IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: U.S. INTERACTIVE, INC. SECURITIES LITIGATION	:	CLASS ACTION No. 01-CV-522

MEMORANDUM

Giles, C.J. August , 2002

I. Introduction

This securities class action is brought on behalf of all persons, except for defendants, who purchased U.S. Interactive, Inc. ("USIT") common stock between February 10, 2000 and November 8, 2000 ("Class Period"). The action is also brought on behalf of a sub-class of investors who purchased in an April 12, 2000 secondary offering of USIT common stock ("Secondary Offering"). An amended complaint alleges claims against the individual officers of USIT during the Class Period ("Individual Defendants") for violations of Section 10(b), Rule 10b-5 (Count I), and Section 20(A) (Counts II) of the Securities Exchange Act of 1934 ("Exchange Act"). It also charges the Individual Defendants, directors of USIT at the time of the Secondary Offering ("Director Defendants"), and the underwriters of the Secondary Offering ("Underwriters") with violations of Sections 11 (Count III) and 12(a)(2) (Counts IV) of the Securities Act of 1933 ("Securities Act"). Count V is a claim against the Individual Defendants for violation of Section 15 of the Securities Act against the Individual Defendants.

Now before the court is a motion to dismiss Counts I-II by the Individual Defendants, a

motion to dismiss Counts III-V by the Individual Defendants and Director Defendants, and a motion by the Underwriter Defendants to dismiss Counts III-IV.

For the reasons that follow, the motion by the Individual Defendants to dismiss Counts I-II is granted in part and denied in part, the motion by the Individual Defendants and Director Defendants to dismiss Counts III-V is granted, and the motion by the Underwriters to dismiss Counts III-V is granted.

I. Facts

A. Parties

Plaintiffs, a class of former shareholders of USIT who purchased stock during the Class Period and a sub-class of shareholders who purchased stock pursuant to the Secondary Offering, allege that the Individual Defendants undertook a scheme to inflate artificially the price of USIT stock by making highly positive statements about the Company when they knew they were false and misleading. The Director Defendants and the Underwriter Defendants allegedly participated in the issuance of the Registration Statement and Prospectus ("Prospectus") for the Secondary Offering which contained material representations and omissions known by them to be false.

Defendants are the former directors of USIT at the time of the Secondary Offering,[1] the underwriters for the secondary offering,[2] and the following four individual defendants: (1) Stephen Zarrilli ("Mr. Zarilli") was President and Chief Executive Officer of the Company

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[1] The six directors who signed the Prospectus are Mohan Uttarwar, Robert E. Keith, Jr., Michael Forgash, John H. Klein, William C. Jennings, and Robert V. Napier.

[2] The underwriters are Lehman Brothers Inc., Chase H&Q Securities Inc., Deutsche Banc Alex. Brown, First Union Securities Inc., Adams, Harkness & Hill, Inc., and Fidelity Capital Markets.

for much of the Class Period until his resignation on September 8, 2000. It is alleged that during the Class Period, while in possession of confidential USIT information, he sold 60, 000 shares of USIT stock at artificially inflated prices for proceeds of more than $1 million. Specifically, on the days immediately following his positive remarks in an April 25, 2000 RadioWallstreet.com interview, (April 26, 27, and 28), he sold 51, 500 shares of his USIT stock for proceeds of $858, 419 and on May 1, 2000 he sold 8, 500 shares for $144, 942.[3] (Id. ¶¶ 55-58.);

(2) Eric Pulier ("Mr. Pulier") was the Chairman of the Board of USIT. It is alleged that while in possession of confidential USIT information, he sold 242, 500 shares of USIT stock at artificially inflated prices for proceeds of more than $3.59 million. Specifically, on the days immediately following Mr. Zarrilli's remarks in an April 25, 2000 RadioWallstreet.com interview, (April 26, 27, and 28), **Mr. Pulier sold 128, 000 shares for proceeds of $2.14 million and on May 1, 2000, sold an additional 21, 500 shares for proceeds of $366, 618. (Am. Compl. ¶¶ 55-58.) Mr. Pulier sold another 92, 500 shares for $1.09 million on August 3, 2000. (Am. Compl. ¶ 74.)**; (3) John Shulman ("Mr. Shulman") was a director of the Company and a member of its audit committee. It is alleged that he was privy to non-public information about the Company, and had the power to influence and control the decision-making of the Company, including the content and dissemination of the false and misleading statements in the public statements. During the class period, while in possession of confidential USIT information, he sold 37, 500 shares of USIT stock at artificially inflated prices for proceeds of more than $484, 625. Specifically, within days of Mr. Zarrilli's positive remarks in a May 2, 2000 RadioWallstreet.com interview about USIT, it is alleged that on May 17, 2000, Mr. Shulman sold 25, 000 shares for proceeds of $352, 000 and

[3] Only stock sales relevant to the allegations of scienter are discussed.

on May 24, 2000, sold an additional 10, 000 shares for proceeds of $100, 300. (Id. ¶ 63.); and (4) Philip Calamia ("Mr. Calamia") was the Senior Vice President and Chief Financial Officer during the Class Period. Mr. Calamia signed the Company's 10-Q and 10-K filings with the SEC. All Individual Defendants signed the Company's Prospectus in connection with its Secondary Offering, effective April 12, 2000. (Id. ¶ 19.)

B. USIT

USIT was an Internet professional services firm which provided integrated Internet strategy consulting, marketing, and technology services to enable clients to utilize Internet-based technologies to transact business, communicate information, and share knowledge across employees, customers, and suppliers. (Id. ¶ 33.) The Company was formed in 1991, commenced business in 1994, and took its present name in 1995. (Id. ¶ 34.) USIT went public in an initial Public Offering ("IPO") in August 1999 and raised about $38.2 million, after deducting costs and expenses. (Id. ¶ 35.) In August 1999, the officers entered into a lock-up agreement which prevented them from selling their shares for a period of 180 days from the date of the IPO. (Id. ¶ 36.)

On February 1, 2000, USIT announced that it had entered into a definitive merger agreement to acquire Soft Plus, Inc. The consideration for the transaction was 4.8 million shares of USIT common stock, $20 million in cash, and a one-year $80 million note due to the selling Soft Plus shareholders. (Id. ¶ 37.) On March 8, 2000, USIT completed its acquisition of Soft Plus.

On March 10, 2000, USIT filed the initial registration statement for its Secondary Offering and USIT's Registration Statement and Prospectus became effective on April 12, 2000.

(Id. ¶ 44.) The Company received approximately $41.7 million after deducting costs and expenses for its Secondary Offering. (Id.)

Plaintiffs allege that during the Class Period, the Individual Defendants repeatedly represented that the USIT was achieving explosive growth and would achieve profitability by year end. At the time that they were making these statements. It is alleged that they were aware of underlying conditions which were adversely affecting the company which made their statements false and misleading. Specifically, plaintiffs allege that the Individual Defendants knew that USIT's acquisition of Soft Plus would cause a debt burden to USIT and prevent the company from achieving profitability. (Id. ¶ 3.) Plaintiffs contend that the Individual Defendants knew, but did not disclose, that the $80 million Soft Plus debt would not be paid off with the proceeds of USIT's Secondary Offering even though allegedly the company stated in public interviews, in its 10-K, and in its Prospectus that it anticipated repaying the $80 million note with these proceeds. (Id. ¶¶ 39, 42-43, 45.) By the end of the Class Period, no part of the $80 million debt had been paid off.

Plaintiffs further allege that by late April 2000, the Individual Defendants were aware that at least two of the dot-com companies, NetSmart and Exist Corporation, owned in part by several of them, had financial difficulties and would not be paying USIT for services it provided. Mr. Pulier owned equity in, and was a director of, NetSmart. Mssrs. Pulier and Shulman owned stakes in, and were directors of, Exist Corporation. (Id. ¶ 67.) However, during the Class Period, the Individual Defendants reassured the public that its dot-com risk was minimal because the Company carefully evaluated all dot-com organizations that it provided services to and made sure that USIT only did business with dot-com organizations with proper levels of funding. (Id. ¶

4.)

Plaintiffs further allege that in late April 2000, the Individual Defendants knew that USIT was being negatively affected by a lengthening of its sales cycle; nevertheless, the Individual Defendants represented that any effects from the lengthening of the sales cycle were being counterbalanced by larger sales. (Id. ¶ 5.)

Plaintiffs allege that in July 2000, USIT sent Dieter Schoenegger, Chief Technology Officer of the company adidas America, a letter informing him that USIT was going out of business. (Id. ¶71.)

On September 20, 2000, USIT pre-announced that its third quarter performance would be worse than expected due to rapid changes in the Internet professional services market. (Id. ¶ 6.) On November 8, 2000, when USIT announced its actual third quarter performance, its third quarter financial results were worse than pre-announced, and the Company wrote-off $8.8 million of uncollectible accounts receivable during the third quarter, which amounts were primarily related to services performed for dot-com organizations. (Id. ¶ 8.)

During the class period USIT stock traded as high as $50.00 and, by the end of the Class period, USIT stock dropped to $0.81 per share. (Id. ¶ 9.)

III. Procedural History

Plaintiffs argue that, although not named as a defendant because it filed for bankruptcy protection in January 2001, USIT is a primary violator of Section 10(b) of the Exchange Act and Rule 10b-5, as well as Sections 11 and 12(a)(2) of the Securities Act, through the conduct of the named defendants who were controlling persons of USIT. (Am. Compl. ¶ 16.)

Counts I-II allege that 23 different statements made in press releases, Internet-based

interviews on the website RadioWallstreet.com, public filings, and through analysts' statements violate Section 10(b) and 20(a) of the Exchange Act and Rule 10b-5 because they were false and misleading. (Am. Compl. ¶ 10.) Plaintiffs allege that the Individual Defendants artificially inflated USIT's stock in order to sell over $5 million worth of their USIT stock at prices significantly higher than the price to which USIT shares dropped at the end of the Class Period. (Am. Compl. ¶ 11.)

Counts III-IV are against the Director Defendants, Underwriter Defendants, as well as the Individual Defendants. Plaintiffs allege that the six Director Defendants are liable for false statements contained in USIT's Prospectus as directors of the Company at the time of USIT's Secondary Offering and as signatories of the Prospectus. (Am. Compl. ¶ 21.) Plaintiffs allege that the six Underwriter Defendants are liable for the misrepresentations and omissions made in the Company's Prospectus as sellors, offerors, and/or solicitors of sales of the shares offered in connection with USIT"s Secondary Offering. (Am. Compl. ¶ 23.)

The defendants moved in three different motions to dismiss the respective claims against them on the basis that plaintiff's allegations failed to meet the heightened pleading standard of the Private Securities Litigation Reform Act ("PSLRA"). Argument was heard on all motions on July 30, 2002. Counts I-II are dismissed in part. Counts III-V are dismissed in their entirety. The Director Defendants and Underwriter Defendants are dismissed from this case.

IV. Discussion

A. Legal Standards

1. 12(b)(6) Motion to Dismiss

While plaintiffs must plead fraud with specificity under Rule 9(b)[4] and meet the standards of the PSLRA, Rule 12(b)(6) standards still apply to securities fraud litigation. On a motion to dismiss, the court must accept as true all well-pled allegations of fact in the plaintiff's complaint, construe the complaint in the light most favorable to the plaintiffs, and determine whether, "under any reasonable reading of the pleadings, the plaintiffs may be entitled to relief." Colby v. Upper Darby Twnshp, 838 F.2d 663, 665-66 (3d Cir. 1988).

Documents "integral to or explicitly relied upon in the complaint" and related matters of public record may be considered on a motion to dismiss. In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1426 (3d Cir. 1997).

2. *Pleading Standards Under the PSLRA*

a. Relationship to Rule 9(b)

The PSLRA made two changes to the Securities Act and Exchange Act that are relevant here. First, it established a pleading standard requiring particularized allegations even beyond Rule 9(b) of the Federal Rules of Civil Procedure. Under this standard a plaintiff must "specify

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[4] Rule 9 (b) Fraud, Mistake, Condition of the Mind. In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally. FED. R. CIV. P. 9(b).

each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). The third circuit has noted that the particularity language of § 78u-4(b), like Rule 9(b) of the Federal Rules of Civil Procedure, requires plaintiff to plead "the who, what, when, where and how: the first paragraph of any newspaper story." In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999).

The PSLRA also requires that a complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). This is in contrast to Rule 9(b) which allows state of mind to be averred generally. Therefore, on the issue of state of mind, the third circuit has found that the PSLRA supersedes Rule 9(b) for securities fraud litigation. Advanta, 180 F.3d at 531 n.5.

Second, the PSLRA provides a safe-harbor for certain forward-looking statements that prove to be false. See, discussion infra.

A complaint that fails to comply with any of these requirements must be dismissed. See 15 U.S.C. § 78u-4(b)(3)(A).

b. Group Pleading Under the PSLRA

Defendants argue that the "group pleading rule," a doctrine which allows allegations that misstatements contained in company documents such as press releases and SEC filings to be presumed to be the collective work of that company's directors and officers, did not survive the passage of the PSLRA. (Defs.' Mem. of Law in Supp. of Mot. to Dismiss Counts I and II of the Am. Compl. at 9 n.7.) Thus, each individual defendant would only be liable for a statement

made by him.

There is no third circuit precedent on this issue and district courts in this circuit are divided. See Marra v. Tel-Save Holdings, Inc., 1999 WL 317103, at *5 (E.D. Pa. May 18, 1999) (holding that the continued vitality of the group pleading doctrine is suspect); In re Home Health Corp. of Am., 1999 WL 79057, at *21 (E.D. Pa. Jan. 29, 1997) (same). But see In re Aetna, Inc. Sec. Litig., 34 F. Supp.2d 935, 949 (E.D. Pa. 1999) (analyzing the liability of an outside director using the group pleading doctrine). **This court follows a narrowly construed group pleading doctrine and finds that it is valid when applied to officers where it is almost certain that given the high-level position of the officer within the company and the nature of the published writing that he or she would have been involved directly with writing the document or approving its content and that the officer was privy to information concerning the accuracy of the statements within the document. All of the individual officers in this case are such high-ranking officers and the SEC filings and press releases are such collectively published documents. Thus, the Individual Defendants are presumptively responsible for the statements in the SEC filings and press releases.**[5]

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[5] The Individual Defendants cannot be held liable for the September 20, 2000 press release which is attributed to a new CEO. "The Company expects its revenues for the third quarter ending September 30, 2000 will be in the range of $21 million to $23 million, more than double third quarter 1999 revenues of $9.9 million but below the $29.5 million reported for second quarter 2000. William C. Jennings, recently appointed CEO, US Interactive, said, " 'After a track record of double-digit sequential growth each quarter, this quarter's performance is principally due to the rapid changes in the Internet professional services market, including lengthening sales cycles, re-evaluation of e-business initiated by our clients and prospects, and reduced funding available to dot-com clients.'" September 20, 2000 Press Release (Am. Compl. ¶ 78.) (Statement D)

B. Section 11 and 12 Claims Under the Securities Act (Counts III-IV)[6]

Counts III-IV of the Amended Complaint allege as to the Individual Defendants, Director Defendants, and Underwriter Defendants violations of Sections 11 and 12(a)(2) of the Securities Act because they issued, caused to be issued, or participated in the issuance of the Prospectus in connection with USIT's Secondary Offering, which misrepresented or failed to disclose material facts. (Am. Compl. ¶ 113.) Allegedly, the Prospectus contained material misstatements concerning (1) use of proceeds from the Secondary Offering, (2) USIT"s ability to remain solvent, and (3) the its competitive position. Plaintiffs argue that the cautionary statements in the Prospectus were insufficient because the Prospectus did not contain two additional warnings: (1) that two of USIT's largest customers were likely to withhold payments on substantial debts owed USIT and (2) that USIT's expenses were increasing dramatically while its revenues were not keeping pace. (Pls.' Mem. of Law in Opp. to Mots. to Dismiss by Underwriters, Directors, and Individual Defs. at 15.)

Under Section 11 of the Securities Act, purchasers of registered securities may sue, among others, an issuer, its directors, any person who signs the corresponding registration statement, and every underwriter, if the registration statement (which includes the prospectus) contains an untrue statement of a material fact or an omission of a material fact required to be stated or necessary to make the statements in the registration statement not misleading. See 15 U.S.C. § 77k(a). Section 12(a)(2) imposes liability upon any person or officer who offers or sells a security by means of a prospectus which contains a material misstatement or omission. 15

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[6] The Securities Act claims are discussed first because resolution of the claims based on the statements in the Prospectus results in the dismissal of the Director Defendants and the Underwriter Defendants and is relevant for the claims against the Individual Defendants.

U.S.C. § 77*l*. Therefore, to state a claim under Sections 11 or 12(a)(2) of the Securities Act, plaintiffs must demonstrate that the Prospectus contained misleading statements of material fact or omissions of material fact necessary to make the statements not misleading. 15 U.S.C. §§ 77k(a) & 78j(b).[7]

The challenged statements in the Prospectus are as follows:

(A) The amount of principal which we must pay under the $80 million note will be reduced under certain circumstances relating to: (i) our rights to be indemnified by the principal shareholders of Soft Plus under the Merger agreement, (ii) the results of certain audits being performed after the closing of the Merger, and (iii) costs incurred by Soft Plus in the Merger above agreed levels. The $80 million note is due and payable on the earlier of March 8, 2001 or the receipt by us of not less than $80 million from the net proceeds of a public offering of our capital stock. However, we may pay a portion of the $80 million note with some of the proceeds from this offering. We intend to use the net proceeds from this offering to repay any outstanding balance under our revolving credit agreement with a commercial bank, open new offices and for other general Corporate purposes. In addition, we may use a portion of the net proceeds from this offering for acquisitions or to repay a portion of the $80 million dollar note issued in the Merger. ("Statement A.") (Am. Compl. ¶ 45; Prospectus at pp. 14-15)

(B) The Company believes that the net proceeds from this offering, current cash balances, and borrowings available under the credit facilities will be sufficient to fund requirements for working capital and capital expenditure for at least the next 18 months. ("Statement B.") (Am. Compl. ¶ 47; Prospectus at p.26.)

(C) We believe that in order to be successful in this market, professional services firms must possess an integrated model of Internet strategy, marketing skills, expertise in wireless and broadband technologies, technology integration skills, and clients and project management capabilities. We believe we are the only Internet professional services firm that integrates all of these skills, with a

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[7] The liability of the Individual Defendants under Section 15 of the Securities Act (Count V) is not discussed separately because resolution of the Section 11 and 12 claims in favor of all of the defendants necessarily decides whether the Individual Defendants were controlling persons within the definition of Section 15 of the Securities Act. Controlling person liability is derivative of whatever underlying liability may exist. Dismissal of Counts III and IV requires dismissal of Count V.

dedicated focus on e2e solutions. ("Statement C.") (Am. Compl. ¶ 49; Prospectus at p. 29.)

For all practical purposes, the court considers the two motions to dismiss Counts III-V together and then discusses any relevant differences in the bases for dismissal.

The Individual Defendants and Director Defendants argue that all three statements are protected under Prong 1 of the PSLRA safe-harbor and that Statement 3 is immaterial since it is mere puffing. (Mem. of Director Defs. and Individual Defs. in Supp. of Their Mot. to Dismiss Counts III, IV, and V at 2.) The Underwriter Defendants argue that Statements 1-3 are not misleading when read in the context of the Prospectus as a whole because these statements are not false on their face, or are accompanied by cautionary text that precludes risk of misleading as a matter of law. (Mem. of Underwriter Defs. in Supp. of Their Mot. to Dismiss at 2-4.) The Underwriter Defendants also argue that the claims against them are time-barred. (Id. at 31.)

As a threshold matter, the court finds that plaintiffs' claims against the Underwriter Defendants are not time-barred. The Underwriter Defendants argue that plaintiffs' claims against them are time-barred because all the facts forming the basis for the claims were revealed in the Prospectus for the Secondary Offering on April 12, 2000. According to the Underwriter Defendants, plaintiffs were under inquiry notice on April 12, 2000, more than one-year before they filed their Amended Complaint on June 18, 2001, which first included the Underwriter Defendants. Plaintiffs argue that the "dire financial problems of the Company," its lack of a niche in its industry, and its inability to pay off any of the $80 million note, was not known until the first week of November 2000. (Pls.' Mem. of Law in Opp. to Mots. to Dismiss Counts III-V at 21-22.)

Claims for relief pursuant to Sections 11 and Section 12(a)(2) of the Securities Act must be brought within one-year from the time the plaintiff discovered or, after the exercise of reasonable diligence, should have discovered, the untrue statements or omissions. 15 U.S.C. § 77m. A court need only consider at what point in time investors were on notice of the facts which rendered the alleged misstatements false or misleading. McKowan Lowe & Co. v. Jasmien Ltd., 127 F. Supp.2d 516, 526 (D. N.J. 2000), rev'd on other grounds. The court agrees with the plaintiffs that they were not on inquiry notice about the securities fraud claims until the stock price dropped and that the June 18, 2001 amended complaint is well within the one-year statute of limitations.

Four principles are relevant to the court's analysis of whether the Prospectus contained an actionable misstatement or omission of material fact.

First. In order to be actionable under securities fraud, a statement must be a fact and not an opinion. Vague expressions of hope by corporate managers are not actionable. See EP Medsystems Inc. v. EchoCath, 235 F.3d 865, 872 (3d Cir. 2000).

Second. Even a false statement is not actionable if it is " immaterial." Id. In order for a misrepresentation or omitted fact to be material, "there must be a substantial likelihood that the disclosure of the omitted fact [or misrepresentation] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Id. at 872 (quoting TSC Indus. V. Northway, Inc., 426 U.S. 438, 449 (1976)). "Vague and general statements of optimism that constitute no more than 'puffery' and are understood by reasonable investors as such," will not support a claim. Advanta, 180 F.3d at 538. In other words, only

statements that would be important to a reasonable investor in making his or her investment decision are material. Burlington, 114 F.3d at 1425-26. Because questions of materiality have traditionally been viewed as particularly appropriate for the trier of fact, in order for a court to determine that a statement is immaterial, the omission or misstatement must be so obviously unimportant that courts can rule them immaterial as a matter of law at the pleading stage. See id. at 1426.

Third. The third circuit has held that in determining whether statements contained in a prospectus are materially misleading, the prospectus must be read as a whole. Courts must avoid examining the alleged misstatements in isolation "because accompanying statements may render [them] immaterial as a matter of law." EP Med Systems, 235 F.3d at 873.

Fourth. Congress passed the PSLRA in 1995 which added to the Securities Act a "safe harbor" provision that applies to certain forward-looking statements.

The PSLRA states in relevant part:

> A person shall not be liable with respect to any forward-looking statement if and to the extent that-
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> (A) the forward-looking statement is-
>
> (i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or
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> (ii) is immaterial ("Prong 1"); or
>
> (B) the plaintiff fails to prove that the forward-looking statement-
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> (i) if made by a natural person, was made with actual knowledge by that person that the statement was false or misleading; or
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> (ii) if made by a business entity; was-
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> (I) made by or with the approval of an executive officer of that

> entity; and
>
> (II) made or approved by such officer with actual knowledge by that officer that the statement was false or misleading. ("Prong 2")."
>
> 15 U.S.C. § 78u-5(c)(1)(A)-(B).

The PSLRA establishes a two-pronged analysis for determining when persons will be insulated from liability for forward-looking statements that prove to be incorrect. The PSLRA first looks to the statement itself and grants protection to the forward-looking statement if it is accompanied by sufficient cautionary statements or if it is otherwise immaterial. In a second and alternative prong, the PSLRA looks to the state of mind of the person making the disclosure and grants protection if the plaintiff cannot prove that the forward-looking statement, even if unaccompanied by cautionary language, was made "with actual knowledge...that the statement was false or misleading." Greebel v. FTP Software, Inc., 194 F.3d 185, 201 (1st Cir. 1999).

1. Statement (A) Concerning Use of Proceeds from Secondary Offering

Statement (A) is not actionable because, on its face, it is not misleading. Plaintiffs allege that Statement (A) is materially misleading because defendants knew that "such funds were required to pay off other debts and for working capital" and would not be used to repay the $80 million note. (Am. Compl. ¶ 46.) However, Statement (A) disclosed that USIT intends to use the net proceeds from the Secondary Offering to repay a commercial loan, open new offices, and for other general corporate purposes. (Id. ¶ 45.) The Prospectus stated that USIT might use some of the proceeds from the Secondary Offering to repay a portion of the $80 million note. (Id.) To find this statement actionable, the court would have to find that it was materially misleading in that it promised that proceeds of the Secondary Offering would definitely be used

to repay all or a substantial portion of the $80 million note, even though USIT stated that it would use the proceeds to pay a different loan and for capital expenditures. It is not possible for a reasonable investor to read Statement (A) except as an expression of a hope that some portion of the $80 million note might be reduced by such proceeds.

Further, other statements within the Prospectus stated the means, other than the Secondary Offering, by which USIT intended to repay the $80 million note. The Prospectus expressly stated that USIT expected to pay down the $80 million note with funds raised through "proceeds to be obtained from one or more of the following: borrowings under our credit facilities, a refinancing, and a sale of capital stock or debt securities in the public or private markets, together with revenues generated from operations." (Prospectus at p.9.) Reading the Prospectus as a whole shows unequivocally that it was the intent of USIT, as a last resort, to repay the $80 million note with proceeds from the Secondary Offering and that the Company preferred to repay the note through alternate sources. The Prospectus even warned that the note might not be paid off at all. It stated, "there can be no assurances that we will be able to obtain funds sufficient to repay the [note] on terms satisfactory to us, in which event our ability to achieve profitability may be materially adversely affected. (Id.) Thus, as to Statement (A), the court finds that plaintiffs have failed to plead a misleading fact.

2. Statement (B) Concerning USITS Ability to Remain Solvent

This statement is not actionable because it is protected under the PSLRA safe-harbor provision.[8] The statement about USIT"s ability to remain solvent is a financial projection that

[8] Because the court finds that the statements in the Prospectus are protected by the PSLRA safe-harbor, see discussion infra concerning Section 10(b) liability as well, the court dispenses with a discussion of the bespeaks caution doctrine, a common-law doctrine which

falls squarely within the statutory definition of a forward-looking statement.[9] 15 U.S.C. § 78u-5(i)(1)(A). Within the Prospectus, it is explicitly identified as forward-looking as it is qualified by the term "belief." The Prospectus explained under the heading "Forward Looking Statements," "that [w]hen used in this prospectus, the words 'anticipate,' 'believe,' 'estimate,' 'expect,' 'seek,' 'intend,' 'may,' and similar expressions are generally intended to identify forward-looking statements. (Prospectus at p. 13.)

Further, this statement was accompanied by sufficient cautionary language of risk factors that might cause USIT to exhaust available funds within 18 months. As required under applicable SEC regulations, the Prospectus made extensive disclosures about USIT's "Liquidity and Capital Resources," which included the Company's current and historical cash positions, past borrowing and available credit, and working capital requirements. (Id. at 24-27.) The Prospectus detailed that the Company had not achieved profitability, that it may never achieve profitability, and that it may continue to incur substantial losses even if revenues increase. (Id. at

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provides that affirmative forward-looking statements are not actionable where the company has previously or contemporaneously warned investors of risks that could cause a projection not to come to pass. See EP Medsystems, 235 F.3d at 873-75; In re Donald Trump Casino Sec. Litig., 7 F.3d 357, 871 (3d Cir. 1993).

[9] The PSLRA defines "forward-looking" statements to include:

(A) A statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

(B) A statement of plans and objectives of management for future operations...;

(C) A statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the [SEC].

15 U.S.C.§ 78u-5(i)(1)(A)-(C).

p. 6.) The Prospectus disclosed that the Company's expenses were dramatically increasing and that losses had increased recently. (Id. at pp. 5, 6, 19.) The Prospectus included a seven-page discussion of risk factors that could cause investors to "lose all or part of their investment." (Id. at 6.)

As discussed supra, plaintiffs argue that defendants failed to disclose two material omissions about forgiving certain customers' debts and about increasing expenses and thus, the cautionary statements in the Prospectus were made inadequate. Defendants respond that under the First Prong of the safe harbor, a person is not required to caution against every material risk and need not even warn against the specific risks that ultimately caused actual results to differ from predicted results. Harris v. Ivax, 182 F.3d 799, 807 (11th Cir. 1999) (citing H.R. Conf. Rep. 104-369, at 44 (1995) reprinted at 1995 U.S.C.C.A.N. 730, 743. The issue is whether the cautionary language is sufficient to convey to an investor that the prediction in question is not a guarantee. Cautionary language is sufficient when an investor has been warned of risks similar to that actually realized so that the investor is on notice of the danger of the investment. Harris, 182 F.3d at 807. The court finds that a host of factors was disclosed and that the accompanying cautionary language was sufficient to warn investors that it was not guaranteed that USIT would be solvent for a period of 18 months.

Plaintiffs argue that the safe-harbor provision is defeated by their demonstrating that the challenged statements were made with actual knowledge that the statements were false or misleading. 15 U.S.C. § 78u5(c)(1)(B). However, once a court determines that a statement in a Prospectus is forward-looking and is accompanied by meaningful cautionary language, the state of mind of the person making the statement is irrelevant. Harris, 182 F.3d at 803. The

legislative history of the PSLRA shows that use of the words "meaningful" and "important factors" are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss without examining the state of mind of the defendant. Id. (citing H.R. Conf. Rep. 104-369, at 44 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 743). The first prong of the safe harbor requires courts to examine only the forward-looking statement and the cautionary statements accompanying it.

Moreover, the third circuit has found a virtually identical statement not to be actionable. In EP Medsystems, defendants' representatives stated that the proceeds of the plaintiffs' investment, when coupled with the funds of other investors, would provide sufficient operating funs for "at least 18 to 24 months." Id. at 879-80. Since the representation was about "anticipated" funds, "not guaranteed," the third circuit held that the statement was immaterial and protected under the PSLRA safe-harbor since it was a mere expression of belief. Id. Similarly, Statement (B) conveys a hope by corporate managers based on the amount of money that USIT might obtain through the Secondary Offering. It is necessarily a contingent statement and is not a misstatement of fact.[10]

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[10] The Individual Defendants and Defendant Directors also argue that the plaintiffs lack standing to assert claims under Sections 11 and 12 of the Securities Act because all plaintiffs have not alleged that they purchased stock in the Secondary Offering itself.

Plaintiffs counter that they have standing under Sections 11 and 12 because at least one plaintiff bought USIT shares in the Secondary Offering. Plaintiffs submitted an affidavit that plaintiff Contino purchased USIT common stock in the Secondary Offering on the date of the Second Offering and at the price of the Secondary Offering through her broker, Deutsche Banc Alex. Brown, which served as a managing underwriter for the Secondary Offering. (Dec. of Douglas Risen.)

Defendants counter that the affidavit and documents do not state whether the shares were acquired through the open market or were part of Alex. Brown's initial distribution of its allotment of shares. Defendants argue that regardless of how plaintiff Contino obtained her

3. Statement (C) Concerning USIT's Competitive Position

This statement is not actionable because it is nothing more than a general statement of optimism about USIT and is mere puffery. It would be understood by a reasonable investor as such and is immaterial. Advanta, 180 F.3d at 538 (finding that "vague and general statements of optimism constitute no more than mere puffery and are understood by reasonable investors as such"). Statement (C) is not claiming that USIT possessed any skills that a professional services firm would not be expected to have. Further, a reasonable investor would expect a professional services firm to say that it was the best at integrating these skills. Such "puffing" would not significantly alter the "total mix" of information available to a reasonable investor or be important to a reasonable investor in making an investment risk decision, especially as to a company that it knew had never made a profit. Burlington, 114 F.3d at 1426. As such, Statement (C) is immaterial.

C. Claims under Section 10(b) of the Exchange Act and Rule 10b-5 (Count I)

The Amended Complaint alleges that a series of statements by the Individual Defendants, including those in the Prospectus, constitute violations of Sections 10(b) and 20(A) of the Exchange Act and Rule 10b-5. The court has resolved the claims based on the statements in the Prospectus and the same discussion and analysis is dispositive of the Exchange Act claims based on those statements. The principles, discussed supra, of whether the Prospectus contained an actionable misstatement or omission of material fact are equally relevant in analyzing the

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shares, the claims of alleged class members who did not purchase their USIT shares directly from the underwriters in the initial distribution of shares do not have standing. Third circuit precedent shows that plaintiffs are entitled through discovery to try to establish that they purchased their stock directly in the Secondary Offering itself. Shapiro, 964 F.3d at 286. However, because the court dismisses all the claims based on the statements in the Prospectus on other grounds, discovery on this issue is moot.

remaining challenged statements. In addition, the court must consider whether plaintiffs' allegations support a strong inference of scienter.

To state a cause of action under Section 10(b) of the Exchange Act and Rule 10b-5, a complaint must allege (1) that the defendant made a materially false or misleading statement or omitted to state a material fact necessary to make a statement not misleading; (2) that the defendant acted with scienter; (3) that the defendant's misstatement caused injury; and (4) those facts sufficient to meet the pleading requirements of Rule 9(b) of the Federal Rules of Civil Procedure and the PSLRA. Burligton Coat Factory, 114 F.3d at 1417. Because Section 10(b) and Rule 10b-5 are anti-fraud provisions, plaintiffs must plead with the particularity required by Rule 9(b). Id.

Section 10(b) makes it unlawful for any person "to use or employ, in connection with the purchase or sale of any security, ...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78(j)(b). Rule 10b-5 makes it unlawful "to make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading...in connection with the purchase or sale of any security." 17 C.F.R.§ 240.10b-5(b). These provisions create a private right of action for plaintiffs to recover damages for "false or misleading statements or omissions of material fact that affect trading on the secondary market." Advanta, 18 F.3d at 535.

The Individual Defendants argue that plaintiffs' complaint fails to meet the heightened pleading standard required by the PSLRA which establishes a safe harbor for statements from

securities fraud liability. Specifically, defendants argue that plaintiffs' Section 10(b) and Rule 10b-5 claims suffer from the three following deficiencies: (1) the challenged statements, when read in full context, are not misstatements or omissions of material facts; (2) the challenged statements fall within the PSLRA safe harbor and the bespeaks caution doctrine because they were accompanied by meaningful cautionary statements, and in any case, were not made with actual knowledge; and (3) plaintiffs' conclusory allegations are devoid of facts necessary to support a strong inference of scienter. (Defs.' Mem. of Law in Supp. of Mot. to Dismiss Count I-II at 1.)

1. Allegations of a Strong Inference of Scienter Under the PSLRA

In Advanta, the third circuit found that the PSLRA was intended to modify procedural requirements while leaving substantive law undisturbed. 180 F.3d at 534. Thus, even after the PSLRA, the third circuit has maintained the substantive second circuit standard for pleading scienter when it is required in securities fraud cases: "[I]t remains sufficient for plaintiffs to plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute evidence of either conscious or reckless behavior.'" Id. at 534-35. However, motive and opportunity, like all other allegations of scienter (intentional, conscious, or reckless behavior), must now be supported by facts stated "with particularity" and must give rise to a "strong inference of scienter." Id. at 535.

In attempting to meet the scienter requirement, plaintiffs maintain that knowledge concerning a company's key businesses or transactions may be attributable to the company, its officers, and directors. In re Tel-Save Sec. Litig., No. C.I.V.A.98-3145, 1999 WL 999427, at *5

(E.D. Pa. Oct. 19, 1999).

a. Motive and Opportunity

Plaintiffs pled that the Individual Defendants had the motive and opportunity to artificially inflate USIT's stock price. Motive would entail concrete benefits that could be realized by one or more of the statements and wrongful disclosures alleged. Opportunity would entail the means and likely prospect of achieving concrete benefits by the means alleged." Aetna, 34 F. Supp.2d at 955.

Plaintiffs attempt to rely on the Individual Defendants' stock sales during the class period as evidence of a motive and opportunity giving rise to an inference of scienter. The third circuit has stated that it will not infer fraudulent intent from the mere fact that some officers sold stock; instead, in order for such an inference to be drawn, plaintiffs must plead facts that show that the stock sales were unusual in scope or timing. See Advanta, 180 F.3d at 540. To support an inference that sales are made at suspicious times or in suspicious amounts, the third circuit requires that plaintiffs plead the percentage of the insider's stock holdings sold, the trading practices of the insider prior to the class period, whether the profit made by the insider from the sales during the class period was substantial in relation to his or her compensation, and the holdings and trading activity of other parties. See Aetna, 34 F. Supp.2d at 955.

b. Circumstantial Evidence of Conscious Misbehavior or Recklessness

A plaintiff may also establish a strong inference of scienter by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. A reckless statement is one "'involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers

or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Advanta, 180 F.3d at 535.

c. Novak Factors

In a more recent decision, the second circuit elaborated on the scienter requirement. The court stated that courts should not be wedded to the words "motive and opportunity" and found that an inference of scienter may arise when 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. 2000).

This court must decide whether any of the nineteen remaining challenged statements could be a basis for liability against the Individual Defendants under the Exchange Act. The court discusses by category which statements are not actionable. The court also discusses which statements meet the PSLRA pleading requirements and on which the plaintiffs are entitled to discovery.

2. Challenged Statements Which Are Not Misleading Statements of Fact

(E) "God knows, we feel exceptionally devalued [in terms of stock price.]" Pulier's remarks in September 12, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 76.)

(F) "The Company believes that the net proceeds from the recently completed public offering, combined with current cash balances and borrowings available under the credit facilities will be sufficient to fund requirements for working capital and capital expenditures for at least the next eighteen

months provided, however that the Company is able to obtain funds sufficient to repay the $80 million note on terms satisfactory to the Company as described above." First Quarter 10-Q dated May 15, 2000 (Am. Compl. ¶ 61.)

(G) "Knowing that we're at a cash flow of break even or soon to be, it's obviously not there to supplement working capital for general operating purposes . . . . We do have a $80 million note due to the sellers of Soft Plus that's due in March of 2001. I would expect a fair amount of the proceeds associated with the secondary offering that we just completed will be applied to the note." Zarrilli's remarks in April 25, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 53.)

(H) "It is anticipated that the filing will occur in the first quarter of 2000. . . . It is anticipated that part of the proceeds to the Company will be used to satisfy the $80 million one-year note to be issued to shareholders of Soft Plus, Inc. in connection with its pending merger of Soft Plus announced last week by the Company." February 10, 2000 Press Release (Am. Compl. ¶ 38.)

(I) "[W]e anticipate that we will repay the $80 million note, which we issued in the [Soft Plus] Merger, with proceeds of an underwritten public offering of our common stock. On March 10, 2000, we filed a registration statement on Form S-1 . . . relating to the offering . . . ." 1999 10-K filed on March 29, 2000 (Am. Compl. ¶ 42.)

Statement (E) is not actionable because it is not a statement of fact but rather an opinion. In order to be actionable, the challenged statement must be one of fact and not of opinion or subjective evaluation. See EP Medsystems, 235 F.3d at 872.

Statement (F) is not actionable because it is not misleading on its face. The statement about the sufficiency of the funding is qualified by the phrase "provided, however that the Company is able to obtain funds sufficient to repay the $80 million note on terms satisfactory to the Company as described above." The statement makes clear that the belief about sufficiency of

cash and capital is contingent on the Company securing funds to repay the note.

When read in context, as it must be, Statement (G) is not materially misleading.

The entire statement is as follows:

> Interviewer: One final question for you, and that's the company recently completed a secondary offering raising approximately 45 million dollars in proceeds. How does the company plan to put that to work over the next several months.
>
> Mr. Zarilli: Well, knowing that we're at a cash flow of _____soon to be it's obviously there to supplement working capital for general operating purposes. A little bit of it will be used to the continuous built out of offices or our business across the world actually, but we expect to sit quietly with this cash and we don't have any specific plans other than to manage our business in the way that we have in the past. We do have a $80 million note due to the sellers of Soft Plus that's due in March of 2001. I would expect that a fair amount of the proceeds associated with the secondary offering that we've just completed will be applied to that note. But also we we'll be looking for other ways in which to continue to enhance out financial position in the marketplace. (Exs. to Defs.' Mem. of Law in Supp. of Mot. to Dismiss Counts I & II, Ex. 15 Radiowallstreet.com interview dated April 25, 200 with Steven Zarilli at 6-7.)

In this statement, Mr. Zarilli speaks of the intended multiple uses for the proceeds of the Secondary Offering. Read in context, it cannot be read as an intention to use the proceeds to pay down the note, but rather a "wait and see" approach to the management of the business, as a whole, subject to possible changes in financial conditions.

Statements (H) and (I) are neither misleading on their face nor material. The statements indicates that USIT hopes that proceeds from the Secondary Offering will be used to satisfy the $80 million note. It does not say that USIT will pay off the note with the proceeds but only that it anticipates that it would do so. (Defs.' Mem. of Law in Supp. of Mot. to Dismiss Counts I & II at 8.) Further, the statements are immaterial as a reasonable investor would read these

representation only as an anticipated use and not a firm guarantee of how the money would be used. See EP Medsystems, 235 F.3d at 880.

3. Challenged Statements Which are Immaterial

(J) "The strong second quarter operating results reflect our ability to remain nimble, anticipate the changing needs of our clients, and pave the way to the next generation of e-business using leading edge technologies. . . US Interactive strives to create and deliver innovative solutions . . . ." Remarks attributed to Zarrilli in July 27, 2000 Press Release (Am. Compl. ¶ 69.)

(K) "[O]pportunities [are] really bright right now when we look at some of the expansion opportunities in Europe and Asia and the Fortune 500 companies that are going to finance around our customer value contribution message . . . . [The Internet] is deepening the relationship with their customers and it's mandating a completely new type of organization . . . . And to bring together all the different silos of an organization in order to become competitive in this arena, is really a different type of expertise. I think you're seeing softness in the industry because not a lot of companies can nail this expertise. As we evaluate ourselves and prepare ourselves for this next phase, we realize and celebrate that we are the leader *right now* in the telecom industry in enabling the customer value chain. We've got a prefabricated, preintegrated hub that has the [incomprehensible] to market advantage that is in use in tens of thousands of users right now around the world. . . . We think that right now our ability to leverage that with a change in the market place gives us an edge, and that's what we want." Pulier's remarks in September 12, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 76.)

These statements are typical of "[v]ague and general statements of optimism that constitute no more than 'puffery' and are understood by reasonable investors as such." Advanta, 180 F.3d at 538. This type of optimistic statement would not alter the "total mix" of information available to an investor to make a decision. Burlington, 114 F.3d at 1426.

4. Challenged Statements Which are Analyst Statements

(L) "We spoke with management and 2Q00 appears to be on track with estimates of $28.0 mm in revenue and ($0.07) 'cash' EPS. Tone of

business remains solid across all verticals and virtually all products in queue now benefitting from 4Q99 rate increase. . . . We are fine-tuning our 2000 estimates to $119.9 mm in revenue from $106.5 mm and to ($0.19) 'cash' EPS from ($0.25) to better reflect momentum from 1Q00 results and current tone of business. Also adjusting 2001 estimates to $192.0 mm in revenue from $180.0 mm and to $0.26 'cash' EPS from $0.17. . . . Retain our Strong Buy rating. Reiterate greater comfort with combined company's ability to scale, generate stronger momentum, and become more visible leader in the sector." June 1, 2000 Deutsche Banc Alex. Brown analyst report. (Am. Compl. ¶ 64.)

(M) "On the profitability side, management expects to approach break even EBITA, notably ahead of our estimate of a loss of $443,000 . . . With most of its (10-15% of revenue) dot-com business coming from related venture capitalists (Safeguard and TL Ventures) management sees no concern with its exposure in this area." June 6, 2000 First Union analyst report**.** (Am. Compl. ¶ 66.)

(N) "I'm actually excited...about the prospects for U.S. Interactive. The company is signing on some very high-profile clients overseas, the integration of Soft Plus is running smoothly, and we could see the company reach a break-even a little ahead of schedule. August 3, 2000 Adams, Harkness & Hill analyst report. (Am. Compl. ¶ 73.)

These statements issued by analysts are not actionable against the Individual Defendants. Such statements would be actionable only if plaintiffs pled facts showing that a particular defendant both made the statement to the analyst and controlled the content of the report. See Klein v. General Nutrition Cos., 186 F.3d 338, 345 (3d Cir. 1999). Plaintiffs have not pled who made the statements to the analysts, much less that a particular Individual Defendant controlled the content of the report. Plaintiffs only plead that Deutsche Banc Alex. Brown based its report on conversations with "USIT management Pulier and/or Zarrilli." (Am. Compl. ¶ 64.)

5. Plaintiffs Have Alleged Misstatements Made with Sufficient Scienter to Defeat a 12(b)(6) Motion for the Following Statements:

(O) **"[A]s the announcement has indicated, we're looking to offer approximately 5 million shares, 50% of which will be offered by the company and the balance by selling shareholders . . ., and outside of that, one of the uses of the proceeds, if you will, will be the satisfaction of the debt that is part of the Soft Plus merger. . . ." Calamia's remarks in February 10, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 39.)**

(P) "Pulier stated that there was 'incredible demand for [USIT's] services'; that 'we really have no price demand, we charge our full rates'; that 'this sector is known widely for explosive growth and I don't think you're going to see a manifestation of that anywhere more fully than in US Interactive's numbers moving forward'; and that 'we believe that we will be the number one player in this space.'" Pulier's remarks in a February 10, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 39.)

(Q) "Calamia stated that 'demand...is certainly very, very robust' and that 'we can see [margins] accrete upward toward 50% in the latter part of the year.'" Calamia's remarks in February 10, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 39.)

(R) "US Interactive has changed the e-business services landscape through the Soft Plus acquisition on March 8, 2000, with a vertical penetration model to exploit the opportunities of B2B and wireless...The record revenue and strong first quarter operating results are indicative of our ability to remain ahead of market demands." Remarks attributed to Zarrilli in April 24, 2000 press release (Am. Compl. ¶ 51.)

(S) "Third quarter break even along the line that analysts had projected for the Company is reasonable. We don't expect to have any difficulty meeting that goal. . . . The sales cycles are beginning to get a little bit longer, but interestingly enough, the sales themselves are beginning to be a lot larger than they were in the past. So they tend to counterbalance themselves. What we're seeing is a lot of strength in the demand tunnel for the services we're providing in the marketplace. Relationships with our partners were driving a fair number of leads and opportunities. We are working on a number of different joint opportunities . . . . We are seeing that a significant amount of expansion and activity around our European operations. . . . So when you look at all of the various points of the marketplace that we're touching upon, we're seeing a significant amount of demand for our services, so it's not surprising that we're able to go into a quarter with such a strong level of confidence with a solid book of business. And we continue to see that even growing as we move towards

the third quarter. . . .” Zarrilli's remarks in April 25, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 53.)

(T) “Well, we’re hitting our stride. . . . [T]he company’s really maturing into something that’s really going to be significant in the marketplace. We’re hitting our stride, we’re growing our business quickly, we’re seeing that the demand flow on the revenue side being very strong, but we’re also starting to see the leverage of the infrastructure assets that we’ve put into place. That spending, if you will, that we’ve gone through over the last two or three years as we’ve put the foundation there for the business to grow upon, that’s all taking form now. It is like a bud on a tree that’s starting to bloom. The other thing that we’re finding is that we’re [sic] actually there’s a lot of noise in the marketplace. When you look at the sector that US Interactive is focused upon, the e-business services sectors, there is now 22 companies that are public. But what people have to remember is US Interactive went public when there were only about 3 or 4 others out there. So we’ve been around this block for a longer period of time and we’re one of the more mature players out there in the marketplace. We’re a quarter away from profitability, based upon where the financial analyst [sic] have their models. . . .” Zarrilli’s remarks in May 2, 2000 RadioWallstreet.com interview. (Am Compl. ¶ 59.)

(U) “[D]emand is still strong. . .Well, let’s talk about gross margins. 52% is the financial model that we currently have and that we operate under for the balance of the year, running into the first part of the year, but I actually think there is some upside there. . . . From a dot com perspective. Let’s keep in mind a couple of things. The company’s always had a target of keeping our dot com exposure to no more than 20% of our revenue. In Q2 it was 13%, in Q1 it was 11%. We like the dot com work on one level because it provides some unique challenge to our staff and our staff like to work on those types of projects. But we do have to manage the financial risk. One way to do that is making sure what types of dot coms we're working with. And a lot of the flow of our dot coms come from parties we have relationships with, be it SafeGuard Scientific, be it Internet Capital Group, or TL Ventures, or Trident Capital, you know, original investors in the Company. If it’s not coming through that fashion, which the majority are going through that funnel, if you will, then the other ones are dealt with companies we feel have proper levels of funding. We make sure we’ve got real solid contracts in place. We do as much as we can to evaluate their levels of funding as it relates to their ability to meet their obligations to U.S. Interactive. We have proactively created ways in which to make sure that we bill timely and collect timely on those amounts so that we’re not at risk. But the overall emphasis is not to let it get to be too much of our overall business. We’ve only had one significant

situation with a dot com that was properly reserved for in connection with the closing of Q2 . . . . I think you'll start seeing some of our metrics start reflect the accelerated integration of SoftPlus. You'll see it in our billing rates, you'll see it in our utilization rates, you'll see it in our ability to generate levels of profitability that the company has obviously focused on. That is our primary goal today. . . . " Zarrilli's remarks in a July 27, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 70.)

(V) "I actually think that our sector has taken an unduly amount of punishment with regard to valuation over this period of time. A sector that, if you will . . . for the most part is at profitability or moving toward profitability with regard to each of the individual companies that comprise the sector. . . . I look at the group and I tend to view us as being probably at a valuation of half of where we should be in a legitimate market environment. But we know that we can recapture that value . . . ." Zarrilli's remarks in April 25, 2000 RadioWallstreet.com interview (Am. Compl. ¶53.)

(W) "We're not getting the recognition, I don't think, with regard to our stock price, quite honestly in the marketplace. And I think we're oversold, we're being undervalued, the discount is just way too large in relationship to some of our peers. Not that I necessarily need to trade at 12 or 15 times revenue multiples any longer – I know that there's been a reevaluation in the marketplace – when you're trading at 3 or 4 times knowing you've got a lot of value and you're building your business at greater than 100% a year, a quarter away from being profitable, meeting or beating the street expectations . . . Joe, I don't know what else I can do to kind of get this thing moving in the right direction for the company." Zarrilli's remarks in May 2, 2000 RadioWallstreet.com interview (Am. Compl. ¶ 59.)

The above statements purport to be representations of the current situation of USIT at the time the respective statements were made.[11] To the degree that the statements contain forward-

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[11] Individual defendants argue that Harris holds that "mixed statements" containing both forward-looking statements and statements of present facts should be treated as forward-looking statements for purposes of analyzing whether a statement falls under the PSLRA. 182 F.3d at 806-7. First, this is eleventh circuit precedent, not third circuit, and therefore is not binding on this court. Second, the court reads Harris as having a much more narrow holding than defendants assert.

Harris distinguishes between observed facts and assumptions. Id. at 806. The statutory

looking statements, the court specifies which components of the larger statement are not actionable.[12] As stated above, because questions of materiality have traditionally been viewed as particularly appropriate for the trier of fact, in order for a court to determine that a statement is immaterial, the omission or misstatement must be so obviously unimportant to an investor that reasonable minds cannot differ and courts can rule them immaterial as a matter of law at the pleading stage. Burlington, 114 F.3d at 1426. The court finds that the above statements are not so obviously unimportant that a trier of fact does not have to determine their materiality.

As to these statements, plaintiffs have pled sufficient allegations of scienter to meet the stringent PSLRA requirements. **Plaintiffs allege that the Individual Defendants knew**

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definition of a forward-looking statement includes any statement of the assumption underlying or relating to any statement described in subparagraph (A), (B), or (C). 15 U.S.C. § 78u-5(i)(1)(D) [emphasis added]. The opinion quotes Webster's for the definition that an "assumption" is "the act of taking for granted or supposing that a thing is true." Webster's Third New International Dictionary (1981). Id. n.9. Harris states that if any of the individual sentences within the larger statement describe known facts which were allegedly false, "we could easily conclude that that smaller non-forward-looking statement falls outside the safe-harbor. But the allegation here is that the list *as a whole* misleads anyone reading it for an explanation of the [Company's] projections." Id. at 806. Conversely, in this case plaintiffs address components of the various larger statement and analyze why a component is allegedly false. Further, Harris specifies that a list or explanation will only qualify for this treatment [treating mixed lists as forward-looking] if it contains assumptions underlying a forward-looking statement. Id. at 807.

Defendants cannot convert a larger statement containing a series of misstatements about current factual conditions into one forward-looking statement simply by including one statement that is clearly forward-looking. A larger statement can be divided into component parts and analyzed. In this case since most of the components of the above statements are statements of current facts, this court details which specific components of the larger statements are forward-looking and clearly non-actionable. See In re Lason Sec. Litig., 143 F. Supp.2d 855, 860 (E.D. MI. 2001) (finding that false statements were mixed with forward-looking statements, yet "the actionable statements were based on fraudulent historical and current facts.")

[12] This following specific component of a larger statement is not actionable: Statement **A**–"We believe that we will be the number one player in this space."

that various public statements were false when made. (Am. Compl. ¶¶ 86-90). Plaintiff may establish a strong inference of scienter by alleging that defendants knew or had access to information suggesting that their public statements were not accurate. Novak, 216 F.3d at 311. Given the positions of the Individual Defendants in USIT, plaintiffs have alleged that they knew specific facts and had access to particular information which suggested that their public statements were inaccurate. Tel-Save Sec. Litig., 1999 WL 999427, at *5.

As to Statements (P), (Q), (S), and (U), which concern demand for USIT's services, plaintiffs allege that at the very time defendants made statements concerning "the healthy demand" for USIT's services and its "strong business condition," defendants were well aware that sales to large, established traditional companies were being negatively impacted by longer sales cycles, of the reduced demand by these companies for USIT's services due to USIT's weakness in back-end integration, and of existing and prospective clients' decisions to use more established companies or "Big 5" consulting companies rather than USIT, for example, USIT was aware that large clients such as AIG and Citigroup were dissatisfied with the work performed by USIT. (Am. Compl. ¶ 90.) Similarly, as to Statement (O) pertaining to the satisfaction of the $80 million

Soft Plus note, plaintiffs allege that contrary to defendants' representation that "one of the uses of the proceeds, if you will, will be the satisfaction of the debt that is part of the Soft Plus merger," the Company was aware, at the time this statement was made, that no funds raised in the Secondary Offering would be used to satisfy the note. (emphasis added) (Id. ¶ 43.)

Plaintiffs also allege that the scope and timing of the stock sales by the Individual

Defendants supports an inference that the defendants schemed to artificially inflate USIT's stock price to sell their own shares. (Am. Compl. ¶ 91.) Consistent with third circuit precedent and Novak, plaintiffs pled the substantial proceeds the Individual Defendants received from the sale of USIT stock in order to show that the Individual Defendants benefitted in a concrete and personal way from the fraud. Novak, 216 F.3d at 311. On the days immediately following Mr. Zarrilli's remarks in an April 25, 2000 RadioWallstreet.com interview, (April 26, 27, and 28), Statements (R), (S), and (V), Mr. Zariili sold 51, 500 shares of his USIT stock for proceeds of $858, 419 and on May 1, 2000 sold 8, 500 shares for $144, 942; Mr. Pulier sold 128, 000 shares for proceeds of $2.14 million and on May 1, 2000, sold an additional 21, 500 shares for proceeds of $366, 618. (Am. Compl. ¶¶ 55-58.)

Similarly within days of Mr. Zarrilli's remarks in a May 2, 2000 RadioWallstreet.com interview, Statements (T) and (W), on May 17, 2000 Mr. Shulman sold 25, 000 shares for proceeds of $352, 000 and on May 24, 2000, he sold an additional 10, 000 shares for proceeds of $100, 300. (Am. Compl. ¶ 63.) These were the first times any of the Individual Defendants sold USIT stock.

The court finds that for each challenged statement, plaintiffs have alleged a strong inference of scienter with particularity to survive a motion to dismiss.

D. Control Person Liability Under § 20(a)(Count II)

Plaintiffs allege that the Individual Defendants acted as controlling persons of USIT for purposes of Section 20(a) liability. Section 20(a) of the Exchange Act imposes joint and several liability on any persons who controls a "person"liable under any provision of the Exchange Act.

15 U.S.C. § 78t(a). Section 20(a) requires proof that "one person controlled another person, but also that the 'controlled person' is liable under the Act." Tel-Save, 1999 WL 999427, at *6 (quoting Aetna, 34 F. Supp.2d at 956.)

Having decided that plaintiffs have sufficiently alleged a primary violation by USIT of Section 10(b) of the Exchange Act, the court now has to decide whether plaintiffs have alleged sufficient control by the Individual Defendants for Section 20(a) purposes. Tel-Save, 1999 WL 999427, at *6.

The heightened pleading requirements of Rule 9(b) do not apply to claims under Section 20(a). Id. Allegations that "support a reasonable inference that [defendants] had the potential to influence and direct the activities of the primary violator" suffice to plead control person liability. Id. (quoting In re Health Management, Inc., Sec. Litig., 970 F. Supp. 192, 205 (E.D. N.Y. 1997).

Plaintiffs have met this less-stringent pleading requirement. They have alleged that by virtue of these defendants' "high-level positions, substantial stock holdings, participation in and/or awareness of USIT's operations...the Individual Defendants had the power to influence and control and did influence and control, directly or indirectly, the decision-making of USIT, including the content and dissemination of the various statements which plaintiffs contend are false and misleading. Each of the [Individual Defendants] was provided with or had unlimited access to copies of USIT's internal reports, press releases, public filings and other statements alleged by plaintiffs to be misleading prior to and /or shortly after these statements were issued and had the ability to prevent the issuance of the statements or cause the statements to be corrected." (Am. Compl. ¶ 106.) Through these contentions, plaintiffs have alleged sufficient

control by the Individual Defendants over USIT to state a claim under Section 20 (a).

V. Conclusion

For the reasons discussed above, defendants' motions to dismiss Counts III-V against all defendants are granted. These counts are dismissed with prejudice. The Individual Defendants' motion to dismiss Counts I-II is granted in part and denied in part.

An appropriate order follows.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

IN RE: U.S. INTERACTIVE, INC.	:	CLASS ACTION
SECURITIES LITIGATION	:	No. 01-CV-522
	:	
	:	
	:	
	:	

ORDER

AND NOW, this ___ day of August, 2002, upon consideration of the Motion by the Individual Defendants to Dismiss Counts I-II, the Motion by the Individual Defendants and Director Defendants to Dismiss Counts III-V, and the Motion by the Underwriter Defendants to Dismiss Counts III-IV, and the respective responses thereto, as well as oral argument on the motions, it is hereby ORDERED as follows:

(1) The Motion by the Individual Defendants to Dismiss Counts I-II, Docket #39, is GRANTED IN PART and DENIED IN PART;

(2) The Motion by the Individual Defendants and Director Defendants to Dismiss Counts III-V, Docket #40, is GRANTED;

(3) The Motion by the Underwriter Defendants to Dismiss Counts III-IV, Docket #41, is GRANTED;

(4) All claims against the Director Defendants and

Underwriter Defendants are DISMISSED WITH PREJUDICE. These Defendants are DISMISSED from this matter; and

(5) A scheduling conference shall take place on September 9, 2002 at 4:00 p.m. in Chambers, Room 17614, United States Courthouse.

BY THE COURT:

_____

JAMES T. GILES C.J.

copies by FAX on

to

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