No. 08-2452

UNITED STATES COURT OF APPEALS
for the
EIGHTH CIRCUIT

IN RE 2007 NOVASTAR FINANCIAL, INC. SECURITIES LITIGATION

DR. KEVIN LESTER, on behalf of himself and all others similarly situated,

Appellant,

v.

NOVASTAR FINANCIAL, INC., ET AL.,

Appellees.

Appeal from the United States District Court for the
Western District of Missouri
Master File No. 07-0139-CV-W-ODS
The Honorable Ortrie D. Smith

BRIEF OF APPELLEES

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I. INTRODUCTION AND SUMMARY OF ARGUMENT

This case, like so many others this Court has seen in recent years, sought to allege a claim of securities fraud with a lengthy complaint that spent dozens of pages selectively quoting from or characterizing a company's public statements and then claiming indiscriminately that all of those statements were false because they did not disclose a hypothesis of wrongdoing created by plaintiff's attorneys. At its core, however, plaintiff's tactic failed for four fundamental reasons.

First, the hypothesis of wrongdoing — constructed from the anonymous statements of so-called "confidential witnesses" ("CWs") — even if accepted as true, did not render false or misleading any of the company's public statements.

Second, the CW statements did not permit plaintiff to plead with the requisite particularity that any defendant acted with scienter.

Third, plaintiff's hypothesis ignored the myriad cautionary warnings the company had disseminated about its future prospects.

And, fourth, plaintiff's hypothesis did not permit him to allege that any loss he may have suffered was caused by anything he alleges was false or misleading.

These central defects in plaintiff's attempt to plead fraud have much

in common with the many recent cases in which this Court has affirmed dismissals with prejudice of similarly conclusory speculations of "fraud." But here there was an even stronger basis for the district court's dismissal The defendant company, NovaStar Financial, Inc. ("NovaStar") is a subprime lender whose fortunes declined in lockstep with an entire industry battered by the housing and credit meltdown that has roiled the nation's financial markets since early 2007. In the light of the allegations of plaintiff's complaint, the actual disclosures made by NovaStar, and the turbulent environment that provides context to those allegations and disclosures, the most plausible explanation for the February 2007 drop in NovaStar's stock price is not fraud, but rather an industry-wide phenomenon from which no participant was able to escape.

Plaintiff centers his hypothesis of fraud on the claim that NovaStar's February 20, 2007 announcement of both prior-year results and future prospects (the "February Announcement") constituted a revelation that the company's internal controls were "in shambles" (AOB 4). But, in truth, one searches the February Announcement in vain for any hint of such a statement. Indeed, one searches NovaStar's prior announcements in vain for any hint of a statement that such a revelation would have rendered false or misleading in any event.

The complaint here was even worse than the conventional "puzzle style" of pleading that the courts routinely condemn, *i.e.*, a barrage of alleged

misrepresentations followed by a "CW story" that purports to constitute "the truth," without anything connecting a particular alleged statement to a particular alleged fact that supposedly rendered it false or misleading. Here, the usual defects were compounded by the fact that plaintiff ignored or mischaracterized NovaStar's actual disclosures — indeed, even on appeal he refuses to acknowledge NovaStar's multitude of risk disclosures — and then sought to rely on a CW story that did not contradict the company's actual statements in any event.

In reality, the record before the district court established without contradiction that the heart of NovaStar's February Announcement was that the company did not expect to earn taxable income in the foreseeable ***future***. Far from admitting or even suggesting that any of NovaStar's prior statements were false, the February Announcement's report of the company's historical results ***exceeded*** analysts' expectations (Ap. 235-245).[1] While plaintiff cites analyst comment that the February Announcement was "inexcusable" and "unfathomable," viewing the actual comment shows that it was directed, not at any suggestion of prior misstatement, but only at NovaStar's gloomy prediction of its future in the light of the industry-wide subprime meltdown (*Id.)*.

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[1] We refer to pages in Appellees' Separate Appendix as "Ap. ___;" pages in Appellant's Separate Appendix as "ASA ____" (as did appellants); pages in the district court's opinion attached as an addendum to Appellant's Opening Brief ("AOB") as "ADD ___" (as did appellants); and pages from documents included in the Clerk's Docket below but not in either party's separate appendix as "CD ___:

As we detail below, plaintiff was unable to satisfy any of the fundamental requirements for pleading falsity, scienter or loss causation in a claim of securities fraud. Nor was plaintiff able to show the district court how he might have satisfied those requirements if given leave to amend, and he has done no better here. The judgment of dismissal with prejudice should be affirmed.

II. STATEMENT OF ISSUES

Appellees agree with appellant that this appeal raises the following issues:

1. Whether the court below erred in holding that plaintiff had failed to allege with the requisite particularity any materially false or misleading statement or omission. *In re: Cerner Corp. Sec. Litig*., 425 F.3d 1079, 1083 (8th Cir. 2005); *In re: Hutchinson Tech., Inc. Sec. Litig*., 2008 U.S. App. LEXIS 16538 (8th Cir. August 5, 2008); *Kushner v. Beverly Ent., Inc*., 317 F.3d 820, 829 (8th Cir. 2003); *In re: AMDOCS Ltd. Sec. Litig*., 390 F.3d 542, 549 (8th Cir. 2004) (concurring op. of Wollman, J.).

2. Whether the court below erred in holding that plaintiff had failed to allege with the requisite particularity any cogent and compelling facts giving rise to a strong inference of scienter. *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 127 S. Ct. 2499 (2007); *Cerner*, 425 F.3d at 1085; *In re Ceridian Corp. Sec*.

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___" (using the district court's docket number as did appellants).

Litig., 2008 U.S. App. LEXIS 19289 (8th Cir. Sept. 11, 2008).

3. Whether the court below erred in denying plaintiff leave to further amend his complaint. *Cerner,* 425 F.3d at 1086; *In re: K-tel Int'l Inc. Sec. Litig*., 300 F.3d 881, 899 (8th Cir. 2002); *Cornelia I. Crowell GST Trust v. Possis Medical, Inc*., 519 F.3d 778, 784 (8th Cir. 2008).

Beyond the issues identified by appellant, this appeal also raises two additional issues. While the district court did not need to reach these issues in light of its dismissal on other grounds, the judgment below may be affirmed "on any basis supported by the record." *K-tel,* 300 F. 3d at 889. Here, the parties fully briefed below the following two additional issues that provide alternate bases for affirmance:

4. Whether NovaStar's extensive risk disclosures entitle it to the protection of the Reform Act's "safe harbor" protection for forward-looking statements and/or the protection of the "bespeaks caution" doctrine. *In Re NVE Corp. Sec. Litig*., 551 F. Supp. 871 (D. Minn. 2007), *aff'd,* 527 F. 3d 749 (8th Cir. 2008); *Parnes v. Gateway 2000, Inc.,* 122 F. 3d 539, 548-49 (8th Cir. 1997); *AMDOCS*, 390 F. 3d 542, 545-48.

5. Whether the complaint failed to adequately plead the requisite element of loss causation. *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. 336 (2005); *Metzler Investment GMBH v. Corinthian Colleges, Inc.*, 2008 U.S. App.

LEXIS 18226 (9th Cir. August 26, 2008); *Schaaf v. Residential Funding Corp*., 517 F. 3d 544, 550 (8th Cir. 2008).

III. STATEMENT OF THE CASE

On February 20, 2007, NovaStar publicly announced its financial results for the fourth quarter and full year 2006 (Ap 235-245). Despite the rapidly failing environment for subprime lenders like NovaStar, the company was able to report a 21% increase in nonconforming loans in 2006 over 2005 (*Id*.). At the same time, however, NovaStar reported that it expected to recognize little if any taxable income over the next five years and that, given the current outlook and constraints, management was evaluating whether it was in shareholders' best interest to retain the company's REIT status beyond 2006 *Id*.[2]

Following NovaStar's February 20 announcement (the "February Announcement"), its share price fell 42% the next day (Ap 266-275). Two days later, the first of eight class action lawsuits was filed against NovaStar and three of its officers, CEO Scott Hartman, President and COO Lance Anderson and CFO Gregory Metz (CD 1).

Following consolidation of the eight cases and the appointment of

[2] NovaStar operated as a Real Estate Investment Trust, or REIT, in the years prior to 2007, thereby requiring it to distribute at least 90% of its taxable income to investors each year, with that income being taxed only at the investor level (ASA 27-28 ¶3). The poor outlook for future taxable income as of February 2007 meant that the tax benefits ordinarily created by REIT status were unlikely to be of use going forward (Ap 235-245).

lead plaintiff and lead counsel (CD 45, 53), lead plaintiff filed a 104-page consolidated complaint in October 2007 (ASA 24-131). The consolidated complaint alleged that defendants had violated the federal securities laws by claiming that NovaStar had strong internal controls when in fact they were "in shambles" (AOB 4).

Defendants moved to dismiss the consolidated complaint, pointing out that (a) plaintiff had not alleged with the requisite particularity any material misstatement or omission; (b) plaintiff had not alleged the "cogent and compelling facts" necessary to establish a "strong inference" of scienter; (c) NovaStar's extensive risk disclosures entitled it to the protection of the Reform Act's "safe harbor" and the "bespeaks caution" doctrine for forward-looking statements; and (d) plaintiff had failed to plead loss causation (CD 70, 74). Defendants also pointed out that the individual officer defendants could not have "controlling person" liability in the absence of a viable claim against NovaStar (CD 74) and supported their motion with a request for judicial notice of public documents establishing NovaStar's risk disclosures and stock price history and establishing the widespread meltdown of the subprime lending market in which NovaStar operated (CD 72, 86, Ap. 1-649).

The district court, Hon. Ortrie D. Smith, granted defendants' motion to dismiss without leave to amend on June 4, 2008 (ADD 1-8) and entered

judgment in favor of defendants that same day (ADD 9).

The district court's dismissal order, after summarizing the Reform Act's pleading requirements as articulated by the Supreme Court[3] and by this Court,[4] addressed in detail the consolidated complaint's failure to plead any particularized facts that specified allegedly false statements, indicated why any statements by defendants were false or misleading, or gave rise to a strong inference of scienter.

First, the court noted that, despite its length, the consolidated complaint specified neither the allegedly misleading statements nor why they were supposedly misleading. By presenting a broad, general picture in defiance of the Reform Act, the plaintiff could only "create an illusion of detail and insinuate the existence of fraud …" (ADD 3). The court noted that paragraphs 103-55 of the complaint consisted largely of financial data that plaintiff broadly characterized as false statements without ever alleging in detail why any of it was incorrect (ADD 4).

As for the "why" component of pleading falsity, the court pointed out that plaintiff posited all of these 35 pages of quoted statements as false simply by saying they concealed five highly generalized "facts" alleged in paragraph 157,

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[3] *Tellabs*, 127 S. Ct. at 2509.

[4] *Kushner*, 317 F. 3d at 824; *K-tel*, 300F. 3d 881; *Fla. St. Bd. of Admin v. Green Tree Financial Corp.*, 270 F. 3d 645, 660 (8th Cir. 2001).

i.e., that NovaStar supposedly lacked internal controls, failed to account for an adequate allowance for loan losses, would need to tighten underwriting guidelines in light of the deterioration and volatility of the subprime mortgage market, had no reasonable basis for predicting that it could maintain its REIT status, and was creating an undue risk of loan defaults by deviating from underwriting standards (ADD 4).

Relying on this Court's opinion in *Cerner*, 425 F. 3d at 1083-84, the court highlighted the absence of any necessary inconsistency between a company's allegedly changing or weakening its internal controls or underwriting standards and still having "strong" or "effective" controls or standards; nor was there any alleged connection between any changes at NovaStar and the company's later misfortunes, especially in light of the economic downturn pled by plaintiff himself (ADD 5). Similarly, the claim that the company may have incorrectly believed its reserves to be adequate does not mean a false statement was made if they eventually prove to be inadequate (*Id*.). Setting aside the wisdom of relying on "confidential witnesses" for such subjective matters, said the court, plaintiff had not explained how those CWs' alleged reports demonstrated the falsity of any particular public statement by NovaStar (*Id*.).

As for plaintiff's generalized claim that NovaStar violated GAAP by understating reserves and loan loss provisions, the court noted that "nobody—the

SEC, NovaStar's auditors or anyone else—has suggested NovaStar should or must restate its financial reports" (*Id.*). Simply failing to plan sufficiently for future events does not mean that NovaStar's accounting provisions were "false;" as the court put it, plaintiff "fails to identify a single false entry in the Company's financial statements, nor does he identify the 'truth' that should have been disclosed. This is not a case in which the defendants falsified or 'cooked' the books" (ADD 5-6). Companies "are not expected to be clairvoyant and bad decisions do not constitute securities fraud," as this court held in *K-tel*, 300 F. 3d 891 (ADD 6).

The district court was equally emphatic in concluding that plaintiff failed to allege scienter. Relying on "confidential witnesses," plaintiff had contended that defendants knew about or recklessly disregarded weakened underwriting practices through regular meetings and reports discussing the adverse effects of policy changes and ways to improve the company's operations (ADD 6). But that conduct is normal and expected and does not permit an inference of fraudulent intent; "management is supposed to review results and search for ways to improve operations, and this customary endeavor does not indicate an intent to deceive when positive information is disseminated" (ADD 6-7). Rather than giving rise to an inference that is "cogent and at least as compelling as any opposing inference one could draw from the facts alleged" (*Tellabs*, 127 S. Ct. at

2509-10), plaintiff's allegations here were "more consistent with a company and executives confronting a deterioration in the business and finding itself unable to prevent it than they are with a company and executives recklessly deceiving the investing community" (ADD 7).

Finally, the court noted that plaintiff had not addressed defendants' contention that any amendment to the complaint would be futile (ADD 7).[5] Since nothing in the consolidated complaint contained any suggestion that any material information was concealed or that any defendant acted with fraudulent intent, there was no reason to think that further or different pleading would create the necessary inferences (ADD 8).[6]

Plaintiff timely appealed from the judgment of dismissal on July 1, 2008 (CD 92).

IV. STATEMENT OF FACTS

NovaStar, headquartered in Kansas City, is a specialty finance company whose business units historically originated, invested in, and serviced residential nonconforming mortgage loans, *i.e.*, "subprime" mortgage loans that do

[5] Plaintiff disputes the court's statement by noting that a footnote in his brief had requested leave to amend if the complaint were dismissed (AOB 7). But neither in the footnote nor elsewhere had plaintiff ever suggested ***how*** he could amend his complaint to state a cognizable claim.

[6] In light of the absence of falsity and the absence of scienter, the district court did not address defendants' additional showings that plaintiff had not pled loss causation and that NovaStar's copious risk disclosures invoked the protections of

not meet the criteria for conventional loans to be owned or guaranteed by government-sponsored entities such as Fannie Mae and Freddie Mac (ASA 27, 34 ¶¶ 2, 22; Ap 38). NovaStar also managed a long-term mortgage asset portfolio consisting of subprime loans acquired primarily from its wholly-owned subsidiary, NovaStar Mortgage, Inc., and mortgage securities retained in securitization transactions. Prior to 2007, NovaStar regularly securitized the mortgage loans it originated by pooling mortgage loans to serve as collateral for asset-backed bonds (*Id.*). From these securitizations, NovaStar generally retained certain mortgage securities that primarily represent the right to receive the net cash flows of the underlying mortgage loan collateral in excess of bond expenses and cost of funding (*Id.*).

The subprime mortgage market includes loans to borrowers with high credit risk and high loan-to-value ratios – *i.e.*, a high mortgage loan amount compared to the value of the underlying property. While this market has existed since the early 1970s, it has grown substantially in the last decade. Some of the beneficiaries of this market-wide up-swing were those who invested in NovaStar securities. However, originating, managing and securitizing subprime loans is an inherently risky business. NovaStar made certain that it alerted investors and would-be investors to that risk. NovaStar bluntly cautioned from the beginning of

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the Reform Act's "safe harbor" and of the "bespeaks caution" doctrine.

the putative class period that:

- ***Changes in interest rates may harm our results of operations***. Our results of operations are *likely* to be harmed during any period of unexpected or rapid changes in interest rates.

- Loans made to nonconforming mortgage borrowers entail relatively higher delinquency and default rates which would result in higher loan losses. Lenders in the nonconforming mortgage banking industry make loans to borrowers who have impaired or limited credit histories, limited documentation of income and higher debt-to-income rations than traditional mortgage lenders allow… Any failure by us to adequately address the delinquency and default risk associated with nonconforming lending could harm our financial condition and results of operations.

- ***Our Option ARM mortgage product exposes us to greater credit risk***. There has been an increase in production of our loan product which is characterized as an option ARM loan… Federal banking regulators have expressed serious concerns with these programs and an intent to issue guidance shortly concerning offerings of these products. In addition, already one agency (Standard & Poor's) has required greater credit enhancements for securitization pools that are backed by option ARMs.

- ***A prolonged economic slowdown or a decline in the real estate market could harm our results of operations***… Because we make a substantial number of loans to credit-impaired borrowers, the actual rates of delinquencies, foreclosures and losses on these loans could be higher during economic slowdowns… [A]ny material decline in real estate value would weaken our collateral loan-to-value ratios and incr*e*ase the possibility of loss if a borrower defaults.

(Ap 98-99, 101) (emphasis in original). Thus, investors were cautioned that NovaStar's business, at the best of times, depended on nonconforming loans to borrowers with poor credit histories and that this business could be materially damaged if either interest rates increased or real estate values decreased. And just

after defendants issued this warning, it happened that both of these risk factors came to pass, sending the entire subprime market – including NovaStar – into a spiral.

The primary risk in the subprime credit market relates to credit quality. As NovaStar warned, when interest rates rise and the economy slows, subprime borrowers are more likely to default than prime borrowers. In June 2004, the Fed began to raise the short-term target rate, eventually taking it to 5.25 percent, where it hovered throughout the putative class period (Ap 330-334). Such a boost usually leads to a corresponding rise in long-term rates, which are important to rates on mortgage loans. This time it did not, due to the "global savings glut" of overseas capital infusion (Ap 335-338). Prior to 2006, several years of growth in the housing market meant that even when a subprime borrower's personal finances were stressed, the increase in home values provided the option to refinance or even sell instead of going into delinquency. The resulting low delinquency rate was ephemeral. When home prices began falling in 2006 and long-term interest rates began to rise, the market took notice and the price of NovaStar securities (and that of NovaStar's competitors) began to fall.

Broad economic factors fueled NovaStar's price decrease, shared as it was across the industry. Of the top 10 subprime companies, none has remained unscathed from this market meltdown:

Top 10 Subprime Originators, 2006

Rank	Company	Status
1	HSBC Financial	2/7/07: Warns that its charge for bad debts would be more than $10.5 billion for 2006. 3/29/07: Announces US subprime operation would be scaled back "significantly."
2	New Century Financial	4/2/07: Declares bankruptcy.
3	Countrywide Financial	9/7/07: Cuts up to 12,000 jobs.
4	CitiMortgage	11/4/07: Announces estimated write-downs ranging from $8 billion to $11 billion in its subprime unit.
5	Fremont Investment & Loan	5/22/07: After selling off most of its loans, Fremont General Corp. announces the sale of its real estate lending business, Fremont Investment & Loan.
6	Ameriquest Mortgage	8/31/07: ACC Capital Holdings announces the sale of its wholesale origination lending unit Argent Mortgage, its servicing unit AMC Mortgage Services and shuts down its retail lending unit Ameriquest Mortgage.
7	Option One Mortgage	12/4/07: H&R Block, Inc. closes Option One Mortgage, its subprime lending unit after the sale to Cerberus Capital Management LP unraveled.
8	Wells Fargo Home Mortgage	7/26/07: Wells Fargo announces that its mortgage division, Wells Fargo Home Mortgage, will stop making subprime mortgages through brokers.

Rank	Company	Status
9	First Franklin Financial Corp.	9/5/06: National City Corp. announces sale of First Franklin, its subprime mortgage unit, to Merrill Lynch.
10	Washington Mutual	12/11/07: After dismantling much of its subprime mortgage business, the company announces that it will get out of the subprime business altogether, closing 190 offices and laying off more than 3,000 workers.

(Ap 357-392)

NovaStar explicitly warned of the possibility of this outcome and the materially negative impact it could have on the Company's financial results. NovaStar also specifically cautioned that, despite its best efforts, with such risky loans to such delicate borrowers:

- Our efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans and, as a result, our results of operations may be affected… [Q]uality control and loss mitigation operations may not be successful in limiting future delinquencies, defaults and losses. Our comprehensive underwriting process may not be effective in mitigating our risk of loss on the underlying loans…. The frequency of defaults and the loss severity on loans upon default may be greater than we anticipated…. Expanded loss mitigation efforts in the event that defaults increase could increase our operating costs. To the extent that unforeseen or uncontrollable events increase loan delinquencies and defaults, our results of operations may be adversely affected.

- We attempt to manage [risks inherent to subprime loans] with risk-based mortgage loan pricing and appropriate underwriting policies and loan collection methods. However, if such policies and methods are insufficient to control our delinquency and default risks and do not result in appropriate loan pricing, our business, financial condition,

liquidity and results of operations cold be significantly harmed. (Ap 214).

NovaStar similarly warned that when "making budgeting and other decisions, we use projections, estimates and assumptions based on our experience with mortgage loans. Actual results and the timing of certain events could differ materially in adverse ways from those projected, due to factors including changes in general economic conditions, fluctuations in interest rates, fluctuations in mortgage loans prepayment rates and fluctuations in losses due to default on mortgage loans" (Ap 100).

Further, NovaStar's risk factors specifically identified as a material risk "changes in assumptions regarding estimated loan losses and fair value amounts" (Ap 18-25). NovaStar cautioned that its allowance for loan loss reserves was based "on the assessment by management of probable losses incurred based on various factors affecting [the Company's] mortgage loan portfolio… The allowance is maintained through ongoing adjustments to operating income. The assumptions used by management regarding key economic indicators are highly uncertain and involve a great deal of judgment" (Ap 177). The Company further warned:

- We estimate future cash flows from [our] securities and value them utilizing assumptions based in part on projected… credit losses. It is extremely difficult to validate [these] assumptions… [They] are highly dependent upon the reasonableness of our assumptions and the

> predictability of the relationships which drive the results of the model. Such assumptions are complex as we must make judgments about the effect of matters that are inherently uncertain

(Ap 211).

Plaintiff attempts to portray NovaStar as a company whose stock price was artificially boosted by false announcements of financial results and announcements of successful securitizations. But he cannot question that the securitizations were in fact successful (and never had a significant impact on NovaStar's stock price or trading volume) and that NovaStar's announcements of its results were in fact met with ***decreases*** in its stock price. Indeed, NovaStar's stock price had dropped by 53% during the putative class period; and in just the two months between NovaStar's announcements of securitizations on December 6, 2006 and February 8, 2007, the stock price dropped by 41.5% (Ap 266-275).

Throughout the putative class period, NovaStar constantly and forcefully warned of a challenging credit market and made no guarantees that it was immune to market conditions. Although appellant attempts to characterize NovaStar's February Announcement as an admission that its internal controls were "in shambles," a reading of the actual Announcement only makes clear that the Company's earnings were indicative of the challenging sub-prime environment generally and that the Company was launching a plan to remain viable during expected worsening conditions. Among the news that appellant highlights in the

Announcement:

- The Company had reported a net loss of $0.39 per share for the fourth quarter;
- The Company expected to realize little REIT taxable income in 2007-2011 and was considering shedding its REIT status;
- The Company had sufficient liquidity to meet operational requirements and its dividend carryover payout obligation;
- During 2007, the Company "may commit additional equity to purchase or retain mortgage securities. These securities are rated higher in the capital structure than [the Company's] traditional residual investments and [they] intend to finance these securities with CDO debt;"
- The Company planned to enhance its internal controls to "ensure that the 2007 originations perform better than 2006."

(Ap 235-245).

Thus, the February Announcement did not announce any sort of restatement or reexamination of NovaStar's financial statements, suggest any type of misconduct, or imply that the Company's operational plans for the future were anything other than a current strategy to account for more trying times.

Nor could NovaStar's February Announcement have "shocked" readers about the deterioration in loan quality that NovaStar, like other subprime lenders, was beginning to experience as the subprime meltdown took hold. NovaStar had anticipated these concerns by reporting in its third quarter 2006

earnings announcement and 10-Q.[7] In both, NovaStar observed increasing repurchase requests from whole loan buyers and said it was preparing for a more adverse credit market by increasing multiple categories of reserves and loss assumptions. By that time, the Company's press releases were warning of a "more adverse credit market" which already had "significantly affected net income, including loss provisions for whole loan re-purchasers, losses on derivatives held in their trading account, and mortgage securities impairments" (Ap 126-134). Repeatedly and quite specifically, NovaStar warned about the increasing uncertainty and risks endemic to its industry:

- Higher expected credit losses due to housing appreciation concerns contributed to impairments increasing by $3.2 million in 2006 from 2005. As can be seen by our increase in credit loss assumptions as well as our high provision for credit losses, we are beginning to see the effects of a cooling housing market on mortgage credit quality.

- The increase in the provision for credit losses for the [third quarter, 2006] from the same period in 2005… [was] approximately $18.8 million… due to $2.7 billion of securitizations… Our provision for credit losses significantly offset the positive impact to interest income yielded by these transactions.

- Various industry publications predict that growth in the nonconforming origination market will be relatively flat for the remainder of 2006 and beginning of 2007 with some publications predicting a decline. Our ability to increase the size of our securitized

[7] As early as NovaStar's May 4, 2006 press release, the Company cautioned that actual results could differ materially from the Company's projections because of "increases in prepayment or default rates on our mortgage assets; interest rate fluctuations on our assets that differ from our liabilities;… the stability of residual property values;… [and] the impact of general economic conditions" (Ap 18-25).

mortgage loan portfolio, which drives our mortgage securities portfolio,… could be impaired under these tighter conditions.

- Mortgage banking profit margins have lowered as a result of interest rates rising faster than the coupons on newly originated mortgage loans ... [M]argins could continue to tighten if short-term interest rates increase and competitive pressures hold coupons on mortgage loans flat… Additionally, the mortgage securities we are currently adding to our portfolio are yielding lower returns than our older securities as a result of these compressed margins.

- Rising home prices have begun to cool along with housing growth rates after a multiyear boom… This could have a significant impact on origination growth in our mortgage lending segment, as well as, prepayment speed and credit loss assumptions…

- While we continue to believe our best economic execution is realized from structuring a securitization as a sale for both GAAP and tax purposes, the current economic environment has made it necessary to add additional assets to our REIT balance sheet.

(Ap 168-170).

Likewise in its November 8, 2006 conference call with investors (Ap 616, 618-619), NovaStar said:

> S***o I think we're seeing delinquencies tick up a little bit and that information is posted on our website really on a securitization-by-securitization basis. And again, as we go through and do the analysis we've reflected our changes really in our loss assumptions that are in the Q.***
>
> So as we look forward ***I think one of the themes is we clearly are looking at data that comes in from a combination of delinquencies, severities, housing price data and we're going to let that data continue to lead us to as we model out our loss assumptions going forward***. And obviously we monitor that on a monthly and a quarterly basis.

> ***I think—we've tightened our guidelines somewhat and we've tightened up on our exception making process*** and that obviously would have a negative impact on volume.
>
> And more specifically, ***our provision for credit losses in Q3 was $10.3 million versus 100,000 during the period last year and $6 million in the second quarter of 2006***. And again, this increase is indicative of the steps we've been taking during the quarter to prepare our balance sheet for a more adverse credit environment.

NovaStar made similar statements in its November 7, 2006 press release, also related to the third quarter 2006. Among other things, the release noted:

> Scott Hartman, NovaStar's Chief Executive Officer commented: "***During the third quarter we took several steps to prepare for a more adverse credit market***. First, we increased reserves for our on-balance sheet transactions. Second, we increased reserves for loan repurchases for our whole loan sales. Third, we increased loss assumptions in our mortgage securities portfolio, resulting in some impairments and a reduction in unrealized gains (ASA 75-78 ¶ 128, emphasis supplied; emphasis deleted).

In short, investors and analysts knew in early November 2006 that NovaStar was responding to a "more adverse credit market" by increasing reserves and tightening underwriting guidelines. Statements to the same effect more than three months later can hardly have caused the "shock" that appellant describes.

The fact that NovaStar was swept up in an industry-wide meltdown negates any "cogent" or "compelling" inference of fraud at the company. Nor can investors claim to have been blind-sided by anything NovaStar hid in its public statements. During the entire putative class period, NovaStar explicitly warned investors of the risks that ultimately materialized.

V. ARGUMENT

A. STANDARD OF REVIEW

The district court's dismissal is reviewed *de novo*. *Possis,* 519 F. 3d at 781. A district count's denial of leave to amend resting on a holding that amendment would be futile is reviewed for abuse of discretion when based on a finding that no actual amendments to the complaint are possible. *Cerner* 425 F. 3d at 1086. If the holding of futility instead rests on a finding that the complaint, as amended, still fails to state a claim as a matter of law, it is reviewed *de novo*. *Id*.

B. THE REFORM ACT IMPOSES EXACTING PLEADING REQUIREMENTS ON A PLAINTIFF CLAIMING SECURITIES FRAUD

A plaintiff seeking to plead a claim for securities fraud must allege facts sufficient to establish each of the following elements:

1. a material misrepresentation or omission;
2. scienter, *i.e.*, a wrongful state of mind;
3. a connection with the purchase or sale of a security;
4. reliance, often referred to as "transaction causation;"
5. economic loss; and
6. loss causation, *i.e.*, a causal connection between the material misrepresentation and the loss.

Dura, 544 U.S. at 341-42.

After passage of the Private Securities Litigation Reform Act of 1995 (The "Reform Act"), a plaintiff must "state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter." *Tellabs*, 127 S. Ct. at 2504. "The purpose of [the Reform Act's] heightened pleading requirement was generally to eliminate abusive securities litigation and particularly to put an end to the practice of pleading fraud by hindsight." *Kushner*, 317 F. 3d at 829, quoting *In re Navarre Corp. Sec. Litig.*, 299 F. 3d 375, 742 (8th Cir. 2002).

As with other kinds of complaints, the court generally accepts a plaintiff's allegations as true, but with a critical exception: the court must "disregard all 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the [Reform Act]." *Kushner*, 317 F. 3d at 824, quoting *Green Tree*, 270 F. 3d at 660; *K-tel*, 300 F. 3d at 889 (same).

Moreover, the court is not limited to reviewing the complaint in determining whether a plaintiff has stated a cognizable claim. "The court may consider, in addition to the pleadings, materials embraced by the pleadings and materials that are part of the public record." *K-tel*, 300 F. 3d at 889 (internal quotation omitted).

Here, defendants asked the district court to take judicial notice of NovaStar's actual public statements, rather than simply accepting as true plaintiff's characterizations of those statements. Defendants also requested judicial notice of

NovaStar's stock price history and of other documents in the public record that detailed the meltdown that has roiled the housing and subprime lending markets since late 2006 (Ap. 266-275; 331-481). The court below granted the request with the caveat that, while it could take judicial notice of those industry reversals, it would not consider their impact on NovaStar in particular (ADD 2). Plaintiff does not challenge on appeal the district court's granting of the request for judicial notice.

As we detail below, plaintiff in this case failed to allege particularized facts sufficient to plead three of the elements of securities fraud: a false or misleading statement or omission; scienter; and loss causation. In addition, plaintiff's claim was undermined as a matter of law by NovaStar's extensive risk disclosures, both as a statutory matter under the Reform Act's "safe harbor" provisions and by virtue of the "bespeaks caution" doctrine that deprives alleged misstatements of materiality when they are accompanied by meaningful cautionary statements that disclose the risks attendant to forward-looking statements.

C. PLAINTIFF FAILED TO PLEAD WITH THE REQUISITE PARTICULARITY ANY MATERIAL MISSTATEMENT OR OMISSION BY DEFENDANTS

The Reform Act required plaintiff to specify with particularity each allegedly false or misleading statement or omission and to specify the reasons ***why*** each statement was materially false or misleading at the time it was made. *Cerner*,

425 F. 3d at 1083. Instead, plaintiff here reverted to the kind of "puzzle-style" pleading that was common before the Reform Act: reciting a litany of NovaStar's public statements (here in paragraphs 104-56 of the consolidated complaint, ASA 61- 95) and then claiming in conclusory fashion that those statements were false because they failed to disclose the hindsight contentions that plaintiff states in conclusory terms in paragraph 157 (ASA 95-96).[8]

The court below penetrated the puzzle, noting that despite its 100-page, 200-paragraph girth, the generalities populating the consolidated complaint painted only a "very broad picture" that allowed plaintiff "to create an illusion of detail and insinuate the existence of fraud" instead of specifying it with the requisite particularity (ADD 3).

On appeal, plaintiff urges that the court below failed to give him sufficient credit for the statements of "confidential witnesses" collected in paragraphs 31-102 of the consolidated complaint (AOB 45-49). But the "CW story" plaintiff tried to tell failed to allege falsity with particularity for myriad reasons.

First, plaintiff was never able to specify any particular part of NovaStar's public statements that was necessarily rendered false by any of the

[8] This Court in *Ceridian* recently affirmed dismissal of a similarly "sprawling jungle" of a complaint filed by the same lawyers that represent the plaintiff here. 2008 U.S. App. LEXIS 19289 at *7.

alleged CW claims.

As Judge Wollman noted in his concurring opinion in *AMDOCS* (adopted by the panel as an alternative basis for its affirmance of dismissal, 390 F. 3d at 549), the facts alleged in a securities fraud complaint must "***necessarily*** show that the defendants' statements were misleading." *Id*. (emphasis added). But plaintiffs there simply recited a litany of company statements and then, as here, claimed that they were false and misleading only by describing impressions of various problems stated by "confidential witnesses." There, as here, however, the CW statements did not "allege facts that are necessarily inconsistent" with the company's statements. *Id*.; *see also*, *Cerner*, 425 F. 3d at 1083-84 (same).

Second, as this Court pointed out in *Possis*, 519 F. 3d at 783, the opinions of lower-level employees at a company do not establish that different opinions by senior management are necessarily false, citing *Cal. Pub. Employees Ret. Sys.* v. *Chubb*, 394 F. 3d 126, 155 (3d Cir. 2004).

Indeed, as the Seventh Circuit recently noted in *Higginbotham* v. *Baxter Int'l, Inc.* 495 F. 3d 753, 757 (7th Cir. 2007), allegations attributed to anonymous sources must receive a "steep discount" under the Reform Act. "It is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences.

Perhaps these confidential sources have axes to grind. Perhaps they are lying. Perhaps they don't even exist." *Id*.

This Court recently skewered an attempt to rely on "confidential witnesses" by the same lawyers that represent plaintiff here. In *Hutchinson*, plaintiff relied on the alleged statements of senior managers (including the quality engineering manager, the manufacturing supervisor, the plant manager and the human resources manager), 2008 U.S. App. LEXIS 16538. at *8-11, for its claim that the company's return allowances were too low and earnings were correspondingly overstated. *Id*. at *14.

This court affirmed dismissal of the complaint, noting that the CW statements were anecdotal, out of context and made without showing the basis of the CWs' knowledge. *Id*. at 15. As here, nothing in the complaint supported the hypothesis that defendants' allowances were inadequate at the time made. *Id*. at *16. Nor, as here, had the company ever restated its financials to correct allegedly inadequate reserves. *Id*. at *17.

The fact that the company's auditors in *Hutchinson* never required restatement of allegedly inadequate reserves finds a parallel in the district court's observation in this case that "it is noteworthy that nobody – the SEC, NovaStar's auditors, or anyone else – has suggested that NovaStar should or must restate its financial reports" (ADD 5). Similarly in *Kushner*, 317 F. 3d at 829, this Court said

it was telling that the company's outside auditors did not question its accounting practices and that the company received no warnings from the SEC or other regulators that its accounting practices were inappropriate.[9] *See also, Corinthian*, 2008 U.S. App. LEXIS 18226 at *45 (plaintiff's failure to allege that external auditors counseled against challenged accounting treatment undermines any claim of irregularity).

This Court has made clear that attacks on a company's setting of reserves cannot rest on the hindsight observation that the reserves turned out to be inadequate. In *In re: Acceptance Ins. Cos. Sec. Litig.*, 423 F. 3d 899 (8th Cir. 2005), for example, plaintiffs alleged that defendant had established insufficient reserves to account for increased claims stemming from a court decision. *Id.* at 901-02. There, as here, the company's reserves had been blessed by external auditors. *Id*.

This Court agreed with the district court that plaintiffs' allegations of falsity were insufficient because they did not establish inadequacy of the company's estimates ***at the time they were made***. The Court rejected plaintiffs' reliance on later statements about the reserves because "this type of retrospective analysis of awareness cannot be the bases for a claim." *Id.* at 903.

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[9] In *Kushner*, it was undisputed that a company subsidiary had engaged in outright fraud and had pled guilty to criminal charges. Here, in contrast, there has never been a regulatory suggestion that any of NovaStar's conduct during the class

Plaintiff here tries to save his conclusory claim of falsity by urging that his consolidated complaint had alleged statements by NovaStar that its risk-management strategies were continuing to "perform well" despite a difficult interest-rate environment; that NovaStar had seen an increase in loan origination production in the first quarter of 2006 and expected its portfolio to be "relatively stable" for the rest of the year; that NovaStar's loan production in the second quarter was its "highest ever;" that proactive risk management strategies were protecting its portfolio against interest rate risk; that loans were "performing well;" that its "risk management strategies go back to the fundamentals of what we've always done;" and that "we're letting the data lead us" and "we're not projecting that we're going to have anything other than what the data we have right now tells us" (AOB 41-44).

Plaintiff's attempt to portray those statements as "false" is as unavailing in this Court as it was below. In the first place, plaintiff has never alleged or even suggested facts showing any of those statements to be false; nowhere, in the CW story or elsewhere, has he alleged anything that is "necessarily inconsistent" with NovaStar's statements, as required by, *e.g.*, *Cerner* and *AMDOCS*.

Moreover, the theme of plaintiff's CW story, and hence of his appeal,

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period was improper.

is that NovaStar concealed changes in or deviations from its underwriting guidelines. But neither the company statements highlighted in his brief nor those alleged elsewhere in the consolidated complaint ever made representations about underwriting that stand in contrast to anything in the CW story.

Plaintiff's specification of allegedly false statements on appeal relies heavily on statements about risk mitigation. But all of those statements, when read in their entirety, are about interest-rate risk, not credit risk. Nowhere does (or could) plaintiff claim that NovaStar ever said anything misleading about its mitigation of interest-rate risk, or that improper mitigation of interest-rate risk was behind the nationwide subprime meltdown. To the extent that plaintiff's CW story offers opinions about NovaStar's underwriting guidelines, the only risk implicated is credit risk, not interest-rate risk, and plaintiff cannot point to any allegedly false statements that NovaStar made on that subject.

The closest plaintiff comes to alleging any statement by NovaStar about underwriting standards is his reference to NovaStar's warnings about the importance of making "good loans" during the class period (*e.g.*, ASA 64, 68-71 ¶¶108, 116, 118).

Beyond the fact that such a statement is a truism that would be difficult to render false in any case, plaintiff cannot rely on it here for a further reason as well: such statements are the sort of vague puffery that cannot ground a

claim of securities fraud because, among other things, they are immaterial (*i.e.*, incapable of inducing reasonable reliance) as a matter of law. This Court's decisions affirming dismissal of securities class actions frequently note that statements far more concrete than those NovaStar is alleged to have made here are incapable of grounding a fraud claim. Examples include:

> *K-tel*, 300 F. 3d at 897: "significant growth" projection;
>
> *Parnes*, 122 F. 3d at 547: the company "won't compromise financial integrity;" "commitment to create earnings opportunities;" "business strategies would lead to continued prosperity;" "recession-resistant;" prediction of "significant growth";
>
> *Hutchinson*, 2008 U.S. App. LEXIS 16538 at *18-19: "well-positioned";
>
> *In re: NVE Corp. Sec. Litig.*, 551 F. Supp. 2d 871, 893-903 (D. Minn. 2007), *aff'd*, 527 F. 3d 749 (8th Cir. 2008) (affirming "for the reasons stated in the district court's thorough opinion"): "leading the race;" "once in a lifetime;" "important advances;" "Holy Grail;" "close to fruition;" "remarkable progress;" "significant strides;" "strong potential;" "potential to revolutionize;" "good position to capitalize;" "capable;" "passionate belief" in the future; "impressive accomplishment;" "remarkable devices;" "revolutionary;" "answer to a critical need".

Here, none of the vague statements on which plaintiff attempts to rely are necessarily inconsistent with the claims of plaintiff's CWs; even more importantly, however, this Court's opinions uniformly establish that they would be incapable of inducing the reasonable reliance necessary to establish material falsity in any event.

D. PLAINTIFF FAILED TO PLEAD ANY "COGENT AND COMPELLING" FACTS ESTABLISHING THE REQUISITE "STRONG INFERENCE" OF SCIENTER

As the Supreme Court made clear in *Tellabs*, 127 S.Ct. at 2504, "[e]xacting pleading requirements are among the control measures" Congress included in the Reform Act as a "check" against litigation that, "if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law."[10] Those requirements include a plaintiff's obligation to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." *Id*. (quoting the Reform Act).

The Court in *Tellabs* resolved a split among the circuits by holding that, to qualify as "strong" within the meaning of the Reform Act, "an inference of scienter must be more than merely plausible or reasonable – it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." *Id*. at 2504-05. Or, as this Court put it in *Ceridian* just last week, "strong means strong." 2008 U.S. App. LEXIS 19289 at *5.

Quoting this Court's opinion in *Cerner*, the *Tellabs* Court said

[10] The court has described the abuses Congress sought to curb as including "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers." *Id*. at 2508, quoting *Merrill Lynch, Pierce, Fenner and Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006).

Congress "did not merely require plaintiffs to 'provide a factual basis for [their] scienter allegations,'" *i.e.*, to allege facts from which an inference of scienter rationally ***could*** be drawn, but instead to "plead with particularity facts that give rise to a 'strong' – *i.e.*, a powerful or cogent – inference." *Id*. at 2510. Nor can the strength of an inference "be decided in a vacuum;" the inquiry is "inherently comparative" such that "a court must consider plausible nonculpable explanations for the defendant's conduct" as well as those sought by the plaintiff. *Id*.

In this case, plaintiff has struggled both below and in this Court to identify ***any*** plausible inference of fraudulent intent, let alone one that trumps nonculpable explanations for defendants' conduct.

Plaintiffs in securities fraud cases typically point to sale of stock by insiders as evidence of a motive permitting an inference of fraudulent intent. Just as typically, this Court has affirmed dismissals of such claims. *See, e.g.*, *Cerner*, 425 F.3d at 1085; *K-tel*, 300 F.3d at 895-96; *Possis*, 519 F.3d at 783; *Navarre*, 299 F3d at 747.

Here, however, the case is unusual in that none of the individual defendants sold any NovaStar stock during the class period (Ap 276-310). That alone tends to negate any inference of fraudulent intent. *See, e.g.*, *Cerner*, 425 F.3d at 1085; *K-tel*, 300 F.3d at 895-96. As a consequence, plaintiff here was forced to reach for even thinner air in an attempt to plead something from which an

inference of scienter might be drawn.

Plaintiff ultimately settled on the hypothesis that (a) two of the individual defendants were motivated to commit fraud so they could receive, as NovaStar shareholders, the dividends that NovaStar was obligated to distribute in light of its REIT status (AOB 58-60) and (b) NovaStar was motivated to commit fraud so it could close securitizations of mortgage-backed loans during the class period (AOB 57-58).

These speculations collapse both in the light of common sense and in the light of this Court's jurisprudence. It is entirely ***implausible*** to suppose that two of the individual defendants were committing fraud simply to reap the same dividends that all NovaStar shareholders received; indeed, a rational shareholder knowing that the benefit was destined to be short-lived would have dumped his stock upon receiving the undeserved dividend.

Here, in contrast, none of the individual defendants sold any stock, and they suffered the same loss as all other investors when the stock price fell. The courts reject invitations to infer such hypotheses of irrational behavior as plaintiff posits here. *See, e.g.*, *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (affirming dismissal of 10b-5 claim based on allegedly inadequate loan loss reserves; "indulging ready inferences of irrationality would too easily allow the inference that ordinary business reverses are fraud").

This Court has regularly affirmed the dismissal of claims that scienter may be inferred from an executive's desire to maximize incentive compensation. *See, e.g.*, *Cerner*, 425 F.3d at 1085; *Kushner*, 317 F.3d at 830 (noting that "defendants' stock would have been affected by the same downturn in prices as were the investors' stock"); *K-tel*, 300 F.3d at 895 (a desire to increase executive compensation is too generalized to support an inference of scienter).[11]

Similarly, this Court rejects speculation that a company was motivated to commit fraud so it could complete corporate transactions at favorable prices. *See, e.g.*, *Cerner*, 425 F.3d at 1085 (the desire to make a company seem more profitable is "universally held" and not unusual); *K-tel*, 300 F.3d at 894 ("the general desire to maintain a high credit rating or make a company attractive to potential buyers may be 'too thin a reed on which to hang an inference of scienter,'" quoting *Green Tree)*; *Green Tree*, 270 F.3d at 664 (the desire to maintain a high credit rating to permit securitizations at a good price is universally held and does not give rise to an inference of scienter).

Plaintiff also urges that the district court could have inferred scienter

[11] In contrast to these cases, this Court in *Green Tree*, 270 F.3d at 661, said in the pre-*Tellabs* era that an individual defendant's scienter could be plausibly inferred from a compensation package based on a percentage of pre-tax earnings that was set to expire at the end of the year in which the fraud allegedly occurred, where the defendant received $102 million as a result of the later-restated earnings. Plaintiff here points to nothing even remotely approaching the facts of *Green Tree*.

from the importance of NovaStar's underwriting and loan portfolio to the company's continued success (AOB 60-61). But while magnitude may help to render a misstatement material to investors, magnitude is irrelevant where, as here, there was no misstatement at all. In the absence of statements by NovaStar touting its underwriting process that are rendered necessarily false by plaintiff's CW story, the alleged importance of underwriting is an entirely neutral fact in any assessment of scienter.

Equally unavailing is plaintiff's attempt to infer scienter from the CW story itself (AOB 51-56). Inasmuch as the CW story did not establish the falsity of any NovaStar statement, neither can it permit an inference that a false statement was made with scienter.

As the court below noted, no intent to defraud can be inferred from the individual defendants' attendance at meetings in which, according to the CWs, policy changes and ways to improve the company's operations were discussed – such conduct is normal and expected; indeed management is ***supposed*** to search for ways to improve operations (ADD 6-7).[12]

Plaintiff challenges the district court's analysis by claiming that, while such discussion is admittedly "customary" and "normal," it is "***not*** customary to

[12] As the court made clear in *Corinthian*, no inference of scienter can be drawn from a company's "internal reforms" in any event. 2008 U.S. App. LEXIS 18226 at *43-44 n. 12.

then turn around and (falsely) reassure investors that nothing in the company's historical loan-underwriting practices has changed. ***It is securities fraud***!" (AOB 56, emphasis in original). The problem with plaintiff's cry of "fraud," however, is that he can point to no statements in which NovaStar "reassured" investors that nothing in its historical loan-underwriting practices had changed. Unable to point to any such statement at all, plaintiff can hardly urge that it was made with scienter.

The court below was precisely correct in concluding that the complaint here at most alleged mismanagement rather than securities fraud, in that it "reads more like a cautionary tale from a treatise on business management than a charge of knowing misstatements and concealments. Plaintiff has not stated a claim because companies (and their management) are not expected to be clairvoyant and bad decisions do not constitute securities fraud" (ADD 6, citing *K-Tel*, 300 F. 3d at 891 and *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 - 80 (1977)).

E. NOVASTAR'S EXTENSIVE RISK DISCLOSURES ENTITLED DEFENDANTS TO THE PROTECTIONS OF THE REFORM ACT'S SAFE HARBOR AND OF THE "BESPEAKS CAUTION" DOCTRINE

The court below took judicial notice, without objection from plaintiff, of the myriad public statements by NovaStar that repeatedly disclosed risks faced by its business, including the specific risks that ultimately materialized on an

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industry-wide basis (ADD 1-2).

Defendants argued below the protections that these risk disclosures afford to defendants on two grounds. First, NovaStar's risk disclosures entitle defendants to the statutory "safe harbor" embedded in the Reform Act with respect to forward-looking statements that are accompanied by meaningful risk disclosure. Second, those risk disclosures render any alleged misstatements about future prospects immaterial under the judicially created "bespeaks caution" doctrine because a reasonable investor would not rely on the alleged misstatements in light of the disclosed risks (CD 74: 29-35).

The court below did not need to reach either the statutory or judicial version of the protection afforded by meaningful risk disclosure because it concluded that plaintiff had failed to allege either falsity or scienter with the requisite particularity. But because this Court can affirm the judgment below on any basis supported by the record, *K-tel*, 300 F.3d at 889, defendants continue to rely on both the safe harbor and the "bespeaks caution" doctrine. Appellant's Opening Brief, however, is silent on the issue and, remarkably, altogether ignores NovaStar's cautionary statements even though plaintiff never contested the district court's judicial notice of those statements. Both doctrines mandate affirmance in light of the risk disclosures that NovaStar candidly and repeatedly gave to investors.

1. NovaStar's Extensive Risk Disclosures Invoke the Reform Act's Safe Harbor Protections

Congress created a statutory safe harbor in the Reform Act to loosen the "muzzling effect" of potential liability for forward-looking statements. H.R. Conf. Rep. No. 269, 104th Cong., 1st Sess. (1995) at 42. The statutory safe harbor prescribes two ***independent*** bases on which a court must dismiss claims based on forward-looking statements: (1) where they are accompanied by meaningful cautionary language, ***or*** (2) where plaintiff fails to plead or prove they were made with "actual knowledge" of their falsity. 15 U.S.C. § 78u-5(c)(1)(A)(i).

Here, plaintiff's consolidated complaint failed to escape either branch of the statutory safe harbor. Virtually the entire complaint rested on the hypothesis that NovaStar had expressed an overly optimistic view of the future, particularly regarding the adequacy of its loan loss reserves to protect against future defaults. Such reserves are a classic form of forward-looking statement protected by the safe harbor. *See, e.g., Harris v. Ivax Corp*., 182 F.3d 799, 806 (11th Cir. 1999).

The complaint's voluminous quotations from NovaStar's public statements studiously avoided any mention of NovaStar's detailed risk disclosures that accompanied each of these statements. Indeed, despite his concession below that judicial notice of such statements is proper, plaintiff continues to ignore them in his opening brief on appeal—his "statement of facts" is drawn entirely from his consolidated complaint's characterizations and turns a blind eye to NovaStar's

actual disclosures.

The Reform Act does not tolerate such myopia, instead requiring that on a "motion to dismiss… this court ***shall*** consider any statement cited in the complaint and any cautionary statements accompanying the forward-looking statement, which are not subject to material dispute, cited by the defendant." 15 U.S.C. § 78u-5(e) (emphasis added).

Each of NovaStar's press releases and other public statements that plaintiff claims contained misleading reserves or projections identified them as forward-looking statements; specifically cautioned that they were "subject to risks and uncertainties" and that "certain factors can cause actual results to differ materially from those anticipated;" discussed specific, important risks that could materialize; and directed investors to the company's prior public filings for a still more detailed analysis of those risks. *See, e.g.*, Ap. 18-25, 117-134, 235-245 (the quarterly earnings releases by NovaStar during the class period).

Plaintiff's theory that, while NovaStar's "business conditions [were] crumbl[ing] due to worsening conditions in the sub-prime market sector," the company fraudulently proclaimed only good times ahead, is belied by reality (ASA 59, 102 ¶¶98, 169). From the very inception of the putative class period, NovaStar warned of a challenging credit market, disclaimed guarantees that it was immune to market conditions and warned about the uncertainty and risks endemic to its

industry. For example, the May 4, 2006 press release cautioned that actual results could differ materially from the company's projections because of "increases in prepayment or default rates on our mortgage assets; interest rate fluctuations on our assets that differ from our liabilities;… the stability of residual property values;… [and] the impact of general economic conditions." (Ap 18-25). Further, by the third quarter, the company's press releases were warning of a "more adverse credit market" which had significantly affected net income, including loss provisions for whole loan re-purchasers, losses on derivatives held in their trading account, and mortgage securities impairments (Ap 126-134, 168-170).

The complaint repeatedly speculated that NovaStar's net earnings were overstated as a result of the company's underestimation of loan loss reserves (ASA 95, 97-98 ¶157, 220). But NovaStar specifically warned that "changes in assumptions regarding estimated loan losses and fair value amounts" constituted a material risk (Ap 18-25). NovaStar cautioned that its allowance for loan loss reserves was based "on the assessment by management of probable losses incurred based on various factors affecting [the Company's] mortgage loan portfolio… The allowance is maintained through ongoing adjustments to operating income. The assumptions used by management regarding key economic indicators are highly uncertain and involve a great deal of judgment" (Ap 77).

Plaintiff also asserted that NovaStar failed to adjust its internal

controls, which supposedly had grown ineffective in the wake of the market downturn (ASA 83 ¶137). However, the company specifically warned investors that, while it strived to maintain high standards:

> [Q]uality control and loss mitigation operations may not be successful in limiting future delinquencies, defaults and losses. Our comprehensive underwriting process may not be effective in mitigating our risk of loss on the underlying loans... Expanded loss mitigation efforts in the event that defaults increase could increase our operating costs. To the extent that unforeseen or uncontrollable events increase loan delinquencies and defaults, our results of operations may be adversely affected.

(Ap 214).

Similarly, NovaStar's conference calls expressly warned that actual results could differ from what was being reported, and referred the listener to the company's recent SEC filings for a detailed discussion of specific risks involved.[13] Such warnings clearly suffice to invoke the statutory safe harbor. See 15 U.S.C. §78u-5(c)(2); *Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132-33 (9th Cir. 2004) (cautionary language sufficient where company disclaimed certainty and referred to the cautionary statements in defendant's Form 10-K).

These disclosures confirm that, as to each of the areas in which

[13] For example, at the beginning of the August 4, 2006 conference call, listeners were cautioned that "Certain matters discussed in this release constitute forward-looking statements… subject to risks and uncertainties and certain factors can cause actual results to differ materially from those anticipated" and were referred

plaintiff contends NovaStar misrepresented or omitted material information, NovaStar in fact provided detailed, substantive warnings that satisfy the statutory safe harbor. As a matter of law, projections that fail to come to fruition based on the occurrence of the clearly identified risks are simply non-actionable. While the Reform Act's legislative history makes it clear that to gain the protection of the statutory safe harbor a defendant need not identify the specific risks which actually come to pass,[14] what is striking in this case is that NovaStar's specific warnings did address each of plaintiffs' points of contention, and therefore more than satisfy the requirements of the statutory safe harbor. *See, e.g. NVE*, 551 F. Supp. at 893 ("[Defendant's] warning specifically addresses [its] failure to meet deadlines and… the fact that possibly unresolvable technical issues still remained. This warning is not a boilerplate warning, but is tailored to the actual risk of which plaintiffs complain. To the extent that [defendant's] forward-looking statements were accompanied by these warnings, … they fall under the safe harbor and the bespeaks caution doctrine").

Even had the cautions expressed in each of NovaStar's public statements been insufficient, dismissal would still be required under the alternative

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to the company's SEC filings for further analysis (Ap 311-317).

[14] *See* H.R. Conf. Rep. No. 369 at 44 (The "Committee expects that the cautionary statements identify important factors… but not all factors. Failure to include the particular factor that ultimately causes the forward-looking statement not to come

prong of the statutory safe harbor because plaintiff failed to allege "with particularity" facts giving rise to a "strong inference" that defendants' projections were made with "actual knowledge" of falsity. *See* 15 U.S.C. §78u-5(c)(1)(B); *Navarre*, 299 F.3d at 742 (complaint must allege "facts or further particularities that, if true, demonstrate that the defendants had access to, or knowledge of, information contradicting their public statements when they were made").[15]

Plaintiff attempted to plead defendants' actual knowledge by citing their high-level positions with the company and their access to non-public information, such as internal reports and the views of lower level employees, then asked the court below to leap to the conclusion that the individual defendants must have known that "adverse facts" were being concealed from investors and that positive representations were false" (ASA 37 ¶29). The complaint simply does not provide a basis for this conclusion. The great majority of plaintiff's allegations of defendants' "knowledge" of the claimed "adverse facts" are attributed to the claims of the former NovaStar employees plaintiff invokes as confidential witnesses.

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true will not mean that the statement is not protected by the safe harbor.").

[15] *See*, *also*, *K-tel*, 300 F.3d at 891 ("What makes many securities fraud cases more complicated is that often there is no reason to assume that what is true at the moment plaintiff discovers it was also true at the moment of the alleged misrepresentation, and that therefore simply because the alleged misrepresentation conflicts with the current state of facts, the charged statement must have been false. . . . [A] plaintiff must set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading when made") (citations omitted).

However, as shown above, the CW statements on which plaintiff attempted to rely as establishing defendants' knowledge and intent do not suffice to plead even scienter, much less the more stringent "actual knowledge" necessary to deprive defendants of the Reform Act's safe harbor.

2. The "Bespeaks Caution" Doctrine Further Undermines Plaintiff's Claims

Even as to complaints that pre-date the Reform Act's erection of a statutory safe harbor for forward-looking statements that are accompanied by meaningful risk disclosure, this Court had adopted its judicially-created equivalent the "bespeaks caution" doctrine. In *Parnes*, 122 F. 3d at 548, the Court held that statements alleged to be false or misleading are immaterial as a matter of law if accompanied by sufficient cautionary statements that address the substances of the statements challenged by plaintiffs. "Only by discarding common sense and ignoring the multitude of explicit and on-point warnings … could investors have been misled…" *Id*. at 549.

More recently, the Court amplified that analysis in *AMDOCS*, 390 F.3d at 545-48. There, plaintiffs alleged in the context of a high-tech recession that defendants had misled investors with statements such as "we don't see any slowdown," "we are experiencing strong demand," "we feel comfortable" with projections, and "demand is not being negatively affected" by the recession. 390 F.3d at 545-47.

But this Court agreed with the district court that defendants' statements "were immaterial as a matter of law because they were accompanied by cautionary statements that bespoke caution." *Id*. at 548. Those statements disclosed as a "business risk" that the company's sales were closely tied to the "global communications market," in which a slow-down in spending could result in slower growth rates for the company. *Id*. at 546. That cautionary statement put plaintiffs on notice that demand had softened and could affect customer purchases from the company. *Id*. at 548; *see also*, *NVE*, 551 F. Supp. 2d at 893, *aff'd*, 527 F.3d 749 (cautionary language need not specifically mention the realized risk, as long as it warned of risks of similar significance).

Here, the myriad risk disclosures that populated NovaStar's public statements, as discussed above, were directed to the very matters that plaintiff claims materialized. They would provide an alternate basis for affirming the judgment below even had plaintiff been able to plead false or misleading statements with the requisite particularity.

F. PLAINTIFF FAILED TO PLEAD LOSS CAUSATION

The Supreme Court confirmed in *Dura*, 544 U.S. at 345, that the securities laws are not intended to "provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations ***actually cause***" (emphasis added). Accordingly, the Court held

that a plaintiff claiming securities fraud must both plead and prove that an alleged misrepresentation proximately caused the economic loss of which he complains. *Id*. at 346.

The Ninth Circuit's recent opinion in *Corinthian*, 2008 U.S. App. LEXIS 18226, notes that the "undocumented assertion" that a stock price drop was caused by a revelation of the truth is insufficient to allege loss causation, since a plaintiff could always make such an allegation and *Dura* would be undermined. *Id*. at *31-32.

In *Corinthian*, the court held that an announcement that the company had failed to hit earnings estimates was a far more plausible explanation for a stock drop than an "unwarranted inference" that the market read other aspects of the announcement as a revelation of misconduct. *Id*. at *33. Here, the leap that plaintiff asks the Court to make is even more far-fetched, since NovaStar's February Announcement reported earnings that ***exceeded*** analyst estimates (Ap. 235-245), and the forward-looking prediction of a bleak earnings future is the ***only*** plausible explanation for NovaStar's stock price drop the next day.

Indeed, plaintiff admits as much. He describes that prediction as the aspect of the February Announcement that was "most sobering of all" and cites analysts' description of that prediction as "unfathomable," "inexcusable," "alarming" and "more of a surprise" than anything else in the Announcement,

citing ASA 85-87 ¶ 143 and ASA 115 ¶ 199 (AOB 34).

This Court recently reiterated that loss causation, notwithstanding its "exotic name," harkens back to the same standard "employed in a common law fraud case." *Schaaf v. Residential Funding Corp.***,** 517 F.3d 544, 550 (8th Cir. 2008) (citation omitted). "[U]nless the plaintiff can show that the defendant's fraud caused his loss, he cannot recover." *Id*. (quoting *Dura*, 544 U.S. at 343-44). The Court summarized how this common-law and common-sense standard applies in a claim under 10b-5:

> In a securities case, this standard requires the plaintiff to show that the defendant's fraud—and not other events—caused the security's drop in price. This is because the security's "lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." Thus, to recover for securities fraud at common law and under SEC Rule 10b-5 . . . the plaintiff must show "that the loss [was] foreseeable and that the loss [was] caused by the materialization of the concealed risk."

Id. (quoting *Dura*, 544 U.S. at 343 and *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 173 (2nd Cir. 2005).

A securities plaintiff must show that a public disclosure "corrected" an earlier misstatement and that this correction caused the stock price to drop. Beyond the fact that plaintiff here alleged no misstatement in any event, he failed

to allege that putative corrections of earlier statements caused the fall in NovaStar's stock price. Indeed, he successfully alleged precisely the opposite.

1. Plaintiff Alleged an *Absence* of Loss Causation

The complaint placed considerable weight on NovaStar's February Announcement that the company was considering shedding its REIT status because it expected to recognize between little and no taxable income for the years 2007 through 2011. The portion of the Announcement highlighted in the complaint reads:

> As a result, during the period 2007 through 2011, we expect to recognize little, if any, taxable income. Given this outlook, management is currently evaluating whether it is in shareholders' best interests to retain the company's REIT status beyond 2007 given the asset, income and other REIT related restrictions the company must operate within (ASA 85-87 ¶143).

While plaintiff claimed that this statement precipitated the drop in NovaStar's share price, the statement had nothing to do with defendants' underwriting practices during the class period. Moreover, plaintiff's own allegations established the absence of any relationship between the statement and class-period underwriting.

The complaint acknowledged that NovaStar attracted investors largely by virtue of its REIT status. A certain type of investor—one interested in receiving regular dividends — would prefer a REIT over the traditional "C corporation"

because a REIT, as a matter of federal tax law, enjoys very little room to reinvest and must instead pay out the great bulk of its income to investors. As the complaint put it, "The most important component of the NovaStar REIT status is that it had to pay 90% of its income out as dividends to shareholders" (ASA 27-28 ¶ 3).

Plaintiff also explicitly alleged that NovaStar's share price fell on February 21, 2007 due to its disclosure on February 20, 2007 that it expected to recognize little to no taxable income over the next five years and that it might therefore shed its REIT status and, in turn, stop paying out REIT-related dividends:

> NovaStar's February 20, 2007 press release stunned the market and prompted outcry from analysts. On February 21, 2007, Stifel Nicolaus issued an analyst report titled "Poor 4Q 06; Unfathomable (and Inexcusable) Dividend Guidance" which stated, "[w]hat comes as more of a surprise is mgmt's ***alarming disclosure in the press release that it now expects to realize little to no REIT taxable income (which drives dividends for the next 5 (yes 5) years)***." "This comes as a shock especially since 4Q06 REIT portfolio income this quarter actually exceeded our relatively conservative estimates."
>
> On April 1, 2007, an article in the *New York Times* entitled "Borrowing Trouble" by Gretchen Morgenson and Julie Creswell described NovaStar's February 2006 disclosures as jolting its investors and described the aftermath of defendants' revelations. NovaStar was a ***"highflying stock paying a handsome dividend that made it a favorite among small investors***, NovaStar lost 42 percent of its value in one day." The article also reported that, "Fitch Ratings placed NovaStar's Mortgage Servicing unit on alert for a possible downgrade. The

> company's 'ability to fund its ongoing servicing operation and maintain servicing quality could come under pressure,' Fitch said" (ASA 115 ¶¶ 199 and 200).

Yet while plaintiff alleged that that this news about REIT taxable income and a possible "de-REITing" caused the fall in NovaStar's stock price, he could not allege that the news had anything to do with allegedly defective underwriting practices during the class period or with disclosures about a "tightening of underwriting guidelines." In fact, he alleged facts definitively establishing otherwise by quoting from the February Announcement:

> Greg Metz, Senior Vice President and Chief Financial Officer, noted: "As we have discussed in prior conference calls, taxable income from our REIT mortgage securities portfolio will normally exceed GAAP earnings during the early life of the portfolio due to the accelerated income recognition provisions of the tax code. Generally, this timing difference is created because of the different income accrual methods prescribed for the computation of GAAP and tax income. However, over the life of the portfolio, GAAP and tax income will be equal; therefore, in the later life of the portfolio GAAP income will be greater than taxable income. The reversal in timing differences between the recognition of GAAP income and taxable income is occurring and will accelerate as our older vintage securitizations mature. ***As a result***, during the period 2007 through 2011, we expect to recognize little, if any, taxable income. Given this outlook, management is currently evaluating whether it is in shareholders' best interests to retain the company's REIT status beyond 2007 given the asset, income and other REIT related restrictions the company must operate within (ASA 85-87 ¶ 143, emphasis supplied).

As plaintiff himself alleged, it was the aging of NovaStar's portfolio rather than alleged class-period underwriting practices that caused NovaStar to predict a reduction in taxable (but not GAAP) income and to consider de-REITing. Because no link exists between the alleged misrepresentations relating to underwriting and the disclosure that plaintiff himself conceded caused the drop in share price, plaintiff not only could not allege loss causation, but established the absence of loss causation. Even had NovaStar misrepresented its underwriting prowess during the class period and then somehow corrected that misrepresentation on February 20, the correction could not, according to plaintiff's own allegations, have caused the February 21 drop in share price.

2. Defendants' Stated Decision to Revise Underwriting Guidelines Did Not "Correct" A Prior Misstatement

While NovaStar announced the adaptation of its underwriting guidelines to changing market conditions, that Announcement did not "correct" any prior contrary statement. Plaintiff alleged at ASA 31 ¶ 14 that in its February Announcement:

> The Company further effectively admitted that its internal controls were a shambles, and made the promise to examine them going forward:
>
> Anderson added, "The key area of focus for our mortgage banking operation is to ensure that the 2007 originations perform better than 2006 and in line with our expectations. In this regards, we have taken several steps which include:

1) Tightening of our underwriting guidelines

2) Limiting the number of exceptions to our underwriting guidelines policy

3) Enhancing our appraisal review process

4) Implementing the use of NovaStar's Risk Assessment Score (NRAS) to identify loans with unacceptable levels of risk."

Defendants had never before represented to investors that NovaStar would (1) apply any given underwriting guidelines, (2) limit exceptions from underwriting guidelines to any particular number or percentage of loans, (3) apply any particular appraisal process, or (4) gauge loan risk according to the NRAS. As a result, a statement that guidelines would be tightened in these ways could not have disabused investors of an earlier impression that NovaStar was already doing those things. Put another way, there was no earlier statement for this statement to correct.

Nor could this statement be read as an "admi[ssion] that [the company's] internal controls were a shambles." *See, e.g.*, *In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 335 (D. N.J. 2007) ("[I]t would be anomalous to legally transform any corporate announcement about upgrading its financial system, new hire or detection of a past error into an automatic admission that the corporation's previous control systems were either 'weak' or 'inadequate'").

Indeed, defendants ***explicitly*** stated in their February Announcement

that they were adjusting underwriting and auditing guidelines not because of historical deficiencies but due to a changing climate. The following exchange occurred during the February investor call:

> BOB NAPOLI, ANALYST, PIPER JAFFRAY: Just a question on the tightening. You are one of the companies that you kind of grew originations throughout 2006. There were several others there were cutting back. It seemed what somewhat earlier, but it seems like you tightened much later than others. Is that -- am I correct on that? Are you just tightening now, because otherwise I don't think you would have had the growth that you did?
>
> LANCE ANDERSON: ***No, I don't think that is right at all.*** I think we always look at where the competition is from a guideline perspective, because you don't want to be the only one out there -- you want to be the one guy out there with the widest guidelines. So we keep an eye on that at all times. ***We actually started tightening back in September. And I would say historically our guidelines are probably been a little bit on the tighter side than the market as a whole. So I don't think that is the case at all*** (ASA 631) (emphasis added).

Defendants, then, were not correcting some earlier statement or "fessing up" to some earlier mistake, much less some earlier wrongdoing. They stood by their historical guidelines—which were always "probably . . . a little bit tighter" than those of the competition — and were tightening standards in response to an adverse market. Plaintiff himself conceded that times were changing. As he put it, "economic data presented a negative outlook for the housing market in the coming year and NovaStar as a subprime lender was even more susceptible to such

a downward trend" (ASA 96-97 ¶ 160). A company adjusting processes in the face of these "worsening economic conditions in [its] market sector" is not conceding that those processes were inadequate or defective in sunnier climes. Suggesting otherwise is akin to suggesting that an auto manufacturer marketing a new model to meet changing market demands has "effectively admitted" that its older models were defective. Markets shift, as plaintiff repeatedly acknowledged, and shifts in markets call for shifts in strategy.

3. Defendants Told Investors About Tightening Underwriting Guidelines and Increasing Delinquencies More Than Three Months Prior to the End of the Class Period

Plaintiff's allegation that the February 2007 drop in NovaStar's stock price was caused by its projection of little or no future taxable income, rather than its statement of tightened underwriting guidelines, is consistent with the fact that over three months earlier NovaStar had already disclosed deteriorating loan performance and the amplified loan loss reserves and assumptions with which it had already reacted. In its November 8, 2006 conference call with investors (Ap 614-6240), NovaStar said:

> So ***I think we're seeing delinquencies tick up a little bit and that information is posted on our website really on a securitization-by-securitization basis***. And again, as we go through and do the analysis we've reflected our changes really in our loss assumptions that are in the Q.
>
> So as we look forward ***I think one of the themes is we clearly are looking at data that comes in from a***

> ***combination of delinquencies, severities, housing price data and we're going to let that data continue to lead us to as we model out our loss assumptions going forward***. And obviously we monitor that on a monthly and a quarterly basis.
>
> ***I think—we've tightened our guidelines somewhat and we've tightened up on our exception making process*** and that obviously would have a negative impact on volume.
>
> And more specifically, ***our provision for credit losses in Q3 was $10.3 million versus 100,000 during the period last year and $6 million in the second quarter of 2006***. And again, this increase is indicative of the steps we've been taking during the quarter to prepare our balance sheet for a more adverse credit environment *Id*. (emphasis added).

Defendants made similar statements in their November 7, 2006 press release, also related to the third quarter 2006. Among other things, the release noted:

> Scott Hartman, NovaStar's Chief Executive Officer commented: "***During the third quarter we took several steps to prepare for a more adverse credit market***. First, we increased reserves for our on-balance sheet transactions. Second, we increased reserves for loan repurchases for our whole loan sales. Third, we increased loss assumptions in our mortgage securities portfolio, resulting in some impairments and a reduction in unrealized gains (ASA 75-78 ¶ 128, emphasis added; emphasis deleted).

In short, investors and analysts knew in early November 2006 that NovaStar was responding to a "more adverse credit market" by increasing reserves and tightening underwriting guidelines. Statements to the same effect more than

three months later can hardly have caused the stock drop of February 21, 2007.

G. THE DISTRICT COURT PROPERLY DENIED LEAVE TO AMEND

Plaintiff made no attempt in the district court to articulate how he might amend his complaint to allege a cognizable claim of securities fraud under the Reform Act's exacting standards, instead saying in a footnote only that plaintiffs "request an opportunity to amend their claims" if the district court found them insufficient (CD 79: 44n.21).

In the absence of any hint at how plaintiff might improve his complaint, the district court properly stated that it "agrees with Defendants that attempting to amend the complaint would be futile" because "In all that has already been alleged, there is no suggestion that any material information was concealed or that any Defendant acted with fraudulent intent, and there is no reason to think further or different pleading will create the necessary inferences" (ADD 8).

Since plaintiff did not offer any proposed amendments that the district court could evaluate under the Reform Act's legal standards, the denial of leave to amend is reviewed for abuse of discretion. *See, e.g.*, *Cerner*, 300 F. 3d at 1086; *In re: Charter Comm., Inc. Sec. Litig.*, 443 F. 3d 987, 933 (8th Circ. 2006), *aff'd sub. nom. Stoneridge Inv. Partners* v. *Scientific-Atlanta*, 128 S. Ct. 761 (2008) (denial of leave to amend on ground of futility not an abuse of discretion).

In this Court, plaintiff tries to atone for his failure to present below

any basis for amendment by suggesting that he could amplify the allegations made in the original and amended complaints below. But examination of the suggested amplification confirms that plaintiff proposes only to rearrange the deck chairs on the Titanic. Even if amended, each of the plaintiff's theories would remain bereft of the particularity demanded by the Reform Act and fail to state any legally-cognizable claim.

The "even more relevant facts" plaintiff proposes to add (AOB 62-64) are just more of the same conclusory assertions that doomed the consolidated complaint to begin with. Plaintiff says he could provide further detail about NovaStar's supposed weakening or abandonment of internal controls and underwriting standards. But no amount of additional detail could ever cure the fundamental problem that plaintiff's CW story is not "necessarily inconsistent" with NovaStar's public statements, and that is the central requirement of alleging falsity. *Cerner*, 425 F.3d at 1083-84.

As in *Hutchinson*, 2008 U.S. App. LEXIS 16538 at *23-24, the proposed amendments — even if they had been more concrete and less conclusory — would still not show fraud. The court below properly denied leave to amend, regardless of whether its decision is reviewed for abuse of discretion or *de novo*.

VI. CONCLUSION

For the reasons given above, the judgment below should be affirmed.

Dated: September 15, 2008

Respectfully submitted,

By_____

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Corporate Disclosure Statement

Pursuant to Fed. R. App. Proc. 26.1 and Local Rule 26.1A, the undersigned counsel of record for Appellees NovaStar Financial, Inc. ("NovaStar"), W. Lance Anderson, Scott F. Hartman and Gregory S. Metz certifies that NovaStar has no parent companies, that no publicly-owned company owns 10% or more of its stock, that each of its subsidiaries is wholly owned, and that it has no affiliates that have issued shares to the public.

Dated: September 22, 2008.

Respectfully submitted,

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RULE 32(a)(7)(C) CERTIFICATE

The undersigned counsel certifies that BRIEF OF APPELLEES uses proportionally spaced Times New Roman typeface, 14-point, and that the text of the brief comprises 13,179 words according to the word count provided by Microsoft Word 2002 word processing software.

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CERTIFICATE OF SERVICE

I, the undersigned, declare:

1. That on September 15, 2008, declarant served two true copies of the BRIEF OF APPELLEES to the parties listed on the attached Service List In addition, declarant filed an original and ten (10) copies of the BRIEF with the Clerk of the Court.

3. Also on September 15, 2008, declarant served one copy of the APPELLEES' SEPARATE APPENDIX, VOLUMES I AND II on the parties listed on the attached Service List. In addition, declarant filed an original and three copies with the Clerk of the Court.

4. I am employed in the county from which the mailing occurred. I placed the sealed boxes(s) for collection and mailing at this firm's office business address indicated above. I am readily familiar with this firm's practice for the collection and processing of correspondence for mailing with the United States Postal Service. Under that practice, the firm's correspondence would be deposited with the United States Postal Service on this same date with postage thereon fully prepaid in the ordinary course of business.

5. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 15th day of September, 2008, at San Francisco, California.

_____

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