

*Not To Be Published:*

**IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF IOWA  
CEDAR RAPIDS DIVISION**

IN RE MCLEODUSA  
INCORPORATED SECURITIES  
LITIGATION,

No. C02-001-MWB

**ORDER REGARDING  
MAGISTRATE’S REPORT AND  
RECOMMENDATION  
CONCERNING DEFENDANTS’  
MOTION TO DISMISS  
CONSOLIDATED AMENDED  
COMPLAINT**

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## ***I. INTRODUCTION AND BACKGROUND***

On June 27, 2002, plaintiffs filed a 73 page Consolidated Amended Class Action Complaint for Violation of Federal Securities Laws. In this lawsuit, there are two classes of plaintiffs: the “Purchaser Class,” which consists of persons who purchased or otherwise acquired McLeodUSA Incorporated (“McLeodUSA”) securities from January 3, 2001, to December 3, 2001 (the “Class Period”); and the “Merger Class,” which consists of persons who acquired McLeodUSA common stock pursuant to a registration statement and prospectus issued in connection with McLeodUSA’s acquisition of the company Intelispan, Inc. The named defendants are four of McLeodUSA’s senior officers who are alleged to be responsible for the public dissemination of materially false and misleading statements made during the Class Period. The named defendants are: Clark E. McLeod, McLeodUSA’s founder who also served as Co-Chief Executive Officer, Chairman of the Board of Directors, and Executive Committee Member; Stephen C. Gray, who served as President, Co-Chief Executive Officer, Director, and Executive Committee Member; J. Lyle Patrick, who served as McLeodUSA’s Chief Financial and Accounting Officer until August 1, 2001; and Chris A. Davis, who served as Chief Operating and Financial Officer, Director, and Executive Committee Member since August 1, 2001. In general, the Amended Complaint alleges that defendants misrepresented and lied to the public in order to conceal McLeodUSA’s true financial condition. Specifically, Count I of the Amended Complaint, brought on behalf of the Merger Class, alleges violations of section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (“the 1933 Act”). Count II, also brought on behalf of the Merger Class, alleges violations of section 12(a)(2) of the 1933 Act, 15 U.S.C. § 77l(a)(2). Count III alleges that defendants are liable as controlling

persons under section 15 of the 1933 Act, 15 U.S.C. § 77o. Count IV alleges defendants violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (“the 1934 Act”) and Rule 10b-5 promulgated under that statute, 17 C.F.R. 240.10b-5. Count V alleges that defendants are liable as controlling persons under section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a).

Defendants have moved to dismiss the Amended Complaint, filing a Motion to Dismiss the Consolidated Amended Class Complaint in which they argue that plaintiffs have failed to plead fraud with particularity. This case was referred to United States Magistrate Judge Thomas J. Shields to submit a report and recommended disposition of defendants’ Motion to Dismiss the Consolidated Amended Class Complaint. Judge Shields filed a comprehensive and detailed Report and Recommendation in which he recommends that defendants’ Motion to Dismiss the Consolidated Amended Class Complaint be denied in its entirety. Judge Shields concluded that plaintiffs had set forth sufficient allegations to meet the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (“the Reform Act”). Judge Shields also found that defendants were not entitled to dismissal of any claims based on the Reform Act’s safe harbor’s provisions. He further found that the alleged misstatements and omissions could be considered material. Judge Shields also concluded that plaintiffs’ allegations of scienter were sufficient and that plaintiffs have sufficiently pled reliance. Judge Shields further recommended that defendants’ motion be denied as to plaintiffs’ claims under the 1933 Act and plaintiffs’ control person claims under section 20(a) of the 1934 Act.

Defendants then sought, and were granted, an extension of time in which to file any objections to Judge Shields’s Report and Recommendation. Defendants have filed objections to Judge Shields’s Report and Recommendation. Defendants, however, have limited their objections to Judge Shields’s recommendation regarding Counts IV and V—

that the court not grant defendants' motion with respect to plaintiffs' claims under the 1934 Act. Defendants do not object to Judge Shields' Report and Recommendation with respect to Counts I, II, and III, which comprise plaintiffs' claims under the 1933 Act. Plaintiffs then sought and were granted an extension of time in which to file their response to defendants' objections to Judge Shields's Report and Recommendation. After plaintiffs filed their response to defendants' objections, defendants then sought and were granted an extension of time in which to file a reply brief in support of their objections to Judge Shields's Report and Recommendation. The court, therefore, undertakes the necessary review of Judge Shields's recommended disposition of defendants' Motion to Dismiss the Consolidated Amended Class Complaint.

## *II. ANALYSIS*

### *A. Standard Of Review*

Pursuant to statute, this court's standard of review for a magistrate judge's Report and Recommendation is as follows:

A judge of the court shall make a de novo determination of those portions of the report or specified proposed findings or recommendations to which objection is made. A judge of the court may accept, reject, or modify, in whole or in part, the findings or recommendations made by the magistrate [judge].

28 U.S.C. § 636(b)(1). Similarly, Federal Rule of Civil Procedure 72(b) provides for review of a magistrate judge's Report and Recommendation on dispositive motions and prisoner petitions, where objections are made, as follows:

The district judge to whom the case is assigned shall make a de novo determination upon the record, or after additional evidence, of any portion of the magistrate judge's disposition to which specific written objection has been made in

accordance with this rule. The district judge may accept, reject, or modify the recommended decision, receive further evidence, or recommit the matter to the magistrate judge with instructions.

FED. R. CIV. P. 72(b).

The Eighth Circuit Court of Appeals has repeatedly held that it is reversible error for the district court to fail to conduct a *de novo* review of a magistrate judge's report where such review is required. *See, e.g., Hosna v. Goose*, 80 F.3d 298, 306 (8th Cir.) (citing 28 U.S.C. § 636(b)(1)), *cert. denied*, 519 U.S. 860 (1996); *Grinder v. Gammon*, 73 F.3d 793, 795 (8th Cir. 1996) (citing *Belk v. Purkett*, 15 F.3d 803, 815 (8th Cir. 1994)); *Hudson v. Gammon*, 46 F.3d 785, 786 (8th Cir. 1995) (also citing *Belk*). Because objections have been filed in this case, the court must conduct a *de novo* review. With these standards in mind, the court turns to consideration of defendants' objections to Judge Shields's Report and Recommendation.

### ***B. Plaintiffs' Claims Under The 1933 Act***

As noted above, Judge Shields recommended that defendants' motion be denied as to plaintiffs' claims in Counts I, II and III—plaintiffs' claims under the 1933 Act. Defendants do not object to Judge Shields' Report and Recommendation with respect to Counts I, II, and III. With respect to plaintiffs' claims in Counts I, II, and III, it appears to the court upon review of Judge Shields's findings and conclusions, that there is no ground to reject or modify them. Therefore, the court **accepts** Judge Shields's Report and Recommendation concerning those counts and defendants' Motion to Dismiss the Consolidated Amended Class Complaint is **denied** with respect to Counts I, II, and III.

*C. Objections Concerning Plaintiffs' Claims Under The 1934 Act*

Defendants have filed several objections to Judge Shields's recommendation regarding that the court not grant defendants' motion with respect to plaintiffs' claims under the 1934 Act. Therefore, after reviewing the pertinent statutes at issue here, the court will examine each of defendants' objections seriatim.

Section 10(b) of the 1934 Act provides in relevant part:

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, 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(b).

Rule 10b-5, which was promulgated under § 10(b) and codified at 17 C.F.R. § 240.10b-5, similarly provides:

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. The Eighth Circuit Court of Appeals has instructed that:

In order to proceed on claims brought pursuant to section 10(b) and Rule 10b-5, the Class is required to show four elements: (1) misrepresentations or omissions of material fact or acts that operated as a fraud or deceit in violation of the rule; (2) causation, often analyzed in terms of materiality and reliance; (3) scienter on the part of the defendants; and (4) economic harm caused by the fraudulent activity occurring in connection with the purchase and sale of a security.

*In re K-tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 892 (8th Cir. 2002).

Section 20(a) of the Exchange Act provides that:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t. To make out a *prima facie* case under Section 20(a), a plaintiff “must show a primary violation [of the 1934 Act] by the controlled person and control of the primary violator by the targeted defendant, and show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person.” *S.E.C. v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (quotations and internal alterations omitted).

### *1. Group pleading*

Defendants object to the Report and Recommendation on the ground that it does not “differentiate among the individual defendants” concerning its analysis of the alleged misrepresentations. Thus, defendants assert that plaintiffs have failed to particularize each defendant’s role in the alleged fraud as required the Reform Act. *See* 15 U.S.C. § 78u-4(b)(2) (“[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”). However, under the group-published information doctrine, plaintiffs may impute false or misleading statements conveyed in annual reports, quarterly and year-end financial results, or other group-published information to corporate officers. The Ninth Circuit has described the doctrine as follows:

In cases of corporate fraud where the false or misleading information is conveyed in . . . annual reports or other ‘group published information,’ it is reasonable to presume that there are the collective actions of the officers. In such circumstances, a plaintiff has fulfilled the particularity requirement of Rule 9(b) by pleading misrepresentations with particularity and where possible the role of individual defendants in the misrepresentations.

*Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987). The doctrine is limited in scope and applies only to “clearly cognizable corporate insiders with active daily roles in the relevant companies or transactions.” *Polar Int’l Brokerage Corp. v. Reeve*, 108 F. Supp. 2d 225, 238 (S.D.N.Y. 2000). Here, defendant McLeod was the founder of McLeodUSA and, at all relevant times, co-Chief Executive Officer, Chairman of the Board of Directors and an Executive Committee member. Defendant Gray served as President, Co-Chief Executive Officer, Director, and Executive Committee Member. Defendant Patrick served as McLeodUSA’s Chief Financial and Accounting Officer until

August 1, 2001. Defendant Davis was McLeodUSA's Chief Operating and Financial Officer, a Director, and Executive Committee beginning on August 1, 2001. Thus, because defendants occupied the top executive positions within the company and are alleged to have taken part in the day-to-day operations of McLeodUSA, defendants may be held accountable under the group pleading doctrine for false and misleading statements, as well as material omissions, made by McLeodUSA during the time that they were in charge of the company. Although there has been some debate as to whether the Reform Act abolished this doctrine, *see generally In re Cabletron Sys., Inc.*, 311 F.3d 11, 40 (1st Cir. 2002), a majority of the federal courts addressing the issue have determined that the group pleading doctrine has in fact survived the passage of the Reform Act. *See In re Raytheon Sec. Litig.*, 157 F. Supp. 2d 131, 152-53 (D. Mass. 2001) (collecting cases and concluding that presumption survives). The court concurs with the majority of courts that have held that the rationale behind the group pleading doctrine remains sound in the wake of the passage of the Reform Act. Therefore, for purposes of this order, the court will employ the group pleading presumption in determining whether the complaint states a claim against each defendant. Therefore, this objection is overruled.

## ***2. Sufficiency of pleadings on scienter***

Defendants also object to Judge Shields's conclusion that the complaint adequately plead facts giving rise to a strong inference of scienter. As the Eighth Circuit Court of Appeals has observed:

"Scienter means the intent to deceive, manipulate, or defraud." *Green Tree*, 270 F.3d at 653 (internal quotations omitted). Although the Reform Act's heightened pleading rules require a showing of a "strong inference" of scienter, Congress did not codify any particular methods of satisfying that requirement. *Id.* at 659-60. Thus, we believe that the Reform Act was not intended to alter the substantive nature of the scienter

requirement, and our prior case law on the issue remains instructive. *Id.* at 653 & n. 7.

In general, inferences of scienter tested under the Reform Act will not survive a motion to dismiss if they are only reasonable inferences—the inferences must be “both reasonable and strong.” *Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir. 2001) (*en banc*) (quoting *Greebel*, 194 F.3d at 195-96), *cert. dismissed*, 536 U.S. 935, 122 S. Ct. 2616, 153 L. Ed. 2d 800 (2002). Cases from other circuits suggest that a strong inference of the required scienter may arise where the complaint sufficiently alleges that the defendants (1) benefitted in a concrete and personal way from the purported fraud, (2) engaged in deliberately illegal behavior, (3) knew facts or had access to information suggesting that their public statements were not accurate, or (4) failed to check information they had a duty to monitor. *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir.), *cert. denied*, 531 U.S. 1012, 121 S. Ct. 567, 148 L. Ed. 2d 486 (2000). “[W]e look to how other circuits have interpreted the strong-inference-of-scienter language as valuable guidance about what factors help to establish such an inference, but take care to use subsidiary formulae as an aid to interpreting the strong-inference standard and not as a substitute for it.” *Navarre*, 299 F.3d at 746 (internal quotations omitted).

*Kushner v. Beverly Enter., Inc.* 317 F.3d 820, 827 (8th Cir. 2003). The court of appeals went on to instruct that:

[S]cienter may be demonstrated by severe recklessness involving “highly unreasonable omissions or misrepresentations” amounting to “an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.” *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 978 (8th Cir. 1991) (internal quotations omitted), *cert. denied*, 505 U.S. 1205, 112 S. Ct. 2993, 120 L. Ed.2d 870

(1992). Recklessness, then, may be shown where unreasonable statements are made and the danger of misleading investors is so obvious that the defendant must have been aware of it. *Id.* “[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants’ knowledge of facts or access to information contradicting their public statements.” *Novak*, 216 F.3d at 308. Also, recklessness is shown where alleged facts demonstrate that the defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. *Id.*

*Id.* at 828.

Although a close question, the court concludes that the allegations of scienter contained in the Consolidated Amended Class Action Complaint raise a sufficiently strong inference of scienter to survive defendants’ motion to dismiss. It is important to remember that in determining whether plaintiffs have pleaded a "strong inference" of scienter, the court must examine the totality of the allegations. *Gompper v. VISX, Inc.*, 298 F.3d 893, 896 (9th Cir. 2002) (“Under the PSLRA, the court ultimately reviews the complaint in its entirety to determine whether the totality of facts and inferences demonstrate a strong inference of scienter.”); *Adams v. Baker Hughes, Inc.*, 292 F.3d 424, 431 (5th Cir. 2002) (noting that the appropriate analysis “is to consider whether all facts and circumstances ‘taken together’ are sufficient to support the necessary strong inference of scienter”); *City of Philadelphia v. Fleming*, 264 F.3d 1245, 1258-59 (10th Cir. 2001) (noting that “courts must look to the totality of the pleadings to determine whether the plaintiffs’ allegations permit a strong inference of fraudulent intent.”); *In re Telxon Corp. Secs. Litig.*, 133 F. Supp.2d 1010, 1026 (N.D. Ohio 2000) (“Thus, the Sixth Circuit employs a form of ‘totality of the circumstances’ analysis; this Court, accordingly, declines to examine plaintiffs’ allegations in piecemeal fashion and, will instead, assess them collectively to

determine what inferences may be drawn therefrom.”) (citing *Hoffman v. Comshare, Inc.*, 183 F.3d 542, 549-52 (6th Cir. 1999). Here, plaintiffs have alleged that: defendants engaged in and/or knew failed to disclose improper accounting practices, Amended Comp. at ¶¶ 32-39, knew and failed to disclose that McLeodUSA was unable to properly manage and integrate at least two corporate acquisitions, Amended Comp. at ¶¶ 40-45, secretly abandoned plans for a national network, Amended Comp. at ¶¶ 46-47; and, while making public assurances to the contrary, knew and failed to disclose that McLeodUSA was unable to service its substantial debt load and lacked the financial flexibility to avoid a restructuring, Amended Comp. at ¶¶ 48-51. Although defendants argue that many of the allegations are vague blanket assertions which cannot be credited, the Amended Complaint contains specific descriptions and details of defendants' alleged actions. For instance, the Amended Complaint alleges that a former employee responsible for managing a segment of the CapRock acquisition states that senior management of McLeodUSA was well aware prior to the acquisition that McLeodUSA was acquiring a company that was incapable of “performing as projected.” Amended Comp. at ¶ 41. The Amended Complaint also contains allegations attributed to a former Group Vice President for the Southwest Region, and a former Vice President responsible for integrating CapRock, that defendants Gray and Patrick had direct knowledge that problems existed with McLeodUSA's integration of CapRock. Amended Comp. at ¶¶ 42-43. According to a former Group Vice President in Chicago, a significant percentage of the revenue reported from the CapRock acquisition was based on fictitious orders. Amended Comp. at ¶ 44. Such allegations go to the heart of the matter here, whether defendants knew of or were severely reckless in failing to discover significant problems in McLeodUSA's core business. Federal courts facing similar issues have held that when considering a motion to dismiss, making all reasonable assumptions in favor of the plaintiff includes assuming that individuals in top management

of a corporation are aware of matters central to that business's operation. *See, e.g., Angres v. Smallworldwide P.L.C.*, 94 F. Supp. 2d 1167, 1175-76 (D. Colo. 2000). Based on the detailed pleading as to the defendants' roles in the company, the complaint establishes a strong inference that defendants were aware of the allegedly problems of assimilating CapRock, which in turn establishes a strong inference that the later statements about McLeodUSA's integration of CapRock were made with scienter. Because of the importance to the market of McLeodUSA's consolidation of CapRock, the danger that overstating McLeodUSA's ability to integrate CapRock would mislead buyers and sellers of securities was either known to defendants or so obvious that such knowledge may properly be attributed to them. Thus, the court concludes that Judge Shields correctly concluded that such allegations raise a reasonable and strong inference that defendants possessed the requisite state of mind. Therefore, this objection is also overruled.

### ***3. Circumstances constituting fraud***

Defendants also object to Judge Shields's Report and Recommendation on the ground that it reaches "a legally unsupportable conclusion on the 'circumstances constituting fraud.'" The court disagrees with this assessment and concludes that plaintiffs have alleged specific examples of statements and omissions which are alleged to have been materially false and misleading. One such example is found in the Amended Complaint's allegation that McLeodUSA failed to follow General Accepted Accounting Principles ("GAAP"). The Amended Complaint alleges that McLeodUSA's 2000 annual report detailing the company's financial results declares, in accordance with GAAP, that:

the Company recognizes revenues at the time services are performed. On time and expense contracts, revenue is recognized as costs are incurred. On fixed-price contracts, revenues are recorded using the percentage-of-completion method of accounting by relating contract costs incurred to

date to total estimated contract costs at completion.

Amended Comp. at ¶ 100. The Amended Complaint goes on to allege that McLeodUSA's financial statements were materially false and misleading because defendants recognized sales and accounts that had been cancelled by customers; recorded revenue from fictitious orders and fictitious customers; and, back-dated contracts so as to recognize additional revenue at the end of a fiscal quarter. Amended Comp. at ¶¶ 32-39. It is alleged, the allegations being purportedly based on "a former executive director of sales," that "in a few months during the Class Period as much as 35% of the reported revenues were the result of a single fictitious order." Amended Comp. at ¶ 36. The Amended Complaint contains similar allegations made by "a former group vice president in Chicago" that:

based on regularly updated reports it was clear that the numbers were manipulated and fraudulently reported to investors and analysts: "As the month would unfold, almost every month would show that we were behind on the numbers, and then out of nowhere, there may appear a line item on the report that would say 'Corporate Sales' and those numbers would shoot up. Everyone would question, where the hell are they getting those sales?"

Amended Comp. at ¶ 38.

Thus, the court finds that the amended Complaint alleges that it was misleading for McLeodUSA to state that its financial statements were prepared according to GAAP when, according to the Amended Complaint, they were not. Based on the detailed allegations contained in the Amended Complaint, the court finds that the Amended Complaint clearly sets forth the statements plaintiffs alleged to be misleading and the reason or reasons why those statements were misleading. *See Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1096 (10th Cir. 2003) (holding that complaint clearly set out the allegedly misleading

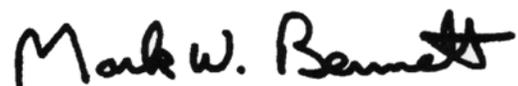
statements and the reasons why the statements were claimed to be misleading where the complaint pointed to corporate filings which contained reported misleading net income figures and misleading operating income figures); *Cooper v. Pickett*, 137 F.3d 616, 626 (9th Cir. 1997) (recognizing that a “company that ‘substantially overstate[s] its revenues by reporting consignment transactions as sales . . . mak[es] false or misleading statements of material fact.’”) (quoting *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1418 (9th Cir. 1994); *see also Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994) (“We cannot find a single precedent . . . holding that a company may violate FAS 48 and substantially overstate its revenues by reporting consignment transactions as sales without running afoul of Rule 10b-5”). Therefore, this objection is also overruled.

### ***III. CONCLUSION***

The court accepts Judge Shields’s Report and Recommendation. Accordingly, defendants’ motion to dismiss is **denied**.

**IT IS SO ORDERED.**

**DATED** this 31st day of March, 2004.



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MARK W. BENNETT  
CHIEF JUDGE, U. S. DISTRICT COURT  
NORTHERN DISTRICT OF IOWA