean Woerner, Tana Lin, Keller Rohrback, LLP, Seattle, WA, James C. Bradley, Michael J. Brickman, Nina H. Fields, Richardson Patrick Westbrook & Brickman, Charleston, SC, Ron Kilgard, Keller Rohrback, P.L.C., Phoenix, AZ, for Plaintiffs.
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ORDER PARTIALLY GRANTING AND PARTIALLY DENYING DEFENDANTS' MOTION TO DISMISS

ILLSTON, J.
*1 On February 4, 2005, the Court heard oral argument on defendants' motion to dismiss the complaint. Having carefully considered the arguments of counsel and the papers submitted, the Court hereby PARTIALLY GRANTS and PARTIALLY DENIES defendants' motion.

BACKGROUND

This action is brought by shareholders of several mutual funds ("Funds") created, sold, advised, and managed as part of the Franklin Templeton fund family ("the Fund Complex"). Specifically, the Funds are Templeton Growth Fund, Franklin Balance Sheet Investment Fund, Franklin U.S. Government Securities Fund, Franklin Flex Cap Growth Fund, Franklin DynaTech Fund, Franklin Income Fund, Franklin Small-Mid Cap Growth Fund, Franklin Biotechnology Discovery Fund, Mutual Shares Fund, and Franklin Utilities Fund. First Am. Compl. ("Am.Compl.") at ¶ 1.[FN1]

FN1. On March 4, 2004, plaintiffs filed this action on behalf of five funds; they amended the complaint on June 3, 2004, adding Franklin Income Fund, Franklin Small-Mid Cap Growth Fund, Franklin Biotechnology Discovery Fund, Mutual Shares Fund, and Franklin Utilities Fund as plaintiffs, and adding as defendants Franklin Mutual Advisers, LLC, and Franklin Templeton Services, LLC.

Defendants are Franklin Resources, Inc., Templeton Global Advisors, Ltd., Franklin Advisory Services, LLC, Franklin Advisers, Inc., Franklin Templeton Distributors, Inc., Franklin Mutual Advisers, LLC, and Franklin Templeton Services, LLC. *Id.* at ¶ 2. The companies are various investment advisors affiliated with a single parent company, also a defendant, Franklin Resources, Inc. ("Franklin Resources"), a publicly traded company incorporated in Delaware and headquartered in San Mateo, California. *Id.* Plaintiffs allege that defendants receive advisory fees from the Funds for investment advisory services and administrative services, and these fees are based on a percentage of the net assets of each of the Funds. *Id.* at ¶ 5. Defendants also charge distribution fees for marketing, selling, and distributing mutual fund shares to new shareholders under "Distribution Plans " adopted pursuant to Rule 12b-1, 17 C.F.R. §

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270.12b-1. *Id.* at ¶ 8. These distribution fees are based on a percentage of the net assets of each of the funds in the Fund Complex and amount to more than $7 million annually. *Id.* Plaintiffs allege that the advisory fees charged by defendants are higher than those for other funds for which defendants perform equivalent services and that the distribution fees are excessive, in violation of Rule 12b-1 and § 36(b) of the Investment Company Act ("ICA"). Plaintiffs specifically claim that, despite significant growth in the Funds since 1983, the Funds have not benefitted from the economies of scale and instead have been charged advisory and distribution fees that are disproportionately large in relation to the services provided. *Id.* at ¶ 14.

Plaintiffs seek to either rescind the investment advisory agreements and Distribution Plans and recover the total fees charged by defendants, or, in the alternative, to recover the excess profits resulting from economies of scale wrongfully retained by defendants, and any other excessive compensation or improper payments received and retained by defendants in breach of their fiduciary duty under § 36(b), 15 U.S.C. § 80a-35(b), and state law. *Id.* at ¶ 27. The complaint alleges (1) breach of fiduciary duty under § 36(b) for excessive investment advisory fees; (2) breach of fiduciary duty under § 36(b) for excess profits from economies of scale; (3) breach of fiduciary duty under § 36(b) for excessive Rule 12b-1 distribution fees and extraction of additional compensation for advisory services; (4) violation of § 12(b) for unlawful distribution plans; (5) breach of fiduciary duty under California law; (6) civil conspiracy to breach fiduciary duty under California law; (7) common law aiding and abetting breaches of fiduciary duty by Franklin Resources; (8) "acting in concert" under § 876(b) of the Restatement (Second) of Torts; (9) breach of Cal. Business & Professions Code § 17200; (10) breach of Cal. Business & Professions Code § 17500; and (11) common law unjust enrichment.

*2 Now before the Court is defendant's motion to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6). Both parties have also filed Requests for Judicial Notice ("RJN").[FN2]

FN2. The Court GRANTS both RJNs.

LEGAL STANDARD

Under Federal Rule of Civil Procedure 12(b)(6), a district court must dismiss a complaint if it fails to state a claim upon which relief can be granted. The question presented by a motion to dismiss is not whether the plaintiff will prevail in the action, but whether the plaintiff is entitled to offer evidence in support of the claim. *See Scheuer v. Rhodes,* 416 U.S. 232, 236, 94 S.Ct. 1683, 1686, 40 L.Ed.2d 90 (1974), overruled on other grounds by *Davis v. Scherer,* 468 U.S. 183, 104 S.Ct. 3012, 82 L.Ed.2d 139 (1984).

In answering this question, the Court must assume that the plaintiff's allegations are true and must draw all reasonable inferences in the plaintiff's favor. *See Usher v. City of Los Angeles,* 828 F.2d 556, 561 (9th Cir.1987). Even if the face of the pleadings suggests that the chance of recovery is remote, the Court must allow the plaintiff to develop the case at this stage of the proceedings. *See United States v. City of Redwood City,* 640 F.2d 963, 966 (9th Cir.1981).

"The court may also consider documents attached to the complaint in connection with a FRCP 12(b)(6) motion to dismiss." *Parks Sch. of Business, Inc. v. Symington,* 51 F.3d 1480, 1484 (9th Cir.1995) (quoting *Cooper v. Bell,* 628 F.2d 1208, 1210 n. 2 (9th Cir.1980)). "If a plaintiff fails to attach to the complaint the documents on which it is based, defendant may also attach to a FRCP 12(b)(6) motion the documents referred to in the complaint." *Lee v. City of Los Angeles,* 250 F.2d 668, 688-89 (9th Cir.2001)). "In addition, whether requested or not, the court may consider documents whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the plaintiffs' pleadings." *In re Silicon Graphics Sec. Litig.,* 183 F.3d 970, 986 (9th Cir.1999)). "On a motion to dismiss, [the court] may take judicial notice of matters ... outside the pleadings." *MGIC Indem. Corp. v. Weisman,* 803 F.2d 500, 504 (9th Cir.1986).

If the Court dismisses the complaint, it must then

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