06-2902-CV

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Teamsters Local 445 Freight Division Pension Fund, on its own behalf/ on behalf of all others similarly situated
Plaintiff - Appellee,

v.

Dynex Capital, Inc. and Merit Securities Corporation
Defendants – Appellants,

Stephen J. Bendetti
Thomas H. Potts, Lehman Brothers, Inc. and
Greenwich Capital Markets, Inc.
Defendants.

On Appeal From The
United States District Court for the Southern District of New York
Case No. 05-CV-1897 (HB)

BRIEF OF *AMICUS CURIAE*
OF THE WASHINGTON LEGAL FOUNDATION IN SUPPORT OF APPELLANTS SEEKING REVERSAL

DANIEL J. POPEO
PAUL D. KAMENAR
Washington Legal Foundation
2009 Massachusetts Avenue, N.W.
Washington, D.C. 20036
Telephone: (202) 588-0302
Facsimile: (202) 588-0386

LISA KEENAN
LYLE ROBERTS
JOHN LETTERI
ILONA COLEMAN-LANGE
RACHEL WOLKINSON
LeBoeuf, Lamb, Greene & MacRae LLP
1875 Connecticut Avenue, NW
Suite 1200
Washington, D.C. 20009
Telephone: (202) 986-8000
Facsimile: (202) 986-8102

Attorneys for Amicus Curiae
The Washington Legal Foundation

January 17, 2007

CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1, *amicus curiae* Washington Legal Foundation hereby states that it is a non-stock, non-profit corporation organized under Section 501(c)(3) of the Internal Revenue Code, and therefore, there are no parent corporations or publicly held corporations that own stock of *amicus*.

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INTEREST OF AMICUS CURIAE

The Washington Legal Foundation (WLF) is a national, non-profit public interest law and policy center based in Washington, D.C. WLF devotes a substantial portion of its resources to defending and promoting free enterprise, individual rights, business civil liberties, and a limited and accountable government. To that end, WLF has appeared before the Supreme Court and lower federal courts, including this one, in numerous cases that raise these issues. In particular, WLF has participated as *amicus curiae* in cases about the proper scope of securities law, scienter, and mens rea. *See, e.g.*, *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006); *In re Stock Exchanges Options Trading Antitrust Litig.*, 317 F.2d 134 (2d Cir. 2003); *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).

In addition, WLF publishes policy papers that oppose abusive securities class action cases that are detrimental to the public interest. *See, e.g.*, James Maloney, *Strict Standing Requirement For Securities Fraud Suits Upheld* (WLF Counsel's Advisory, June 3, 2005); Lyle Roberts & Paul Chalmers, *Lower Courts Will Determine Impact Of Supreme Court's Securities Fraud Suit Ruling* (WLF Legal Backgrounder, May 20, 2005); Neil M. Gorsuch & Paul B. Matey,

Settlements In Securities Fraud Class Actions: Improving Investor Protection (WLF Working Paper, April 2005).

WLF submits this *amicus curiae* brief in support of appellants Dynex Capital, Inc. and Merit Securities Corporation in their appeal from the district court order denying Dynex Capital, Inc.'s motion to dismiss. *In re Dynex Capital, Inc. Secs. Litig.*, No. 05-cv-1897, 2006 WL 314524 (S.D.N.Y. Feb. 10, 2006). This brief is being filed by leave of Court pursuant to Fed. R. App. P. 29.

SUMMARY OF ARGUMENT

Applying a "collective scienter" theory that has been rejected by every federal court to expressly consider the issue, the court below in *In re Dynex Capital, Inc. Securities Litigation*, No. 05-cv-1897, 2006 WL 314524 (S.D.N.Y. Feb. 10, 2006) ("*Dynex*"), held that for purposes of determining a corporation's scienter, the corporation is charged with the knowledge of all of its employees, regardless of whether these employees had any role in making the alleged misstatements. The collective scienter theory raises a fundamental question for securities fraud litigation: if an officer makes a statement and only the janitor knows the statement is false, has the corporation acted with fraudulent intent? The *Dynex* court not only believes that liability attaches to a corporation under these circumstances, but it also would not require the plaintiff to identify the particular

nonspeaking employee (*e.g.*, the janitor) who knew the statement was false. The holding below should be reversed because it is contrary to public policy and established law.

As a matter of public policy, courts have recognized that securities class action litigation is particularly susceptible to abuse by plaintiffs and their counsel. Notably, the expense associated with discovery in such cases may coerce defendants into settlements regardless of the merits of the underlying claims. Not only has this Court long insisted on a rigorous pleading standard for alleged fraudulent violations of Section 10(b) to avoid the *in terrorem* effect of abusive securities fraud strike suits, but Congress enacted the Private Securities Litigation Reform Act of 1995 ("Reform Act") for the express purpose of creating heightened pleading standards for these cases that would limit the ability of plaintiffs to bring meritless claims. The key provision of the Reform Act requires plaintiffs to establish a "strong inference" of scienter (*i.e.*, fraudulent intent) as to *each* defendant before a case will be allowed to proceed.

If the collective scienter theory is adopted, however, the protections afforded by the Reform Act will be completely undermined. At the time the Reform Act was enacted, it was widely understood that a corporate defendant could only be found to have acted with scienter if the corporate agent who made the alleged

misstatements acted with scienter. In other words, courts declined to "personify" a corporation by finding that it could have an independent mental state sufficient to support a fraud claim. The collective scienter theory turns this understanding on its head. When applied in the manner used by the *Dynex* court, the collective scienter theory allows plaintiffs to establish a "strong inference" of scienter as to the corporate defendant based on the knowledge of any of its agents. As a result, a securities fraud case can be pursued against a corporate defendant even if the claims against all of the individual defendants – who made the alleged misstatements – are dismissed.

Moreover, the district court's holding should be reversed because application of the collective scienter theory conflicts with existing law on several fronts. First, the collective scienter theory runs contrary to the common law of agency (as discussed in detail in the appellant's brief and incorporated by reference here). Second, the collective scienter theory allows plaintiffs to use generic and conclusory allegations, which would never be sufficient for an individual defendant, to meet their scienter pleading burden as to the corporate defendant. Finally, while this Court has not decided whether scienter is a necessary element of a Section 20(a) controlling person claim, a number of lower courts have held scienter is not required to be pled. Application of the collective scienter theory by these courts has allowed securities fraud cases to proceed against individual

defendants (based on control person liability) where the plaintiffs have been unable to successfully plead a strong inference of scienter as to those individual defendants.

The practical consequences of the collective scienter theory are obvious: meritless securities fraud lawsuits will continue longer, discovery in such cases will proceed more often, and plaintiffs will be able to extort higher settlement amounts from corporate defendants. While deterrence of corporate fraud is a laudable goal, this Court should not act to override the intent of Congress in this area of the law. The only position on collective scienter that supports the goals of Congress and does not conflict with existing law is the one adopted by the Fifth Circuit in *Southland Securities Corp. v. INSpire Insurance Solutions*, 365 F.3d 353, 366 (5th Cir. 2004) and the Ninth Circuit in *In re Apple Computer, Inc.*, 127 Fed. Appx. 296 (9th Cir. 2005) and *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424 (9th Cir. 1995), which soundly rejects the theory. We strongly urge this Court to follow the lead of its sister courts.

ARGUMENT

I. APPLICATION OF THE COLLECTIVE SCIENTER THEORY IS CONTRARY TO CONGRESS' EXPRESS INTENT TO CURB ABUSIVE STRIKE SUITS

With respect to securities fraud claims, this Court has long held that the pleading requirements of Federal Rule of Civil Procedure 9(b) ("Rule 9(b)") should

be interpreted to both protect defendants from harm to their reputation or goodwill and reduce the number of strike suits. *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989); *DiVittorio v. Equidyne Extractive Indus.*, 822 F.2d 1242, 1247 (2d Cir. 1987). As this Court stated nearly 25 years ago: "[s]trike suits in this area . . . permit plaintiffs with groundless claims to abuse liberal federal discovery provisions, with the right to do so representing 'in terrorem' increments in the settlement values of the alleged claims." *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 114 (2d Cir. 1982) (*citing Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)).

The legislative history of the Reform Act is similarly replete with references to Congress' intent "to restrict abuses in securities class-action litigation, including: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants' culpability; (2) targeting of 'deep pocket' defendants; [and] (3) the abuse of the discovery process to coerce settlement; . . . ." H.R. Conf. Rep. No. 104-369, at 28 (1995), reprinted in 1995 U.S.C.A.A.N. 679, 748. *See Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000) (goal of Reform Act to "deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit"). To meet these goals, the Reform Act imposes stringent procedural requirements on plaintiffs pursuing private securities fraud actions. Perhaps most importantly, the Reform Act augments Rule

9(b) – which does not require that a defendant's state of mind be pled with particularity – by creating a heightened pleading standard for that element of a securities fraud action. Under the Reform Act, a plaintiff must "state with particularity facts giving rise to a strong inference" that *each* defendant acted with scienter. 15 U.S.C. § 78u-4(b)(2). Any complaint that does not meet this standard must be dismissed. *Id.* § 78u-4(b)(3)(A).

In the last ten years there has been little dissipation of the concerns that led to the passage of the Reform Act. In 1998, Congress was forced to pass the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") to stop plaintiffs from filing securities class actions in state courts so that they could avoid the Reform Act's rigorous pleading requirements. Pub. L. No. 105-353, 112 Stat. 3227. *See also Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25, 32 (2d Cir. 2005) ("Congressional investigation revealed a 'federal flight' loophole whereby many class action plaintiffs avoided the [Reform Act's] heightened requirements by bringing suit in state courts under statutory or common law rather than in federal court."). Despite the existence of the Reform Act and SLUSA, however, the filing of securities class actions has continued apace, with an average of 239 new cases being filed every year. Todd Foster, Ronald I. Miller, Ph.D., Stephanie Plancich, Ph.D., *Recent Trends in Shareholder Class Action Litigation:*

Filings Plummet, Settlements Soar, NERA Economic Consulting, at 1 (Jan. 2, 2007).[1]

Moreover, the size of settlements has increased dramatically, culminating in a record average settlement value of $34 million in 2006. *Id.* at 5. Not surprisingly, policymakers have continued to discuss the deleterious effects of securities class actions. In late 2006, The Committee on Capital Markets Regulation – a bipartisan group – strongly recommended that these suits be subject to further limitations to enhance the competitiveness of the U.S. capital markets. *See* R. Glenn Hubbard and John L. Thornton, *Is the U.S. Losing Ground?*, Wall. St. J., Oct. 30, 2006, at A12.

Thus, over the last decade, public policymakers have acted consistently to curb securities fraud strike suits. Moreover, this Court has long recognized and promoted a similar goal. Adoption of the collective scienter theory would thwart this progress and, for the reasons discussed below, likely encourage meritless securities fraud cases.

[1] This article is *available at* http://www.nera.com/image/BRO_Recent%20Trends_%201288_FINAL_online.pdf

II. ADOPTION OF THE COLLECTIVE SCIENTER THEORY WOULD HAVE NEGATIVE UNINTENDED CONSEQUENCES

The handful of courts that have chosen to distinguish between a corporate defendant's scienter and that of its speaking officers or directors have applied two equally untenable versions of the collective scienter theory. Under the strong version (applied by the *Dynex* court below), the corporate defendant is personified and its "state of mind" can be inferred from general allegations concerning the entity's "knowledge." Under the weak version, a corporate defendant's "state of mind" is sufficiently pled based on allegations that an officer knew or should have known the statement was false, even if the officer is not a defendant and the misstatement was made by another individual. Both of these theories, if widely adopted, would lead to negative unintended consequences.

The strong version of the theory has been adopted by the lower court in this case, holding that plaintiffs may allege scienter on the part of a corporate defendant without pleading scienter as to any particular employee. *Dynex*, 2006 WL 314524 at *9. *See also In re Worldcom, Inc. Sec. Litig.*, 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) ("[P]laintiffs in securities fraud cases need not prove that any one individual employee of a corporate defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient."). In particular, the lower court reviewed allegations made in the complaint that "Dynex typically" and

"systematically" waived its internal underwriting guidelines at the regional and corporate levels, that "Dynex underwriters" approved loans despite the imminent likelihood of default, and that "Dynex salespeople" purchased loan paper that failed credit standards. *Dynex*, 2006 WL 314524 at *9. The lower court then concluded that "[t]hese allegations are sufficient to infer that officers and employees of the corporate defendants had the motive and opportunity to commit fraud" and that "plaintiff has adequately plead scienter with respect to Dynex and Merit [the other corporate defendant]." *Id.* at *10

If this Court were to endorse the strong version of the collective scienter theory, it would impose an impossible standard of knowledge on a company's executives. Communications in today's modern publicly-traded enterprises, which are often large and operate in many parts of the world, are neither perfect nor instantaneous. Under the strong version, however, plaintiffs will be able to exploit the normal lag times in corporate communication channels to create fraud claims by charging the company with the "knowledge" of a far-flung employee or agent who had no communications with the officers making the supposedly false or misleading statements. To counteract this possibility, an officer about to make a public statement regarding the corporation would have to survey every employee and agent regarding the subject matter of his remarks. This is wholly unrealistic,

unnecessarily burdensome, and would actually hurt shareholders by creating strong disincentives for companies to disclose information.

The weak version of the corporate scienter theory posits that a corporate defendant's "state of mind" is sufficiently pled based on allegations that an officer knew or should have known the statement was false, even if the officer is not a defendant and the misstatement was made by a different employee. *See, e.g.*, *In re Marsh & McLennan Cos., Inc. Secs. Litig.*, 04-cv-8144 , 2006 U.S. Dist. LEXIS 49525 (S.D.N.Y. July 20, 2006), *appeal dismissed*, 2006 U.S. Dist. LEXIS 70476 (S.D.N.Y. Sept. 27, 2006) (attributing knowledge of non-speaking head of Global Broking division and Senior Vice President to corporate defendant); *In re NUI Secs. Litig.*, 314 F. Supp. 2d 388, 412-13 (D.N.J. 2004) (inferring corporation's scienter from notice of accounting improprieties provided to non-speaking assistant general counsel). The apparent position of these courts is that it is reasonable to infer the corporate defendant's knowledge based on the knowledge of a non-speaking officer, as opposed to other non-speaking employees or agents, because officers are charged with the management of the company.

In *Marsh & McLennan*, for example, the plaintiffs alleged that the corporate defendant engaged in illegal bid-rigging and contingent commission arrangements with respect to the brokering of insurance policies and violated Section 10(b) by

concealing those practices from investors in annual and quarterly reports filed with the Securities and Exchange Commission ("SEC"). 2006 U.S. Dist. LEXIS 49525 at *53. The court found that plaintiffs had adequately alleged that the corporate defendant acted with the requisite scienter in concealing the practices from investors. *Id.* at *75. In reaching this conclusion, the court recognized that "there is no simple formula for how senior an employee must be in order to serve as a proxy for corporate scienter. . . ." *Id.* at *70. The court went on to find, however, that allegations that the head of the corporate defendant's Global Broking Division and a Senior Vice President knew of the allegedly illegal practices were sufficient to plead that the corporate defendant also knew of the practices. *Id.* at *75.

Although the weak version of the collective scienter has the virtue of not "personifying" the corporate defendant and actually looking to the knowledge of an individual, it is equally as troublesome in its application as the strong version. One of the questions it raises (putting aside the issue of whether this theory is permissible under agency law) is which non-speaking corporate officers are sufficiently senior to have their knowledge charged to the corporate defendant. In *Marsh & McLennan* (which notes the existence of this problem without solving it), the court looked to allegations concerning a division head and a senior vice-president, while in *NUI* the court focused on an associate general counsel. There are, so to speak, a lot of division heads, vice-presidents, and associate general

counsels in the U.S. corporate world. Is it reasonable to charge the corporation with their knowledge in the absence of any averments as to whether, when, and how this knowledge was conveyed to the more senior corporate officers who actually made the alleged false or misleading statements? *Compare In re Apple Computer, Inc. Sec. Litig*., 127 Fed. Appx. at 303 (knowledge of lower-level corporate employees about new product problems cannot be imputed to CEO absent specific allegations establishing that CEO was informed of problems at time that he made positive statements regarding expected revenues from new product). If this Court were to adopt the weak version of the collective scienter theory, there would be endless litigation over whether the non-speaking officer who is alleged to have known the falsity of the statement is sufficiently senior to justify the theory's application.

III. CONTRARY TO THE REFORM ACT, THE COLLECTIVE SCIENTER THEORY PERMITS PLAINTIFFS TO CREATE A STRONG INFERENCE OF SCIENTER USING VAGUE, GENERIC ALLEGATIONS

This Court also should reject the collective scienter theory because it allows a plaintiff to create a strong inference of scienter as to a corporate defendant using only vague, generic allegations that this Court finds unacceptable for individual defendants. As discussed above, Congress substantially augmented Rule 9(b)'s pleading standards when it passed the Reform Act. To survive a motion to

dismiss, a plaintiff must allege *with particularity* facts giving rise to a strong inference that a defendant acted with the required scienter. In instances in which a plaintiff alleges fraud against multiple defendants, as in this case, the plaintiff must particularize *each* defendant's scienter.

Courts have vigorously applied the Reform Act's scienter pleading standard as to individual defendants, refusing to accept vague, generic allegations as sufficient to meet the "strong inference" requirement. Courts consistently have found, for example, that "must have known" allegations based on an individual defendant's title or position with the company cannot create a strong inference of scienter. *See, e.g., In re NTL, Inc. Secs. Litig.*, 347 F. Supp. 2d 15, 33 (S.D.N.Y. 2004) ("Allegations that [individual defendants] should have known about [alleged fraud] based solely on their executive positions are not enough to plead *scienter*"). Similarly, courts have rejected the "group pleading" of scienter, where a plaintiff alleges that if one officer acted with fraudulent intent, other officers can be assumed to have done the same. *See, e.g., In re Cross Media Mktg. Corp. Sec. Litig.*, 314 F. Supp. 2d, 263 (S.D.N.Y. 2004) (rejecting plaintiff's attempt to use group pleading to allege scienter on the part of defendants). Finally, courts will not accept statements from low-level employees – who did not communicate with corporate officers – as persuasive on the subject of the corporate officers' knowledge. *See Cal. Pub. Employees' Ret. Sys. v. The Chubb Corp.*, 394 F.3d 126,

150-55 (3d Cir. 2004) (rejecting plaintiffs' attempt to rely upon statements of confidential witnesses who were low-level employees, did not communicate with the officer defendants, and would not have known about company's overall business).

Adoption of the collective scienter theory, however, will allow plaintiffs to create a strong inference of scienter on the part of the corporate defendant using any or all of these pleading strategies. In this case, for example, the court was faced with conclusory allegations that "Dynex systematically originated defective loans, despite clear signs that borrowers were not creditworthy." *Dynex*, 2006 WL 314524 at *10. Although it found these allegations to be insufficient to establish a strong inference of scienter as to the CEO and President of Dynex, they somehow were sufficient to establish a strong inference that Dynex, the company those individuals managed, acted with scienter. *Id.* The lower court effectively found the plaintiffs had adequately plead that Dynex "must have known" about the alleged fraud, a type of pleading that it soundly rejected as to the individual defendants.

In sum, the collective scienter theory directly conflicts with the Reform Act's requirement that a plaintiff must plead scienter with particularity and effectively reduces the "strong inference" standard to one that only requires a plaintiff to make

vague, generic allegations as to the corporate defendant's supposed knowledge. This Court should not condone such a result.

IV. THE COLLECTIVE SCIENTER THEORY ALLOWS PLAINTIFFS TO AVOID THE REFORM ACT'S SCIENTER PLEADING STANDARD AS TO INDIVIDUAL DEFENDANTS.

The collective scienter theory also allows securities fraud cases to proceed against individual defendants (based on control person liability) where plaintiffs have been unable to successfully plead a strong inference of scienter as to those individual defendants. Section 20(a) of the Securities Exchange Act of 1934 provides that any person who controls another person liable under Section 10(b) for securities fraud will also be jointly and severally liable to the same extent as the controlled person. 15 U.S.C. § 78t(a). Although this Court has held that to prove control person liability a plaintiff must demonstrate "that the controlling person was 'in some meaningful sense [a] culpable participant[]" in the alleged fraud (*SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996)), district courts in this circuit are split as to whether this creates a scienter pleading requirement. *Compare Lapin v. Goldman Sachs Group, Inc.*, No. 04-cv-2236, 2006 U.S. Dist. LEXIS 71417, at *59 (S.D.N.Y. Sept. 29, 2006) ("[C]ulpable participation is a pleading requirement to state a section 20(a) claim, and that it must be plead with the same particularity as scienter under section 10(b)."); *see also Borden, Inc. v. Spoor Behrins Campbell & Young, Inc.*, 735 F. Supp. 587, 588 (S.D.N.Y. 1990)

(all that is required to make out a *prima facie* case of control person liability is an allegation of control). If there is no scienter pleading requirement, the "strong inference" standard imposed by the Reform Act is inapplicable.

Because of the potential for control person liability, the collective scienter theory can have a significant impact on individual defendants. In courts that do not require the pleading of scienter for Section 20(a) claims, individual defendants may have the underlying securities fraud claims dismissed against them, only to be brought back into the case as "control persons" when the court finds that a Section 10(b) claim can proceed against the corporate defendant. *See, e.g., In re Interpublic Sec. Litig.*, No. 02-cv-6527, 2003 U.S. Dist. LEXIS 8844 (S.D.N.Y. May 29, 2003) (finding scienter insufficiently plead against individual defendants, but applying a collective scienter theory to allow the securities fraud claims to proceed against the corporate defendant and against the individual defendants as control persons); *In re BISYS Sec. Litig*., 397 F. Supp. 2d 430 (same); *In re NUI Sec. Litig*., 314 F. Supp. 2d 388 (same).

As a result, the collective scienter theory – at least in courts that do not require the pleading of scienter for control person claims – effectively allows plaintiffs to do an end run around the Reform Act's requirement that scienter be adequately plead as to each defendant. Rather than being dismissed from the case

when the plaintiff fails to establish a strong inference of scienter, individual defendants are bootstrapped back in based on the plaintiff's ability to satisfy what is effectively (as discussed above) a much lower scienter pleading standard for the corporate defendant. It is simply impossible to reconcile this result with the clear mandates of Congress in the Reform Act.

CONCLUSION

For the foregoing reasons, the Washington Legal Foundation respectfully submits that the judgment of the district court should be reversed.

Dated: January 17, 2007

Respectfully submitted,

/s/

DANIEL J. POPEO
PAUL D. KAMENAR
Washington Legal Foundation
2009 Massachusetts Avenue, N.W.
Washington, D.C. 20036
Telephone: (202) 588-0302
Facsimile: (202) 588-0386

LISA KEENAN
LYLE ROBERTS
JOHN LETTERI
ILONA COLEMAN-LANGE
RACHEL WOLKINSON
LeBoeuf, Lamb, Greene & MacRae LLP
1875 Connecticut Avenue, NW
Suite 1200
Washington, D.C. 20009

Attorneys for Amicus Curiae
The Washington Legal Foundation

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Lisa Keenan

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I hereby certify that two true and correct copies of the foregoing were served by electronic mail and by first class mail, postage pre-paid on the counsel listed below this 17th day of January, 2007.

Edward Joseph Fuhr, Esq.
Hunton & Williams, LLP
Riverfront Plaza, East Tower
951 E. Byrd Street
Richmond, VA 23219

Joseph J. Saltarelli, Esq.
Hunton & Williams, LLP
200 Park Avenue
New York, NY 10166

Frank Rocco Schirripa, Esq.
Joel P. Laitman, Esq.
Schoengold & Sporn, P.C.
19 Fulton Street
New York, NY 10038

James E. Brandt, Esq.
Jeff G. Hamel, Esq.
Latham & Watkins LLP
885 Third Avenue
New York, NY 10022

/s/
Lisa Keenan