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IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH, CENTRAL DIVISION

MELANIE DAVIS, Individually and on Behalf of All Others Similarly Situated, Plaintiff, v. SKULLCANDY, INC., SETH DARLING, JASON HODELL, and RICHARD P. ALDEN Defendants.	Case No. 2:16-cv-00121-RJS-PMW **LEAD PLAINTIFFS' BRIEF IN OPPOSITION TO DEFENDANTS' MOTION TO DISMISS THE AMENDED COMPLAINT** Judge Robert J. Shelby Magistrate Judge Paul M. Warner

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I. INTRODUCTION AND STATEMENT OF RELIEF SOUGHT

This is a securities class action alleging violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78h(b), 78t(a) and SEC Rule 10b-5, on behalf of all purchasers of the common stock of Skullcandy, Inc. ("Skullcandy" or the "Company") between May 5, 2015 and January 11, 2016 (the "Class Period"). The Defendants are Skullcandy – a maker and distributor of headphones and other audio products and accessories – its CEO Seth "Hoby" Darling ("Darling"), its CFO Jason Hodell ("Hodell") and its founder, director and major shareholder Richard P. "Rick" Alden ("Alden").

Beginning on May 5, 2015, Defendants made a series of false and misleading statements about the Company's business and prospects in China, a market critical to the Company's success. Among other things, Defendants touted explosive quarterly Chinese sales growth in the first three quarters of 2015 – as much as 36% compared to the same quarters in the prior year. Defendants said that China represented "a huge opportunity for the brand" and was growing "at the fastest pace" of the Company's sales regions. After several years of disappointing performance following the Company's 2011 IPO, Defendants' purported growth in China buoyed the Company's stock price and fueled hopes of a turnaround based on international sales.

As was soon revealed, Skullcandy's China success was a mirage, and its statements about its China performance were false. On January 11, 2016, Skullcandy stunned investors by announcing that it expected to miss its own full-year earnings forecasts from just two months earlier by a staggering 50%. Contradicting their prior representations, Defendants admitted that Skullcandy had not seen strong growth in China in 2015 – in fact, fourth quarter international sales had fallen 11% from the prior year, "primarily due to decreased sales of gaming and audio products in China." Significantly, the Company further disclosed that it would be forced to take a $1.6 million bad debt charge resulting from "challenges with a China distributor" – a change so

material that it wiped out 20% of the Company's 2015 full-year earnings. The news caused the Company's stock to fall more than 28% in one day, from $4.55 on January 11, 2016, to close at $3.26 per share on January 12, 2016.

As was subsequently revealed, the bad debt charge and the Company's poor sales were the direct result of Defendants' fraudulent "channel stuffing"[1] scheme. In sum, throughout 2015, the Company improperly booked revenue on "sales" to its main Chinese distributor – Timesrunner – for which it knew there was no demand, and which it knew the distributor could not sell. As a result, the Company was required to take returns of huge amounts of product in the fourth quarter of 2015 that it had previously "sold."

Skullcandy's outlook only worsened in the months following the Class Period, as the fallout from Defendants' fraudulent channel stuffing continued. Indeed, as late as August 2016, the Company was still reporting poor results and negative sales growth in China as it continued to try to "clean up" its China distribution channel, i.e., write off prior sales to its distributor for which there was no consumer demand and take returns on product that the distributor could not sell. Skullcandy's survival as a public company was cast into doubt, and, on October 3, 2016, it was taken private and its stock was delisted.

In response to these well-pled allegations – many of which are based on the Company's own admissions – Defendants raise several meritless arguments. First, Defendants suggest that "[a] certain amount of channel stuffing could be innocent and might not even mislead…." MTD

[1] Channel stuffing is defined as "premature pushing of product into [] wholesale channels to artificially inflate sales." *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 939 (9th Cir.2003), rev'd on other grounds, 544 U.S. 336 (2005).

at 14[2] (quoting *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702, 709 (7th Cir. 2008)). But the facts here give rise to no competing "innocent" inference. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 326, (2007) (a plaintiff survives a motion to dismiss by creating an inference of fraud "at least as compelling as any opposing inference one could draw from the facts alleged."). "Innocent" channel stuffing would not have resulted in Skullcandy's China sales crashing to a halt only two months after it predicted robust growth and called China "a huge opportunity for the brand," nor would it have required the Company to take a bad debt charge that wiped out 20% of its 2015 earnings. "Innocent" channel stuffing would not have impacted the Company so dramatically for nearly a full year, and it would not have resulted in Skullcandy's demise as a public company. Indeed, Defendants never offered investors any "innocent" explanation for why its China distributor suddenly began to return large amounts of product and refuse to pay for what it had received, resulting in a $1.6 million bad debt charge.

Second, Defendants argue that Lead Plaintiffs' allegations aren't "specific" enough because they don't state the precise amount by which Skullcandy's revenue was overstated, or allege specifics of transactions with Timesrunner such as dates and amounts of specific shipments. However, no court has made this level of detail a *per se* requirement at the motion to dismiss stage. *See In re St. Jude Med., Inc. Sec. Litig.*, 836 F. Supp. 2d 878, 890 (D. Minn. 2011) (quoting *In re Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1084 (8th Cir.2005)) (a plaintiff "is not required to describe in detail the circumstances of [a defendant's channel-stuffing] activities.") *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 81 (1st Cir. 2002) (prior to discovery, a plaintiff need not "in every case allege the amount of overstatement of revenues and earnings in

[2] References to "MTD at _" refer to page numbers of Defendants' Motion to Dismiss Plaintiffs' Amended Complaint and Brief in Support.

order to state a claim"). Rather, Lead Plaintiffs have satisfied the PSLRA standard by pleading that Defendants "knew [their China distributor] had excessive inventory and knew that the company had been artificially increasing demand forecasts in order to satisfy the expectations of Wall Street rather than meet the realistic demand or attempt to sell more aggressively," resulting in inflated sales and earnings. *In re Connetics Corp. Sec. Litig.*, No. C 07-02940 SI, 2008 WL 3842938, at *10 (N.D. Cal. Aug. 14, 2008).

Defendants also argue that Lead Plaintiffs have failed to plead scienter. But Defendants' atomized approach goes against the Supreme Court's admonition that courts must not "scrutinize each [scienter] allegation in isolation" but rather "assess all the allegations holistically." *Tellabs* 551 U.S. at 326, (2007). Contrary to what Defendants contend, Lead Plaintiffs have created a strong inference of scienter that is "cogent and at least as compelling as any opposing inference….." *Id.* at 324.

Specifically, Defendants Darling and Hodell, the CEO and CFO of the Company, made numerous statements about the centrality of the Company's China sales to its growth strategy throughout the Class Period, making it implausible that they weren't paying close attention to the Company's results in China. Indeed, the Company boasted in its SEC filings of its state of the art systems for monitoring sales and inventory around the globe, and former employees confirmed that Darling and Hodell participated in weekly sales calls where sales reps from all regions – including China – kept them up to date on sales. Darling and Hodell also participated in annual forecasting meetings every November, during which both domestic and international sales teams provided "details from the accounts they work…down to the SKU level." Moreover, the Company had a single primary distributor in China, making it easy for the Company both to track China sales and inventory and to receive information from China on a

timely basis. In addition, the magnitude of Defendants' sales and forecasting errors, the short timespan of the Company's reversal of fortune, and the exceedingly long "clean up" period that followed make it highly unlikely that Defendants weren't aware of the underlying channel stuffing during the Class Period. In sum, these highly specific allegations – taken together – establish scienter, and it is simply not plausible to believe that management had no idea that it was stuffing its main China distributor with millions of dollars worth of unwanted inventory.

Defendants' remaining falsity and scienter arguments are equally without merit, as is their Section 20(a) argument. Defendants' motion should be denied in its entirety.

II. STATEMENT OF FACTS

A. Background

Skullcandy is a Utah-headquartered designer, marketer and distributor of audio and gaming headphones, earbuds, speakers and other accessories. ¶ 25.[3] The Company was founded in 2003 and went public in July 2011. ¶¶ 25, 28. A mere six months after its IPO, however, the Company's stock had fallen 66% due to lackluster sales and growing competition. ¶¶27-28. In the years leading up to the Class Period, commentators emphasized the Company's poor outlook due to intense competition, as well as retailer and marketing issues. ¶¶ 28-31. For example, a March 2013 CNN *Money* article stated that "Skullcandy's stock is getting crushed on a poor outlook" and warned that investors might need to "steer clear of Skullcandy (SKUL) stock." ¶ 29. Similarly, a March 2014 *Seeking Alpha* article labeled Skullcandy's stock "A Sell Ahead of Earnings" and stated that investors should "worry not only about Q4 Skullcandy sales numbers, but Q1 2015 guidance and forward." *Id*. Noting poor sales through retailers like RadioShack, Target and Best Buy, the article asked, "[i]f guidance is based for the most part on the sales of

[3] All citations to "¶ _" refer to paragraphs of the Consolidated Amended Class Action Complaint filed May 8, 2017 ("Complaint").

these key retailers, and each one of them is experiencing epic times of hardship, where are the revenues going to come from?" ¶ 30.

Skullcandy and its stock found a lifeline in the promise of international growth to make up for its lackluster domestic sales. ¶ 31. Prior to the start of the Class Period, Defendant Darling revealed a five pillar "strategy" to return to growth that included "grow[ing] international to reach 50% of the Company's business." ¶ 32. Key to that international growth would be sales growth in China. *Id*. A former employee who was a Global Demand Planning Manager through May 2015 noted that the Company's targets were "aggressive" and cautioned Darling and Skullcandy's Chief Revenue and Sales Officer that "you're going to be asking a lot from your sales teams," to achieve the Company's 2015 growth targets. ¶ 33.

B. Defendants Engage in a Fraudulent Channel Stuffing Scheme to Inflate Sales Results and Earnings Forecasts

At the start of the Class Period, Defendants made it appear as though Skullcandy's international growth plan was working. On May 5, 2015, Skullcandy announced its financial results for the first quarter of 2015, including net sales of $46.2 million for the quarter and international net sales of $15.1 million for the quarter. ¶ 78. The Company attributed its reported 18% first quarter total net sales growth in part to "increased sales in China" and said that its 17% international net sales growth was "primarily due to strong gains in China." ¶¶ 78-80. Based on these results, the Company reiterated its full year 2015 EPS guidance of $0.36 to $0.40 per share. ¶ 79. Darling emphasized in an earnings call that day that, of all of the company's regions, "China grew at the fastest pace in the first quarter" and that "China represents a huge opportunity for the brand." ¶81. The Company's Form 10-Q filed May 8, 2015 and signed by Darling and Hodell affirmed the Company's financial results and that

international net sales increased "primarily due to increased sales in China." ¶ 82. Analysts reiterated the importance of China to the Company's results and future growth potential. ¶ 38.

On August 6, 2016, Skullcandy announced that its "net sales in the second quarter increased 8% to $58.0 million from $53.9 million in the same quarter of the prior year" and that "international (Non U.S) net sales increased 16% to $16.7 million from $14.4 million in the same quarter prior year" due in large part to "increased audio sales in…China." ¶ 87. On a constant currency basis, international growth was reported at 24% from the prior year. ¶88. During the earnings call that day, Darling emphasized China's "strong growth performance" and said that the 16% increase in international sales was "primarily due to strong gains in…China…." *Id*. The Company *raised* its 2015 full year EPS guidance to a range of $0.41 to $0.43 per share "based on [the Company's] updated view of the second half…." ¶ 89. Hodell also forecasted a net sales increase in the fourth quarter compared to the same quarter of the prior year, "with growth led by our international segment." *Id*. The Company's financial results were reaffirmed in the Company's Form 10-Q filed August 7, 2015 and signed by Darling and Hodell. ¶ 90.

Skullcandy's representations convinced the market that the Company's China sales were propelling it to success. On the news, the Company's stock increased in price by $0.68 per share, or approximately 9.32%, to close at $7.98 per share on August 7, 2015 on unusually heavy volume. ¶ 41. Analysts cited "headphone and earbud sales growth coming from…China" as a "key value driver" and part of a Company "turnaround." ¶ 42.

In reality, the Company's Chinese sales were not strong, and the Company was not experiencing a "turnaround" based on international growth. Rather, Defendants were engaging in a fraudulent channel stuffing scheme – pushing their China distributor, Timesrunner, to take product it didn't have demand for and couldn't sell in order to temporarily inflate Skullcandy's

results and investors' expectations. ¶ 44. A former area sales supervisor in Shanghai ("FE 2") said that, in 2015, the Company's China distributor had large amounts of product piling up in its warehouses that it could not sell. ¶¶ 45-46. FE 2 said that the Company did not have a strong marketing plan in China, and that, although the Company prodded its distributor to purchase Skullcandy products, "the [distributor could not] sell the products to the customer." ¶ 46.

A former warehousing and logistics manager ("FE 3") who worked for the Company through November 2015 observed: "I definitely wouldn't say [China sales] were robust. It seemed like they were pretty flat. My impression of sales in China is that we weren't really gaining traction within the market." ¶47.

Not only were Defendants pushing inventory on their Chinese distributor that they knew the distributor couldn't sell, but the Company was barely marketing its products in China. As of year-end 2015, the Company had no established email marketing campaign and had not made digital sales efforts in China. ¶ 51. As Skullcandy's former Email Marketing and Database Manager explained, "I can tell you that we never tried to do anything with the China Market in 2015. Skullcandy performed no email marketing in China…We were not doing any digital effort in China while I worked [for Skullcandy]." ¶51.

Defendants were well aware during the Class Period that the Company's China sales were poor. Skullcandy's senior management participated in weekly calls with all domestic and international sales reps to see where they were trending with sales numbers. ¶129. Defendant Darling frequently led the calls, and Defendant Hodell was "on every one of them" according to a former Sales Manager who participated in the calls, as was "either the VP of Sales or the Chief Sales Officer." ¶129. According to the Sales Manager, sales reps would have to explain details of their sales numbers: "Whenever you're short the forecast or whenever you're not trending in

the proper manner, you'd have to defend why you're off or tell them how you would recoup the loss." ¶ 129. The same Sales Manager also said that Darling and Hodell participated in annual forecasting meetings every November, along with domestic and international sales reps. ¶ 128. She said that the sales reps provided details from the accounts they worked "down to the SKU level." ¶128. The Sales Manager also recalled "I don't think China was ever great" for sales, at least through July 2015, when she left Skullcandy. ¶130.

Throughout the Class Period, Defendants also had access to a sophisticated inventory management system called SAP Business ByDesign, which allowed the Company to manage purchasing, inventory tracking, financial information, and retail, distributor and direct order fulfillment. ¶125. Both domestic and international sales, including Chinese sales, were tracked through SAP Business ByDesign. ¶ 125. Further, because the Company's software systems were integrated with third-party logistics warehouses that managed inventory and fulfillment, Defendants had the ability to know immediately when a particular product was not selling or when inventory was backing up. ¶126. This should have enabled precise revenue and earnings forecasting, making Defendants' subsequent guidance miss all the more egregious. ¶ 126.

C. The Truth Begins to Emerge

Eventually, as unsold and unsellable inventory piled up in the China distributor's warehouses, the distributor would not take or pay for further shipments – even with inducements such as "promotional credits" – and began to return large amounts of unsold product.[4]

Cracks in Skullcandy's façade of international growth began to emerge on November 5, 2015, when the Company announced its third quarter results and lowered its full-year 2015 EPS

[4] Fraudulent channel-stuffing schemes are typically "short-term," because eventually "the unneeded product will be returned" and "sales figures [will be] readjusted downward." *Goldthwaite v. Sensear, Inc.*, No. 15-CV-13143-MLW, 2016 WL 5329635, at *1 (D. Mass. Aug. 25, 2016).

guidance to $0.37-$0.39 compared to prior guidance of $0.41-$0.43. ¶¶ 52, 93-94. Although the Company lowered its guidance, it continued to claim robust sales growth "primarily due to increased audio product sales in…China," ¶ 93 and forecasted fourth quarter net sales growth of 5-7%. ¶ 94. Darling claimed that guidance was being lowered slightly due to distributor issues that he characterized as mere "growing pains." ¶ 95. Darling continued to insist that China remained a "huge opportunity for the brand long-term," while downplaying problems and failing to disclose the Company's true sales and inventory problems:

> With international, these are growing pains and we're taking some of the lumps in order to put us in a place where longer term we can increase excitement for our brand, be closer to our consumer, increase gross margins and see higher sales growth. In these cases, we're doing the right thing for the brand even if it causes some short term pain.

¶95. Darling further claimed that "[i]n China, sales grew 29% on a reported basis and 32% on a currency neutral basis," and insisted that any problems were "short term in nature and not a reflection of brand health." ¶ 96. Defendant Hodell also affirmed the Company's "strong growth in China" as the primary driver of international net sales growth, ¶97. And although Hodell stated that "international sales will be tempered due to…slower-than-expected growth and distributor transitions in Europe and China," Defendants minimized the situation as a "transition period" and stated that the "China situation" would only cause growth to be "down a little bit. ¶ 55. Darling conceded that sales were slowing in China but assured investors that problems were temporary and that Skullcandy would soon "make the changes and really start accelerating." ¶ 55. The Q3 10-Q filed on November 9, 2015 reaffirmed the Company's financial results. ¶ 98.

On this news, the Company's stock fell $1.53 per share, more than 24%, to close at $4.81 per share on November 6, 2015, on unusually heavy volume. ¶ 56.

D. The Channel-Stuffing Scheme is Revealed

Only two months later, on January 11, 2016, the Company stunned the market with abysmal preliminary fourth quarter and full-year results. ¶ 57. Significantly, the Company further announced that it had dramatically missed its Q4 2015 net sales and earnings projections, and stated that its 2015 full year EPS would likely come in at $0.20-0.22 – approximately 50% lower than its previous outlook of $0.38-$0.40. ¶ 57. Significantly, the Company further announced that net sales would be flat for Q4 2015 compared to Q4 2014 (versus previous forecasts of a 5-7% increase in net sales) due to a "2015 Q4 bad-debt allowance for [Skullcandy's] China distributor." ¶57. Darling cited "continue[d]…clean-up work with our largest China distributor during the fourth quarter" as a major cause of the disappointing results. ¶ 58. The Company also announced a $1.6 million pre-tax charge for bad debt as a result of "challenges with a China distributor." ¶ 58. As the Company ultimately admitted, Skullcandy took the charge because the distributor was returning product to the Company that had been previously booked as "sales," and now the Company had to reverse those sales. ¶ 58. The bad debt charge alone was expected to reduce earnings per share by $0.05, wiping out 20% of the Company's full-year 2015 earnings. ¶¶ 59, 66.

These disclosures caused the Company's stock to fall more than 28% in one day, from $4.55 on January 11, 2016, to close at $3.26 per share on January 12, 2016, on unusually heavy volume. ¶ 62. Analysts slashed their price targets for the Company by as much as 45%, citing "much weaker-than-anticipated" sales, and the noting that bad debt charge "related to further challenges with a China distributor." ¶¶ 9, 60.

E. Post Class Period Events Further Confirm a Fraudulent Channel-Stuffing Scheme

After the Class Period, fallout from the Company's channel stuffing continued to dramatically impact the Company's business. On March 2, 2016, the Company announced its fourth quarter and full-year earnings, including full-year EPS of just $0.20 per share. ¶ 66. International net sales decreased 11% "primarily due to decreased sales of gaming and audio products" in China, and SG&A expenses had increased 2% "primarily due to increased bad debt expense of $1.6 million related to a China distributor." ¶ 66.

During the March 2, 2016 earnings call, Defendants made clear that the problems in China were still materially impacting its sales. Defendants blamed "headwinds from certain distributor markets that are in transition, especially China where we continue to have some challenges around payment and maximizing the territory." ¶ 67. Darling explained that the Company's "wholesale business in China declined during the fourth quarter and we withheld shipments to Timesrunner, our distributor that sells into the brick and mortar CE channel." He stated that the Company "needed to address [Timesrunner's] current inventory overhang and respond to payment challenges." Defendants also admitted they expected the China fallout to continue into Q1 2016, with China sales for Q1 2016 forecasted to decrease from Q1 2015. ¶ 68.

In reality, the "inventory overhang" from Defendants' channel-stuffing scheme could not be "addressed" because they had shipped millions of dollars of goods for which they knew there was no demand. On May 4, 2016, the Company announced financial results for the first quarter, including a decrease of 3% in international net sales "primarily due to continued clean-up in China." ¶ 69. Defendants said they had continued to take "actions to improve [the Company's] China wholesale position which unfortunately offset solid growth in several of [Skullcandy's] other overseas markets and negatively impacted earnings per share by $0.02 cents versus [the

Company's] plan." ¶ 69. Gross margin was also down 340 basis points from the prior year primarily due to the "fall in [Skullcandy's] year-over-year China sales operation's gross margin where [the Company] experienced large Q1 promotional credits and returns to aid in the continued cleanup of the China channel." ¶ 69. In other words, the fallout from the channel-stuffing scheme was forcing Skullcandy to take returned unsold product from its distributor and write off "credits" to the distributor on sales previously booked as revenue. ¶ 69.

The Company's channel-stuffing scheme ultimately led to its demise as a public company. By August 2016 – when Skullcandy had already announced its impending acquisition by a private equity group – the Company still had not cleared the unsold inventory from its main China distributor. ¶ 71. The Company disclosed on August 10, 2016 that its international sales had declined 10% "primarily due to significantly decreased sales in China" and said that it was "continu[ing] to clean up" its China channels. ¶ 71. Soon thereafter, the Company went private and its stock was delisted on October 3, 2016; Skullcandy thus escaped having to disclose audited full-year 2016 financial results (as opposed to quarterly results, which are unaudited). ¶ 74.

III. ARGUMENT

To state a claim under section 10(b) and Rule 10b–5, a complaint must allege:(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Wolfe v. Aspenbio Pharma, Inc.*, 587 F. App'x 493, 494 (10th Cir. 2014) (internal quotations omitted). While the PSLRA requires that a plaintiff plead the required mental state, scienter, with particularity, it otherwise imposes the same standard as Rule 9(b). *Lighthouse Fin. Grp. v. Royal Bank of Scotland Grp.*, PLC, No. 11 CIV. 398 (GBD), 2013 WL 4405538, at *4 (S.D.N.Y. Aug. 5,

2013), *aff'd sub nom. IBEW Local Union No. 58 Pension Trust Fund & Annuity Fund v. Royal Bank of Scotland Grp., PLC,* 783 F.3d 383 (2d Cir. 2015).

A. Lead Plaintiffs Have Adequately Alleged Actionable Misstatements

1. Defendants' Statements About Sales and Sales Growth in China During the Class Period Were False

Throughout the Class Period, Defendants misleadingly created the impression that sales in China were strong and growing rapidly: they touted overall purported sales growth of 18% in the first quarter of 2015, attributing it largely to 36% growth in China, ¶¶ 35-37; they highlighted international sales growth of 16% in the second quarter, "primarily due to strong gains in China," ¶ 40; and even as the façade of strong China sales began to crack in November 2015, they re-emphasized "strong growth in…China" of 30% over the same quarter prior year. ¶¶ 52-54. Defendants relied on these inflated sales numbers to justify inflated forecasts – for example, offering full year 2015 earnings per share guidance of $0.37 to $0.39 on November 5, 2015 (a mere two months before the end of the year). ¶¶ 52, 66.

In reality, the Company's 2015 earnings per share would come in at just *half* of the amount it had forecasted only two months earlier. ¶ 66. International sales in the fourth quarter of 2015 actually *decreased* 11% from the same quarter prior year, primarily due to decreased sales in China, and the Company took a bad debt charge of $1.6 million, wiping out 20% of its already poor full-year earnings. ¶ 66. The Company continued to report fallout from its use of a channel stuffing scheme in China to inflate its sales and forecasts in May 2016, as international net sales continued to decline "primarily due to continued clean up in China" and the Company experienced a "fall in [Skullcandy's] year-over-year China sales operation's gross margin where [the Company] experienced large Q1 promotional credits and returns to aid in the continued cleanup of the China channel." ¶ 69. In other words, the Company continued accepting returns

from the distributor (though it had never warned investors that these "sales" could be returned and reversed), and writing off the sales as its channel-stuffing scheme unraveled. This continued through August 2016, when the Company announced a 10% decline in second quarter international sales "primarily due to significantly decreased sales in China," as the Company was "continu[ing] [to] clean up" the China channel. ¶ 71. The Company was saved from reporting further fallout only by going private and having its stock delisted in October 2016.

Channel stuffing consists of "premature pushing of product into [] wholesale channels to artificially inflate sales." *Broudo*, 339 F.3d at 939 (9th Cir.2003). Often achieved "by way of encouragement, discounts, or incentives," the goal of channel stuffing is "to increase current fiscal performance: taking from the future to embellish the present." *Phillips v. Sci.-Atlanta*, Inc., 489 F. App'x 339, 342 (11th Cir. 2012). While it is not *always* illegal or fraudulent, channel stuffing amounts to fraud where, as here, it is "done to mislead investors," by "creating the impression that sales are strong, and will continue to be strong, when—in fact—'stuffed' product is stacking up at customers; and the product backlog will likely cause a slowing of future orders." *Id.* Fraudulent channel stuffing "necessarily" carries "the implied allegation of intent to overstate the revenue for the period in question." *Cunha v. Hansen Nat. Corp.*, No. EDCV 08-1249-GW JCX, 2011 WL 8993148, at *3 (C.D. Cal. May 12, 2011) (internal quotation omitted).

Defendants' own post-Class Period statements and admissions confirm that Skullcandy's sales figures were inflated as a result of the fraudulent channel-stuffing scheme. In Skullcandy's earnings call on March 2, 2016, Defendant Darling cited "challenges around payment" in China and "inventory overhang," ¶ 67, classic signs of a fraudulent channel stuffing scheme that led to excessive inventory being shipped to the distributor. Defendants further stated they were "withholding" shipments to the Company's China distributor, Timesrunner – in other words,

Timesrunner was too clogged with unwanted inventory to take on more or to pay for more shipments. *Id.* Defendant Hodell himself blamed falling sales in China on "higher product returns," ¶¶ 67-68. *See*, e.g., *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008) (large number of returns on sales previously booked as revenue is strong evidence of fraudulent channel stuffing); *id*. at 709 (channel stuffing is fraudulent when used to "book revenues on the basis of goods shipped but not really sold because the buyer can return them.").

Similarly, in the Company's May 4, 2016 earnings call, Darling stated international sales decreased again "primarily due to continued clean-up in China," and noted that the Company's poor results in China occurred precisely because it "experienced large Q1 promotional credits and returns to aid in the continued cleanup of the China channel." ¶ 69. *See Phillips*, 489 F. App'x at 342 (channel stuffing schemes use "encouragement, discounts or incentives" to get distributors to take more product than they can sell); *In re Sci. Atlanta, Inc. Sec. Litig.*, 754 F. Supp. 2d 1339, 1356 (N.D. Ga. 2010) (issue of material fact created regarding channel stuffing scheme where Defendants used "liberal return policies, warehousing credits, and unusually permissive extended payment terms.").[5]

Remarkably, Skullcandy stuffed Timesrunner with so much unwanted inventory that its purported "clean-up" of the China distribution channel (i.e. the process of clearing and accounting for the unsold inventory) was still ongoing when the Company went private in October 2016. The fact that Skullcandy had still not been able to clear its distribution channel in China by October 2016 – or nearly a full year after the Company first began to disclose issues with its distribution channel – is powerful evidence that Defendants' Class Period statements

[5] The district court granted defendants summary judgment on loss causation and dismissed the case, but found for the plaintiffs on all other issues.

were false. Such massive and pervasive channel stuffing does not happen by accident, but is instead the product of deliberate conduct.

Moreover, the shortness of time between Defendants' Class Period statements and their disclosures makes it even clearer that the statements were false, as the Company reiterated its 2015 earnings forecast less than two months before it missed the forecast by 50% and announced the bad debt charge. *Fecht v. Price Co.*, 70 F.3d 1078, 1083–84 (9th Cir. 1995); *Kurtzman v. Compaq Computer Corp.*, No. CIV.A.H-99-1011, 2000 WL 34292632, at *26 (S.D. Tex. Dec. 12, 2000). Defendants' problems with growing inventory overhang, returns, and depressed sales "likely did not come to light all at once." *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. 1273, 1284 (D. Minn. 1997); certainly, they did not spring up in the last eight weeks of 2015, especially since Defendants' post-class-period disclosures do not point to any "intervening catastrophic event" that would account for the sudden drastic change in outlook. *Fecht*, 70 F.3d at 1083–84. The short timespan is even more striking considering the magnitude of the errors. *See*, e.g., *In re Catalina Mktg. Corp. Sec. Litig.*, 390 F. Supp. 2d 1110, 1114 (M.D. Fla. 2005) (overstatement of earnings per share by 56% supported an inference of fraud). *Rehm v. Eagle Finance Corp.*, 954 F.Supp. 1246, 1255–56 (N.D. Ill. 1997) ("the more serious the error, the less believable are …defendants protests that they were completely unaware of [the corporation's] true financial status and the stronger is the inference that defendants must have known about the discrepancy");[6] *In re NUI Sec. Litig.*, 314 F.Supp.2d 388, 406 (D.N.J. 2004) (20% earnings

[6] While magnitude of error is typically cited as a factor supporting scienter rather than falsity, the analysis is effectively the same with respect to forecasts or projections, because an allegation that projections were "false" implies that Defendants knew that they lacked a reasonable basis. *See In re New Century*, 588 F.Supp.2d 1206, 1227 (C.D.Cal.2008) (citing *In re Read–Rite Corp.*, 335 F.3d 843, 846 (9th Cir.2003), and *Ronconi v. Larkin*, 253 F.3d 423, 429 (9th Cir. 2001)) (noting that "falsity and scienter are generally inferred from the same set of facts").

shortfall resulting from bad debt supported inference that earnings had been fraudulently inflated). Indeed, "clean-up" was still ongoing when the Company went private, and, consequently, the full magnitude of the Company's misstatements was never disclosed.

Former employees also subsequently confirmed that China sales were weak during the Class Period and that the Company was stuffing its China distributor with unwanted product. As a former Warehouse & Logistics Manager observed: "I definitely wouldn't say [China sales] were robust. It seemed like they were pretty flat. My impression of sales in China is that we really weren't gaining traction within the market." ¶ 47. Skullcandy's former Area Sales Supervisor in Shanghai stated that in 2015, sales were "not good because our dealer cannot sell product to customers," and the Company was prodding the distributor to take unwanted product. ¶¶ 45, 47. The former employee also said that the distributor was warehousing large amounts of unsold products – a hallmark of a fraudulent channel-stuffing scheme. ¶ 45. A former Global Demand Planning manager later observed that there was something "disconnected between the sell through to the customer," and that it suggested "cooking the books" or "a misstatement. ¶ 49. Further, the Company's Email and Database Marketing Manager said that the Company wasn't doing a proper marketing push in China, suggesting that claims about China growth and opportunity were pure hype to inflate Skullcandy's stock price. ¶ 51. The employee said that the Company had no email marketing campaign in China and did not make digital sales efforts there, and that the Company "never tried to do anything with the China market in 2015." *Id.*

Defendants suggest that "[a] certain amount of channel stuffing could be innocent and might not even mislead – a seller might have a realistic hope that stuffing the channel of distribution would incite his distributors to more vigorous efforts to sell the stuff lest it pile up in inventory.") MTD at 14 (quoting *Makor Issues & Rights Ltd. v. Tellabs Inc.*, 513 F.3d 702, 709

(7th Cir. 2008)). But an "innocent" explanation is "very unlikely" here, 513 F.3d at 709, because "the huge number of returns" from Timesrunner "is evidence that the purpose of the stuffing was to conceal the disappointing demand for the product rather than to prod distributors to work harder to attract new customers, and the purpose would have been formed or ratified at the highest level of management." *Id.* at 710. Further, "innocent" channel stuffing would not have caused the Company to take a bad debt charge that reduced full-year earnings by 20%, and it certainly would not have caused the harm that occurred here, with the Company unable to clear unsold inventory for more than three quarters and continuing to "clean up" its China distribution channel even as it went private. Indeed, Defendants never offered investors any "innocent" explanation for why its China distributor was suddenly unable to sell Skullcandy products, began to return large amounts of product, and refused to pay for what it had received, resulting in a $1.6 million bad debt charge.

Defendants also incorrectly assert that Lead Plaintiffs must allege "particular transactions in which Skullcandy shipped the Chinese distributor more inventory than it requested or needed," the specifics of "inducements, discounts or rights of return Skullcandy allegedly offered to distributor," and the dates and "volume of excess inventory shipped." (MTD at 12). But no court has created such a *per se* requirement, because to do so would create "an enormous burden on plaintiffs at the pleading stage," prior to discovery. *In re CBT Grp. PLC Sec. Grp. Litig.*, No. C-98-21014-RMW, 2001 WL 1822729, at *6 (N.D. Cal. Dec. 28, 2001); *St. Jude*, 836 F. Supp. 2d at 890 (D. Minn. 2011) (quoting *Cerner*, 425 F.3d at 1084 (8th Cir.2005) ("a plaintiff is *not* required to describe in detail the circumstances of [a defendant's channel-stuffing] activities."); *Cooper v. Pickett*, 137 F.3d 616, 627 (9th Cir. 1997) (no requirement to allege "specific shipments to specific customers at specific customers at specific times with a specific

dollar amount of improperly recognized revenue."); *see also Luna v. Marvell Tech. Grp. Ltd*, No. 15-CV-05447-RMW, 2016 WL 5930655, at *10 (N.D. Cal. Oct. 12, 2016); *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 81 (1st Cir. 2002) ("*Greebel* did not hold that a plaintiff, before discovery, must in every case allege the amount of overstatement of revenues and earnings…."). Plaintiffs should not be required to plead facts uniquely within Defendants' possession prior to discovery. *See*, e.g., *St. Jude*, 836 F. Supp. at 878; *Connetics*, 2008 WL 3842938, at *10.

In *Connetics*, the court found that, although the plaintiff had not alleged the "nuts and bolts" of the underlying channel stuffing scheme, the complaint was adequate because it pleaded that "defendants knew specific facts at the time that rendered their accounting determinations fraudulent, i.e. knew the distribution channels had excessive inventory and knew that the company had been artificially increasing demand forecasts in order to satisfy the expectations of Wall Street rather than meet the realistic demand or attempt to sell more aggressively." 2008 WL 3842938, at *10. Similarly, in *St. Jude*, the court found it sufficient that plaintiffs pled that the defendant company "mislead investors by stating that its earnings and growth rate would be maintained even though [the company] was engaging in an unsustainable pattern of channel stuffing and not properly accounting for its sales." 836 F. Supp. 2d at 891.

Even the cases cited by Defendants did not *require* the level of detail Defendants demand. *See In re Trex Co., Inc. Sec. Litig.*, 212 F. Supp. 2d 596, 612 (W.D. Va. 2002) ("Like the First Circuit in *Greebel*, the court today does not hold that a plaintiff must always allege the specific amount of displaced revenues in order to state a claim that undisclosed channel stuffing activities were fraudulent."). Indeed, moderating its earlier approach in *Fitzer v. Sec. Dynamics Techs.*, 119 F. Supp. 2d 12, 35 (D. Mass. 2000), the District of Massachusetts more recently

found that, where other allegations support an inference of a fraudulent scheme to inflate revenue, there is no requirement to allege the amount by which revenue was inflated:

> [W]hile it is true that the Plaintiffs cannot allege by exactly how much the revenues were inflated, this ought not prevent them from surviving the motion to dismiss. Once more, because they do not have the benefit of discovery, the Plaintiffs are not required to plead evidence….

Washtenaw Cty. Employees Ret. Sys. v. Avid Tech., Inc., 28 F. Supp.3d 93, 106 (D. Mass. 2014). Instead, it was sufficient that plaintiffs:

> (i) pointed to the statements they claim to be false or misleading (the many press releases and financial reports presenting financial revenues artificially inflated by accounting upfront revenue that should have been accounted ratably); (ii) identified the speakers responsible for such statements (broadly, the Avid Defendants, but each statement is attributed to one or more of them); (iii) defined where and when such statements were made (providing dates and context); and (iv) provided the reasons why each statement was fraudulent (broadly, to inflate the Company's revenue).

Id. Resolving this inference in Plaintiff's favor is especially called for here, since Defendants avoided full disclosure of the amounts by which their sales were inflated when the Company was taken private. *Avid.*, 28 F. Supp.3d at 107 (plaintiffs not required to plead amount of revenue inflation where Defendants still had not made full disclosure after ten months).

2. Defendants' Earnings Forecasts Were False at the Time

Throughout the Class Period, Defendants made financial projections that they knew were implausible, because they were based on false sales and sales growth numbers that were facilitated by fraudulent channel stuffing.

Earnings projections are false or misleading when a defendant omits material facts that render the basis for the projections unsound. *In re Spiegel, Inc. Sec. Litig.*, 382 F.Supp.2d 989, 1029 (N.D. Ill. 2004). Where, as here, projections are based on prior undisclosed improper revenue recognition, or fail to take into account known declining sales trends, the fact that they

"lacked a reasonable basis when made" renders them actionable false statements. *In re Veritas Software Corp. Sec. Litig.*, No. 04-831-SLR, 2006 WL 1431209, at *7 (D. Del. May 23, 2006).

Here Defendants' earnings projections clearly lacked a reasonable basis when made. First, as argued in detail above, the revenues and earnings on which the projections were based were false, because they were the product of a fraudulent channel-stuffing scheme. Second, Defendants ignored facts that cast serious doubt on their public forecasts, including lackluster demand in China, large amounts of product being held in their distributor's warehouses, a lack of marketing in China, and the likelihood of factors such as returns and "promotional credits" impacting results. *See In re Next Level Systems, Inc.*, No. 97 C 7362, 1999 WL 387446, at *7 (N.D. Ill. March 31, 1999) (forecast was false where Defendants "ignor[ed] facts that seriously undermin[ed] the accuracy of the forecast"). Third, the large proportional impact of Defendants' bad debt writeoff on earnings implies the projections were based on improperly recognized revenue. *See NUI*, 314 F.Supp.at 406 (D.N.J. 2004) (fact that company missed earnings projections by 20% due to bad debt supported inference that projections lacked reasonable basis). Moreover, Defendants' SAP Business ByDesign system should have enabled precise revenue and earnings forecasting. ¶ 126. Thus, the facts contradict any assertion that Defendants merely made an innocent error of excessive optimism less than two months before the end of 2015.

3. Defendants' Statements About Opportunity in China Were Actionable False and Misleading Statements

The only statements the MTD identifies as inactionable "vague statement[s] of corporate optimism" are statements by Defendants to the effect that China represented a "huge opportunity for the brand long term." MTD at 18. These statements, however "are not the crux of Plaintiff's allegations but rather, lend support to Plaintiff's more specific allegations of false statements and fraud on the market"; as such, the statements "can be considered in context, and as part of

Defendants' larger statements, are not immaterial puffery." *In re Nash Finch Co.*, 502 F. Supp. 2d 861, 879 (D. Minn. 2007) (internal citation omitted). The statements identified by the MTD were made in the context of numerous verifiable claims of fact; for example, on May 5, 2015, Darling preceded his statement about China representing a "huge opportunity for the brand" with factual claims about sales growth in China, and followed it with statements about specific actions the Company was purportedly taking to develop the brand in China. Moreover, these same conference calls contained inflated sales and earnings projections based in large part on inflated assumptions about China. As such, the statement that China represented a "huge opportunity for the brand," taken in context, was not puffery, but a highly material statement meant to assure investors that the Company's prospects in China were strong.

B. The Complaint Adequately Alleges Scienter

The Supreme Court has emphasized that courts must not "scrutinize each [scienter] allegation in isolation" but rather "assess all the allegations holistically." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 326, (2007). In order to survive a motion to dismiss, an inference of scienter "need not be irrefutable, *i.e.*, of the 'smoking-gun' genre, or even the most plausible of competing inferences" *Tellabs*, 551 U.S. at 323. Rather, taking all of a plaintiff's allegations as true, the question is whether the inference of scienter is "at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324.

The facts in the Complaint render it implausible that Defendants did not know about Skullcandy's massive channel stuffing. Defendants repeatedly touted China sales and sales growth as critical to the Company's overall growth strategy, and credited China with being the primary driver of the Company's supposed international sales success. Defendants also monitored the Company's China sales on a *weekly basis* via sales calls that included China sales reps, and they had access to state-of-the-art sales and inventory tracking software called SAP

Business ByDesign. Moreover – and significantly – Defendants used a single China distributor – Timesrunner – meaning that it was simple for Defendants to monitor Skullcandy's China sales and inventory, since the Company did not have a large network of distributors to track and manage. The Company further missed its own full-year earnings forecasts by 50% just two months after affirming those forecasts, and took a bad debt charge that alone wiped out 20% of its remaining earnings for the year. Indeed, former employees subsequently confirmed that the internal outlook on China sales was poor during the Class Period, and that the Company was pushing its China distributor to take product it could not sell. In addition, the Company's founder and former CEO – who remained a director and major shareholder – dumped $4.1 million of his stock during the Class Period, after previously selling no stock for a long period of time. These facts, taken together, render it implausible that Defendants were not aware that the Company's China sales were poor, and that their financials and forecasts were inflated by fraudulent channel stuffing.

1. Plaintiffs' "Core Business" Allegations Support Scienter

Allegations that a fraud concerned a Defendants' "core business" or "core operations" can substantially strengthen an inference of scienter. *See*, e.g., *In re Molycorp, Inc. Sec. Litig.*, 157 F. Supp. 3d 987, 1010 (D. Colo. 2016), *as amended* (Jan. 28, 2016); *S. Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 785 (9th Cir. 2008); *Yates v. Mun. Mortg. & Equity, LLC*, 744 F.3d 874, 890 (4th Cir. 2014); *KBC Asset Mgmt. NV v. 3D Sys. Corp.*, No. 0:15-CV-02393-MGL, 2016 WL 3981236, at *9 (D.S.C. July 25, 2016). Under a "core operations" theory, allegations regarding an individual defendant's role in a company and access to information are, in some cases, sufficient to satisfy the PSLRA standard for pleading scienter where the allegations suggest that the information "is of such prominence that it would be absurd to suggest that

management was without knowledge of the matter." *S. Ferry LP*, 542 F.3d at 785-6. Further, even where such allegations are insufficient on their own, they may support a strong inference of scienter in combination with other allegations. *Id.* at 785.

Defendants Darling and Hodell were the CEO and CFO of the Company and certified the Company's false financial statements.[7] Throughout the Class Period, Darling and Hodell repeatedly and consistently touted the centrality of China to the Company's growth strategy. ¶¶ 32-43. The Company's China sales were "so fundamental" to Skullcandy, and the problems were on such a significant scale, that it "would be difficult to conclude that those Defendants at the top levels of…management did not know what was going on." *In re Countrywide Fin. Corp. Sec. Litig.*, 588 F. Supp. 2d 1132, 1194 (C.D. Cal. 2008); *see also Berson v. Applied Signal Tech., Inc.*, 527 F.3d 982, 989 (9th Cir. 2008) (internal quotation omitted) (facts were "prominent enough that it would be absurd to suggest that [the CEO and CFO were] unaware of them."); *In re Tel–Save Sec. Litig.*, No. 98–CV–3145, 1999 WL 999427, at *5 (E.D.Pa. Oct.19, 1999) (knowledge concerning "a company's key businesses or transactions may be attributable to the company, its' officers, and directors."); *In re Campbell Soup Co. Sec. Litig.*, 145 F.Supp.2d 574, 599 (D.N.J.2001) (top executives imputed with knowledge of "bread and butter" of Company's business).[8] Additionally, when management made repeated statements about China sales

[7] *See Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1106 (10th Cir. 2003). (defendants senior executive positions considered "relevant" in "weighing of the totality of the allegations."); *In re SemGroup Energy Partners, L.P.*, 729 F. Supp. 2d 1276, 1298 (N.D. Okla. 2010) (defendants' positions as c-suite executives meant they were "in a position to know [the undisclosed] information…."); *In re Medicis Pharmaceutical Corp. Securities Litigation*, No. CV-08-1821-PHX-GMS, 2010 WL 3154863, at *5 (D. Ariz. Aug. 9, 2010).

[8] Defendants cite *Jun Zhang v. LifeVantage Corp.*, No. 2:16-CV-965 TS, 2017 U.S. Dist. LEXIS, at *24 (D. Utah June 15, 2017) (unpublished) for the proposition that the use of the core operations doctrine requires "detailed and specific allegations" showing that defendants were actually exposed to the relevant information. MTD at 22. As argued above, Lead Plaintiffs have
(*footnote continued on next page*)

growth, they "held themselves out as possessing significant knowledge" about sales there. *W. Palm Beach Police Pension Fund v. DFC Glob. Corp.*, No. CIV.A. 13-6731, 2015 WL 3755218, at *14 (E.D. Pa. June 16, 2015).

Further, this is not a case where Defendants can plausibly claim that they were unaware that their distribution channel was stuffed because the corporation had dozens or hundreds of distributors located across the country, making it difficult to monitor sales or obtain information.[9] To the contrary, here Skullcandy had only one relevant distributor – Timesrunner – and it assured investors in its SEC filings that it had sophisticated sales and inventory tracking software. ¶¶ 125-26.

2. Darling and Hodell Were Given Detailed Information about the True Picture of the Company's China Sales via Weekly Sales Calls and the Company's Information Management Systems

The Complaint's allegations are not limited to "core business" allegations based on the Defendants' positions; rather, Defendants Darling and Hodell were made aware of the details of the Company's China sales performance on a weekly basis. The Company's senior management held weekly sales calls with all domestic and international sales reps to see how sales were trending in various territories and regions. ¶ 129. According to a former employee who worked

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pled such allegations. Moreover, *LifeVantage* is inapposite; there, material weaknesses were discovered in the company's internal controls relating to improper sales practices. The only false statements for which plaintiffs relied on the "core operations" theory of scienter were the Company's SOX Certifications, and the underlying transactions were "relatively small"; thus alleging that management "should have done more to detect the improper sales" was not sufficient to create a strong inference that they knew the SOX Certifications were false. Here, the allegations concern China sales and growth, subjects that were essential to the Company.

[9] *Compare with Trex*, 212 F. Supp. 2d at 610 (W.D. Va. 2002) (cited in MTD at 12) (in channel stuffing case, casting doubt on allegation that defendants could easily have monitored inventory because the company sold its product to 25 wholesale companies operating from 75 locations that marketed to approximately 2600 dealer outlets).

in marketing and sales and participated in the calls through July 2015, Darling often led the calls, and "Hodell was on every one of them" as well as "either the VP of Sales or the Chief Sales Officer." ¶ 129. The same former employee recalled learning, via calls no later than July 2015, that China sales were underperforming and that they were never "great." *Id.*; *see New Orleans Employees Ret. Sys. v. Celestica, Inc.*, 455 F. App'x 10, 13-14 (2d Cir. 2011) (defendants' participation in "monthly operational review" conference calls created strong inference that they knew about the company's inventory crisis.); *In re Bio-Tech. Gen. Corp.*, No. CIV.A. 02-6048(HAA), 2006 WL 3068553, at *12 (D.N.J. Oct. 26, 2006), *aff'd sub nom. In re Savient Pharm., Inc. Sec. Litig.*, 283 F. App'x 887 (3d Cir. 2008) (noting that plaintiff could have survived dismissal by pleading, for example, that "the sales staff would routinely summarize the Oxandrin sales data and deliver the summaries to the Individual Defendants for review."). And Defendants' direct involvement in annual forecasting meetings every November – during which both domestic and international sales teams provided "details from the accounts they work…down to the SKU level," implies that Defendants certainly would have been aware of sales problems in China as of November 2015. ¶ 128.

Defendants also had access to a sophisticated and comprehensive information management system called SAP Business ByDesign. ¶ 125. The system included detailed tracking of Chinese sales orders and inventory. ¶ 125. Further, the system was integrated with third-party logistics warehouses that managed worldwide inventory and fulfillment, enabling Defendants were able to know immediately when a particular product was not selling or when inventory was backing up. ¶126. *See Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1231, 1234 (9th Cir. 2004); *Countrywide*, 588 F. Supp. 2d at 1194 (C.D. Cal. 2008) ("access to corporate reports and information systems" contributed to scienter).

The above allegations create a strong inference of scienter, and an even stronger inference in combination with others. *See*, e.g., *S. Ferry LP #2 v. Killinger*, 687 F. Supp. 2d 1248, 1260 (W.D. Wash. 2009) (positions of three top executives in combination with their statements implying their access to information and their stock sales were sufficient to create inferences of scienter "more cogent and compelling than competing innocent inferences."). Here, other allegations also contribute strongly to an inference of scienter.

3. The Magnitude and Timing of Defendants' Forecast Miss and Bad Debt Charge Support Scienter

The sheer magnitude of Skullcandy's earnings and sales miss – a 100% overestimate proven wrong just two months later – further strongly supports an inference of scienter. *See*, e.g., *S.E.C. v. Fisher*, 2012 WL 3757375, at *13 (N.D. Ill. Aug. 28, 2012) (long settled that magnitude of errors "lend[s] weight" to scienter allegations "where defendants were in a position to detect the errors.") *Rehm*, 954 F. Supp. at 1255–56 ("the more serious the error, the less believable are [corporate] defendants protests that they were completely unaware of [the corporations] true financial status and the stronger is the inference that defendants must have known about the discrepancy"). So, too, does the short timespan – less than two months – between Defendants' positive statements about China and their disclosure that sales were in fact poor support a strong inference of scienter. *Fecht* 70 F.3d at 1083–84.; *Kurtzman*, 2000 WL 34292632, at *26. The underlying problems of inventory overhang, returns, and depressed sales "likely did not come to light all at once," *In re Grand Casinos, Inc. Sec. Litig.*, 988 F. Supp. at 1284, and Defendants' post-class-period disclosures did not identify any "intervening catastrophic event" that would account for the sudden change in outlook. *Fecht*, 70 F.3d 1078, 1083–84 (9th Cir. 1995).

Defendants' bad debt charge similarly weighs in favor of scienter, particularly given its large proportional size to 2015 earnings (erasing 20% of the Company's already reduced full year earnings). *See In re Medicis Pharmaceutical Corp. Securities Litigation*, 2010 WL 3154863, at *5 (D.Ariz.2010) ("Accounting errors that prove to have a significant impact on core business operations, i.e. cash, revenue, profits, liquidity, or viability of a product, sometimes give rise to a compelling inference of scienter. This is so because such substantial errors give rise to an inference that the defendant acted recklessly or intentionally used deceptive accounting principles to disguise serious problems.") (internal citations omitted); *Crowell v. Ionics, Inc.*, 343 F. Supp. 2d 1, 18 (D. Mass. 2004) ("[w]hat matters most to investors is income...and the restatement led to a downward revision of income" by 32.5%).[10]

4. Alden's Insider Sales Further Support Scienter

Insider stock sales can "supply evidence of scienter". *In re Qwest Commc'ns Int'l, Inc.*, 396 F. Supp. 2d 1178, 1194 (D. Colo. 2004) (quoting *In re Cabletron Systems, Inc.*, 311 F.3d 11, 40 (1st Cir.2002)). This is not an all-or-nothing proposition; rather the "vitality of the inference to be drawn depends on the facts, and can range from marginal to strong." *Mississippi Pub. Employees' Ret. Sys. v. Boston Sci. Corp.*, 523 F.3d 75, 92 (1st Cir. 2008). Courts in this circuit look at whether trades were "made at times and in quantities that are suspicious" considering factors such as "(i) whether the alleged trades were normal and routine for the insider; (ii) whether profits reaped were substantial enough in relation to [the insider's] compensation

[10] The fact that Skullcandy "did not restate its financial statements in connection with the bad debt charge" (MTD at 7) is not a defense to Lead Plaintiffs' allegations, since Skullcandy went private in October 2016, and thus never had a reason to restate prior results. Further, in a channel stuffing case, requiring restatement for fraud would "allow officers and directors…to exercise an unwarranted degree of control over whether they are sued, because they must agree to a restatement of the financial statements." *St. Jude* 836 F. Supp. 2d at 889 (quoting *Aldridge*, 284 F.3d at 83 (1st Cir.2002)).

levels…so as to produce a suspicion that they might have had an incentive to commit fraud; and, (iii) whether, in light of the insider's total stock holdings, the sales are unusual or suspicious." *Qwest*, 396 F. Supp. 2d at 1195 (internal quotations omitted).

Plaintiff has alleged that Defendant Alden, in combination with Ptarmagin, sold a total of over $4 million worth of stock in the four-month period between September 8, 2015 and January 7, 2016, ¶ 136. These sales were unusual, because they represented Alden's first individual sales since October 2012, and the Alden Irrevocable Trust's (which was the sole member of Ptarmagin) first sales since March 2014. ¶ 137.[11]

Alden's class period sales were particularly significant given that they represented not only 10.4% of his individual holdings and 13.4% of Ptarmagin's holdings, but, in combination, nearly 3% of the *entire company*.[12] Further, Alden earned only $130,225 in 2015 from his position as a director of Skullcandy, and his director biography listed no other current employment; therefore, proceeds of over $4.5 million in a single year would have been highly material to Alden. *See W. Palm Beach Firefighters' Pension Fund v. Startek, Inc.*, No. 05-CV-01344WDMMEH, 2008 WL 879023, at *11 (D. Colo. Mar. 28, 2008) (insider sales more likely to support scienter where "substantial enough in relation to…compensation levels…so as to produce a suspicion that [the defendant] might have had an incentive to commit fraud.")

Defendants argue that Alden's class period sales constitute an insufficient percentage of his entire holdings to contribute to an inference of scienter. However, there is no threshold percentage for insider sales to contribute to an inference of scienter; and sales similar to Alden's

[11] The Alden Irrevocable Trust had also made suspiciously well-timed trades prior to the Class Period. For example, in a three-day period during March 2014, the Trust sold 1.5 million shares at prices as high as $9.69, where just two months later the stock would be 30% lower. ¶ 137.

[12] The Company had 28,530,493 shares outstanding as of October 31, 2015. ¶18.

are often found to contribute to scienter. *See*, e.g., *Provenz v. Miller*, 102 F.3d 1478, 1491 (9th Cir.1996) (finding sale of 20% of holdings raised inference of scienter where sales occurred during two-month period between misleading statement and corrective disclosure); *In re SeeBeyond Tech. Corp. Sec. Litig.*, 266 F.Supp.2d 1150, 1169 (C.D.Cal.2003) (sale of 7.6% of holdings for $18 million contributed to inference of scienter); *McCarthy v. C–COR Elec. Inc.*, 909 F.Supp. 970, 978–79 (E.D.Pa.1995) (finding sales of between 15% and 20% of holdings raised inference of scienter where sale occurred roughly one month after false statement and one month before corrective disclosure); *In re SmartTalk Teleservices, Inc. Sec. Litig.*, 124 F.Supp.2d 527, 542 (S.D.Ohio 2000) (CFO's sale of 11 % of holdings contributed to inference of scienter); *In re Oxford Health Plans, Inc.*, 187 F.R.D. 133, 140 (S.D.N.Y. 1999) (well-timed sale of 17% of holdings raised inference of scienter where made shortly before negative press release and during state investigation); *Marksman Partners L.P. v. Chantal Pharm. Corp.*, 927 F.Supp. 1297, 1313 (C.D.Cal.1996) (20% of holdings sold for $6.3 million contributed to scienter).

Defendants also argue that Alden's Rule 10b5-1 plans shield his suspicious trades. However, trades through a Rule 10b5-1 plan are not automatically immunized, because "a clever insider might maximize their gain from knowledge of an impending price drop over an extended amount of time, and seek to disguise their conduct with a 10b5-1 plan." *Freudenberg v. E*Trade Fin. Corp.*, 712 F.Supp.2d 171, 200 (S.D.N.Y.2010); *see also In re Immucor Inc. Sec. Litig.*, No. 1:05–CV–2276–WSD, 2006 WL 3000133, at *18 n. 8 (N.D.Ga. Oct. 4, 2006). Indeed, Alden established his two 10b5-1 plans on June 5, 2015 – during the Class Period, and thus the plans are "not a cognizable defense to scienter allegations on a motion to dismiss." *Employees' Ret.*

Sys. of Gov't of the Virgin Islands v. Blanford, 794 F.3d 297, 309 (2d Cir. 2015).[13] Moreover, Alden's two 10b5-1 plans carry "red flags" of abuse, including abnormal divestment, multiple, overlapping plans, and irregular, and inconsistent disclosures. ¶¶ 138-139.

Finally, the lack of sales by Darling and Hodell during the class period does not create an inference in Defendants' favor. Insider sales are not a requirement for scienter, and a lack of motive cannot be inferred from a lack of insider sales. *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1191 n.12 (10th Cir. 2003); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 944 (9th Cir. 2003). Similarly, the fact that a few insiders made *de minimis* purchases during the class period should be given little if any weight.

C. Defendants' Earnings Forecasts are Not Entitled to the PSLRA Safe Harbor

1. Defendants' Cautionary Language Was Not Meaningful

To receive protection under the PSLRA's "safe harbor," a forward looking statement must be accompanied by "meaningful cautionary language identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." 15 U.S.C. § 78u-5(c)(1)(A)(i). Meaningful cautionary language consists of "substantive company-specific warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors." *Southland Sec. Corp. v. INSpire Ins. Sols., Inc.*, 365 F.3d 353, 372 (5th Cir. 2004) (citing H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, 44 (1995)). It is Defendants' burden to show that they are

[13] *Elam v. Neiderdorff* (MTD at 25) merely held that stock sales pursuant to 10b-5 plans "*can* raise an inference that the sales were prescheduled and not suspicious." 544 F.3d 921, 928 (8th Cir. 2008). Here the Complaint creates a far stronger inference that Alden set up his 10b5-1 plans specifically to avoid the appearance of improper sales. *See*, e.g., *In re Questcor Sec. Litig.*, No. SA CV 12-01623 DMG, 2013 WL 5486762, at *16 (C.D. Cal. Oct. 1, 2013) (resolving competing inferences regarding trades pursuant to a 10b5-1 plan in plaintiff's favor).

protected by the cautionary language prong of the safe harbor. *Slayton v. American Exp. Co.* 604 F.3d 758, 773 (2d Cir. 2010).

Defendants' brief identifies only two examples of cautionary language accompanying their forward-looking statements. The first is a "risk factor" statement from its 2014 Form 10-K that was incorporated by reference into all of the Company's Class Period statements,[14] noting that the company's future growth would depend on factors including "the strength of our brand image, market demand for our current and future products, competitive conditions,…and the implementation of our growth strategy." MTD at 16 (ellipses in MTD). The second is a statement from the Company's second quarter 2015 earnings call:

> In putting forth this new outlook, we want to remind everyone of the complexity of accurately assessing future earnings and revenue growth given the competitive nature of the industry, the difficulty in predicting sales of our products by key retailers, changes in technology, sourcing costs, trends in consumer preferences….[15]

The "risks" outlined by these statements are merely the general risks associated with the sale of any retail product that faces competition; in effect, they say "our ability to meet our sales forecasts depends upon how well our product sells." As such, Defendants' cautionary language is not meaningful for purposes of the PSLRA. *See*, e.g., *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223, 247 (2d Cir. 2016) (company's warning that it could face "inability to identify, develop and achieve success for new products, services and technologies; increased competition and its effect on pricing, spending, third-party relationships and revenue; [and] inability to establish and maintain relationships with commerce, advertising, marketing, technology, and content

[14] Some courts have held that a written document, as opposed to an oral statement, may not incorporate by reference cautionary language from other documents. *See*, e.g. *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 910 (S.D. Tex. 2001).

[15] This language "accompanies" only the statements contained in the same conference call; thus even if it were "meaningful" it would not immunize Defendants' other statements.

providers" was merely a "kitchen-sink disclaimer, listing garden-variety business concerns that could affect any company's financial well-being."); *Slayton* 604 F.3d at 772 (2d Cir. 2010) (cautionary language "verge[d] on the mere boilerplate" because it "essentially warn[ed] that 'if our portfolio deteriorates, then there will be losses in our portfolio.'"); *In re Amylin Pharm., Inc., Sec. Litig.*, No. 01CV1455BTM(NLS), 2002 WL 31520051, at *9 (S.D. Cal. Oct. 10, 2002), ("merely warning investors that FDA may not approve the drug tells them something they already know"); *Sgalambo v. McKenzie*, 739 F. Supp.2d 453, 478–79 (S.D.N.Y. 2010) (disclaimer mentioned "myriad, general factors—such as natural gas prices or environmental hazards—that might cause actual results to differ" from projections but "provided no company-specific information, failed to link any specific projections to specific risks, and remained constant throughout the Class Period" even as risks changed.) The fact that the *only* cautionary language Defendants have identified in connection with most of their statements is a generic "risk factor" from a Form 10-K underscores the generic, boilerplate nature of the language, particularly since the language remained the same as Skullcandy's outlook worsened.[16]

Further, cautionary language must be "sufficiently specific" about the risks associated with the statement as to "nullify any potentially misleading effect." *Karacand v. Edwards*, 53 F. Supp. 2d 1236, 1243 (D. Utah 1999) (quoting *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119-20 (10th Cir.1997)); *see also Asher v. Baxter Intern., Inc.*, 377 F.3d 727, 734 (7th Cir. 2004) (cautionary language failed to mention the "principal or important risks" that could cause a projection not to come true); *In re St. Jude Med.*, 836 F. Supp. 2d at 893 (cautionary statements

[16] *See*, e.g., *Lormand v. US Unwired, Inc.*, 565 F.3d 228, 245 (5th Cir. 2009) ("As further evidence that the disclaimer is mere boilerplate, the disclaimer, only with slight variations, was used in conjunction with each alleged misrepresentation the district court exempted from analysis under the safe harbor provision.").

not meaningful where they failed to "address the theory of Plaintiffs' case" namely, that many of the defendant's customers had more inventory than needed on hand, leading to heightened risks of missing guidance).[17] Defendants' boilerplate cautionary language fails this test, because it doesn't address the true "risks" (some of which were in fact certainties) that Defendants knew to be associated with their projections, including: that Skullcandy's China distributor could return large amounts of product the Company had previously recorded as sales; that Skullcandy could face reduced China sales in subsequent quarters and/or bad debt write-offs due to credits and returns; and that Skullcandy lacked a reasonable basis for the amount of product it was shipping and "selling" to its main China distributor, or for recording all of those sales as revenue.[18]

[17] *See also*. *Cent. Laborers' Pension Fund v. SIRVA, Inc.*, No. 04 C 7644, 2006 WL 2787520, at *23 (N.D. Ill. Sept. 22, 2006) ("…the cautionary language in this case lists a host of factors…but not the ones plaintiff contends were most important."); *compare with Norfolk Cty. Ret. Sys. v. Tempur-Pedic Int'l, Inc.*, 22 F. Supp. 3d 669, 681 (E.D. Ky. 2014), *aff'd sub nom. Pension Fund Grp. v. Tempur-Pedic Int'l, Inc*., 614 F. App'x 237 (6th Cir. 2015) (cautionary language "adequate under the safe harbor provision because it warns specifically of named competitors' viscoelastic products, not of the mere possibility of such competition.").

[18] Relatedly, cautionary language must not be "misleading in light of historical facts." *Howard v. Liquidity Servs., Inc.*, 177 F. Supp. 3d 289, 308 (D.D.C. 2016) (disclaimer that "increased competition may result in reduced operating margins and loss of market share" not meaningful where plaintiffs alleged that "increased competition had already resulted in reduced margins and loss of certain customers."); *City of Ann Arbor Employees' Ret. Sys. v. Sonoco Prod. Co.*, 827 F. Supp. 2d 559, 576 (D.S.C. 2011) (internal citation omitted) (cautionary language not meaningful where defendants "know that the potential risks they have identified have in fact already occurred and that the positive statements they are making are false.").

2. The Complaint Pleads Actual Knowledge[19]

In order to raise a strong inference of actual knowledge, Lead Plaintiffs need not provide a "smoking-gun," or even demonstrate that Defendants' actual knowledge is "the most plausible of competing inferences." *Tellabs*, 551 U.S. at 323. Rather, taking all of Lead Plaintiffs' allegations as true, the question is whether they have created an inference "at least as compelling as any opposing inference one could draw from the facts alleged." *Id.* at 324.

As argued further *supra*, Lead Plaintiffs have alleged numerous facts that raise a strong inference of actual knowledge; for example, Defendants Darling and Hodell regularly participated in weekly sales calls, and during calls no later than July 2015, China's poor sales performance was discussed. ¶¶129-130. This directly contradicts Defendants' May 2015 and August 2015 public statements about strong sales and sales growth in China. Similarly, Darling and Hodell participated in annual forecasting meetings every November – during which China sales reps provided "details from the accounts they work…down to the SKU level." ¶ 128. And further, Defendants' November 2015 statements are admissions that they knew by that time that the Company was having distributor-related issues in China. ¶ 133. Yet management minimized

[19] Defendants argue that, in some circuits, even an outright lie is protected by the safe harbor so long as it is accompanied by meaningful cautionary language. MTD at 16. This circuit has not adopted any such view. Further, several of the circuits cited by Defendants (or courts within them) have since affirmed that "meaningful" cautionary language cannot be misleading. *See*, e.g., *FindWhat Inv'r Grp. v. FindWhat.com*, 658 F.3d 1282, 1299 (11th Cir. 2011); *NECA-IBEW Health & Welfare Fund v. Pitney Bowes Inc.*, No. 3:09-CV-01740 VLB, 2013 WL 1188050, at *18 (D. Conn. Mar. 23, 2013) ("[m]isrepresentation of present or historical facts cannot be cured by cautionary language,"). *In re TETRA Techs., Inc. Sec. Litig.*, No. 4:08-CV-0965, 2009 WL 6325540, at *35 (S.D. Tex. July 9, 2009), ("Nowhere in this cautionary language does the company explain that significant portions of the insurance receivables have already been denied.") Even the *Slayton* court noted that "in order to determine what risks the defendants faced, [a court] must ask of what risks they were aware." 604 F.3d at 771. Regardless, Lead Plaintiffs have alleged *both* that Defendants' cautionary language was not "meaningful" *and* that Defendants had actual knowledge that their statements were false.

these problems as "growing pains" that were "short term in nature" and reduced their 2015 earnings per share forecast by a mere two cents (rather than the 20 cents per share by which earnings would actually miss forecasts). ¶¶ 52-56.

Finally, Lead Plaintiffs' pleading *in the alternative* that Defendants "knew or recklessly disregarded" certain facts does not lessen the strong inference of actual knowledge created by the Complaint. *See*, e.g., *Van Dongen v. CNinsure Inc.*, 951 F. Supp. 2d 457, 472-73 (S.D.N.Y. 2013) (plaintiffs pled "conscious misbehavior *or* recklessness"; facts implied that defendants "were *actually aware* of information that contradicted their statements") (emphasis added).

D. Alden is Liable for the False Statements under the Group Pleading Doctrine

Alden is liable for statements in the Company's SEC filings and press releases based on the group pleading doctrine. Alden is not only the founder and former CEO of Skullcandy, ¶ 23, but a major shareholder of the Company – for example, as of the Company's 2015 Proxy Statement[20] filed April 6, 2015, Alden directly held 3.4% of the Company's outstanding common stock, and indirectly held 18.3% of the Company's outstanding common stock through Ptarmagin, making him, apparently, the Company's largest shareholder. Similar facts have been found sufficient to holding a director liable through the group pleading doctrine. *See*, e.g., *In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 749 (S.D.N.Y. 2001), *abrogated*

[20] "In securities cases…a court may take judicial notice of the contents of SEC filings that are a matter of public record." *In re Oppenheimer Rochester Funds Grp. Sec. Litig.*, 838 F. Supp. 2d 1148 (D. Colo. 2012). Further, the Complaint notes that Ptarmagin was a 10% (or greater) owner of the Company's stock, ¶ 136, and that Alden exercised control over the Alden Irrevocable Trust (including its investments), which was the only member of Ptarmagin. ¶ 24.

on other grounds, *In re Initial Public Offering Sec. Litig.*, 241 F.Supp2d 281 (S.D.N.Y 2003) (founder and 3.1% shareholder found liable under group pleading doctrine).[21]

E. Lead Plaintiffs Have Pled Corporate Scienter

Defendants sole argument against Skullcandy's corporate scienter is derivative of their arguments against scienter for the Individual Defendants. As Defendants acknowledge, corporate scienter may be pled solely by pleading scienter on the part of a senior controlling officer. MTD at 31-32 (citing *Adams*, 340 F.3d at 1106-7). Because Lead Plaintiffs have satisfied this requirement, Defendants' corporate scienter argument fails.

F. Lead Plaintiffs Have Stated a Claim for Section 20(a) Liability

Because Lead Plaintiffs have stated a claim for a primary violation of the securities law by Skullcandy, Defendants' only argument against finding control person liability for Darling and Hodell fails. *See In re Ribozyme Pharm., Inc. Sec. Litig.*, 119 F. Supp. 2d 1156, 1167 (D. Colo. 2000). In addition, Alden's status as founder, director and major shareholder of the Company support a finding that he was a control person and can be held liable under Section 20(a). *See Stat-Tech Liquidating Tr. v. Fenster*, 981 F. Supp. 1325, 1343 (D. Colo. 1997) (director with "sizeable minority interest" found to be control person).

[21] Much as Lead Plaintiffs here alleged that Alden "had direct involvement in the day-to-day operations of the Company in reviewing and managing its regulatory and legal compliance, and in its accounting and reporting functions," ¶ 169, the plaintiff in *Indep. Energy Holdings* alleged that the founder "was significantly involved with the Company's affairs." 154 F.Supp.2d at 749. Accepting this allegation as true, the court found that the founder was "more akin to a corporate insider with a special relationship to the Company, rather than an outside director."

IV. CONCLUSION

Lead Plaintiffs' allegations create a strong inference that Defendants knowingly (or, at a minimum, recklessly) undertook a fraudulent channel-stuffing scheme that led to false revenues, earnings, forecasts and other false and misleading statements during the Class Period. For these reasons, the Court should deny Defendants' Motion to Dismiss.

DATED: September 5, 2017

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CERTIFICATE OF SERVICE

I hereby certify that, on September 5, 2017, I filed the foregoing in the U.S. District Court for the District of Utah through the Court's CM/ECF system. All parties were served electronically.

/s/ Jeffrey L. Silvestrini
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